THE EU PROSPECTUS DIRECTIVE

CONCERNS FOR ISSUERS OF WHOLESALE SECURITIES

Executive Summary

The replacement Prospectus Directive is close to being finalised. The Directive will completely overhaul the law in the EU applicable to securities offerings. It aims to facilitate pan-European securities offerings, but unless changes are made it will significantly increase the costs of preparing prospectuses and is likely to result in the virtual closure of several segments of the securities markets. It will significantly impact the wholesale markets which have been subject to an appropriately modified regime in the past which has worked efficiently and has provided investors with an appropriate level of protection. These changes are expected to come into force within 2004; however, the timetable for influencing the regulations is very short and action must be taken immediately if potential problems are to be resolved.

The detailed disclosure requirements for a prospectus will be set out in separate "building blocks" for different types of issue and for different types of issuer. The comment period for many of these building blocks has officially closed due to an unreasonably short timetable – this in turn leading to an unsatisfactory consultation process. However, the Commission has extended the period for certain types of securities: in particular, wholesale markets and programmes, where comments are required by 31 March 2003.

Key problems with the disclosure requirements are:

- they are far too detailed and prescriptive, so that particular types of issue or issues for unusual issuers may prove impractical;
- considerable information is required which is not important to investors and would be onerous to produce: in particular, there has been insufficient differentiation of the requirements for wholesale offerings;
- non-EU issuers, which make up a major part of the market, are not accommodated and many are likely to be unwilling to offer securities in the EU under the proposals: there is no provision for non-EU governments, agencies and authorities, e.g. Freddie Mac, Province of Ontario;
- the building blocks for derivative and asset backed issues are inappropriate for many existing types of such issues and may not accommodate new types of transaction;
- a different approach to disclosure requirements for covered warrants and for wholesale depositary receipt issues and convertibles is required if these markets are to continue as at present;
- it is likely that national regulators and stock exchanges will have insufficient discretion to waive or vary unnecessarily onerous provisions; and
- confusion will occur if there is no clear map of how to apply the building blocks.

Comment by senior industry executives directly carries much greater weight than comment from trade associations alone. This is a crucial time for senior executives of issuers, investors and other market participants to draw attention to the defects in the approach to disclosure, the defects in the building blocks and the remaining defects in the Prospectus Directive itself.

Background

As part of the Financial Services Action Plan, the European Union is currently rewriting its rules for admission of securities to its regulated markets ("listing"). Three related Directives are intended to change the basis on which listing is granted and on which issuers are required to make disclosure to the market. These are the Prospectus Directive ("PD"), the Transparency Obligations Directive ("TOD") and the Market Abuse Directive ("MAD"). The MAD has already been adopted and negotiations are ongoing for the PD and the TOD. The Committee of European Securities Regulators ("CESR") is now working on detailed second-level proposals to flesh out the PD and the MAD. Their proposals will be used by the European Commission as the basis for the final detailed rules, with or without amendment.

The existing regime in the EU contains considerable discretion for the listing authority selected by the issuer to waive or adapt disclosure requirements, where they are inappropriate for a particular issuer or type of issue. This is especially so in the case of securities sold to professional investors. The proposed new regime will contain considerable detail and will have much less flexibility, because the listing authorities will only have limited ability to waive the content/disclosure requirements.

Non-EU issuers are put in a particularly difficult position. In many important areas they are required to make disclosure and otherwise organise their affairs in the same way as EU companies.

Wholesale issues, that is issues with a minimum denomination of €50,000, will be confronted by significant new barriers. To overcome exchange rate fluctuations, the €50,000 threshold will probably be $100,000 for dollar-denominated issues. Where an issue falls below this threshold, it will be subject to the retail-based disclosure regime being proposed by CESR. This note focuses on issues in relation to wholesale debt; similar (but greater) concerns apply to equity and retail offerings, in relation to which CESR is proposing much more extensive disclosure requirements.

