The latest piece of the Prospectus Regulation puzzle has arrived.

On 28 November, 2018, the European Commission published the Commission delegated regulation and Annexes on the format, content, scrutiny and approval of the prospectus (the Delegated Regulation). The Delegated Regulation largely follows the European Securities and Markets Authority’s (ESMA) final report (published in March 2018), although there has been some reformatting of the annexes.

The European Commission intends to adopt this Delegated Regulation, which will apply, along with the Prospectus Regulation, from 21 July, 2019.

Market participants need to start thinking now about how they are going to address these new requirements in their debt prospectuses, in particular the:

- more prescriptive approach to risk factors, which cannot be generic and must be categorised and restricted;
- modified requirements for the summary and interaction with the PRIIPs KID; and
- enhanced disclosure obligations for credit-linked notes and securitisations.

Some of these changes, such as the categorization of risk factors, could lead to increased costs and liability for issuers.

**Prospectus Regulation - timing**

Although the Prospectus Regulation entered into force on 20 July, 2017, the majority of the provisions will apply only from 21 July, 2019. As a regulation, it will be directly applicable in EU Member States and no implementing legislation will be required for it to take effect. The Prospectus Regulation repeals and replaces the existing Directive 2003/71/EC (the Prospectus Directive). It forms part of the Commission’s Action Plan on Building a Capital Markets Union, which aims to create more integrated capital markets in EU member states and to make it easier for companies to raise funding and reach investors across borders. For more information on the CMU please see our client alert on the Capital Markets Union.

The Prospectus Regulation introduces some new changes to the existing prospectus regime. For an overview, please see our previous alert: The Revised EU Prospectus Directive: A New World or Same Old, Same Old?

As noted above, in terms of substance, the Delegated Regulation largely follows the ESMA final report although the annexes have been reordered and reformatted in an attempt to make the drafting more user friendly. The proposed requirements for cover notes have not been taken forward. However, the proposals for more detailed disclosure in relation to underlying securities and reference obligations for certain credit linked notes have been carried through, despite strong market response raising concerns.

This alert highlights the main changes that will impact debt issuances. Some of these changes, such as the categorization of risk factors could lead to increased costs and liability for issuers.

**Grandfathering**

Although the Prospectus Regulation repeals the Prospectus Directive, there is some limited grandfathering for prospectuses approved before 21 July, 2019. A prospectus (including a Base Prospectus) approved under the existing Prospectus Directive regime (as implemented in the relevant EU Member State) before 21 July, 2019 will continue to be governed by that regime, and thus securities can be listed under such prospectuses without the need for a new or supplementing prospectus compliant with the new regime, until the later of: (i) the end of its validity period; or (ii) 21 July, 2020.
Risk factors will need to be categorized and restricted
The Prospectus Regulation introduces a new approach to risk factors that issuers will need to think about carefully when drawing up their prospectuses.

Risk factors should be limited to those risks that are specific to the issuer or the securities and material for taking an informed investment decision. In addition, risk factors will need to be categorized according to the issuer’s assessment of the probability of their occurrence and the expected magnitude of their negative impact. The risk factors should be presented in distinct categories, with the most material mentioned first. Specific risk factors relating to the guarantor will also be required. In the prospectus summary, issuers will need to limit the risks to the 15 most material risk factors specific to the securities.

Issuers will be concerned that this new approach may expose them to increased liability if a risk factor is mischaracterised or left out due to restrictions on the number of risk factors or length of the summary.

ESMA’s consultation paper on risk factor guidelines provides further details for national competent authorities to take into account when scrutinising and approving prospectuses under this new approach in order to encourage a more concise, streamlined approach to risk factors in prospectuses.

The guidelines propose that competent authorities should challenge the inclusion of risk factors that have not been drafted specifically for the issuer or securities or are generic and only serve as disclaimers or where there is no direct link between the issuer or the securities and the risk factor.

Helpfully, the consultation paper also acknowledges the current different approaches taken in relation to different types of prospectuses (such as a multi-product base prospectus, where further risk factors may be relevant) and it will be important that this flexibility is retained, particularly for example when approving wholesale prospectuses.
The consultation period closed on 5 October, 2018. ESMA will consider responses and deliver its technical advice on risk factors to the European Commission and is expected to publish its final report by 31 March, 2019. The actual impact of these risk factor guidelines will depend on the particular approach taken by the individual competent authority.

