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CESR's Advice on Level 2 Implementing Measures for the Proposed Prospectus Directive Consultation Paper June 2003

Opinion

of boerse-stuttgart/EUWAX

Ref: CESR/03-162

Stuttgart, 12.08.2003

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III.1 DERIVATIVE SECURITIES

No. 22.:

We strongly disagree with the approach described in no. 22., i.e. of not defining derivative securities. We think that we really need a separate definition for derivative securities for the following reasons:

1) Some products which fall under the debt security definition given by CESR in no. 54. are seen by the market as derivative securities (e.g. securities which provide for a return of 100% of the capital but have a derivative feature regarding other payments; see below in our comment to no. 54.), and some products which qualify as equity security pursuant to the definition contained in Article 2(1)(b) of the Directive are also seen as derivative securities by the market (e.g. warrants and certificates with a physical settlement relating to shares of the issuer or its group). The reason why some products qualify as equity under the Directive is to ascertain that the authority where the issuer has its registered office is the competent authority and that there is no free choice regarding the competent authority. However, the distinction between equity and non-equity of the Directive does not need to apply to disclosure requirements for equity, debt and derivative securities. The risk profile for warrants and certificates relating to shares of the issuer or its group is the same as for warrants and certificates relating to third party shares. In particular, the risk profile for warrants and certificates relating to shares of the issuer or its group with a physical settlement is the same as the one for the same warrants and certificates with cash settlement. No investor would understand why the disclosure would have to be different in the event of warrants and certificates with a physical settlement relating to

shares of the issuer or its group. Thus, "derivative securities" should include securities which provide for a physical delivery of existing shares, i.e. shares which do not constitute or result in an issuance of new shares by means of an increase of the issuer's share capital.

2) The market for derivative securities is such a substantial market - at least already in some countries and it will hopefully also expand to other countries if derivative securities are dealt with appropriately by the legal environment - that it is not justified to put these products in a trash box (everything else box) but it is justified to have a proper definition for these products to reflect their importance.

3) A definition for derivative securities would facilitate the use of Annex E, i.e. the securities note for derivative securities developed by CESR. If there is no appropriate definition, how should one know to which securities this Annex applies? The aim should be to apply this securities note to all securities having a derivative feature, i.e. a link to something else (with the exception to non-exotic interest rates like fixed rates or recognized inter-bank interest rates like LIBOR, EURIBOR or similar rates).

4) A separate definition is needed because we think that derivative securities deserve a separate registration document for the reasons given below in our answer to question no. 59.

We would like to suggest that CESR should continue to try to find a commonly acceptable definition of derivative securities. We have consulted the following proposal:

"Derivative securities are securities where the payment and/or delivery obligations are linked to an underlying (including but not limited to securities, currencies, commodities, indices or other measures), unless the payment of interest is merely linked to a fixed rate or to a recognized inter-bank interest rate."

among various German and international experts and market participants and found agreement for our proposal. The definition excludes plain vanilla fixed rate or floating rate debt instruments the interest payments of which depend on a recognized inter-bank interest rate such as LIBOR or EURIBOR. The

text in brackets corresponds to the text contained in Article 3(1) no. 15(c) of the latest draft of the Investment Services Directive.

If CESR does not deem the words "derivative securities" appropriate for products which provide for a return of 100% of the denomination or nominal amount but have nevertheless a derivative feature, e.g. for other payments, one could consider to call these securities "structured products" instead and use the definition given above for these products.

32. *Do you consider that this disclosure [about the issuer's principal activities] is relevant for these products? Please give your reasons.*

Generally, a disclosure about the issuer's principal activities is not relevant to investors in derivative securities. If it is relevant to such investors in any particular case, the information will be disclosed in accordance with the general disclosure obligations under Article 5 of the Directive. It should, however, not be generally required. It is preferable to focus the attention of investors in derivative securities on the key information relating to the risk factors of the securities.

34. *Do you consider that disclosure about the principal markets in which the issuer operates is relevant for these products? Please give your reasons.*

Generally, a disclosure about the principal markets in which the issuer operates is not relevant for investors in derivative securities for the reasons given in our answer to question no. 32.

36. *Do you consider that disclosure about an issuer's significant business developments is relevant for these products? Please give your reasons.*

No. For the reasons see above in our answer to question no. 32. Furthermore, any significant business developments will already be dealt with in the registration document under the heading "Trend Information". One should avoid duplicating information in the prospectus.

