



The Law Society

**Response of the Law Society of England and Wales  
to the Call for Evidence issued by the European  
Commission on EU Regulatory Framework for  
Financial Services**

01/2016



## **INTRODUCTION**

- 1.1. The Law Society of England and Wales ("the Society") is the professional body for the solicitors' profession in England and Wales, representing over 160,000 registered legal practitioners. The Society represents the profession to parliament, government and regulatory bodies in the UK and at EU level, and has a public interest in the reform of the law.
- 1.2. This response has been prepared by the Society's standing committee on Company Law. The Committee is made up of senior and specialist corporate and financial services lawyers.
- 1.3. The Law Society welcomes the opportunity to contribute to the call For Evidence on the EU Regulatory Framework for Financial Services (the "Consultation Paper"). We have set out below our comments on relevant sections of the Consultation Paper.

### ***Section A: Rules Affecting the Ability of the Economy to Finance Itself and Grow***

#### ***Issue 1: Unnecessary regulatory constraints on financing***

- 1.4 The Law Society does not have any comments.

#### ***Issue 2: Market Liquidity***

- 1.5 The proposed 20% limit on shares resulting from conversion or exchange of other securities in Article 1(4)(b) of the draft Commission Prospectus Regulation may cause difficulties for issuers of convertible securities, in particular for financial institution issuers (typically banks and insurers) of regulatory capital instruments with an automatic conversion feature on certain (regulatory capital-based) triggers.
- 1.6 Where there is a requirement for automatic conversion, producing a prospectus at conversion will not be feasible and thus it will be necessary to produce a prospectus on issue of the securities. To date most issuers have sought to avoid this because although the relevant instruments are debt, a prospectus for convertible securities is treated as an equity prospectus given the conversion feature, requiring, among other things an operating and financial review, a working capital statement and a statement of capitalisation and indebtedness. This may impact liquidity on relevant markets.

#### ***Issue 3: Investor and consumer protection***

- 1.7 The new summary format requirements and comparability objective introduced by Directive 2010/73/EU amending the Prospectus Directive (particularly the 'key information' concept in Article 5(2) of the Prospectus Directive) and Article 24 and Annex XXII to the Prospectus Regulation have not been helpful as they have made summaries more confusing for investors.

- 1.8 The previous requirements allowed for a more readable format. In the case of share offers, at least, investors rarely make a direct comparison between one investment and another (as each company's business growth prospects, and likely future dividends are, to an extent, unique) and including this objective does not serve a useful purpose. The proposals in the draft Commission Prospectus Regulation with respect to the summary remain too prescriptive and it is unclear how they benefit investor protection. For example, imposing a limit on the number of pages and risk factors within the summary may result in summaries that omit information that would be useful for investors when making an investment decision. Furthermore, Recital 25 provides that the summary should be modelled as much as possible on the key information document required under Regulation (EU) No 1286/2014. Many of the PRIIPS requirements are not suited to bonds or shares and investors could be confused. The requirement introduced in the draft Commission Prospectus Regulation for prospectuses to be "succinct" (recitals 21 and 48, Articles 6(1), 7(3)(b) and 14(2) could also unhelpfully reduce disclosure intended to protect investors.)

***Issue 4: Proportionality / preserving diversity in the EU financial sector***

- 1.9 The Law Society does not have any comments.

***Section B: Unnecessary Regulatory Burdens***

***Issue 5: Excessive compliance costs and complexity***

- 1.10 The Law Society gives following three examples of the excessive compliance costs and complexity relating to financial services regulation.
- 1.11 The first example concerns the Prospectus regime. The proposals in the draft Commission Prospectus Regulation for third country issuers to appoint a representative, which appears to require a financial institution to take responsibility for an issuer's compliance with the regime, is likely to add costs for third country issuers and deter them from listing in the EU, which could be damaging for EU markets and drives both non-EU issuers and in some cases other peer companies from the EU, to listing in markets outside the EU. It is unclear why the proposal has been made and what the benefits of the proposal are for investor protection.
- 1.12 The proposal in the draft Commission Prospectus Regulation with respect to ranking the materiality of risks (see Recital 48 and Article 16) is unhelpfully complex and it is unclear how it will benefit investor protection. Assessment of materiality of risks is necessarily subjective as it depends on an investor's time frame and reasons for investing – for example, for some investors the risk that an issuer ceases to pay dividends for a period will be a more serious risk than for others, who may be investing more for capital growth than for income. Therefore it is not appropriate to require the issuer to rank the materiality of risks. Under the Transparency Directive regulated market issuers are required to disclose principal risks and uncertainties and it would be better to align the prospectus requirements with this requirement.

