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The Changing Face of European Securities Issuance

The European securities market looks set to undergo the most radical changes that have been proposed since the adoption of the Prospectus Directive (2003/71/EC) in 2003. The passing of the Amendment Directive (2010/73/EU) in December 2010[1] heralded significant, though not earth-shattering, changes to the Prospectus Directive. However, if the additional changes currently proposed by ESMA in its recent Consultation Paper[2] are implemented, they will have a wide-ranging impact on European debt programmes and offers of securities to retail investors.

We will focus in this alert mainly on two of the sections covered in the Consultation Paper, namely (i) the format of final terms to a base prospectus and (ii) the format and detailed content requirements of the key information to be included in the summary of the prospectus (where such a summary is required under the Prospectus Directive).

The Consultation Paper is a precursor to ESMA's technical advice to the European Commission as to possible delegated acts under the amended Prospectus Directive, in relation to the topics mentioned above.

Format of Final Terms to the Base Prospectus

For issues of certain securities (primarily non-equity securities), the Prospectus Directive provides that a base prospectus may be used in place of a separate registration document, securities note and summary. The Prospectus Directive and the Prospectus Regulation (Regulation 809/2004) together allow for the final terms of the securities offer to be contained in a final terms document separate from the base prospectus and, unlike the base prospectus, the final terms document is not required to be approved by the relevant competent authority of the issuer's home member state for the securities offering.

ESMA's predecessor, CESR, had previously raised concerns about the levels of inconsistency between the approaches of different competent authorities as to what information could be omitted from the base prospectus and instead included in the final terms document.

ESMA's initial conclusion in the Consultation Paper has been that too much information is typically contained in a final terms document that should be approved by the relevant competent authority and therefore contained in a base prospectus. It therefore considered the possibility of developing a format for final terms which would list exhaustively the items allowed to be included in the final terms, but concluded that this would be virtually

[1] See Morrison & Foerster client alert "Amendments to the Prospective Directive" http://www.mofo.com/files/Uploads/Images/101217-Amendments-Prospectus-Directive.pdf.
[2] http://www.esma.europa.eu/data/document/11_141.pdf.

impossible, due to the varied characteristics of the securities that can be issued using a final terms document, and the desire not to hamper future innovation in financial products.

ESMA has nevertheless proposed an extremely restrictive approach to the issue of what information can be contained in final terms. In addition to setting out certain structural requirements for a final terms document, it has also produced a list of information items, contained in Annex A of the Consultation Paper, indicating whether such items can or cannot be contained in a final terms document.

Despite Article 5(4) of the amended Prospectus Directive and Article 22(4) of the Prospectus Regulation specifying that a final terms note may only contain information relating to the securities note (i.e., not information required in the registration document, such as that relating to the issuer and its business), ESMA considers that if such information is useful to investors, then it could be contained in final terms as "Additional Information."

Consistent with its more restrictive approach to the format and contents requirements for final terms and summary notes, ESMA has produced a list of the information which can qualify as Additional Information in Annex B of the Consultation Paper.

ESMA's Structural Approach to Base Prospectus/Final Terms

1. The base prospectus has to include all information that is "knowable" at the time of drawing up the base prospectus, i.e., that information which could have been included in the base prospectus at that time.

2. The base prospectus can contain options with regard to the relevant securities note schedule of the Prospectus Regulation and the Additional Information, with the final terms then specifying which of the options are applicable, either by referring to the relevant sections of the base prospectus or by replicating the relevant information.

3. However, the final terms cannot be used to contain information already known at the time of drawing up the base prospectus. In other words, the final terms cannot be used as a short-form prospectus and it would continue to be necessary for an investor to have read both the base prospectus and the final terms in order to have all the information necessary for them to make an investment decision.

4. Final terms must be prepared in an easily analysable and comprehensible form.

5. Any information that is not applicable to a particular issuance may not be included in a final terms document.

6. Final terms are not allowed to amend or replace any information contained in the base prospectus, and for such purposes a supplemental prospectus should be prepared and approved by the relevant competent authority.

7. The final terms document should also contain introductory language which points the investor to the base prospectus, as well as to the summary relating to the individual issuance (which is discussed below).

8. The base prospectus will continue to include, as a template, the form of final terms.

Contents Requirement of Final Terms

The Prospectus Regulation, and the schedules thereto which are applicable to the type of securities being issued, will continue to dictate the minimum content requirement of the registration document and the securities note.

As to which of that information will in future be allowed in the final terms document, ESMA envisages four types of information:

- Information from the relevant securities note annex which is labelled by ESMA as Category B or Category C information in Annex A to the Consultation Paper;
- The Additional Information as contained in Annex B to the Consultation Paper;
- Any replication of the applicable options already contained in the base prospectus; and
- The new "drawdown" summary (discussed below), duly completed for the relevant issuance and annexed to the final terms document.

Within Annex A, ESMA has reproduced certain securities note annexes to the Prospectus Regulation, with each information item labelled as Category A, B or C; the categories effectively denote the level of flexibility allowed as to how that piece of information can be provided, with Category A being the least flexible and Category C the most flexible.

