The Prospectus Directive:

John Russell of Sidley Austin Brown & Wood analyses some of the crucial changes the Prospectus Directive will bring about that require urgent decisions by treasurers.

The Prospectus Directive comes into effect in the European Economic Area (EEA) states on 1 July 2005. I predicted in my article in *The Treasurer* in December 2002 (www.treasurers.org/purchase/customcf/download.cfm?resid=994) that "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". But, will issuers find that the disadvantages associated with retail issues outweigh their benefits?

As the UK's implementation of the Directive is nearly finalised, this article addresses:

- The key factors with respect to the most important decision treasurers need to make: whether to issue in denominations below €50,000 (or equivalent), and if so, whether to take the additional steps necessary to allow sales to retail investors; and
- The most substantive changes affecting how medium-term note programmes operate or affecting other debt issues.

THE WHOLESALE MARKET To permit the wholesale Eurobond market to operate and activities such as underwriting to take place, a prospectus is not required when offers are made only to qualified investors, such as credit institutions, governments and companies, unless they are small or medium size enterprises (SMEs) (Article 3 of the Directive), or the securities are non-equity securities with a denomination of at least €50,000 (wholesale debt), unless the securities are to be admitted to trading on a regulated market. Where wholesale debt is to be admitted to trading on a regulated market, the requirements are less onerous than for the retail market.

However, it will not be possible to access retail investors generally if sales are made relying on the qualified investor exemption because it only extends to SMEs and individuals in an EEA state if that state has elected to establish a register of such investors. Even if an EEA state does so (the UK, for example, will), the class of individuals is very limited and there are not likely to be many applicants who would wish to apply for individual qualified investor status because their relative wealth would then be apparent on a public register.

Securities issues with denominations less than €50,000 are attractive to institutional investors as they enable them to fine-tune the investment spread in their portfolios to get the appropriate weighting. It is also easier for them to trade securities of smaller denominations on the secondary market. The issue of securities with low denominations may be attractive to the treasurers of some issuers based on their investor market, despite the more onerous Directive requirements and the greater risk that an issuer could face litigation under the Directive.

Executive summary

- **The Prospectus Directive sets out the new requirements for content and approval of a prospectus applicable to securities offerings and the admission of securities to a regulated market, such as the London Stock Exchange, for listing throughout the European Economic Area (EEA). The London Stock Exchange will be introducing a new unregulated market as referred to in this article.**
- **The principal achievement of the Directive is that a prospectus approved by the regulatory authority of one EEA state can be used to make retail offers throughout the EEA without requiring further approvals.**
- **EEA companies, particularly UK companies, are in a strong position to complete the additional requirements necessary to enable them to access retail investors as they will generally be preparing their accounts in accordance with International Financial Reporting Standards (IFRS) and most, if not all, of the additional Directive disclosure required will already be contained in their annual report and accounts.**

RETAIL ISSUES The new passporting regime under the Directive allows sales by an issuer to retail investors throughout the EEA (after initial approval of the prospectus by the regulatory authority of one EEA state) by simply notifying the competent authority of each of the relevant EEA states of such proposed sales. The only constraint is that issuers may be required to translate the summary section of its prospectus into the national language of the relevant EEA state, or the whole prospectus if it is not in a language used in international finance, such as English. This gives UK issuers an advantage. This translation requirement is likely to lead to issuers limiting retail sales to those jurisdictions that do not require a translation from English or where the cost of translation is likely to be justified by additional sales.

The most significant issue that treasurers need to consider is the increased risk of litigation where a prospectus is used for retail sales. Civil and criminal liability for breaches of the Directive regulations are decided by each EEA state and an issuer could be sued in each state where its securities are offered or sold for an alleged breach of the Directive. This means that issuing to retail investors could greatly heighten the risk to issuers. Critically, where the denomination of the securities is €50,000 or more, no prospectus is required under the Directive for sales in an EEA state unless there is admission of the securities to trading on a regulated market there. In such cases, the issuer should only be liable to be sued for failure to comply with the Directive in the EEA state where the prospectus is originally approved for any such admission. As a result, treasurers should want to be convinced by their investment bankers that the pricing advantages for a retail issue outweigh the increased risks of litigation.

THE FORM OF THE NEW PROSPECTUS
Directive-compliant prospectuses can be drawn up as a single prospectus consisting of a registration document (which contains corporate details and information about the issuer), a securities note (which contains information about the securities to be issued), and a summary note (which gives an overview of the essential characteristics and risks associated with the issuer and the securities).

For a Medium Term Note (MTN) programme, a

strategic considerations

base prospectus is required instead (which contains the same elements described above), and a pricing supplement known as 'final terms' is used for each issue. The advantage of this arrangement is that only the base prospectus, and not the final terms, needs to be approved by the regulator, allowing immediate sales of the programme using final terms without additional authorisation.

However, final terms cannot be used for more complicated transactions where it is necessary to do more than simply complete dates and pricing. This is because the Directive requires that every significant new factor relating to information included in the prospectus which could affect the assessment of the securities, and which occurs between when the prospectus is approved and the final closing of the offer to the public, should be included in a supplement to the prospectus. Final terms can only include information required by the relevant securities note annex. Therefore, any material changes or material additions to the pro forma terms and conditions contained in the base prospectus necessary for an issue will require a supplementary prospectus.

The listing approvals for an MTN programme normally run for 12 months. Treasurers should have been contacted by their dealers already regarding the need for all MTN issuers to have their prospectuses reissued under the new Directive requirements and further approved on or after 1 July 2005 in order for them to continue to access the regulated markets.

