

Amendment of Prospectus Regulation: Complex Financial Histories

Comparison between draft amendment to Commission Regulation (EC) No. 809/2004 and CESR Advice

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This note accompanies ESC working Document.....: a draft amendment to the Prospectus Regulation¹ that addresses a deficiency in its application to issuers with a complex financial history. The amendment is based on CESR's advice which was delivered at the end of October 2005.

That advice recommends that the Regulation should be amended to enable competent authorities to require such issuers to provide historical financial information relating to entities which, when that information was drawn up, were legally separate from the issuer but which have subsequently been acquired by the issuer and form part of its business at the time the prospectus is produced. The advice does not prescribe the information which should be required in cases of a specified kind. Rather, the intention is to allow competent authorities sufficient discretion to deal flexibly with cases which, by their nature, are atypical and may be unique.

Subject to certain modifications, the working document retains the necessary element of flexibility for competent authorities to determine, on a case by case basis, the additional financial information that must be included in a prospectus where the issuer has a complex financial history. The issue is too complex, and cases of issuers with a complex financial history too diverse, to be subject to the format used in the Regulation generally (detailed and comprehensive information requirements set out in a series of 'building blocks'). This gives effect to CESR's advice.

Principal differences between working document and CESR Advice

However, the working document modifies CESR's advice in a few areas. We believe that such divergence is necessary to ensure consistency with the Directive, and to avoid inconsistent application by competent authorities. The principal differences are summarised below. A more detailed comparison, together with explanations, is set out in the Annex to this Note.

1. Duty, not power

CESR recommends that competent authorities "should be able to require" – a *power*. By contrast, new paragraph 3 of the working document imposes a *duty* on competent authorities to require the disclosure of any supplementary financial information relating to entities other than the issuer that is necessary to meet the requirements of Article 5(1) of the Prospectus Directive ('PD'). That Article provides that "the prospectus shall contain all information which, according to the particular nature of the issuer and of the securities [...], is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer".

¹ Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements.

As a matter of legal consistency, it is necessary to impose a duty. A power for competent authorities to require that information (which they may choose not to exercise) would be inconsistent with Level 1. If information is necessary to ensure that the prospectus meets the overriding requirement of that Article, competent authorities should always ensure that it is included in the prospectus.

2. Principles recommended by CESR

CESR recommends a principles-based approach to the determination by competent authorities of what supplementary financial information is necessary in a particular case. Under this approach, an authority's determination would take into account the disclosure requirements of the Regulation as respects the historical financial information relating to the *issuer*, filtered through the following principles: the additional information should reflect the economic substance of the business carried on by the issuer, and not simply the legal form of the issuer; the information should be material in relation to the whole of the issuer's business; and it should be reasonable to impose on the issuer the costs of supplying the additional information.

The working document gives effect to CESR's advice to a large extent. New paragraph 7 requires competent authorities to take into account the requirements of the Regulation as respects the historical financial information relating to the issuer, subject to any modification which is appropriate in the view of the specific nature of the undertaking of the issuer and the availability to the issuer of financial information relating to another entity. This provision preserves the necessary flexibility for competent authorities to respond to the circumstances of a particular case, since the primary requirement is that the prospectus should contain such supplementary financial information as is needed to satisfy the requirements of Article 5(1) PD. This must be determined on a case by case basis, and the existing requirements of the Regulation in respect of historical financial information are a guide, and not a binding set of items which apply in all cases.

However, the working document does not require competent authorities to take into account the principles of materiality and reasonableness as recommended by CESR. This is because a restriction of that kind might be open to an interpretation which would be inconsistent with Article 5(1) PD, by allowing the omission of supplementary financial information which is in fact necessary for investors to make an informed assessment of the issuer and the securities.

Nevertheless, we consider that this modification of CESR's advice should have minimal impact in practice, since supplementary financial information which is necessary to enable investors to make an informed assessment of the issuer and of the securities, as required by Article 5(1) PD, will also satisfy the standards of materiality and reasonableness as described by CESR.

