

# Recent Developments for U.S. Issuers Offering Securities into the EU

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9 June 2011

# Overview

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- Prospectus Directive / Transparency Directive – recap and recent amendments
- Packaged retail investment products (PRIPs)
- Review of Markets in Financial Instruments Directive (MiFID)
- HIRE Act / FATCA
- New safekeeping structure
- Securities Law Directive

# Prospectus Directive - History

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- EU Prospectus Directive (2003/71/EC) (also known as the (“PD”)) came into force on 31 December 2003 (was fully implemented by 1 July 2005)
- The PD sets out the requirements (in terms of both form and content) for issuers of securities within the EEA to produce a prospectus
- Introduces a passport procedure making it easier to issue securities in different EEA member states
- Directive amending the PD (2010/73/EU) came into force on 31 December 2010 and must be implemented by member states by 1 July 2012
- PD is a “maximum harmonization” Directive

# When is a Prospectus Required?

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- (1) An “offer of securities to the public” within the EEA; or
- (2) An application for securities to be admitted to trading on an EEA regulated market
- Offer of securities to the public (Article 2(1)(d)):
- *“A communication to persons in any form and by any means, presenting sufficient information on the terms of the offer and the securities to be offered, so as to enable an investor to decide to purchase or subscribe to those securities”*

# Implementation of PD in Member States

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- PD is not directly enforceable in EEA member states and must be enacted by implementing legislation
- The main implementing legislation in the UK is set out in Part VI of the Financial Services and Markets Act (FSMA) 2000.
- UK Listing Authority (UKLA) Rules are made up of:
  - The Listing Rules;
  - The Prospectus Rules; and
  - The Disclosure and Transparency Rules

# When a Prospectus is Not Required

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- Article 3 of the PD provides a prospectus shall not apply to:
  - An offer of securities addressed solely to qualified investors
  - Offers of securities to fewer than 100 persons per member state
  - Offers of securities where the denomination is at least EUR50,000 per unit
  - Offers of securities with total consideration of less than EUR100,000 over a 12 month period
  - Offer of securities to investors who acquire securities for a total consideration of at least EUR50,000 per investor for each separate offer
- Above exemptions do not apply if securities are listed on a regulated exchange in the EEA
- Separate exemptions also apply for certain types of securities:
  - Collective investment schemes
  - Securities guaranteed by EEA member state or local authority
  - Total consideration is less than EUR2.5m over 12 months

# Format of Prospectus

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- Single document or separate documents consisting of:
  - Registration document
    - Contains information about the issuer/guarantor
  - Securities note
    - Contains information relating to the securities
  - Summary note
    - Must convey the essential characteristics and risks associated with the issuer/guarantor and the securities
- Order: Contents, Summary (if applicable), Risk Factors and then everything else
- Supplements
  - New factors/material inaccuracies
- Incorporation by reference

# Content of Prospectus

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- Article 5 of the PD and the Annexes
  - Set out basic framework of requirements
- Prospectus Regulation (809/2004/EC) sets out detailed information to be included in Prospectus
- Level of information required
  - Depends upon the type of securities and their denomination
  - Less onerous disclosure requirements for debt securities with a denomination of less than €50,000 (“wholesale”) than the retail regime

# Retail Cascades

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- A 'retail cascade' - e.g., where an issuer sells securities to an investment bank which underwrites the issue, and then the bank in turn sell the securities on to retail distributors (thereby creating a distribution chain)
- PD is not clear whether each such sale would strictly require a separate prospectus
- The UKLA has taken the view that details relating to distribution chains may be omitted pursuant to Prospectus Regulation, Article 23, Paragraph 4
- Position clarified in amendments to PD

# Home Member State

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- Rules vary depending on whether the securities are non-equity or equity and whether the issuer is an EEA entity or not:
  - Issuers of non-equity securities (regardless of whether an EEA entity or not) can choose the home member state, provided that denominations have a value of at least €1,000
  - The home member state for EEA issuers of equity or low denomination debt securities (value of less than €1,000) is the member state where the issuer's registered office is located
  - The home member state for non-EEA issuers of equity or low denomination debt securities must make a one time choice of home member state the first time any security is issued to the public or listed on a regulated market in the EEA
- Non-EEA issuer making first issuance of securities in EEA should carefully consider home member state issue

