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CESR's Advice on possible Level 2 Implementing Measures for the Proposed Prospectus Directive Consultation Paper

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Opinion

of boerse-stuttgart/EUWAX

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44. *Do you agree with the disclosure obligations set out in Annex A?*

We do not agree that the IOSCO Disclosure standards are of direct application and that they constitute the minimum on top of which even further requirements may be added. Our view is justified by the wording of Article 7(2) as well as by the purpose of the IOSCO Disclosure standards. Article 7(2) of the Draft EU Prospectus Directive states that the implementing measures referred to in Article 7(1) shall be "based" on the IOSCO Disclosure standards. The term "based" means from its wording that these standards shall be "taken into account" or shall "serve as a guideline" but it does not mean that these standards have to be the minimum on which one is allowed to add still further obligations. Furthermore, the purpose of the IOSCO Disclosure standards was to have maximum standards comprising all requirements of all countries involved whereas the requirements of the Directive are minimum standards. It would not be covered by the purpose of the IOSCO Disclosure standards being maximum standards that they now become imposed as minimum standards by way of the implementation procedures on the Directive. Therefore, we are of the opinion that the disclosure obligations currently set forth in the Annexes have to be adjusted to the various products (shares, debt and derivative securities) individually to strike an acceptable balance between the information needs of the investors and the time and cost burdens for the issuers. How these adjustments should be made has been marked in Annexes A and I.

47. *Do you agree with this approach?*

Yes.

129. *Do you consider that the disclosure requirements for debt securities should be identical to those for equity, as set out in Annex A?*

No. There should be less disclosure requirements for debt securities and even less for derivative securities because it is not an investment into the equity of the company. The only risk for a debt or derivative security investor is the insolvency risk of the issuer and in the event of a derivative security the risk of the security itself whereas the risk of an equity investor is already a deterioration of the performance of the issuer which occurs long before the insolvency. In particular for derivative securities

II.B (risk factors relating to the issuer) should be deleted and replaced by risk factors of the product,
III.B, C2-8, E, IVA, B, C, D, V B-D, VI A, B should be deleted because they are not relevant for derivative securities,
VII A should be shortened,
VII G1 should be deleted as of "provided, however",
VV H2, I, J, VIII A2-7, VIII B2-9, VIII C, VIII G should be deleted because they are not relevant for derivative securities.

With regard to derivative securities the most important thing is a proper description of the product, including the terms and conditions, which should be set forth in the securities note. The information regarding the issuer is of minor importance and should be limited accordingly.

In addition, I.B should be deleted for all categories of securities. The legal advisers should not be mentioned in a prospectus. The mentioning of the legal advisers does not have an added value. On the contrary it would even be misleading, e.g. if the advisers did not carry out a complete due diligence (often no complete due diligence is carried out!) or if they did not have to take care of all legal issues (what also happens frequently) or if they were not involved with respect to the issue of securities at all. Even if the legal advisers carried out a complete due diligence and were involved with all legal issues, the mentioning of the legal advisers is not to be recommended since the mentioning of their names could be interpreted by courts as the assumption of a liability by the lawyers for the prospectus. If this were the case, the legal advisers would have to increase their fees substantially to cover an additional insurance coverage. The increase of the lawyers' fees could be really substantial per transaction which can neither be in the interest of the issuer nor in the interest of the investor.

134. *Do you consider disclosure about the issuer's bankers and legal advisers to the extent that the company has a continuing relationship with such entities to be relevant for corporate retail debt?*

No, such a disclosure would rather be misleading (see above at the end of the answer to question 129).

135. *Do you consider that disclosure relating to bankers and legal advisers who were involved in the issue of that particular debt instrument to be relevant?*

No, such a disclosure would rather be misleading (see above at the end of the answer to question 129).

