Simmons & Simmons

CMU: Proposed Amendments to the Prospectus Directive (PD3) – Legislative Proposals

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Following the publication by the European Commission on 30 November 2015 of legislative proposals to modernise the Prospectus Directive (PD), this article looks in detail at the proposed changes and assesses the potential impact of PD3 on issuers and market participants, with a particular focus on the Eurobond market.

Background

- In 2014, European Commission President Juncker kicked off the process of building a genuine EU Capital Markets Union (CMU) with a view to creating deeper, stronger and better capital markets in Europe to support jobs and growth.
- As part of this, a consultation on the review of the PD[1] was carried out in the first half of 2015.
- On 30 September 2015 the Commission's CMU Action Plan was published, which stated that a formal proposal to modernise the PD would be published in November 2015. The Commission's stated intent in this regard is (among other things) to "*make it less costly for businesses to raise funds publicly*" and to "*review regulatory barriers to small firms listing on equity and debt markets*".
- A leaked draft of the legislative proposals prepared by the Expert Group of the European Securities Committee has been in circulation since September; however, the formal proposal was not published until 30 November 2015.
- In many respects the Commission's proposal represents a significant overhaul to the existing PD regime.

Summary of Key Changes

- Abolition of EUR 100,000 exemption – one of the key proposals affecting debt securities is to remove the automatic exemption from the requirement for a prospectus for public offers where securities are issued with a denomination of at least EUR 100,000, and the accompanying removal of the different disclosure regime for low- and high-denomination securities (thereby removing the clear, but arbitrary, distinction between so-called "wholesale" and "retail" debt securities). As a result, the same disclosure requirements will apply to all non-equity securities. The Commission has suggested that the disclosure requirements will be based on the existing wholesale disclosure annexes (Annexes IX and XIII), with the addition of "*only the information items necessary for retail investor protection*" – though clearly what this means in practice (which will only be known once delegated acts are published in due course) will be key.
- Changes to form and content of summaries – one of the major changes brought about by the Prospectus Directive Amending Directive[2] in 2012 (PD2) was to the form and content of prospectus summaries. The PD3 proposals require summaries to be in a shorter, clearer and more user-friendly format. They also provide that where a "key information document" is required to be prepared for purposes of an offering of securities to retail investors (under the PRIIPs Regulation regime), parts of the key information document may be replicated in the prospectus summary – this will be particularly relevant (and helpful) in the case of retail structured products.

  Encouragingly, there will no longer be a requirement for a base prospectus summary (for EMTN programmes), though there will instead be a requirement for an issue-specific summary for every PD-compliant issuance – which will not be welcomed by issuers accustomed to the existing wholesale regime who may prefer to avoid this requirement by listing on a MTF instead of a regulated

[1] Directive 2003/71/EC, as amended by Directive 2010/73/EU
[2] Directive 2010/73/EU

market. Furthermore, the prescribed limits on the length of summaries in particular – proposed to be a maximum of 6 pages – may be problematic given the level of information required to be included.

- Risk Factors – the new rules will require risk factors to be more precise and tailored to the issuer and specific securities. They must be limited to risks that are "material for taking investment decisions". They will also need to be categorised as "high-risk", "medium-risk" or "low-risk". This should be helpful for investors, though it is likely to provide certain challenges for issuers who may consider (with some justification) that they are being asked to take a quantitative decision on future events that may never happen, in what is often a shifting landscape.
- Universal Registration Document – for European Economic Area (EEA) incorporated issuers, a new form of issuer disclosure document called a "Universal Registration Document" will be available. This is designed to reduce the administrative burden for issuers who regularly access the capital markets. However, it looks likely that this will benefit only the most regular issuers, such as financial institutions and certain of the largest corporates.
- Incorporation by Reference - the scope of information that may be incorporated by reference will be expanded to include information published under Transparency Directive requirements[3], and will specifically include annual and interim financial information, audit reports and financial statements and constitutive documents of the issuer.
- Proportionate Disclosure Regime for SMEs – the Commission has proposed a specific new minimum disclosure regime for SMEs offering vanilla securities to the public, provided the SME has no securities admitted to trading on a regulated market. This is very much consistent with the aims of CMU.
- Proportionate Disclosure Regime for Secondary Issuances - the Commission has proposed a revised and extended minimum disclosure regime for secondary issuances to replace the little used proportionate disclosure regime for pre-emptive offers.

It is worth noting that one change that had originally been mooted involved changing the definition of "home Member State" to mean, for European incorporated issuers, the Member State where the issuer has its registered office. However, this change has been dropped in the latest proposals.

