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Frederik Knobloch  
Directorate General, Internal Market & Services  
European Commission  
C107 5/32  
B-1049 Brussels  
Belgium

Dear Mr Knobloch

#### **FMLC Comments on the Proposal to amend the Prospectus Directive**

As you may be aware, the role of the Financial Markets Law Committee (the "FMLC") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

This letter represents a response by the FMLC to the Commission's publication on 24 September 2009 of a draft Directive to amend Directive 2003/71/EC (the "Prospectus Directive"). The FMLC has previously raised concerns in relation to the Prospectus Directive with the Commission in letters dated 10 March 2009 and 25 September 2007 (copies of which can be found on the FMLC's website: <http://www.fmlc.org/>).

The FMLC is broadly supportive of many of the proposed changes to the Prospectus Directive. However, these changes would not remove all of the elements of uncertainty previously identified by the FMLC, and there are certain proposed amendments which are likely to give rise to other elements of legal uncertainty, as set out under the headings below.

#### **Retail Cascades**

The FMLC identified the "retail cascades" issue as its main area of concern in its letter of 10 March. Retail cascades occur when securities are distributed through intermediaries and are ultimately offered to the public and, in particular, to retail investors by intermediaries. The issues of legal uncertainty that arise from this are: (i) that it is unclear with whom liability for the prospectus lies in the case of a placement; and (ii) that there is uncertainty over the extent and duration of any such liability on the issuer when distribution is in the control of intermediaries.

These issues of uncertainty are acknowledged in section 5.3.4 of the Explanatory Memorandum. The Commission has sought to address them by the addition of the following sentence to Article 3(2) of the Prospectus Directive:

"Member States shall not require another prospectus in any such subsequent resale of securities or final placement of securities through financial intermediaries as long as a valid prospectus is available in accordance with

Article 9 and the issuer or person responsible for drawing up such prospectus consents to its use.”

The wording reflects previous clarification by CESR that where financial intermediaries are acting in association with the issuer, they are not required to draw up a new prospectus and the issuer is only responsible for publishing supplements for the duration of the sub-offer conducted by these intermediaries. The FMLC welcomes the Commission’s proposal to make the substance of this guidance legally binding via the proposed amendment.

However, as the FMLC explained in its letter of 10 March, the CESR guidance does not entirely remove the uncertainty as to where liability will lie for breach of the Prospectus Directive in an unauthorised placement. With the drafting of the proposed amendment, this uncertainty persists. Conceivably, a national regulator might, within the existing wording, impose continuing liability on the issuer of securities for inaccuracies in the original prospectus (i.e. that accompanied the initial offer) in any subsequent resale, despite his withdrawing his express consent to the use of the prospectus. This might be done, in a manner strictly consistent with the additional wording, by exploiting the fact that the wording does not specify that the issuer’s consent must relate not only to a particular prospectus but also to a particular intermediary and a particular act of on-selling. Thus, by implying, imputing or deeming an intermediary to be acting in association with the issuer or simply by providing that in circumstances where one intermediary has been given specific authorisation (i.e. the issuer “consents”, in at least one case), all other intermediaries may also use the same prospectus, the national authority may extend liability to the issuer in a way that is probably not within the intended meaning of this additional wording. If this is correct, liability would remain with the issuer for any inaccuracies in its prospectus after it has been distributed by the intermediary, notwithstanding that the issuer may have no knowledge of that intermediary’s activities.

It would be helpful, in this context, if the proposed amendment to Article 3(2) were to provide clarification to the effect that an issuer is not liable for the information in its prospectus, in the event of a subsequent resale or final placement of securities, unless the intermediary in question has acted with the express consent of the issuer and within the terms of that consent.

Further, the FMLC is given to understand that the proposed amendment to Article 3(2) is likely to cause significant concern to practitioners who operate in Germany. Unlike in other jurisdictions, German law imposes liability for the information contained in a prospectus, not only on the issuer, but also on those persons who are specified in the prospectus as acting as financial intermediaries to the issue. However, under the proposed amendment to Article 3(2), only the issuer’s consent to the use of the original prospectus in a subsequent resale of securities is required. This means that if, after publication of the prospectus, the issuer consents to its use by another intermediary, but fails properly to update the prospectus before the placement is made, or indeed if the intermediary in question has failed to update it in his stead, then all of the intermediaries listed in the original prospectus would be liable for its contents.

Indeed, the issuer may be incentivised to give its consent to an intermediary’s use of the original prospectus in these circumstances because, by assisting in the retail placing, it may be able to secure a better price for its securities. By contrast, the intermediaries listed in the original prospectus, even though they would be equally liable for the information contained in the prospectus, would derive no benefit from the placement and, in all likelihood, will not have consented to or may be unaware of the placement being made. This appears an inequitable result and one that leaves those financial institutions which are listed as intermediaries in the original prospectus with significant uncertainty as to their potential liability.<sup>1</sup>

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<sup>1</sup> It is likely that the issuer will have indemnified the intermediaries against liability under the Prospectus Directive. However, even if any losses suffered by an intermediary will ultimately be borne by the issuer, the intermediary in question may nevertheless have to spend time and resources on defending claims made against it; particularly where it is more convenient for the claimant investor to sue that intermediary than the issuer because, for example, it is incorporated in the same jurisdiction as the claimant and the

## The Summary (Standard of Disclosure)

Under the proposed amendments to Article 5(2) of the Prospectus Directive, the format and content of the summary of the prospectus would have to:

“provide key information in order to enable investors to take informed investment decisions and to compare the securities with other investment products”.

