An Absence of Regulatory Design? Recent European Directives and the Market for Corporate Bonds.[1]

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Abstract

This report examines the recent European Prospectus and Transparency Directives and their impact on corporate bond markets, drawing on interviews with a number of asset managers across Europe. We contrast the direct approach to the regulation of disclosure in the United States based on SEC registration, with the indirect approach taken in Europe working through listing status. We identify a number of problems with the these directives, including: (a) The Transparency Directive imposes unreasonable disclosure costs on a number of outstanding international bond issues, a problem which is *not* resolved by the various exemptions in the directive; (b) The directives do not seem to fully exploit the Lamfalussy procedures, incorporating elements in primary co-legislation that may need to be altered, as a consequence of market or other developments; (c) Although the directives achieve their purpose of harmonising both disclosure and documentation of new issues, they appear to have been constructed as a bolt-on to existing regulatory practice, without attention having been paid to the overall design of pan-European securities market regulation.

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Executive summary

1. There are a number of motivations for this study. Corporate bonds are increasingly important competitor with both bank and equity finance. The issue and trading of international corporate bonds has been a significant financial activity in Europe for many years. There are new opportunities for the further development of corporate debt markets at pan-European level, especially for high-yield corporate debt, a relatively undeveloped market in Europe compared to the United States. Finally corporate bonds provide an informative case study of the wider challenges to be met in creating pan-European securities markets.

2. We compare securities disclosure in the United States and Europe. Subject to some exemptions, notably rule 144a for securities sold only to professional investors, all securities in the United States must be registered with the SEC and abide by SEC disclosure requirements. In Europe disclosure has been governed by the requirements of various national securities exchanges. The Prospectus and Transparency Directive extend this arrangement to pan-European level through application of the concept of "admission to a regulated exchange" i.e. securities that are listed or traded on an official list of regulated exchanges. These will have to abide by the various disclosure requirements of these directives.

3. The objectives of these directives has been to create a European passport for the documentation material prepared for new securities issues; and to enforce standards of accounting disclosure, including the use of International Accounting Standards or one of a limited number of 'equivalent' national standards. It appears that virtually all domestic securities and most international bonds issued in Europe will follow the requirements of the two directives.

4. The directives offer exemptions to wholesale bonds, generally defined as having a minimum subscription size or denomination of€50,000. We have conducted interviews with asset managers across Europe. These indicate that asset managers will face few practical problems in incorporating wholesale bonds in their portfolios. It will however be difficult for issuers to avoid the requirements of these directives by issuing securities outside of regulated markets. Our interviews reveal that because of client guidelines and portfolio regulations, most asset managers would find it difficult to hold such un-listed bonds.

5. The directives appear to have been developed without reference to any overall design for the future regulation of European securities markets. In consequence, these directives have several undesirable features that could hinder the further development of pan-European bond markets:

- The framework of disclosure regulation is complex, based around an association of each security with a 'home member state' as well its admission onto a regulated market. These complexities are potential barriers to pan-European competition.
- Security issuers can avoid the requirements of the Transparency Directive, and some requirements of the Prospectus Directive, by removing their securities from

any European regulated markets. The resulting incentive to avoid regulation through de-listing is tempered only by the widespread application, across Europe, of portfolio restrictions that limit institutional investment in unlisted securities

- The directives are untidy, offering exemptions for example to at least three different categories of security and with no clear link between the qualifications for exemption in the two directives.
- 'Wholesale' bonds issued on regulated markets will have only partial exemption from the requirements of the Prospectus Directive; this limitation could hamper the development of pan-European markets for high-yield corporate debt.
- Broader problems of bondholder protection and of the reliability or accuracy of disclosure are not addressed in either of these directives.

6. The directives do not make full possible use of Lamfalussy mechanisms, especially in the Prospectus Directive. The core co-legislation is not restricted to statements of principal, but includes considerable detail on the requirements for summary prospectus and accompanying documentation. The requirements for a `home member state' and `admission onto a regulated market' are also embedded in the co-legislation of both directives.

7. These directives have a potentially costly impact on international issuers who would not otherwise be stating their accounts according to international accounting standards. While the exemptions offered in the directives avoid most of these costs, outstanding bond-issues by such issuers can still be heavily penalised by the Transparency Directive. This is because (as our interviews reveal) issuers cannot credibly de-list and because `wholesale exemptions' to the Transparency directive do not seem to be available for outstanding issues. Resolving this issue will require a flexible application of level 2 rule making, offering a much broader range of transitional 'equivalent' accounting standards than are currently under discussion.

8. We discuss what overall regulatory design for pan-European securities markets might have guided these directives. In our view this should have:

- Appropriately allocated different elements of market regulation to EU and national levels. Given that, for reasons of law, infrastructure, and language, new issues are typically separately marketed in different European nation states; and rarely marketed across the entire EU; it is appropriate that prospectus approval should remain a national competence. In contrast disclosure standards for annual account should be a Union level competence; because trading at pan-European level will lead to securities being held across all member states.
- Jettisoned the concepts of a 'regulated market' and 'home member state', which play no constructive role in the creation of pan-European securities markets; and instead create new barriers to pan-European competition.
- Offered just two forms of exemption for bonds: a time-limited exemption for high-yield bonds and a permanent acceptance of a wide range of "equivalent national standards" for international bonds . Both these exemptions could have been appropriately limited to "wholesale bonds", as defined using the current €50,000 limit. All exemptions might have been implemented as level 2 decisions, supported only by a general power in co-legislation for the creation of exemptions in order to support active markets in specific categories of security.

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1. Introduction

This report examines two recent European directives, the Prospectus Directive and the Transparency Directive, and their impact on the market for corporate bonds. One reason for undertaking this exercise is the importance of corporate bonds as a source of corporate finance. The global market value of outstanding corporate bond issues is nearly one-third of the global market value of corporate equity.[2] Bonds provide an even higher share of new external funding. In the European Union the erosion of traditionally `bank-orientated' financial systems has augmented the growth of the corporate bond market; as state support for the banking sector has been withdrawn and banks have become more commercially orientated, larger companies have turned to the issue of bonds and notes as a replacement for bank credit. Corporate bond markets are an important and growing part of the European financial system and we should be aware of how recent regulatory developments are affecting them.

The second, perhaps an even more important, justification is as a case study of the many obstacles to the creation of pan-European capital markets. These two directives are amongst the 42 pieces of legislation being implemented at European level since the European Financial Services Action plan was adopted at the Lisbon summit of March 2000. The European Commission has recently announced that 93% of this legislation is now finalised. We seek, in this report, to analyse the effectiveness of these two particular pieces of legislation in supporting the development of a single European market in corporate bonds; and to draw lessons for the achievement of the wider goal of creating pan-European capital markets. Specifically we are concerned to examine the support given by these directives to the development of a pan-European market for high-yield debt, a market that is relatively undeveloped when compared to the United States.

These are major issues, for market professionals, for investors, and for European companies. As has been argued by the European Commission, the creation of pan-

[2] According to the International Federation of Exchanges the market value of end-2002 worldwide equity issue amounted to $23bn; this compares with BIS estimates of worldwide corporate bonds and notes outstanding of $6.8bn (in September 2003.)

European capital markets offers the prospect of large reductions in the cost of financial intermediation and hence for significant increases in economic output.[3] But the required regulatory change is both difficult to design and costly to implement. If these benefits are to be realised, then policy makers must succeed in introducing a legislative and regulatory framework that both *supports* pan-European financial intermediation and at the same time *avoids* imposing excessive costs on existing financial activities. As the example of corporate bonds examined in our report illustrates, these tasks are especially difficult because each piece of European regulation must be imposed on top of a patchwork of existing European and national regulations; without careful attention to the overall regulatory architecture there is every likelihood of creating unintended and undesirable outcomes.

The specific issues highlighted in this report are as follows:

- We consider the use made by these directives of the "Lamfalussy" 'comitology' arrangements for altering the legislation through relatively flexible committee procedures in response to changes in market structure and practice. Both of these directives frame their core 'level 1' co-legislation around the concept of security that is "admitted" to one of a list of EU regulated markets. This is in contrast to the situation in the United States, where the key national legislation on securities disclosure (the 1933 Securities Act) applies to all securities regardless of listing and trading status; but where subsequent rules have been developed to allow differing application to particular categories of security. We question whether placing such a specific institutional arrangement as an "EU regulated market" at the core of European financial legislation is an appropriate application of the Lamfalussy framework. This creates an incentive to remove securities from admitted markets. It also "freeze" a particular institutional arrangement that could be harmful to the longer term development of corporate bond markets in Europe and restricts competition. Subsequent co-legislation may eventually be needed to adjust these aspects of the Prospectus and Transparency directives.
- The directives seek to avoid imposing inappropriately high costs on issuers, by allowing a lower level of disclosure requirements for certain categories of

[3] The Commission's views are supported by the November 2002 study by London Economics, in association with Price WaterHouse Coopers and Oxford Economic Forecasting, suggesting an increase in real GNP of 1.1% over ten years.

‘wholesale’ securities, defined by a minimum denomination of €50,000 or the buyer to which they are sold. But we note that the Transparency Directive fails to offer equivalent exemption for bond issues already outstanding. Issuers also remain concerned about the effectiveness of the exemptions in the two directives for wholesale bonds, questioning whether the disclosure exemptions will work in practice and whether they will then be forced to issue bonds outside an admitted market (and therefore outside of the legislation altogether) and possibly outside of Europe. In order to investigate these issues we have conducted interviews with 21 asset managers in six European countries, asking them how they would respond to a “de-listing” (transfer or issue of securities outside of an admitted exchange); and how well they can work with the €50,000 minimum denomination wholesale securities.

- These interviews also offered us the opportunity to contrast the range of regulation and market practice in these different countries. We discuss the interaction of these directives, with the range of different existing national industry practice and regulations, in particular with the requirements on portfolio composition applied by a number of national regulators to various categories of institutional investor, such as insurance companies, and to collective investment vehicles; we also discussed the effectiveness of protection for bond issuers.
- Finally we consider how best to address remaining barriers to a pan-European corporate bond market. Here we argue, from the example of corporate bonds, that allowing both investors and issuers a greater degree of regulatory choice might not be both more effective and less costly means of achieving a single pan-Euroepan market, than further efforts either to harmonise regulation or require mutual recognition of different national approaches.