Category A information has to be provided in the base prospectus and there can be no placeholder provided in this regard in the base prospectus for information to be included in the final terms.

In respect of Category B information, the base prospectus must contain the general principles of such item and can only leave placeholders for the details which are not known at the time of drawing up the base prospectus, such as amounts, currencies, dates, rates, percentages, places, etc. The final terms may either replicate or refer to the general principles and fill in the relevant placeholders.

For Category C information, there should be a placeholder in the base prospectus for the entirety of such information item, and the final terms should fill in the placeholder.

One concession to flexibility that ESMA makes in this regard, is allowing the use of multiple options in the base prospectus. So, the base prospectus can specify that the relevant information item is either X or Y, with the final terms then specifying which of X or Y is applicable to that issuance.

By way of example, ESMA currently considers that the information as to whether a debt security is in bearer form or registered form should be Category A information, and therefore not able to be accommodated by a placeholder to be filled out in the final terms. If not for the possible use of multiple options, this could result in issuers needing one programme for bearer securities and a different one for registered securities. However, with optionality being permitted, the base prospectus can state that the securities will be "either in bearer form or registered form," and the final terms for a particular issuance can then state which of "bearer" or "registered" applies to that issuance.

Many respondents to ESMA's earlier Call For Evidence considered that payout formulae ought to be contained in final terms, since they differ from issuance to issuance and should not be subject to specific analysis by the competent authority. However, ESMA considers that the competent authority should review algebraic formulae as part of its role of reviewing the completeness and comprehensibility of the prospectus. Therefore, any payment formula must have at least its principles set out in the base prospectus, with only placeholders to be completed in the final terms. ESMA also considers that the effect that any underlying asset, or any market

disruption/adjustment events, could have on the payment formula, and any associated risk factors, would be known at the time of the base prospectus and should be contained in the base prospectus.

The general principles of the manner of redemption and settlement of the securities should be set out in the base prospectus, and for securities linked to a proprietary index of the issuer's group, ESMA considers that such index must be disclosed in the base prospectus. Similarly, in relation to asset-backed securities issued off a programme, details of such items as the structure and cashflows of the securities, the description of the swap counterparty and the description of the obligors of all underlying assets not listed on a regulated market must all be contained in a base prospectus or supplement.

Issues Relating to the Proposed Contents Requirements

The inflexibility of this general approach by ESMA will give rise to significant problems and changes to the way that certain securities issuances have been documented to date.

The prospectus as a whole (i.e., the combination of the base prospectus, final terms and summary in the case of programme issuances) must, under Article 5(1) of the amended Prospectus Directive, contain all information which is necessary to enable investors to make an informed assessment of the issuer and the securities.

Therefore, for any deal-specific information (i) which is "necessary" information under Article 5(1), but (ii) which was not known at the date of the base prospectus, and (iii) for which no placeholder or optionality was provided in the base prospectus, disclosure will not be possible in the final terms document. If that information constitutes a significant new factor capable of affecting the assessment of the securities, a prospectus supplement is required under Article 16 of the amended Prospectus Directive. That supplement is required to be separately approved by the relevant competent authority, and the competent authority is allowed to take up to seven working days to review and approve it. This will add significantly to the amount of time required for a programme issuer to complete an issuance, although it is hoped that relatively simple supplements could in practice be turned round by competent authorities in a much shorter time frame.

ESMA's stated intention is not to move all programme issuance to prospectus supplements, rather than final terms documents; they note that this would be contrary to Recital (4) of the Amending Directive, which states the goal of enhancing the international competitiveness of the European Union. However, ESMA acknowledges that the new, rigid approach would have the effect of substantially increasing the number of prospectus supplements needed.

To put the significance of this change in context, a typical major financial institution might make tens of thousands of issuances per year, using final terms. Even if only a certain proportion of those offerings were in the future required to be made on the basis of programme supplements, this would entail not only a major increase in its costs of doing business (due to the fees required by the competent authorities in relation to their review of each supplement), but more importantly the ensuing delay in being able to issue the securities will inevitably mean some precious fund-raising opportunities will be missed.

Requirement as to Summaries

ESMA was also asked by the European Commission to advise on possible schedules and building blocks of the summary document (which summary is required for prospectuses for securities with a denomination of less than €100,000 or its equivalent) as well as the format and content of the key information which, under the amended Prospectus Directive, is a required component of the summary. The intention behind developing a format for the key information is to promote comparability between summaries of similar products by ensuring that equivalent information will always appear in the same position in the summary.

The same motivations lie behind the Key Investor Information Document ("KIID") currently being developed under the European Commission's PRIPs initiative[3]—namely, providing for disclosure of key points in a short document which aids comparability of different "packaged retail investment products" (in the case of PRIPs, not just limited to products in the form of securities, but also including deposits, units in collective investment schemes and insurance and pension products). ESMA has been asked by the European Commission to take account of the PRIPs initiative in delivering its technical advice.

