FRESHFIELDS BRUCKHAUS DERINGER

October 2004

BRIEFING

The Prospectus Directive and its implementation in the UK

Summary

This briefing provides an overview of the EU Prospectus Directive (PD), which comes into effect on 1 July 2005, and of the proposals for its implementation in the UK. The PD sets out new pan-European rules governing when an issuer or offeror needs to publish a prospectus, what the contents of a prospectus must be, and the mechanism for approval of a prospectus. On 11 October 2004, the FSA published its consultation paper (CP04/16) discussing how it proposes to implement the PD in the UK. The consultation ends on 14 January 2005.

Introduction

The new Prospectus Directive (PD), which is due to be fully implemented across the EU from 1 July 2005, aims to create common and enhanced standards for the issue of securities and to allow the 'passporting' of approved prospectuses throughout the EU. Its impact will be felt not just in Europe but also globally, as it will affect all issuers who want to sell to the public or list securities within the EU. It will cause issuers and investment banks to reconsider whether it is necessary to list certain securities at all, and if it is necessary to list them, whether it is necessary for that listing to be within the EU. Switzerland, Hong Kong and Singapore are all actively marketing themselves as attractive listing alternatives to the new EU regime, but what they cannot offer (and time will tell as to whether investors demand it) is securities listed on an EU-regulated market.

Status of the Directive

The PD follows the four-stage 'Lamfalussy process,' which comprises the core Directive (Level 1), detailed implementing measures (Level 2), non-binding guidance (Level 3) and, eventually, co-ordinated enforcement procedures (Level 4). The Directive itself entered into 'force' on 31 December 2003. One of its provisions (fixing of home member state) applies from 31 December 2003, but in the main, the Directive must be implemented through national law in all 25 EU member states by 30 June 2005. The Level 2 implementing measure (the PD Regulation) was published on 30 April 2004 and is directly effective, which means that it automatically becomes law in all member states on 1 July 2005. The Committee of European Securities Regulators (CESR) published its recommendations for Level 3 guidance on 24 June 2004 and after a consultation period, which closed on 18 October 2004, CESR will publish its guidelines prior to 1 July 2005. These do not have to be implemented into national law and are not legally binding, although it is assumed that most member states (and certainly the UK) will adopt them probably without any further consultation.

Implementation in the UK

Implementation of the PD in the UK will be achieved by (i) amending the powers and responsibilities of the Financial Services Authority (FSA) under Part VI of the Financial Services and Markets Act 2000, (ii) introducing new FSA rules and guidance, (iii) the automatic effect of the PD Regulation, and (iv) adoption by the FSA of the CESR guidelines. All these measures will come into effect on 1 July 2005. The new FSA rules will be in the form of a new FSA Handbook, which will replace the existing Listing Rules in their entirety. The new FSA Handbook will be split into three sections as follows.

- Listing Rules – these will apply to issuers of securities admitted (or seeking admission) to the Official List. They focus on eligibility for listing, the continuing obligations of listed issuers and the role of sponsors. They also contain chapters on overseas companies with a secondary listing, debt securities (including asset-backed securities and convertible securities), depositary receipts and securitised derivatives.

- Disclosure Rules – these will cover the disclosure and control of 'inside information' and the disclosure of transactions by persons discharging managerial responsibilities and their connected persons.
- Prospectus Rules – these will apply (i) whenever there is an offer to the public in the UK (whether listed or not) and will replace The Public Offers of Securities Regulations 1995, and (ii) where securities are being admitted to a regulated market in the UK. These rules focus on the format of a prospectus, what it must contain and the approval process.

When do you need a PD prospectus?

There are two situations that require the publication of a PD prospectus:

- When an offer of securities is made to the public in any country in the EU.
  - The definition of 'offer' is extremely broad and covers any 'communication to persons in any form and by any means, presenting sufficient information on the terms of the offer and the securities to be offered, so as to enable an investor to decide to purchase or subscribe to these securities'.
  - Securities mean 'transferable' securities, so non-transferable options, for example, will be exempt from the need to produce a PD prospectus. It is not yet clear whether employee stock options should be classified as non-transferable securities (and therefore exempt), or whether one should look through the option to the underlying security that is transferable.
  - The obligation to publish a prospectus is subject to a number of exemptions (see below).

