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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 89: PROSPECTUS DIRECTIVE - CHOICE OF HOME MEMBER STATE

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FINANCIAL MARKETS LAW COMMITTEE

**ISSUE 89: PROSPECTUS DIRECTIVE - CHOICE OF HOME MEMBER STATE
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An issue has arisen out of the entry into force of the Prospectus Directive (2003/71/EC), on 31 December 2003. The issue relates to the meaning of “offer of securities to the public”. In summary, although the Prospectus Directive includes a definition of offer of securities to the public, it is not clear whether that definition 'speaks' before implementation of the Directive into national law (i.e. before 1 July 2005). There would be no gap in the law if it did not, as there is already an EU-wide concept of public offer. Uncertainty about which is the correct definition has caused disruptive problems in wholesale financial markets.

The role of the Financial Markets Law Committee is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed. The Committee also acts as a bridge to the judiciary to help UK courts remain up-to-date with developments in financial markets practice.

The establishment of the Financial Markets Law Committee in 2002 reflects the view, widely held across the wholesale financial markets, that arrangements should be in place to identify and analyse these areas of legal uncertainty or misunderstanding which may affect those markets. The Committee is made up of senior lawyers and representatives of financial market participants, regulatory authorities, trade bodies and associations.

Some element of legal uncertainty is inevitable in financial markets. One possible source of legal uncertainty is proposals for new law or regulation. These can sometimes give rise to uncertainties or misunderstandings, if the specific features of wholesale market practice or of the existing framework of law have not been fully understood by a legislator or other public authority.

The Committee is sponsored by the Bank of England, which provides facilities for the Committee including its Secretariat. The Committee is independent from the Bank and its views and any published materials should not be taken to reflect the views of the Bank.

In May 2004 an issue arising under the Prospectus Directive was raised with the Committee. At its meeting on 13 May 2004 the Committee resolved to address the issue, in the first instance by forming a working group to analyse in detail the nature of the issue. This paper was developed for the Committee by that Working Group. The views set out in this paper, however, are those of the Committee itself, as well as of the Working Group. Phil Wynn Owen took no formal part in the FMLC's discussions on this issue, as he has an official role in the implementation of the Prospectus Directive.

The issue

Article 3 (1) of the Prospectus Directive provides that,

“Member States shall not allow any offer of securities to be made to the public within their territories without prior publication of a prospectus”,

and Article 3 (3) that,

“Member States shall ensure that any admission of securities to trading on a regulated market ... is subject to the publication of a prospectus.”

Article 13 (1) provides that,

“No prospectus shall be published until it has been approved by the competent authority of the home Member State”.

For the purpose of equity and low denomination non-equity securities, “home Member State” is defined under Article 2 (1) (m). For EU issuers the home Member State and therefore the competent authority is the state where the issuer has its registered office. For non-EU issuers the home Member State and therefore the competent authority is,

“... the Member State where the securities are intended to be offered to the public for the first time after the date of entry into force of this Directive [which was 31 December 2003] or where the first application for admission to trading on a regulated market is made, at the choice of the issuer, the offeror or the person asking for admission as the case may be ...” (Article 2 (1) (m) (iii))

Thus, for non-EU issuers who apply for securities to be admitted to trading on a regulated market, it is clear that the competent authority will be the one of the state in which admission is sought. However, for non-EU issuers who are not applying for admission of securities to trading on a regulated market, it is uncertain which state’s regulatory authority should regulate the offer.

This uncertainty arises because the concept of offering securities to the public has two possible meanings.

One meaning is that provided by the Directive itself. Article 2 (1) (d) provides that, for the purposes of the Directive,

“... ‘offer of securities to the public’ means a communication to persons in any form and by any means, presenting sufficient information on the terms of the offer and the securities to be offered, so as to enable an investor to decide to purchase or subscribe to these securities ... ”

This definition does not expressly refer (and so is not expressly subject) to any of the types of offer listed in Articles 3(a) to (e), nor to the types of securities listed in Article 4, of the Prospectus Directive as being exempt from the obligation to publish a prospectus. Thus it appears that, if the definition is applicable, it would cover all offers made after 31 December 2003, even if they would otherwise fall within one of the exemptions currently in force under the existing national laws of Member States, or would otherwise be within the exemptions in the Prospectus Directive itself.

A second possibility is that the concept of offer of securities to the public has the meaning given to it under existing law: the national laws of the Member States reflect the Public Offers Directive of 1989, which will be superseded by the Prospectus Directive only on or before 1 July 2005, being the date by when Member States must have implemented the Prospectus Directive.

Each interpretation has arguments in its favour. The fact that non-EU issuers will be accessing EU markets for the first time long after the 1989 Public Offers Directive definition has been repealed argues in favour of the first interpretation. But the fact that the new Prospectus Directive expressly preserves the 1989 Directive until 1 July 2005 argues that, until that date, the 1989 definition is intended to be used. And one should only treat as ‘speaking’ now those parts of the Prospectus Directive which are absolutely necessary to give teeth to article 2.1(m)(iii). Another argument is that the new definition could never have been intended to speak - only the nationally-implemented versions of it. Directives are intended to be directions to Member States to implement appropriate laws. They are not intended to have direct effect on persons in the EU (or elsewhere).