Our report is arranged as follows. Section 2 provides an overview of global corporate bond markets and their importance in Europe. Section 3 discusses the regulatory framework applied to corporate bonds; first in the US before the introduction of Sarbanes-Oxley; and then in Europe prior to the introduction of the new directives. This section includes a brief review of portfolio regulations affecting institutional investors and retail funds in the major European countries. Section 4 discusses the operation and impact of the new European directives. Section 5 describes how we conducted our interviews and reports the response to our questions about bond denomination, listing status, and bondholder protection. Section 6 states our conclusions.

2. Corporate bond markets

The different types of corporate bond

This section provides an overview of corporate bond markets in Europe, paying particular attention to international bonds. We begin with a description of the various terms used to describe bonds, which can be especially confusing as they are not always applied in an entirely consistent manner. We then look at the statistics on corporate bond issue.

Domestic bonds are bonds issued in the issuer’s home market and home currency and subject to national law and regulation. *International bonds* are bonds that are issued outside the issuer's home market, often motivated by a desire to avoid domestic tax and regulation and to reach a larger international investor base. There is a grey area in this classification. Domestically issued bonds aimed at international investors, for example Euro-denominated bonds issued by Euro-zone residents, are usually still classified as international bonds, even though they are issued in the issuer’s home currency. This is because they are sold to an international investor base.

International bonds can be either “foreign bonds” or “Eurobonds”. *Foreign bonds* are bonds issued by a foreign entity in a domestic bond market, and hence denominated in the currency of that market. Examples include the Samurai bond (a yen-denominated bond issued by a foreign company in Japan), the Bulldog bond (a sterling-denominated bond issued by a foreign company in the UK) and the Yankee bond (a dollar-denominated bond issued by a foreign company in the US). Today, with the growth of Eurobond markets, foreign bonds have become a relatively small part of total international bond issuance.

Most international bonds are Eurobonds. The term Eurobond does not refer to the European currency or to a bond issued in Europe. A *Eurobond* is an international bond aimed at an international investor base and typically denominated in a currency other than that of the country in which it is issued. The first market for Eurobonds developed in Europe in the 1960s and 1970s, appealing especially for the issue of dollar denominated bonds by US banks avoiding US tax and interest rate regulations. Now however Eurobonds are issued in the US, Japan, and many other countries outside of Europe. Many Eurobonds are traded on a bearer basis and without any withholding taxes, these features giving them particular appeal to wealthy private investors seeking the most efficient management of their tax affairs. Note that for historical reasons Euro-denominated bonds issued by non-European entities to investors in the Eurozone are regarded as Eurobonds, not as foreign bonds.

Eurobonds are often categorized according to the currency in which they are denominated. As an example, a Eurobond denominated in Japanese Yen but issued anywhere outside of Japan can be referred to as a Euroyen bond. While US dollars continue to be the most common currency denomination for Eurobonds, the number of issues denominated in Euro (perhaps fortunately the term Euroeuro bonds is not usually applied in this case) has increased considerably since the inception of the single European currency in 1999.

Another category are *global bonds*. These are bonds issued as both a domestic bond, in a national market, and internationally as a Eurobond. Thus a US dollar bond issued by a US company and sold both in Europe (as a Eurodollar bond) and in the US (as a domestic bond) would be a global bond. Global bonds have to satisfy the requirements of both domestic and international markets; although sometimes special domestic arrangements allow, for example, exemption from withholding tax.

Statistics on corporate bond issue.

According to Molinas and Bayles (2004) total outstanding Eurobonds amounted to some $7,067 billion, or 15.8% of the total stock of world wide bond issues of $44,844 billion, at end-2003. The total stock of domestic corporate bonds was $13,135 billion or 29.3% of the total. Foreign bonds were relatively unimportant, some $870 billion or 1.9% of the total and about only one-tenth of all international bonds. Domestic government issues (including mortgage backed securities issues by US government agencies such as Fannie Mae) accounted for the remaining $23,770bn or 53.0% of the world stock of bonds.[4]

Table 1 reports additional statistics on international bond issues, for the period Jan 1999 – May 2003, broken down by principal currencies and distinguishing EU and non-EU issuers. As this table indicates, the volume of Euro and sterling denominated issuance now exceeds that denominated in dollars. EU issuers also account for nearly one-half of all international bond issues, much the largest part of Euro denominated issues.

Table 1: International corporate bond issues Jan1979 – May 2003

Currency	Number of issues	Amount (€ bn equivalent)	Average size (€mn)
All issuers			
US Dollar	1,172	826	705
Sterling	397	143	361
Euro	1,507	715	474
Total	**3,076**	**1684**	**547**
EU 15 issuers			
US Dollar	264	175	663
Sterling	267	99	371
Euro	1,109	539	486
Total	**1,640**	**813**	**496**
Non-EU 15 issuers			
US Dollar	908	651	717
Sterling	130	44	340
Euro	398	176	442
Total	**1,436**	**871**	**606**

Source: Dealogic "Bondware" database. Issues of less than €100mn equivalent excluded from this tabulation. Because this tabulation includes only larger issuers the coverage is smaller than the BIS numbers reported by Molinas and Bayles (2004).

[4] Molinas and Bayles (2004) discuss some of the statistical problems in measuring the global bond market. The two main sources of data on international bond issues, the BIS and the ECB, use incompatible procedures, with the ECB counting Euro-denominated issues by European issuers as domestic bonds, while the BIS counts them as international bonds if they are marketed to an international investor base. Simply adding together the statistics from these two sources therefore results in a major double counting. Molinas and Bayles (2004) use unpublished BIS tables to correct the ECB data, reclassifying their numbers to be consistent with those of the BIS.

A more detailed analysis of international bond issuance, based on the same statistical source and covering the years 1980-1999, is given by Claes et. al. (2002). They document the rapid growth of the international bond issuance, with the number of Eurobonds rising from less than 400 per annum at the beginning of the 1980s to 3,799 bonds in 1999. Eurobonds are of high credit quality, almost all rated as investment grade with 40% of rated issues AAA and a further 30% of rated issues AA (Claes et. al. (2002)). In the early years of the market international bond issues were dominated by governments and banks. Subsequently the market has been increasingly used by other corporate issuers, especially non-bank financial companies; over the entire period 1980-1999 over 60% of international bond issues were by companies categorized as either financial corporations or banking and financial services (Claes et. al. (2002) Table 3).

Some years ago the distinction between these categories was very clear. Eurobonds were issued as bearer bonds, with the certificate providing the claim to ownership and the right to coupon payments (Claes at al. (2002) report that 84.5% of Eurobonds are bearer bonds). Foreign and domestic bonds, in contrast, have been registered or book-entry bonds with ownership and the right to coupon payments determined by presence on a register of owners (this is usually supported by domestic law, in the US for example the 1982 Tax Reform Act ended the issue of bearer bonds).

Eurobonds were also not subject to withholding tax and were aimed at an international investor base. Because the investor base is international the issue of Eurobonds has also been distinguished by the use of an international syndicate for primary issuance. Finally there has been an exclusively OTC market for secondary trading in Eurobonds with settlement either through Euroclear in Belgium or Clearstream (formerly Cedel) in Luxembourg. Foreign and domestic bonds, on the other hand, have been aimed at domestic investors, subject to withholding taxes, normally issued using a domestic syndicate or an auction, and trading has been settled through a local securities depository.

Over time many of these distinctions between Eurobonds, foreign bonds, and international bonds have eroded: foreign underwriters now often compete for domestic syndication business; Euroclear and Clearstream have expanded their activities into the settlement of domestic bond and equity markets; and there has been major growth of global bond issues, targeted at both domestic and international investors, requiring these bonds to share features of both domestic and Eurobond issues (e.g. they are registered rather than bearer bonds but where possible they still do not pay withholding tax). The creation of the Euro has further blurred these distinctions; with, as we have already mentioned, Euro-denominated bonds sold within the Euro-zone to international investors are often classified as Eurobonds, rather than as foreign or domestic bonds.

Both domestic and international corporate bond markets are important in Europe. European corporations, especially financial institutions, have long issued large amounts of bonds. Eurobond issuing and trading was first established in Europe and a large proportion of Eurobonds are still issued in Europe. There is a large market for bonds amongst both retail and institutional investors across much of Europe. In addition there is the Pfandebrief market providing a major source of funding for property investment and public sector lending intermediated by German and other financial institutions.

Since the establishment of the single European currency in 1999, both short term and long term security issue have been an increasingly important substitute for traditional bank finance. There were some $3,998 billion worth of domestic corporate issues denominated in Euro (including Pfandebriefe bonds) at end-2003 compared with $2,469 billion at end-1999; and there were also a further $1,669 billion of Eurobond issues denominated in Euro at end-2003 compared with $595 billion at end-1999 (Molinas and Bales (2004), Table 66). The stock of Euro-denominated corporate and international issuance has thus risen by 85 % in four years.

The growing liquidity of the Euro denominated bond market is of particular attraction to international investors, with US issuers accounting for some 15% of total Euro denominated issues, second only to Germany as nation of issue (Molinas and Bales (2004), page 15). There has been even more rapid growth of Eurodollar issues, with the stock of outstanding issues increasing by 108% from end-1999, to reach $4,106bn by end-2003; and with much of this higher level of Eurodollar issue acquired by European investors (Molinas and Bales (2004), Table 66).

3. The regulation of corporate bond markets

Regulation of issuers in the US.[5]

Three types of financial regulation directly affect corporate bond markets; regulations applicable to the issuers of corporate bonds, especially requirements on disclosure; regulations on investors that may limit their freedom to hold corporate bonds; and finally regulation of the conduct of participants in markets where corporate bonds are traded. Corporate bonds are traded on over the counter markets, not on formal exchanges. The regulations that apply to market conduct are the same as for other OTC markets. Since these market conduct regulations operate independently of the new Transparency and Prospectus directives, we will say no more about them.

What we will do, in this subsection, is briefly review the regulations affecting corporate bond issuers in the US. The basic framework of US securities regulation is the 1933 Securities Act, administered by the Securities and Exchange Commission created by Congress the subsequent year.

