

## European Commission Publishes Draft Proposal for New Prospectus Regulation

The European Commission (the "Commission") recently published its latest draft for a new Prospectus Regulation (the "[New Regulation](#)"). It is envisaged that the New Regulation will replace in its entirety the existing Prospectus Directive and parts of the current Prospectus Regulation. No specific timing has been set for the implementation of the New Regulation, although early indications are that it will become effective some time in 2017.

The New Regulation makes a valiant effort to move European securities laws forward, particularly for seasoned issuers. However, there are some potentially significant stings in the tail of some of the seemingly positive developments, while some of the developments are likely in themselves to give issuers pause. The issues will be particularly troublesome for global offerings involving issuers or investors both within and without the European Union.

### OVERVIEW OF CHANGES

**Wholesale Securities Regime.** The current distinction in the Prospectus Directive between wholesale and retail securities is to be abolished. This will remove the current public offer exemption and streamlined prospectus disclosure regime for wholesale securities. A summary will also be required for wholesale securities.

**Risk Factors.** Risk factors will be required to be limited to those determined to be material and specific to the issuer. The issuer will also be required to allocate risk factors across two or three expressly stated categories of materiality.

**Requirements for Summaries.** New requirements for summaries will apply, including an overall limit on the length to six A4 pages and a limitation to only five risk factors.

**Universal Registration Document.** The option for a new Universal Registration Document (the "URD") will be introduced, providing for the potential publication of a shelf registration document, ultimately aimed at allowing issuers faster access to the capital markets and more streamlined annual reporting.

**Further Issues of Securities.** There is to be a relaxation of prospectus disclosure requirements for further issuances by issuers with existing listings. The existing exemption for employee incentive schemes will also be given a long awaited boost, no longer requiring issuers to have securities listed on a regulated market to be able to benefit from the exemption.

**SME Disclosure Regime.** The proportionate disclosure regime recently introduced for SMEs will be replaced with a new regime designed to encourage SMEs to access the international capital markets. The definition of SME has been widened, thus allowing a greater number of smaller companies to draw up an offering document with shorter form disclosure than a full prospectus.

**Form of Implementation.** The proposed changes will be effected by way of a European regulation, and will therefore have direct effect in each Member State. This is in contrast to the current directive, which required specific implementation by Member States, with greater scope to give effect to their own interpretation of the directive.

## WHAT CAN ISSUERS LOOK FORWARD TO IN THE PROPOSED CHANGES?

### Universal Registration Document

The New Regulation introduces the URD to Europe, alongside the existing registration document system, which will also survive. Based on a system that has been tried and tested in France for many years, the URD provides for a shelf registration type structure, intended to allow seasoned issuers fast access to the European capital markets and to avoid duplicative public disclosures to the market.

The key differences between the URD and the existing registration document system (both of which can be incorporated by reference into a prospectus) are the following:

- The URD can also be used in lieu of the annual report (or half yearly report) required under the Transparency Directive, allowing for a single annual disclosure document;
- Seasoned issuers (issuers who have published preapproved URDs or a registration document three years in a row) can go on to publish URDs without regulatory preapproval; and
- Once a URD has been published, a prospectus using that URD benefits from a fast tracked approval process.

### Further Issues of Securities

Seasoned issuers (issuers who have had certain types of listings for at least 18 months) are intended to have the benefit of a short form disclosure regime for further issuances. This could be particularly beneficial for the issuance of debt securities, or further shares, by issuers that have had equity securities already listed for the requisite period, especially if the securities are not intended to be offered in the United States (where a longer form offering document would be more usual).

The short form disclosure regime is in addition to a more generous exemption, allowing 20% (rather than current 10%) additional shares to be issued and admitted to trading without any prospectus having to be published.<sup>1</sup>

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<sup>1</sup> Other considerations will continue to be relevant to deal size for follow-on transactions aside from the prospectus requirements. Taking the United Kingdom as an example, the shareholder approval requirements for premium listed companies impose a 10% limit absent shareholder approval (other than for rights issues), and the revised Pre-emption Group Statement of Principles published in February 2015 limit the routine disapplication of pre-emption rights to 5% in any one year and 7.5% in any rolling three year period, with an additional 5% if used for specific acquisition or capital purposes.

There will be a clean prospectus exemption for offers of securities to group employees and directors and for the admission to trading of further issuances of such securities, providing only for the publication of a very short form disclosure document. This exemption will no longer be reliant on the relevant issuer having securities admitted to trading on a regulated market or an equivalent market.

### **Requirements for Summaries**

There has been a significant effort to make the summary regime more investor-friendly than the current summary regime, which many market participants considered to be a recipe for highly technical and immaterial disclosure, presented in an inaccessible format.

The summary will consist of three sections covering key information on the issuer, the securities, and the offer/admission. General headings will be introduced but issuers are otherwise free to tailor each section based on what they consider to be material.

In addition, base prospectuses for issuance programmes will no longer need to contain a summary (though a template summary is expected to be required in the base prospectus, forming the basis for the ultimate issue specific summary). Issue specific summaries can be prepared and annexed to the final terms.