# PD – Other Issues

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- **Passporting:**
  - At same time or after submitting prospectus for approval to competent authority of home member state, request for “passporting certificate” can be made, confirming prospectus has been properly drawn-up
  - Competent authority of home member state must send passporting certificate and copy of approved prospectus to competent authority of host member state within 3 working days of request
  - Host member state cannot require additional approvals or administrative processes
- **Prospectus Liability:**
  - Under the PD, the issuer, directors, offeror, person requesting admission to trading or the guarantor can be liable for the content of a prospectus
  - PD does not specify liability for breach – left to member states
  - Member states cannot impose liability for the summary unless misleading, inaccurate or inconsistent when read with the rest of the prospectus

# PD – Other Issues (cont.)

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- Advertisements:
  - Must state a prospectus has been or will be published and where investors can obtain it
  - Information must not be inaccurate or misleading and must be consistent with information in prospectus
  - Member states can impose additional requirements
  - UK has financial promotion regime under FSMA 2000

# Amendments to Prospectus Directive

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- Amendments to PD came into force on 31 December 2010 and must be implemented by member states by 1 July 2012
- Some member states may implement some or all changes early so care needs to be taken in cross-border issues prior to July 2012 to ensure relevant requirements are complied with
- ICMA has published suggested debt selling restrictions to reflect the amendments and which are designed to work during the transitional period whether or not relevant member states have implemented the amendments

# Amendments to Prospectus Directive (cont.)

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- Amendments to exemptions to need to publish a prospectus include:
  - Minimum denomination to qualify as “wholesale debt” is raised from EUR50,000 to EUR100,000
  - The “offer to less than 100 persons per member state” exemption is increased to 150 persons per member state
  - The definition of qualified investor is amended to be consistent with the “professional client” and “eligible counterparty” definitions under MiFID
  - Limit for total consideration exemption over 12 month period increased from EUR2.5m to EUR5m
  - Employee share scheme exemption is extended
- Retail cascade issue is clarified:
  - Clarifies that in relation to secondary sales, no new prospectus is required provided a valid prospectus is available and the issuer or other person responsible for it has consented to its use in writing

# Amendments to Prospectus Directive (cont.)

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- Summary section of Prospectus:
  - 2,500 word limit remains
  - Liability can now attach if summary does not provide, when read together with other parts of the prospectus, the key information required in order to aid investors when considering whether to invest in the securities
- Withdrawal rights:
  - Period during which a supplementary prospectus may be required will now end on the later of the close of the offer or the admission of the securities to listing
  - Withdrawal rights now only apply where there is an offer to the public and the matter triggering the publication arose before the final closing of the offer and the delivery of the securities
  - Withdrawal rights must be exercised within two working days

# Amendments to Prospectus Directive (cont.)

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- Proportionate disclosure regime for offerings of shares:
  - Already admitted to trading on regulated market or MTF provided statutory pre-emption rights are not disapplied; or
  - By listed companies with a market capitalization of less than EUR100m and SMEs
- Obligation to publish annual information statement under PD is abolished (it was duplicative of rules under the Transparency Directive which continue to apply)
- UK HMT has published consultation on early implementation of parts of the PD amendments by 31 July 2011 being:
  - Exemption for offers to less than 150 persons per member state
  - Offers with total consideration of less than EUR5 million

# Transparency Directive

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- Deals with financial reporting requirements, disclosure of interests in securities and communications with holders of securities
- Implementation of the Directive involved changes to:
  - The periodic financial reporting rules for companies
  - The regime for disclosing major shareholdings
  - The way companies communicate with shareholders and the market
- Periodic financial reporting
  - Annual and half yearly financial reports and in some cases interim management statements
  - Annual and semi annual financial reports must be prepared in accordance with IFRS (or standards considered “equivalent”) and filed with competent authority of home member state
  - Exemption for issuers of exclusively wholesale debt, amongst others
- TD is a “minimum harmonization” directive

