



ESMA Consultation on Further Prospectus Directive Technical Advice

Fresh from delivering its final technical advice to the European Commission on final terms and summaries in the context of the Prospectus Directive Amending Directive (2010/73/EU),¹ the European Securities and Markets Authority (ESMA) has now turned its focus towards some of the remaining topics on which it has been mandated by the Commission² to provide technical advice. On 13 December 2011, ESMA published a Consultation Paper³ containing its proposed advice in relation to the consent to use a prospectus in a retail cascade, as well as a review of certain provisions of the Prospectus Regulation (809/2004). Once ESMA's technical advice is delivered to the Commission in final form, the Commission will consider it in proposing legislation on the issues which were delegated to it in the Amending Directive.

Consent to Use Prospectus in a Retail Cascade

ESMA's definition of a retail cascade is "a distribution mechanism where securities are offered to retail investors not directly by the issuer, but by a distribution network of financial intermediaries." It considers that this can encompass more than one structure – firstly, a sale from the issuer to the financial intermediaries and a subsequent sale by the intermediaries to the retail investors, and secondly, a placement of the issuer's securities to the retail investors by the intermediaries, without the intermediaries actually acquiring those securities at any point. In both cases, though, the financial intermediaries are acting in association with the issuer.

Nevertheless, from the point of view of the Prospectus Directive (PD), any offer by the intermediaries to the retail investors can constitute an offer of securities to the public, distinct from any offer made by the issuer to the financial intermediaries. The offer by the issuer to the intermediaries would usually be exempt from the requirement to publish a PD-compliant prospectus, but the subsequent offer to retail investors would require the publication of such a prospectus unless (unusually) it fell within one of the PD exemptions.

ESMA's predecessor, CESR, had previously issued guidance to the effect that separate prospectuses were not required where intermediaries were acting with the issuer's authorisation. However, the Amending Directive enshrined for the first time in legislation the concept that a PD-compliant prospectus, published by the securities issuer, could be relied upon by financial intermediaries placing or re-selling the securities, so long as the prospectus remained valid and up-to-date at the time of the placing or re-sale and so long as the issuer consented to the use of the prospectus by such intermediaries for such purpose.

¹ See Morrison & Foerster client alert "ESMA Final Report on Summaries and Final Terms Under the Prospectus Directive," <http://www.mofo.com/files/Uploads/Images/111020-ESMA-Final-Report.pdf>.

² http://ec.europa.eu/internal_market/securities/docs/prospectus/esmaadv_en.pdf.

³ <http://www.esma.europa.eu/system/files/2011-444.pdf>.

The Amending Directive requires that such consent is to be contained in a written agreement. In its Mandate, the Commission asked ESMA to advise on the possible format and method of disclosing such an issuer consent to the relevant parties. In particular, ESMA was asked to focus on the duration of the consent, any conditions to be attached, the effect of such consent on the respective liabilities of the issuer and the intermediaries for the prospectus content, and the circumstances in which a resale or final placement of securities can be considered compliant with the written agreement.

Terms of Subsequent Offers/Placements

ESMA considers that the terms of any subsequent offer/placement of securities in a retail cascade must be in accordance with the terms set out in the prospectus published by the issuer, and therefore that the issuer needs to include, in the prospectus, information on the method of determining the price for offers by the intermediaries, and how that pricing will be disclosed. It considers that intermediaries cannot re-sell or place the securities on terms that conflict with those in the prospectus and therefore that any pricing variation, or contractual selling arrangements of the intermediary, contained in the retail placing must not be inconsistent with the methodology set out in the prospectus for determining the price.

The implication of this is that, in circumstances where the terms of a re-sale or final placement conflict with the contents of the issuer's approved prospectus, then any consent provided to the financial intermediary by the issuer would no longer be applicable for such re-sale/placement and the financial intermediary would need to produce its own PD-compliant prospectus.

This approach of ESMA would seem to restrict retail cascades to only a very tightly controlled distribution chain and would be very limiting for future retail issuances.