As is so often the case, the devil is in the detail and while these are the headline features of the new proposals, there are a number of points of detail included in the proposal which may have a significant impact on other areas of the market.

Detailed Review of the Proposals

1. Scope of PD

The basic triggers for publication of an approved prospectus are unchanged, namely: (i) an offer of securities to the public in the EEA; and (ii) admission to trading on an EEA regulated market.

In its consultation earlier in 2015, the Commission did consider expanding the scope of the PD to multilateral trading facilities (MTFs). The fact that this has not been included in the latest proposals is welcome as MTFs provide useful flexibility for issuers, particularly in the context of the issuance of debt securities that are not targeted at retail investors and issuance where a more flexible regime (such as that adopted by the Irish Stock Exchange for subsidiary guarantors) can be very beneficial.

2. Format of Legislation

The changes to the PD are being enacted by way of a Regulation (which has direct effect) rather than a Directive (which requires individual Member States to enact implementing legislation). This is helpful in achieving the goal of maximum harmonisation in the EEA as experience has shown that direct effect avoids anomalies in implementation across Member States. However, the draft Regulation does still leave some room for Member States to exercise discretion and apply their own rules, though only in certain limited situations – one such example being that individual Member States may set their own limit below which no prospectus is required for public offers made in that individual Member State only in a 12-month period, provided that it is between EUR 500,000 and EUR 10m. The current equivalent exemption is well-used by SMEs, so allowing individual Member States to limit this would appear to be somewhat at odds with the stated aim of CMU.

3. EUR 100k exemption abolished

One of the biggest changes brought about by the implementation of the PD in 2005 was to introduce a formal distinction between wholesale and retail securities, illustrated most starkly by the EUR 50,000 minimum denomination public offer exemption (subsequently increased to EUR 100,000 by PD2) and accompanying more limited wholesale disclosure regime. By scrapping this, the Commission's intention is to increase the scope of products available to retail investors while also increasing liquidity in the secondary bond market. The market will, however, have to adjust to ensure that systems are in place so as to be confident that another prospectus exemption is

[3] "regulated information" as defined in Article 2(1)(k) of Directive 2004/109/EC

available as they have got comfortable relying on the EUR 100,000 exemption. It is likely that for issuers of what is now regarded as "wholesale" debt two key exemptions will be relied upon: (i) offering to qualified investors only, and (ii) issuing to investors whose minimum subscription amount is EUR 100,000. The second of these in particular may be challenging to implement, and it is unlikely to be something that is readily policed (e.g. by the clearing systems).

One of the key questions that is not currently dealt with fully is the level of disclosure that will apply to debt securities. In recent years, the distinction between the scope and presentation of disclosure for retail versus wholesale debt has become especially pronounced, with competent authorities focusing in the retail space on the requirement that prospectuses should be "easily analysable and comprehensible"[4]. While this is a laudable notion in the context of pure retail debt, and arguably this is the inevitable direction of travel for disclosure more generally (in the same way that "plain English" disclosure is now the standard in certain jurisdictions, particularly the US), no purpose would be served by requiring particularly "retail-friendly" disclosure for wholesale debt issues, particularly where the sole purpose of the prospectus is to obtain a technical regulated market listing. While the introduction to the proposals suggests that the existing wholesale regime will be the bedrock for the new regime, it awaits to be seen exactly what will be required in terms of disclosure particularly when one considers the tension between the CMU's aim of widening retail investment in bond issues with the consumer protection role of regulators (as evidenced recently in the ban on the distribution of contingent convertible securities (CoCos) to retail investors).

4. Summaries

One of the most contentious aspects of the implementation of PD2 in 2012 was the introduction of over-rigid and very formulaic prospectus summaries. These have been particularly problematic in the context of retail structured products, where it has been particularly challenging to condense complex concepts into the prescribed summary format. In the context of EMTN programmes, the requirement imposed by some competent authorities for a base prospectus summary which includes in it options for an issue-specific summary has made summaries particularly unwieldy, and it is clear that the current prescribed format is not helpful for anyone, least of all retail investors (at whom summaries are primarily aimed).

The proposed format follows a Q&A style approach, and limits the length of the summary to 6 pages. The Regulation prescribes in some detail the content of summaries, which will be required to be split into four key sections. On the plus side, a summary will only be required for individual issuance[5] and is to be annexed to the related Final Terms, though it is likely that as a practical matter a template form of summary would be included in base prospectuses. The shorter regime for summaries, and removal of the requirement for a summary for base prospectuses for EMTN programmes, should facilitate the preparation of base prospectuses, and should alleviate concerns around condensing a large amount of detailed information contained in base prospectuses (particularly for financial institution issuers) into a short summary document. Some aspects of the new regime may be contentious, however – for example, it is proposed that the risk factors relating to each of the issuer and the securities in a summary be limited to five each.