# Transparency Directive – Disclosure of Major Shareholders

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- Disclosure of Major Shareholdings:
  - Notification requirements triggered where size of holdings of voting rights in shares listed on an EU regulated exchange reach, exceed or move below specified thresholds, being 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75%
  - UK and some other member states have additional notification requirements
- TD also contains provisions requiring the dissemination of certain information

# PRIPs - Background

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- Proposal is to create a more consistent approach for regulation of packaged retail investment products irrespective of how the product is packaged
- It is envisaged the PRIPs legislation will cover at least the following products:
  - Investment funds
  - Structured securities
  - Certain life insurance policies
  - Structured deposits

# PRIPs - History

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- PRIPs process has included a number of calls for evidence and consultations including:
  - European Commission Call for Evidence – October 2007
  - EU Commission Communication – April 2009
  - Report of the 3L3 Task Force on PRIPs – October 2010
  - EU Commission further Consultation on PRIPs – 26 November 2010
  - EU Commission MiFID Review Consultation – 8 December 2010

# Proposed Definition of PRIPs

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- “A product where the amount payable to the investor is exposed to fluctuations in the market value of assets or payouts from assets, through a combination or wrapping of those assets, or other mechanisms than a direct holding”
- Consideration of “white list” of PRIPs
- Definition does not embed retail element but it is intended that disclosure and selling rules should only apply to sales to retail investors
- Commission objectives include:
  - Definition should be flexible enough to cover new products as they develop
  - Avoid incentivising regulatory arbitrage
  - Sufficient legal certainty as to the products covered

# PRIPs – Disclosure Requirements

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- EU Commission proposes development of new disclosure framework applicable to PRIPs generally – “Key investor information disclosure”
- UCITS “KII” regarded as benchmark
- Objective is harmonisation and standardisation of key disclosures:
  - Product disclosures should be fair, clear and not misleading
  - Information necessary to allow investor to take an informed investment decision
  - Allowing for comparison between products
  - Some tailoring permitted
- Issue as to whether KIID should be a document separate from any other prospectus or background document
  - Interaction of PD summary section and KIID not yet clear

# PRIPs – Disclosure Requirements – Issues for further consideration

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- Risk considerations – inclusions of simple risk indicator?
- Costs – aim is to enable easy comparison between different products
- Approach in relation to information on performance
- Information to enable comparability between guarantees or capital protection for PRIPs
- Responsibility for KIID preparation – likely to be product manufacturer in most cases
- Obligation to update KIID?
- Development of KIID template:
  - Template produced for UCITS KIID is very prescriptive
  - JAC submissions and proforma template

# PRIPs – Selling Practices

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- Key elements identified by the Commission are:
  - Conduct of business rules
  - Inducements
  - Conflicts of interest
- MiFID regarded as benchmark
- Now being dealt with as part of MiFID review considered below

# MiFID - Overview

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- MiFID fully implemented on 1 November 2007
- MiFID's aim is to set out high-level provisions governing the organisational and conduct of business requirements that should apply to firms engaging in investment business and to harmonise certain conditions governing the operation of regulated markets
- Sets out obligations of firms in respect of:
  - Client classification
  - Due diligence
  - Transaction reporting/ transparency
  - Best execution
  - Inducements
  - Conflicts of interest

# MiFID - Core Investment Services and Activities

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- Reception and transmission of orders in relation to financial instruments
- Execution of orders on behalf of clients
- Dealing on own account
- Portfolio management
- Investment advice
- Underwriting / placing of financial instruments
- Operation of a Multilateral Trading Facility

# MiFID - Passporting

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- General approach is authorisation in one EEA Member State provides a “passport” for the firm to conduct cross-border business and establish branches in other member states free from additional local authorisation requirements
- Under MiFID Member States cannot impose additional requirements on incoming firms providing cross-border services in its jurisdiction
- Host Member State is however responsible for applying certain MiFID rules on the branch of an incoming firm including:
  - Conduct of business obligations
  - Best execution

