Looking ahead - the DCM year to come

February 2020

It is a time of change for debt capital markets participants - the UK has left the EU and is beginning the next phase of Brexit, the transition from the IBORs to near risk-free rates gathers pace and there is ever increased market and regulatory interest in green and other ESG bonds.

In this briefing we discuss what is on the DCM legal and regulatory horizon for issuers over the coming year and how best to navigate upcoming MTN programme updates and bond issuances.

Key considerations:

- ***Green and other ESG bonds:*** Interest in green and other ESG bonds both among market participants and regulators increased dramatically during 2019. This will continue to be a key topic for issuers over the coming year. Many issuers are considering now the steps needed to be in a position to issue an ESG bond in the short or medium-term.
- **Brexit:** The UK left the EU on 31 January 2020 and entered into the Implementation Period, which is currently scheduled to last until 31 December 2020. During the Implementation Period, other than some relatively minor documentation changes, Brexit has no legal impact on DCM market participants. It remains important to consider what might happen subsequent to the expiry of the Implementation Period.
- **The transition from the IBORs to near risk-free rates:** The FCA continues to emphasise that LIBOR users should assume that LIBOR will not be available after the end of 2021 and accelerate efforts to ensure they are prepared for its cessation. Issuers therefore need to understand the implications of this transition both for their new issuances and their legacy debt securities that reference LIBOR.
- **The prospectus regime:** Since 21 July 2019, all new prospectuses have been required to comply with the new Prospectus Regulation. Many programme issuers which took advantage of grandfathering pre-21 July 2019 will be brought within its scope when they next update their programmes. We are continuing to advise issuers to anticipate a longer prospectus approval process with more extensive regulator comments, in particular in relation to risk factors.

Green and other ESG bonds

Interest in green and other environment, social and governance (ESG) bonds both among market participants and regulators increased dramatically during 2019. This will continue to be a key topic for issuers over the coming year, within the wider context of questions over the sustainable nature of their businesses and how the private sector should respond to climate change. Many issuers are considering now the steps needed to be in a position to issue an ESG bond in the short or medium-term.

What is the current legal position around disclosure and documentation?

The prospectus regime still does not have a dedicated framework for green and other ESG bonds. Currently, therefore, there are a variety of approaches that issuers take to documenting their 'use of proceeds' for ESG purposes within their prospectuses: some programme issuers opt to include this disclosure within their base prospectus while others opt to include it in their final terms. Provided that an issuer's approach to ESG disclosure meets the broad requirements of the prospectus regime (disclosure that is easily analysable, comprehensive and concise and that gives investors the information necessary to make an investment decision) and there is no potential 'green-washing' concern, our experience is that regulators will take a pragmatic approach.

The ICMA green bond principles cover (i) use of proceeds, (ii) the process for project evaluation and selection, (iii) management of proceeds and (iv) reporting. They do not themselves have the force of law, but are seen as highly persuasive among market participants and many issuers therefore voluntarily comply with them.

Typically, the disclosure on use of proceeds within a prospectus will be supported by an appropriate risk factor. Many issuers also publish their green bond frameworks on their websites, though this will not form part of the prospectus itself. Questions over the appropriate contractual documentation tend to be negotiated from transaction to transaction, though it is worth noting that dedicated ESG representations, covenants and termination events are not currently market standard.

What else is happening in the market?

The ESG bond market is highly innovative and evolving rapidly beyond 'use of proceeds' ESG bonds. For example, during 2019 the Italian energy company, ENEL, issued a sustainable development goal (SDG) bond, with the coupon linked to ENEL's ability to reach certain renewable generation targets. This kind of product differs from a conventional 'use of proceeds' ESG bond and resembles the structures that are common in the green loan market. Unlike a conventional 'use of proceeds' ESG bond, it requires significant changes be made to the bond terms and conditions.