- When securities are admitted to trading on a regulated market in the EU.
  - 'Admission to trading' – this is wider than the current concept of listing, as it includes securities traded on domestic 'second' markets and on trading facilities (eg virt-x). In the UK, it is this distinction that will dictate whether the Prospectus Rules as well as certain parts of the Listing Rules will apply to an issuer.
  - 'Regulated market' is as defined in the Investment Services Directive, although some EU countries are seeking to remove their second markets from the list of regulated markets (eg AIM in the UK) or create new markets that are not classified as regulated markets so as to avoid the need for a PD compliant prospectus for issues listed on these markets (which do not amount to a public offer).
  - The London Stock Exchange is proposing to establish a 'listed but unregulated' market for issuers of specialist securities, so that they do not need to include accounts prepared in accordance with the International Financial Reporting Standards Regulation (IFRS Regulation) (see below). Admission to a regulated market is also the critical test for the application of several other related directives (eg the Transparency Obligations Directive (TOD)).

The diagram opposite illustrates when a PD prospectus might be required.

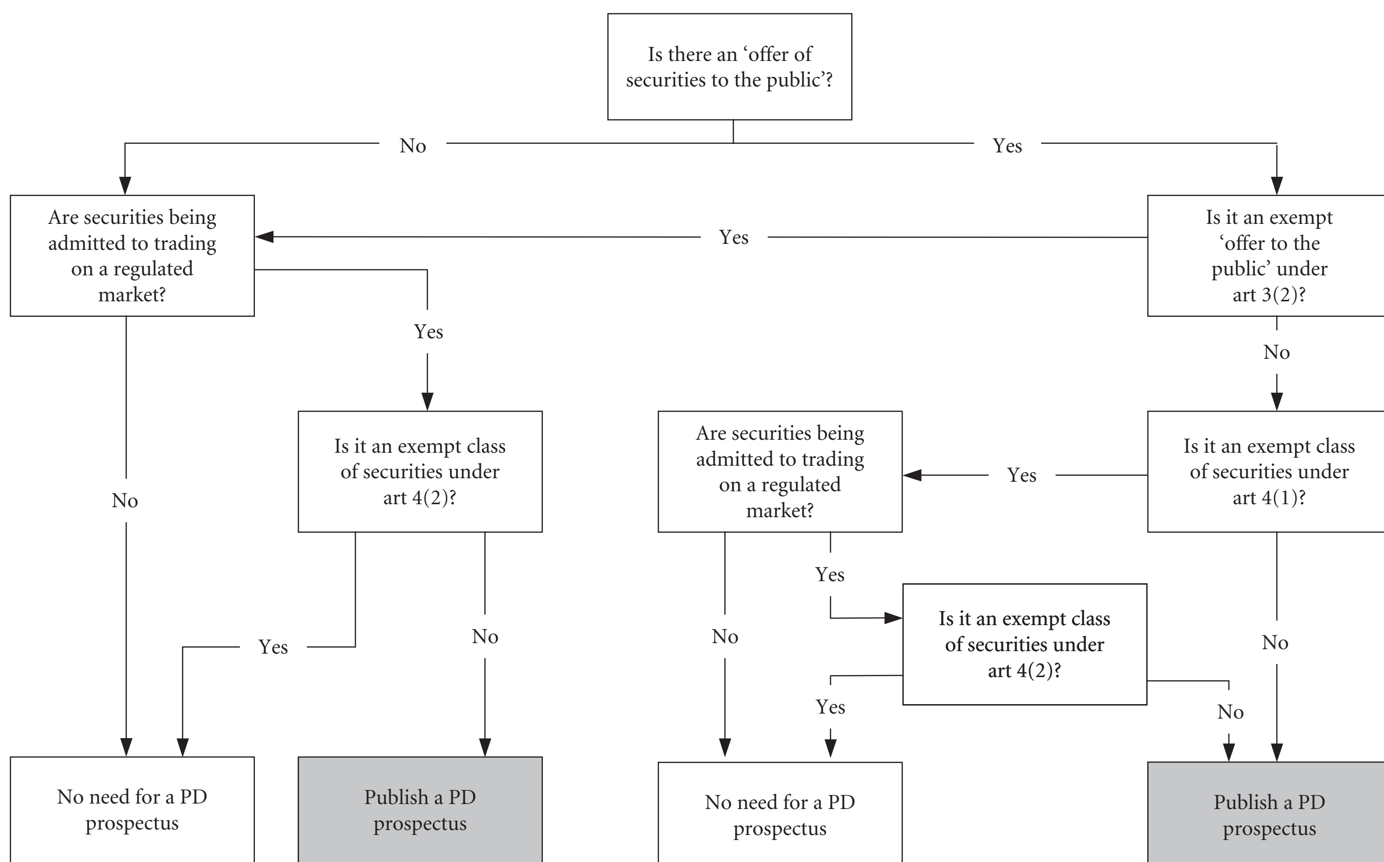
How do you avoid the PD?