ANNEX

Detailed comparison between draft amendment and CESR Advice

1. Supplementary nature of new requirements

CESR Advice

Preliminary remark: "CESR would like to clarify that the proposed requirements are in addition to the requirements already set in the Regulation. In particular, it is important to highlight that issuers with a complex history, will need to comply with item 20.1 of Annex I and with Annex II, should this be applicable, in addition to the proposed requirements."

Draft amendment

"3 Notwithstanding the restriction in the second paragraph of Article 3, where the issuer of a security falling within paragraph 2 –

- (a) has a complex financial history; or
- (b) has made a significant financial commitment,

the competent authority of the home Member State shall require that the registration document include, **in addition to the information items included in the schedule set out in Annex I and Annex II**, such supplementary financial information relating to or produced by entities other than the issuer as is necessary to ensure that the prospectus complies with the requirements set out in Article 5(1) of Directive 2003/71/EC."

Comment

The draft amendment fully implements CESR's advice.

2. Scope of application

CESR Advice

Para. 31: "The additional requirements for issuers that have a complex financial history should only be requested in those cases where the Shares Registration Document applies according to article 4 of the Regulation."

Draft amendment

"3 Notwithstanding the restriction in the second paragraph of Article 3, **where the issuer of a security falling within paragraph 2 –**

- (a) has a complex financial history; or
- (b) has made a significant financial commitment, [...]."

Comment

The draft amendment fully implements CESR's advice: paragraph 2 of Article 4 of the Prospectus Regulation lists the cases where the shares registration document is required.

3. Application to issuers

CESR Advice

Para. 34: "The additional requirements for issuers that have a complex financial history should not make any distinction between different types of issuers."

Draft amendment

"3 Notwithstanding the restriction in the second paragraph of Article 3, **where the issuer of a security falling within paragraph 2 –**

- (a) has a complex financial history; or
- (b) has made a significant financial commitment, [...]

Comment

The draft amendment fully implements CESR's advice: new paragraph 3 applies to *all issuers* of a security to which the shares registration document applies.

4. Meaning of "complex financial history"

CESR Advice

Para. 40: CESR considers that it would not be appropriate for the Regulation to provide a definitive list of cases of issuers with a complex financial history. In general, CESR considers that such cases would be those where the issuer has not prepared its historical financial information as a single business during the whole of the period for which the historical financial information is required under the Regulation. Therefore, the historical financial information required by the Regulation to be included in the prospectus might not sufficiently reflect the issuer's whole business throughout the required period. The same applies in cases where there is a firm commitment or an agreement to perform the relevant transactions.

Draft amendment

"4 For the purposes of paragraph 3, an issuer has a complex financial history if, as a result of any acquisition or disposal undertaken by the issuer, the entire business undertaking of the issuer at the time that the prospectus is drawn up is not covered by or represented in the historical financial information which the issuer is required to provide under item 20.1 of Annex I.

5. For the purposes of paragraph 3, an issuer shall be treated as having made a significant financial commitment if it has entered into a binding agreement to undertake a transaction which, on completion, will give rise to a significant gross change in the assets and liabilities and earnings of the issuer. For the purposes of this paragraph, an agreement shall also be treated as binding if the firm commitment of the parties is conditional on the outcome of the offer of the securities that are the subject matter of the prospectus."

Comment

The draft amendment is intended to give full effect to CESR's advice. Accordingly, the amendment does not provide a list of cases where an issuer has a complex financial history.

Rather, it contains a general description of the circumstances in which an issuer should be treated as having such a history.

Similarly, the draft implements CESR's extension of 'complex financial histories' to "cases where there is a firm commitment or an agreement to perform the relevant transactions" by the concept of cases where the issuer has made a "significant financial commitment". This category is dealt with separately since it might be misleading to include it in the same category as issuers with a complex financial history. Because it concerns a future transaction as opposed to one which has already taken place, the information which is required for the purposes of Article 5(1) of the Prospectus Directive ('PD') may be different.

