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 the CESR Consultation on Possible Implementing Measures of the Proposed Prospectus Directive

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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 regarding the implementing measures of the Prospectus Directive. It was submitted on 23 December 2002.

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.

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I. General Remarks

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 suggested Implementing Measures of the proposed Prospectus Directive.

Before answering the specific questions posed, we would like to make the following general comments:

- We are fully aware of the time constraints. However, given the need for a proper legislative procedure, it is our considered opinion that the fact that the documents presented are based on a version of the Directive that is already outdated is unacceptable (this is particularly an issue with respect to the registration document system).

- We find the volume of rules suggested by CESR more than astonishing. We support the need for a harmonised regime for prospectuses throughout the EU. However, we see no reason whatsoever for this to imply a surfeit of regulatory arrangements at Level II. We are highly concerned about the fact that an inflexible regime could counterbalance the aim of the Prospectus Directive to facilitate the raising of capital for issuers. We are more in favour of streamlining the regulation arrangements at Level I, the establishment of the minimum rules required at Level II and cooperation between the competent authorities at Level III (see also our remarks on the building block approach below).

- We see a further problem in principle arising out of the fact that the IOSCO Disclosure Standards are regarded as the basis for the Implementing Measures. On the one hand this supports the mentioned overregulation since the IOSCO Standards were originally seen as maximum requirements and are now taken as minimum EU Prospectus Standards. On the other hand this leads to inflexibility since the IOSCO standards were originally addressed to equities only and in many cases a differentiation to other asset classes is required, which is not fully taken into account in the Consultation Documents.

II. Detailed Comments

In the following, we would like to address the key issues from our perspective. Due to the expanded scope of the suggested implementing measures and the restricted deadlines for consultation, we have not been able to comment on all critical issues and every detail.

Paragraph 29 (IOSCO Disclosure Standards)

According to paragraph 29, CESR considers the IOSCO Disclosure Standards as the minimum requirements, on top of which even more far-reaching requirements may be added. We do not agree with this point of view. It contradicts the wording of Article 7 (2) of the Draft EU Prospectus Directive and the reasoning behind 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. That means that these standards shall be taken into account, but certainly not that these standards should be treated as the minimum requirements. Furthermore, the purpose of the IOSCO Disclosure standards was to create maximum standards covering all requirements of all the countries involved, whereas the requirements of the Directive are minimum standards. If they are now imposed as minimum standards by way of implementation procedures on the Directive, this would conflict with the original purpose of the IOSCO Disclosure standards as maximum standards.

Paragraphs 33 to 38 (IAS)

With regard to clauses 33 to 38, we explicitly reject the requirement to make IAS reporting a binding obligation for all issuers whose securities are admitted to trading on a EU regulated market starting from 1 January 2005, above and beyond the requirements already stipulated by the Regulation on the application of IASs approved on 7 June 2002. Such a requirement is in contrast to many efforts to open the securities markets, especially for small and medium-sized companies. It should be abandoned on a European-wide basis and should not be subject to individual regulation by Member States. In Germany, for example, some hundreds of small and medium-sized companies are listed. The shares of such issuers in most cases are not the focus of investor attention; even where these companies are profitable, their growth potential is limited, their market capitalisation is small, the stock exchange turnover is negligible and their most recent securities issue was many years ago. If these issuers were burdened with additional costs, they will opt for a delisting purely on cost grounds. We would therefore expect hundreds of companies in Europe to delist their shares.

Annexes regarding Accounting Standards

We are of the opinion that the disclosure obligations currently set forth in the Annexes must be adapted to the various products, as we do not concur that the IOSCO Disclosure Standards are directly applicable to equity securities (see comment on paragraph 29 above).

In particular, we would like to draw attention to section VII.G of various annexes for registration documents which requires that the last year of audited financial statements may not be older than 15 months from the date of the registration document. For a number of reasons, we suggest either extending this period to 18 months or, as a compromise, establishing a general rule that would allow the respective authority to

extend this period on a discretionary basis. Many issuers (with a financial year ending December 31) will not be able to issue equity (in the case of a capital increase) or a bond early in the following year. Most companies will not normally publish their annual accounts prior to end March or end April. After factoring in the time needed to incorporate the financial data in the draft prospectus and the approval period with the authority, they can only start placing new securities starting in June. In addition, frequent issuers (for MTNs, debt or derivatives) will face severe problems. The renewal of a base prospectus will become impossible if publication of the issuer's annual accounts is postponed – for whatever reason. In such cases, the issuer cannot tap the market for a certain period of time.