There is also a potential concern for issuers as to whether a 6-page summary can satisfy – in particular in the case of complex securities issued by complex entities, such as financial institutions - the requirement in Article 7(1) of the proposed Regulation to provide "*the key information that investors need in order to understand the nature and the risks of the issuer, the guarantor and the securities that are being offered or admitted to trading on a regulated market, and that, when read together with the other parts of the prospectus, aids investors when considering whether to invest in such securities.*"

In recognition of the interplay between the PD and the PRIPS regime (which, among other things, requires the preparation of a "Key Information Document" (KID) for securities caught by the regime (principally retail structured products)), it is proposed that parts of the KID may be replicated in the prospectus summary. This is a welcome development for that area of the market.

5. Risk Factors

Perhaps in response to the perception that risk factors in prospectuses have become primarily a risk management tool for issuers, with the benefit for investors being a secondary concern (it is not uncommon to see a significant number of very generic risk factors in EMTN programme documentation), the draft Regulation proposes a more prescribed regime for risk factors. In particular, it is proposed to limit the risk factors to "*risks which are specific to the situation of the issuer and/or the securities and are material for taking investment decisions*". Furthermore, it is proposed that risk factors be grouped into 3 categories: 'high-risk', 'medium-risk' and 'low-risk', according to their materiality.

The proposed regime may result in challenges for issuers in terms of determining the risks that merit inclusion in the risk factors section of a prospectus, as well as the categorisation of the risks, but the proposals are consistent with the aims of CMU, not least the extension of the capital markets to more retail investors. There may also be a tension between other risk disclosures made by issuers (for example in

[4] Article 5.1 of the PD
[5] Article 8.7 of the proposed Regulation

their annual reports) and the limitations imposed by the proposed new regime. This in itself reflects the underlying tension between the goal of reducing barriers to capital markets issuance for issuers, and making prospectuses more user-friendly while ensuring investor protection. Issuers who find themselves having to make quantitative judgements on the risks related to their company, while knowing that ultimately they will be judged with the benefit of hindsight, might take some time to adjust to the new regime.

As mentioned above (see "Summaries"), prospectus summaries are limited to five risk factors on each of the issuer and the securities.

6. Universal Registration Document and "Frequent Issuers"

A significant change that has been proposed in the draft Regulation, and which should benefit regular issuers having a registered office in an EEA Member State, is the introduction of the concept of a "Universal Registration Document". This would be available for issuers who have securities admitted to trading either on a regulated market or on a MTF, and would contain information on the issuer's organisation, business, financial position, earnings and prospects, governance and shareholding structure.

The main benefit of having a Universal Registration Document is that after an issuer has had the Universal Registration Document approved by the relevant competent authority in its Home Member State for three consecutive years, subsequent Universal Registration Documents can be filed without requiring approval – though the competent authority will still have the ability to review the document and require amendments to be made (i.e. an "after the event" review). Issuers who fall within this category are referred to as "frequent issuers". The review process for a Universal Registration Document for a "frequent issuer" is stated as 5 working days, which is significantly shorter than for other prospectuses (see "Prescribed Review Timing" below). In order to retain the status (and benefits) of a "frequent issuer", a new Universal Registration Document will have to be filed each year and the issuer will have to comply with the relevant requirements to publish "regulated information" under the Transparency Directive and the Market Abuse Regulation.

Once an issuer has in place a Universal Registration Document (or any other registration document), then it will only need to draw up a securities note and summary note when conducting public offers or applying for the admission of securities to trading on a regulated market. These documents (which together constitute a prospectus) will require separate approval – though it is also worth highlighting that a Universal Registration Document will also be reviewed at the time of any issuance. Notably, if an issuer has in place an approved registration document (including a Universal Registration Document) and then prepares a securities note and summary note, it can include in the securities note information on any material change or recent development which would affect an investor's assessment (without the requirement for a supplement to effect the same – though a supplement could still be used for this purpose, and may be advisable in any event for a regular issuer).