The term 'social bond' refers to bonds the proceeds of which are used to fund projects with positive social outcomes while 'sustainability bonds' are bonds where the proceeds are exclusively applied to finance or re-finance a combination of both green and social projects.

What is the official sector doing?

At the global level, the Financial Stability Board's Taskforce for Climate-related Financial Disclosures (TCFD) has published a set of voluntary recommendations aimed at ensuring that both financial institution and corporate issuers disclose the financial impacts of climate change in their public filings in the areas of governance, strategy, risk management and metrics and targets.

At the EU level, the European Commission's Sustainable Finance Action Plan proposed (i) a taxonomy regulation establishing an EU-wide taxonomy of environmentally sustainable activities to facilitate sustainable investment, (ii) a regulation on disclosures relating to sustainable investments and sustainability risks, introducing disclosure obligations on how institutional investors and asset managers integrate ESG factors into their risk management processes and (iii) a regulation amending the benchmark regulation, creating a new category of benchmarks comprising low-carbon and positive carbon impact benchmarks. The Disclosure Regulation and the Low Carbon Benchmark Regulation entered into force on 29 December 2019 with most provisions of the former applying from 10 March 2021. Political agreement on the Taxonomy Regulation was reached at the end of 2019 and the legislative process is likely to complete shortly.

The UK Government's Green Finance Strategy includes an expectation that all listed companies and large asset owners publish climate-related financial disclosures in line with the TCFD by 2022. Irrespective of Brexit, the UK Government has pledged to at least

match the ambition of the EU's Sustainable Finance Action Plan.

What should we expect from the FCA?

The FCA is due to publish a consultation paper in early 2020 (i) proposing new disclosure rules for certain listed issuers aligned with the TCFD's recommendations on a comply or explain basis (it is currently unclear which issuers this would apply to) and (ii) clarifying existing disclosure obligations relating to climate change risks. The FCA already takes the view that prospectuses should disclose the impact of climate change on a business where this is financially material and will consider whether disclosure on other sustainability factors beyond climate change is adequate. The FCA will also consider how best to enhance climate-related disclosure by regulated financial services firms that fall outside the proposed new rules on certain listed issuers.

What are trading venues doing?

The London Stock Exchange, Euronext Dublin and the Luxembourg Stock Exchange have established dedicated green and other ESG bond capabilities. In October 2019, the London Stock Exchange launched a new Sustainable Bond Market (SBM) with distinct platforms for different classifications of sustainable bonds. Since January 2020, admission of bonds to the SBM is conditional upon submission by the issuer of a SBM declaration and application form including disclosure of mandatory sustainability related documents and an acknowledgement of on-going reporting obligations.

Brexit: the Implementation Period and beyond

Under the Withdrawal Agreement agreed between the EU and UK and the related EU (Withdrawal Agreement) Act implementing it into UK domestic law, the UK left the EU on 31 January 2020 and entered into the Implementation Period, which is currently scheduled to last until 31 December 2020. During the Implementation Period, other than some relatively minor documentation changes, Brexit has no legal impact on DCM market participants. It remains important to consider what might happen subsequent to the expiry of the Implementation Period.

What is the Implementation Period? How long will it last?

The UK will continue to be treated as if it were part of the EU single market during the Implementation Period, with all related rights and obligations and implications for UK domestic law (supremacy of EU law and EU regulations being directly applicable). During the Implementation Period, therefore, other than drafting amendments to reflect the fact that the UK is no longer technically a member of the EU or the EEA, there are no consequences for debt capital markets participants. For example, during the Implementation Period, MAR continues to be directly applicable in the UK and passporting under the Prospectus Regulation between the UK and the EEA continues.

Article 132 of the Withdrawal Agreement provides a mechanism for the EU and the UK to extend the Implementation Period prior to 1 July 2020 for up to two years. As a matter of UK domestic law, under section 15A of the 'European Union (Withdrawal) Act 2018 the UK is prohibited from giving its consent to an extension to the Implementation Period. Were an extension envisaged under the terms of the Withdrawal Agreement, the UK would need to legislate to remove this restriction.

