

A QUIET CHEER



THE 5 NOVEMBER SAW EUROPEAN COUNCIL FINANCE MINISTERS TAKE THE PROSPECTUS DIRECTIVE A STEP FURTHER. JOHN RUSSELL OF SIDLEY AUSTIN BROWN & WOOD INVESTIGATES.

It is poignant that on 5 November the European Council finance ministers should have done the political deal settling the shape of the Prospectus Directive. The obvious question is – is this the big bang that will create a single European capital market or one that will destroy existing markets? The smoke is still drifting, but although a number of painful adjustments will be required to current markets and techniques, the Directive will enable pan-European retail issues to take place much more efficiently than before. However, the detailed requirements for the content of a prospectus for particular types of issue will be subject to 'Level 2' provisions, on which consultation by the Committee of European Securities Regulators has only recently commenced. I summarise the key provisions and effect of the Directive from the perspective of a UK company below.

KEY ELEMENTS OF THE DIRECTIVE. The Directive's requirements for content and approval of a prospectus apply to public offers of securities and the admission of securities to a 'regulated market' – that is, for a listing and more.

The Directive divides securities into 'equity securities' and 'non-equity securities'. This has crucial effects, for example, it determines whether the issuer can choose which competent authority approves its prospectus and what disclosure regime is applicable.

To permit the wholesale Eurobond market to operate and activities such as underwriting, an offer is not a public offer when made to a 'qualified investor'. In addition, where non-equity securities with a denomination of at least €50,000 are to be admitted to trading on a regulated market there are a number of exemptions (see *Box A*).

Pan-European retail offerings are facilitated by a 'passport' – approval of the prospectus in other Member States, where an offering or admission occurs is no longer required. This will allow UK companies to have a retail prospectus approved by the FSA and use this freely to make offerings elsewhere in the EU for the first time.

THE WHOLESALE MARKET. The Eurobond market will be able to continue to operate, subject to some important new restrictions, which will have significant effects on practice.

▪ **Qualified investors.** For the first time, there will be EU-wide exemptions from the requirement to produce a prospectus, which will make private placements much easier. The most important of these for the Eurobond market is the exemption for 'qualified

investors'. This should permit sales of unlisted wholesale Eurobonds. The UK is likely to allow 'small and medium-size enterprises' (SMEs), plus a limited class of sophisticated individual investors to register as qualified investors (see *Box B*).

▪ **Wholesale securities admitted to trading.** Where the securities are admitted to trading on a regulated market, they must be non-equity securities with a minimum denomination of €50,000 (referred to below as 'wholesale debt') to benefit from exemptions for wholesale securities intended to replace exemptions under which the Eurobond market currently functions. However, convertible and other issues carrying the right to acquire shares of an entity in the issuer's group (which are treated as 'equity securities'); and global depositary receipts (GDRs), warrants and the like that do not have a denomination cannot be wholesale debt.

This will end the current exemption allowing lighter content in a prospectus for wholesale convertible bonds. These securities have not frequently been issued by UK companies and the requirement to comply with the requirements for a share prospectus, with its associated financial and time costs are likely to discourage further issues, unless a technique is used to avoid the requirement.

Denominations of €50,000 may be unattractive to some wholesale investors and will prevent retail sales. This may result in pressure on issuers to produce retail standard prospectuses for all debt issues, despite the additional costs.

OFFER OF SECURITIES TO THE PUBLIC. The directive's requirements for the publication of a prospectus are triggered if there is an 'offer of securities to the public', unless an exemption applies. Accordingly, the meaning of such term is key. The definition is more one of advertising or promotion, referring to any communication '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'.

The UK is likely to implement the definition so as to mean as close to a contractual offer as it considers permitted by the Directive. However, other EU States are likely to give it a much wider meaning. Some EU States' laws require a prospectus to be filed before any statement is made about an offering, and assume investors will set aside money to subscribe for securities as soon as there is a belief that an offering may occur. Implemented in this way, it could have absurd results, for example, must a prospectus be approved before a company chairman may respond honestly to a shareholders' meeting

BOX A: Provisions benefiting 'wholesale debt'

That is, non-equity securities with a denomination of at least €50,000:

- No requirement for annual update
- content requirements to be appropriate for wholesale investors.