Initial disclosure regime

CESR's detailed proposals for the PD contain provisions that **many issuers of wholesale securities will find difficult and expensive to comply with**. See the Annex to this paper for a list of problem areas, some key examples of which are:

- Issuers will have to provide detail on **present and future capital expenditure and investments, and funding**. This will be expensive.
- Issuers will have to detail **directors' conflicts of interest**. This could be a major burden particularly for non-EU issuers.
- **Accounting principles.** The PD requires accounting principles for use in the prospectus "determined according to international accounting standards". CESR's proposals require the accounts to provide a "true and fair view". For non-EU issuers that prepare their accounts on some other system of accounting principles, restating or reconciling them according to international GAAP will be a costly exercise. The current EU regime permits the use of the issuer's home accounting principles.
- **Audit standards.** The PD says that the international *audit* standards must be used - CESR talks of a "comprehensive body of auditing standards". This will be even more costly for many issuers, requiring them to change their financial reporting systems. The current regime permits the issuer's home audit standards to be used.
- **Material contracts**. All material contracts, other than those entered into in the ordinary course of business, will have to be summarised in the prospectus and put on public display. Under the current regime for wholesale debt, only the contracts relating directly to the issue (such as the subscription agreement) have to be described and displayed. The

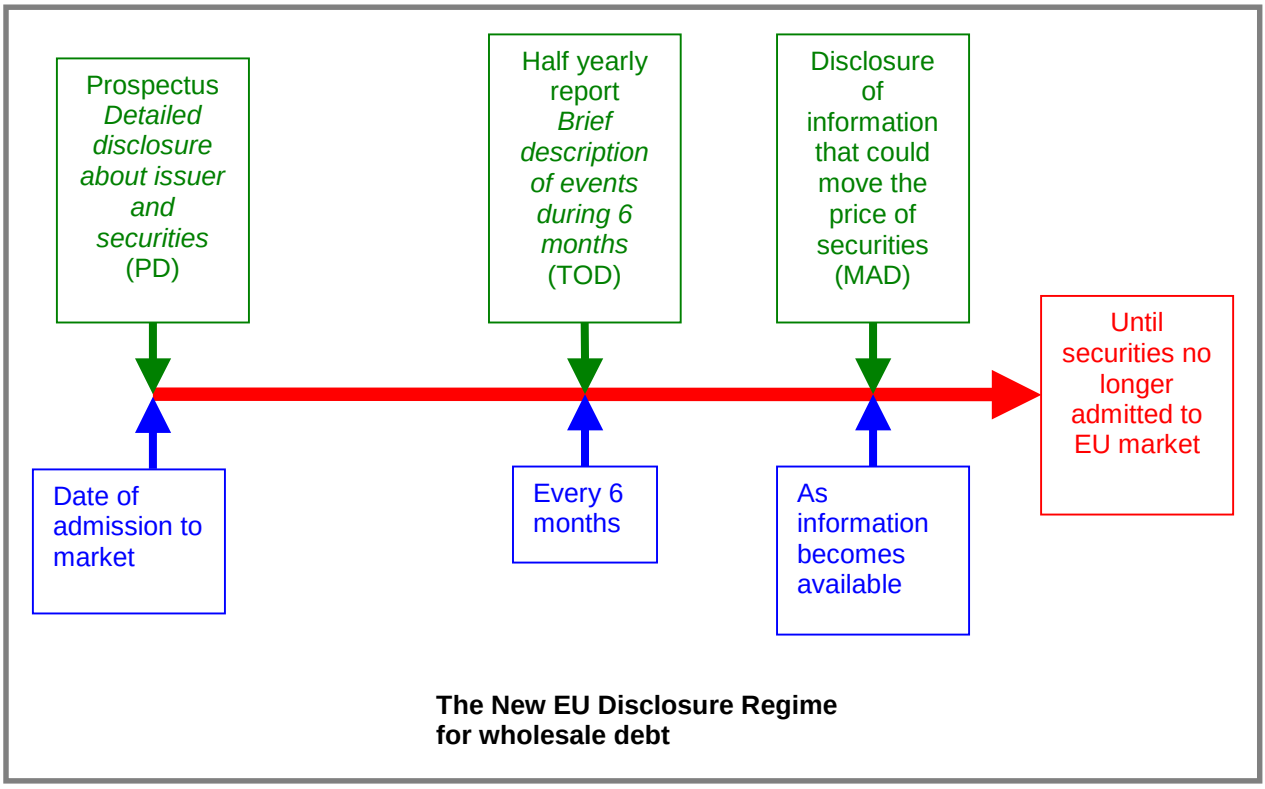
new regime will be much more costly and unnecessarily intrusive for EU and non-EU issuers alike (particularly if the contracts are not in the language of the prospectus and if they have to be translated).

