

20 June 2005

Mr. Fabrice Demarigny
The Committee of European
Securities Regulators
17 Place de la Bourse
75082 Paris Cedex 02
France

Via email

Re: CESR's Advice on Possible Amendment to the Requirements in Commission Regulation (EC) 809/2004 Regarding the Historical Financial Information Which Must be Included in a Prospectus (Ref. CESR/05-384)

Dear Mr. Demarigny:

The Capital Markets Policy Council (the "Council") of the CFA Institute's CFA Centre for Financial Market Integrity (the "Centre")¹ is pleased to comment on CESR's *Advice on Possible Amendment to the Requirements in Commission Regulation (EC) 809/2004 Regarding the Historical Financial Information Which Must be Included in a Prospectus* (the "Consultation"). The Centre, through the experience in international markets and different investment disciplines of the 12 CFA Institute members on the Council, represents the interests of investors and investment professionals to standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis, investment management, and the efficiency of global financial markets.

General Comments

Support for the Proposed Amendment

The Council supports the efforts of the European Commission, CESR, and EU Member States with regard to the proposed amendments (the "Amendments") to the Prospectus Directive (the

¹ With headquarters in Charlottesville, VA and regional offices in New York, Hong Kong and London, CFA Institute (formerly, the Association for Investment Management and Research[®]) is a non-profit professional association of 78,000 financial analysts, portfolio managers, and other investment professionals in 119 countries of which 63,000 are holders of the Chartered Financial Analyst[®] (CFA[®]) designation. The CFA Institute membership also includes 132 Member Societies and Chapters in 52 countries and territories. The CFA Centre develops, promulgates, and maintains the highest ethical standards for the investment community including the CFA Institute *Code of Ethics and Standards of Professional Conduct*.

“Directive”) as contained in the Consultation. The issues are important to the interests of investors and require the kind of special attention CESR is giving to them.

Furthermore, the Council agrees with the determinations made from the fact-finding exercise (the “Exercise”) regarding certain situations that may require inclusion of the financial information of an entity other than an issuer of the securities (the “Issuer”) that is the subject of the Prospectus. As noted below, while the Council agrees that most of these situations may require supplemental financial information, the list is not exhaustive, and the Council provides additional examples of situations in response to specific questions.

Need for Five Years of Financial Information.

Aside from the specific situations described below concerning the information requirements for the target of a merger or acquisition (the “Target”), the Council believes investors should receive more than three years’ financial information about an Issuer and relevant third parties. In particular, the Council believes that where possible, investors should have access to up to five years of audited financial statements for the Issuer and/or its predecessor companies. In those cases in which the Issuer has not existed long enough to have five years of audited financial information, investors should have access to audited financial information for as many years as the company has them available. If the Issuer has existed for fewer than five years, then the Issuer should have to include as many years of audited financial information as is available, and include unaudited financial information for as many years as is available prior to its initial audit.

Need to Include Restated and Pro-Forma Information of Issuers and Third-Parties

The Council also urges CESR to recommend steps that ensure that the Issuer includes all restated and relevant pro-forma information of third-party entities whose information is required by this Amendment. The Council is concerned that without such a requirement some Issuers may not provide the most relevant and correct information that investors need for their investment assessments and decisions.

Information Needs of Wholesale Debt Investors

The Council reiterates the position taken by CFA Institute’s former European Advocacy Committee (“EAC”), stated in EAC’s letter to CESR on the Directive’s information requirements for wholesale debt investors.² Specifically, the Council supports the position that investors in wholesale debt have similar information needs as investors in debt with smaller denominations and supports EAC’s justification of this view:

“Just because investors can make larger investments does not imply that they are necessarily aware of all of the issues affecting specific securities. Given the larger investment amounts, it is imperative that they receive the same amount and types of information they can expect from smaller issuers.”

Specific Defined Terms

Finally, for the purpose of this response the Council makes the following distinction between “Financial Statements” and “Financial Information.” Financial Statements will refer only to

² http://www.cfainstitute.org/advocacy/pdf/03CESR_Directive.pdf

traditional statements of operations and cash flow, balance sheets, and notes to these financial statements. This includes audited and unaudited versions of these statements as circumstances warrant.

Financial Information, on the other hand, will relate to all other types of reports as needed on a case-by-case basis. Included in this category are performance measures relating to securitization pools, collateral descriptions, and other specialized information.

Specific Comments

3.1 Amendment of Commission Regulation (EC) 809/2004 in order [to] ensure that a prospectus includes the historical financial information which is necessary to enable an investor to make an informed assessment of the issuer and securities in question.

(3.1a) In what kinds of cases might it be necessary for a prospectus to include historical financial information relating to legal entities other than the issuer?

In general, the Council believes such information is needed whenever it is required to enable investors to make informed decisions. As described below, these circumstances differ as a function of the type of securities offered, support provided, linkages between entities, market circumstances and other relevant factors relating to a specific offering of securities.