148. *Do you feel that issuers should be required to put on display all documents referred to in the prospectus (as set out in CESR reference VIII in Annex A)?*

Only publicly available documents should be displayed. Other documents, in particular material contracts, often contain confidential information and therefore may not be publicly displayed. In addition, a complete display of these contracts could affect the competition because such a display would give competitors an easy access to contracts they otherwise would not have access to. Furthermore, if all material contracts on display had to be translated into the same language as the prospectus, this would be so cost and time consuming that most issues would become too burdensome for issuers. Last but not least, the prospectus or any documents relating to the issuer should not be a due diligence report but should inform the investor only about the nature and the risks of the security involved. An overload of information generally does not make the investors happier or more informed but rather deters them from being interested in the product.

150. *Please give views on which if any of the documents that are not in the language of the country in which the public offer or admission to trading is being sought should be translated.*

No translation regarding documents on display should be required. This would be much too expensive and time-consuming. Since these documents are rarely read by investors (even less than the prospectus itself which is already hardly ever read before an investment is made) the costs and time delay would outweigh by far any benefit.

160. *Do you consider it necessary to have specific derivative registration document requirements, or do you consider this unnecessary as the registration document requirements for debt securities should be used for derivative securities as well? Please give your reasons.*

The requirements regarding the issuer should be much lower for derivative securities than for equity but also lower than for debt securities. With regard to derivative securities the most important thing is a proper description of the product, including the terms and conditions, which should be set forth in the securities note. The information regarding the issuer is of rather minor importance and should be limited accordingly.

170. *Do you think it useful to provide some form of definition for these securities?*

Yes. A definition is necessary if a special regime shall apply to these securities.

171. *If so, which of the two approaches set out above do you prefer? Please give your reasons.*

Neither of the approaches is preferable. The first approach is too limited as to the underlyings and does not give enough flexibility regarding the underlyings. The second approach is too complicated, too specific and therefore does not give enough flexibility with regard to new products. Furthermore, it has the following flaws:

- The first sentence in 3) is unclear and not correct. What is meant by "some form of payment payable by the investor"? With regard to warrants and certificates the investor only has to pay the purchase price for the warrants/certificates. Thereafter there are no further payments by the investor. Furthermore, derivative securities - once bought by the investor - generally only contain obligations of the issuer but do not impose any obligations on the investor. Therefore, the reference to an obligation of the investor is not correct. Even in reverse convertibles or discount certificates the investor is only entitled or offered to receive the underlying but never obliged to take it.

- The features described in 3 a)-c) do not provide any added value to the feature described in 1).

- The feature in 4 a) is only applicable to warrants. Warrants, however, represent only a very small part of the derivative securities. Therefore, to say that "The instrument will give the investor rights – *normally* in the form of

exercise rights …" is incorrect. Certificates which represent a significant part of derivative securities are not exercised.

- The feature in 4 b) is senseless as all derivative securities give an entitlement to the investors but do not impose any obligations on the investors.

- The feature in 5 a) is a repetition of what is said in 1).

- The feature in 5 b) is unnecessary as the performance of the described security depends on the value of the underlying instrument even if it is (partly) guaranteed. There is no reason for a distinction between derivative securities which partly guarantee a certain return and derivative securities where the investment is totally at risk. This is only a question of a proper risk warning.

- The feature in 6) is not necessary to qualify a security as a derivative security.

A more general and shorter approach should be chosen to be flexible for new products. A possible definition could be as follows:

"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 recognized inter-bank interest rate.".

The second part of the sentence starting with "unless" should be inserted to make 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 text in the square brackets in our proposal does not necessarily have to be used in our view but maybe it may serve as a compromise for Member States who have a preference for detailed rules. In any event, if used it is absolutely necessary that the words "including but not limited" are stated.

173. *If you prefer the approach based on fundamental features, are there other features that should be but are not included in the above list?*

The definition should be as proposed in the answer to question 171 above.

179. *Do you agree with the above sub-categorisation of derivative products?*

No. Although we are in favour of three types of registration documents (one for equity securities, one for debt securities and one for derivative securities), we disagree with the sub-categorisation into guaranteed and non-guaranteed return derivative securities.