### **Form of Implementation**

As a European regulation with direct effect as law in each Member State, there will be less scope for divergent practices between Member States. This is in contrast to the Prospectus Directive, which required specific implementation in each Member State giving greater scope for inconsistent laws throughout Europe.

### **Concessions for SMEs**

A specific regime for SMEs is designed to improve access to the international capital markets for smaller companies by allowing them in many circumstances to draw up a short form prospectus intended to focus on information that is material and relevant for SMEs. The definition of SME has also been widened to encompass companies that have had an average market capitalisation of less than €200,000,000 at the end of the previous three years as well as companies that meet at least two of the following three criteria: an average number of employees during the financial year of less than 250, a total balance sheet not exceeding €43,000,000 and an annual net turnover not exceeding €50,000,000.

It is worth noting that this threshold is still some distance from its U.S. counterpart, the *JOBS Act*, which came into force in 2012. An “emerging growth company”, which

benefits from significant exemptions from US federal securities regulations, is defined as an issuer with “total annual gross revenues” of less than \$1 billion (compared to €50,000,000 under the New Regulation) during its most recently completed fiscal year, which is a far more inclusive definition than that of the UK SME regime.

## WHAT IS LIKELY TO GIVE ISSUERS PAUSE IN THE PROPOSED CHANGES?

### Risk Factors

In an effort to make prospectuses more user-friendly to investors, the Commission has made a significant attack on issuers’ liberty to take an inclusive approach to risk factors, an approach issuers have often taken in a litigious environment to help protect themselves from liability (particularly where offerings are made to investors in the United States). The key changes are as follows:

- Risk factors will have to be specific to the issuer and/or the securities and must be material for making an informed investment decision.
  - The New Regulation requires these conditions to be “corroborated” by the content of the rest of the prospectus. This could involve a challenging negotiation with regulators with respect to the inclusion of each risk factor the issuer wishes to describe in a European prospectus. This change could lead to the deletion of risk factors at the behest of regulators, or otherwise by issuers in an effort to meet these requirements. These efforts may prove to be unfortunate if the deleted risk factors cover issues that ultimately result in a loss to investors.
- Risk factors will have to be ranked across no more than three distinct categories of materiality based on probability and expected magnitude of adverse impact.
  - The effective obligation on issuers to mathematically analyse risks that are inherently incapable of such analysis is likely to be extremely difficult for issuers to handle. Issuers will be forced to compare, for example, the materiality to investors of a high probability risk with relatively modest direct impact (such as competitive market conditions), with a low probability risk that could have a catastrophic impact (such as an explosion at a key industrial facility).
  - Issuers will be at risk for second-guessing with hindsight, where a risk assigned a lower materiality category ultimately proves to have a significant adverse impact for investors.

We expect issuers (and underwriters) will be rather concerned about the liability risks that these changes will pose - not just in Europe (where no effort has been made to mitigate the potential liability), but throughout the rest of the world (where no allowance for the new European rules could reasonably be expected). Many have commented that this change by itself may give issuers sufficient concern that they will seek out alternative listing venues to regulated markets in Europe. Alternatively, issuers conducting global offerings may feel compelled to draw up separate offering documents for Europe (with streamlined and ranked risk factors) and the rest of the world (with more robust risk factors and no ranking), raising issues, among others, of comparable treatment of investors in different markets.

### Requirements for Summaries

The ranking requirement with respect to risk factors has been taken even further for the summary. The key changes are as follows:

- Issuers will need to include no more than the top five risk factors in the summary, without regard to the type of issuer and the type of securities.
  - One might liken this to requiring a doctor to disclose, from within the confines of the doctor's surgery, only five diseases that the doctor thought could result in the demise of the patient, even if the wretched patient was suffering from 10 potentially terminal diseases. The other five diseases the patient would have to discern for himself from the full written medical report. Given that the summary is the only local language document that many investors will see, the patient's efforts may be hindered by foreign language disclosure that could be as difficult to comprehend as typical medical jargon.
  - If the investors ultimately suffer a loss as a result of matters in risk factors not described in the summary, the issuer is subject to a greater risk of liability than if the issuer had disclosed all the key risks in the summary (note that the summary is required to disclose all key information, even if the summary can be read with the rest of the prospectus). Again, no changes have been proposed to the European liability regime to help mitigate the impact of this obligation. Even if such changes had been proposed, they would have done nothing to mitigate the risk of liability elsewhere in the world.
- The summary will have further limits on its length.
  - Currently, it can be the "longer of 7% or 15 pages". This will be replaced with a rule limiting the length of the summary to six pages of A4,

irrespective of the overall length of the prospectus and without regard to the type of issuer or the securities being issued. This is likely to cause non-vanilla issuers and issuers of complex products particular challenges, especially given the move described below to require prospectuses for wholesale bonds to include summaries.