(1b) Do all the kinds of cases considered in CESR's fact-finding exercise on this topic require the inclusion of such information in a prospectus?

CESR's Exercise indicated five primary examples in which investors would need information beyond the financial information required of the Issuer in a prospectus. The Exercise described five situations in which companies with "complex financial histories" should provide financial disclosures relating to a third-party entity, specifically where the Issuer:

- is a newly incorporated holding company inserted over an established business;
- consists of companies that were under common control or ownership but which never formed a legal group;
- has made a significant acquisition (representing 25% or more of the group) during the three-year historical record or subsequent to the last audited consolidated financial statements on the Issuer, including specific reference to cases where the Target has different accounting policies;
- has disposed of a significant part of its business since the last audited accounts; or
- has changed its accounting reference date during the three-year period.

In the following paragraphs, the Council answers the question as it pertains to different groups of entities described in the Exercise.

Holding Companies and Groups

Those situations where the Issuer is a new or existing conglomeration of affiliated and established companies would certainly require inclusion of information about the subsidiary/group entities. In part this is a result of existing accounting rules relating to mergers and acquisitions in most major financial markets. These rules generally require companies to use the purchase method if a newly formed holding company or group were to acquire a number of existing entities. Under the purchase method, a business combination does not restate prior-years' Financial Statements of the parent company (the "Parent") and the Target(s) to make it appear that the entities were combined prior to consummation of the merger or acquisition. Rather the combination of the companies' Financial Statements begins the day of consummation.

As a result of these accounting rules, a newly formed group or holding company structure that is now the Issuer will not have a track record of consolidated operations dating back five years. In such a case, investors would need to review the historical Financial Statements of the separate entities to determine whether the group as a whole has sufficient and viable financial operations and resources to enable the combined entity to generate adequate returns on their investments.

Moreover, as the Parent is new, it is likely that the Issuer is completely or nearly completely reliant on the operations of the affiliated or subsidiary companies for its financial position and performance. Consequently, investors would need to see the historic Financial Statements of subsidiaries or affiliates to understand the prospects for the Issuer.

Finally, investors would benefit from seeing the Financial Statements of affiliated companies regardless of whether they are members of an established group or holding company if they are linked with regard to operations, financing, ownership, and liability. This is particularly the case if the companies are each jointly and severally liable for the obligations of the others.

Mergers and Acquisitions

Definition of Substantial. In general, this question asks how significant an acquisition must be to the business of the Issuer/acquirer for it to warrant a requirement that the Issuer/acquirer must include the historic financial information of the Target in a prospectus. In the Consultation, CESR suggests that this point is crossed when the Target accounts for "more than 25% of the group." However, the Consultation does not specify whether the 25% relates to a percentage of revenues, assets, net shareowners' equity, or outstanding shares.

In general, the Council believes that a "bright-line" number such as 25% of any of the above-mentioned measures would not capture the real purpose for including such information. Indeed, in the past companies have made acquisitions in which the Target accounted for as little as 12% of total assets, but ultimately led to the failure of the Issuer.³

Consequently, the Council suggests that CESR state that the Issuer should provide the Financial Statements and Financial Information of the Target when the transaction noticeably alters the Issuer's business or risk structure. However, if CESR ultimately chooses to include a bright-line percentage, the Council believes it should lower that number to no more than 10%.

³ For example, Consecro Inc. reported \$35.9 billion in assets prior to its acquisition of Green Tree Financial Corp. and its \$5.3 billion in high-risk loan assets in June 1998. The acquisition was a significant reason for Consecro's bankruptcy in December 2002.

How Many Years of Target's Information to Include. The Council believes that the relevance of a Target's pre-acquisition information is greater the closer the prospectus is to the deal's consummation. In this view, the Financial Statements of a Target that was acquired more than two years ago will have less relevance to an investor today than if the acquisition occurred more recently. The reason is that the stand-alone Financial Statements of the Target will provide less useful information about the future capabilities of the combined entities two or more full years after the acquisition than the current consolidated Financial Statements of the combined companies will.

Conversely, if the acquisition were completed 18 months ago, investors could not rely solely upon the Financial Statements of the Issuer/acquirer or the combined entities to assess future performance. This is because it is likely that it would take the Issuer/acquirer a few months to make important decisions about how to manage the Target and how to integrate it with existing operations, issues that the first year's audit would only partially reflect. It is only after the Issuer has published audited financial statements covering at least one full year of combined operations — which will likely require two full audit cycles to achieve⁴ — can investors begin to rely on the combined Financial Statements as an indication of how the two companies will perform in the future.

On the basis of these arguments, the Council suggests that CESR require audited Financial Statements about the Target until the Issuer/acquirer can include at least two years of audited operations of the combined companies within the Prospectus.