**Risk Factors**

Care will be needed to avoid generic risk factors. Market participants should be alert to the potential for comments to come back from national competent authorities asking for details explaining the approach taken.

**Wholesale issuances**

The scope of “wholesale” issuances (debt securities with a denomination of at least €100,000) is extended to include debt securities that are traded solely on a regulated market or segment of a regulated market, accessible to qualified investors only, regardless of denomination, (which can be less than €100,000).

The Luxembourg Stock Exchange has recently launched two Professional Segments on both the regulated market and the Euro MTF. Securities admitted to those segments will only be accessible to qualified investors and trading is only allowed between qualified investors. For more information on these Professional Segments please see the next article in this brochure “Luxembourg Stock Exchange Professional Segments – the real impact.”

**Summary for retail only and PRIIPs KID**

Going forward, a summary will still be required in the final terms or prospectus in respect of a debt issuance to retail investors although a pro forma summary will no longer be required in base prospectus programmes. There are, however, prescriptive requirements for how a summary must be drawn up and it should generally not be more than 7 sides of A4 paper, with no more than 15 risk factors.

If a key information document (KID) is also required under Regulation 1286/2014 (the PRIIPs Regulation) and the content of the KID is included in the summary, the issuer will be deemed to have produced the KID so long as it provides investors with a copy of the summary. However, if a KID is produced and used as part of the prospectus summary, the information in the KID must also be disclosed elsewhere in the prospectus, for example, in the securities note or final terms (on the basis that the summary should be summarising information included in the prospectus). As the KID is required to be updated regularly (when the securities continue to be made available to the public), a corresponding supplement may need to be prepared for the prospectus each time.

**Summary and PRIIPs KID**

Market participants need to think carefully about including the contents of a KID in a prospectus given that the person responsible for preparing the KID is the manufacturer and may not be the same person who is responsible for the contents of the prospectus. The KID is likely to contain more product related information than is typically included in a prospectus and is also required to be regularly updated which could trigger the requirement for a supplement. The difference in liability between the two regimes should also be considered.
Advertisements are communications
The Prospectus Regulation seeks to harmonise advertisements to ensure that they are consistent and accurate. An advertisement is now more broadly defined to be a “communication” relating to:

i. a specific offer of securities to the public or admission to trading on a regulated market; or

ii. aiming to specifically promote the potential subscription or acquisition of securities.

Market participants need to ensure that all communications are accurate and not misleading and all information disclosed in oral or written form should be consistent with the information in the prospectus, even if not for advertising purposes. If material information is disclosed to one or more selected investors, this should be disclosed to all investors to whom the offer is addressed, such as in a supplement if a prospectus is required.

Advertisements communicated to institutional investors should include a hyperlink to the prospectus (or identify where it will be published) and include the word “Advertisement” in a prominent place or, for oral advertisements, a clear identification of the purpose of the communication at the beginning of the message. In addition, in respect of complex securities, the comprehension alert, which is required under the PRIIPs Regulation, may have to be included in an advertisement.

Advertisements
Market participants will need to consider if term sheets and other materials are caught by this rule and if more rigorous checks need to be implemented. Market participants may wish to conduct some internal training for sales teams and other colleagues who may be communicating advertisements.

Incorporation by reference expanded
More types of documents will be able to be incorporated by reference into a prospectus, such as constitutional documents, asset valuation reports, management reports and information in existing approved prospectuses, supplements and final terms. This should help issuers save time, costs and avoid having to prepare a supplement in some circumstances.

Impact on structured products
Issuers will no longer be required to produce a pro forma summary in the base prospectus, just an issue specific summary for retail issuances, which should be helpful for structured product issuers.

However, the new risk factor requirements may be particularly problematic for structured products issuers given the nature of the more complex products. Multiproduct structured note programmes typically include numerous risk factors and it will be challenging to organise these into a limited number of categories.

More detailed disclosure will also be required for underlying securities and reference obligations. In respect of credit-linked notes, where the reference entity or issuer of the reference obligation has no securities admitted to trading on a regulated market,
equivalent third country market or SME Growth Market, the prospectus must include information on that reference entity or issuer of the reference obligation as if it were an issuer of a prospectus. The same rule applies to a basket of underlyings where a single reference entity or reference obligation represents more than 20% of the pool.

Credit-linked notes
More detailed disclosure will be required in respect of underlying securities and reference obligations, although if the relevant underlying securities are listed the disclosure requirement will be similar (although not exactly the same) as the current rule.

