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CAPITAL MARKETS UNION – SECURITIES LAW REFORM: NECESSARY OR NOT?

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The European Commission has unveiled its plan to boost funding and growth across Europe by the creation of a Capital Markets Union – a single market for capital across the 28 EU member states.

Introduction and background

The Green Paper on *Building a Capital Markets Union* was issued on 18 February 2015, to stimulate debate on the measures needed to achieve the Commission's 'top priority of jobs and growth', by removing the many obstacles to deeper and more integrated capital markets. To this end, the US capital markets are often seen as the "gold standard" that the European markets should aspire to and certain of the proposals seek to emulate that market. One of these priority actions identified in the Green Paper is to develop the European private placement market. A fully functioning private placement market is seen as key to the development of capital markets union as it allows issuers swift and relatively inexpensive access to the capital of professional investors. The Green Paper indicates the need for securities law reform as a step to achieve this, but is not clear why as the current legislation would allow such a market to develop. A useful first step in understanding why no change in securities law, but perhaps in other laws and practices, is needed is to compare the US approach to private placements under Regulation D to the existing European securities laws governing private placements.

The US and European private placement regimes – spot the difference

Our analysis of the US and European legislative approach to private placements shows that, perhaps surprisingly, there is very little to differentiate the two regimes on a pure securities law basis. However, a fundamental operational difference, and one which does impede the European private placement market, is the tax treatment applicable in the European markets which often drives privately placed securities to be 'listed', as well as fund requirements to buy only 'listed' securities. This in turn brings such securities within scope of the Prospectus Directive regime, or other local listing rules, compliance with which negatively impacts on costs, timing and flexibility for issuers. This is in contrast to the US position where private placements are not listed. There are other factors, which we look at briefly, which make the US Regulation D (**Reg D**) market successful but we believe the primary driver of difference and one which the European Commission may want to examine in the context of CMU is the tax treatment applicable to privately placed securities.

A closer look at "Reg D"

Reg D is a private placement exemption to the requirement to register securities with the SEC under the US Securities Act of 1933, as amended (the **Securities Act**). Reg D provides a safe harbour for the initial sale of securities by issuers to certain sophisticated investors but, unlike Rule 144a, it does not apply to resales of securities. The

Reg D exemption relates to both equity and debt private placements and the securities remain subject to ongoing transfer restrictions.

One of the primary advantages in structuring an issue of securities to comply with Reg D is that it allows an issuer to avoid the time and cost involved in the full registration process with the US Securities and Exchange Commission (the **SEC**). Additionally securities issued pursuant to Reg D are not underwritten so no underwriter liability (or defence) arises requiring greater disclosure, nor are they listed on a stock exchange which might impose additional requirements. Consequently issuers are able to quickly and easily access capital from sophisticated investors who conduct their own due diligence.

Reg D – the exemptions

Reg D operates by restricting either or both of the amount of securities sold and the types of investors to whom the securities can be sold. There are four regulatory safe harbours under Reg D:

- Rule 504 exempts offerings with an aggregate price of up to USD1 million in any 12 month period with no limits on the type or number of investors;
- Rule 505 exempts offerings with an aggregate price of up to USD5 million in any 12 month period which can be offered to an unlimited number of accredited investors and up to 35 non-accredited investors;
- Rule 506(b) does not impose any limit on the size of the offering but the securities can only be offered to an unlimited number of accredited investors and up to 35 **sophisticated** non-accredited investors;
- Rule 506(c) again does not impose any limit on the size of the offering but restricts the offering to accredited investors only, non-accredited investors are prohibited from participating in the offering.

When introduced Rule 504 and 505 were intended to assist small business but in practice are rarely used. The most commonly used exemption is Rule 506(b) which is discussed in the following paragraph.

Reg D and the "Big Boys"

Rule 506(b) restricts the offering of securities to sophisticated investors who can "fend for themselves" and do not need all the protections afforded by the Securities Act – these investors are often referred to as "Big Boys". An SEC compliant offering document is not required for a Reg D offering although some information on the issuer and its business is generally provided to investors. This disclosure is on a much more limited basis than that required by the SEC as market practice dictates that investors are responsible for undertaking their own due diligence on the basis that they are buying for an investment with no intention to resell. Investors will provide a "Big Boy" letter to the issuer to address the Rule 10b-5 liability which still applies under Reg D stating that it is a sophisticated investor able to assess the risks involved in the purchase of the securities, has

undertaken its own due diligence and waiving any claim against the issuer for non disclosure of material information.

The European equivalent to Reg D – the Prospectus Directive

The Prospectus Directive (**PD**) regulates securities issuance in the Europe Union. It details the circumstances when a prospectus is required and the contents of that prospectus. Unlike Reg D there is no formal "private placement" exemption but the PD does provide comparable exclusions from its provisions.

Small issuance size exclusion: the PD excludes from its scope entirely securities with a consideration up to EUR 5 million[1] offered in a 12 month period – a carve out similar to the Rule 504 and 505 safe harbours under Reg D. As the small issuance size safe harbour is used infrequently under both the PD and the Reg D regimes it is unlikely to be a significant piece of the private placement jigsaw and will not be discussed further in this briefing.