The building blocks for **derivative and asset backed issues** are inappropriate for many existing types of such issues and may not accommodate new types of transaction. The asset-backed issues proposals focus only on mortgage-backed issues. They do not reflect the wide range of issues in this market sector and risk stifling new and innovative issues. The proposals in relation to derivatives make an artificial distinction between guaranteed and non-guaranteed issues, rather than focussing on the actual information requirements which investors need.

Continuing disclosure regime

Significant changes are being proposed that will make it much more difficult and expensive to list in the EU. Some key examples are as follows:

- Under the MAD, the issuer will have to disclose any information that could have a **significant effect on the price of its securities**. The disclosure has to be made as soon as the information comes into its possession.
- **Half-yearly report:** The TOD is likely to require a half-yearly report by the issuer and mandate the level of information required (which may be extensive). Again, liability under EU law is likely to attach to this report. This will be expensive to produce for those issuers not already producing half-yearly reports, and/or to the standard that may be required. Again, this prejudices particularly non-EU issuers. The TOD is likely to require quarterly reports by issuers of equity securities.
- **Annual update:** under the PD, the issuer of securities other than debt with denominations of €50,000 or more will have to produce, every year, a list of the information which it has produced during the year, whether in the EU or elsewhere, in compliance with any laws or rules dealing with the regulation of securities. This will potentially cause **EU legal liability** to attach to that information, which may be of concern to non-EU issuers, who will no longer be able to have regard only to their own local standards when they file information with their home authorities.



The New EU Disclosure Regime for wholesale debt

Does it matter?

The short answer is – Yes: the market will be severely disrupted. The proposed disclosure regime is likely to produce rules

. . . that are inflexible . . .

The more detailed the rules are at the EU level, the more likely it is that an issuer or an issue will find it difficult to fit precisely within them. If an issuer cannot comply, there is very little discretion given to the national authorities to waive or modify the requirements. **If you don't fit, you can't do your issue**.

. . . over-protective of the wholesale investor . . .

Even in the context of wholesale markets, the new draft rules often set up quality controls rather than requiring simple disclosure. A wholesale regime ought to permit wholesale investors to take their own risks, provided they have had those risks properly explained to them. A number of the detailed disclosure requirements act as **barriers to entry to the markets** – if you can't make the required disclosure, you can't be admitted to the market. Examples of this are given in the Annex .

. . . and leave some issuers out . . .

Some issuers simply are not covered by the disclosure requirements. For example, non-EU sovereign issuers are required by the Directive to produce a prospectus, and clearly cannot produce the same sort of information as a typical corporate issuer. But there is no regime setting out what disclosure they should make.

. . . with the result that many issuers may no longer wish to issue in EU markets . . .

The more difficult and expensive the disclosure requirements are, **the less likely it is that issuers will wish to access the EU markets**. Over 50 per cent of the issuers in the wholesale international debt markets are non-EU entities. Some of these (and perhaps some EU issuers) may decide that a more attractive option is to access other markets (perhaps the US markets). Others will decide to raise funding from commercial banks privately, or issue non-listed securities, rather than issue listed securities.

. . . or to maintain their listing of existing issues . . .

The continuing disclosure regime is also likely to be onerous and expensive. This may lead issuers who already have their securities admitted to EU markets to **delist**. If they did so, many EU institutional investors might well find it difficult to continue to hold their securities as they are often subject to regulatory or other limits restricting their investment in non-EU or unlisted securities.

. . . leading to market volatility and a contraction of the market . . .

If EU institutional investors have to sell on a significant scale thanks to cancellation of EU listings, effects would include market disruption and unpredictable changes in asset values. This, together with an eventual reduction in market size by up to 50per cent if non-EU issuers are driven from the market, will be detrimental to both investors and issuers (both EU and non-EU).