- 1.13 The Prospectus Directive Amending Directive (Directive 2010/73/EU) introduced a Proportionate Disclosure regime for certain secondary issues, which was intended to simplify the requirements for prospectuses on these issues. This regime is little used. Reasons for this include the fact that issuers may have shareholders outside the EU and are concerned that a proportionate disclosure regime prospectus might not fully meet the disclosure requirements in non-EU jurisdictions. In particular, underwriters often have specific liability concerns regarding offerings into the United States so that the practice has grown up of underwriters requiring an issuer in effect to prepare a full prospectus, even where the relevant transaction has little or no US component. In addition, the proportionate disclosure regime does not sufficiently reduce the prospectus disclosure requirements to make a compelling case for companies to seek to make use of it. This is partly because the overriding disclosure standard under Article 5 of the Prospectus Directive still applies and is arguably not compatible with the production of shorter prospectuses. The draft Commission Prospectus Regulation introduces a revised regime for secondary issues and a revised disclosure standard. This, however, remains restrictive and is worth revisiting, particularly given that issuers with shares listed will be required to comply with disclosure requirements under the Market Abuse Regulation and Transparency Directive on a continuing basis.
- 1.14 The second example concerns the Market Abuse Directive and the standards developed by ESMA. We consider that the proposed technical advice and technical standards which have been developed by ESMA in relation to the new Market Abuse Directive ("MAR") in a number of instances place a burden on issuers which is disproportionate, costly on an ongoing basis and impractically burdensome and that insufficient thought has been given to the different position of issuers and persons in charge of managerial responsibilities ("PDMRs") compared to that of regulated firms. We believe that ESMA has also underestimated the effect of some of its proposals on issuers, PDMRs and the non-regulated advisers of issuers and that the proposals create requirements which are not needed to achieve the aims of MAR.
- 1.15 A joint working party of senior and specialist lawyers from the company law committees of the Law Society of England and Wales and of the City of London Law Society have submitted detailed comments to ESMA on the technical advice (which is now reflected in the draft Commission Delegated Regulation of 17 December 2015) and on the draft technical standards in which they have, inter alia, highlighted the items which they consider to be disproportionate and impractical. There are a number of points in these papers which, from our perspective, have not been adequately addressed and details of these are set out in the appendix to this letter.
- 1.16 According to the third and final example, under the Alternative Investment Fund Managers Directive (AIFMD), there are a number of issues which increase complexity and costs for managers.

- 1.17 In particular, a number of Member States, when acting as ‘host’ Member States, impose additional requirements, in particular initial and ongoing fees which can be substantial, on managers exercising passporting rights within their jurisdictions. These seem contrary to the Directive and the concept that an AIFM granted a passport by its home Member State should be free to market its funds across the EU. The imposition of such local requirements creates cross-border impediments to marketing.
- 1.18 Further, inconsistencies across EU member states in implementing the passporting regime has meant that fund managers can on occasion prefer to use an offshore structure and rely on private placement in favourable jurisdictions. This is an example of complexity and costs resulting in investors getting less protection than they would have done were an EU structure to have been used.
- 1.19 Additionally, although the AIFMD regime permits authorised managers to market their funds in the EU to both per se professional investors (as listed in part I of Annex II to MIFID) and elective professional investors (as listed in part II of Annex II to MIFID), there is an inherent issue in marketing funds to elective professional investors in that it can be difficult, particularly in the context of private equity, infrastructure and other long-term investments which do not involve frequent trading activity for investors to meet the quantitative test relating to transactions carried out by the investor (i.e. significant transactions on the relevant market at an average frequency of 10 per quarter over the previous 4 quarters). The effect is that, for many funds, a range of high-net worth sophisticated investors cannot be classed as professional clients: this inevitably places limits on the pool of capital from which funds can be raised. It would be helpful for the Commission to consider whether this quantitative test should be redefined to take account of different types of investment strategy, including long-term investments.
- 1.20 Further, EU AIFs are presently required to appoint a depositary which is established in the same Member State as the AIF. For AIFMs managing AIFs in a number of Member States, this makes it difficult to benefit from the economies of scale which could be achieved by having a single depositary for all its funds. It would be helpful in this context, and reduce the costs to fund managers of setting up and marketing funds across the EU, for a depositary established in the EU to be able to act as depositary for an EU AIF established in any Member State - in other words, for EU depositaries to be able to passport their services across the EU.

***Issue 6: Reporting and disclosure obligations***

- 1.21 The Law Society does not have any comments.

***Issue 7: Contractual documentation***

1.22 The Law Society does not have any comments.

***Issue 8: Rules outdated due to technological change***

1.23 The Law Society does not have any comments.

***Issue 9: Barriers to Entry***

1.24 The AIFMD, although helpful in introducing marketing and management passports for EU fund managers, has increased the costs of establishing, marketing and operating funds and has increased barriers to entry to the market and thereby reduced competition in the market.