### **Wholesale Securities Regime**

Issuers of debt securities with a minimum denomination of €100,000 will no longer receive any concession on the level of disclosure required in a prospectus. In particular, such prospectuses will be required to include New Regulation compliant summaries. This is likely to be an unwelcome change given that many issuers, particularly issuers of complex products, choose wholesale minimum denominations partly to avoid the challenging rules around summaries. The streamlined prospectus disclosure regime previously available for such bonds has also been eliminated.

Issuers will no longer have the benefit of an automatic public offer prospectus exemption for securities with a minimum denomination of €100,000. Issuers and underwriters of wholesale bonds have been able to rely on this exemption to avoid special procedures to direct the initial placement and early onward distribution exclusively to qualified investors (away from retail investors under 'a retail cascade').

Since the New Regulation does not remove the existing exemption for offers addressed to investors who acquire securities for a total consideration of at least €100,000 per investor, it could well be that issuers maintain a minimum denomination of €100,000 to obtain the automatic benefit of that exemption, undermining the policy objective of the Commission to create greater access for retail investors to the bond market.<sup>2</sup>

Given this policy objective, and given that many issuers currently use this wholesale minimum denomination threshold to avoid more onerous disclosure obligations under the Transparency Directive, the change in the New Regulation may point towards a future change in the Transparency Directive. Such a change may require issuers to publish annual reports within four months and half yearly reports within two months, all in accordance with IFRS, regardless of the minimum denomination of the relevant securities admitted to trading.

There is a palpable concern within the market that the abolition of the €100,000 minimum denominations concession will push many issuers towards alternative listing venues to regulated markets in Europe.

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<sup>2</sup> The Commission appears to wish for such greater access even though many products currently with wholesale minimum denominations are not designed for an investment decision to be made on them by retail investors.

## Universal Registration Document

The URD will not be available to issuers incorporated outside the European Economic Area. This will exclude from this regime a great number of issuers who would have expected to receive equal treatment with European issuers.

The URD will have to be prepared in accordance with the most onerous disclosure annexes for shares, or if applicable, banks. This will be the case even if the issuers wish to use the URD in prospectuses for the issuance only of debt and/or derivative securities.

Issuers who have published a non-preapproved URD will have to bear an uneasy period post publication during which the regulator could require it to make changes to that URD. This risk is unlikely to be taken lightly – having a regulator publicly expose its positive determination that a change needs to be made to an already published document on the basis that it suffered from “an omission or a material mistake or inaccuracy which is likely to mislead the public” could be a serious matter for the issuer. Even in the absence of actual liability, it is not likely to enhance the public standing of that issuer. While the French regulator has very rarely used (or had cause to use) its discretion to require changes to be made to the equivalent documents in France (generally requesting that issuers make changes in response to comments in the following year’s registration document), there will naturally be a concern that other European regulators could be more aggressive in their use of this discretion.

## Short Form Disclosure Regime

The New Regulation does not make it entirely clear what the proposed disclosure obligation actually consists of.

- On the one hand, it suggests that the information is the minimum financial information covering the last financial year only, the rights attaching to the securities, the reasons for the issuance and its impact on the issuer.
- On the other hand, it is prefaced by an obligation to include “the relevant information which is necessary to enable investors to understand the prospects of the issuer and of any guarantor.” This latter obligation seems to be much broader and echoes the general prospectus directive obligation to include all material information in a prospectus.

In addition, the recitals seem to suggest the requirements will include use of proceeds disclosure, risk factors, board practices, directors’ remuneration, shareholding structure, related party transactions, and a working capital statement (seemingly even if a working capital statement wouldn’t be required for a prospectus, for example, for debt securities

or GDRs). This last requirement may be the most important, and perhaps the most problematic, in terms of the work an issuer has to undertake for the disclosure document.

The New Regulation therefore appears to give the market little clarity at this point in formulating a judgment as to what is actually required. Even if greater clarity ultimately appears during the implementation process, the survival in the legal text of an obligation to include the relevant information which is necessary to enable investors to understand the prospects of the issuer and of any guarantor is likely to maintain a potentially significant residual risk for issuers.

### **Form of Implementation**

There were numerous matters in the Prospectus Directive which benefited from interpretation in the context of implementation in various Member States. As a regulation with direct effect in each Member State, there is likely to be greater pressure on the meaning of every word of the New Regulation, which is not necessarily a straightforward text. This is of even greater significance as many of the provisions that benefited from interpretation have been taken verbatim from the existing Prospectus Directive and included in the New Regulation.

### **No Comment**

The Commission has not invited formal comment on the text of the New Regulation from interested parties. This is surprising given that the public consultation conducted in February 2015 was on the functioning of the existing Prospectus Directive without reference to any regulatory text that might succeed the Prospectus Directive. Given the scope of the proposed changes, we believe that the New Regulation would benefit from a full consultation process focusing on the details of the text.

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Please feel free to contact any of your regular contacts at the firm or any of our partners or counsel listed under "[Capital Markets](#)" in the "Practices" section of our website (<http://www.clearygottlieb.com>) if you have any questions.

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