There is no clear winner among these arguments; and the resulting uncertainty has damaging results for non-EU issuers. The FMLC believes that, on balance, the correct reading is that the 1989 definition should be used for the purposes of Article 2.(1)(m) until 1 July 2005, and thereafter the definition in the Prospectus Directive as implemented by the relevant Member State.

As regards the first meaning, since 31 December 2003 many non-EU issuers have already issued securities relying on an exemption from the obligation to publish a prospectus available to them under the law of a particular Member State. If the Prospectus Directive definition of offer of securities to the public were to have been applicable, it may be the regulatory authority of some other Member State (or possibly more than one Member State) that should have regulated the offer. For example, many non-EU companies undertake employee offers from time to time in many EU countries simultaneously, on a basis which is exempt under the local prospectus requirements in each of the countries. If the Prospectus Directive definition were to apply to these schemes, the companies may have already made their first public offer in the EU on or since 2 January 2004. (Indeed, for multi-national companies, the employees of which live in a number of Member States, the companies would have made simultaneous offers in all those Member States and will have as many possible "*home Member States*", although the Directive anticipates only one). Another example of this problem arises where there has been any takeover or merger of an EU company by a non-EU company involving non-cash consideration or a private placement made since 31 December 2003. Such issues will have been made under an exemption from the public offer regimes under current national law but, if the Prospectus Definition of public offer applies, then again there could be uncertainty over whether the issuer has inadvertently chosen a home Member State and, if so, which.

In each case, if the Prospectus Directive definition of "offer of securities to the public" were to apply, non-EU issuers must risk making an election for a home Member State inadvertently and may well find the offer, and all future offers of securities, regulated by an authority which is not appropriate to the issuer or its securities.

The second possibility, that the old definition of public offer as found in the domestic law of each Member State is applicable, would avoid these results. The employee offer, takeover, or placement would operate under an exemption from the current (i.e., old) public offer regimes and, therefore, would not trigger an election of home Member State.

Consequences for the market

There is significant current confusion in the international capital markets as to which is the correct understanding of the concept of offering securities to the public. Indeed, some advisors have recommended to their clients generally that no further action be taken anywhere in the EU of the kind that might amount to a public offer, until the uncertainty is resolved. And the regulatory community are not able safely to give clear guidance to those making enquiries of them.

The uncertainty affects both the regulated and the regulators. Non-EU companies may, as a result of the ambiguity, find themselves locked into an inappropriate regulatory authority, by which all future equity (including debt convertible into equity) and low denomination non-equity prospectuses would have to be approved. And there will remain legal uncertainty as to which authority is the competent authority. Thus, if State A (having been selected as home Member State, on the assumption that the second interpretation of public offer is correct) approves a prospectus and the price of the securities falls significantly after the issue closes, investors may argue that the approval was invalid, and the offer void in consequence, on the ground that, the second interpretation being incorrect, the issuer's home Member State should have been State B. They may also argue that the issuer had therefore committed a criminal act by issuing without a valid prospectus.

As for regulators, if a competent authority accepts that it is the home competent authority for a non-EU issuer, it may approve a number of prospectuses over the years. If the issuer eventually runs into financial difficulties, it is possible that investors who are alert to the issue will look at the authority under which those approvals were given and may use the uncertainty as to the meaning of “public offer” as the basis for their argument that the competent authority had wrongly given its approval. Indeed the listing itself might be called into question, because, without a validly approved prospectus, there can be no listing.

Possible solutions

One possible solution for non-EU issuers to avoid uncertainty as to which is the properly competent authority to regulate an offer would be to apply to have securities admitted to trading on a regulated market, thereby fixing the home member state through a listing rather than through an offering (assuming they have not already made an offering). However, this is hardly an optimal solution for issuers who have no other commercial reason to list their securities.

A better solution might be for the European Commission (with the assistance of the European Securities Committee), to resolve the ambiguity by adopting ‘implementing measures’ under Article 2(4) of the Prospectus Directive.

The implementing measures could clarify that the current national law definitions of “public offer” apply until the Directive is implemented into national law; and alter the timing regime provided in the Prospectus Directive so that the attribution of a competent authority by virtue of a public offer would apply only to public offers made after, say, 1 March 2005. This will enable companies that may have, thanks to the ambiguity of the Directive, unconsciously chosen their home member state already by making a public offer to reconsider the choice in the light of the new, more certain, regime. It would also need to ensure that choices of a competent authority by reason of a listing since 31 December 2003 are not undermined (i.e. some kind of grandfathering provision).

Of these solutions, the second seems preferable. Only the adoption of “implementing measures” by the Commission would be conclusive and thus provide market participants with sufficient legal certainty. The FMLC is ready to assist in suggesting the technical wording required for such an ‘implementing measures’ under Article 2(4) of the Prospectus Directive.

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