The following text, taken from the SEC website, describes how this works:

> *"Often referred to as the 'truth in securities' law, the Securities Act of 1933 has two basic objectives:*
>
> - *To require that investors receive financial and other significant information concerning securities being offered for public sale; and*
> - *To prohibit deceit, misrepresentations, and other fraud in the sale of securities.*

[5] The Sarbanes-Oxley act is having a major impact on disclosure by companies issuing securities in the United States; but it is too early to make firm judgements on exactly how this new legislation will work in practice and so we have not discussed it in this report.

> *“The SEC accomplishes these goals primarily by requiring that companies disclose important financial information through the registration of securities. This information enables investors, not the government, to make informed judegments about whether to purchase a company's securities.*
>
> *“Here’s how an overview of how the registration process works. In general, all securities offered in the U.S. must be registered with the SEC or must qualify for an exemption from the registration requirements. The registration forms* [that] *a company files with the SEC provide essential facts while minimizing the burden and expense of complying with the law. In general,* [the] *registration forms call for:*
>
> - *A description of the company's properties and business;*
> - *A description of the security to be offered for sale;*
> - *Information about the management of the company; and*
> - *Financial statements certified by independent accountants.*
>
> *“Registration statements and prospectuses become public shortly after the company files them with the SEC. All companies, domestic and foreign, are required to file registration statements and other forms electronically. Investors can then access registration and other company filings using EDGAR.*[the electronic information service provided by the SEC]*”*

The process is straightforward, but the disclosure requirements of the SEC are burdensome. This is one reason why foreign companies who do not have any other US securities listing, may prefer to issue debt internationally on Eurodollar markets.

Rule 144a exemption from the 1933 act

The 1933 act provides for a number of exemptions. Government and municipal securities are not subject to these registration filing requirements, nor are small scale issues (e.g. sold within a single US state, or of limited size, or through a private sale including many employee share-ownership schemes and other categories).

The SEC has introduced further exemptions of which the most important is 144a.[6] Rule 144a defines a category of "qualified institutional buyers" to include insurance companies, collective pension funds, securities dealers, asset managers, and banks, who control at least $100 million investment dollars on a discretionary basis. The issue of securities sold to and traded amongst such qualified institutional buyers is deemed *not* to be public offer and thus does not require registration under the 1933 act.

There has been rapid growth in the the volume of issuance under Rule 144a, with total rule 144a debt issuance rising from less than $3.4bn in 1990 to $235bn (in constant 1990 dollars) by 1998 (Livingston and Zhou (2002)); and with debt issuance by non-US companies rising from $357mn in 1991 to $12.1bn in 1997 (Chaplinsky and Ramchand (2004)). While Rule 144a can be applied to equity as well as to debt, the amount of debt issued has been around twelve times as much as the amount of equity. Rule 144a issues accounted, in 1998, for around one-fifth of all corporate debt issued in the US (Livinston and Zhou (2002).)

The principal intention of Rule 144a was, according to commentary at the time, to assist the issue of debt securities in the US by foreign issuers – ie to encourage the return of Eurodollar business to the US. In practice Rule 144a has grown to be especially important in the market for high-yield debt. Rule 144a accounts for around 80% of all high-yield issuance and 68% of Rule 144a issuance is high-yield; but Rule 144a accounts for only around 20% of investment grade issuance (according to the data reported by Livingston and Zhou (2002).)

[6] Not to be confused with rule 144 concerning the resale of securities initially issued by "private sale", referred to as *restricted* securities. Rule 144, introduced in 1972, allows such securities, that have been initially privately issued and so not subject to full registration reporting requirements, to be subsequently sold on the public market. It also applies to the resale of so called *control* securities (these are securities acquired by affiliates with a controlling interest in the issuing company.) Under rule 144, restricted and control securities can be resold in the public market place, without the need to file SEC registration forms, subject to a number of limitations. These limitations include holding restrictions (the securities must have been held for at least two years as a restricted security), limitations on the volume of sales, and requirement for the publication of adequate financial information. Rule 144 is not an attractive option for initial security issue. The two year holding requirement means that there is no liquid market for security issues that avoid registration by private sale.

A feature of Rule 144a issuance is the practice of issuing bonds with “registration rights”, actually a right for investors to obtain higher coupon payments if the bonds are not eventually fully registered with the SEC. Here there is a difference in practice between high-yield and investment grade rule 144a issuers. Livingston and Zhou (2002) find that some 98% of high-yield issuers offer registration rights, with virtually all these bonds eventually being registered with the SEC two years after original issue; in contrast only 40% of investment grade bonds issued under rule 144a offer registration rights.

The overall structure of US regulations, affecting securities issuers, is thus quite straightforward. There are no listing requirements. Securities must be *registered* with the SEC. The requirements for registration are demanding, and costly for smaller firms. The registration requirements for bond and equity issues are the same. There are some exemptions to registration of which the most significant is for issues sold only to institutional investors under rule 144a. This exemption is used particularly for the issue of high-yield debt, but it is not a distinct market from the “public” market for registered securities. All high-yield rule 144a issues are registered eventually, usually after two years, with the SEC. Listing on particular exchanges play no role in US disclosure.

Issuer disclosure in Europe, prior to the Prospectus and Transparency Directives.

Practice in Europe has been quite different from in the US, with disclosure requirements, both for initial sale of securities and for subsequent reporting, operating through the listing requirements of various national exchanges. These requirements affect bond issuers as well as equity issuers because in Europe all corporate bonds, other than a small amount sold via private placement, are listed. The practice of listing is supported by both regulation and market practice. As we shall document shortly, in most European countries the regulation of portfolio allocations strictly limit the ability of institutional investors and collective investment vehicles to invest in unlisted securities. It is also usual practice, for almost all institutional investors, to set internal investment guidelines that limit their investment in unlisted securities, to an even greater degree than they are required by regulation.

The different national exchanges naturally require different accounting statements produced according to national accounting standards. This is an obvious obstacle to the creation of pan-European equity and corporate-debt markets; both because some national accounting standards are regarded with suspicion and also because institutional investors favour standard reporting practices, allowing them to conduct comparative analysis without having to engage in extensive correction of accounting statements. One of the main objectives of both the Prospectus and Transparency Directives has been to enforce the adoption of common international accounting standards across Europe and hence promote the acceptability of securities issued by European companies all across Europe.

We have been unable to obtain a comprehensive statement of the various European portfolio regulations applied to institutional investors and collective investment vehicles such as mutual funds. The material provided here is taken from Freshfields (2004) supplemented by additional information from web-sites and our own interviews. In most European countries (including France, UK, Germany, Italy, UK) long term insurance schemes ("life insurance") are subject to strict limits on their portfolios that make it difficult for them to hold unlisted bonds. In recent years national regulations have been amended, so that these limits do not apply to to any security admitted to a regulated market; but in practice this still means that any bond that is to be held in the portfolios of insurance companies have to be listed; otherwise it will be included in a restricted category of assets.

There is national variation in the operation of these limits. In each case institutional investors cannot invest more than a certain percentage of their total assets in various unapproved securities. According to our interviewees, in Germany insurance companies are subject to particularly strict laws and effectively cannot hold unlisted bonds at all. In France and the UK there is a limit on these restricted assets of 10% of total assets, although the exact definition of what is included in this 10% bucket varies. Similar restrictions apply in Italy and Switzerland. Defined benefit pension funds are also subject to similar restrictions, although these are only important institutional investors in a few countries such as the UK. The one country we have examined not applying any portfolio restrictions of this kind to any institutional investors is the Netherlands, but it seems that this is exceptional.

Similar portfolio regulations are applied to collective investment schemes, such as mutual funds. The introduction of the “UCITS” directive has led to a greater harmonisation of such rules across Europe. Once again a 10% “bucket” is applied for other investments, including any unlisted securities.

Institutional investors rarely come close to the limits of these portfolio restrictions (Freshfields (2004)). This finding is confirmed by the interviews we report in Section 6 below. The preference for holding listed securities is deeply rooted in market practice as well as in formal regulations. Even in the case of the Netherlands, where no such restrictions apply, few unlisted securities are held and, as our interviews reveal, there is still a reluctance to hold a significant proportion of unlisted bonds in a managed fixed income portfolio.

4. The recent directives

The previous section contrasted the regulation of corporate bond markets in the US and Europe. In the US this regulation is built around the requirements of SEC registration; even when bonds are initially issued, to professional investors, without SEC registration, it is usually the case that registration follows a couple of years later. There is in otherwords a very standard set of requirements for reporting of financial statements, one factor supporting the deep and liquid market US market for corporate bonds. Even though the Sarbanes-Oxley act is introducing new and additional reporting requirements, registration of securities remains a cornerstone of US capital market regulation.

This section summarises the key economic features of the Prospectus Directive and the Transparency Directive and their impact on corporate bond issuers. We are economists not lawyers; so, while we have studied the directives carefully along with a number of descriptions written by lawyers, we cannot guarantee that we have all the legal details correct. The following is our account of the implications of the two directives.

As stated in our introduction, these two directives are part of the much larger package of measures known as the Financial Services Action Plan or FSAP, a blueprint for developing a single European market in financial services published in May 1999 (European Commission (1999)) and adopted by the Lisbon European Council in March 2000. The Lisbon Council set a deadline for completion of the measures listed in the Action Plan by 2005 and as reported by the European Commission webpages, almost all of these measures have no been completed.

Given the lack of standardised financial reporting and new issue documentation across Europe, it is natural that the Financial Services Action Plan should include the Transparency directives requiring companies with European listed securities to report according to International Accounting Standards and the Prospectus Directive to ensure mutual recognition of new issue documentation.

The directives have caused a good deal of concern on the ‘sell side’ of the market. Underwriters in Europe are concerned that some international issuers of debt securities will be less willing to issue in Europe, because of the possibility that these directives will require them to restate accounts according to International Accounting Standards (IAS). This would be a significant additional cost to those international bond issuers not otherwise adopting IAS. Issuers potentially affected include major companies from the Canada, and Japan (US companies are unlikely to be affected since US GAAP will be allowed as an alternative to IAS. International and EU issuers of both debt and equity are also concerned about potential legal liability associated with the short summary prospectus material required by the Prospectus Directive.

