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EUROPEANISSUERS' POSITION ON THE PROPOSED APPLICATION OF A KEY INFORMATION DOCUMENT (KID) TO CORPORATE BONDS[1]

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BACKGROUND

The Packaged Retail Investment Products (PRIPs) initiative of the European Commission had originally limited the obligation to provide a Key Information Document (KID) to packaged products (e.g. investment funds, retail structured products and certain types of insurance contracts used for investment purposes). However, the European Parliament voted on 20 November 2013 to include corporate bonds[2] in the scope of the proposed regulation.

SUMMARY OF THE POSITION

While European quoted companies share the Parliament's objectives of promoting retail investment into corporate bonds and providing relevant information to investors, they fear that the **application of the proposed regulation to corporate bonds,** which are of a different nature than packaged products, **may result in several unintended consequences**, for **companies and investors alike**, and does not take into account the existing disclosure requirements applying to bonds.[3]

In the framework of the trilogue discussions, issuers therefore kindly ask Members of the Council and of the European Parliament to keep the initial scope of the KID/PRIPs regulation (packaged products only), i.e. without including corporate bonds, for the following **main reasons**;

- Having to provide a key information documents (KID) for corporate bonds which are traded on regulated markets is superfluous and redundant. Existing prospectus and transparency requirements are very detailed and provide the information the investor needs to draw a well informed investment decisions. In particular, it is the main function of the prospectus' summary to describe the key aspects of the financial instrument in a brief manner.

- In an environment where alternatives to bank financing are much needed[4], KID would undermine efforts to increase the attractiveness of capital markets and to improve issuers' (including SMEs') access to market funding:
    - ➢ adding disclosure obligations for non-financial companies would contradict recent efforts of the European Commission to reduce unnecessary regulatory burden and costs for companies[5];
    - ➢ the potential to mislead investors, in particular retail investors, could lead to the opposite result than the intention of policy makers, who, as we understand, aim to promote plain

[1] Formerly known as PRIPs initiative (Packaged Retail Investment Products)

[2] Amendment 2 recital 6, Amendment 3 Recital 7, in the Committee draft report dating 20.12.2012; Amendments 76, 77 of recital 6, amendments 85, 86, 87 of recital 7, amendments 171, 184, etc. of Article 2 – paragraph 2 tabled on 20.02.2013

[3] Companies already produce prospectus including a summary, periodic information (reports under the Transparency Directive, i.e. annual and half yearly financial, management reports, etc.), and ongoing information (press releases).

[4] [4] See the report of the High Level Expert Group on SME and Infrastructure Financing "Finance for Growth" and EC Green Paper on Long-Term Financing of the EU economy

[5] e.g. abolishment of the quarterly reporting obligation under the Transparency Directive;

vanilla bonds to retail investors.

- this would be a key obstacle in the achievement of the overall objectives to foster economic growth and long-term approaches, which are put forward by the European institutions[6][7][8].

<u>European issuers' **more specific concerns** relate to the following points:</u>

1. a requirement on the issuer to measure and/or summarise the company's risk and reward, in particular using a synthetic (risk) indicator, which would be difficult for issuers to manage and could potentially result in misleading information ;
2. the status of the KID as a standalone document ;
3. a requirement on the issuer to keep the KID up to date;
4. the liability regime attaching to the KID ;
5. a requirement on the issuer to establish a documented product approval process including review of the compatibility of the bond with the interests of the identified consumer group, stress testing, etc.

We provide further information on each of these points below.

Burdensome disclosure requirements make capital markets no longer attractive and have strongly contributed to a serious decline of IPOs in Europe[9] and many de-listings. Similar effects should be avoided for bonds, at a time when alternatives to bank financing are particularly needed. The retreat of corporate issuers from bond markets would also limit possibilities of retail investors to diversify their investments in a manner which is adequate from a risk / return perspective.

1. RISK AND REWARD PROFILE / SYNTHETIC RISK INDICATORS

While we agree with the usefulness of KID for packaged products, as it is indeed often not clear what the underlying product is due to the packaging, nor what the conditions for gain/loss could be, **bonds are different from packaged products**[10]. The **value** of corporate bonds is **linked to many other factors than the financial characteristics of the securities, including macro-economic perspectives, the issuer's business-model and competitive environment, corporate activities** (industrial, commercial, managerial, etc.) **and the issuer's financial position**.

Unfortunately, **all these factors cannot be adequately disclosed in a narrative form in a short document of four A4 pages as foreseen by the KID/PRIPs draft regulation**. For instance, in the case of the prospectus, which serves a basis of an investment decision, EU regulation for the headings alone for mandated disclosure on the issuer and its business run to five and a half pages for a straight bond issue, and the financial statements account for 15 pages or more (see Prospectus Directive Regulation (809/2004)[11] article 7 and ANNEX IV). This stems from its stated purpose to enable an investor to take an informed investment decision which necessarily requires a detailed description of the issuer's business and financial position.