In the context of the Prospectus Directive, ESMA proposes that disclosure of information in the summary should be divided into five sections—Introduction and Warnings, Issuer/Guarantor, Securities, Risks and Offer—and has set out in an annex to the Consultation Paper its proposed format and contents of the summaries, divided into those categories. No information will be allowed in a summary that does not fall within one of these categories.

Previously, summaries were subject to a 2,500-word limit. The amending Directive has removed this numeric limit, although still retains the principle that the summary should be as short, simple and easy to understand as possible.

It is worth noting, therefore, ESMA's view that the summary should not contain any cross-references to parts of the prospectus and also that it should contain both the wording of the underlying disclosure requirement and the disclosure itself. The combination of this lengthy format and the prohibition on cross-references means that summaries will inevitably become much longer than they were before the Amending Directive.

Such a result seems completely inconsistent with the PRIPs initiative. The European Commission originally envisaged the KIID under the PRIPs initiative being not more than two pages in length (although this result was always going to be difficult to achieve in the case of structured securities).

Some of ESMA's other prescriptions in drafting the summary are that:

- A "copy-out" approach should be avoided;
- There should be no copying of "boilerplate" from the prospectus to the summary; and
- In respect of key information in the summary as to risk factors, the minimalist approach of simply listing the risk factor headings will not be acceptable, but neither will the opposite extreme of reproducing the risk factors in long form.

Combining Final Terms and Summaries

One completely new suggestion of ESMA, which is not contained in the Prospectus Directive, is that of a "drawdown" or issuance summary, which would be attached to the final terms document. ESMA considers that the summary drawn up at the time of the base prospectus should consist of three types of information—information already known at the date of the prospectus, options for Additional Information or information required by the securities note schedule/building blocks (with the applicable option to be specified in the final terms) and placeholders for those types of information (with the placeholders being filled in in the final terms).

ESMA now proposes that a "drawdown" summary also be prepared, by taking the base prospectus summary and "completing" it with details of the relevant securities issuance, and attached to the final terms document for that issuance. In terms of the three categories of information specified in the previous paragraph for the base prospectus summary, this would mean:

[3] See Morrison & Foerster's "Structured Thoughts Volume I, Issue 18," http://www.mofo.com/files/Uploads/Images/101217-Structured-Thoughts.pdf.

- For information already known at the date of the base prospectus, no change but simply a replication of that information;
- For the options, the replication of just the option that is applicable to that issuance; and
- For the placeholders, the filling-in of the placeholders with the relevant information for that issuance.

No approval of such a drawdown summary by a competent authority would be required because the information in that summary would be either a replication of information already contained in a base prospectus that had been approved, or the disclosure of information permitted to be contained only in a final terms document, which document does not require approval by a competent authority.

Proportionate Disclosure

The Amending Directive also introduced the principle that certain types of issuer should be able to comply with a slightly relaxed disclosure regime, such as credit institutions undertaking continuous issuance of certain non-equity securities and companies with reduced market capitalisation, and that there should be a "proportionate" disclosure regime applicable to certain rights issues by companies whose shares of the same class are already listed on a regulated market or multilateral trading facility and subject to appropriate ongoing disclosure requirements and rules on market abuse, so long as the issuer has not disapplied the statutory pre-emption rights.

The Consultation Paper also sets out ESMA's proposals in this regard.

Conclusions

Notwithstanding the stated aims of ESMA, there are several features of the Consultation Paper which, when combined, seem to indicate an unspoken intention. The specific format and content requirements of the summary, combined with the abolition of the 2,500 word limit, will lead to longer summaries. In addition, summaries in future will be required to contain the key information and to be developed into drawdown summaries attached to final terms. All of the above, combined with the ability of a final terms document to contain Additional Information (i.e., information not required by a securities note schedule) seems to indicate an intention of ESMA to prescribe a document which will give the investor all the information it needs to know in order to make an investment decision, without reading the base prospectus.

Such an approach would not be in accordance with the Prospectus Directive itself which, as ESMA itself notes in the Consultation Paper, provides that investors can only make an informed investment decision if they consult the final terms along with the base prospectus and the summary. However, it is difficult not to draw a conclusion that ESMA's approach will render the information in the base prospectus less important to an investor's informed decision.

Such approach also diverges from that of the PRIPs initiative, which envisages a very short key information document being made available at issuance, to be read in conjunction with all other required disclosure, as opposed to a stand-alone short-form disclosure document (something the final terms plus summary might be regarded as).

ESMA is required to deliver its technical advice to the Commission by 30 September 2011. In doing so, it is required to take account of the KIID being developed under PRIPs, and it will be vital to ensure that these two initiatives do not develop in inconsistent ways, and thereby produce a confusing and overly burdensome disclosure regime across different products.

However, since the European Commission is not expected to produce its further PRIPs proposals until the last quarter of 2011 at the earliest, it is surely premature to require ESMA's advice on summaries by September 2011. This deadline is driven by the deadline imposed on the Commission for adopting delegated acts under the amended Prospectus Directive, but many market participants would prefer that European lawmakers should focus less on delivering unsatisfactory results by artificial deadlines, and more on a joined-up and holistic approach to European disclosure regimes.

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