There is no need for the sub-categorisation. In both cases the issuer is liable for the fulfilment of the obligations under the derivative securities. As a consequence thereof, the investor is at risk that the issuer might not be able to meet its obligations under the derivative securities. In this connection it is not relevant whether this risk exists with respect to the fulfilment of the guaranteed or the non-guaranteed obligation of the issuer.

180. *Do you agree with the approach of having two distinct registration document building blocks to reflect this sub-categorisation?*

No (see comments to question 179 above).

185. *Do you agree that the nature of the decision that an investor is making about the issuer in the case of a non guaranteed derivative is different to the one an investor is making in the case of a guaranteed derivative? Please give your reasons.*

No (see comments to question 179 above).

190. *Do you consider that disclosure about the issuer's senior management, as set out in IOSCO reference I.A, is relevant for these products? Please give your reasons.*

The term "senior management" is not known in Germany. Therefore any disclosure about such a management would not be possible. Instead one should only refer to "board of directors" (*Geschäftsführung*) which would be the "Vorstand" in a German *Aktiengesellschaft* (stock corporation).

192. *Do you consider disclosure about the issuer's advisers, as set out in IOSCO reference I.B, to be relevant for these products? Please give your reasons.*

No, on the contrary. For the reasons see above at the end of the answer to question 129.

199. *Do you consider the level of detail set in IOSCO disclosure standard IV.A to be inappropriate for these products? Please give your reasons.*

Partially they are inappropriate for derivative securities. For further detail see below the answer to question 200.

200. *Which particular items of IOSCO disclosure in this section do you consider to be relevant for these products? Please give your reasons.*

The information set forth in IV.A.1.-3. seems to be appropriate information to be provided by the issuer of derivative securities.

The information required in IV.A.4.-7. should be deleted. The description of the history of the issuer and past expenditures and divestitures are not relevant for an investor of derivative securities when evaluating the capability of the issuer to fulfil its obligations under the derivative securities.

202. *Do you consider that a general description of what the issuer's principal activities are is a more appropriate level of disclosure for these products? Please give your reasons.*

A general description of the issuer's principal activities is more appropriate since the investor of the derivative security is not making an investment in the equity of the issuer.

203. *Please advise what, if any, other items of Section IV.B of IOSCO you consider to be of relevance for these products? Please give your reasons.*

IV.B.1. should be limited to the past financial year (instead of the last three financial years) because the history is not relevant for an investor of derivative securities.

IV.B.2. should be limited to the description of the principal markets in which the company competes. The breakdown should be deleted.

IV.B.3.-8. should be deleted completely because these items do not apply to the issuers of derivative securities (e.g. seasonality of the business, raw materials, instalment sales, manufacturing processes).

205. *Do you consider that a brief description of the issuer's group and the issuer's position within it, as set out in IOSCO reference IV.C, to be an appropriate disclosure requirement for these products?*

Yes.

207. *Do you consider Section IV.D of IOSCO to be relevant disclosure for these products? Please give your reasons.*

The information set forth in IV.D. (property, plants and equipment) is not applicable to the issuers of derivative securities and should be deleted.

209. *Do you consider Section V.D of IOSCO to be relevant disclosure for these products? Please give your reasons.*

This section is not relevant to the issuer of derivative securities. It is applicable only for producing companies (see terminology such as "production, sales, inventory").

212. *Do you consider that the name and function of the directors of the issuing company to be the appropriate level of disclosure for these products?*

Yes. Name and function of the directors are appropriate and sufficient.

213. *Please advise what if any other items of Section V of IOSCO you consider to be of relevance for these products. Please give your reasons.*

No further information is of relevance since the investment in derivative securities is not an equity investment in the shares of the issuer.

215. *Do you consider that a statement setting out whether or not the company is directly or indirectly owned or controlled by another entity and the name of that entity to be the appropriate level of disclosure for these products?*

Yes, but only to the extent that the company has been notified by the shareholders about the shareholding and is obliged to publish such notifications according to national law.