CESR's advice refers to "a firm commitment or an agreement to perform" the range of transactions which, if already performed, would constitute a 'complex financial history'. By contrast, the draft refers to "a binding agreement to undertake a transaction which, on completion, will give rise to a significant gross change in the assets and liabilities and earnings of the issuer". This drafting is intended to reflect the objective of CESR's advice and, by mirroring the wording in item 20.2 of Annex I, links to the circumstances where pro forma financial information would be required if the transaction had already taken place at the time when the prospectus is drawn up. It is not necessarily the case that all planned transactions which, if completed, would give rise to a 'complex financial history' should be caught by the provision dealing with "significant financial commitments".

The provisions defining what is a 'complex financial history' or a 'significant financial commitment' are supplemented by draft recitals 10 and 11. Recital 10 reflects the illustrative list of the most common cases where an issuer has a complex financial history, set out in paragraph 36 of CESR's advice. Recital 11 provides a gloss on what should be considered as a 'significant financial commitment', and includes a cross-reference to the explanation in recital 9 of the Prospectus Regulation of what constitutes a 'significant gross change'. That cross-reference is based on paragraph 49 of CESR's advice.

5. Additional requirements for issuers with a complex financial history or a "significant financial commitment"

CESR Advice

Para. 44: "CESR considers that competent authorities should be able to require issuers with a complex financial history to provide in the prospectus historical financial information for the significant businesses or subsidiaries, for each year during the required periods (the last three years or such shorter period that the business or subsidiary has been in operation).

Para. 45: "When deciding on the need and the extent of the historical financial information of the significant businesses or subsidiaries, competent authorities should take into account the requirements as set in item 20.1 of Annex I of the Regulation for issuers as regards to accounting and auditing principles and content of the financial information in light of the principles set out below."

Para. 52: "When assessing the need and the extent of the additional information on the significant businesses or subsidiaries, competent authorities should have flexibility to decide on the requirements, taking into account the requirements set by item 20.1 of Annex I of the Regulation in light of the principles of economic reality, materiality and reasonability."

Draft Amendment

"6 The supplementary financial information mentioned in paragraph 3 may include any of the following –

- (a) financial information relating to significant subsidiaries of the issuer covering the preceding three financial years or such shorter period that the subsidiary has been in operation;
- (b) financial information relating to any part of the business undertaking of the issuer which, at the time when the information was drawn up, was carried on by an entity other than the issuer;
- (c) financial information relating to an entity or business undertaking which the issuer has undertaken to acquire pursuant to a significant financial commitment of a kind mentioned in paragraph 5.

"7. When deciding how the obligation imposed by Article 5(1) of Directive 2003/71/EC should be satisfied in cases covered by paragraph 3, and in particular the nature and extent of the supplementary financial information which should be required and the form in which it should be presented, the competent authority shall take into account the requirements set out in item 20.1 of Annex I as regards the content of financial information and the applicable accounting and auditing principles, subject to any modification which is appropriate in view of –

- (a) the facts of the case, including the economic substance of the transactions by which the issuer has acquired or disposed of its business undertaking or any part of it, and the specific nature of that undertaking; and
- (b) in cases where the issuer has made a significant financial commitment, the availability to the issuer of financial information relating to an entity other than the issuer.

Where the obligation imposed by Article 5(1) of Directive 2003/71/EC may be satisfied in more than one way, the competent authority shall take into account the costs to the issuer and shall not require that the obligation is satisfied in a way that is more costly or onerous than an adequate alternative. "

Comment

The draft modifies CESR's advice in a couple of ways. Such modification is necessary to ensure that the new provision is consistent with Article 5(1) PD, which provides that "*the prospectus shall contain all information which, according to the particular nature of the issuer and of the securities [...], is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer*".

First, paragraph 3 of the draft amendment imposes a *duty* on competent authorities ('CAs') to require any supplementary financial information relating to or produced by entities other than the issuer which is necessary to meet the requirements of Article 5(1). By contrast, CESR recommends that CAs "should be able to require" – a *power* rather than a *duty*.