There are a number of circumstances in which the PD does not apply (eg securities with a maturity of less than 12 months – as in conventional commercial paper programmes). There is an exemption for issuers that disapplies the PD for offers of securities (debt and equity) where the total size of the offer is less than €2.5m over a 12-month period.

Even where the PD does apply, a number of exemptions are available if the securities are not admitted to trading on a regulated market in the EU. These are:

- an offer solely to 'qualified investors' – which is wider than the previously used term in many member states and is wider in reach than the QIB concept in the US;
- an offer to fewer than 100 people per member state (other than qualified investors) – the UK is proposing to add a qualification that this limit is an annual limit per class of securities for each offeror;
- an offer where the minimum consideration per investor, or the minimum denomination per unit, is equal to or greater than €50,000; and
- an offer where the total consideration is less than €100,000 over a 12 month period.

Given the breadth of these exemptions, non-EU issuers should reconsider whether admission to a regulated market in the EU (which would require a PD prospectus)



is really necessary. For many investors (such as fund managers and pension funds) it is, because they are governed by regulations or investment criteria that state that they must invest, wholly or largely, in such securities. For example, EU occupational pension providers must invest predominantly in securities admitted to regulated markets, and an EU life insurer cannot invest more than 10 per cent of its total gross technical provision in securities that are not dealt in on a regulated market. However, if the regulations and/or investment criteria just state that the securities must be 'listed', it may be worth considering a listing outside the EU (eg in Zurich, Hong Kong or Singapore, especially if these markets make themselves more attractive to traditional users of euro markets) combined with the use of the exemptions referred to above.

A number of exemptions (for both offerings and admissions to trading) apply to certain types of securities. These largely track existing exemptions and cover situations such as conversion offers, mergers and takeovers and employee offers. The exemption for shares representing less than 10 per cent of a class already listed also remains, although it now applies over a 12-month period and relates only to admissions on a regulated market, not offers to the public. This may impact certain block placings.

Rights issues

Traditionally in the UK, rights issues have been subject to a relatively relaxed disclosure regime – comprising a circular or abbreviated prospectus rather than a full prospectus. However, under the PD, no preferential treatment is afforded to rights issues (other than the exemption for shares representing an increase of less than 10 per cent, which only applies on admissions to trading, not on a public offer). Therefore, any rights issue to the public, at whatever level, will now require a full PD prospectus. The implications of this on the timetable for a rights issue may persuade UK issuers to file an annual registration document as part of the tripartite prospectus structure being introduced by the PD (see below) so that when an issuer decides to launch a rights issue, it only has to submit the securities note (which should update the 'shelf' registration document as necessary) and the summary for approval.

Secondary market trading

The 1989 prospectus directive only required a prospectus to be produced when securities were offered to the public 'for the first time' – thereby clearly excluding offers in the secondary market. The PD does not clearly carry over this concept. There appears to be a belief in some quarters that retail investors in the secondary market should obtain the same protection as on a primary offer in terms of disclosure, despite the fact that there should be adequate information available to retail investors of listed securities through the operation of the TOD (see below). Unfortunately, the PD makes no clear allowance for this and creates a situation where all offers of securities (whether listed or not) may require the publication of a PD prospectus, unless an exemption applies. This could mean at an extreme that any investor selling through a market where they cannot control how many purchasers buy their shares could be triggering a prospectus requirement. This is clearly an unintended result, and each member state will have to choose how to rationally apply the provisions. The UK proposal will, it is thought, include a carve-out in the definition of 'offer to the public' for communications in connection with trading on a regulated market or a multilateral trading facility.