One point to note is that there have been cases in recent years of issuers seeking listings away from their Home Member State (e.g. where there is an advantage offered by listing on a MTF in a third country, for example in the case of high yield issuers who benefit from a more flexible regime for disclosure on guarantor subsidiaries in certain jurisdictions). A regular issuer that might otherwise wish to take advantage of the "frequent issuer" regime may be discouraged if it means having to seek approval of the Universal Registration Document in its Home Member State where that Home Member State has a less flexible approach. Although the PD was intended to be a maximum harmonisation directive, the fact that the Commission has not sought to bring MTFs within the ambit of the draft Regulation means that there will continue to be an element of regulatory arbitrage available for issuers of debt securities.

7. Prescribed Review Timing

The draft proposals specify set review times for prospectus reviews, ranging from 20 working days for first time issuers to 5 working days for "frequent issuers" (with a 10 working day period for other issuers). There is also a prescribed review period of 3 working days for supplements. While helpful to have prescribed limits in terms of giving market participants some certainty, the rules do not seem to cater for a shorter review period for second- or third- round comments – though we would hope/expect this to be factored into the Regulation before it is finalised.

8. Other Amendments

A number of other less high-profile but equally important amendments are proposed, including:

Straddling public offers

A public offer will be allowed to straddle the expiry of a base prospectus and the approval of a new base prospectus, so long as there is no gap between the two base prospectuses. This will be particularly welcomed by the retail structured products market where previously this has limited flexibility around the timing of public offers at certain times, though it is worth noting that where a public offer straddles two base prospectuses, walkaway rights will apply when the second base prospectus is published.

Higher exemption threshold

No prospectus will be required for offers of securities with a total consideration in the EU of less than EUR 500,000 (up from EUR 100,000.) As stated above (see *Format of Legislation*) individual Member States will have the option to exempt offers to the public from the prospectus requirement where the total consideration of the offer is between EUR 500,000 and EUR 10 million provided that the offer is made only in that Member State.

Takeover exemption

The proposals include a change to the current exemption that applies where securities are offered to the public in connection with a takeover by means of an exchange offer. Under existing rules, a prospectus is not required where the relevant competent authority considers that a document containing "equivalent" information to a prospectus is available. This means that the equivalent document must be vetted by the competent authority. Under the proposed Regulation, the takeover exemption will apply provided that a document is available containing information "*describing the transaction and its impact on the issuer*". It remains to be seen whether competent authorities will still want to vet this document, though the fact that it is no longer required to be "equivalent" to a prospectus may make it a more attractive option to issuers.

Fungible issues

No new prospectus will be needed for the admission to trading on a regulated market of fungible issues that represent, in a period of 12 months, less than 20% of the number of securities already admitted to trading. We expect the markets will welcome this development, which is an extension of the current regime.

Although the wording of Article 14 of the proposed Regulation (relating to the minimum disclosure regime for secondary issuances) is unclear, this appears to provide that there will be a lighter disclosure regime for secondary issues of equity and tap issues of debt securities (in each case listed on a regulated market). The concept of secondary issues in the equity world is well recognised, but the same cannot be said for the debt markets. While the introduction to the new Regulation suggests that this is the intention, this will need to be clarified. Clearly while a lighter touch regime will be especially welcome for secondary equity issues (e.g. rights issues) and tap issues of standalone bonds, it will be less relevant to tap issues under EMTN Programmes.

20% limit on conversion or exchange

The PD has always contained an exemption[6] for the requirement for a prospectus where shares are issued on conversion or exchange of other securities, meaning that issuers of convertible or exchangeable bonds or warrants do not need to worry about preparing a prospectus when investors exercise their conversion, exchange or exercise rights. The proposed Regulation amends this by capping the number of securities that may be issued in this way without a prospectus to an annual amount of 20% of the number of shares of the same class already admitted to trading on the same regulated market. For most issuances this cap should not be problematic, however in the case of contingent convertibles (or CoCos) where conversion could result in a large number of shares being issued in a potentially distressed scenario this could be seen as a barrier to investors receiving listed shares – which (if it inhibited the successful functioning of the CoCo market) would seem to be an unfortunate and negative outcome. There is a way to avoid this scenario, which is by ensuring that the securities bearing the conversion or exchange right are listed on a regulated market at the outset, though that may not always be desirable or even considered necessary at the time, with the subsequent problem only occurring much later (by which time it may be too late to do anything about it).

Supplements

While no significant changes are proposed to the supplements regime, ESMA will be required to prepare draft regulatory technical standards to specify situations where a significant new factor, material mistake or inaccuracy relating to the information included in the prospectus requires a supplement to the prospectus to be published, and which parts of a prospectus can be amended by way of supplements – these are due to be tabled within 9 months of the Regulation coming into force.