A power for CAs to require that information (which they may choose not to exercise) would be inconsistent with Article 5(1). CESR's advice recognises that supplementary financial information may be necessary in cases where an issuer has a complex financial history to ensure that the investor is fully informed about the issuer's assets and business (paragraph 22). If information is necessary to ensure that the prospectus meets the overriding requirement of

Article 5(1), CAs should ensure that it is included in the prospectus. As a matter of legal consistency, therefore, it is necessary to impose a duty.

Secondly, CESR recommends a principles-based approach to the determination by CAs of what supplementary financial information is necessary in a particular case. Under this approach, an authority's determination would take the requirements of item 20.1 of Annex I to the Regulation as a point of reference, but would then apply a number of general principles in order to determine what information is required in a particular case. Item 20.1 of Annex I deals with the extent of historical financial information relating to the *issuer* which must be included in a prospectus, the form in which it should be presented, and auditing requirements. The general principles suggested by CESR are as follows: the additional information should reflect the economic substance of the business carried on by the issuer at the time of the prospectus, and not simply the legal form of the issuing entity; the information should be material in relation to the whole of the issuer's business; and it should be reasonable to impose on the issuer the costs of supplying the additional information.

The Commission services understand that this approach is intended to ensure that CAs can respond with appropriate flexibility to the circumstances of a particular case. Such flexibility is a regulatory necessity since cases where the issuer has a complex financial history will vary widely and may be unique. The draft amendment gives effect to CESR's advice to a large extent and, in particular, aims to give CAs the necessary flexibility -

- Draft paragraph 6 contains an indicative and non-comprehensive list of the kinds of information which may be required to be included in a prospectus as supplementary financial information where the issuer has a complex financial history or has made a significant financial commitment. These are intended to reflect the circumstances, cited by CESR in its advice, where there is likely to be a complex financial history. This provision has been included for guidance and clarification for issuers and for regulators.
- Draft paragraph 7 requires CAs, when deciding on the extent of supplementary financial information and the form in which it should be presented, to take into account the requirements set out in item 20.1 of Annex I, subject to any modification of those requirements which is appropriate in the view of two kinds of consideration:
 - (i) the facts of the case, including the economic substance of transactions which constitute the 'complex financial history', and the specific nature of the undertaking of the issuer. This gives effect to CESR's recommendation that the additional information should reflect economic reality.
 - (ii) the availability to the issuer of financial information relating to another entity. This applies only where supplementary information is required to reflect a significant financial commitment of the issuer, since it is considered that where the transaction which constitutes a 'complex financial history' has already been completed, the issuer should have ready access to any such financial information.

This provision preserves the necessary flexibility for CAs, since the primary and overriding requirement is that the prospectus should contain such supplementary financial information as is necessary to satisfy the requirements of Article 5(1) PD. This must be determined on a case by case basis, and the requirements of item 20.1 of Annex I are a guide which the CA must take into account when determining how that overriding requirement should be satisfied, and not a binding set of items which apply in all cases.

However, the proposed amendment does not expressly require CAs to take into account the principles of "materiality and reasonability" as recommended by CESR. This is because a restriction of that kind might be open to an interpretation which would be inconsistent with Article 5(1) PD, by allowing the omission of supplementary financial information which is necessary for investors to make an informed assessment of the issuer and the securities. If supplementary financial information is required to ensure that the prospectus satisfies the standard of accuracy and completeness specified by that Article, CAs should not be obliged to consider whether the requirement for such information is consistent with the principles of economic reality, materiality or reasonableness, or to waive the requirement on such grounds. That information must in all circumstances be included: any other approach would constitute a derogation of the overriding principle in Article 5(1) PD, which is not permitted by the level 1 Directive.²

However, this apparent deviation from CESR's advice should have minimal impact in practice: it is hard to envisage a case in which the supplementary financial information that is necessary to enable investors to make an informed assessment of the issuer and of the securities would not satisfy standards of materiality and reasonableness. This is explained in draft recital (13), which refers to the fact that the regulatory principles of proportionality, materiality and reasonableness underlie Article 5(1) of the PD. The recital also gives effect to the explanation of 'significance' in paragraph 49 of CESR's advice.