37. *Do you consider that this disclosure [administrative, management and supervisory bodies' conflicts of interest] is relevant for these products? Please give your reasons.*

Such a disclosure should not be requested because the issuer generally is not aware of any specific conflicts of interest since the members of its administrative, management and supervisory bodies do not have to inform the issuer of such conflicts. One should not impose obligations on the issuer which it cannot fulfil. One could, however, insert a paragraph in the risk factors section stating generally that there may arise conflicts of interest which may affect the price of the security.

39. *Do you consider that disclosure about an issuer's major shareholders is relevant for these products? Please give your reasons.*

No. The issuer's major shareholders are of no relevance when making an investment decision about derivative securities. Much more important than the major shareholders is the composition of the management.

Nos. 43.-47.:

We continue to believe that interim financial information should only be required where the issuer has already published such interim financial information or if it is required by the EU Transparency Directive to do so. Apparently, most consultees had supported this approach in previous hearings. It is unclear why CESR changed its view on this matter. Furthermore, it is unclear what is meant in no. 46. by "CESR anticipates banks will be required to make public interim financial information even where its securities are not admitted…". CESR definitely should not go beyond the requirements of the EU Transparency Directive. Therefore, interim financial information should be required to be disclosed in a prospectus only if the issuer is required to disclose them under the EU Transparency Directive.

No. 54.:

We disagree with the proposed differentiation between debt and derivative disclosure based on whether the security repays 100% of the capital or not. First of all, it is unclear what is meant by "capital". Is this the invested capital, i.e. the purchase price (which, of course, would be different for each purchaser), or is it the denomination or nominal amount? Furthermore, recent market developments have shown that there are products in the market which provide for a repayment of 100% of the nominal amount but where other payments (called interest or otherwise) are linked to an underlying and thus have a derivative feature. These products are deemed by the market (like

products where only 95% or 70% of the nominal amount are guaranteed) as derivative securities or structured products. These products should have the same disclosure requirements as products with other derivative features (e.g. warrants). For a proposal of a definition of derivative securities, see our answer to no. 22. above.

59. *Do you agree with CESR's revised approach in relation to retail non-equity securities and wholesale non-equity securities? If not please give your reasons.*

Since most derivative securities do not have a denomination, the current approach taken by CESR would mean that non-banks (which will be SPVs in most cases) would never be able to use the wholesale debt registration document for derivative securities since this one shall apply only if the denomination is EUR 50,000 or more, but would always have to use the most comprehensive registration document, i.e. the retail debt registration document. This is not justified. Therefore, like in the past we continue to think that a specific derivatives registration document taking into account the beforementioned answers should be in place for derivative securities or there should be a common registration document for banks, wholesale debt and derivative securities with lower disclosure requirements than for other products. In any event, it would be justified to have lower requirements for derivative securities than for retail debt.

If CESR thinks that banks should use a bank's registration document for derivative securities, a special derivative securities registration document would be mainly used by SPVs. For such issuers, the following items in the current retail debt registration document draft should be deleted:

1) "3. Selected Financial Information" because historical financial information is already covered (and even more broadly) by 13. and the historical financial information as required by 13. is easy enough to understand for a SPV and does not need to be highlighted again in the separate (selected, i.e. shortened version in) Section 3.

2) "8.1. Trend Information". It should be replaced by "Include a statement that there has been no material adverse change in the financial position, or prospects of the issuer, since the date of its last published accounts or, in the event that the issuer is unable to make such a statement, the issuer should provide the details of the material adverse change". The current wording which refers to "production and inventory" does not fit to SPVs which only issue derivative securities.

3) "11. Board Practices". This information is irrelevant for the investor in derivative securities. Furthermore, the required information generally

does not apply to SPVs since they will most likely not have audit committees or have to follow a corporate governance regime.

4) "13.1 Historical Financial Information": the last paragraph should be deleted. Issuers of derivative securities should be able to disclose their accounts in whatever form they are required by corporate law. In particular, they should not be required to disclose a cash flow statement. The production thereof outweighs any potential benefit for an investor in a derivative security of a SPV.

5) "13.6.2 Mandatory Interim Statements". First of all, this requirement goes beyond the requirements of the EU Transparency Directive, is too far reaching and should therefore be deleted (this was already a comment we made regarding the retail debt registration document also as it applies to retail debt). In addition, there are usually no material changes within a financial year of a SPV which is limited to the issue of derivative securities. If there is no big change within a year, there is no big change either within 6 months. Therefore, the information contained in interim financial statements usually is not interesting for the investor. On the other hand, it is burdensome for the issuer to produce interim statements.

61. *Do you agree that information about investments should not be required for banks issuing wholesale debt securities? Please give your reasons.*

Yes, we agree. Such information is not relevant for the investor.

