MATTERS OF EUROPEAN SECURITIES

JOHN RUSSELL OF SIDLEY AUSTIN BROWN & WOOD REPORTS THAT THE EU'S PROSPECTUS DIRECTIVE WILL FUNDAMENTALLY ALTER SECURITIES OFFERINGS IN EUROPE FROM 2005.

After two years of intensive effort by the securities professionals who responded to the consultation, the EU's Prospectus Directive has been reshaped from a disastrous first draft to a final version that promises to radically improve access to European Union (EU) investors. However, the saying that 'the devil is in the detail' has never been more apposite than when applied to the detailed requirements for the prospectus, which has still to be finalised. This article focuses particularly on debt issues by EU corporates.

EXECUTIVE SUMMARY. EU companies with their shares listed in the EU will gain substantially by the directive facilitating a pan-EU new issue market. In particular, pan-EU access to retail investors will become practical for the first time. This promises particular benefits in terms of diversification of investors and improved new issue terms, especially for those companies with large funding requirements, which also have household name recognition. In time, internet offerings to retail investors might even become a significant factor, compensating for the lack of an EU retail brokerage network on the US model.

Before the directive becomes effective, companies will need to reassess how they access the EU capital markets at a macro level, and in terms of documentation and procedures. Documenting financing programmes in advance will become even more critical to achieving a flexible ability to access debt capital quickly to take advantage of strong market conditions.

KEY ELEMENTS OF THE DIRECTIVE

PASSPORT. The most important benefit of the directive is the new passport provisions. These will allow the passporting of, for example, an English language prospectus across the EU by a simple notification procedure. Where translation into the local language is required, it will be applicable to the summary only. Local regulators will no longer be able to block issues, which will greatly facilitate pan-EU retail offerings and bring the EU closer to the US model of a single capital market.

AMBIT. Where there is an 'offer' or sale of securities in the EU with a denomination of less than €50,000 or 'admission' to a regulated securities market in the EU, a prospectus must be approved unless an exemption applies. 'Offer' is given the very wide meaning of a communication to persons in any form and by any means, providing sufficient information on both the offer and the securities to be offered to enable an investor to decide to purchase or subscribe to these securities. 'Admission' relates to listing or trading.

PROFESSIONALS' EXEMPTION. To enable the wholesale Eurobond market to operate, offers to 'qualified investors', including larger legal entities, governments and supranational organisations, are exempt, unless there is also admission.

CHOICE OF REGULATOR. An important aspect is whether the issuer can choose the competent authority that vets the prospectus. Issuers of non-equity securities whose denomination per unit amounts to at least €1,000 are afforded this choice. If the securities are in a currency other than euros, it will suffice for the denomination to be 'nearly equivalent' to €1,000.

Ultimately, the speed with which such authority approves the prospectus and the language it requires will determine preference of competent authority, as the same content should be required in all Member States. Unfortunately, equity securities include convertibles and equity warrants into the issuer's group where, therefore, there will be no choice (unless a structural solution is used).

Where there is no choice, the prospectus must be approved in the Member State where the issuer has its registered office or, if a non-EU issuer, the Member State in which securities are first admitted to a regulated market.

WHOLESALE DEBT EXEMPTIONS. A denomination of €50,000 carries important benefits. No prospectus is required unless the securities are admitted to a regulated market. In that case, the prospectus will not need to have a summary and there will be no domestic language requirement, unless required by a host state. The content requirements for the prospectus are also reduced to a level deemed appropriate for wholesale investors. In addition, the Transparency Obligations Directive (TOD) may not require the publication of semi-annual and quarterly accounts.

NON-EU ISSUERS. This exemption from the accounting requirements is irrelevant to companies with shares listed in the EU, as they will be subject to the requirements in respect of their shares.

The exemption will be important to non-EU companies not producing International Accounting Standards (IAS) accounts, particularly if their accounts are not prepared to the 'true and fair view standard'. The additional requirements imposed on non-EU companies by the Prospectus Directive and the TOD with respect to accounts and otherwise may dissuade such companies from accessing the EU capital market, with detrimental effects on the market.