These two directives are applicable to a wide range of securities, including equities, convertibles and also asset-backed securities, not just bonds or short-term debt; but, in recognition of the extent of international bond issues in Europe by non-European issuers, both these directives contain exemptions for “wholesale bonds” defined as bonds with a denomination of no less than €50,000. These are intended to reduce the costs for international bond issuers in Europe, reducing disclosure requirements in cases where their bonds are being sold only to institutional investors.

The Prospectus Directive

We consider first the Prospectus Directive and then the Transparency Directive. The Prospectus Directive has been designed to provide a "single passport" for European security issues, allowing securities to be sold across the European Union using a prospectus approved by the regulatory authorities in a single member state. In this respect the Directive is much more flexible than previous national legislation.

The Prospectus Directive was completed in 2003 and is supposed to be implemented in national law in all EU member states by July 31st 2005. The requirements of the Directive apply in two cases:

- to a public offer for sale in the EU (this is defined as taking place whenever communications about the security contain sufficient information, notably an offer price, enabling members of the public to decide to purchase the security)
- *and* to any security admitted onto an EU regulated market (a list of regulated markets is published each year in the official journal of the European Communities based on the names of markets supplied by regulators in member states; these include stock exchanges and screen-based markets; currently there are no screen based markets trading corporate securities, but this could change in the future).

In either case a security issue must be accompanied by an approved prospectus. This can be a shelf-registration document containing general information and supplemented by a securities note containing details of the offering. Or it can be a single one-off document. In either case the issuer must also prepare a summary of no more than 2,500 words in "brief, non-technical language, … conveying all of the essential characteristics and risks associated with the issuer… and its securities". Member states may also require this summary to be translated into the local languages of all member states in which the securities are being offered to the public or admitted into a regulated market.

The Directive contains a number of further requirements (see Appendix for more details). The prospectus must be supported by financial statements for the previous two years, stated according to International Accounting Standards or an 'equivalent' national accounting standard. 'Equivalent' accounting standards are not defined in the

Directive, but will be determined under “Lamfalussy” procedures by a level 2 regulation ie the European Commission will introduce a regulation on the advice of CESR (the Committee of European Securities Regulators). Current information indicated that US GAAP will accepted as equivalent. Other national GAAP may be accepted as well.

The Prospectus Directive contains further disclosure requirements. Issuers must: provide an ongoing annual disclosure report of information required under the Transparency Directive, Market Abuse Directive or other EU or home-country security laws; make a mandatory risk-disclosure requirement; provide disclosure of major shareholders; and disclose all material contracts (other than those entered into as part of the normal course of business).

A final element of the Prospectus Directive is the choice of “home member state”, ie the regulator responsible for approving the prospectus and admitting the security to trading on regulated markets in the EU. For an EU company this is the EU member state in which they have their registered office. For a non-EU company this is the member state where they first choose to have a prospectus approved and a security admitted for trading. However, for both EU and non-EU companies, issuing only debt securities with a denomination of less than €1,000, the home member state may be chosen from amongst those states where the security is admitted for trading, on an issue-by-issue basis. Other EU member states where the admitted for trading, are referred to as “host member states”.

There are *two* forms of exemption from the Prospectus Directive available to bond issuers, both utilising a €50,000 minimum denomination requirement that defines a “wholesale” debt security:

1. Wholesale bonds (but not convertibles which are counted as equity) admitted to an EU regulated market (this can be described as an admitted wholesale bond) will be subject to a separate disclosure regime. Issuers will not need to produce a summary of their prospectus (unless required under individual member state national law). They will have a free choice of authority to approve the prospectus (this applies at a minimum denomination threshold of only €1,000 provided they do not issue equity or retail bonds in the EU) .

These admitted wholesale bonds will also be subject to a reduced ongoing disclosure regime, for which full details are currently are being developed by CESR. The following features are anticipated. They will not need to provide an annual disclosure report. They will not be required to prepare accounts according to IAS or equivalent standards, but instead have to provide only a narrative account of differences in their accounts under their own national standard and IAS. They will not be required to provide information on material trends. But they will still have to make a mandatory risk-disclosure requirement; and disclose major shareholders and all material contracts.

2. A wholesale security that is *not* admitted to an EU regulated market at all will not be treated as a public offer and hence avoid the requirements of the Prospectus Directive entirely. Here the definition of wholesale security includes both debt (subject to the same minimum denomination requirement of €50,000) and non-debt securities (with a minimum subscription of €50,000 per subscriber).

   Securities that are *not* admitted to an EU regulated market can also avoid the requirements of the Prospectus directive entirely if they are sold only to "qualified investors" (defined fairly broadly to include credit institutions, insurance companies, investment schemes and governments) or to less than 100 non-qualified investors in each EU member state. This exemption applies to equity as well as to debt and to debt denominations of any size.

Thus international investors seeking to avoid some of the impact of the Prospectus Directive have two choices. (a) Not listing on a regulated European Stock Exchange and seeking exemption from the public offer requirements of the directive by issuing *either* as a wholesale security *or* by selling only to institutional investors. In these cases the requirements of the directive will not apply at all; *or* (b) taking advantage of exemption available for wholesale debt securities that are admitted to European regulated markets. However in the latter case some disclosure requirements will continue to apply; and there are also the concerns over the legal liability of the prospectus in all different national jurisdictions where the security is issued, especially where investors base their investment decisions on the reading of the short prospectus alone.

The Transparency Directive

The Transparency Directive was agreed by the European Parliament on 30th March 2004. Further “level 2” implementing measures are now being developed by CESR, with a target for adoption by the European Commission in January 2006. The level 1 directive is supposed to be adopted in national legislation by across the European Union by late 2006.

The Transparency Directive is much simpler than the Prospectus Directive. The intention of the directive is to introduce a minimum standard of reporting that will be applicable to securities admitted to regulated markets anywhere in the European Union. Security issuers will have a “home member state” chosen on the same basis as in the Prospectus Directive.[7] This choice is of particular importance for meeting the requirements of the Transparency Directive since, in contrast to the Prospectus Directive, the standards it sets are minimum standards. Individual home members states may require higher standards of disclosure than set out in the Transparency Directive. Inernational issuers, who have a choice, may prefer some home member states to others.

The Transparency Directive will require issuers of all securities listed on regulated European exchanges to publish annual and half-yearly financial reports stated according to International Accounting Standards or ‘equivalent’ national accounting principles. Again, as with the Prospectus Directive, the national accounting principles that are accepted as equivalent will be determined by level 2 regulation. These are expected to parallel the prospectus directive and include US GAAP. Companies that do not report on a quarterly basis will be required to issue an interim management statement instead.

[7] As a consequence of some hasty drafting there is discrepancy in the definition of the choice of home-member that, potentially, could result in a different “home member state” under the Prospectus and Transparency Directives (see Cleary Gottlieb (2004) footnote 9). We presume that this is unintended and regulators will required the same home member state for both directives.

The Transparency Directive offers a parallel “wholesale bond” exemption to the Prospectus Directive, issuers of bonds with a minimum denomination of at least €50,000 are not required to prepare their accounts to IAS standards. Alternatively, if securities are not admitted for trading on any regulated markets in the EU, then they are not subject to the Transparency Directive at all.

The Transparency directive also requires issuers of both bonds and equities, admitted to regulated markets, to make half-yearly financial statements. There is again an exemption from this requirement, for issuers who have only wholesale (minimum €50,000) bonds admitted. Furthermore a transition period of 7-years is allowed during which issuers who have only bonds admitted on regulated markets, and make no new issues of such bonds, are exempted from half-year reporting. They are not however exempted from stating their annual accounts according to International Accounting Standards or an equivalent standard determined by the level-2 committee process.

Assessment

Before turning to the outcome of our interviews, we provide a short assessment of the effectiveness of the two directives. The major first impression from examining these directives is how strikingly complicated the new disclosure regime is, especially when compared to that which has operated in the United States since 1933.

Some degree of greater complexity of the European directives is inevitable in comparison to their 1933 US equivalent, simply because European directives are being applied to an existing structure of different national securities regulators and national securities laws. But much of the complexity seems unnecessary. We will argue that regulation based on being “admitted to a regulated markets” -- ie normally a listing – is an unnecessarily roundabout way to achieve standardised disclosure and issuance documentation across Europe. It is difficult to understand why the much simpler alternative, of a shift to US style registration, seems not to have been considered as a policy for supporting the development of pan-European securities markets.

In the case of over-the-counter traded instruments such as bonds the concept of “admission to a regulated market” collapses to a distinction between listing and nonlisting. It is hard to see why disclosure standards should not apply to listed and unlisted issues alike. In the case of equities it may create an unnecessary regulatory game, with secondary exchanges such as London's AIM vying to be counted outside of the approved list of EU regulated markets; such an outcome is much more likely if there is any relaxation of the portfolio regulations applied to institutional investors.

The use of the concept of an "admitted security" is associated with a further problem, the concept of "home member state" as it appears in the Transparency Directive. The "home member state" makes sense in the context of the Prospectus Directive. The prospectus and other qualifications for listing are to be approved at national level and then "passported" throughout the European Union. The "home member state" is simply the EU member state where the new security obtains regulatory approval for listing. The only concern here is that the legislation suggests that a home member state should be permanent, and may make it excessively difficult for an issuer to change from one home member state to another. This appears to be a restraint on competition.

The concept can be understood in the context of the Prospectus Directive, but there appears to be no practical or economic justification for associating issuers with particular "home member states" in the Transparency Directive; other than as a means of sharing out the work of enforcing the directive amongst regulators across Europe. This legislation needs to state the applicable disclosure standards, but these can be quite independent of the platform on which the security is traded or the country that initially granted approval for the issue prospectus. Again this could be seen as a restraint on competition, preventing different trading platforms competing for the business of different securities. The implicit thinking here seems to be that every security must be admitted, on some national regulated market, and hence every security must have a home. But if the concept of an admitted security is recognised to be redundant, then the application of "home member state", after an issue is completed, can also be abandoned.

