Working Group on the Prospectus Directive
of the Commission of Stock Exchange Experts
(*Börsensachverständigenkommission, BSK*)

at the German Federal Ministry of Finance (*Bundesministerium der Finanzen*)

Response to CESR's Second Call for Evidence on the Prospectus Mandates

March 2003

The present position paper constitutes the response by the Working Group on the Prospectus Directive of the Commission of Stock Exchange Experts (*Börsensachverständigenkommission*, BSK) to CESR's second call for evidence on the Prospectus Mandates (CESR/03-038)

The Commission of Stock Exchange Experts is a body appointed by the Federal Minister of Finance and entrusted with the task of advising the German federal government on issues relating to capital markets and stock exchanges. The Commission's membership is made up of stock exchange representatives, representatives from banking, industry and insurance, investors, academics, the Deutsche Bundesbank and those German Laender which host a stock exchange. In October 2001, the Commission established a permanent Working Group on the Prospectus Directive; this Working Group is joined by several legal experts on capital market law with guest status.

The Working Group on the Prospectus Directive of the Commission of Exchange Experts (BSK Task Force on Prospectus) at the Federal Ministry of Finance in Germany is highly appreciative of this opportunity to comment on the Additional Provisional Mandate to CESR for Technical Advice on Possible Implementing Measures concerning the Future Directive on the prospectus to be published when securities are offered to the public or admitted to trading.

Contact details:
Börsensachverständigenkommission
Sekretariat
c/o Deutsche Börse
Neue Börsenstr. 1
60487 Frankfurt/Main
Germany
Tel.: +49 69/2101-3980
Fax: +49 69/2101-3981

I. General Remarks

We are grateful that the Commission has taken our initial comments into account, and that it is taking care to ensure an orderly legislative procedure by giving time for more extensive consultation on certain aspects.

However - and combined with the first remark - we still see the problem of volumes of rules. The level of detail is still too high. This endangers modern capital market practices that require a certain degree of flexibility (for example in the case of "unvollständige Verkaufsprospekte"/preliminary offering prospectuses, see below). The major reason for the over-regulation is the so-called building block approach, which leads to extensive regulation.

II. Measures of Level 2 implemented as a Regulation or as a Directive?

The Commission has announced that it takes into account to implement the level 2 measures of the Lamfalussy procedure in the form of a regulation. We understand that the arguments for this approach are the head-start in terms of the timetable, and a higher degree of harmonisation.

We concur with the first argument but do not agree with the second. As the implementing measures – as suggested by CESR in the Consultation Paper and in the Addendum to the Consultation Paper - are already very detailed, there is almost no discretionary power for the Member States to diverge from the text, even if implemented in the form of a directive. On the other hand, a directive gives the Member States scope to adapt the wording to the legal terminology of their national jurisdiction. This is specifically necessary for the interaction with company law. Therefore in total, we strongly recommend opting for the format of a directive.

III. Particular Format of Base Prospectus and Supplement

(referring to 3.1. (2) of the second call for evidence on the prospectus mandates)

As far as the base prospectus is concerned, we would like to draw the attention to the procedures for the present "unvollständiger Verkaufsprospekt"/preliminary offering prospectus according to German law. Under this regime, the base prospectus contains the following information:

- Securities note for the respective product. The securities note specifies the type of product and provides all basic information, including the conditions of issue and the section on risk. All information to be supplemented on the day of issue should be marked by "placeholders".

- Registration document with all information on the issuer. Any update to the registration document part of the base prospectus is provided in a supplement.

A single base prospectus should contain various securities notes for various types of debt and/or derivative securities, to avoid double paperwork.

In the case of an issue, the securities note for the respective product is filled with the "placeholders". CESR should allow for a high degree of flexibility with regard to the "placeholders". As practical experience has shown, even new tranches of "standard products" require certain adjustments very often, for example additional information regarding certain specifics of a new underlying, any changes in the method of calculating the interest rates or exercise values, etc, which could not be foreseen in detail at the time of the preparation of the base prospectus. The supplement should also be provided in an easily readable form, not only in a simple compilation of "placeholders".

The prospectus for an individual transaction therefore consists of the base prospectus prepared once for a set of terms which may be either supplemented into the base prospectus by filling out the placeholders or supplemented by way of a separate pricing supplement comprising all the placeholders, plus the final terms prepared for the specific transaction.

The placeholders may include - **but are not limited to** - the following information:

- Number of securities issued (transaction volume);
- Underlying, (in case of derivative securities);
- Coupon,
- Strike; Barriers etc. (if any),
- Lifetime, Exercise Period (if any);
- Evaluation Dates (if any);
- Ratio (if any);
- Risk Factors (if any);
- Tax Language;
- Security Codes;
- Listing.