Paragraphs 48 to 65 (Pro forma information)

The criteria mentioned in numbers 48 – 54, governing when pro forma financial information should be required, seem to be overly restrictive. The criteria mentioned in number 54, under which pro forma financial information should be required if this is material to the investor, seems to be an appropriate measure to determine the applicability of pro forma standards. We would like to stress that the typical circumstances to be interpreted as "material to the investor" should include, for example, changes in legal form, the adoption of new accounting standards, or material changes in the legal or commercial structure of an issuer that have not been reflected in the preceding financial statements (e.g. business combinations, takeovers, acquisitions or disposal of material business units). In particular, from a material perspective, pro forma financial information should be allowed in those cases where the business operations of the issuer have undergone material legal or economic changes. Hence, the decision whether or not to require pro forma financial statements should remain at the discretion of the listing authority.

Paragraphs 66 to 87 (Profit forecasts)

The consultation paper (paragraphs 66 to 87) and the annexes for the respective registration documents contain detailed requirements with regard to the prospects of the company. The issuer shall be allowed to include concrete figures for a profit forecast. We support the notion of giving investors certain information on the future of an issuer from the perspective of that issuer. Any prospective reporting should always be limited to a narrative description of the trends expected for a period of around 12 months starting from the date of issue, but in any case for no longer than until the end of the current financial year. In addition, forward-looking statements should be unambiguously identified as such by means of appropriate language. This would be achieved by using standard phraseology, such as "expects", "assumes", or "forecasts". Care must also be taken to ensure that it is made clear which assumptions were made in order to make the forecasts, which factors could lead to a failure of the forward-looking statements to materialise, and what the consequences of such a failure may be.
Any further details, particularly a detailed presentation of specific figures and tables, should be avoided, as they could be regarded by investors as having the seal of a certain degree of credibility and reliability – not least because the prospectus is offi-

cially approved. However, current developments show how quickly budgeted figures, even in the case of large companies, can become obsolete, due to changes in the general economic climate. To this extent, investors could be misled if too much detail is given. Profit forecasts should not therefore mention exact numbers, but describe the major trends in narrative form.
If CESR decides not to follow this approach, which has (with the exception of start-up companies, where projections must be disclosed) been the market standard for many years in Germany, and is also one of the major sources of conflict for issuers seeking a dual listing in Germany and the U.S., but intends to be more open to concrete profit forecasts, it should make clear that such disclosures are merely voluntary rather than compulsory. Even if the issuer opts for such disclosures, he should not be obliged to submit a special statement by the company's auditors or reporting accountants, but be required only to supply detailed information on the assumptions which have led to published numbers for revenues, other income, profit and loss, respectively. Any involvement of external experts will incur high costs. Based on practical experience in the IPO business over the last few years, we doubt whether this will substantially raise the quality of the forecast, as such experts will comment only on the link between assumptions and profit forecasts, with no more than a limited appraisal of the assumptions.
In addition, in the case of debt issues, an investor is not interested in whether the company expects to make a profit of x or y million euros, but only whether the issuer expects that it will be able to meet its interest and principal repayment obligations. A written statement outlining major trends in the business and financial position should therefore be sufficient.

Paragraphs 88 to 89 (Directors and senior management privacy)

In principle, we support the disclosure of information about the previous history of directors. However, regarding the wording in Annex A, V.A.1, a time limit governing the reporting period of such disclosures is absolutely necessary. A period of five years could be appropriate as regards the aspect of rehabilitation of an individual. Both those cases of insolvency where the directors have been involved in a private capacity and those cases where directors have been involved in their function as board members of another company should be included.

Paragraphs 92 and 93, 147 to 150 (Documents on Display)

We explicitly reject the proposal for extension of the practice for documents on display as laid down in paragraphs 92, 93 and 147 to 150. Previous market practice in Germany has been to allow investors to inspect general documents that relate to the issuer. Such documents usually include the annual report, interim reports, an excerpt from the Commercial Register and the Memorandum and Articles of Association. More onerous disclosure requirements should definitely be rejected:

- Contracts with third parties generally contain trade secrets; any effective publication of such secrets would have a material adverse effect on the issuer's ability to compete and could cause real damage to the issuer. Furthermore,

such publication could be a violation of insider trading law. Any provision for exemptions or allowing the issuer to conceal certain sections of the text (e.g. with black ink) would create an unacceptable administrative burden.