Another weakness of the directives is the very complicated implementation of exemptions for wholesale securities. Both directives offer lower level of disclosure requirements on wholesale bonds satisfying a minimum (€50,000) denomination. The

Prospectus directive makes a further distinction within this category, between wholesale securities not admitted to a regulated market (which are entirely exempt from the directive) and wholesale bonds (but not equities) admitted to a wholesale market – provided that the issuer does not have any equity or retail bonds issued on EU regulated markets. Curiously the wholesale denomination limit here is €1,000 not €50,000. These bond issues are subject to an intermediate level of disclosure, described in more detail above. Most importantly they will have to provide only a narrative account of how their accounts differ from IAS standards. The Prospectus Directive finally also provides a third and quite different definition concept of a security not admitted to a regulated market and sold only to qualified investors (paralleling the US rule 144a); these are once again exempt from the directive.

These three separate definitions of wholesale securities are confusing. The following "box diagram" may elucidate the way they work:.

Table 2 : a 3 ×2 Categorisation of Exemptions in the two directives.

Admitted to a regulated market?	Definition in:		
	Prospectus Directive		Transparency Directive
	Sold only to institutional investors and a maximum of 100 other investors in each EU member state	Minimum subscription/ denomination of €50,000	Minimum denomination of €50,000
Yes	No exemption	Partial exemption at €1,000 denomination, but only for bonds, and only when no other EU admitted equity or retail bond issue.	Exemption for bonds.
No	Fully exempt	Fully exempt	All securities exempt, regardless of wholesale definition.

As this table indicates, the exemptions from the requirements of the Prospectus directive depends upon two factors:

- whether or not the security is admitted onto a regulated market

- whether it qualifies for one of several definitions of being a “wholesale” security, based on the initial investor base or on minimum denomination.

Set out in this way, these provisions seem both unnecessarily complicated and also difficult to rationalise. They actually create an incentive to remove securities from regulated markets, presumably not something that regulators are seeking to achieve. In practice most securities in Europe will likely remain on regulated markets, but this will be only because of the strict regulatory portfolio requirements that make it extremely difficult for institutional investors to purchase unlisted bonds or equity.

There are also serious inconsistencies between the two directives. The full requirements of the Prospectus Directive apply to all new issues (unless they are not admitted to a regulated market *and* qualify for one of the two definitions of a wholesale security, as illustrated in Table 2.); but the Transparency Directive applies only to admitted securities, it does not apply at all to any unlisted securities. All issuers of wholesale bonds can claim exemption from the Transparency Directive; but effcctively only non-European issuers all of whose outstanding bonds can be classified as wholesale, can claim exemption from the Prospectus Directive.

To have two definitions of “wholesale” in the Prospectus Directive also seems redundant. Perhaps the first definition has been included so that if the wholesale denomination fails to provide issuers with the protection they desire, then an alternative way of avoiding some of the costs of the regulation will be available; but if this is the case it is hardly an advertisement for the confidence of the framers of the directive in their own drafting.

> The Transparency Directive applies to both new and outstanding issues. This creates a serious problem for some international issuers. The minimum denomination exemptions offer a ‘get out’ clause for new issues; but for outstanding issues it will be possible to avoid the Transparency Directive requirement for stating accounts according to International Accounting Standards, only by withdrawing the listing on regulated European markets (the possibility of changing the denomination of outstanding bonds has been

raised, but there are differences of legal opinion as to whether this is possible.) To make matters worse, such issuers may well also be unable to take advantage of the wholesale exemptions in the Prospectus Directive for any further European bond issuance they might wish to undertake; since if their outstanding bonds have a minimum denomination of less than €1,000 they are unable to qualify.

There is thus a particular concern amongst international issuers about the impact of the two directives. If international issuers of bonds in Europe are to continue reporting their accounts in their own national accounting standards and also at the same time comply with the Transparency Directive; then a number of them will have to delist or buyback all their outstanding bonds listed on exchanges inside the European union (affecting bonds listed on London, Luxembourg, Paris, Frankfurt, Dublin, Milan and elsewhere). The number of issuers affected depends upon which national GAAP standards are eventually recognised as equivalent to IAS in the level 2 regulations for the Transparency Directive; but these issuers are also likely to need similar recognition of their national accounting standards for the Prospectus Directive if they are to be able to undertake new bond issues in Europe. Issuers from the EU and also Australia are not so affected since they will in any case be required to prepare financial statements under IAS.

In order to comply with both the Prospectus Directive and the Transparency Directive; then new bond issues by these issuers will have to *either* be in denominations greater than €50,000, or the equivalent in foreign currency; *or* not listed on stock exchanges in the EU. In the latter case new bond issues will have to be sold only to institutional investors or again in wholesale denominations greater than €50,000 (depending upon which version of the exemptions in the Directive are utilised).

Some international issuers have already suggested that, rather than adopt new accounting standards, they will delist outstanding bonds. As an alternative to de-listing they might switch their listings to exchanges in Switzerland, Singapore, Hong Kong, the Channel Islands, or elsewhere outside the EU.

Yet another undesirable feature of the Prospectus Directive, raised by some lawyers, is that it appears to introduce a potential new risk of *criminal liability for companies issuing in Europe*. This arises because a translated short prospectus, if it refers to other documents in a different language, cannot give all potential investor a complete picture of the financial situation and risk profile of the issuer. In the event of a unexpectedly poor post-issue performance, the issuer might be subject to criminal charges under various national securities laws. This possibility is only hypothetical – it might take a successfully prosecuted case to seriously frighten issuers – but it threatens a fragmentation of the European corporate bond market.

Finally we must question whether the directives provide the appropraite help to the development of a European market for high-yield corporate debt. Some degree of initial exemption from disclosure requirements does seem to be helpful for supporting this market. The experience of the rule 144a market in the US (see Section 3) is that the lighter disclosure requirements of this market are of particular appeal at time of issue to relatively low credit-quality issuers, those whose bonds are rated as speculative rather than investment grade. Most high yield issuance by domestic corporate issuers in the US takes advantage of rule 144a and most rule 144a issuance by international issuers is by those of relatively lower credit standing. High-yield issues then normally, voluntarily, comply with the stricter SEC disclosure requirements a couple of years after issue.

It appears that European issuers will be able to utilise the exemptions in the two directives to do likewise, but only by initially issuing bonds outside of an EU regulated market; and taking advantage of one of the two Prospectus Directive exemptions; either utilising a minimum denomination of €1,000; or selling only to institutional investors and a maximum of 100 other investors in each EU member state. Admission to a regulated market will only be an option if the issuer has no equity or outstanding bonds traded on any EU regulated market. The problem is that the ability to issue outside of an EU regulated market is very uncertain. We examine this question in the interviews, reported in the next Section.

5. Interviews

Conduct

Our research has been completed by undertaking interviews with 21 asset managers across Europe. The purpose of these interviews was to ascertain their views on possible bond de-listing and on the issue of wholesale denomination bonds, undertaken to take advantage of the exemptions of the two directives. We also sought to elicit more general discussion of protection of bond holders. We focused on a number of aspects of possible issuer response to these two directives:

1. What will the impact be on investor portfolio decisions, if a substantial numbers of issuers come the market with bonds in "wholesale" €50,000 minimum denominations?
2. If bond issuers are to delist outstanding bonds, what impact will this have on portfolio decisions (to what extent can we expect investors to sell these bonds)?
3. If bond issuers instead transfer listings of outstanding bonds, to exchanges outside of the European Union, what impact will this have on portfolio decisions?
4. Could any of the responses (change in listing status, switch to wholesale denomination) damage the liquidity and price transparency of international bonds issued in Europe?

Additionally we also sought to obtain views on the disclosure and accounting practices of corporate bond issuers.

We interviewed 21 institutions from six countries (Italy, France, Germany, the Netherlands, Switzerland, and the United Kingdom). All our interviews were with asset managers or banks conducting asset management. We do not claim this to be a fully representative statistical sample. Our aim was in depth questioning of informed market participants, in order to reach judgements about the impact of the two directives. We concentrated our enquiries on the largest institutions. While many more individuals were approached (by email or telephone), the interviewees were determined primarily by willingness to respond to our enquiries and to spend between thirty and sixty minutes discussing our questions and their views about bond market regulation.

Typically we ended up interviewing the head of credit for fixed-income, since this was usually the individual who was responsible for implementing all rules and guidelines determining the decision to invest in a particular bond. Few interviewees expressed any difficulty in offering answers on the factors affecting their ability to purchase bonds, whether these were practical problems of allocation, internal or client guidelines, national regulations, tax considerations or for other reasons.

Most interviews were conducted face-to-face, a few by telephone. The technique used was the structured interview. Interviewees were promised anonymity. We followed a common list of questions (these are reproduced in an appendix). We recorded the interviews in hand written notes. We sent the draft report to all our interviewees, giving them an opportunity to respond to our interpretations of their answers.

Some of these questions elicited short and specific answers that can be summarised meaningfully in a statistical fashion. Most encouraged a general expression of views on bond listing, disclosure, and other aspects of bond market regulation; or were open to different interpretations. Since we conducted only a small number of interviews we are able to summarise these answers in a narrative fashion.

Outcome of interviews

Denomination

We obtained a nearly unanimous response to our questions about the practical implications of holding “wholesale” denomination bonds. All but three of those interviewed said that the €50,000 denomination could be allocated without difficulty to sub-funds (Table 3); and even those three, while indicating a preference for a smaller denominations, suggested that purchases of €50,000 denominations would be manageable.

Table 3 – What bond denomination could be allocated without difficulty to sub-funds?

Bond type	Proposed €50,000 minimum will cause	€25,000	€10,000	€5,000

	no problems			
	18	**1**	**1**	**1**

Few problems arise simply because €50,000 is such a small amount relative to the size of the funds managed by our interview sample. The asset managers we spoke to had total fixed income funds under management ranging from between €6bn to €200bn. Even for the smallest of these asset managers individual fund sizes are all of at least several million €. We also found that none of those we spoke to were operating "tracking funds". We had thought minimum denominations might be causing significant practical difficulties for "tracker funds", but this turned out not to be an issue since none of those we spoke to operated such products (these are common equity products but unusual for fixed income.)