# MiFID – Client classification

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- Clients of an investment firm must be categorised into following categories:
  - Eligible counterparties
  - Professional clients
  - Retail clients
- Some overlap between eligible counterparties and professional clients
- Clients may be reclassified, subject to certain safeguards
- Eligible counterparty regime limited to dealing on own account and receiving, transmitting and executing orders on behalf of client:
  - Firms dealing with eligible counterparties do not need to comply with conduct of business requirements

# MiFID – Due Diligence

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- Deals with due diligence to be conducted by firms before provision of investment services (not relevant to eligible counterparty regime)
- Three different levels:
  - Suitability (portfolio management or investment advice)
  - Appropriateness
  - Execution only (no due diligence required)
- Suitability covers client's:
  - Knowledge and experience
  - Financial situation
  - Investment objectives
- Appropriateness covers client's:
  - Knowledge and experience
- Certain assumptions allowed for professional clients:
  - That professional clients have requisite knowledge and experience
  - In respect of suitability test for investment advice, that professional clients (other than opted-up retail clients) financially can bear risk of loss

# MiFID – Execution-only Exemption

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- Provides exemption to performing appropriateness determination
- Only applies if:
  - Service is limited to reception and transmission of orders or execution of orders on behalf of clients
  - Service relates only to non-complex instruments
  - Service is provided at the initiative of the client
  - A prescribed warning is given to the client
  - The firm complies with its conflict management obligations

# MiFID – Non-complex Financial Instruments

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- Shares admitted to trading on a regulated market (or equivalent third-country market)
- Money market instruments
- Bonds and other securitised debt which do not embed a derivative
- Units in UCITS funds
- Certain other financial instruments

# MiFID – Additional Duties

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- Best execution - Article 21 requires firms to take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or other relevant considerations. Duty can be overridden by specific instructions
- Inducements - As part of general duty of fair dealing, MiFID restricts provision of and receipt of inducements by investment firms. No specific definition but will catch fees, commissions, non monetary benefits, in each case provided to or received by a firm. Exceptions are:
  - Inducements provided to or by the client
  - Fees necessary for the provision of investment services
  - Certain disclosed inducements designed to enhance the quality of the relevant service to the client

## MiFID – Additional Duties (cont.)

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- Conflicts of interest:
  - Firm must take reasonable steps to identify and manage conflicts. It must maintain and operate effective arrangements to prevent conflicts adversely affecting clients' interests, but if risk to client's interests can not be prevented under above measures, the firm must disclose the general nature and/or source of the conflict to client before undertaking business on its behalf
- Transaction reporting - Firms must retain relevant data pertaining to all transactions in financial instruments. Must also report details to competent authority of transactions executed in financial instruments admitted to trading on a regulated market not later than the close of the following day

## MiFID – Additional Duties (cont.)

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- Post trade transparency for regulated markets/MTFs:
  - Price, volume and times of trades must be made available to the public on a reasonable commercial basis. Three alternatives for publication - regulated market or MTF, third party or proprietary arrangements
- Pre-trade transparency – complex rules contained in Article 27
  - Currently only applies to shares

# EU Commission MiFID Review

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- EU Consultation Paper published on 8 December 2010
- Legislative proposals expected in October 2011
- Conduct of business and conflicts of interest rules to be extended to:
  - Advised and non-advised sales of structured deposits
  - Firms selling their own securities to clients even on a non-advised basis
- Client classifications largely unchanged
  - Some exceptions regarding “complex” instruments

## EU Commission MiFID Review (cont.)

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- Introduction of concept of Organised Trading Facility (OTF)
  - Any facility or system operated by an investment firm or market operator that brings together buy and sell orders in relation to financial instruments on an organised basis
  - Likely to catch broker crossing systems and interdealer broker system
- OTFs will become subject to certain MiFID requirements including:
  - Authorisation requirements
  - Reporting rules
  - Transparency obligations
  - Conflicts of interest rules

## EU Commission MiFID Review (cont.)

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- Existing MiFID pre and post trade transparency regime for equity markets to be extended to all bonds and structured products which are admitted to trading on a regulated market or MTF and all derivatives eligible for central clearing or reported to a trade repository
- Other matters subject to the Review include:
  - Additional requirements on automated trading/high frequency trading
  - Alignment of organisational requirements of regulated markets, MTFs and OTFs
  - Greater reinforcement of supervisory powers and ability to intervene in derivative contracts