What documentation changes are necessary during the Implementation Period?

ICMA has circulated standard language for selling restrictions and legends relating to the prospectus regime, PRIIPS and product governance that is appropriate for use for documentation that is signed and prospectuses that are published during the Implementation Period. Care should also be taken when referring to the EU and the EEA elsewhere in prospectuses and contractual documentation to include the UK and UK entities if that is the intention.

Many issuers are continuing to include a Brexit-related risk factor within their prospectuses, describing risks that may arise once the Implementation Period expires.

What about after the Implementation Period?

As a matter of politics, it is impossible to predict whether (and, if so, the extent to which) the UK and the EU will agree a new free trade agreement covering financial services that will be in place once the Implementation Period expires. Under the non-binding political declaration that accompanied the Withdrawal Agreement, the UK and the EU are due to assess 'equivalence' with respect to each other's' regulatory regimes and conclude those assessments before the end of June 2020. The consequences of the Implementation Period expiring without there being in place a new free trade agreement covering financial services (or equivalence decisions) between the UK and the EU are broadly the same as would have occurred had the UK exited the EU without a withdrawal agreement (which we covered in our briefing last year). In this scenario under the EU (Withdrawal) Act 2018, EU law and regulation related to financial services will be on-shored into UK domestic law on 31 December 2020, so at least initially the distinct UK and EU regulatory regimes will be very similar.

What should we do now to prepare for this?

Since the referendum we have not observed a pattern of behaviour among DCM market participants (for example, in relation to choice of law and jurisdiction provisions, choice of trading venue, drafting and documentation and location of counterparties) that differs from pre-referendum behaviour and generally we are advising clients to continue in this vein. In any event, bonds being issued now will continue to be legal, valid, binding and enforceable after the expiry of the Implementation Period in the same way that they are now.

It will be important to keep abreast of legal and regulatory developments in this area over the coming months.

The transition from the IBORs to near risk-free rates

The FCA continues to emphasise that LIBOR users should assume that LIBOR will not be available after the end of 2021 and accelerate efforts to ensure they are prepared for its cessation. Work undertaken by market participants on the transition from LIBOR (and other IBORs) to near risk-free rates continues to gather pace. Issuers therefore need to understand the implications of this transition both for their new issuances and their legacy debt securities that reference LIBOR.

New issuances

In relation new GBP-denominated FRNs, the Working Group on Sterling Risk-Free Reference Rates (RFRWG) has recommended that market participants cease new issuances of GBP denominated FRNs linked to LIBOR by the end of Q3 2020. Recent GBP denominated FRN issuance by financial institutions and supranational issuers has been almost exclusively SONIA-based and broadly the technology is becoming increasingly familiar, subject to some technical points of detail, and consolidated around overnight SONIA compounded in arrears, with the 'lag' mechanism (whereby the observation period lags the interest period by five business days) used to provide a window at the end of the interest period for calculating, agreeing and reconciling the SONIA rate, interest amounts and making the actual payment on the due date. It is expected that corporate issuers will follow suit as the year progresses. Documentary fallbacks for SONIA tend to mirror the Bank of England's contingency plan.

There have no new GBP-denominated plain vanilla FRNs linked to LIBOR in recent months, though MTN programmes continue to grant issuers a theoretical ability to issue GBP LIBOR-linked FRNs. The terms and conditions for these include extensive mechanics designed for the demise of LIBOR, including cessation triggers, negative consent provisions and adjustment mechanics aimed at retaining economic equivalence beyond the transition.

New USD-denominated FRNs are increasingly being linked to SOFR. The Alternative Reference Rate Committee (ARRC) has published a user's guide to referencing SOFR and a SOFR FRNs conventions matrix.

There has been a flurry of €STR-linked FRNs even though the ECB appears keen to support the continuation of EURIBOR alongside €STR. It may be the case that market demand for FRNs referencing increases €STR even though EURIBOR continues to be available.