Issuers needing to update their programmes prior to 1 July because their current approval has expired will be able to prepare documents under the new rules. The FSA is willing to read the update for compliance with the Directive, so it is possible to use the Directive-compliant prospectus before and after 1 July. However, the prospectus must be re-approved by the regulator on or after 1 July. The issuer must either confirm that, as at the date of resubmission, there have been no material changes or litigation or include additional information to make sure the prospectus is completely up to date and accurate. As at the date of this article, regulators have expressed no preference as to what form this update may take; either a new prospectus with a blackline version highlighting the changes or a 'wrap' containing additional information can be filed. Issuers are also likely to be asked to obtain an auditor's comfort letter for this additional update.

INVESTOR RIGHT TO CANCEL If a supplementary prospectus is required, investors have a right to cancel their purchases for two working days from the date of the supplement publication. Issuers will wish to avoid this occurring.

For MTN programmes, one solution, which the UK Listing Authority has indicated it will accept, is for the issuer to produce a separate registration document to be read alongside the base prospectus. The registration document would incorporate by reference that part of the base prospectus containing the information required by the relevant registration document annex.

Instead of issuing notes under a base prospectus, which could trigger the requirement to produce a supplementary prospectus, the securities could be issued under the registration document. On drawdown, the issuer could issue a securities note which, together with the registration document, could constitute the prospectus. The securities note would incorporate by reference information contained in the base prospectus and set out, in similar form to a pricing supplement, the information for the specific issue. As a securities note is not a supplementary prospectus, the cancellation right would not be triggered.

THE MOST SIGNIFICANT ISSUE THAT TREASURERS NEED TO CONSIDER IS THE INCREASED RISK OF LITIGATION WHERE A PROSPECTUS IS USED FOR RETAIL SALES. CIVIL AND CRIMINAL LIABILITY FOR BREACHES OF THE DIRECTIVE REGULATIONS ARE DECIDED BY EACH EEA STATE AND AN ISSUER COULD BE SUED IN EACH STATE WHERE ITS SECURITIES ARE OFFERED OR SOLD FOR AN ALLEGED BREACH OF THE DIRECTIVE.

LISTED BUT UNREGULATED The UK is currently in the process of establishing a listed but unregulated market in EU regulatory terms which may be known as the Professional Securities Market (PSM). A similar approach is being taken in Luxembourg and Ireland. Its establishment is designed to continue to allow issuers which do not wish, or are not able, to comply with the Directive's requirement for IFRS or equivalent accounts (or the Transparency Directive's similar requirement in the future) to continue to issue and list their securities in the UK. This is because the Prospectus Directive and the Transparency Directive will not be applicable to securities listed and admitted to trading on such market.

However, the securities can only be marketed and sold under an exemption from the Directive, such as that for sales to qualified investors. Therefore, a general marketing of the securities to individuals will not be possible. Furthermore, it remains unclear whether institutional investors will be subject to any regulatory or internal restrictions preventing them from investing in securities only admitted to such markets or which limit such investments, despite various surveys of investors by the International Primary Market Association.

The UK currently intends the content requirement of a prospectus for the PSM to be the same as for a wholesale prospectus under the Directive (as discussed above). Luxembourg, by contrast, will not be applying the Directive to its PSM but will instead apply its current regime.

The PSM's most important value for UK and many other EEA issuers appears to be in providing a safety net if they are unable to have a Directive-compliant prospectus in place on 1 July. Issuers which do not update their prospectuses to be Directive-compliant once it comes into force will automatically be able to use their programmes on the PSM.

OTHER SUBSTANTIVE CHANGES We will see some changes to the format of prospectuses because of the new requirement that the prospectus for a straight debt issue to retail investors must contain two years of IFRS or equivalent accounts. However, the Directive expressly permits the incorporation by reference of documents previously filed with the same regulator, so it will be possible to satisfy this, and many of the other new requirements, by incorporating information from the annual report and accounts. Care will be needed in this as the information will need to have been prepared to prospectus standards of due diligence. As not all the information in such incorporated documents may satisfy this demanding requirement, it may be necessary to be specific about what information is being incorporated by reference or to reproduce the information in full in the prospectus. The second approach would, of course, be more helpful to prospective investors, but will increase printing costs.

For a wholesale issue, if the issuer does not include IFRS accounts, it must make a prominent statement to this effect and provide a description and details of the material differences between IFRS and the accounting principles actually adopted.

A potentially serious threshold issue for EEA issuers (who do not benefit from transitional relief by virtue of having securities admitted to trading on a regulated market on 1 July 2005) is the requirement in the Annexes to the Directive that "the most recent year's historical financial information must be presented and prepared in a form consistent with that which will be adopted in the issuer's next published annual financial statements having regard to accounting standards and policies and legislation applicable to such annual financial statements."

For example, if the accounting treatment for an issuer's accounts in respect of 2005 will be different from that with respect to 2004 because of changes to IFRS or a change from national accounting standards to IFRS and the 2004 accounts are included in the prospectus, the 2004 accounts will have to be adjusted to conform to the new basis. This has the effect of bringing forward the need for this adjustment as the 2004 accounts included with the 2005 accounts would in any event have to be on a basis consistent with the 2005 accounts. However, making this adjustment in time for the prospectus may be problematic if this requirement has not been anticipated.

STRATEGIC DECISIONS UK and many other EEA issuers are likely to find the additional disclosure requirements of the Directive relatively easy to satisfy as they will already be accounting using IFRS or EEA domestic accounting standards and their annual report will contain much of the additional information required under the Directive regime. However, they have various strategic decisions to make and implement before 1 July.

In addition, there are a myriad of more technical issues not mentioned in this article which are being discussed with regulators and which need to be resolved by that date. They will also affect the detailed content of prospectuses or market practice, particularly for MTN programmes. Early summer promises to be very busy months for treasurers, their advisers and regulators.

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