*Qualified Investor (**QI**) and mini mum denomination exemptions*: offers of securities which are made only to "qualified investors" and offers of securities where the minimum denomination of such securities is Euro 100,000 (or equivalent in other currencies) are exempted from the PD requirement to produce a prospectus. "Qualified Investors" (as defined by reference to MiFID[2]) are essentially professional investors who possess the experience, knowledge and expertise to make their own investment decisions and properly assess the risks incurred. This definition is not the same as the definition of the terms "accredited investor" and "sophisticated non-accredited investor" used in the Reg D safe harbours but conceptually it is broadly equivalent. Utilising either the QI or minimum denomination exemption will have the effect of restricting the offering of securities to sophisticated professional investors, either directly or indirectly by virtue of such investors being QIs or because they are able to purchase securities in such large denominations. Thus the effect is analogous to the Reg D safe harbours and is a recognition by the drafters of the Prospectus Directive that the sophisticated participants in such wholesale markets do not need the protections of the Prospectus Directive.

The PD listing limb – the "kicker" for private placements

However the PD regime, in addition to regulating the disclosure requirements for offers of securities, also applies with respect to securities admitted to trading on a European regulated market (admission to trading is colloquially referred to as being 'listed'). In Europe most debt issuances need to be listed for tax reasons or due to fund requirements, as described below, even if they are not traded on the applicable exchange. Consequently many issuers are obliged to prepare a PD compliant prospectus for securities listed on an European regulated market which, given the

[1] Although member states are free to impose lower national limits and the Commission is currently consulting under PDIII if this threshold should be increased.

[2] Directive 2004/39/EC.

costs and time involved in preparing a prospectus, reduces their ability to tap the markets quickly and cheaply. In addition even issuers of securities listed on an EU non-regulated market will be subject to similar costs and restrictions as the relevant listing authority or exchange will require the preparation of an offering document compliant with its rules, which in many cases will be similar to the PD requirements. Unfortunately then under the current regime the QI and minimum denomination exemptions are not as beneficial to the functioning of a private placement regime as they may first appear.

In significant contrast securities offered in accordance with Reg D are not listed on a stock exchange as they cannot be publicly traded and therefore there are no additional listing requirements that override or overlay the Reg D private placement regime in the United States.

The listing conundrum

Fundamentally the QI and minimum denomination exemptions under the Prospectus Directive regime already provide a legislative basis comparable to the Reg D private placement regime. An issuer can utilise these exemptions to avoid the time and expense in producing a PD compliant prospectus provided that the securities do not need to be listed.

The question then becomes how can an issuer avoid listing its securities that would otherwise fall within the European public offer exemptions? As highlighted earlier in this briefing, it seems to us that a primary reason issuers list privately placed securities is to enable such securities to benefit from favourable tax treatment such as the United Kingdom's "quoted Eurobond exemption".[3] So rather than looking to securities laws to provide a new solution the focus should be on removing the tax requirement to listing which undermines already effective securities laws. In the pre-election Finance Act, the UK Government enacted a new withholding tax exemption for unlisted private placement debt. The details will be set out in Regulations likely to be enacted before the summer, after a consultation process – however in practice the exemption is expected to apply to most private placement debt where the issuer is a corporate and the holder is not resident in a tax haven.[4] We would suggest that similar changes in tax laws at a local level in other European countries should be considered to encourage the development of a private placement market based on existing legislation. The Green Paper already highlights taxation as an area of potential discussion while recognising that further analysis and feedback is needed.

As touched on earlier, unfortunately listing securities on other EU non-regulated markets (such as the PSM or the EuroMTF), and therefore taking them out of the ambit of the PD, which is the current practice in the European High Yield market, does not help very much with this concern. For although favourable tax treatment

[3] As noted above some investors are prohibited from investing in unlisted securities which is also an impetus to list.

[4] For more on this see our briefing "Withholding Tax Exemption – Private Placements".

will be given to securities listed on 'recognised' markets that are not EU regulated markets a listing on such markets will still require an issuer to comply with disclosure rules of such markets or exchanges, often similar to those imposed by the PD (in the case of European High Yield the securities are offered via an offering memorandum which already contains extensive Rule 144a disclosure.

Market self help

Putting to one side the question of tax reform, there are steps market participants themselves could take to develop the private placement market as has been done in the US. These include developing their own ratings system, disclosure standards and terms and conditions as insurance industry did in the US. And, looking again to the US experience, market players could consider adopting a lighter touch to disclosure and diligence requirements and make use of "Big Boy" letters. It may also be possible for the market to do away with disincentives such as restrictive investment criteria which prevent investors investing in unlisted securities.

Finally, it is worth mentioning that slightly different private placement models to those discussed in this briefing have been developed by both the LMA and the ICMA. Both industry bodies have recently published pro forma documentation for private placements. These are market led initiatives designed to encourage growth in those sections of the private placement market without the need for legislative input.

The Green Paper itself recognises that solutions will often by market led and the Commission is explicit that it will support effective market-driven solutions in favour of regulatory changes, except where such regulatory change is necessary.

CLIFFORD CHANCE CONTACTS

John Connolly
Partner, London
T: +44 20 7006 2096
E: john.connolly@
cliffordchance.com

Michael Dakin
Partner, London
T: +44 20 7006 2856
E: michael.dakin@
cliffordchance.com

Fabio Diminich
Partner, London
T: +44 20 7006 1500
E: fabio.diminich@
cliffordchance.com

Claudia Kim
Senior Associate, London
T: +44 20 7006 4992
E: claudia.kim@
cliffordchance.com

Henry Peacock Jr.
US Counsel, London
T: +44 20 7006 4031
E: henry.peacock@
cliffordchance.com

Jessica Walker
Senior Associate PSL, London
T: +44 20 7006 2880
E: jessica.walker@
cliffordchance.com

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*Linda Widyati and Partners in association with Clifford Chance.

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