Impact on securitizations
Issuers of securitizations will be required to include more detail in prospectuses on the underlying assets. Requirements will include:

- an explanation of the flow of funds, including how the cash flows from the assets will meet the issuer’s obligations;
- information on any credit enhancements;
- details of any subordinated debt finance;
- the applicable risk retention requirement; and
- the material net economic interest retained by the originator, sponsor or original lender.

In addition, prospectuses will need to include a statement in relation to simple, transparent and standardized (STS) compliance and a warning that the STS status of a transaction is not static and that investors should verify the current status of the transaction on ESMA’s website.

Securitizations
Securitization issuers will need to include more detail on the underlying assets as well as a statement regarding STS compliance.

Impact of Brexit
Although the Prospectus Regulation will be in force on 29 March, 2019 (the day that the UK is scheduled to leave the EU), as it will not be operative, it will not be caught by the European Union (Withdrawal) Act 2018. Therefore, the Prospectus Regulation will not automatically become law in the UK post-Brexit. If there is a transition period, EU law is expected to continue to apply as if the UK were an EU member so the Prospectus Regulation, which would come into force during the transition period, would be directly applicable law in the UK from the time it becomes operative.

In the event of no transitional or other arrangements, the current prospectus regime will continue to apply in the UK post Brexit.

However, the UK has indicated in the explanatory information on the Draft Official List of Securities, Prospectus and Transparency (Amendment) (EU Exit) Regulations 2019 that it intends to implement the Prospectus Regulation into UK domestic law, in the event of no other arrangements being agreed between the EU and the UK. The Prospectus Regulation is listed in the draft of The Financial Services (Implementation of Legislation) Bill (which is intended to deal with the changes to EU financial services legislation currently in the pipeline) as one of the pieces of financial services legislation that HM Treasury intends to implement after Brexit day. The explanatory information also reiterates the UK government’s intention to continue to treat prospectuses that are valid in the UK before exit (including those approved by a competent authority in a different EU member state and passported into the UK) as valid for the remainder of the 12 months from their date of approval, including where that includes a period after the UK exits the EU. However, prospectuses that are approved before Brexit by the UK Financial Conduct Authority (FCA) would not be able to be used in EU 27 member states/EEA EFTA states in the event of a no-deal Brexit.

In the explanatory information, HM Treasury stated that it intends to issue an equivalence decision prior to the day the UK leaves the EU determining that EU-adopted IFRS can continue to be used to prepare financial statements for the purposes of preparing a prospectus and for the requirements under the Transparency Directive so that issuers registered in EEA states with securities, or applying for securities to be, admitted to trading on a regulated market in the UK or making an offer of securities in the UK will be able to continue to use EU-adopted IFRS when preparing consolidated accounts.

Article 29 of the Prospectus Regulation does, though, contain a third-country equivalence regime which allows the competent authority of
a home Member State of a third country issuer to approve a prospectus prepared in accordance with third-country laws, provided that:

i. the information requirements of that third country are equivalent to the Prospectus Regulation requirements; and

ii. the competent authority has concluded cooperation arrangements with the relevant supervisory authorities of that third-country issuer (which is subject to equivalence criteria set out by the European Commission and technical standards developed by ESMA on the minimum content of the cooperation arrangements).

The European Commission is empowered to adopt delegated acts to establish general equivalence criteria and may adopt implementing decisions stating that the information requirements of a third country are equivalent to the requirements under the Prospectus Regulation.

Although there is an existing equivalence regime under the Prospectus Directive, it has not often been used in the context of debt securities. It may be that post-Brexit market participants will look to make more use of this equivalence mechanism.

**Brexit**

On Brexit day (29 March, 2019) the Prospectus Regulation will be in force but not operative so it will not become English law under the European Union (Withdrawal) Act 2018.

Post-Brexit, the UK government has indicated that it intends to adopt into English law the provisions of the Prospectus Regulation that do not apply on Brexit day.

**Next steps**

The European Commission now needs to adopt the Delegated Regulation.

It will then enter into force within 3 months if the European Parliament and European Council have no objection, or, in the event of any objections, this period will be extended by a further three months.

ESMA will also be looking at the Q&As on prospectuses as well as working on the equivalence of third country regimes.

**What do you need to think about now?**

Issuers should start thinking now about how they are going to comply with the new requirements, in particular the new approach to risk factors, which is likely to result in significant changes to many prospectuses.