64. *Do you consider that information on investments is relevant for wholesale debt securities? Please give your reasons.*

No. Information on investments is neither relevant for the investor of retail debt nor for the investor of wholesale debt.

75. *Do you consider that examples are necessary in order to fulfil the principle that the prospectus must contain a clear and understandable explanation of how an investor's return is calculated and how the instrument works? Please give your reasons.*

No. Examples are not necessary. There are other means to explain the investor's return and how the instrument works (see below our answer to question no. 76.).

76. *What other methods (if any) do you consider can be used to provide investors with a clear and understandable explanation of how an investor's return is calculated and how the instrument works? Please give your reasons.*

Another method to provide the investor with a clear and understandable explanation of how the return is calculated is the drafting of clear and comprehensible terms and conditions and/or a description of the features of the security in abstract terms in the general section of the prospectus. From an investor's point of view it is much more important to be informed about the risks of the security than seeing best case scenarios (which will hardly ever realise). The risks of the security should best be described in the section about the risk factors.

77. *If you do not consider that examples are necessary to provide investors with a clear and understandable explanation of how an investor's return is calculated and how the instrument works, do you consider that the provision of examples in the prospectus is useful for investors? Please give your reasons.*

Yes, examples can be useful for investors in some cases. However, as they can also be misleading and raise too many expectations, they may also be dangerous for the investors if the investors rely on the examples and on the figures used by the issuer. Therefore, the use of examples should under no circumstances be mandatory. The issuer should have the discretion on whether to include examples or not in fulfilling its obligations under Article 5 of the Directive.

78. *Do you consider that the use of examples in the prospectus is dangerous and misleading and should not be mandatory? Please give your reasons.*

The use of examples in the prospectus may be misleading. Since it is rather unlikely that the issuer will use figures which will really occur (because he cannot see into the future), the examples given will almost never reflect the actual return. Still, investors tend to believe in the examples especially if the result is a profit. Therefore, they may be dangerous. Furthermore, it is not clear what CESR understands by "examples". If it understood by "examples" the display of scenarios or calculations of a return during the term of the product, i.e. prior to maturity, such calculations would be extremely difficult to produce and to understand because too many factors (e.g. volatility and continuing term) would have to be included. The resources to produce such examples would outweigh by far any potential benefit to an investor. If it

understood "examples" as being calculations of the return at maturity, there would be less parameters to be included. Still, these examples could be misleading as explained before. Thus, examples should in no event be mandatory. The issuer should have the discretion to decide how to fulfill its obligations under Article 5 of the Directive. If it does not comply with these obligations by making the calculation of the investor's return or, more importantly, the risks associated with the security transparent, it will be liable in accordance with the prospectus liability rules anyway.

79. *If examples are to be included in the prospectus, do you consider that CESR should stipulate how the examples should be prepared, for example that they should be realistic, not misleading and should provide a neutral view of how the instrument works?*

No. It should be up to the issuer to decide how to prepare the example. A potential prospectus liability is a sufficient incentive to do it in a proper form. CESR should not patronize issuers too much. If, despite the wishes of the market participants, CESR insists to have examples included, it has to be made absolutely certain that these examples are limited to the return at maturity and are included only in the base prospectus. If they were to be included in the final terms and to be approved, the concept of the base prospectus with the aim to have a speedy procedure could not be achieved any longer.

81. *Do you consider that examples should be provided for derivatives? Please give your reasons.*

No. See answer to question no. 75.

83. *Are there any other type of securities for which you consider examples should be provided, for example structured debt instruments that have a derivative component?*

No. See answer to question no. 75.

89. *Which of the above options do you consider should be adopted by CESR (1, 2 or 3)? Please state your reasons.*

No past performances and no volatility should be required (no. 1. above) for the reasons given in no. 85.a) above.

Most of the arguments in favour of the inclusion of past performance as set forth in no. 85.b) are not correct. Since the description of the past performance only relates to the past and not to the future, it does not help to understand the product and to assess its risk. For example, if one had issued a warrant in 2001 on a share listed in the *Neuer Markt* in Germany, the past performance would have been extraordinarily good. A year later, it was extremely bad. If the issuer had had to produce the past performance, it could have completely misled the investor and would not have helped him at all to assess the risk. In addition, for the same reason, it would not have helped him to take an investment decision. Finally, the pricing made by the issuer is not based at all on the past performance of the underlying and therefore should not be made as an argument in favour of the inclusion of past performance.

III.2 BASE PROSPECTUS

101. Do you agree with this generic rule?

We agree with no. 99.a). However, we disagree with no. 99.b). Setting out line item numbers in a base prospectus will confuse an investor. Any information which cannot be given at the time of the publication of the base prospectus because it will be determined only at the time of the individual issue should be marked with a "●" and is therefore easily visible by any investor.

