FESE Feedback
Commission's Draft Delegated Regulation on the Prospectus Regulation

FESE fully supports the European Commission's Capital Markets Union (CMU) project, and its goal to strengthen the European economy and ensure easier access to markets for all companies, including growth companies which are the backbone and engine of the economy. The revision of the prospectus rules is a first step to reduce costs and burdens for companies whilst improving their access to funding, increasing information and financing choices for investors, and delivering more efficient European capital markets overall.

The Level II measures will, in this respect, play a key role in shaping the final prospectus rules, hopefully ensuring a major relief for companies looking for funding on capital markets while making disclosed information more useful for investors. In order for this review to have the intended effect, it is crucial that the regulatory framework allows producing prospectuses that are as accessible and digestible as possible for the investor. If the prospectus is too long and difficult to read, understand and analyse, it will simply not be a useful document.

On 20 July 2017, the Prospectus Regulation entered into force and required the European Commission to adopt delegated acts in several areas. In accordance with its mandate, the Commission has published its draft delegated regulation relating to the format, content, scrutiny and approval of prospectuses, after receiving ESMA's Technical Advice, for public consultation. FESE welcomes the majority of the Commission's proposed amendments to the Prospectus Regulation, many of which we believe will deliver a more proportionate disclosure regime for issuers and a more useful document for investors. However, ahead of the Commission's final delegated regulation proposal, FESE believes that there are some outstanding points on which we would welcome further consideration. These points are the following:

A. The Format and Content of the Prospectus

- Clarification that derivative contracts are outside the scope of the Regulation (Annex 1)
- Disclosure of secondary issuances (Annex 3, 8, 12 & 15)
- Disclosure of collective investment undertakings of the closed-end type registration document (Annex 4)
- Disclosure of derivative securities building blocks (Annex 16)

B. The EU Growth Prospectus

- Disclosure of unaudited profit forecasts (Annex 23)
- Additional recommendations on the EU Growth Securities Note (Annex 25)

A. The Format and Content of the Prospectus

<u>The inclusion of a statement clarifying that derivative contracts as referred to in Annex I Section C (4) to (10) of MiFID II are not within scope (Annex 1)</u>

As part of ESMA's and the Commission's work on Level 2 measures, we strongly **recommend clarifying which derivative instruments are within the scope of the Prospectus Regulation**.

Our understanding, as confirmed informally by Commission and ESMA services, is that the scope of the Regulation covers products such as securitised derivatives, which are currently subject to prospectus requirements, and does not cover exchange-traded derivative contracts, for which no prospectus requirements currently apply.

Securitised derivatives and derivative contracts are **two distinct types of instruments**. Exchange-traded options and futures are standardised contracts between financial counterparties – they are created by exchanges rather than issued and do not constitute an offer to the public. Securitised derivatives on the other hand are issued by financial institutions, typically investment banks, and sold to predominantly retail investors as investment products.

A potential confusion however comes from the fact that the Level 2 measures (and the framework currently applicable in the markets) refer to 'derivatives' and 'non-equities securities' interchangeably without defining these terms. As the term 'derivatives' in the industry is commonly used to refer to options and futures contracts, we believe there would be a **benefit in clarifying that derivative contracts are not within the scope of the prospectus regime**. This would give further legal backing to current market practice and provide clear guidance to national competent authorities, which could otherwise interpret the provisions in diverging manners.

FESE Recommendation

We welcome ESMA's view that the relevant definitions contained in the Commission Regulation should be carried over to the new regime in order to provide issuers with clarity and ensure that NCAs have the same understanding of similar provisions. However, ESMA's response to this issue is to **carry forward Article 15.2 of the Commission Regulation** (which clarifies when the derivatives schedule should be used) and therefore considers it unnecessary to include a definition of derivatives and securitised derivatives.

However, in order to fully clarify this point, **we would suggest introducing a Level 2 recital to explicitly state that the derivative instruments referred to in Annex I Section C (4) to (10) of MiFID II are not in scope of the prospectus requirements.**

<u>Secondary Issuance – Risk Factors (Annex 3, 8, 12 & 15)</u>

We welcome the reduced disclosure requirements for secondary issuances, but we have one additional point that should be considered in relation to risk factors as we are of the view that there is scope for further alleviation of the disclosure regime without compromising on investor protection. We believe it would be appropriate to require disclosure of only new material risks arising since the last published audited annual financial statements for secondary issuances as any previous risks will already be disclosed to the market, and this is an area of the prospectus that gives rise to significant cost to issuers to prepare.

FESE Recommendation

We suggest the following amended text:

Annex 3 - Item 3.1 (equity securities):
"A description of the material risks that have arisen since the last published audited annual financial statements that are specific to the issuer, in a limited number of categories, in a section headed 'Risk Factors'."

Annex 8 – Item 3.1 (non-equity securities):
"A description of the material risks that have arisen since the last published audited annual financial statements, and are specific to the issuer and that may affect the issuer's ability to fulfil its obligations under the securities, in a limited number of categories, in a section headed 'Risk Factors'."