Contents of a PD prospectus

Although the framework for drawing up a prospectus is contained in the PD, all the detailed content requirements are set out in annexes to the PD Regulation. Despite looking complicated, not much has actually changed with regard to disclosure. As before the prospectus must contain all information which 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 the securities.

International Accounting Standards

The biggest issue relating to disclosure is that of accounts, as the PD is being introduced in conjunction with the move across Europe to international accounting standards (IAS). Subject to some limited transitional provisions, the IFRS Regulation requires that EU companies whose (debt or equity) securities are admitted to trading on a regulated market in the EU prepare their consolidated accounts in accordance with IAS for any financial year starting on or after 1 January 2005. As a result, the PD starts from the premise that all issuers, EU and non-EU, must include in any prospectus IAS accounts or accounts reconciled, restated, or *equivalent* to IAS. The question of what should be deemed 'equivalent' to IAS is currently being considered by CESR. As a first step, CESR has published a draft concept paper for consultation that sets out the basis upon which CESR will approach the analysis of equivalence. Once this is finalised (the consultation ends on 22 December 2004), the second step for CESR is to determine whether US, Canadian and Japanese Generally Accepted Accounting Principles (GAAP) (the only ones the Commission has asked CESR to look at for the moment) should be considered equivalent by applying the principles set out in the concept paper. CESR hopes to submit its final advice to the Commission by 30 June 2005.

For countries with a national GAAP not regarded as equivalent to IAS, issuers and guarantors who do not prepare their accounts in accordance with IAS or an equivalent will (subject to the €50,000 exemption discussed below) be required to reconcile or restate their accounts to IAS before they are included in any prospectus or furnished as part of the issuer's continuing obligations under the TOD (see below).

This is the most important change that the PD will bring about – and principally impacts non-EU issuers of equity and debt. There is an exemption from the requirement to use IAS for non-equity securities with a denomination of at least €50,000 (wholesale debt) and some transitional measures that will provide temporary relief, especially to non-EU issuers. Some non-EU issuers are presently reserving the contractual right (in trust deeds and underwriting agreements) to delist in order to avoid having to re-state their (or their guarantor's) accounts to IAS as a result of TOD.

Issuers wanting to make use of the proposed 'listed but unregulated' market in the UK for non-public offerings of specialist securities will still need to have a document approved by the FSA (although it will be called listing particulars rather than a prospectus) and comply with the relevant section of the Listing Rules. However, such issuers will not be subject to the Prospectus Rules, although the proposed content requirements for listing particulars will be very similar to those required under

the PD for a wholesale debt issue (ie debt with a denomination of at least €50,000) – which importantly have no requirement for IAS accounts. It is proposed that existing outstanding issues of specialist debt in the UK will be grandfathered to the new 'listed but unregulated' market on 1 July 2005 without the need for the production of listing particulars. The listed but unregulated category will also enable issuers to avoid TOD and its requirement to produce IAS or equivalent accounts.

Guarantors

A guarantor must provide the same level of disclosure as if it were the issuer. The concept of guarantor includes keepwell providers and other providers of credit support (including, for example, monoline insurers). In practice this will lead to more extensive information on the guarantor without any concomitant relief upon the issuer.

Format

Under the PD, the issuer will have a choice of format for the prospectus. It can be either a single document, or a tripartite document made up of a registration document, a securities note and a summary note. The registration document, once approved, is valid for 12 months. The advantage of using this tripartite route is that when securities are offered to the public or admitted to trading, the issuer has only to submit the securities note and the summary for approval. Obviously, any information in the registration documents that needs updating and any information on recent developments must be included in the securities note. Non-equity securities issued under a programme (eg an MTN programme) or in a repeated manner by credit institutions can continue to use a programme (now called a base prospectus) supplemented by a pricing supplement (now called final terms). The FSA will allow issuers to submit draft base prospectuses for approval before 1 July 2005 to enable an orderly transfer to the PD regime, although the actual mechanics and timing of this procedure have not been announced.

Summary

A summary of the prospectus (with a suggested limit of 2,500 words) will become mandatory for all issues other than admissions to trading of wholesale debt (although a competent authority may still request one for a wholesale debt issue). The summary must be in non-technical language and contain a warning that it should be read in conjunction with the rest of the prospectus. As a result, the FSA proposes to abolish the existing provisions for mini-prospectuses, offer notices and summary particulars.