Besides giving a definition of "final terms" we would appreciate if CESR stated that the final terms may be supplemented either directly into the terms and conditions which are part of the securities note by filling in the blanks contained in the base prospectus or by way of a supplement in the form of a pricing supplement containing a list of the items which have been left open or blank. The form of the pricing supplement should in any event not be a fixed form but should be left to be drafted in the discretion of the issuer on a case by case basis who knows best his product and the way how to describe it in the individual case.

112. Which of these two approaches do you think should be applied to base prospectuses? Please give your reasons.

We think that the approach set forth in no. 110 should be applied to base prospectuses. Article 19 of the Directive states that only the summary may be required to be translated. As the final terms do not form part of the summary, the final terms or items thereof may thus not be required to be translated. We question the basis of the approach taken in no. 111 which does not seem consistent with the Directive. Furthermore, the approach taken in no. 111 is not practicable and would run contrary to the purpose of basis prospectuses of providing for a speedy way to issue securities.

115. *Which of these views do you consider should apply to base prospectuses with multiple products? Please give your reasons.*

It should be left to the issuer to decide how to comply with the general requirement of the content of a summary. However, CESR should make clear that a limitation to 2,500 words applies only with regard to each product such that a summary covering for example three products would be allowed to contain up to 7,500 words.

122. *Which of these views do you consider should apply to the form of final terms? Please give your reasons.*

The issuer should be free to replicate in the final terms either the whole base prospectus, the whole securities note, the entire Terms and Conditions or should limit the final terms to the parts which had previously been left blank (e.g. in the form of a pricing supplement). Giving the issuer the right to decide arbitrarily that other parts of the base prospectus may be replicated would indeed create the risk of misleading investors.

125. *In relation to the publication of the final terms, should the method of publication be restricted as set out in Article 14?*

The method of publication could be restricted to the methods set out in Article 14, provided that the issuer may decide which of those methods to use. One may consider to require that the method to be used is set forth in the base prospectus.

127. *Do you agree with this analysis?*

Yes.

131. *Do you agree with the above additional disclosure requirements in relation to base prospectuses?*

We agree that information regarding how the final terms will be published should be given (see no. 130.1.). Any other information is not necessary. Regarding the requirement of the identification of line items see our answer to question no. 101. above. Furthermore, a general description of the programme is not necessary if the only missing information is marked with a "●" because it is evident that only these blanks need to be filled in.

132. *Are there any other disclosure requirements that are not specified above that you consider necessary for base prospectuses? If so, please specify what these are and give your reasons for why you think they are necessary.*

No.

136. *Do you agree with the above types of base prospectuses?*

No. The issuers should be free to insert any type of security into one base prospectus as long as it is clear which products the base prospectus covers. This can be made clear, for instance, by the use of a separate set of terms and conditions for each product. In particular, it could be envisaged that a base prospectus shall not cover only some sorts of warrants or certificates but all, i.e. also warrants and certificates relating to shares of the issuer or the group of the issuer (provided that the new shares do not lead to a share capital increase) which according to Article 2(1)(b) of the Directive qualify as equity. Furthermore, it should be possible to cover securities where the investor is repaid 100% of the nominal amount but where other payments (e.g. interest) are linked to the performance of the third product which according to the current view of CESR seems to be debt securities but according to our view would still be derivative securities. Including different products in a single base prospectus leads to efficiency and reduced costs. Establishing a requirement to file separate base prospectuses for different products would increase the costs for the issuers without any related benefit for investors.

137. *Are there any other types of base prospectuses that you consider are necessary? Please give your reasons.*

Again, issuers should be free to insert into the base prospectus the types of securities they think are appropriate to be covered in one prospectus.

III.3 WHOLESALE DEBT SN

143. Do you agree with this approach?

Yes.

144. *Do you consider that the information provided for in Annex F is adequate for wholesale investors? Please give your reasons.*

The information provided for in Annex F is adequate for wholesale investors, provided that it is changed in the manner marked in the attachment hereto. The most important comment is that (like in the other securities notes for debt and debt securities) there is no reason to pick only some items of the terms and conditions. Rather, the full text of the terms and conditions should be set forth in the securities note because this is what the investor needs. The most important items may then be repeated in the summary.

145. *Are there any other items included in the retail debt SN that should be included for wholesale investors? Please give your reasons.*

No. Wholesale investors need less extensive disclosure than retail investors due to their greater knowledge and experience.

