



ESMA Final Report on Summaries and Final Terms Under the Prospectus Directive

As we reported in our earlier alert,¹ the European Securities and Markets Authority was required to deliver, by 30 September 2011, its final technical advice to the European Commission in relation to possible delegated acts under the amended Prospectus Directive. Its advice came in a few days late,² which fuelled hopes in some people that this signalled a re-think of many of the more radical proposals in their June 2011 Consultation Paper. These hopes have proven largely unfounded and very few of the responses received to the consultation have resulted in a change of position from ESMA.

We have drawn out, in the following paragraphs, some of the more notable comments and responses in respect of the technical advice on the format of final terms and summaries.

General Observations

ESMA freely acknowledges comments that the proposals will reduce the flexibility of the base prospectus regime under the Prospectus Directive, but considers its approach is necessary to stem what it perceives as practices that abused the intent of the regime by circumventing the prospectus vetting process. ESMA considers that its approach provides clarity as to what can and cannot be included in final terms and that any resulting approval delays or additional costs should be addressed at some point in the future.

ESMA states that it is fully aware of the impact of its technical advice on the structured products industry. It still considers that structured products can be issued by a base prospectus and final terms, but regards many existing structured note programmes as lacking in readability and comprehensibility by virtue of a lack of clear presentation of complex product terms.

Most commentators pointed out that base prospectuses would become lengthier due to ESMA's approach, resulting in them becoming less comprehensible. ESMA states that it sees no linkage between the length and comprehensibility of a document, thereby avoiding the undeniable fact that a longer disclosure document is more likely to deter an investor from reading it, thereby leading to lack of comprehension on the investor's part.

Some commentators also expressed the view that the ESMA proposals went beyond the scope of the Prospectus Directive, and were disproportionate to the goal of eliminating inconsistencies in the use of final terms. Perhaps not surprisingly, ESMA disagrees with this view, though it chose not to go into detail as to its reasons.

¹ See Morrison & Foerster client alert "The Changing Face of European Securities Issuance," <http://www.mofo.com/files/Uploads/Images/110729-Changing-Face-of-European-Security-Issuance.pdf>.

² Final Report, <http://www.esma.europa.eu/popup2.php?id=7983>.

Prescriptive Lists and Additional Information

In ESMA's view, only prescriptive lists (as opposed to general principles) of securities note items should be permitted in final terms. One of the few concessions that ESMA makes to flexibility is the ability of final terms to contain information ("Additional Information") not required by the securities note schedules in the Prospectus Regulation. However, pleas to make any list of permitted Additional Information items flexible, rather than exhaustive, have fallen on deaf ears.

Commentators note that, in the interests of information being useful to investors, any exhaustive list of Additional Information should also contain items such as country-specific information, selling restrictions, inducements paid to distributors, product-specific risk factors and descriptions of conflicts of interest. ESMA has at least agreed to take more time to consider these issues and has conceded that the exact content of the list will be determined only at a later stage.

Interestingly, ESMA's final advice to the Commission in this regard expressly acknowledges that the Prospectus Directive and Regulation expressly state that final terms may only contain information from the securities note schedules, but that it still thinks the Additional Information items (when prescribed) will be "useful to investors." Whilst noble in purpose no doubt, this is a novel argument to put forward for "gold-plating" a maximum harmonisation directive and regulation.

Category A, B and C Information

As it did in its previous consultation paper, ESMA has put each item in the securities note schedules in the Prospectus Regulation into either category A (where the information must be included in the base prospectus and no additional information can be included in final terms), category B (where the base prospectus must contain the general principles of such item and can only leave placeholders for the details which are not known at the time of drawing up the base prospectus) or category C (where the final terms should fill in the details of a placeholder (but not replicate any information) in the base prospectus).

Many respondents argued that any securities note information items not known at the time of the base prospectus could be contained in final terms. However, ESMA's firm stance is that only certain categories of information, which are unknown at the time of the base prospectus, may be included in the final terms.

Some respondents noted that this formalistic approach, while constituting a somewhat artificial and arbitrary categorisation methodology for issuers to apply, resulted in a simpler and more streamlined approach to scrutiny by the competent authorities. ESMA stated that this had not been the driving factor behind its approach.

ESMA's proposal for Category B-designated information items was that the base prospectus should contain all the general principles of such item and placeholders for relevant details not known at the time of the base prospectus. The final terms may then replicate the principles and fill out the placeholders. ESMA proposed in its Consultation Paper that the list of relevant details should be a limited one, consisting of only items such as amounts, currencies, dates, times, percentages, etc. While ESMA still considers that there must be a limited list of such items, it now proposes to determine the contents of such list only at some point in the future.