Prospectuses both for RFR FRNs and IBOR FRNs should continue to include appropriate risk factors relating to use of benchmarks.

Existing LIBOR issuances and the 'tough legacy' question

In relation to legacy GBP-denominated FRNs, the RFRWG has recommended that market participants establish a framework for the transition of their legacy LIBOR products, in order to significantly reduce the stock of LIBOR referencing contracts by Q1 2021 and consider how best to address the issue of 'tough legacy' contracts. In January 2020, the RFRWG published a paper discussing the 'lessons learned' from the much-publicised recent consent solicitations transitioning legacy GBP LIBOR FRNs to SONIA. Its 'tough legacy' task force, which is focusing on identifying the categories of LIBOR-linked assets that are likely to be most challenging to transition to RFRs, is aiming to publish a further paper during Q1 2020 which may contain information on further practical solutions. In the interim we are advising issuers at least to ensure that they understand the extent to which their existing bonds include GBP denominated FRNs linked to LIBOR (or that could reset to LIBOR) beyond the end of 2021, and what the consequences would be under the existing terms were it not possible to transition the bond to a RFR before LIBOR ceases. Some bonds (for example, those that were issued after Andrew Bailey's 2017 speech and therefore contain negative consent provisions) may be relatively easier to amend than others. Some issuers may consider redeeming certain of their existing bonds early and re-issuing SONIA-linked FRNs rather than undertaking a consent solicitation exercise.

In relation to legacy USD-denominated FRNs, the ARRC has produced a proposal for New York State legislative relief for legacy USD LIBOR contracts governed by New York law. Market participants are likely to follow this development closely before deciding how to proceed.

The new prospectus regime

Since 21 July 2019, the date that the new EU prospectus regime took full effect, all new prospectuses have been required to comply with the new Prospectus Regulation and its related implementing measures (known together as 'PD3'). Many programme issuers which took advantage of grandfathering pre-21 July 2019 will be brought within the scope of PD3 when they next update their programmes. Our experience of the transition to PD3 is that it has been smoother than some market participants had feared, but we are continuing to advise issuers that are new to PD3 to anticipate a longer prospectus approval process with more extensive regulator comments, in particular in relation to risk factors. See our earlier client briefing for a more detailed discussion of the impact of PD3 on debt issuers.

Documents on display and documents incorporated by reference

A significant difference from PD2 is that issuers are required to include hyperlinks to all documents incorporated by reference, which must remain available on a website, together with the prospectus itself, for at least ten years after initial publication of the prospectus.

There has been some debate over the extent to which transaction documentation should also be made available electronically on an issuer's website. Regrettably the text of PD3 is somewhat ambiguous here, but a consensus has emerged that this includes trust deeds and deeds of guarantee and potentially also agency agreements, but that dealership agreements/subscription agreements do not need to be made available electronically.

Low denomination debt

Despite PD3 reforming the contents and style of summaries, low denomination debt aimed at true retail investors continues to be very unusual, partly because of perceived onerous process and documentation requirements of the MiFID II product governance and the PRIIPs regimes. In relation to FCA-approved true retail debt prospectuses, the FCA no longer imposes super-equivalent obligations in relation to how true retail debt prospectuses should be drafted (previously their guidance required issuers to provide further disclosure on the return on investment and expected prospectuses to be drafted in a different style aimed at true retail debt investors). At the time of writing the take-up of low denomination debt prospectuses aimed at qualified investors for bonds admitted to a 'qualified investor only' segment of a regulated market continues to be muted.

Use of proceeds

Wholesale debt issuers should be mindful of the new obligation to disclose within their prospectuses (or, in relation to drawdowns under programmes, their final terms) 'the use and estimated net amount of the proceeds', rather than the previous requirement to disclose the less extensive 'expenses related to the admission to trading' under PD2.