1.25 For instance, private equity funds, which generally are not highly leveraged and invest on a longer-term basis under structures in which the investor's interests are typically aligned with those of the fund manager, are unlikely to create systemic risks.

1.26 It would be helpful for the Commission to consider, in particular, whether a more differentiated regime would be desirable. Similarly, a more tailored regime could be justified for infrastructure fund managers and managers of funds investing in other types of real assets. Lowering the barriers to entry for these types of fund managers by removing some of the more onerous requirements of the AIFMD (such as the need to appoint a depositary) should create incentives to raise larger amounts of capital for investment.

***Section C: Interactions of individual rules, inconsistencies and gaps***

***Issue 10: Links between individual rules and overall cumulative impact***

1.27 The Law Society does not have any comments.

***Issue 11: Definitions***

1.28 The Law Society does not have any comments.

***Issue 12: Overlaps, duplications and inconsistencies***

1.29 There are inconsistencies in time periods in the AIFMD which there seems to be little logic and which can be problematic.

1.30 For instance, the one month period for a competent authority to vet material changes under Article 10(2) (including taking on a new fund) and the 20 working day period to process marketing notifications under articles 31 and 32. In practice, in the context of the establishment of a new fund the material change notification and the

marketing notifications are made at the same time and it makes little sense for them to be subject to different timeframes.

1.31 We note the following with a view to simplifying legislation and avoiding inconsistencies and gaps between rules relating to different sectors:

- there is a case for using a single directive to deal with a particular subject across all sectoral directives (for instance the change of control regime introduced by the Acquisitions Directive), rather than applying provisions in a more recent directive on piecemeal basis across other relevant sectoral directives;
- there is a case to be made for substantially reducing or removing Recitals from directives, given that the level of detail now included in directives and regulations and in Level 2 regulations; Recitals only serve to add length and complexity to legislation and can introduce ambiguities.

***Section D Rules giving raise to unintended or impossible consequences***

1.32 The Law Society does not have any comments.

## APPENDIX

### A. DRAFT TECHNICAL STANDARDS UNDER MAR

#### **Appropriate arrangements, systems and procedures for disclosing market participants conducting market soundings**

The draft proposes that it should apply to all disclosing market participants (DMPs). Market soundings for (i) listed issuers or (ii) a person selling securities or (iii) a person proposing to make a takeover bid (the principal) are normally carried out by that person in conjunction with its financial adviser and its broker. This means that, as currently proposed, three different bodies will each be required to keep records and interact with the recipient of the same market sounding. The principal itself will often not be regulated by a National Competent Authority and so would not normally have a system for recording calls. The draft envisages that each DMP must use its own system for recording calls. It may be impossible to achieve this in practice.

We suggest that, where a principal proposes to conduct a market sounding with one or more other DMPs who are acting on its behalf, the Commission Delegated Regulation should state that the principal is to be treated as complying with the requirements in relation to that market sounding provided that at least one other DMP acting on its behalf has confirmed to it in writing before the market sounding that it is aware of the requirements that apply to it under the Regulation and that it will allow the principal access to its records of the procedures in relation to that market sounding kept in accordance with Article 6. This recording or written record would then be treated as being made and kept by the relevant DMPs and the principal. This would be a proportionate approach and workable in practice.

If more than one DMP would be required to keep a recording of a call with a market participant for a particular market sounding or if more than one DMP would be required to keep written minutes for a particular market sounding, the Regulation should state that a DMP will be treated as complying with the requirements if one DMP makes and keeps the recording of the call or keeps and signs the written minutes, as appropriate, and provided that all DMPs involved in the market sounding have agreed which DMP will do so and that all those DMPs will be allowed to have access to that recording or those written minutes. In that case, the identity of the DMP that is to keep the recording or keep and sign written minutes should be notified to the recipient of the market sounding. In addition, if all DMPs involved in a market sounding have agreed which DMP will notify the recipient that the inside information disclosed has ceased to be inside information and have notified the recipient of that DMP, all DMPs should be treated as having met the requirement to notify the recipient in accordance with Article 5 when that DMP notifies the recipient. This approach will also avoid the recipient having to agree more than one set of written minutes and receive more than one notification that the inside information has ceased to be inside information.



We note that ESMA has taken the view at paragraph 73 of the Final Report that the issue of joint soundings has not been considered within the mandate. We can see nothing within the Level 1 text that justifies this approach.

We also suggest that the words of the draft Recommendation "has access to recorded telephone lines" are too broad and uncertain. We think it is unclear whether the court would decide that an issuer or seller of securities who does not have a system for recording telephone calls nonetheless has "access to recorded telephone lines" either if it could have a system for recording telephone calls, if it purchased or leased a system on payment of a fee or if one of its advisers has a system for recording telephone calls.

We suggest the wording is changed to "has a system for recording telephone calls" in all relevant places.