Duration of Consent/Responsibilities of the Issuer

ESMA is of the view that any consent of the issuer to a financial intermediary cannot extend beyond the validity of the prospectus, and that it remains the issuer's responsibility to keep the prospectus up to date for the whole of the period of consent. A prospectus must, under Article 16 of the Amending Directive, be supplemented to address every significant new factor, material mistake or inaccuracy in the prospectus information, which is capable of affecting the assessment of the securities and which arises after the approval of the prospectus, but before the final closing of the offer to the public or, if later, the commencement of trading of the securities on a regulated market.

In a case where there is no trading on a regulated market, ESMA therefore considers that a prospectus cannot be supplemented after the final closing of the offer to the public and therefore that no consent by the issuer to a financial intermediary to use the prospectus can extend beyond the closing of the offer to the public. It therefore believes that the offer period to be stated in the prospectus, in accordance with Annex V to the Prospectus Regulation, must take into account the dates of the subsequent public offers by the intermediaries who are considered to be part of the retail cascade.

Disclosure Principles Regarding Retail Cascades

ESMA does not consider that the written agreement, containing the consent, needs to be publicly disclosed. However, it has stated that there needs to be a public disclosure of the consent itself, of the identity of the financial intermediaries and of any conditions attached to the consent. Its intention is that the investor will know that the issuer takes responsibility for the prospectus if it knows that the issuer has consented to the intermediary's use of it, but that if there is no consent, the intermediary must publish a new prospectus and be responsible for the information contained in it.

Problems arise here for the issuer in disclosing the identities of the financial intermediaries in circumstances where additional intermediaries are added to the retail cascade after the date of publication of the approved prospectus, or after the date of a final terms document, in the case of a programme offering.

Such issues could potentially be alleviated if the consent, and the identity of the intermediaries and any conditions to the consent, could be published separately from the prospectus/final terms, for instance on the website of the issuer, where it could be kept constantly updated. However, ESMA has concerns regarding the accessibility of information on a website, what language requirements should apply and how it could be proved that a consent had been given previously, when the consent is subsequently removed from the website. It therefore currently takes the view that such publication has to be made in the prospectus or the base prospectus/final terms, as the case may be.

Therefore, ESMA believes that the prospectus or base prospectus/final in relation to a retail cascade terms need to disclose:

- that the issuer will be offering securities through financial intermediaries;
- that the issuer consents to the use of a prospectus by such intermediaries (thereby accepting responsibility for the prospectus contents for the offers by such intermediaries);
- the intermediaries' identities and addresses; and
- any conditions to the consent, including its duration, and proposes the amendment of the relevant Annexes to the Prospectus Regulation to reflect the above principles.

In the context of a base prospectus/final terms structure, ESMA considers that the last two information items, if not known at the time of approval of the base prospectus, can be included in final terms if the base prospectus leaves placeholders for that information.

In the case of an issuance under a programme, using final terms, ESMA considers that where a new intermediary is appointed after the filing of the final terms document, an announcement to the market as to the new intermediary is not sufficient and it expects the issuer to publish and file a "replacement final terms" document each time a new financial intermediary is given consent to use the prospectus for its retail offers.

This approach ignores the fact that a final terms document is a contractual document, as well as a disclosure document, since it is typically incorporated into the terms of the global note itself and therefore would require the consent of the other contracting parties, e.g., the noteholders. It seems likely that noteholders may be somewhat bemused by a request to consent to a change to the final terms which is irrelevant to the ongoing relationship between the issuer and noteholders.

Even if this approach were considered workable for programme issuances, there is no equivalent for "standalone" issuances. Therefore, if ESMA continues to take the view that an announcement to the market is not sufficient, the question arises as to how an issuer under a standalone prospectus can add additional financial intermediaries to the retail cascade after the publication of the prospectus.

Assuming that the appointment would not meet the criteria contained in Article 16 of the Amending Directive (as discussed earlier), and if ESMA seems to accept that such appointment would not be a "significant factor" in this context, then a supplement to the prospectus would not be required. However, if an announcement to the market is not considered sufficient, it is not clear how ESMA proposes that the issuer would communicate to investors that a new consent has been given without a prospectus supplement. This would entail a right for investors to withdraw their acceptances under Article 16 of the Amending Directive, not to mention the cost and delay factor involved in the preparation and approval of the supplement.

