One of the core initiatives of the European Commission’s plan for a Capital Markets Union is its proposal to replace the existing legal framework for public offerings with a new regulation. The new regulation would bring some incremental changes to the existing framework, mainly in the direction of: (a) lowering the burdens for issuers (via broader exemptions for secondary offerings, an attempt to increase the use of shelf registration, and simplified prospectuses for small issuers); and (b) making prospectuses more retail investor-friendly (via shorter summaries and limits on the use of risk factors).

Both the ultimate rationale of the existing framework (“a high level of consumer and investor protection”) and its building blocks would remain the same. Chief among them are, first, the idea of a prospectus to be
drafted pursuant to detailed schedules identifying required disclosures item by item with a view to “removing asymmetries of information between [investors] and issuers;” second, pre-approval of the prospectus by competent authorities with a view to ensuring that the prospectus is complete, consistent and comprehensible.

It is a mystery why policymakers keep deluding themselves with the idea that issuer disclosure is a useful tool to protect retail investors. While reasonable minds may differ on whether mandatory disclosure does enhance the efficiency of capital markets by reducing the costs securities analysts and sophisticated investors have to bear in order to acquire and process the information they need for their investment decisions, a strong and convincing body of evidence exists showing that retail investors are unable to make better investment decisions by processing available information about an issuer (for a summary of the evidence see e.g. N Moloney, How to Protect Investors 291-96 (CUP, 2010)).

Policymakers, including in the EU, should explicitly recognize that, generally speaking, mandatory disclosure performs three different roles in three different contexts, as John Armour, Dan Awrey, Paul Davies, Jeffrey Gordon, Colin Mayer, Jennifer Payne and I argue in the book Principles of Financial Regulation (OUP, 2016. p. 162-63). First, when an offer is made with a view to having securities admitted to trading on a regulated market (i.e., in IPOs), mandating disclosure may only serve the purpose of laying down once and for all the information items that sophisticated buyers and investment analysts would anyway deem necessary in order to price the securities. Retail investors are not users of issuer disclosures in this context. Rather, they free ride on the mechanisms (usually in the form of the book-building process) that lead to setting an IPO price reflecting available information. Second, when a bank or another financial intermediary places securities among clients without a proper parallel placement among institutional investors, mandatory disclosure’s function is to provide investors with information which they may find useful, rather than to support investment decisions, as a basis for legal redress in case of mis-selling. Finally, for “fringe” offerings directly marketed to the investing public, the mandatory disclosure process, coupled with pre-approval of the prospectus, may serve the function of screening for fraud and amateurish initiatives (more likely the latter: given the relatively generous exemptions regime within the EU, fraudsters are unlikely to be caught by prospectus rules anyway).

If this framework holds, a more cost-effective way to reshape prospectus regulations would be the following. First of all, for IPOs (and non-exempt secondary offerings marketed in a similar way):

1. a requirement that the price of the offer to the public will be no higher than the price set for the offering reserved to institutional investors should be introduced (it is currently just a best practice within the EU);

2. required disclosures should cover the kind of information that securities analysts find relevant rather than working out the information needs of a mythological non-professional prospectus reader;

3. unlike in the current framework and in the Commission’s proposal, there should be no need for:
a. mandating the inclusion in the prospectus of a summary, let alone for detailing its scope, length and contents;

b. prescribing which risk factors should be highlighted and which should be omitted;

c. laying out detailed rules on how to publish the prospectus;

d. imposing any language requirement for prospectuses.

Getting rid of the seemingly minor requirements referred to under (3) would reduce issuers’ administrative costs, in addition to reducing their liability risk [ A 2008 report commissioned by the European Commission estimated the administrative costs of preparing a prospectus for equity offerings at above €900,000; unsurprisingly, the European Banking Federation’s response to the 2015 European Commission consultation on the Prospectus Directive review came up with a higher estimate, ranging from €1.8m to €2.5m for an IPO prospectus. Of course, the requirements mentioned above account for only a fraction of the costs of preparing a prospectus, but for smaller issuers even such a fraction could be a non-trivial expense.] In other words, a similar regime would be even more consistent with the goal of “mak[ing] markets work more efficiently and offer[ing] investors and savers additional opportunities to put their money at work”, as the preamble to the prospectus regulation proposal reads.

A more controversial step, and most likely a political non-starter in the present regulatory climate, would be to move away from imposing itemized disclosure and securities regulators’ pre-approval of the prospectus, based on the argument that in IPO markets there is little role to play for these regulatory tools. In fact, one may wonder what the added value is of these regulatory requirements in a system where professional buyers are used to receiving a wealth of information and will want to continue receiving it: they will simply refuse to deal with (or discount securities offered by) an issuer omitting price-sensitive information. Underwriters themselves will make sure that such information is given.

No significant change is suggested here for direct “fringe” offerings, for which the risks of unscrupulous or outright fraudulent behaviour are high enough to make disclosure requirements a useful barrier to entry. But for offerings that are exclusively placed via banks and other regulated intermediaries relying on wide customer networks a good deal of simplification should be possible: here, it is the case that no reputation intermediary is available (in the case of self-placed products) and/or that no independent and sophisticated market players are involved in the pricing of the securities. The EU should not look too far for a better solution: key information documents (KIDs) similar to those required for PRIIPs would be suitable also for other bank-placed (non-structured) securities. While views may differ on the usefulness of KIDs as a tool for retail clients’ investment decisions, a shorter document focusing on the financial instrument’s characteristics and risks would make more sense than the pointlessly bulky prospectuses currently required. The document’s focus, as hinted before, should be on the investment features that are relevant to assess whether the selling intermediary has violated conduct of business regulations, such as the suitability rule or rules on conflicts of interest, and thereby mis-sold the financial product.

To conclude, the Commission’s proposal, while overall moving in the direction of reducing compliance costs, still reflects the
misconception that disclosure regulation can help retail investors. Abandoning this misconception would allow for bolder steps in the direction of modernizing EU securities markets and facilitating capital raisings within the EU.

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*EU Prospectus Regulation: Some Out-of-the-Box Thinking*