BOX B: Individual 'qualified investors'

Natural persons may be qualified investors if they expressly ask to be considered as such and meet at least two of the following:

- the investor has carried out transactions, in significant size, on securities market at an average frequency of 10 per quarter over the previous four quarters;
- the size of the investor's securities portfolio exceeds €500,000; and
- the investor works, or has worked, in the financial sector for at least one year in a professional position which requires knowledge of securities investment.

There are not likely to be many applicants for this status because the first requirement will rarely be met and due to the existence of a public register of such persons, which could prove useful for kidnappers.

question on whether a public offering of a subsidiary's shares is being considered in order to reduce debt?

Companies contemplating an international offering will need to take advice as to what can be said at an early stage.

CHOICE OF WHICH COMPETENT AUTHORITY APPROVES THE PROSPECTUS. The prospectus must be approved by the 'home Member State' competent authority. For equity securities (including convertible bonds and equity warrants) and debt issues with a denomination of less than €5,000 an EU issuer's home Member State is where its registered office is located, otherwise there is a choice. The principal practical effect of this is that a UK firm would need to have a prospectus for a Luxembourg-listed convertible bond or warrant issue approved by the FSA in the UK.

SMES. The greatest uncertainty exists with respect to how the Directive will ultimately affect SMEs. Level 2 provisions will determine the disclosure required by them unless they benefit from an exemption from the Directive permits domestic law to apply to offers of less than €2.5m in 12 months. Several Member States are still demanding that disclosure be increased, not relaxed for SMEs. If this view is reflected in the provisions, Europe will be denied the vibrant risk capital companies that have powered the US economy's development.

AIM AND OFEX MARKETS. For companies seeking admission to AIM, a prospectus is currently required to Public Offers of Securities Regulations standards. This is not vetted by the FSA as UK Listing

authority, but is submitted by the nominated adviser nomads to AIM. Under the Directive, the prospectus will need to be approved by the FSA as the 'competent authority', unless it delegates its approval of the prospectus. However, because such delegation is only possible for five years, is conditional on conflicts of interest being avoided and nomads could be liable for the approval, there are serious doubts as to whether delegation to nomads is feasible. Some have expressed concern that the time and costs involved in obtaining FSA approval may discourage companies coming to AIM. The Ofex market is currently outside the scope of the Directive as, despite its regulated position in the UK, it is not a 'regulated market' under the current Investment Services Directive. So securities can be admitted to Ofex without the need for a prospectus, unless a public offer is undertaken.

TRANSLATION REQUIREMENT. UK issuers will have an advantage when using the 'passport' for pan-EU offerings. Where the prospectus is in an international language (English), the 'host' Member State may require only the summary forming part of the prospectus to be translated into its language(s). This should make pan-EU retail offerings feasible for UK firms by reducing the cost and time taken to make offerings. The European Parliament is expected to vote against a last-minute change that allows Member States to make the translation requirement applicable to wholesale debt.

KEY PRACTICAL IMPLICATIONS. Some corporate finance transactions, such as auctions, will be subject to some requirements of the Directive, even if there is no requirement to have a prospectus approved, for example, because the investors are qualified investors or there are less than 100 people approached. The most important example is the requirement that material information given to any qualified investors or special classes of investors must be supplied to all of those investors. This may cause difficulties, for instance, when a company is auctioned and the most commercially sensitive information would otherwise be withheld from a bidding competitor.

The full implications of the Directive will only be clear after the Level 2 provisions have been determined. However, it is clear that practices in relation to retail offerings in more than one Member State will need to change substantially, as will Eurobond offerings made available to retail investors after closing.

CONCLUSIONS. The Directive could facilitate the development of a single European capital market by making pan-EU retail offerings much easier. Large UK companies will benefit particularly because the main prospectus will not need to be translated and because the FSA is relatively user-friendly. Potentially, smaller companies could suffer substantially if AIM and Ofex are unable to continue to function efficiently and if the prospectus content requirement for SMEs are increased rather than substantially reduced, so that public offerings and admission to regulated markets become impractical or too costly for them. Much will depend on the Level 2 provisions and the practical implementation of the Directive in each EU State.

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We intend to host a seminar to examine changes in offering techniques required as a result of the directive. Readers may request an invitation by sending an email to ukinfo@sidley.com headed 'Prospectus Seminar Request'.