Annex 12 & 15 - Item 2.1 (securities notes for secondary issuances):
"A description of the material risks that have arisen since the last published audited annual financial statements, and that are specific to the securities being offered and/or admitted to trading, in a limited number of categories, in a section headed 'Risk Factors'."

Collective Investment Undertakings of the Close-End Type Registration Doc (Annex 4)

We welcome a number of the changes that have been made to this annex to make the disclosure regime more appropriate to closed-ended funds; however, there are still a number of points set out below that we have concerns about as they will give rise to unnecessary additional cost for these issuers.

a) Introduction paragraph of Annex 4

Collective investment undertakings of the closed ended type typically do not prepare profit forecasts or estimates. In our experience since the implementation of Directive 2003/71/EU, these disclosure items are typically not applicable. Therefore, we propose:

FESE Recommendation

Item 11 (Profit Forecasts or Estimates) from Annex 1 should be removed as a requirement for closed-ended funds and also item 7 (Profit Forecasts or Estimates) from Annex 3 removed as a requirement for secondary issuances.

b) 2.2 (i) and 2.3 -proposed new text:

The disclosure requirements in paragraph 2.2(i) and 2.3 are very onerous. In practice, this requirement has a negative impact on issuers coming to the market and is not appropriate for many closed-ended funds which are passive in nature. We would suggest that paragraph 2.2(i) should only be applicable in limited circumstances such as where a collective investment undertakings of the closed-ended type is seeking to take control of its underlying investments. By way of example, a venture capital fund or a private equity fund may fall into this category. Therefore, we propose the following text:

FESE Recommendation

2.2 (i) Where a collective investment undertaking of the closed-end type is seeking to take control of its underlying investments where and the underlying securities are not admitted to trading on a regulated or equivalent third country market or an SME Growth Market, information relating to each underlying issuer/collective investment undertaking/counterparty as if it were an issuer for the purposes of the minimum disclosure requirements for the Share Registration Document schedule (in the case of (a)) or minimum disclosure requirements for the [registration document schedule for securities issued by collective investment undertakings of the closed-end type] (in the case of (b)) or the minimum disclosure requirements for the wholesale (qualified) debt and derivatives registration document schedule (in the case of (c)); or

2.3 Where a collective investment undertaking may invest in excess of 20% of its gross assets in other collective investment undertakings (open ended and/or closed ended), a description of if and how risk is spread in relation to those investments. In addition, item 2.2 shall apply, in aggregate, to all underlying investments of the collective investment undertaking as if those investments had been made directly where a collective investment undertaking of the closed-end type is seeking to take control of its underlying investments.

Derivative Securities Building Block (Annex 16)

Item 2.2.2 – Information concerning the underlying

FESE is of the view that the disclosure regime required in respect of credit-linked notes under 2.2.2 of Annex 16 is too onerous and disproportionate for the product type in question. This provision applies to credit-linked notes where there is a single reference entity or reference obligation or where a single reference entity or reference obligation comprises 20% or more of the underlyings to the credit-linked note. We would argue there needs to be a more tailored disclosure regime which is less onerous than 2.2.2(a) while still requiring more meaningful disclosure than 2.2.2(b) as this would be of most benefit to investors. The main issue with the proposal in the Draft Report is:

- **Level of disclosure is disproportionate to the product type - T**he type of disclosure that will result from application of 2.2.2(a) is not appropriate for this product type as the reference entity has no obligation to note holders; it is more relevant for asset backed securities (whereby note holders' return is entirely dependent on an obligor's obligations under the underlying assets). Corresponding disclosure will not alleviate credit risk on credit-linked notes, even where there is a concentration of credit-risk with a reference entity/issuer of an underlying. Note holders invest in asset backed securities and credit-linked notes for very different reasons – they seek different exposures, have different risk appetites and are aware of the widely different outcomes should a default occur.

- Credit-risk is determined by the likelihood of a credit event; much of the disclosure required by this rule (under both the lighter (a)(2) regime and the more onerous (a)(1) regime where the reference entity/issuer of the underlying must provide disclosure as if it were the issuer) is not a useful predictor for this. Providing holders of credit-linked notes with issuer-level disclosure on the reference entity is excessive and potentially confusing as the reference entity has no obligation to note holders. To provide note holders with such disclosure might create the impression that such recourse exists.

FESE Recommendation
We believe a more balanced disclosure regime should be implemented, which would allow for disclosure in line with investor needs (for example, basic corporate details, historical financial information and trend information of the reference entity) but which removes surplus requirements relating to full issuer-level disclosure on the reference entity (such as organisational structure, board composition, shareholder details, and publication of certain documents); this proposal would be far more beneficial to note holders in allowing them to assess the likelihood of a credit event and would also lessen the burden for issuers.