While the wholesale denomination appears to pose few major practical problems for asset managers, we should report reservations expressed by some interviewees, especially in Germany, about the introduction of a distinction between wholesale and retail categories of security. German asset managers all argued that the presence of a substantial retail portfolio base helped provide stability to bond markets and they would therefore be cautious about investing in "wholesale" bonds. This view seems to reflect the importance of retail bond holders in Germany. Some Italian interviewees expressed similar views. Certainly it may turn out that "wholesale" bonds exhibit somewhat different performance than retail bonds, because of their different investor base.

Listing and change of listing status

Purchase of unlisted bonds

Table 4 reports responses about current purchase of unlisted bonds. All but three of our sample were either not purchasing unlisted bonds at all, or only occasional unlisted issues (in the <2% column). The rows of this table reflect different categories of client. Internal funds are those where the asset manager has a direct financial interest in the performance of the fund.

Table 4: purchase of unlisted bonds

% of bond portfolios	Not purchased	<2%	<5%	>5% *
Internal funds	**2**	**4**	**0**	**1**
Institutional funds	**10**	**6**	**1**	**1****
Retail funds	**12**	**7**	**1**	**0**

* one respondent reported holding 5-10% of portfolio mostly in structured financial products, we have placed this in the <2% category in this table.
** between 10% and 20% , this particular asset manager operated a relatively small portfolio, with a very different investment style, closer to a hedge fund than a conventional fixed income fund.

We asked about any restrictions that prevented purchase of unlisted bonds. This question elicited a variety of answers, reflecting different national regulations and practice.

"Unitised" retail funds (ie mutual funds) are subject to the UCITS directive and must comply with a 10% limit on total investment in "other" securities (i.e. not equities or listed bonds). This 10% includes for example asset backed securities or structured financial products as well as any unlisted bonds. It applies across the EU.

A similar 10 % rule applies also in a number of other cases:

- In Germany asset managers are regulated directly by BAFIN under the Kapital Anhlager Gesellscharftern Gestetz , which applies a 10% limit on other securites to all managed funds, institutional or retail. A much tighter limit (effectively 0%) applies to insurance funds.
- According to our interviewees, there is a 10% regulatory limit in other securities for institutional investors in Italy and of 10%-15% in France.
- In Switzerland (which of course is not subject to the UCITS directive) institutional and retail funds are still subject to a similar 10% limit

Such a 10% regulation does not apply to institutional investors in the Netherlands. No asset manager we interviewed in London was aware of the regulatory portfolio restrictions applicable to UK instutional investors. However they did report that UK asset managers were tightly limited in their ability to invest in unlisted securities by strict client guidelines. All our London interviewees reported that at least some institutional clients required holding only listed securities, while other interviewees described such restraints as "typical".

Our interviews revealed only two situations where asset managers are free to invest without effective limit in unlisted bonds. These are institutional funds in the Netherlands, where pension and insurance companies impose no guidelines that restrict investment in unlisted securities; and managed portfolios for high-net worth individuals in Switzerland.

We also asked a question about the return premium that would be required to hold an unlisted bond. We were unable to obtain any consistent or meaningful answer to this question. In some cases the response seemed to be more about credit standing than listing, stating the kind of additional return that would be required for a sub-investment grade investment. More frequently the response seemed to be a required premium that would be looked for on an illiquid bond, but this varied considerably with credit standing, answers ranging from as little as 5 basis points to "much more than 20 basis points for a BBB bond".

Response to a change of listing status

We next asked about the response to a de-listing of an outstanding bond. The responses are consistent with the answers we were given about restrictions on the holding of unlisted bonds. We have seen that funds are usually subject to a regulatory limitation on holding "other" securities; we found that in most cases they would expect to sell a bond that de-lists. While there might still be some "headroom", almost all our interviewees suggested that they preferred to stay well within the 10% limits (as one interviewee put it "we don't like to 'cheat' or even go close to these limits".)

To the extent that client guidelines rather than regulation limits institutional investment in unlisted securities, there is the possibility of persuading the client to change the guidelines. This could be possible if a large proportion of bonds were de-listing at the same time. But it was made clear to us that changing client guidelines was a difficult and time consuming process.

Asset managers in the Netherlands and those in Switzerland managing portfolios for high net worth individuals were the only respondents who reported that a de-listing would have no immediate impact on their willingness to hold a bond.

We also asked about another potential change in listing status, transferring a listing, from a regulated EU exchange, to outside the EU such as the Swiss Exchange or Singapore. The responses were varied. Some interviewees raised objections, such as possible settlement problems or the difficulties of trading in different time-zones, that might lead them not to hold such transferred bonds. These answers can be set aside, assuming that the bonds concerned continue to be traded as they are now on an OTC market within Europe.

Respondents from Germany stated that they would have to sell bonds, held by institutional funds, that transferred their listing in this way. This reflects German regulation that generally requires an EU listing. Retail funds, governed by the UCITs directive would not be affected since there are a number of accepted exchanges on the "used list". In other jurisdictions there appears to be no requirement to sell, from either institutional or retail funds, either because of regulations or client guidelines, provided the transfer is to a recognised exchange.

There are important caveats to these general answers about a change in listing status. The large majority of interviewees were very cautious about how they would respond, suggesting that they might sell even if regulations or guidelines did not strictly require them to do so (the obvious exception were Swiss fund managers who would all be perfectly happy with a listing on the Swiss Exchange). A number of reasons were given for this:

- Perhaps the most important concern was that a transfer of listing, simply in order to avoid disclosure in IAS or similar widely accepted accounting standard would be "very negative signal". A small number of bond issuers changing listing status could see a heavy price penalty.
- A second reason was the strong emphasis placed by almost all interviewees on the desirability of having liquidity and up to date pricing information. Many were

therefore concerned that a de-listing or transfer of listing might result in a bond becoming significantly less liquid and if so this would require them to sell.

- A related concern was whether a de-listed or transferred bond would be included in the major bond indices (eg those produced by JP Morgan, Salomon, Merrill Lynch). If a change of listing status led to exclusion from these indices this would be another strong reason to sell. This is because for most asset managers performance is assessed against one of these benchmark indices, and hence they are reluctant to take the risk of holding a non-index bond
- A small number of our interviewees raised concerns about operational risks associated with de-listing and a desire to have a "standard trading platform across all accounts." If the conduct of the OTC market was unaffected by changed listing status, then this would appear not to be a real concern, but such worries might still affect investor sentiment about a de-listed security.
- Many respondents (particularly those in Italy) were sceptical about whether such changes would ever happen, they did not seem to regard them as credible possibilities. This scepticism would appear likely to exacerbate, especially in the short-run, any negative response to a decision to change listing status.

As a general conclusion, our interviews suggest that bond holders would likely react very negatively to a change in the listing status of outstanding bonds by a single issuer or small group of issuers; a sharp fall in price could be expected. The impact would be particularly pronounced for de-listing, possible less so for a transfer to a familiar non-EU exchange e.g. the Swiss exchange. For a substantial negative price impact not to be the outcome, a mass of issuers would need to act in tandem; this will be necessary to persuade fund managers that the change in listing status is neither an indicator of poor credit quality nor a trigger for declining liquidity. Changing the listing status of bonds will however still risk a negative impact on liquidity and pricing of international bonds issued in European bond markets, especially for the first companies to go down this route. This is clearly a much more difficult step to take than the change to the wholesale €50,000 denomination.

Accounting standards and disclosure

The remainder of our interviews were devoted to discussion of accounting standards and disclosure. On accounting standards we obtained fairly consistent answers, the large majority of our interviewed asset managers required accounts prepared to an internationally recognised accounting standard (so US and Canadian GAAP both seem to be very acceptable). IAS is welcome, and a number of interviewees indicated strong approval of the convergence of international accounting standards, but none seeing it as essential to have accounts in this form.

There were some differences of view. Further discussion indicated, for example, that while Japanese accounting standards were problematic for many investors, they caused less problem for others, mainly those larger firms with offices in Singapore or Tokyo and who thus have staff familiar with analysing these accounts. Some criticised particular European accounting standards (Spanish and Italian were mentioned). Another issue was frequency of accounting information, with some preference for quarterly or at least half yearly reports; this aspect of the Transparency Directive is therefore welcomed.

Some emphasised the need for key additional information, not covered in existing accounting standards. For example detail on the terms of bank lending, off-balance sheet commitments, and pension liabilities. One interviewee emphasised the opportunity to meet and talk with the issuer. There was also some dissatisfaction with the non-standardised treatment of insurance company accounts.

We also discussed questions of disclosure and covenants, going beyond the application of accounting standards. There were two principal concerns, each raised by several of those interviewed:

- Protection of bond-holders, especially the possibility of a leverage buyout putting new debt in front of existing bond-holders, and the potential exploitation of debt holders through asset-stripping. A number of those we interviewed were signatories to the 'group of 26 report', suggesting three remedies to deal with these problems (Group of 26 (2003)). This report has proposed that investment grade issues should include three standard covenants for protection of bond-holders

1. In the event of a takeover, borrowers should be provided with a option to sell the bond back to the issuer (ie a put option) at a value determined by the corresponding government bond spread plus the spread on the bond at the time of launch. The idea is to ensure that a takeover should not be able to exploit bond holders by reducing the credit quality of the instruments they hold.
2. A negative pledge, preventing issuers later subordinating instruments through a variety of possible actions such as pledging of assets, securitising, entering into sale and lease-back transactions, or other contractual change.
3. A disposal of assets restriction limiting the scope for asset stripping (strengthening current limitations on rates of disposal by eliminating clauses that refer to "except in the normal course of business".

  The group of 26 report raises valid concerns about bond holder protection; although it is unclear that their specific proposals are the most cost effective means of providing the desired protection of bondholders. No immediate change along these lines seems in prospect.

- A number were concerned with weak European disclosure requirements, relative to those imposed in the US. Examples given were the much stringent disclosure requirements for listing in NYSE, and by the SEC. There is also a perception that the SEC is more vigorous than European authorities about pursuing failures of disclosure.
- One interviewee stressed the need for disclosure of the affairs of the legal entity (i.e. the subsidiary) issuing the bond; an aspect of disclosure not addressed at all by the Transparency Directive. This is rarely a concern for equity holders, since traded equity is normally issued at group level and hence for equity investors group accounting statements are the appropriate level of disclosure. But bond holders may well need additional information, because of the possibility of a subsidiary being allowed to fail.