Everyone will suffer from such a result. Non-EU issuers will have lost access to the world's most efficient international market. EU issuers will have lost the economies of scale and liquidity afforded by a large market. Investors will have lost the protection of an EU listing; and some of them may have lost the ability to diversify into non-EU issuers' securities, because regulation or other requirements prevent them from buying non-EU listed securities.

What can you do about it?

- Lobby home governments
- Lobby the European Commission

  Non-EU issuers in particular should make it clear to the Commission that they will leave the EU market if the proposed changes go ahead.

- Lobby CESR.

Please contact Cliff Dammers or Helen Style at IPMA (+44 (0) 207 623 9353 / afergusson@ipma.org.uk) should you need contact details of people to lobby in these organisations.

It is of vital importance to mobilise as much support as possible and subject as many parties as possible to lobbying pressure in order to raise the profile of this issue and get it the attention it needs. This must be done now before the proposals are finalised and the law changed. The MAD is already finalised but lobbyists can still influence the PD and the TOD, as well as the detailed second-level rules which CESR is preparing on the PD. CESR will make its first report on the PD rules to the European Commission by the end of June this year. It is imperative that any concerns are voiced as soon as possible.

Annex

Disclosure problems for issuers under the Prospectus Directive

The following table illustrates some of the main problems facing issuers of wholesale securities. If the denomination of the security is instead below €50,000 (or possibly $100,000) then more detailed disclosure will be required. The two final columns indicate which issues affect EU issuers and which affect non-EU issuers. EU entities should note, however, that they may be in the same position as non-EU issuers where they have a non-EU entity in their group that wishes to issue. The fact that the EU entity is prepared to act as guarantor will not alter the situation.

CESR proposal reference	Summary of proposal	Reasons why it is likely to deter issuers	Problem for EU issuers?	Problem for Non EU issuers?
Annex 1, paragraph III.B.1	**Principal future investments** Information concerning the issuer's principal future investments, with the exception of interests to be acquired in other undertakings, on which management bodies have already made firm commitments.	Expensive to collate information and generally less relevant to investors in wholesale securities	Yes	Yes
Annex 1, paragraph IV.A	**Capital expenditure** Information regarding issuer's material commitments for capital expenditures as of the end of last financial year or half year, general purpose of expenditure and sources of funds to fulfil commitments.	Expensive to collate information and generally less relevant to investors in wholesale securities	Yes	Yes
Annex 1, paragraph IV.B.2	**Prospects** Information on the issuer's prospects for the current financial year.	If construed as a profit forecast, would need accountant's report, leading to timing and cost concerns.	Yes	Yes

Annex 1, paragraph V.B	**Conflicts of interest** Potential conflicts of interests between any directors' duties to the issuer and their private interests or other duties must be stated. Negative statement required if none.	Non-EU issuers should not be subject to EU corporate governance requirements. But this requirement potentially makes them subject to EU concepts of conflicts (if what is a "conflict" is judged by EU standards). Collation of this information will be time consuming and costly. Information is less relevant to wholesale investors, who will have an understanding of business practices in other parts of the world.	Yes, because of cost of collating the information. Possibly also because there is no common understanding across the EU as to what "conflict" means.	Yes
Annex 1, paragraph V.C	**Corporate Governance** Details of issuer's audit committee and remuneration committee, including names of members of committees and terms of reference under which they operate.	These disclosure requirements assume that all issuers have audit and remuneration committees. They could be interpreted as imposing a requirement to have such committees (rather than simply disclosing their absence) thus acting as a barrier to admission for issuers that do not have them.	Yes, because of cost and time taken to compile information not relevant to wholesale investors in non-equity securities	Yes
Annex 1, paragraph VI	**Ownership and control** To the extent known to the issuer, state whether issuer is owned or controlled directly or indirectly by another person. If so, give names of such persons and describe nature of such control, including amount and proportion of votes held.	It will often be difficult, if not impossible, to obtain information as to shareholdings, particularly for non-EU issuers, which are not all subject to extensive shareholding registration requirements under local law. Although the requirement is limited to information "known to the issuer", this will not help much, because there will be an assumption that the issuer should make reasonable enquiries. These will be expensive. There will also be considerable uncertainty about what is meant by "control" and "direct or *indirect"*. Cost of preparing this information will not normally bear any relation to the benefit to investors in debt securities, for whom in the majority of cases the identity of shareholders will not be material.	Yes	Yes
Annex 1, paragraph VI.B	**Related Party Transactions** Information for last two years as to transaction or loans between the issuer and: • Persons directly or indirectly controlling the issuer • Persons under common control with	Many non-EU issuers will have a different concept of related party transactions to that operating in the EU. Preparing this information to an EU standard would be time consuming and costly. It would also be unnecessary, because wholesale investors are generally aware of how related party transactions are dealt with in non-EU countries. Disclosure should only therefore be required in general terms. Specific disclosure would normally be	Yes, because even though required to be disclosed under IAS, the disclosure must be updated to the date of issue.	Yes