Risk factors

Issuers and competent authorities continue to grapple with the new risk factor disclosure requirements and in particular how to comply with the ESMA risk factor guidelines. Our experience is that even well prepared issuers can sometimes expect a few rounds of comments from competent authorities on risk factors, sometimes requiring drafting or ordering decisions to be justified and sometimes requiring certain risk factors to be re-written. Issuers should continue to consider carefully the materiality and specificity of their risk factors.

Brexit and the prospectus regime

During the Implementation Period (other than the technical drafting changes discussed earlier) there will be no changes for issuers in relation to the prospectus regime, with FCA approved prospectuses continuing to be required to comply with PD3 and passporting between the UK and the EEA remaining unchanged.

Subsequent to the Implementation Period and in the event that there are no arrangements in place between the UK and the EU to replicate the current regime, the EU prospectus regime will be on-shored into UK domestic law via the EU (Withdrawal) Act 2018 and initially therefore the EU and UK prospectus regimes will be substantively identical. It is likely that during 2020 both the FCA and ESMA will confirm their position in relation to passporting after the expiry of the Implementation Period. Our expectation is that the FCA will grandfather pre-IPCD approved EEA prospectuses but that ESMA will immediately treat pre-IPCD FCA approved prospectuses as third country prospectuses.

The effectiveness of the prospectus regime continues to be debated with some issuers opting to avoid it altogether by issuing high denomination debt admitted to an MTF rather than a regulated market.

Other regulatory developments

The reform of the EU Market Abuse Regime

In October 2019, ESMA published a consultation paper proposing certain changes to the EU market abuse regime. ESMA is not proposing to change the fundamental principles and processes underpinning the market abuse regime, but some of changes may impact DCM market participants, in particular if issuers (and managers acting on their behalf) are required to comply with the market soundings technical standards whenever they conduct a market sounding and not merely in order to benefit from the safe-harbour. We plan to cover this in more detail in an up-coming briefing.

The new European Single Electronic Format

Issuers subject to the Transparency Directive are now required to prepare their annual financial reports for financial years beginning on or after 1 January 2020 in the new European single electronic reporting format (ESEF). Requiring issuers to use the ESEF is designed to bring more uniformity to financial reports and hence to make it easier for investors to analyse and compare them. The ESEF is specified in regulatory technical standards made under the TD which apply directly in the UK. The requirement to use ESEF is expected to lead to a significant change in the way in which annual reports are produced and consumed by the public and is likely to require some additional governance processes for both companies and auditors. Both the European Commission and ESMA have already published guidance to help issuers and their auditors prepare for ESEF, and the FCA, assisted by the FRC, is expected to publish further guidance later this year.

FCA Consultation Paper on disclosure of rights attached to securities

In December 2019 the FCA published a consultation paper in which it proposed that companies within the scope of the UK listing regime will have to ensure that they have filed with the National Storage Mechanism, in respect of each class of their listed securities, an up-to-date document that sets out the rights attached to the securities and how to exercise them, and the limitations on such rights. This is because over the years a small number of companies have proposed to take corporate actions relating to a category of their listed securities that, despite being within the company's rights to take, have caught investors by surprise.

This new obligation will primarily impact those issuers of debt securities with prospectuses published prior to November 2013 (the date that the obligation to file prospectuses with the NSM took effect) and more significantly those issuers of debt securities issued prior to the prospectus regime taking effect in July 2005. Securities issued more recently will typically already be in compliance with the new obligation because the issuer will have already filed a prospectus relating to the securities. Whichever type of document is filed, investors must have access to information that is up-to-date so, if amendments are made to the rights attached to securities after the date a new filing will be required.

If you have any questions on how you will be impacted by any of the topics discussed in this briefing please get in touch with your usual Slaughter and May contact or one of the below.

Contacts

Matthew Tobin
T +44 (0)20 7090 3445
E matthew.tobin@slaughterandmay.com

Eric Phillips
T +44 (0)20 7090 3055
E eric.phillips@slaughterandmay.com

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