2.2.2(a)(1) disclosure cannot fall within Category A

We have significant concerns that 2.2.2(a)(1) disclosure is categorised as Category A. This would not only be impractical from a disclosure point of view but will have a substantial effect on issuers' ability to issue notes by way of Final Terms. **Instead, we propose it should be amended to Category C.**

Category A information is required to be disclosed in an issuer's base prospectus. However, the identity of a reference entity or reference obligation is usually not known until the point of trade so it would therefore be impossible for issuers to satisfy this requirement unless issuers included disclosure on every potential reference entity/reference obligation they might use for a particular issuance. This would be impractical, costly and would lead to unduly lengthy base prospectuses (which might in turn cause issues with comprehensibility). Absent such information in the base prospectus, the issuer would be required to prepare a drawdown prospectus for each trade, which will create significant cost and timing issues.

The alternative, preparing a supplement to the base prospectus each time a reference entity/reference obligation is identified, is equally impractical. As this information is typically not identified until a trade is to be made, this would result in issuers having to prepare a supplement for every Final Terms. This would lead to significant cost and timing issues.

We have not been made aware of any appetite amongst investors for heightened disclosure in this regard, and certainly not the type of disclosure that 2.2.2(a) would require. Indeed, there are major concerns that the proposed provisions will significantly impact this market without any increased benefit for investors.

FESE Recommendation
We strongly argue that 2.2.2(a)(1) disclosure needs to be re-categorised as Category C as it cannot fall within Category A given the information will not be available when the base prospectus is being prepared.

B. The EU Growth Prospectus

Unaudited profit forecasts

We do not agree that **unaudited profit forecasts should be included in the EU Growth Prospectus (regardless of the asset class) or the registration document under item 7.3.** This is because forecasts are akin to a business plan, which could be misinterpreted or mislead investors were they not to be audited.

In its Final Report, ESMA remains of the opinion that the requirement to include an audit report on profit forecasts and profit estimates would create additional costs for the issuer with the limited comfort being provided to investors. ESMA views that it is for the issuer to determine whether, or not, it is necessary to include outstanding profit forecasts and profit estimates in the registration document, and there shall not be a requirement to provide an audit report. ESMA will therefore maintain the status quo under the current regime and **does not intend to revise its technical advice**.

The Commission Regulation should maintain prospectuses as fact-based documents for investors to form an unbiased opinion on the performance of an SME. The inclusion of unaudited profit forecasts would undermine the provision of objective data already present in the prospectuses, and would also create investor bias which, consequently, would have an important impact on the issuers concerned.

This could reflect badly on investor trust and could, over time, damage financing opportunities for all SMEs, as growth segments would suffer from a less robust reputation than the rest of the market. There is a precedent in Germany of a market whose credibility was irreparably damaged by the inclusion in prospectuses of profit forecasts which turned out to be inaccurate.

FESE Recommendation

If profit forecasts were to be included, they should be audited. This would not prevent issuers from communicating to potential investors profit objectives or guidance in parallel to the publication of its prospectus.

EU Growth Securities Note Recommendations

Item 4.2.2 and Item 4.6.6

In its previous response to the ESMA Consultation on EU Growth Prospectus in September 2017, FESE suggested to enhance the disclosure requirements within the Prospectus Regulation. We recommended:

A requirement to disclose all subscription commitments *should be added to the securities note under section 4.2.2.*

This is because we do not believe the 5% threshold currently included in the drafting is particularly relevant. For instance, under the current proposal, 10 persons could subscribe for 4.5% of the offer each, subscribing collectively for nearly half of the offer, however the information would not be disclosed to investors.

***A requirement for the disclosure of expenses in a more granular way in section 4.6.6** to encourage transparency and foster a better understanding of the repartition of IPO fees across all market participants involved.*

For instance, fees could be broken down into categories covering legal, communications, accounting, structuring and placement, as well as regulatory and exchange fees. This would not create additional burdens for issuers as all these fees would anyway need to be identified and added up to produce the aggregate estimate figure initially requested.

ESMA took note of these proposed additions to the securities notes but remarked that the arguments made are not specific to SMEs, and that these disclosure should apply equally to all issuers. As such, it strongly believes that the information requirements of the EU Growth prospectus securities note should not be more onerous compared to the information content of the securities note of the full prospectus, and thus **will not amend its technical advice**.

FESE Recommendation

FESE agrees with ESMA that such disclosures should apply equally to all issuers, however this should not halt the introduction of these information requirements in the EU Growth prospectus. SMEs have less capital than blue chip companies and thus require additional attention on their expenses in regard to their listing on capital markets. As such, introducing these requirements would not only increase transparency, but would also encourage and give prospective listed companies a much better point of comparison to assess the multiple budget strands of an IPO, which will vary considerably depending on the type of company, especially when it comes to the communications budget.

We do not believe that this inclusion will make it more onerous compared to the information content of the securities note of the full prospectus, as we would also advocate such an inclusion in all types of prospectuses since ultimately, budget is relative to all companies regardless of their size.