	the issuer • Major shareholders and their "close" family or entities substantially owned by any of them • Key management and their "close" family or entities substantially owned by any of them.	general terms. Specific disclosure would normally be unnecessary and costly to make.		
Annex 1, paragraph VII.A	**Format of Financial Statements** Apart from balance sheet and profit and loss accounts, these must contain cash flow statements, a statement of changes in equity, details of accounting policies and a set of notes to the financial statements.	It is not necessary to specify the financial documents to be disclosed. Issuers should be able to disclose their accounts whatever form they are in as investors in wholesale debt are able to understand accounts and take investment decisions on the basis of the quality of the accounts they see. Not all non-EU issuers produce all of the items listed here (e.g. a cash flow statement). To require them to do so would add considerably to the expense of admission to EU markets.	No, once IAS has been in operation across EU for two years	Yes
Annex 1, paragraph VII.B	**Notes to the accounts** Notes for the two year period covered by the accounts in the prospectus must be included	Notes to the accounts will usually only be prepared for each specific year. To produce notes in a consolidated format to cover two years will be expensive.	Yes	Yes
Annex 1, paragraph VII.C	**Audit standards** The accounts must be audited in accordance with a "comprehensive body of auditing standards". This will probably be interpreted in conjunction with the Directive, which indicates that international auditing standards will be required	There should be no mandatory requirement as to the standard of account preparation. An issuer should be able to disclose the basis on which the accounts have been made and the professional investor can then make an investment decision on the basis of this information. Many non-EU issuers do not audit to this standard – and wholesale investors are well aware of this when they assess investment risk. Redoing the audit would be prohibitively expensive – and may be impossible, if the audit papers are not suitable.	No, once IAS is introduced across the EU and has been in operation for two years	Yes
Annex 1, paragraph VII.E	**Accounting principles** Accounts be drawn up to "true and fair" view standard as mandated by EU accounting	This is prejudicial to those countries which do not draw up their accounts in accordance with IAS. The application of this provision will involve difficult questions of interpretation and is unlikely to be useful in practice. Any	No, once IAS is introduced across the EU and has been in operation for two	Yes

	Directives. For non-EU issuers an "equivalent" standard "may" be sufficient	restatement of the accounts or reconciliation exercise will be very costly for issuers. Instead, the issuer should be able to disclose the state of the accounts and the professional investor can then make an investment decision on the basis of this information.	years	
Annex 1, VIII.A and C	**Display of material contracts** A material contract is any contract that is not entered into in the ordinary course of business but that could result in the issuer or any member of its group being under an obligation or entitlement that is material to the issuer's ability to meet its obligations to its security holders. Such contracts must be summarised in the prospectus and put on public display	Many non-EU issuers' material contracts will be in a language other than that of the Prospectus. It is likely that they would be required to be translated, before they are displayed. This would be prohibitively expensive. Also, many such contracts contain commercially sensitive information. Obtaining permission to omit such information from any copy put on display will be time consuming and expensive. Investors do not need to see the contracts – a summary should be sufficient.	Perhaps, when contract is not in language of prospectus. Yes, in relation to commercially sensitive information	Yes