Many felt that bond-holder protection was a regulatory responsibility, because as investors they had only limited ability to achieve improvements in disclosure standards, or bond-holder protection, without regulatory intervention. As one investor noted, the ability of investors to place pressure on investors to improve standards is very dependent upon the state of the market. When there is a shortage of issuers, and investors are under pressure to chase yield so as to match or exceed a benchmark, it is difficult then to refuse to purchase a bond, despite concerns about disclosure. Investor pressure for higher disclosure standards tends only to be effective when there is relatively little demand for bonds and investors can afford to be choosy.

Most of our interviewees welcome the disclosure requirements of the Prospectus and Transparency Directives; and so are suspicious of any effort to weaken the impact of the directives on disclosure or use of improved accounting standards. At the same time, as our interviews indicate, some national accounting standards such as US GAAP that are viewed as being at least as good as IAS; this suggests that a “level 2” formalisation of the directives, to allow a range of other national accounting standards, will be a sensible way of reducing the costs imposed on some international issuers.

6. Conclusions and policy recommendations

We have examined the impact of the Prospectus and Transparency Directives on corporate bond markets in Europe. We also report interviews with some 21 asset managers across Europe, documenting the views of bond investors on possible issuer responses to these new directives.

These directives are substantially altering disclosure requirements for security issuers in Europe. New requirements include the provision of:

- Financial statements for both new and outstanding issues, prepared according to International Accounting Standards (IAS) or "equivalent" national generally accepted accounting principles (GAAP). The list of equivalent GAAP has not been finally determined but is likely to include US GAAP.
- A short non-technical summary prospectus for new issues that can be translated into the different languages of the European Union
- Financial statements prepared on a half-yearly basis.

These two directives are amongst the 42 measures set out in the 1999 "Financial Services Action Plan", with the aim of promoting the development of pan-European securities markets. The purposes of these two directives are welcome – to provide a "passport" that will allow a securities to be sold across Europe supported by a prospectus approved by the securities regulator in a single member state; and to ensure minimum standards of financial reporting for all securities sold in Europe. While the directives offer exemptions for wholesale bond issues that will appeal to some international issuers, all domestic and most international bond issuers will be able to comply with both directives. These directives can be expected to achieve the required harmonisation of reporting and issue documentation across the EU.

We have analysed the frequently expressed concern of international issuers and underwriting banks about these two directives, that they impose substantial costs on some Eurobond issuers, requiring them to restate their accounts according to international financial reporting standards (IAS). This is a substantial burden for some international companies who would not otherwise be moving from their own national accounting standards to adopt IAS.

The level 2 implementation of the directives will extend the directives to equivalent national standards, including US GAAP; nevertheless it is still likely that a number of international borrowers will want to take advantage of the exemptions in the directives for “wholesale” bonds i.e. those with a minimum denomination of €50,000 or the equivalent in foreign currency, allowing them to continue stating their accounts in their own national standards. Our interviews indicated that holding such wholesale bonds would not pose any major problems for asset managers.

Alternatively issuers could avoid the requirements of both directives by changing the listing status of their bonds so they are no longer “admitted on a regulated EU market”, effectively no longer listing on the main European stock exchanges. Such a change in listing status can be achieved by de-listing altogether, by listing on an EU exchange that is not on the list of regulated EU markets, or by transferring their listing to an exchange outside of the European Union. In order to avoid the requirements of the Prospectus Directive, these securities would then also *either* have to be wholesale denomination bonds *or* would have to be sold only to institutional investors and to a small number of private investors (no more than 100 in each EU state).

Our interviews show that a change of listing status will be a much more problematic step for issuers than adopting a wholesale €50,000 denomination. Widespread portfolio regulations governing both retail and institutional funds, and customer guidelines, will require most fund managers to sell de-listed bonds. A number of funds, especially retail funds, could continue to hold bonds with listings transferred to ‘recognised exchanges’ outside the European Union. This suggests that a transfer of listing outside of the European Union, e.g. to the Swiss Exchange or the Channel Islands, may be the least disruptive issuer response because it will lead to much less forced selling than de-listing of bonds. But there is still the possibility of a negative investor reaction that could lead to substantial loss of liquidity and price falls.

While these exemptions will resolve most concerns of international issuers, our analysis suggests that much of the detail incorporated in these directives remains problematic. There is a remaining and highly inappropriate burden imposed on a small number of international issuers with outstanding bonds in Europe, not planning to state their accounts according to IAS or equivalent standards. The problem is that the denomination of outstanding bonds cannot be altered at all easily. This must be viewed as a substantial flaw in the Transparency Directive, since it penalises investors for decisions made prior to the directive that cannot be subsequently reversed.

This flaw could still be corrected by using level 2 regulation to provide a wider transitional list of national accounting principles accepted as equivalent to IAS, under the Transparency and Prospectus Directive, open only to international issuers with outstanding bonds trading in the EU. This wider list of accounting standards should certainly include all the non-EU OECD nations with Eurobonds currently listed on European stock exchanges, US, Canada, Japan, etc. This list would have to apply to both directives, because otherwise these international issuers may not be able to take proper advantage of the exemption offered to them in the Prospectus Directive. Such a transitional arrangement would avoid the inappropriate post-issue costs currently threatened for some international issuers. It could then be phased out over a period of a few years. A narrower permanent list of ‘equivalent’ accounting principals should be maintained, limited to those standards that are clearly equivalent to IAS.

A deeper problem with the Prospectus and Transparency Directives – and this applies to their application to equity markets as well as to corporate bonds – is that they seem to have been developed without any overall regulatory design in mind. Yes these directives achieve their purpose of harmonising disclosure and ensuring that the documentation of new issues are legally accepted across the European Union. But this does not ensure the creation of an effective pan-European market.

The comparison we have made between US and European disclosure regulation is instructive. This highlights the question: is it better to retain the European approach of operating disclosure requirements via listing on exchanges or “admittance to regulated markets”; or should instead these directives have removed the regulatory link between disclosure requirements and listing altogether, replacing them instead with a requirement that any security issued within Europe be subject to US style registration with a new European securities body? On the face of it, a shift to an EU wide system of registration would seem to be much more favourable to the achievement of a pan-European capital market integration that what has actually been done, maintaining a nation based system of admittance to regulated security markets.

This point can be developed further in the context of the debates about the need for a "European SEC" (see for example Hertig and Lee (2003)). The US the SEC is widely thought to have played an effective role in supporting the development of US capital markets. But the design of regulatory oversight of European capital does not force a choice between two stark alternatives: purely national securities market regulation , co-ordinated by committee systems and operating through European level legislation *versus* a fully fledged European Securities and Exchange Commission. Rather the real choice is identifying those amongst the many functions carried out by securities regulators which would be best conducted at European level; and distinguishing these from other functions which can be retained at national level. We can always have a "mini-SEC" in Europe that takes over some but not all regulatory functions for securities markets currently carried out at national level.

There is a strong case that the enforcement of disclosure standards should be conducted at EU level, implemented via a European wide registration of securities. But. for reasons of law, language, and financial infrastructure, securities are always issued in one or more national markets. This suggests that approval of prospectuses and documentation of new issues should remain at national level. With a regulatory design operating along these lines, there is simply no need to retain the current concept of "admission to a regulated market". The concept of a 'home member state' could then equally well be also dropped from both directives.

The failure to set these two directives within a clear overall framework for pan-European securities regulation also explains their confusing and seemingly unnecessarily complicated structure. This complexity stands out in comparison to the robust but straightforward approach taken to disclosure requirements for security issuers in the United States.

This complexity has been exacerbated by what seems to be rather untidy drafting. We have seen that for the purposes of exemption, these directives include no less than three different definitions of a wholesale security. The precise form of these exemptions are themselves rather contorted, especially in the Prospectus Directive, where the issue must either also not be admitted on an EU regulated market; or (for the wholesale bond exemption) must not be issued by an issuer with any equity or retail security admitted on an EU regulated market.

Not only do these definitions create problems for some international issuers, they also fail to provide the desired support for high-yield bond issuance in Europe. As we have seen in our discussion of US securities regulation and “rule 144a”, high-yield bond issues benefit from favourable transitional disclosure requirements, even if they usually eventually conform with the same full disclosure as other securities. But many potential high-yield issuers will be unable to take advantage of disclosure exemptions in the Prospectus Directive, because these will often only be available by issuing without admittance to a regulated market (the wholesale exemption will not be available to issuers that already have equity admitted to a regulated EU market). But, as our interviews make clear, such issues will have little appeal to most institutional investors or unitised retail funds. The Directive is not doing enough to assist high-yield issuance (perhaps reflecting the fact that volumes are still low in Europe and so there have been no effective lobbying of the interests of high-yield issuers).

The confusion and complexity of the directives would have been much less were there a clear regulatory plan behind them. One might expect to find two forms of clearly distinct exemption for bonds, one aimed at high-yield issues and another framed for international issuers. In the case of high-yield issues, it would be appropriate to have a time-limited (eg up to three years after issue) exemption for high-yield bonds. For international bonds there should be a permanent acceptance of a wide range of “equivalent national standards”. Both these exemptions could have been appropriately limited to “wholesale bonds”, as defined using the current €50,000 limit.

A related concern is the application in these two directives of Lamfalussy comitology – in which core `level 1’ co-legislation is restricted to issues of principal; and practical implementation or technical details that are likely to alter along with market practice are determined through lower `level 2' and `level 3' committee procedures.

These directives make much less use of Lamfalussy procedures than they might have done. They build in such specific concepts as "admission onto a regulated market" and "home member state" into the core co-legislation. They offer a series of exemptions, but there is no statement of the purpose of these exemptions, and therefore no criteria by which they might be amended using committee procedures. Given the great complexity of these new directives, there is danger that some conflict will emerge with other aspects of European Union securities legislation, for example with rules governing portfolio composition and limiting the holding of unlisted securities.