# EU Commission MiFID Review - Complex v Non-complex products

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- Two possible options outlined
  - Option 1:
    - Minor adjustments to Article 19(6)
  - Option 2:
    - Abolition of execution-only exemption
    - Appropriateness test will then always be needed for non-advised financial services to retail investors

# FATCA

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- Foreign Account Tax Compliance Act (“FATCA”)--enacted on March 18, 2010 as part of the Hiring Incentives to Restore Employment Act (the “HIRE Act”)
- FATCA
  - New Withholding Tax on Certain Payments to Foreign Financial Institutions and Certain Foreign Non-Financial Institutions Beginning in 2013
  - Repeal of U.S. Bearer Bond Rules Effective for Debt Issued After March 18, 2012
  - New Withholding Rules for Substitute Dividends & Dividend Equivalent Payments Effective for Payments On or After September 14, 2010
  - Other Provisions

# Repeal of U.S. Bearer Bond Exception

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- Background

- Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”): compliance initiative from Congress: information reporting and backup withholding – bearer bonds banned unless issued under arrangements “reasonably designed to ensure sale to non-U.S. persons”
  - TEFRA C and TEFRA D
- Deficit Reduction Act of 1984: repeal of 30% U.S. withholding tax on “portfolio” interest – applies to bearer bonds sold under arrangements “reasonably designed”
- Sanctions for failure to comply with TEFRA
  - Issuer denied interest deduction
  - Excise tax equal to 1% of principal amount times number of years to maturity
  - Portfolio interest exemption to 30% U.S. withholding tax not available
  - Holder gain ordinary

# Repeal of U.S. Bearer Bond Exception (cont'd)

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- FATCA repeals TEFRA C and TEFRA D exceptions for denial of interest deduction, portfolio interest exemption, and ordinary income to holder
  - Preserves exception to excise tax
- Effective date
  - Applies to obligations issued after March 18, 2012

# Repeal of U.S. Bearer Bond Exception (cont'd)

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- Therefore, a U.S. issuer must issue bonds in registered form after March 18, 2012
  - Non-U.S. beneficial ownership certification (e.g., IRS Form W-8BEN) to qualify for portfolio interest exemption
  - Treasury may determine certification is not required
  - What about bonds issued by CFCs?
- Debt obligations held through dematerialized book-entry system treated as in registered form
  - IRS Notice 2006-99 (JASDEC)
  - Other book-entry systems specified by Treasury
    - Global bonds held through book-entry systems?

# Registered Notes – New Safekeeping Structure

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- Since October 2010, any registered note intended to constitute eligible collateral for Eurosystem monetary policy operations, needs to be issued under the New Safekeeping Structure
- NSS involves a Common Safekeeper (Euroclear or Clearstream) and a Common Services Provider in respect of the registered notes held in the clearing systems – similar to the New Global Note regime in respect of bearer notes
- Registered Global Note is registered in name of nominee appointed by CSK and note is serviced by CSP (a bank) appointed by CSK
- As was the case pre-October 2010, registered notes cleared through DTC are not eligible as collateral for Eurosystem operations

# Proposed European Securities Law Directive

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- November 2010 Consultation Paper of European Commission
- Addresses issues of incompatibility/ inconsistency of different laws relevant to chain of relationships involved in cross-border holdings of book-entry securities
- Proposes EU law (not national laws) should govern/ regulate legal framework for holding and disposition of book-entry securities
- However, relevant national law to remain sole arbiter of whom an issuer should recognise as legal holder of its securities

# Proposed European Securities Law Directive (cont.)

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- Minimum set of rights stemming from a holding of securities in an account, should be enshrined in national law of each EU member state
- Account providers should also be subject to minimum set of duties – in particular the duty to facilitate the exercise of an ultimate account-holder's rights attached to securities, as against the issuer
- For an ultimate account holder this should include at least the right to receive dividends or other interests and exercise voting rights
- Possible legislative proposal in summer 2011
- Originally planned to finalise legislation in early 2012