- In addition, making such documents available would almost certainly involve obtaining the full consent of the relevant third party, which would be almost impossible.

- The prospectus should be complete and contain all material information; additional information would lead to “information overload“, which would impair the acceptance of a prospectus.

- If investors are given access to more information, they would be able to conduct their own due diligence, which would, however, reduce the value of the prospectus and create a knowledge imbalance between the (wholesale) investors, who would inspect and evaluate the additional documents, and those (retail) investors who would rely on the details in the prospectus.

- Both the ability to conduct due diligence and the necessity to translate these documents into the same language as the prospectus would burden issuers with incalculable costs for making available the relevant material and personnel resources.

Paragraphs 94 and 96 (Building blocks for specialist issuers)

We do not consider it appropriate to build too many building blocks for "specialised issuers" (see also our general remarks). Rather, it should be remembered that small and medium-sized companies can simultaneously be property companies or scientific research-based companies, or that an issuer is organised as a holding company conducting property business, while at the same time it plans to extract mineral resources. The building block approach should therefore at least define what a "principal activity" of an issuer is (i.e. more than 50% of turnover) and stipulate that the additional requirements will only apply if this condition is fulfilled.

Paragraphs 111 to 113 (Property companies)

Again, "primarily engaged in property activities" needs to be defined. There is a need for clarity that an unlisted subsidiary of a holding company will not fall within the scope of these requirements unless the primary activity of the holding company itself will be property activities.

In particular, we do not consider it appropriate that the valuation reports must be no older than 42 days prior to the publication of the document. Bearing in mind the extended approval periods under the Directive and possible postponement of the placement (i.e. market disruption or insufficient demand), an extended time period would be reasonable. In addition, regulators should bear in mind that property is

probably one of the least volatile assets and activities in which an issuer can do business. Therefore, at least for subsequent public offerings or admissions to trading, there should be a clear indication that the valuation report can be prepared in-house. If not, the procedures required and the costs incurred by a public offering would seriously hamper the ability of small and medium-sized property companies to raise money on the capital markets.

Paragraph 129 to 156 (Identical disclosure requirements for equity and debt)

Debt securities should be treated in a different way than equity securities. The Registration Document should be based on the existing schedule in 20001/34/EC, and CESR Annex I should make reference to it. Debt securities require a distinct investor view and the risk structure of a debt investment is, in many respects, not comparable with that of an equity investment. Thus, the core risk for a debt security investor is the insolvency risk of the issuer, whereas the risk of an equity investor is deterioration in the performance of the issuer occurring long before insolvency. Regarding debt issuance, the structure of the issuance and selling procedure is completely different to that of a share issue, and underwriters and advisers have a different structural approach. The tight margins in the primary debt markets are yet another factor. Additional information will adversely affect the costs for issuers - especially SMEs – who are already awaiting additional expenses from the Basle II requirements. Emphasis should rather be given to the issuer’s rating, but not in such detail that the prospectus replicates the rating agency's diligence process.

Paragraphs 157 to 160 (Specific derivative registration document requirement)

We believe a specific derivative registration document is appropriate. The requirements regarding the issuer should be much lower for derivative securities than for equity, but also lower than for debt securities. 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 information regarding the issuer is of more minor importance and should be limited accordingly.

Paragraphs 161 to 173 (Definition of derivative products)

The approaches described in the Consultation Document do not seem to be appropriate, given the aim of standardising prospectus requirements for derivatives.
The first approach (No. 166) is too limited in terms of the underlying, and does not provide enough flexibility regarding the underlying.
The second approach (No. 167) is too complicated, too specific and therefore does not provide enough flexibility with regard to new products. Furthermore, it has the following flaws:

- The first sentence in 3) is unclear and incorrect. What is meant by "some form of payment payable by the investor"? For warrants and certificates, the investor must only 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 inaccurate. Even in the case of reverse convertibles or discount certificates, the investor is only entitled to or offered receipt of the underlying, but is never obliged to accept 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 volume of derivative securities. To say that "The instrument will give the investor rights – *normally* in the form of exercise rights …" is therefore incorrect. Certificates representing a significant proportion of derivative securities are not exercised.