The inclusion of the concept of admission to a regulated market in this core legislation, may in turn be committing the European Union to maintaining the structure of portfolio regulations applied to institutional investors and collective investment vehicles, requiring them to invest predominantly in securities admitted to regulated markets. Without these portfolio regulations there could be a dynamic to move securities off these markets and avoid current disclosure standards. Again we are being committed to a possibly inefficient and certainly inflexible regulatory design, without any analysis of whether this is the appropriate way of achieving integration of capital markets across Europe. More appropriate would have been to set disclosure standards applicable to all securities bought and sold in Europe; grant the level 2 committee the rights to develop exemptions in a simple and practical manner; and avoid any reference to "regulated markets" or "home member states" at all.

Another example of the failure to fully utilise the Lamfalussy framework is the definition of wholesale security. It would have made much greater sense, and have been much more in spirit with the Lamfalussy framework, to have included in the core co-legislation a general commitment to provide exemptions to support specific wholesale security markets. Having placed only the most general principal in the co-legilation – all details on exemptions could then be implemented as as level 2 decisions (or alternatively the co-legilsation could specify such exemptions but make clear that they could be subsequently using level 2 procedures). In either case the resulting exemptions would likely have been much better targeted to the high-yield bonds and international bond issuers.

Finally we comment on some broader concerns about the regulation of bond markets, raised in some of our interviews. A number of the investors we interviewed have worries about the standards of disclosure and of bond-holder protection in Europe, especially relative to the US. The extent to which there really is such a divergence in standards, and the consequences of such investor protection for bond market activity, are both topics that merit further research.

As our interviews confirmed, there is a key distinction between protective covenants and disclosure requirements. Institutional investors are sophisticated enough to determine, for themselves, the financial and business situation of issuers; they do not require issuers to conform to a pro-forma disclosure requirements and, while standardisation is a convenience, they can work with whatever accounting information and other forms of disclosure are available to them. But institutional investors cannot protect themselves from the bond-issuer actions that move them down the hierarchy of claimants, e.g lowering the status of senior unsecured bond holders to junior unsecured by acquiring substantial new debt. There is a case for regulations, eg support “negative pledges”, to prevent such exploitation. Our interviews suggested that bond holders are in a weak position to impose such requirements on an individual basis.

Promotion of pan-European corporate debt markets, especially those for high-yield debt, might be assisted through some regulatory response to the concerns of the “group of 26” position about the degree of bond-holder protection available in European markets; provided that this can be developed and introduced with the broad support of industry participants. But this reveals again a weakness of regulatory design. Nowhere in the new European regulatory framework is there a clear responsibility for developing rules so as to protect the interests of market participants such as bond-holders. Steps, for example, to impose higher standards of covenants; or to require additional disclosure on the legal issuer of a bond, might be desirable, but there is no body in a position to take the lead in developing such an initiative.

Corporate bonds are a clear example of the difficulties faced by European legislators, introducing EU wide legislation on top of a patchwork of different national requirements. In the four and a half years since the adoption of the Financial Services Action plan much has been done to harmonise financial regulation; but there is a long way to go to achieve truly pan-European capital markets and European legislators and practitioners alike seem to losing the stomach for a further major round of regulatory initiatives.

The application of regulatory impact analysis (see Mather and Vibert (2004)) can help ensure that future regulatory initiatives do not impose unnecessarily high costs on market participants. Application of the Lamfalussy proeedures may help ensure that new securities market legislation is sufficiently flexible and adaptable to cope with changing market practice. But these approaches are not sufficient to ensure adequate regulatory support for the project of creating pan-European capital markets. As our analysis of recent European directives and the market for corporate bonds makes clear; this task needs to be undertaken within the context of a clear and widely accepted overall design for the pan-European framework of securities market regulation. This is *not* to say that we necessarily need a European SEC, many aspects of security market regulation may still be appropriately handled at national level. But now that the Financial Services Action Plan is close to completion, this is an appropriate time, before a further wave of European legislation is contemplated, to seek such consensus on the regulatory framework for pan-European securities markets.

Appendix 1: requirements of the Prospectus Directive

The Prospectus and Transparency Directives imposes a number of requirements on all security issues subject to the directive, i.e. public offers for sale *or* any security admitted for trading on an EU regulated market. This appendix lists these requirements. For further information readers may wish to consult summaries of the directives produced by legal experts e.g. Cleary Gottlieb (2003, 2004).

Content A security issue must be accompanied by an approved prospectus. This can be a shelf-registration document containing general information and supplemented by a securities note containing details of the offering. Or it can be a single one-off document. In either case the issuer must also prepare a summary of no more than 2,500 words in "brief, non-technical language, … conveying all of the essential characteristics and risks associated with the issuer… and its securities". Member states may also require this summary to be translated into the local languages of all member states in which the securities are being offered to the public or admitted into a regulated market.

Approval of prospectus – for equity, convertibles, and for bonds with a minimum denomination of €1000 – the prospectus must be approved by the issuers "home member state". For an EU issuer this is the state in which they are incorporated. For non-EU issuers the home member state is the one from which they first obtain approval). For bonds with a minimum denomination over €1000 approval can be on an issue by issue basis.

Minimum turnaround There are clauses intended to ensure a standard 10 day turnaround of approval (20 days for an IPO) but doubts remain about how long this will prove to be in practice, since the 10-day clock can be restarted by a request for further information.

Other sources of information The prospectus may refer ("incorporation by reference") to other sources of information e.g. annual reports and accounts, provided these have been filed with or approved by the "home member state". But it appears that it will not be possible to incorporate by reference documents filed with or approved by non-EU authorities, thus imposing an additional cost on non-EU issuers.

Disclosure requirements The prospectus must contain all information necessary to enable investors to make an informed assessment of the financial position and prospects of the issuer. Detailed disclosure requirements are still being developed under **Lamfalussy** level 2 requirements and will be implemented by the EU commission on the advice of CESR. These requirements will differ by type of security (equity/ debt, wholesale/ retail, etc.). Currently proposals include:

- Accounts prepared according to International Accounting Standards or equivalent, covering the previous 2 years; and it appears that some "equivalent" national accounting standards, including US GAAP, will also be allowed
- there an exemption for admitted wholesale debt securities, defined as debt with a minimum issue denomination of €50,000, allowing a statement

narrative account of how the national accounting differes from IAS is acceptable).

- An ongoing annual disclosure requirement (unless an admitted wholesale debt security) publishing all information disclosed to the public during the last 12 months according to securities regulations in the EU and elsewhere (the "annual disclosure list"); including the requirements of both the Transparency Directive (annual and half-annual reporting for retail debt securities) and the Market Abuse Directive (disclosure of price-sensitive information).
- An audit conducted to international audit standards (not applicable to admitted wholesale debt securities)
- A mandatory risk disclosure section
- Information on trends likely to have a material effect on the issuer; prospects (not required for admitted wholesale debt securities)
- Disclosure on major shareholders (direct and indirect) and any arrangements that might result in a change of control.
- Summaries of all material contracts (except those entered into in the ordinary course of business).
- Possible additional national disclosure requirements, as long as these do not interfere with the drawing up of the prospectus.

Liability There will continue to be a potential liability for content of the prospectus under each national jurisdiction in which securities are offered. There is moreover the potential for criminal liability with respect to the short-summary prospectus (civil liability is explicitly removed by the PD) eg if securities decline in value and investors successfully argue that key information was omitted from the summary. A consequence may be that issuers largely avoid retail issues in more than one country (the very activity which the directive is meant to support!). Lawyers have also argued that there is a potential liability from "outdated" information in the annual disclosure requirement.

Appendix 2: interview questions

Background. In order to interpret your answers about listing and minimum size, we need to know a little about your business. What are total assets under management?

Can you give us some idea of the clients you serve and their percentage breakdown (nearest 10% is perfectly acceptable) along the lines of the following table:

%	Total assets	Fixed income
All clients	100	
Insurance funds		
Pension funds		
Sovereign/ public sector		
High net worth individuals		
"Unitised" retail funds		
Internal funds		
Other (please specify)		

Section A. Listing requirements. In order to minimise regulatory requirements, many issuers are likely to prefer *not* to list their bond issues.

1. Do you actively purchase **unlisted** or **unregistered** bonds at present? If so on whose behalf do you make these purchases and what proportion of their total bond portfolios do these represent?

	Not purchased	<1% bond funds	<2% bond funds	>2% bond funds
Internal funds				
Institutional funds				
Retail funds				

2. What are the nature of any guideliness making it difficult to purchase **unlisted** bonds (eg regulation, tax,) ?

	Internal funds	Institutional funds	Retail funds
Client investment guidelines.			
Your own internal investment guidelines.			

3. How important are the following factors to the decision to hold a bond? Rating class, liquidity, access to regular price information? Taking account of these factors, what basis point return premium would you expect to obtain on an unlisted bond, compared to an equivalent listed security?

0-10	10-15	15-20	20+

4. To consider purchase of unlisted bonds, which forms of financial disclosure do you require?

(a) Detailed prospectus and accompanying financial statements
(b) Accounts prepared to recognised national accounting standard eg US GAAP
(c) Accounts restated to international IAS standards?
(d) Other

5. Many non-EU issuer are planning to delist their bonds if they do not get any relief from the EU directives' requirement that they file IAS accounts.

   a) Which, if any, of your funds would required sale of delisted bonds:
      i. Retail funds?
      ii. Institutional funds?
      iii. Internal funds?

   b) It is possible that, rather than delist, bond issuers will list elsewhere, e.g. on exchanges in Switzerland, Tokyo, or Singapore. In this case, which if any, of your funds would be required to sell bonds:
      i. Retail funds?
      ii. Institutional funds?
      iii. Internal funds?

   c) Would the same answers apply if bonds list in an offshore centre such as the Cayman Islands?

Section B. €50,000 denomination for "wholesale" bonds.

1. As a consequence of new European directives, many Eurobond issuers will prefer to issue bonds in denominations of **€50,000 or above**.

(a) Would such high-denomination bonds be difficult to allocate to individual funds or sub-funds that you operate?

(b) Is this a particular problem for any index tracking funds that you operate?

(c) If bond denomination makes a difference for any of your funds, what denomination could be allocated without difficulty to sub-funds? (please tick once in each row)

Proposed €50,000 will cause no problems	€25,000	€10,000	€5,000

2. Do you perceive any other reasons for not purchasing bonds of denomination of **€50,000 or above**?

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