CLEARY GOTTLIEB

Alert Memo

DECEMBER 30, 2011

www.clearygottlieb.com

# ESMA Issues Consultation Paper on Further Technical Advice on Implementation of Amendments to the Prospectus Directive

## I. OVERVIEW

On December 13, 2011, the European Securities and Markets Authority ("ESMA") published a consultation paper (the "CP") on the second portion of the technical advice it has been mandated to deliver to the European Commission (the "Commission")[1] on the implementation of amendments to the Prospectus Directive (the "PD").[2]

If adopted, the proposals set forth in the CP would, *inter alia*, clarify the disclosure requirements for retail cascades and relax the requirements around the inclusion of preliminary annual results statements in PD prospectuses. On the other hand, the CP recommends that the Commission decline to adopt a number of other far-reaching changes suggested in its mandate. ESMA recommends that the Commission decline to pursue, for example, the complete repeal of the requirement for accountant's reports on profit forecasts and estimates or a reduction in the number of years of audited financial statements from three to two in prospectuses used for follow-on offerings of shares or global depositary receipts ("GDRs").

---

1 The Commission has issued a formal mandate to ESMA requesting technical advice on several aspects of the delegated acts the Commission will adopt to implement the amendments to the PD. ESMA is responding to that mandate in several phases, and issued its final technical advice on the first set of topics on October 4, 2011. Other topics for which technical advice has been requested but not yet delivered include (i) consideration of amendments to disclosure requirements relating to convertible and exchangeable securities under regulation 809/2004 (the "PR"); (ii) the assessment of equivalence of third-country financial markets and (iii) comparison of liability regimes across EU member states. The CP notes that ESMA and the Commission have agreed to defer consideration of items (ii) and (iii) until a "later stage".

2 Directive 2010/73/EU (the "PD Amending Directive"), amending the Prospectus Directive, was published in the official journal of the European Union on December 11, 2010. Member States have until July 1, 2012 to implement its provisions into national law. To ensure harmonization in the application of the Amending Directive throughout the EU, the Commission is required to adopt "delegated acts" by July 1, 2012. Such delegated acts are expected to consist of, *inter alia*, an amended version of the PR.

The deadline for comments on the CP is January 6, 2012, and ESMA plans to deliver its final technical advice on the covered topics to the Commission by February 29, 2012.

## II. RETAIL CASCADES

### 1. General

A 'retail cascade' in the simplest form occurs where securities are issued to financial institutions (often referred to as "financial intermediaries"), which then make follow-on offers ("sub-offers") to retail investors. Under current market practice, this is often, though not always, done with the issuer's cooperation. Retail cascades have given rise to the following questions:

- Who is responsible for drafting and updating a prospectus in a retail cascade?
- What is the responsibility of an issuer or the person responsible for drawing up the prospectus in relation to offers made by financial intermediaries?
- How are the information requirements of the PR applied in case of a retail cascade, particularly regarding the terms and conditions of the offer?

### 2. PD Amending Directive

The PD Amending Directive clarified that a new prospectus would not be required for sub-offers by financial intermediaries if (i) a valid prospectus was available at the time of the sub-offer; and (ii) the issuer or the person responsible for drawing up such prospectus consented to its use in any such sub-offer "by means of a written agreement". In such circumstances, a recital to the PD Amending Directive provides that the issuer or person responsible for drawing up the prospectus is liable for the content of the prospectus. However, the CP notes that the issuer's consent does not prevent the responsibility from also being attached to the financial intermediaries under national law. If no such consent is given, the financial intermediary must file a new prospectus and take responsibility for its contents.

### 3. ESMA Consultation Paper

The CP proposes the following:

- Prospectuses used for retail cascades must disclose at least: (i) the issuer's intention to offer securities via financial intermediaries; (ii) the issuer's consent to the use of the prospectus for the sub-offer by the financial intermediaries (thereby accepting responsibility for the contents of the prospectus in relation to such sub-offers); (iii) the identity of the financial intermediaries that are allowed to rely on the prospectus; and (iv) the

conditions attached to the issuer's consent relevant for the use of the prospectus, including the duration of such consent.[3] The full agreement itself need not be disclosed. The requirement to disclose the identity of each permitted financial intermediary is likely to be particularly problematic in practice as the identity is often unknown at the time of the prospectus, and is sometimes not known by the issuer even at the time of ultimate use of the prospectus, as there is often a distribution chain intervening between the issuer and the relevant financial intermediary.

- Only valid and properly supplemented prospectuses can be used by financial intermediaries for their sub-offers – the issuer's consent cannot extend beyond the 12-month validity of the prospectus.

- When an issuer gives its consent to the use of its prospectus in sub-offers by financial intermediaries, it must ensure that it is able to keep the prospectus updated for the entire period during which such prospectus may be used for sub-offers pursuant to the issuer's consent. This is potentially problematic since the issuer cannot always control the occurrence of a material event or indeed the approval of a supplement. Even if it can, some delay between occurrence of the event and the publication of a supplement would be inevitable.

- The fact that the issuer has given its consent for the use of its prospectus should not, according to the CP, prevent national laws from attaching responsibility for the contents of the prospectus also to the financial intermediaries. This is likely to cause some concern among financial intermediaries who, for the most part, have avoided statutory liability for an issuer's disclosure document. Furthermore, attaching liability to a party that has little or no control over the update process for a prospectus seems to be somewhat incongruous.