Finally, draft paragraph 7 also enforces the principle of reasonableness, as recommended by CESR, to the extent that it requires CAs to take into account the costs to the issuer of disclosing supplementary financial information so as to ensure that where the Article 5(1) requirement can be adequately satisfied in a less costly or onerous way, a more costly alternative is not required.

Need for convergent practice

Draft amendment: recital 13

"Those guidelines should be applied in a uniform manner, which is predictable for issuers, in all Member States. While competent authorities should consider the appropriate supplementary financial information requirements on a case by case basis, issuers nevertheless need to be confident that competent authorities exercise their flexible powers to require that information in a similar way. Although it is not possible to specify fully harmonised information requirements for cases where the issuer has a complex financial history, a consistent approach by competent authorities is necessary for the proper functioning of the passport under the Directive. Effective harmonisation should be achieved through convergent regulatory practice. The Commission therefore sees an important role for the Committee of European Securities Regulators in providing guidance as regards the uniform application of the new requirements for supplementary financial information in all Member States."

Comment

The draft amendment confers the flexibility for CAs to assess the need for supplementary financial information, and the way in which that need should be met, on a case by case basis. However, the requirement to include such supplementary financial information as is necessary to satisfy the requirements of Article 5(1) PD may be capable of varying interpretations by

² The power in Article 8(2) of the PD for competent authorities to authorise issuers to omit information in specified circumstances (disclosure contrary to the public interest or seriously detrimental to the issuer, or such information of minor importance) will also apply in relation to supplementary financial information.

CAs, and may be discharged in diverse ways. To preserve the harmonising approach of the Level 1 Directive, all competent authorities should exercise that flexibility in a similar way. This is necessary, since the passport under the PD will only work effectively if competent authorities trust their counterparts to apply consistent criteria when approving a prospectus, and issuers should be able to predict what information will be required.

Recital 15 recognises both the necessary flexibility, but also the need for predictable application. It is fundamental to the smooth and effective operation of the passport under the PD that a prospectus should contain the same information, regardless of the home Member State of the issuer. Inconsistent interpretation and application of these new requirements by CAs could undermine the passport, and frustrate the aims of the directive. Accordingly, recital 15 urges effective harmonisation of requirements relating to issuers with a complex financial history through convergent regulatory practice, and recognises the desirability of CESR guidance to promote the uniform application of the new requirements for supplementary financial information in all Member States.

6. Change of accounting reference date

CESR Advice

Para. 54: In the case where the issuer has changed its accounting reference date during the three year period, CESR considers that the historical financial information of the issuer should be presented for the issuer's financial periods necessary to show at least 36 months.

Draft amendment

"3. The following sentence shall be inserted after the first sentence of the first paragraph of item 20.1 of Annex I to Commission Regulation (EC) No 809/2004:

" If the issuer has changed its accounting reference date during the period for which historical financial information is required, the audited historical information shall cover at least 36 months (or, if shorter, the entire period for which the issuer has been in operation)."

Comment

The proposed amendment gives full effect to CESR's advice in substance. However, it would be inconsistent with the formulation of a 'complex financial history' in the draft to extend it to cover cases where the issuer has simply changed its accounting reference date, since cases of this kind do not raise the possibility that the prospectus may need to include supplementary financial information relating to an entity other than the issuer. Accordingly, the matter can be dealt with by a simple amendment to item 20.1 of Annex I to the Regulation, to ensure that sufficient historical financial information is required in such cases. Where necessary, this amendment will feed through to supplementary financial information (relating to an entity other than the issuer which changed its accounting reference date) by virtue of the cross-reference to item 20.1 in new paragraph 7 of the draft amendment.