Tripartite prospectuses

As described above (see "Universal Registration Document"), for regular issuers in particular it would appear that a tripartite prospectus (relatively commonly seen in structured finance programmes, though less so for vanilla issuance) may become the norm for offerings involving a regulated market listing.

[6] PD Article 4.2(g)

Proportionate disclosure regime for SMEs

In line with the aims of CMU, the proposed Regulation includes the introduction of a new proportionate disclosure regime for public offers by "companies with reduced market capitalisation and SMEs". Companies with reduced market capitalisation are defined by reference to the definition of small and medium-sized enterprises in MiFID II[7] as companies having an average market capitalisation of less than EUR 200m on the basis of end-year quotes for the previous three calendar years.

The regime will consist of two alternative formats, namely (1) a format (akin to a traditional prospectus) setting out the information required for such a prospectus, and (2) a questionnaire format with open questions to be answered by the issuer. Delegated acts and guidelines will be required to add detail to this regime, but in principle it does seem to be a positive development from the point of view of achieving the CMU ambition of making capital markets funding more easily attainable for SMEs.

Publication of prospectuses by ESMA

In addition to Home Member States publishing prospectuses, the new Regulation will involve ESMA publishing and maintaining for a minimum of 5 years all prospectuses and supplements received from competent authorities. Those prospectuses will be accessible free of charge.

Somewhat surprisingly, however, in a world that is increasingly web-based the draft Regulation also states that issuers, offerors or relevant financial intermediaries are also required to make available (free of charge) a paper copy of the prospectus to any potential investor who requests it.

More powers/responsibilities for ESMA

The draft Regulation also gives further investigatory and enforcement powers to ESMA. While the detail of these is beyond the scope of this note, they include the power for competent authorities to refuse to approve prospectuses drawn up by an issuer for a period of 5 years. It also requires ESMA to publish all prospectuses received by it on a freely accessible electronic platform (with a corresponding requirement on the part of competent authorities to do the same, and provide a copy to ESMA).

What hasn't changed

Without wishing to set out in detail every minor detail that remains unchanged from the existing regime, it is worth flagging where we expect no substantive change to be made – focusing in particular on the more problematic areas of the PD, as well as issues that were raised in the consultation earlier in the year:

- The definition of an "offer of securities to the public" is the same as before, despite suggestions as to how it might be improved (in particular by limiting its scope) in the consultation paper.
- MTFs continue to fall outside of the PD regime, which maintains flexibility for issuers of "wholesale" debt in particular.
- The Final Terms regime is unchanged, such that (in particular) Final Terms cannot be used to incorporate provisions that are not set out in a base prospectus (in that situation a drawdown prospectus would still be required, though if issuers take advantage of a tripartite prospectus regime this may be less of a concern as a new product could be included in the securities note).
- Walkaway rights for investors will continue to apply only in the context of public offers.
- The overriding disclosure requirement set out in Article 5 of the PD is also broadly unchanged, albeit with the addition of the word "succinct" (as follows) i.e. "*the prospectus shall contain the information which, according to the particular nature of the issuer and of the securities offered to the public or admitted to trading on a regulated market, is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and of any guarantor, and of the rights attaching to such securities. That information shall be presented in an easily analysable, succinct and comprehensible form.*"

What next?

While the draft Regulation provides a lot of information on the new regime there is a lot of detail that will need to follow, in particular regarding the detailed disclosure requirements that will apply to prospectuses under the new regime, and whether particular types of securities (such as derivatives and equity-linked bonds) will require equity-style prospectuses – clearly this is an area on which market participants will want to have an opportunity to comment further.

[7] The Markets in Financial Instruments Directive (2014/65/EU)

A number of areas of detail will only become clear once delegated acts and/or draft regulatory technical standards are developed.

It is unlikely that the final Regulation will enter into force until late 2016 at the earliest, with the changes taking effect 12 months later – so there is no immediate need for issuers to make any adjustments to their current practices.

Conclusion

Unsurprisingly, there is a mixture of positive and less positive developments proposed by the draft Regulation. The changes will have a not insignificant impact on the drafting of prospectuses, and existing issuers may well bemoan the fact that they have already had to adapt in recent years to changes emanating from PD2, with further changes therefore being unwelcome.

However, if CMU is going to succeed then modernisation of the PD is undoubtedly required. Many of the proposed changes in the draft Regulation are to be welcomed, but the key is that market participants (including competent authorities) work together to adapt to the new regime, in the process laying the foundations for a genuine Capital Markets Union.