- The feature in 4 b) makes no sense, as all derivative securities provide some sort of entitlement to the investors without imposing any obligations on them.
- 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 merely a matter of providing a proper warning of the risk involved.

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

As a consequence, a more general and shorter approach should be chosen to enable flexibility for new products. One 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 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. We believe that the text in square brackets in our proposal is not absolutely necessary, but rather that it might serve as a compromise for Member States who have a preference for detailed rules. In any event, if it is used, it is absolutely necessary for the words "including but not limited to" to be stated.

Paragraph 174 to 180 (Categorisation of derivative products)

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 further sub-categorisation. In both cases, the issuer is liable for the fulfilment of the obligations under the derivative securities. In consequence, the investor bears the risk that the issuer might not be able to meet its obligations under the derivative securities. It is irrelevant in this context whether this risk exists with respect to fulfilment of the guaranteed or the non-guaranteed obligation of the issuer.

Paragraphs 134, 135, 191 and 252 (Disclosure about issuer's bankers and legal advisers)

I.B should be deleted for all categories of securities. The legal advisers should not be mentioned in a prospectus. As long as prospectus liability has not been harmonised at a European level, mentioning the legal advisers has no added value. Under these circumstances, it could also be misleading, e.g. if the advisers did not carry out a complete due diligence (which is often the case), or if they were not engaged to handle all legal issues (what also happens frequently), or if they have not been involved in any way in the issue of securities. Even where legal advisers conduct complete due diligence and are involved in all legal issues, we would advise against mentioning legal advisers since mention of their names could be interpreted by courts as the assumption of liability by the lawyers for the prospectus.

Paragraphs 249 to 251 (Building block approach)

We welcome the building block approach as long as it helps the competent authorities to provide a flexible response to new products. However, it should not be CESR's aim to develop a building block for each individual product category (see also our general remark). The wide variety of products means that such a strategy would be excessively rigid and untransparent. For more complex products, we therefore endorse an approach whereby the competent authorities can combine requirements from various schedules so as to achieve the greatest possible degree of flexibility. Fine-tuning can then be done at Level 3.

We believe that the classification into equity, debt and derivatives provided for in No. 246 as well as a preceding common list of all common items applicable to all classes of securities is logical. Merging the two components would result in unnecessary duplicate listings in the three individual schedules.

Paragraph 257 (Annex M, III.C.2.c) and d) (Inclusion of examples)

There should be no requirement for examples in the prospectus. This concept is not followed by the majority of jurisdictions in which derivative products are issued. There

is no need for such examples, as the terms and conditions of the products sufficiently elaborate the features of the derivative product. However, if examples were to be required, it must be ensured that in the case of a base prospectus, such examples must only be provided once in the base documentation, and not in the pricing supplement.
Furthermore, the requirement of best and worst case scenarios should be deleted as it is extraordinarily difficult (and often impossible) to summarise the criteria for a best/worst case scenario with respect to the performance of a derivative security. This is especially the case where the number of factors and their interdependence in influencing the performance of a derivative security cannot ultimately be defined.

Annex M III. C. 2. (e) (Hedging Instruments)

We strongly object to the requirement that hedging instruments should be mentioned. This is because no objective criteria exist for instruments qualifying as an optimal hedge for a specific derivative security. Furthermore, the optimal hedging instrument for a derivative security (if such a qualification were at all possible) would depend essentially on the individual composition of investors' portfolios and their investment strategy. Any advice with respect to the optimal hedging instrument might turn out to be to the detriment of the investor. Furthermore, it is important to understand that issuers of derivative flow products typically undertake continuous market-making efforts over the lifetime of the products issued. The investor will therefore always be able to close the position held by selling the respective securities. Consequently, there is no specific need to establish a hedge to neutralise an existing position.

Paragraph 260 (Annex M V. B. 12 first indent – description of the underlying)

We appreciate the disclosure requirements set out in Annex M V.B. 12 first indent. A statement concerning the past performance of the underlying and its volatility should not be required. The past performance of the underlying does not provide a reliable indication of the future performance of the underlying.

Annex A and Annex I, Section VI.B (Related party transactions)

The requirements concerning related party transaction will lead to information overload if no "materiality qualifier" is incorporated. This can either be done in an abstract way, or by using percentage and/or absolute thresholds. Moreover, the information should only be required for the company's preceding financial year, and only major transactions or loans should be mentioned for the preceding three financial years.