SOME OPEN ISSUES AND UNCERTAINTIES OUTLINED

WHOLESALE DEBT EXEMPTION. Although a summary of the prospectus translated into the local language is not generally required for securities with a denomination of €50,000, Article 19.4 of the directive permits Member States to require this. It is unclear whether this discretion relates only to debt that is admitted to trading in that Member State. This would seem logical, since a prospectus is not required for securities with a denomination of €50,000 not admitted to a regulated market. If Member States insist on a summary and translation for such securities, many issuers will simply exclude investors in the state from the offering.

A number of securities, such as global depository receipts (GDRs) and warrants, do not have a denomination. Clarification is being sought that a minimum sale and trading size of €50,000 will be treated as a denomination of such an amount. No 'nearly equivalent' language (as mentioned before) is used with respect to the €50,000 exemption. Consequently, US dollar bonds would currently need to be denominated in significantly larger amounts to ensure that there was no danger of this rule being breached. The next generally used denomination is $100,000. The scope of the exemption is reduced by the exclusion of securities convertible into shares of a group company.

MEDIUM TERM NOTES. Medium term notes (MTNs) should operate in broadly the same way as they do now, but there will be some difficulties:

- A prospectus supplement must be produced every time a significant adverse event occurs and future information, such as quarterly reports, can no longer be incorporated by reference in the prospectus.
- Only 'final terms' can be included in a pricing supplement without it constituting a supplemental prospectus and it is unclear how wide the meaning of 'final terms' is.
- If a supplemental prospectus is produced, any investor can withdraw for two days after the supplement has been approved by the competent authority.
- It is possible that separate base prospectuses will be required, for example, instead of a programme that would currently cover straight debt and derivatives or asset backed securities.

GUARANTORS. Full issuer disclosure applies to the guarantor and the issuer. Monoline insurers and providers of 'keep well agreements' will not welcome these requirements applying to them for the first time.

BANKS. Reduced information requirements and exemptions will apply to banks and are likely to apply to investment banks, but they are unlikely to apply to insurance companies, holding company issuers or guarantors and will not apply to equity issues. This will create problems for excluded institutions for which certain information is inappropriate.

ASSET BACKED SECURITIES (ABS). The current draft definition of ABS is unclear. Synthetic collateralised debt obligations (CDOs) and repackaging may not be included. The provisions are designed for mortgage securitisations, with the result that more complex transactions may prove problematic.

DERIVATIVES. Although there has been considerable debate about the definition of derivative, this will not have serious consequences, provided that a programme can cover debt and derivatives. The proposed prospectus content requirements have been reduced considerably so that they should not generally prove unnecessarily burdensome.

However, the Committee of European Securities Regulators (CESR) is currently consulting as to whether it should be necessary for the prospectus to include examples of how a derivative would work and/or back testing information. The inclusion of this information would not be in the interests of investors.

TROUBLING DISCLOSURE REQUIREMENTS. The principal problem with the disclosure requirements is lack of clarity. The competent authority will also have less flexibility in its ability to waive requirements that are unduly burdensome. Examples of areas in which clarity is wanting are:

- disclosure of recent and future capital expenditures and investments and their funding (as yet there is no materiality test) (the June CESR consultation paper proposes that this not be required for wholesale debt);
- disclosure of conflicts of interest of directors and management;
- a summary of contracts not in the ordinary course of business material to it meeting its obligations to the securities holders;
- to the extent known to the issuer, whether it is directly or indirectly controlled, and details of such control; and
- risk factor disclosure for wholesale debt is not limited to those factors that are unusual to the particular issuer or make the issue unusually speculative or high risk.

OTHER CONCERNS. Practices will change in a number of areas not related to debt finance, including:

- on a takeover, a prospectus will be required for any payment by a loan note or any listed shares;
- on an auction of a subsidiary, if no prospectus is required, all bidders must be given identical information; and
- a prospectus may be required for free shares given to directors or employees.

FINAL COUNTDOWN

The directive was adopted by the Council of Ministers on 15 July 2003 and is due to become law in Member States around mid-2005. Much effort is still required to ensure that the final implementation of the directive assists companies in accessing capital, rather than inappropriate information requirements overwhelming them. If this is to be achieved, companies should participate actively in the consultation on the detailed prospectus requirements before these are finalised by the Commission in May 2004.

John Russell is a Partner at Sidley Austin Brown & Wood.
jrussell@sidley.com
www.sidley.com