III.5 SN BUILDING BLOCK ON UNDERLYING FOR EQUITY SECURITIES

162. *Do you agree with this approach?*

We agree to this approach, provided that it does not apply to securities with derivative features which do not lead to an increase of the share capital, i.e. the issuance of new shares.

163. *Do you agree with the disclosure requirements of the building block concerning the underlying for equity securities as set out in Annex H?*

Yes, if line item 1.11. is deleted and if the disclosure requirements do not apply to securities with derivative features which do not lead to an increase of the share capital, i.e. the issuance of new shares. Regarding line item 1.11. it is difficult to give a clear answer to this line item. The answer would have to be rather vague which would not be helpful for the investor.

165. *Do you deem the Working Capital Statement and the information on Capitalization and Indebtedness necessary for an informed assessment of the securities in cases of products which can be converted or exchanged in newly created shares? Please give your reasons.*

No, because it will be outdated at the time when the investor finally receives the shares.

167. *Do you agree with this approach?*

Yes.

168. *Do you agree with the combinations set out in the table?*

With regard to the combinations we have the following comments:

1) All structured securities (currently referred to in the roadmap as derivative securities or structured bonds) where the exercise, conversion, subscription or acquisition does not lead to an increase of the share capital of the issuer or its group should have a registration document as well as a securities note for derivative securities. The equity registration document should not apply in the event where the security gives the right to acquire the issuer's or group shares, provided that the subscription or acquisition does not require a capital increase because in this event Annex H (Securities Note Building Block on Underlying) applies already which, however, does not apply if shares of a third party are the underlying. Thus, derivative securities relating to own shares of the issuer or its group already have increased disclosure requirements and do not have to be subject in addition to a wider disclosure of the equity registration document.

2) Whenever reference is made to "the issuer's or group shares" it should be added ", provided that the exercise, conversion, subscription or acquisition requires a capital increase".

3) The second last item should not be limited to derivatives giving the right to subscribe or to acquire "third party shares" but should be extended to comprise also other things than shares (e.g. bonds, currencies, other certificates of warrants). We propose to word this

item as follows: "Derivatives giving the right to subscribe or to acquire something other than the issuer's or group shares".

4) In the last item, after "with cash settlement" the following wording should be added "or choice of issuer whether cash or physical settlement" because in a typical reverse convertible note which is mentioned in this last item there is usually a choice of the issuer.

IV. FORMAT OF THE PROSPECTUS

172. Which of the options set out above do you support? Please give your reasons for your choice.

We do not support any of the options specifically. The reasons given for any of the options sound acceptable.

176. Which of the options set out above do you support? Please give your reasons for your choice.

No specific order should be set. However, a duplication of information should be prevented. This can be best done by not asking for the same information in the registration document and in the securities note twice.

182. Which of the options set out above do you support? Please give your reasons for your choice.

We prefer the approach of integrating the new information into the original summary because this is easier for the investor to read and it is not too cumbersome for the issuer to produce this.

No. 186.:

The following guidelines developed by CESR for the drafting of the summary shall be changed:

(1) It should not be specified that the summary should contain return considerations because it is completely unclear what is meant thereby.

(2) The sentence "When drafting the summary, the issuer should keep in mind the fact that the summary might be the only document published in investors' language." should be deleted because it is impossible that a summary of up to 2,500 words informs the investor of all issues dealt with in the prospectus. Such a guideline would raise expectations too high and might even lead to a prospectus liability in case not everything important is set forth therein.

Nos. 192.-194.:

For the reasons given in the answers to question no. 59. we are not in favour of the proposals contained in nos. 192.-194. but think that a wider definition of derivative securities as given in our answer to question no. 59. is preferable.

Nos. 198., 200.:

As set forth in our answer to question no. 162., the mentioned securities, in our view, should only be treated differently from derivative securities or debt securities if they lead to an increase of the share capital, i.e. the issuance of new shares. Only in this event they correspond to the issuance of the respective underlying.

No. 214.:

It is important for the functioning of a single market that also new types of securities benefit from the European passport. Therefore, the last sentence under no. 214. should be amended to say that such prospectuses "do" benefit from the European passport.

VI. ANNUAL INFORMATION

237. Do you agree with the method of publication proposed?

Yes, provided that "seven business days after publication of the annual financial information" means seven business days after the official publication as required by national corporate law (in Germany the publication in the *Bundesanzeiger*) and not after publication in any news report and that "seven" is replaced by "30".

238. *Do you consider CESR should limit the issuer's choice to one or more methods of publication? Which ones?*

No.

239. *Do you consider that a deadline should be defined? If so, do you agree with the proposed deadline or would you suggest a different one? Please give reasons for your answer.*

We think that 30 days is a more appropriate time frame than seven days.