INVESTOR INFORMATION VERSUS INVESTOR PROTECTION: IS PROSPECTUS REGULATION HEADING IN THE RIGHT DIRECTION?

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Throughout the past few decades, the purpose behind regulation of securities offerings, particularly that governing prospectuses, has been largely defined from an investor’s point of view. The more information a potential investor in securities receives about the securities and the issuer, the more protected it is considered to be—at least so the theory, generally known as the “information paradigm”, goes. Consequently, regulators and legislators have spent a great deal of time, energy and expense on ever-increasing regulation of market transparency, including the requirements on the format, nature and specificity of information contained in prospectuses. This goal is very pointedly set out in recital 10 of the EU Prospectus Directive of 2003 (the Prospectus Directive):

The aim of this Directive and its implementing measures is to ensure investor protection and market efficiency, in accordance with high regulatory standards adopted in the relevant international fora.

Furthermore, article 5 of the Prospectus Directive requires that:

the prospectus shall contain all information which, according to the particular nature of the issuer and of the securities offered to the public or admitted to trading on a regulated market, is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and of any guarantor, and of the rights attaching to such securities. This information shall be presented in an easily analysable and comprehensible form.

Admirable goals to be sure. However, at the time the Prospectus Directive was published, the question was then the same as it is today: are those goals achievable if the driving force behind their implementation is investor protection? Or, said a different way: does a single-minded focus on investor protection naturally lead to overregulation?

In 2012, the Capital Markets Forum of the International Bar Association (IBA) published a paper in which it analysed whether disclosure regulation based on the information paradigm had achieved its purposes. The empirical evidence available at the time suggested that such regulation had not. The paper noted that there remained considerable doubts as to whether retail investors were able to understand the information contained in prospectuses “worrying”. Against this backdrop, the Capital Markets Forum called for the information paradigm as the rationale driving disclosure regulation to be revisited and, in particular as to its wider implications, and that alternative approaches be explored. In doing so, it also suggested that international governmental organisations such as the European Securities and Market Authority (ESMA), as well as standard-setting bodies such as the International Organization of Securities Commissions (IOSCO) and the International Capital Market Association (ICMA), should take a step back and reflect on the conceptual basis that should be used for future disclosure regulation.

It was already the case in 2012 and is all the more true today that prospectuses have grown enormously in size and that such growth has come at the expense of readability. In fact, one could argue (and indeed the argument is regularly made) that prospectuses are too often written with the primary focus on avoiding liability, rather than on conveying relevant and useful information to the investors, notably to retail investors. As a consequence, there is widespread belief that the readability and understandability of prospectuses (in particular for retail investors) has significantly declined.

There were indications that the 2012 views of the Capital Markets Forum of the IBA were shared by many market participants, regulators and legislators. In any event, the “intermediary paradigm” started to gain currency in Europe. Its central theory is that protection of retail investors is not (or not only) achieved through extensive disclosure and excessive risk factors, but rather through professional advice given to investors by their financial advisers at the point of sale. The intermediary paradigm has its advantages, but it also comes with serious inherent risks. For one, market access may become less open and flexible and, as a result, less attractive for retail investors. For another, the risk of overregulation may be even greater than in the case of the information paradigm. Specifically, it may ultimately lead to a paternalistic regime in the sense that regulators may take views that certain securities are too dangerous and risky and therefore ban sales of such securities to retail investors. That this risk is actually realistic is evidenced by two contemporaneous examples. First, in 2015 the UK Financial Conduct Authority (FCA) in England, and other European regulators, have banned sales of certain conditional write-down and convertible securities to most classes of retail investors. Second, just a few weeks ago, the European Banking Authority and ESMA issued a joint statement noting that the distribution of what are generally referred to as bail-in bonds or TLAC bonds to retail clients may raise significant consumer protection issues.

Where do we stand today in Europe with respect to these two paradigms? Have regulators been able to find a balanced middle road, taking from both concepts to form an overall, coherent strategy for disclosure regulation? I fear we are not there yet. At first blush, it seems to me that in Europe we have lost our “compass”, if you will, and are not focused on the best way to inform retail investors appropriately and should avoid paternalistically regulating which investments are good or bad for them. There is a widespread belief that, on the one hand the disclosure regulation has led to over-complexity rather than simplification of disclosure, while on the other hand the zeal for investor protection has led to new requirements that at least on their face do not appear to increase the protection of retail clients. This belief is illustrated by two recent legislative developments in the European Union.