One of the main factors influencing the value of a bond is the credit risk of the issuer. It is extremely difficult and potentially misleading to measure and summarise company's credit risk especially using synthetic risk indicators. In case of limited space, there is a temptation to replace the narrative description with a

[6] Europe 2020 agenda; DG Entreprise SME Action Plan, Green Paper on Long-Term Financing of the EU economy.
[7] See ECON report on improving access to finance for SMEs.
[8] See the report of the High Level Expert Group on SME and Infrastructure Financing "Finance for Growth"
[9] See a report from the roundtable "The Future of Enterprise Funding in Europe – Can Europe grow as IPOs decline?" with Mats Isaksson (OECD) as a key note speaker
[10] A corporate bond is a debt security, under which the issuer owes the holders (investors) a debt and, depending on the terms of the bond, is obliged to pay them interest (the coupon) and/or to repay the principal at a later date, termed the maturity date.
[11] Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements

synthetic (risk) indicator, as referred to in the draft KID/PRIPs Regulation. However, **based on the attached detailed analysis**, we would like to underline that **none of the existing synthetic indicators meets the qualitative characteristics needed by investors to take informed decisions on corporate bonds. These indicators cannot adequately and objectively take into consideration all economic and financial aspects that issuers face and measure the credit risk attaching to a bond, while ensuring feasibility at a reasonable cost, as well as understandability**.

It is therefore **extremely difficult and potentially misleading, to measure and summarise company's risk and reward profile, especially using a synthetic (risk) indicator**.

2. STATUS

We would like to underline that treating the KID as a stand-alone document and as the only basis for an investment decision, could be potentially harmful to retail investors as it would not allow companies to provide all relevant information for an investor to take his/her decision.

Disclosure is a very important investor protection tool. The prospectus itself, regulated by the Prospectus Directive (2003/71/EC) and the Prospectus Regulation[12], is the main disclosure document related to issuance of bonds. The prospectus provides all the information relevant to well-informed investor decisions and therefore is a long document (see also above paragraph on risk and reward profile).

As it is impossible to include in a short document all this information, the **KID should not be treated as the sole basis for an investor's decision and should be read together with the full documentation provided by the issuer according to EU legislation.**

Cross-references to other documents should be permitted notwithstanding whether this information is required or not by the legislation.

3. UPDATE

A requirement on the issuer to keep the KID up to date, as well as to communicate those updates to the competent authority would be very difficult to implement and would impose additional significant costs on non-financial companies. It is important to keep in mind that it is not the business of non-financial companies to provide investment advice or sell securities. Companies need to obtain access to finance such as bonds, in addition to banks loans, in order to expand their business operations and thus create the growth and jobs so badly needed by the European Union. Therefore it is important to help companies to focus on their core business, and to reduce the amount of time and money spent on compliance.

4. LIABILITY

If the purpose of the KID and its liability regime are set too high, issuers of bonds would not have the possibility to disclose all the relevant information on an ongoing basis and would be exposed to higher litigation risks. As a result, issuers would start to avoid retail markets as the costs would outweigh the potential benefits, consequently limiting the investment choice of the retail investors. This would lead to the opposite result than the intention of policy makers, who, as we understand, aim to promote plain vanilla bonds to retail investors.

Therefore, if bonds were included in the KID/PRIPs regulation in accordance with the text adopted by the

[12] Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements.

Parliament in plenary, we would insist that:

- the civil liability is restricted to the cases where KID is misleading, inaccurate or inconsistent, when read together with the full documentation provided by the issuer (prospectus, annual report, press releases), as provided for in the Prospectus Directive regarding the summary13 and similarly in the UCITS KID14;
- if the issuer delegates the drawing up of the key information document wholly or partially to third parties, the third party – and not the issuer – should be held responsible for the content drafted by the third party (which is not the case in the current draft)[15]. As mentioned above, it is not the business of non-financial companies to provide investment advice or sell securities. If the regulation were to require synthetic risk indicator(s), companies might then need to engage the services of a financial expert to produce them and would not necessarily be in a position to judge the result.

5. PRODUCT APPROVAL PROCESS

Selling securities or providing investment advice is a role that is usually played by investment firms, financial advisers or financial analysts.

Requiring a non-financial company to establish a documented product approval process - including review of the compatibility of the bond with the interests of the identified consumer group, stress testing, etc. – would impose additional significant burden and costs on non-financial companies. This would deter companies from issuing bonds, prevent them from focusing on their core business and thus reduce the prospects for growth and the creation of productive jobs, which are much needed in the European Union.

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***EuropeanIssuers** represents the interests of quoted companies across Europe.*

We aim to ensure that EU policy creates an environment in which companies can raise capital through the public markets and can deliver growth over the longer-term. We seek capital markets that serve the interests of their end users, including issuers.

More information can be found at www.europeanissuers.eu.