217. *At this stage do you have views about whether the following types of financial information about the issuer are relevant and as such should be disclosed in the registration document for these products? Please give your reasons.*

a) balance sheet
b) profit and loss account

c) *statement showing either (i) changes in equity other than those arising from capital transactions with owners and distributions to owners; or (ii) all changes in equity (including a subtotal of all non-owner items recognised directly in equity)*
d) *cash flow statement*
e) *accounting policies*
f) *related notes and schedules required by the comprehensive body of accounting standards to which the financial standards are prepared.*

a), b) and e) should be required. All other information seems to be not necessary since an investor of derivative securities does not invest into the equity of the issuer.

218. *For how many years should the above disclosure be given?*

a) *for the last year, or*
b) *for the last two years.*

For the last two years.

222. *At this stage do you have views about which of the following sections of IOSCO regarding the issuer's share capital you consider to be relevant information to be disclosed in the registration document for these products? Please give your reasons.*

a) *Section X.A.1.*
b) *Section X.A.2.*
c) *Section X.A.3.*
d) *Section X.A.4.*
e) *Section X.A.5*
f) *Section X.A.6.*

X.A.1.: items a), b) and c) should be provided. Any reconciliation of outstanding shares at the beginning and the end of the year does not seem to be required for an derivative security. The last sentence should also be deleted.

X.A.2. and 3.: meaning is unclear.

X.A.4.-6: should be deleted. These sections are only suited for convertibles but not for derivative securities.

223. *At this stage do you have views about which of the following sections of IOSCO regarding the issuer's Memorandum and Articles of Association you consider to be relevant information to be disclosed in the registration document for these products? Please give your reasons.*

a) Section X.B.1.
b) Section X.B.2.
c) Section X.B.3.
d) Section X.B.4.
e) Section X.B.5.
f) Section X.B.6.
g) Section X.B.7.
h) Section X.B.8.
i) Section X.B.9.
j) Section X.B.10.

X.B.1.: to be disclosed.

X.B.2-10.: not to be disclosed, only relevant for investments in issuer's equity.

224. *In relation to Section X.C of IOSCO which sets out the Material Contracts disclosure requirements, at this stage do you have views about which material contracts for these products should be summarized in the registration document for these products? Please give your reasons.*

The term "material contract" is too vague. If it is used at all, it has to be limited to "material with respect to the performance of the security to which the prospectus relates". Nevertheless, one has to bear in mind that the purpose of the prospectus is not to provide a due diligence report to the investor but only to inform him about the nature and the major risks of his investments. Accordingly, it should be enough if any risk resulting from such contract is described in the prospectus.

226. *Do you consider that the information about the issuer's dividend policy as set out in Section X.F of IOSCO to be relevant for these products? Please give your reasons.*

The dividend policy of the issuer of the derivative security is not relevant for the holder of the derivative securities as the holder is not entitled to any dividend payment of the issuer of the derivative security.

227. *In relation to Section X.H of IOSCO which sets out the Documents on display disclosure requirements, at this stage do you have views about which documents should be put on display for these? Please give your reasons.*

The following documents could be made available for the public on display:

1. most recent annual report of the issuer;
2. published interim figures of the issuer, if any;
3. articles of association of the issuer;
4. paying agency agreement, if any;
5. calculation agency agreement, if any.

No translation should be required. The translation costs and time would outweigh by far the benefits for the investors. If translations were required many issues would not occur for costs and time reasons.

232. *Should all guaranteed derivative securities, irrespective of the percentage return they offer an investor, be treated in the same way, or should there be some form of minimum return that is guaranteed for these instruments in order to be classifiable as a guaranteed return derivative as opposed to a non guaranteed return derivative?*

Guaranteed and non-guaranteed derivative securities should be treated alike. Both categories should be treated like derivative securities and not as debt.