Starting with its 2015 action plan to build a Capital Markets Union, the European Commission has been promoting improving the efficiency of the markets by further promoting transparency to increase funding options for businesses, in particular small and medium-sized enterprises, to create more opportunities for investors, and to encourage cross-border investment. Further, and in particular, the European Commission has stated that it wants to afford retail investors greater confidence, transparency, certainty...
and choice so that they can make the right investment decisions. As one of the first steps towards that goal, the Prospectus Regulation was enacted on 14 June 2017. The aims of the Prospectus Regulation, according to recitals 1 and 7, include making markets work more efficiently, and offering investors and savers additional opportunities to put their money to work. Specifically, recital 7 stresses:

The provision of information, according to the nature of the issuer and of the securities, is necessary to enable investors to make an informed investment decision ensures, together with rules on the conduct of business, the protection of investors. Moreover, such information provides an effective means of increasing confidence in securities and thus of contributing to the proper functioning and development of securities markets. The appropriate way to make that information available is to publish a prospectus.

With these aims in mind, it was expected that the Prospectus Regulation would follow a simplified approach towards disclosure. But what sounded like a step in the right direction was turned on its head when the unyielding amount of detailed regulations on the implementation of the Prospectus Regulation was revealed. For instance, this spring ESMA published its final report on the technical advice under the Prospectus Regulation, which consists of more than 500 pages of very detailed technical regulations. This leads one to the question of whether the density and complexity of the regulations implementing the Prospectus Regulation is really beneficial, or whether it wouldn’t have been better to leave it to the issuers and their advisers to interpret the Prospectus Regulation and autonomously determine (within the basic framework) the appropriate level of disclosure. This would mean giving issuers and their advisers both the freedom and responsibility to make their own judgement (based on their own deep knowledge of their business, industry and offered securities) as to what disclosure is in fact easily readable and understandable for retail investors, rather than perhaps being forced to be a slave to form over substance and check-the-box-exercises, whether due to the unyielding nature of the regulations or due to the lack of onus placed on the issuers and their advisers to make such a determination.

Another initiative set out in the European Commission’s 2015 action plan was to provide retail investors access to meaningful and high-quality information in a comparable and transparent manner across investment products, in particular on the key features of products. The regulation of the European Parliament and the Council on key information documents for a packaged retail and insurance-based investment products (PRIIPs) of 2014 (the PRIIPS Regulation) was enacted to achieve this goal, namely by requiring the preparation and publication of a key investor document (KID) whenever a PRIIP is make available to a retail investor. According to article 6 of the PRIIPS Regulation, the information set out in a KID must be “accurate, fair, clear, and not misleading”. However, the cost of such meaningful disclosure? Do we really believe that the KIDs that have been being produced since January 2018 fulfil the goals and function as originally intended by the European Commission’s 2015 action plan?

In asking this question, it might be valuable to look across the Atlantic to the North American integrated and continuous disclosure systems. In that region of the world, the responsibility for proper and accurate disclosure has largely been left in the hands of issuers and their advisers, with some control and oversight by the Securities and Exchange Commission or the Canadian Securities Administrators. These disclosure systems are backed by significant liability provisions (ie, the so-called 10b-5 liability in the USA). Accordingly, in the future, it may be worthwhile exploring whether there is a middle ground between the European and North American disclosure regimes that ensures market transparency and the provision of understandable information to investors, including retail investors, while at the same time giving sufficient flexibility, autonomy and responsibility to the issuers when determining the appropriate level of disclosure.

As a final note, touching upon something that sits close to my heart and practice, the federal parliament in Switzerland enacted a new Financial Services Act in June, as a result of which Switzerland is implementing a comprehensive prospectus regulation for the first time in its history. The act is set up as a framework regulation, the implementation of which will be governed by an ordinance. While the EU framework has always been a key point of reference during the law-making process, sight has never been lost of the principles and techniques developed in the United States and elsewhere. For me personally, there remains hope that Switzerland will do exactly what I am advocating for, and adopt a middle way when it comes to disclosure regulation. More generally speaking, it would be desirable if European legislators and regulators were to take a step back and try to recalibrate their “compass” in order to work on giving the markets, regulators and practitioners a meaningful and workable disclosure concept.

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