[13] 2003/71/EC article 5 (2)

[14] Article 79 of 2009/65/EC directive (UCITS) states that: "Key investor information (...) shall be consistent with the relevant parts of the prospectus." and that "Member States shall ensure that a person does not incur civil liability solely on the basis of the key investor information, including any translation thereof, **unless it is misleading, inaccurate or inconsistent with the relevant parts of the prospectus**. Key investor information shall contain a clear warning in this respect".

[15] Recital 11 of the draft Regulation as approved by the plenary (P7_TA-PROV(2013)0489)

KEY INFORMATION DOCUMENTS (KID) – CORPORATE BONDS – ASSESSMENT OF POTENTIAL RISK INDICATORS

QUALITATIVE CHARACTERISTICS OF INFORMATION DESCRIPTION / SYNTHETIC INDICATORS	ADEQUACY / RELEVANCE	NEUTRALITY	COMPARABILITY / CONSISTENCY	FEASIBILITY AT A REASONABLE COST	UNDERSTANDABILITY	ASSESSMENT SUMMARY
	Faithful indicators represent the phenomena that they purport to represent.	Neutral indicators are not slanted, emphasized or de-emphasized or otherwise manipulated to increase the probability that information will be received favourably or unfavourably by investors.	Indicators are more useful if they can be compared with similar information about other entities and with information about the same entity for another period.	It is essential that the cost of providing further information does not outweigh potential benefits and increase corporate funding costs.	Indicators are more useful if they enable issuers and investors to understand the phenomenon being depicted.	The developments below point to the inadequacy, lack of neutrality and comparability, as well as complexity of the existing synthetic indicators. Furthermore such indicators would be particularly complex, burdensome and costly to establish for issuers.
CREDIT RATING AGENCIES' RATINGS		Not exempt from risks of conflicts of interest.	No rating methodologies common to all credit rating agencies; Not all issuers are rated.	A requirement to include or update ratings would not only be an additional cost to raising capital, but would result in over reliance on ratings, which the recent revision of the Credit Rating Agencies European Regulation has started to address.		Third-party involvement, with no possibility of control by the bond issuer; No common rating methodologies; Huge potential costs; Over-reliance on ratings.
CREDIT DEFAULT SWAPS RATES (CDS)	Where available, CDS rates may be illiquid, reflecting a very limited number of transactions and therefore be unrepresentative and irrelevant to credit assessment.	Cannot be considered as neutral: they reflect a market view only, which results from the interaction of various market participants, with no involvement of issuers. The CDS market is unregulated and considerably larger than the market of the securities traded, which indicates that speculation is a significant element of the market.	The value of a CDS is based in part on market activity that does not reflect a realistic and reliable assessment of issuer credit risk; also CDS rates are not available for many issuers and, where available, may be illiquid; they are therefore irrelevant to credit assessment or comparisons.			Market distortions, in particular risks of illiquidity and manipulation; Do not reflect a realistic and reliable assessment of issuer credit risk; No availability for many issuers; No relevance to comparisons.

QUALITATIVE CHARACTERISTICS OF INFORMATION DESCRIPTION / SYNTHETIC INDICATORS	ADEQUACY / RELEVANCE Faithful indicators represent the phenomena that they purport to represent.	NEUTRALITY Neutral indicators are not slanted, emphasized or de-emphasized or otherwise manipulated to increase the probability that information will be received favourably or unfavourably by investors.	COMPARABILITY / CONSISTENCY Indicators are more useful if they can be compared with similar information about other entities and with information about the same entity for another period.	FEASIBILITY AT A REASONABLE COST It is essential that the cost of providing further information does not outweigh potential benefits and increase corporate funding costs.	UNDERSTANDABILITY Indicators are more useful if they enable issuers and investors to understand the phenomenon being depicted.	ASSESSMENT SUMMARY The developments below point to the inadequacy, lack of neutrality and comparability, as well as complexity of the existing synthetic indicators. Furthermore such indicators would be particularly complex, burdensome and costly to establish for issuers.
VALUE AT RISK (VaR)	Based on past performance/past market prices, VaR statistically measures the risk of a mark-to-market loss on a portfolio of financial assets over a time horizon that is usually (much) shorter than the life of a bond, assuming normal markets. VaR cannot measure the credit risk attaching to a single corporate bond based on future performance and could therefore give false confidence or result in unjustified mistrust.		VaR calculations are based on numerous important assumptions that are not necessarily consistent.		VaR has been controversial and blamed as part of the cause of the recent crisis, as it was misunderstood and gave a false sense of security to market players and regulators; if it cannot be properly understood by experts, there is little chance that it would be understood by retail investors.	No relevance for single corporate bonds; No single method of determining VaRs and no relevance to comparisons; Difficult to understand.
SPREAD OVER A BENCHMARK					Spread over a benchmark (usually a comparable sovereign bond) would require an understanding of the credit risk of the benchmark issuer, which often is not possible, as in particular, sovereign bonds would not be covered by the PRIPs Regulation.	Dependence on benchmarks; No relevance to comparisons; Difficult to analyse and understand.