This appears to impose the same standard of disclosure on the summary as that which applies to the prospectus itself, since the prospectus must also contain information necessary “to enable investors to make an informed assessment” of the issuer and securities in question.<sup>2</sup> Indeed, a consequential amendment has been made to Article 6(2) in order to attach civil liability on the basis of the summary not only if it is misleading, inaccurate or inconsistent, when read together with the other parts of the prospectus, but also if it does not satisfy the requirements specified in the proposed amendments above.

If the summary is required to meet the same standard of disclosure as the prospectus itself, then it would presumably have to contain a similar volume of information. This seems illogical to the FMLC given that the purpose of the summary, as stated in the Prospectus Directive, is to convey only the essential characteristics and risks associated with the issuer and securities, and to do so “in a brief manner”.<sup>3</sup> In fact, it is conceivable that competent authorities may insist on brevity (or, in some cases, may be required to do so by law) and that, as a result, the issuer may find itself liable to investors for failing to comply with the high standard of disclosure required by the proposed amendment. In such cases, the effect of the proposed amendment would appear to conflict with normal concepts of natural justice.

Furthermore, the requirement that the information in the summary should enable investors to compare the securities on offer with other investment products is uncertain in a number of respects. It is not clear, for example, whether such information need only enable the investor to compare securities issued by companies within the same industry sector and of similar size; or whether the requirement is intended to be much wider in its scope. In any case, it may be very difficult in practice to provide information which would allow for an effective comparison of securities of different companies in light of the significant degree of financial product innovation by market participants.

It also seems to the FMLC that the proposed amendments put competent authorities in an uncertain and undesirable position. The Prospectus Directive requires that a prospectus be approved by the competent authority, but provides little detail on what must be done by the authority for the purpose of giving its approval. Under section 87A of the *Financial Services and Markets Act 2000*, the UK Listing Authority has a statutory duty not to approve a prospectus unless it is satisfied that the requirements of the Prospectus Directive have been met. It may be, therefore, that once the proposed amendments to the Prospectus Directive are made, the UK Listing Authority will have to ensure that the summary does indeed contain all of the information necessary to enable investors to take an informed investment decision and to compare the relevant securities with other investment products. However, this considerable duty, if it exists, is not clearly articulated by legislation; and no account is taken of the potential liability of the competent authority if the duty is found to exist and has not been properly discharged. In this context, it is important to note that any statutory immunity granted to the competent authority in its home state will not be effective when a prospectus has been passported to and used in another Member State.

The FMLC notes that no reference was made to these proposed amendments to Articles 5(2) and 6(2) in the Commission’s consultation papers on the Prospectus Directive, which were

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issuer is not. Further, an indemnity from the issuer will be of limited use to an intermediary where the issuer has become insolvent or the indemnity is ultimately unenforceable.

<sup>2</sup> Article 5(1), Prospectus Directive

<sup>3</sup> Article 5(2), Prospectus Directive

published in January 2009. Market participants have therefore, in the FMLC's view, been given insufficient time to make known their views on the proposals.

### **Supplements to the Prospectus**

The draft Directive would introduce an amendment to Article 16(1) of the Prospectus Directive, under which an obligation to produce a supplement to a prospectus would cease on the earlier of the final closing of the offer to the public and the time when trading of the securities begins. The Explanatory Memorandum states that, without this amendment, the Prospectus Directive creates a considerable degree of uncertainty as to when the requirement to publish a prospectus ends in cases where the securities are to be admitted to trading on a regulated market.<sup>4</sup>

It appears to the FMLC, however, that this proposed amendment may have unintended consequences both for investors and issuers; particularly where, for example, a significant new factor relating to the information in the prospectus arises after admission of the securities to a regulated market but before the offering period has closed. In this scenario, an issuer would not be willing to continue to offer securities on the basis of the unamended prospectus for legal and commercial reasons, but the competent authority would have no power to approve an amending document because admission has already taken place. As a result, the issuer would most likely seek to amend the prospectus using an unapproved "wrapper". However, the use of such a "wrapper" would deprive investors of the protection conferred upon them through the formal approval of a supplemental prospectus. It would also deprive the issuer of the possibility of obtaining a passport for the amended prospectus, such that the issuer would be at risk if it were to distribute the wrapper to investors in other Member States.

It is suggested that these problems would be resolved if the obligation to produce a supplemental prospectus were to cease on the later, rather than the earlier, of the final closing of the offer and the admission of securities to trading.

The FMLC would welcome the opportunity to discuss this further if that would be useful.

Yours sincerely,



Joanna Perkins

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<sup>4</sup> Paragraph 5.3.10