233. *If you consider that a percentage benchmark should be set to distinguish between those products where the return is high and therefore additional disclosure about the issuer is justified, please specify what this percentage of return should be, and give a reason for your answer.*

No percentage benchmark should be set.

234. *Do you consider that in addition to the percentage return on the investment, the life of the product should be taken into consideration, so that an instrument that has a 100% capital guarantee return with only a 6 month life cycle should be treated for disclosure purposes differently than a product with 100% capital guarantee but with a 10 year life cycle? Please give reasons for your answers.*

The life should not be taken into account. One should avoid making too many distinctions. Otherwise the applications of the rules becomes too difficult. Furthermore, a risk of return also exists with regard to short term products.

249. *Do you consider it an appropriate approach to obtain flexibility by creating specific building blocks on particular characteristics of some issuers, offers, markets and securities?*

There should not be further specific building blocks other than for equity, debt and derivative securities and possibly asset backed securities, regardless of the issuer or its line of business / industrial sector.

252. ***Section I.2.*** *- Should advisers be mentioned in all cases, or only if they could be held liable by an investor in relation with the information given in the prospectus?*

Advisors should only be mentioned if they could be held liable by an investor. For the reasons of not mentioning advisors generally see above at the end of the answer to question 129.

254. ***Sections I.6. and I.7.*** *- Sections I.6. and I.7. both concern the responsibility attached to drawing up a prospectus. Although under the proposed directive it is possible to choose a format consisting of three documents (Registered Document, Securities Note and Summary), these three documents are considered as making one prospectus. Is it therefore correct to assume that responsibility for each of these three parts must rest with the same persons?*

No. It may be that also in a single prospectus various people take responsibility for various parts, e.g. the index sponsor for the index description, the issuer for the description of the issuer and the guarantor for the description of the guarantor. This should be possible for the single as well as for the three part prospectus.

255. ***Section III.A.*** *- Under Section III.A., all securities notes must contain a statement of capitalization and indebtedness. Is such a statement necessary for derivatives?*

No. At least for derivative securities the capitalization and indebtedness is irrelevant. With regard to the other securities, this information should appear in the registration document rather than in the securities note.

256. ***Section III.B. (III.B.1. for the derivatives schedule)*** *- Section III.B. asks to list the reasons for the offer and the use of proceeds. While this is an important item for shares and bonds, is it also the case for derivatives?*

No.

257. ***Section III.C.2.(d)*** *- Under Section III.C.2.(d) requires inclusion of a worked example of the "worst case scenario".*

1) Does this information provide material information for investors?
In many cases of derivative securities it should be enough to state that the investor may lose its entire invested capital. A worked example would not make this more evident.

2) Are there circumstances in which an example of the worst case scenario is not appropriate?

It could be superfluous and its drafting too time-consuming if the entire investment may be lost. A risk warning along the lines of 3)a) is enough.

3) Would the disclosures as set out below be an appropriate alternative:
a) a risk warning to the effect that investors may lose the value of their entire investment, and/or
b) if the investor's liability is not limited to the value of his investment, a statement of that fact, together with a description of the circumstances in which such additional liability arises and the likely financial effect.

The alternative a) is better.

260. ***Section V.B.12, first indent of Annex M*** *- Section V.B.12, first indent of Annex M requires a statement concerning the past performance of the underlying and its volatility. Is this disclosure necessary? Should the requirement for disclosure vary depending upon whether the underlying instrument is admitted to trading on a regulated market and the nature of the market? Should the requirement for disclosure vary depending upon the nature of the underlying instrument?*

A statement concerning the past performance of the underlying and its volatility should not be required. The past performance of the underlying does not give any reliable information with regard to the future performance of the underlying. As a

consequence thereof, the information on the past performance is of no additional value for the investor. Such information could even be misleading, in particular if a good performance in the past makes an investor believe that the performance will continue as it did in the past. Misleading information should be avoided. In addition, a description of the past performance would be extremely cumbersome on the issuer since it would take quite some time and would thereby affect the necessity for a speedy process.