Despite being requested by the European Commission to advise on any necessary conditions to a consent, ESMA has declined to do so, taking the view that this is a matter of private contract between the relevant parties, provided that any conditions imposed are published.

Review of Prospectus Regulation Content Requirements

The second part of the Commission's Mandate being considered by ESMA in this Consultation Paper is the request to consider certain provisions of the Prospectus Regulation.

Information on Taxes Withheld at Source

Several Annexes to the Prospectus Regulation require disclosure of information on taxes on income from securities withheld at source. ESMA's predecessor, CESR, in its Frequently Asked Questions publication, had expressed the view that this requirement only extended to amounts to be withheld by the issuer or by its paying agent, so that an investor could know the "net" amount to be received when collecting payment from the issuer or its paying agent.

This interpretation had presumably been decided on by CESR, due to the impossibility of the issuer being able to anticipate and analyse the withholding requirements in respect of custodians and other intermediaries in the payment chain who were not appointed by it. As a result, the European Commission invited ESMA's advice on whether the Prospectus Regulation should be amended to reflect this interpretation.

However, instead of endorsing the European Commission's suggestion in this regard, ESMA has actually rejected CESR's interpretation, citing the reason that some investors have suffered as a result of tax withholdings being made by intermediaries in the payment chain of which the investors were not informed in advance. It considers that the prospectus must disclose sufficient information for investors to know the "net" payments they will actually receive from the securities (whether collected from the issuer, its paying agent or from some custodian or other intermediary appointed by the investor).

However, ESMA does not attempt to express any thoughts as to how an issuer could possibly begin to comply with such an obligation, given the variations involved in the jurisdictions and custody structures through which the investors might hold their securities.

Proprietary Indices

Under Annex XII of the Prospectus Regulation, where a security is linked to the performance of an underlying index, the level of required disclosure varies depending on the nature of the index. If the index is composed by the issuer, a description of the index and how it is compiled is required in the prospectus. If it is composed by an entity other than the issuer, then the prospectus only needs to specify where information on the index can be found.

The European Commission has asked ESMA to advise on the effects of allowing the less prescriptive disclosure standard to apply in respect of all index-linked securities, whether or not the underlying index is composed by the issuer. However, ESMA has concluded that a full index description should continue to be required for a proprietary index and that such requirement should also be extended to cover a circumstance where the index is not composed by the issuer but is composed by an issuer group entity or an entity acting in association with the issuer.

Profit Forecasts

Under various Annexes of the Prospectus Regulation, where profit forecasts or estimates are contained in a prospectus, they are required to be accompanied by an accountant's report confirming that the forecast or estimate has been compiled properly and on an accounting basis consistent with the issuer's accounting policies.

ESMA was requested to advise the Commission on whether the requirement for the accountant's report should be repealed on the basis that market announcements are usually issued in advance of the relevant financial results being published.

ESMA concluded that the requirement for such a report should remain, since it believes that accountants play a role in advising the issuer on what assumptions should be made for the forecast/estimate and how the disclosure of such assumptions should be worded in the prospectus. However, it expressed the view that "preliminary statements" should be treated differently from profit forecasts and estimates because preliminary statements are generally expected to be final figures and are not based on underlying assumptions.

It has therefore proposed, in paragraph 21 of the Consultation Paper, a definition of the criteria that information should fulfil in order to be classified as a preliminary statement (such as being an advance statement of the previous financial year's figures, and not being based on any underlying assumptions) and therefore not to be categorised as a profit forecast or estimate.

Audited Historical Financial Information

ESMA was also asked by the Commission to consider whether, for issuances of shares and depository receipts, the current three financial years' account requirements of the Prospective Regulation should be relaxed to two financial years' accounts, except in the case of initial public offerings.

Such a relaxation would make the financial statements requirement consistent with that for debt securities and for securities issued by small and medium enterprises, and it would also render such requirement less stringent than the disclosure standards issued by the International Organization for Securities Commissions. For all of these reasons, ESMA concluded that such a relaxation would not be appropriate.

Next Steps

ESMA has agreed with the European Commission that its technical advice on these parts of the Mandate will be delivered by 29 February 2012 and therefore has set only a short consultation period and requested comments on this Consultation Paper to be received by 6 January 2012.

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