"Long Form" Final Terms

ESMA's restrictive interpretation of Article 26(5) of the Prospectus Regulation, as meaning that information items contained in the base prospectus may not be reproduced in the final terms document, has met with much consternation from market participants in certain countries, Germany in particular.

In such countries, it has become customary for issuers to retail investors to set out, in the final terms document, the entire terms and conditions of an offering. This practice will seemingly become outlawed if the European Commission agrees with the technical advice given by ESMA in this regard.

Supporters of this practice might argue to ESMA that it is useful for an investor to have all this information set out in one place – “usefulness” being the express justification cited by ESMA for departing from the mandatory provisions of the prospectus regime in respect of Additional Information, as noted above.

Some respondents expressed their view that issuers would have difficulty meeting national-level civil law requirements if this practice were no longer permitted, but ESMA states that it regards this as a problem to be solved by the nation’s lawmakers, not by it or the prospectus regime.

Prospectus Summary

ESMA largely maintains its position in relation to prospectus summaries as set out in its previous consultation paper, including that the summary be split into five prescriptive sections (including risk warnings) and no information be permitted that does not fall within one of the permitted categories. The existing 2,500-word limit for summaries will be replaced with a limit of the shorter of 15 pages or 7% of the length of the base prospectus. No cross referencing to other sections of the base prospectus will be permitted.

Final Term Summaries

As in the consultation paper, ESMA recommends that a separate summary for each issuance off the base prospectus should be annexed to the relevant final terms. The length limit would be the same as for the prospectus summary referred to above. Such summary will also be subject to the same translation requirements as the prospectus summary. ESMA rejected arguments that this translation requirement would be contrary to the principles of the base prospectus regime and would give rise to significant delays in the “passporting” system established by the base prospectus regime.

Concerns remain as to how the new final term summary requirements interact with the EU Commission’s current proposals in relation to packaged retail investment products (“PRIPs”) which currently envisage the production of a short-form key investor information document (“KIID”) of no more than two pages containing key information for investors. It seems unlikely that the final terms summary envisaged by ESMA would be such a short document, giving rise to the prospect of issuers having to prepare both a KIID and final terms summary for securities that could be sold to retail investors. ESMA has asked the European Commission to consider how its proposals in relation to summaries and the Commission’s KIID proposals in relation to PRIPs can be aligned, but at present, it appears that the respective aims of the two documents are very different.

Wholesale/Retail Distinction

Criticisms were raised that requiring such levels of scrutiny by competent authorities for all issuances was inappropriate for qualified investors and that the current approach does not distinguish between these investors and retail investors. ESMA’s response was that the Prospectus Regulation already provides for lower levels of minimum disclosure for non-retail offerings, but otherwise states that issuers are always free to develop separate base prospectuses for their wholesale and retail issuances.

Items for Inclusion in Base Prospectuses

ESMA remains adamant that risk factors and pay-out formulae are items for base prospectuses – not final terms. It acknowledges that changes such as these will inevitably mean that some types of issuance's will no longer be made via final terms, but is not convinced that financial innovation will suffer as a result.

Proprietary Indices

ESMA will distinguish, in its approach, between proprietary and non-proprietary indices, with the former having to be contained in the base prospectus. As with other aspects of ESMA's proposals, this will lead to longer prospectuses, though as they have stated, ESMA does not accept that this gives rise to a lack of comprehension by the investor.

Asset-backed Securities

Following pressure from respondents, the information item "General description of the obligors and their economic environment" has been reclassified by ESMA from Category A to Category B, to reflect the fact that certain obligor information, such as pool-specific statistical information, may not be available before the issue date.

Swap Counterparties

Since arrangements can be series-specific, the identity of the swap provider may not be known at the issue date. Nevertheless, ESMA still believes that such information should remain a Category A item.

Next Steps

Unless there is a further amendment to the Prospectus Directive, the Commission is obliged to adopt delegated acts by 1 July 2012, although it is not obliged to adopt the proposals made by ESMA and it has the power to weigh up ESMA's advice against other possible delegated acts. It would, of course, be something of a surprise if it did not adopt the majority of ESMA's recommendations, though, and set in motion the legislative machinery for what may come to be known as "PD2."

A likely consequence of ESMA's proposals is that issuers will be subject to greater costs and administrative burdens in relation to production of additional prospectus supplements in relation to information which could currently be contained in final terms. As mentioned above, this is likely to be a particular issue in relation to structured securities. One possible consequence is that the proposals may lead to issuers having multiple programmes, each designed for a specific type of product. It may also have the consequence that some issuers may decide that the cost of issuing retail products (particularly structured retail products) is too great and they will only issue notes in wholesale denominations. This would be likely to result in a reduction of choice for retail investors.

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