## III. PROFIT FORECASTS AND ESTIMATES

The PR currently requires issuers to obtain an accountant's report if they wish to include profit forecasts or estimates in their prospectuses. This report is required to state that the forecast or estimate has been properly compiled on the basis stated in the prospectus and the basis of accounting used for the forecast or estimate is consistent with the accounting policies of the issuer. The Commission asked ESMA to consider the effects of repealing this requirement in light of the fact that

[3] Where a retail cascade is used in connection with a debt programme, the base prospectus must specify that the issuer intends to offer the securities through financial intermediaries, but the identity of the financial intermediaries and the conditions attached to the consent may be described in the final terms if not known at the time of approval of the base prospectus.

market announcements are often issued ahead of the related financial statements being finalized.

The CP recommends the following:

- The general requirement to obtain an accountant's report should be retained because it provides assurance to investors that the basis of accounting used for the forecasts and estimates is consistent with the accounting policies of the issuer and that the forecasts and estimates have been properly prepared on the basis of the underlying assumptions.[4] An opportunity to encourage issuers to make helpful forward-looking statements in prospectuses (and to the market more generally since such statements to the market often then need to be included in prospectuses) may well have been missed by recommending the retention of these accountant's reports. Many market participants believe that the requirement for a public report by its accountants has a chilling effect on the willingness of issuers to give the market specific guidance on its future expectations. A market-led (rather than regulator-led) approach of private comfort from accountants to directors and/or underwriters, where appropriate, might well have been a better overall compromise.

- The PR should be revised to create a new category of "preliminary statements" that would not be treated as profit estimates (and would therefore not need to be accompanied by an accountant's report when included in a prospectus). For statements to qualify as "preliminary statements", the following criteria would need to be met:

    - The statements can only contain "non-misleading figures to be published in the next annual audited financial statements in relation to the previous financial year and any significant explanatory information to assess such figures".[5]

    - The disclosed figures cannot be based on underlying assumptions.

    - The statements or the prospectus must state that information in such statements has not been audited.

[4] ESMA also believes that the active role played by accountants in advising on disclosure under the current rules helps ensure that all material assumptions are properly disclosed and not unrealistic.

[5] As proposed, the definition would not extend to preliminary statements relating to interim periods – such statements would continue to qualify as estimates under the PR and therefore require an accountant's report. ESMA does not explain its rationale for this approach, which, on its face, appears rather arbitrary.

- The statements must be "approved by the person(s) responsible for them and published as soon as practicable after such approval". The prospectus would be required to include a prominent statement to this effect.

- The statements must be "agreed by the statutory auditor". The prospectus would be required to include a prominent statement to this effect. The CP does not address the manner or conditions under which such agreement would be obtained or documented. This condition is unlikely to be welcomed by accountancy firms in particular, which have unsurprisingly eschewed proposals that could make them more visible targets for legal claims by investors, and may well render the recommendation unworkable in practice. Indeed, in such a case, accountants may conclude that the work needed to allow such a "prominent statement" to be made in a prospectus is no different to the work needed to underlie the original accountant's report included in a prospectus.[6]

## IV. OTHER TOPICS[7]

### 1. Audited historical financial information

The Commission requested ESMA to consider reducing the requirement of audited historical financial information from three to two years in relation to prospectuses for shares and GDRs, other than IPO prospectuses, with the aim of decreasing issuers' costs when preparing prospectuses.

The CP recommends retaining the present three-year requirement, *inter alia*, because (i) the proposed change would be a significant departure from international disclosure standards for cross-border offerings; (ii) reducing the number of years of financial statements to be disclosed would result in less disclosure of other PR items[8] that depend on the period covered by the financial statements; and (iii) ESMA believes the reduced two-year requirement is appropriately reserved to debt securities, which are traditionally viewed as less risky and not as vulnerable to short-term market volatility as shares or GDRs. ESMA also notes that reducing the

---

[6] In addition, in practice, it may be difficult to obtain any formal auditor signoff on year-end figures prior to substantial completion of related the audit fieldwork. This may well limit issuers' ability to avail themselves of the flexibility offered by the new definition.

[7] In addition to the topics discussed in this section, the CP also addresses certain disclosure issues relating to withholding taxes.

[8] Numerous disclosure items are tied to the periods for which financial information are presented, including, *inter alia*, the operating and financial review, information on factors affecting the issuer's business and markets, information on the principal investments of the issuer and disclosure of related party transactions.

requirement to two years would not always result in substantial cost reductions because issuers would be entitled to incorporate information by reference.

**2. Disclosure of the Composition of Proprietary Indices**

The PR currently requires that prospectuses for derivative securities whose value is determined by reference to a proprietary index include a description of the index, whereas prospectuses for derivative securities linked to third-party indices need only indicate where information about the composition of the relevant index can be found. The Commission requested ESMA's advice on extending the third-party index rule also to cover proprietary indices. The CP recommends that the current requirement for disclosure of information relating to proprietary indices be retained. Moreover, to prevent issuers from circumventing this requirement by outsourcing the production of the index to an affiliate or entity acting on the issuer's behalf, the CP recommends that the PR be amended to provide that the enhanced disclosure requirements apply whenever the index is produced by the issuer or an entity "belonging to the same group as the issuer or acting in association with or behalf of the issuer."

* * *

If you would like to discuss any of the above issues further, please feel free to contact any of your regular contacts at the firm on +44 (0) 207 614 2200 or any of our partners and counsel listed under Capital Markets in the "Practices" section of our website (http://www.clearygottlieb.com).

CLEARY GOTTLIEB STEEN & HAMILTON LLP

CLEARY GOTTLIEB

# Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal
Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299