IV. Mortgage Bond Issues

(referring to 3.1. (3) of the second call for evidence on the prospectus mandates)

Article 5(4) of the current draft of the directive provides for an exemption for mortgage bonds, by which such securities may be issued on the basis of a base prospectus.

We think that as a rule, the registration document for credit institutions and the securities note for retail debt - or wholesale debt, if applicable - may be used as a basis for the information to be included in the base prospectus. However, it must be made clear that not only the issue price and amount of the issue may be filed with the competent authority, but that the base prospectus will only contain the general structure of the securities to be issued, and all details relevant for the individual issue may be filed.

A potential Building Block for mortgage bonds should, however, add a description of the legal requirements for the issue of mortgage bonds quoting Article 5(4) of this

directive, the national legal regulations applicable to the respective mortgage bond and, perhaps, Article 22(4) of Directive 85/611/EEC as well.

Potential investors should be made aware of and be (on a very general basis) able to assess the special regime and protection governing mortgage bonds. The national legal requirements applicable to the respective mortgage bonds provide for investment regulations, which exactly limit and describe in an abstract way the coverage that may be used for a mortgage bond. These investment regulations should also be quoted.

Bearing this in mind, no description of the assets providing coverage for mortgage bonds needs to be included in the base prospectus or any supplement or filing.

In contrast to mortgage-backed securities, where the portfolio of assets has been identified a long time before the issue is made and has already been scrutinised by, for example, rating agencies, mortgage bonds are a flexible instrument and their issue must be possible within a very short time frame. A description of the respective assets used as coverage cannot therefore be provided to investors.

In addition, the trustee monitoring the adequacy and eligibility of the coverage of a mortgage bond has the right to withdraw certain assets from the coverage pool of a mortgage bond, as long as sufficient assets are remaining in the pool to cover outstanding mortgage bonds and the trustee will add assets, if additional coverage is needed. (in Germany: section 30 of the Mortgage Bank Code). If certain assets or the percentages of asset classes have been listed in a prospectus, the option to exchange assets in the coverage pool allowed under the law might lead to the prospectus becoming incorrect over time.

V. Derivative Securities

(referring to 3.2 (1) of the second call for evidence on the prospectus mandates)

On the one hand, issues of derivative securities and demand from investors have shown significant growth over the last years. On the other, derivative securities form the most innovative and diversified segment of the securities markets. Any requirements for derivative securities, therefore, should allow the clear disclosure of the profit and loss potential of such products, and should not stand in the way of further flexibility in the development of the market.

The starting point must be a general definition of derivative securities. We would like to make reference to the position of the Börsensachverständigenkommission on the Consultation Paper, where we suggested the following definition: "Derivative securities are securities where the payment and/or delivery obligations are linked to an underlying (including but not limited to the price of one or more securities, indices, commodities, energy, yields, currency (rates), weather events, etc.) unless the payment of interest is merely linked to a fixed rate or to a recognised interbank interest rate." The second part of the sentence starting with "unless" should be inserted to make it clear that plain vanilla fixed and/or floating rate bonds with

EURIBOR or LIBOR interest payments are not regarded as derivatives. All other linkages to an underlying, should, however, qualify the product as a derivative.

The most important factor for derivative securities is a proper description of the product, including the terms and conditions, which should be set forth in the securities note. The requirements regarding the issuer should be lower for derivative securities than for equities, but in general also lower than for debt.

VI. Small and Medium-sized Enterprises

(referring to 3.2 (2) of the second call for evidence on the prospectus mandates)

In cross-border equity offerings no distinctions should be drawn as regards the disclosure requirements for small and medium-sized companies. For the sake of investor protection and transparency, prospective investors should be able to obtain the same information as from any other issuer. However, especially SMEs of small member states will need additional demand from other markets when offering equity. The additional costs of translation and selling efforts should result in a sufficient level of subscription for the securities offered.

SMEs with dual or multiple listings/offerings mostly complain on the different obligations and formalities in the follow-up of the offering/listing. So, high attention should be given to a coherent and effective set of disclosure requirements with regard to translation costs and disclosure media; article 10 of the proposed directive should be optional for SMEs. The Commission would be well advised to consider a single EU-wide center of evidence for the follow-up obligations of issuers.

Domestic equity offerings should allow SMEs a low key disclosure approach under the present standards of article 7 and 8 if not article 11 (2) of Directive 89/298. This could lead to a reduction of the number of annual accounts that must be presented prior to a Going Public. A difference should be made for companies with a record of earnings/dividends/cash-flow and those companies that are in an early stage of development. Additional information on a qualitative high basis should be given to future expectations, earnings and results and also if necessary how the additional equity gained with the offering will be used in the future ("cash-burn rate"). These informations should be qualified by a respective statement of the sponsor/auditor.