Risk factors

The inclusion of risk factors, although common in practice, will become mandatory, in those member states where it is not already.

Incorporation by reference

Information can be incorporated into a PD prospectus by reference (although not into the summary), as long as it has previously or simultaneously been approved by, or filed with, the FSA. This will represent a change in UK procedure and will be more akin to the process in the US save that 'to be published' documents cannot be incorporated.

Other disclosure issues

- There are provisions which allow a competent authority to accept a prospectus drawn up in accordance with non-EU rules eg an SEC approved prospectus, if it follows International Organization for Governmental Securities Commission (IOSCO) standards and the information, including financial information, is 'equivalent' to that required under the PD. However, it is not yet clear what the policy of national regulators on this is likely to be. In practice there will probably be no change in the short term, so the prospectus will still need a wrap. The FSA proposes to implement this by determining whether a prospectus meets the criteria on a case-by-case basis and judging each application on its merits.
- Although the Level 3 guidance produced by CESR is technically non-binding, it is expected that most home member states will incorporate it into their disclosure requirements. There is a concern that, as this guidance process is continuous, it will add an ever-increasing number of layers to the basic disclosure requirements set out in the PD and the PD Regulation.
- Similarly, although member states are not allowed to require additional disclosure in a prospectus (to that contained in the PD, the PD Regulation and Level 3 guidance) it is feared that individual stock exchanges may find other ways to strengthen disclosure (eg by using eligibility criteria or listing requirements). The

UK has taken advantage of this by retaining eligibility criteria and superequivalent measures in the Listing Rules for issuers wishing to 'list' on the 'Official List'.

Liability for the prospectus

The PD contains a list of those responsible for the contents of the prospectus. They are the issuer (or its administrative, management or supervisory bodies), the offeror, the person asking for the admission to trading on a regulated market and any guarantor. The inclusion of 'offeror' may catch investment banks in certain circumstances giving them clear liability where previously it was only arguable. In the UK, 'persons responsible' will continue to be determined in accordance with regulations made by HM Treasury.

Despite the harmonisation of content and, to some extent, distribution requirements, the PD provides no harmonisation of civil liability in respect of that content. Each member state will still be allowed to maintain its own national liability rules for prospectuses. There is one exception where the PD does attempt to harmonise liability and that is for the summary of the prospectus (designed to meet the concern that a person responsible could be liable for incomplete information contained in the summary, especially as there is a suggested limit of 2,500 words). The PD provides that civil liability attaches to the summary only if it is misleading, inaccurate or inconsistent when read together with the rest of the prospectus. In order to implement this harmonised liability for the summary, some member states will need to update their national laws to avoid there being a conflict. There is still a fear, though, that a domestic court might seek to conclude that the summary is by its very nature misleading if an investor is unable to read and understand the full prospectus because it is in another language (see below).

Annual disclosure list

By way of a continuing obligation, issuers whose securities are admitted to trading on a regulated market (other than issuers of wholesale debt), will be required to file an annual disclosure list with their home member state (see below). This should contain or refer to all information that the issuer has disclosed to the public during the last 12 months pursuant to obligations imposed upon it by securities regulators in the EU or elsewhere in the world, including the US. However, there is no obligation to keep the list updated throughout the year. It may be important to include disclaimers in the list to ensure that investors in a particular home member state do not rely on information in the annual information document to the extent that the information was not directed at them, prepared for them or specifically disclosed in the home member state. The information may also be out of date and this needs to be 'warned about'. The FSA proposes that an Annual Information Update List be submitted stating where the actual information may be obtained and the date of publication and containing a short description of the information. This list should be filed through a Regulatory Information Service within 20 days of the date when the issuer files its annual accounts with the FSA.

Approval of a PD prospectus

Home member state

Under the PD, each issuer has a 'home member state', the competent authority of which is the entity responsible for approval of prospectuses. An issuer's choice of home member state will therefore be important. This is especially so for non-EU issuers of equity (including convertibles) and *low denomination debt* (non-equity securities with a denomination under €1,000, or near equivalent in another currency), as the member state in which they make their *first* application for admission to trading on a regulated market or public offer in the EU after 31 December 2003 will be fixed as their home member state – this fixing is *permanent*. For EU issuers of equity and low-denomination debt, the home member state has to be the country in which they have their registered office so there is no need for any election.