### **Means for public disclosure of inside information**

The draft (in Article 2(1)(b)(i)) requires issuers and emission allowance market participants to identify clearly when information is inside information. The judgment of whether information is inside information is often a difficult one and issuers (and emission allowance market participants) may feel that they have to incur the costs of obtaining external advice. When advice is obtained, if the situation is complex, it may be equivocal. We do not think it is appropriate to require the party making the disclosure to indicate definitively that the information is inside information. It should be sufficient for the information to be identified as information that is or may be inside information. Participants in the relevant market (reasonable investors) will make their own determination of whether the information is useful to them.

### **Delayed disclosure of inside information**

The draft (in Article 4(1)(a)(i)) requires issuers and emission allowance market participants to keep information about the dates and times when the inside information first existed within the issuer or emission allowance participant. The issuer may not know, and may not be able to discover, this information in all cases, for example if the inside information relates to a fraud perpetrated by an employee where the issuer cannot determine when the fraud first started or where the inside information relates to a decision by a third party, such as a decision by someone with whom the issuer has a major contract to terminate that contract. Furthermore, it may be difficult for issuers and emission allowance market participants to identify when information about a developing situation became sufficiently precise or price sensitive to amount to inside information. We suggest the draft is changed to read "the issuer or emission allowance market participant first became aware of the information and determined that the information was, or may be, inside information".

The draft (in Article 4.1(a)(iii)) also requires the issuer or emission allowance market participant to keep information about the dates and times when it is likely to disclose the inside information. It will usually be very difficult to determine this information, particularly when the issuer is negotiating with a third party, for example in relation to a proposed acquisition or disposal. It is also likely that the assessment will change frequently during the negotiating process. We think it is unduly burdensome on issuers and emission allowance

participants to require them to keep this information. If, however, the Commission decides it is necessary to keep a requirement like this, at least we believe it should be changed to read "the issuer or emission allowance participant expects to disclose the inside information" so it is clear that it is their assessment of the likely timing of disclosure that is relevant.

### **Insider lists**

Most issuers and advisers will have some of the information proposed to be included in the insider list, such as date of birth, national ID numbers and personal full address as part of their HR records for employees. We think it is unnecessarily burdensome to require issuers and their advisers to duplicate this information in an insider list and suggest that, instead, the draft Regulation should allow the persons referred to in Article 2(1) to keep this information in separate HR records provided it is added to, or provided to the competent authority with, the insider list when requested. We suggest that further wording is added to Article 2 (3) to allow this as follows: "The persons referred to in paragraph 1 may keep information relating to date of birth, national ID numbers and personal full address as part of their HR records, rather than including such information in an insider list provided that such information is added to, or provided to the competent authority together with, the insider list when requested by the competent authority."

### **B. ESMA TECHNICAL ADVICE (which is now reflected in draft Commission Delegated regulation of 17 December 2015)**

- Article 7(1)(b) – this adds an additional requirement to the circumstances set out in Article 19(12) in which an issuer may allow a PDMR to trade, namely that the PDMR must be able to demonstrate that the particular transaction could not be executed at another moment in time than during the closed period. This is not something that appears in Article 19(12) and so in our view should be deleted.
- Article 9(a) – it would be very unusual for an employee share scheme (particularly one in which PDMRs may participate) to set out "the amount of financial instruments awarded or granted or the basis on which such an amount is calculated", as this would severely limit an issuer's flexibility to tailor its remuneration package to its circumstances from year to year and to comply with legal requirements such as the remuneration provisions of the Capital Requirements Directives. However, such schemes will often set out limits on the amount of rewards that can be granted to any one person and we suggested that it should be made clear that this will be sufficient.
- Article 9(b) – we suggested that in the words "which is free from specific circumstances to such an extent that any inside information that may exist cannot pay a part at the time of the award" the word "cannot" should be replaced by the words "does not" so that the test depends on what actually happens not on the possibility of what might happen.
- Article 9(c) – some schemes (particularly nil-cost option schemes) have very short exercise periods. One month is quite common. The requirement for four months' notice would mean that these options would lapse during a close period when it

might be possible for options with a longer exercise period to be exercised. There is no obvious rationale under MAR for this difference of treatment.

The requirement to agree irrevocably to exercise four months in advance – just in case the company might be in a close period on the expiry date – will produce arbitrary results. However, we suggested that, assuming that the four month notice period will not be changed, it should be made clear that, while the decision should be irrevocable by the PDMR, it would be permissible for the exercise not to occur in pre-defined circumstances and without reference to the PDMR (e.g. if the price of the shares were more than the exercise price at that time).

The giving of the notice of intention to exercise could arguably be described as a transaction in shares under Article 10(2)(b) on the basis that the notice is effectively exercise of the option – just with delayed settlement. We therefore suggested that it should be made clear that this is not the case and so that notice could be given during a closed period.

#### **FOR FURTHER INFORMATION**

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