Debt instruments issued by SMEs will primarily be valued by the issuer´s rating. Under the new Basel II capital requirements all SMEs will be forced to produce ratings. The additional costs for the rating process should not result in disclosure requirements that would only replicate the findings of the rating agency. In this respect SMEs should encounter a lower level of information both cross-border and domestic. The benchmark should be the requirements laid down in article 26 of Directive 2001/34 EU.

Furthermore, it is a matter of record that quite a large proportion of issuers in the so called grey capital market are SMEs. Investors purchasing securities from such companies often run a very high risk of losing the invested capital. Those SMEs should take advantage of reduced disclosure standards to dry up the grey market.

VII. Credit Institutions

(referring to 3.2 (3) of the second call for evidence on the prospectus mandates)

The justification for a specific schedule for credit institutions derives from the different type of business, compared with a manufacturing or service company. A prospectus of a credit institution will therefore have a different character to a prospectus for manufacturing or service companies.

Furthermore, banks and other credit institutions are permanently regulated and supervised by public authorities. As almost all (major) banks are issuers of securities, the disclosure requirements should be brought in line with the disclosure requirements laid down by the supervisory authorities for the financial sector, for instance in the annual report. There is no reason why a bank, as an issuer of debt and derivative securities, should provide substantially more information on its business than as a borrower of term and saving deposits or seller of OTC derivatives. It is the same type of ordinary business, and differs only with respect to the securitisation of the obligation.

VIII. Content of a Base Prospectus / Offering Programme

(referring to 3.2. (5) of the second call for evidence on the prospectus mandates)

The content of the base prospectus must correspond to the provisions of the relevant specialist building block for the registration document (all regular financial information should also be capable of incorporation by reference) and the securities note, depending on the nature of issuer and/or offer (e.g. retail/wholesale issues), and not only limited to the specialist building block for banks, as indicated in the Addendum to the Consultation Paper of December 2002. However, certain specific features of a base prospectus should be taken into account. Especially in the case of Medium Term Note Programmes, a common feature is that a programme is established not only for a single issuer but for a number of different issuers from different jurisdictions, including non-EU jurisdictions. Some of the issuers under the programme may also have the benefit of a guarantee of another issuer under the programme.

The base prospectus will be approved by the relevant competent authority, and the final terms prepared for a specific issue (i.e. the pricing supplement) will not be subject to any further approval.

IX. Dissemination of Advertisements

(referring to 3.6 (2) of the second call for evidence on the prospectus mandates)

Advertisements announcing the intention to offer securities to the public or admission to trading are currently not explicitly regulated in Germany, with the exception that such advertisements must contain a reference to the prospectus and its publication, and that a copy of such advertisements must be submitted to the admissions office of the relevant stock exchange provided that the securities have been admitted to trad-

ing or that admission has been applied for. Besides, there exists the general rule that misleading advertisement is forbidden.

In addition, the "Going Public Principles" promulgated by Deutsche Börse AG as of July 15, 2002 (which are, however, merely voluntary recommendations rather than mandatory rules) stipulate that, during the period commencing on the date of the admission application, but in any event no later than four weeks prior to the commencement of the public offering, and ending at expiration of the stabilization period or 30 days after the commencement of trading in shares or certificates representing shares, whichever is earlier, the issuer may not, publicly or privately, directly or indirectly, disseminate any information about its business and its financial condition and results of operations which is material to the evaluation of the issuer or the shares or the certificates representing shares and which is not set forth in the prospectus (any statutory duty to provide or publish such information is not affected.) In its remarks on this provision, Deutsche Börse AG clarifies that, as the wording "no later than" indicates, a quiet period longer than four weeks is recommended in individual cases, and in particular covers the entire period during which the issuer is actively preparing a share issue.

Other than that, the dissemination of advertisements relating to public offers or the admission to trading of securities is not currently prohibited or restricted in Germany. In particular, there are no restrictions regarding the media allowed for such advertisements or the timing thereof. Consequently, issuers have widely used, and are continuing to use, advertisements, especially relating to equity offerings in Germany. While such advertisements are predominantly placed in the press (mostly in national journals of record that are also used for exchange-related publications, but also in weekly business magazines and – depending on the issuer – industry-related publications), some issuers have also advertised on TV.

Since Article 15 of the latest draft of the Prospectus Directive already contains provisions relating to the content, presentation and quality of information that exceed the current legal provisions in Germany and actually correspond largely to the abovementioned recommendations, we do not believe that additional provisions are necessary or advisable regarding the media in which such advertisements may be placed. Moreover, since we understand the criteria regarding the content, presentation and quality of information to apply to any advertisements, irrespective of their timing, we do not see any need to limit the period during which directive-compliant advertisements can be placed.