The question of what constitutes a 'public offer' for the purposes of triggering a home member state election for non-EU issuers is far from clear. Therefore, non-EU issuers need to be extremely cautious if they are seeking to use the public offer limb of this test. It is also not clear what happens when an issuer makes simultaneous public offerings in more than one member state. In view of the considerable differences in the regulatory approach and

language requirements across the EU, many non-EU companies are currently engineering an offering/admission in their country of choice.

Inadvertently choosing the wrong home member state (for example, through the operation of a share option scheme) is something the issuer cannot subsequently change. Making an error and thinking you have chosen one member state, but in fact having triggered an election in another member state, will lead to even bigger problems, as the issuer may then be distributing a prospectus that has not been approved correctly which may raise questions as to the validity of the prospectus.

Both EU and non-EU issuers of debt with a denomination equal to, or greater than, €1,000, (or near equivalent in another currency) and most *derivatives* (unless the underlying securities belong to the issuer's group) still have a free choice of competent authority on an issue-by-issue basis. This means that an issuer may have several home member states: one governing all issues of equity and low-denomination debt, and different ones for individual debt issues.

Host member state

The rules determining the competent authority that must approve a prospectus do not restrict the choice of stock exchange for any listing or the country in which any public offer can take place. Although an issuer's home member state approves the prospectus and any supplements, it is valid for use (as an offer document or a listing document) in any other EU member state (known as a host member state) provided such host member state is notified (passporting). Although the host member state can impose listing requirements under article 8 of the Directive on Admission of Securities to Listing (2001/34/EC), it is not allowed to undertake any approval or administrative procedures relating to the prospectus (other than require that the summary be translated into its official language).

Relationship with the Transparency Directive

The PD is being introduced in conjunction with the TOD, which relates to the continuing obligations of issuers whose securities are admitted to trading on a regulated market in the EU. In particular, it covers the publication of annual and half-yearly financial reports – also starting from the premise that all such issuers, wherever incorporated, should be using IAS accounts or accounts reconciled, restated, or equivalent to IAS. Issuers of shares, who do not otherwise publish quarterly financial reports, must also publish an interim management statement between the annual and half-yearly reports. TOD also contains disclosure requirements for major shareholdings in all companies (whether incorporated in the EU or not) that are admitted to trading on a regulated market in the EU. Notification will start at 5 per cent of the voting rights, but many jurisdictions already meet or exceed the proposed standards.

Generally speaking, an issuer's TOD home member state will be the same as that elected (or deemed to have been elected) for equity and low-denomination debt issues under the PD. Under TOD an issuer can only have one home member state, and an election remains valid for at least three years unless the issuer ceases to have securities admitted to trading on a regulated market in the EU.

Implementation of TOD is expected in autumn 2006, a full year after the PD has come into effect, and this timing mismatch, together with the fact that some of the definitions are different in the two directives, may raise some issues. The implementation of TOD in the UK will require the FSA to make further amendments to the Listing Rules, and they have announced that they hope to publish a consultation paper on such amendments in 2006.

Conclusion

Although the PD, the PD Regulation and guidance are not expected to cause major upheaval in the capital markets, a lot will depend on not just how the UK implements the PD but also how each other member state implements the PD into national law. Only when this is known will it be clear whether the PD has achieved its aim of harmonising the public offer and listing regimes across the EU. The impact on non-EU issuers will become much clearer once the Commission has concluded whether US GAAP is to be considered equivalent to IAS.

The information and opinions contained in this bulletin are not intended to be a comprehensive study, nor to provide legal advice, and should not be relied on or treated as a substitute for specific advice concerning individual situations.

© Freshfields Bruckhaus Deringer 2004

www.freshfields.com

For further information please contact

Stephen Revell
T +44 20 7832 7217
F +44 20 7832 7001
E stephen.revell@freshfields.com

Tim Jones
T +44 20 7785 2526
F +44 20 7832 7001
E tim.jones@freshfields.com

Mark Kalderon
T +44 20 7832 7106
F +44 20 7832 7001
E mark.kalderon@freshfields.com

9790