# Private placement study on market and regulatory obstacles

*By Katie Kelly*

US private placements, Schuldschein and, more recently, euro private placement in France have developed successfully into credible, functioning private placement markets, and a renewed, pan-European impetus to reduce over-reliance on bank funding, to complement other funding instruments and diversify funding sources has led to the development of private placement markets elsewhere. In line with Capital Markets Union, a pan-European private placement solution should help to mobilise capital and channel it to where it is most needed, deepen financial integration, increase the stability of the financial system and enhance European competitiveness.

With a view to encouraging the development of this market, the European Commission recently commissioned a study on *Identifying Market and Regulatory Obstacles to the Development of Private Placement of Debt in the EU*. Undertaken by Linklaters and Boston Consulting Group (BCG), the study sets out to identify and explore any particular legal, regulatory and market barriers to entry to the private placement market, by reference to the well-functioning American, German and French markets.

Private placements are a complementary alternative to public bond markets, and their advantages are well-documented: they do not subject the issuing company to stringent, ongoing disclosure obligations; they have simpler documentation requirements; and, according to interviews conducted by BCG in the study, most issuers are satisfied with the pricing they receive in the private placement markets. With no minimum issue size (other than in certain jurisdictions for withholding tax purposes), issuers can match immediate funding requirements more precisely, thereby limiting the cost of negative carry. No external rating is required, which is especially attractive for small-mid-sized companies which do not necessarily want to go to the expense of obtaining and maintaining a rating. For investors, it leads to portfolio diversification, and an opportunity to build up a relationship with the issuer. Relatively long maturities (compared to public bonds) suit investors' long-term liabilities, and the fact that private placements are mainly buy-to-hold investments means that there is no mark-to-market valuation for accounting purposes, while the resulting illiquidity premium leads to attractive yields and spreads.

Fortuitously therefore, the study identifies no new insurmountable legal, regulatory or market barriers to entry, with those which were unearthed having already been highlighted by the ICMA-led Euro Corporate Debt Private Placement Joint Committee (ECPP JC). The key message from participants in the study is that they are generally content with the current regulatory environment under which private placements operate and that, to the extent possible, they would like to limit any further regulatory interventions affecting this market.

However, issues which *have been* identified include a lack of capacity to conduct in-house analysis and monitor credit worthiness on an ongoing basis, which coupled with a lack of information on target issuers can lead to potentially high costs when deploying additional efforts to conduct credit analysis in these circumstances. A potential solution to this conundrum may be in the form of a back-up independent third-party opinion on the credit quality of the issuer (such as that provided by FIBEN (*Fichier bancaire des entreprises*, the Banque de France's credit registry)), a course of action which is proposed by the study.

The risk charges reflecting market volatility in the capital requirements for private placements determined under Solvency II remain an issue for insurance investors, although not a particularly significant one. ICMA on behalf of the ECPP JC has previously stressed that, as private

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placements generally suit a buy-to-hold strategy, the correct metric for Solvency II capital requirements should be default risk (which is very low) rather than market volatility. Coupled with this, however, is the aforementioned issue of credit analysis, which is particularly pertinent for insurance investors who are subject to Solvency II and who have to identify, measure, monitor and report the risk associated with private placement transactions.

A further concern for market participants is whether the market soundings regime under the Market Abuse Regulation (MAR) is applicable to private placements in bond format. A Commission-led consultation on *Building a Proportionate Regulatory Environment to Support SME Listing* in February 2018 touched upon this point, as to which ICMA responded to the effect that discussions between an issuer and investors take place with a view to establishing that an investor is interested in a proposed transaction, after which any further communications are not for the purposes of *gauging interest* (as is required by the relevant provision in MAR), but rather for the purpose of executing the transaction, and therefore that the soundings regime does not apply to private placements.

For the target issuers, these discussions may be the only available channel to access investors, as to which ICMA does not consider that the spirit of the soundings regime is intended to apply. Of course, for larger, public issuers, the soundings regime can be used as a means to minimise leveraging investors in order to maximise the transaction itself in terms of, for instance, pricing, size and tenor. Were the soundings regime to be applicable to private placements however, the consequences (intended or otherwise) could prove to be a significant detrimental factor for the development of the private placement market due to the obligations imposed on the persons receiving market soundings, which could disincentivise investors and set European private placements at a disadvantage.

Looking forward, the study identifies a number of innovations in the private placement space, such as in product offerings, including private placement funds and green private placements. There have been developments in private placement platforms, which enable users to access, among other things: automated search, filter and match options; automated calculations; anonymous sharing and collection of information; online negotiation of deal terms and online access to termsheets and standardised documentation. Some platforms also offer support with the issuance process, professional risk analysis and comparison of borrowing curves with peers. A further innovation is the use of blockchain, with Daimler AG and Telefonica Deutschland Holding AG recently having successfully used blockchain technology for Schuldschein transactions. Blockchain has great potential to simplify and increase efficiency in financial services, although according to the European Commission's FinTech Action Plan, there remains a lack of certainty and guidance on how to use it, as well as fragmentation and a lack of common approaches between national regulators and supervisors; something which the FinTech Action Plan aims to address.

Finally, the study has identified significant growth potential for private placement in a number of markets, including Austria, Belgium, Denmark, Italy, Ireland, the Netherlands, Poland, Spain, Sweden and the UK. While resolution of the issues set out above or technological advancements could collectively help to develop the private placement market, a more fundamental issue has been identified by the study, being that information and education campaigns should be launched to increase the awareness of private placements among potential issuers and investors and support further market participation across Europe.

**Contact: Katie Kelly**
katie.kelly@icmagroup.org

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