Divestitures

The Council advises that considerations and information requirements similar to those relating to mergers and acquisitions also apply in the case of divestitures. This is because investors will need to determine what portion of the Issuer/seller's Financial Statements was related to the sold entity. For example, if the Issuer and the divested entity engaged in activities that were sensitive to different parts of the business cycles, the Financial Statements of the divested company would help investors in the Issuer's securities determine how the sale might affect cyclical volatility in the future. Likewise, if the sold entity financed the Issuer's sales, investors could use the divested entity's Financial Statements to assess the affect the divestiture would have on the Issuer's future revenues and profitability.

If the Issuer is the sold entity, investors also would benefit from seeing the Financial Statements of the seller. This would enable them to determine how much of the Issuer's business came from its former Parent.

Different Accounting Reference Date

Finally, the Council does not see why investors would need to see the Financial Statements or other Financial Information of another entity solely because an Issuer has changed its accounting

⁴ The Issuer/acquirer's initial audited Financial Statements published after consummation would represent consolidated operations for only a portion of a full year and, therefore, would not give an accurate picture of the manner in which the two companies will operate jointly.

reference date. Five full years of audited Financials Statements of the Issuer should provide sufficient information to permit investors to make appropriate decisions.

If the Issuer's revised its accounting during the five-year period, then it should provide restated Financial Statements for as much of the period as possible, together with unadjusted Financial Statements for the remainder of the period. The Issuer should prominently include notice that the unadjusted information does not adhere to current accounting rules.

(1c) Are the examples of an issuer with a complex financial history considered in that fact-finding exercise a comprehensive list, or is it possible that information relating to legal entities other than the issuer might also be required in other cases?

The Council agrees that the types of Issuers described by the Exercise represent many of the cases in which Financial Statements or Financial Information about entities other than the Issuers are needed in a prospectus. Nonetheless, the Council also believes that there are situations other than those discovered in the Exercise that would warrant the inclusion of information about other companies in a prospectus.

Special-Purpose Entities

One such situation is when the entity controls and uses special-purpose entities or vehicles ("SPEs"). Current accounting standards applicable to companies based in E.U. Member States and in some of the biggest financial markets elsewhere require companies that create and sponsor SPEs (the "Sponsors") to consolidate such entities into their Financial Statements. Under these rules, investors' in many Issuers with SPEs already will have access to much of the information they need about these entities through the Sponsor's consolidated Financial Statements.

However, not all markets require SPE consolidation. Companies that adhere to U.S. GAAP, for example, only have to consolidate such entities under certain conditions. In these cases, investors would benefit from seeing the Financial Statements and other Financial Information of the SPE as a supplement to the Sponsor's Financial Statements.

Even if the Issuer consolidates the SPE into its own Financial Statements investors would still benefit from inclusion of certain Financial Information about a sponsored SPE in a prospectus. For example, if the SPE were engaged in the securitization of loans or other financial assets, static pool performance data related to losses, delinquencies, prepayments, servicing costs, and income of the SPE would provide indications of trends in both the SPE's financial condition and the underwriting quality of the Sponsor/Issuer.

Moreover, because the Sponsor/Issuer is bound either contractually or by moral suasion—if the Sponsor/Issuer will need to return to the market for future financing—to ensure the credit rating of the SPE, it may take actions detrimental to owners of certain of other securities to secure the SPE's securities. Consequently, investors need access to this type of Financial Information about the SPE to enable them to understand the risks they bear as a result of the Issuer's securitization activities.

If the Issuer is the SPE, itself, investors in its securities would benefit from having access to the Financial Statements of the company managing the collection and distribution of cash flows on behalf of the SPE (the “Servicer”). While the financial and legal ties between the SPE and the Servicer often are contractually and legally limited, the SPE and its investors must rely solely upon the collections on the loans in the pool for interest and principal payments on the securities. The bankruptcy of the Servicer, therefore, could significantly affect an SPE’s investors’ returns.

Another example would be an SPE that is engaged in some activity other than the securitization of finance receivables. In such a case, investors certainly would benefit from seeing Financial Statements of the SPE. Based on the recent historical experience associated with Enron and its SPEs, these entities can have profound affects on the Sponsor’s financial condition.

Structured Finance Products

Structured finance products such as collateralized debt and loan obligations typically involve an investment manager (the “Manager”) whose financial condition and performance can affect investment returns in the same way that a Sponsor’s or Servicer’s finances can affect investors in securitizations. Financial Statements about the Manager would give investors insights into whether the Manager has the financial resources needed to perform its duties as required, and may also provide information about any conflicts of interest that may arise as a result of its role with the fund.

In general, it is unlikely that investors will need to see the financials of the fund sponsor unless it also serves as Manager or provides some guarantee on behalf of the fund. Financial Information about the ownership structure of such entities, however, would give investors important information they need to make investment decisions.

Joint Ventures

Investors in Issuers who rely heavily on the operations of joint ventures will need to see the Financial Statements for that venture. This is particularly important because most such joint ventures are private entities whose securities are not listed on a regulated market and whose information is not available anywhere else. For these same reasons, the Council believes the prospectus also should include the Financial Statements and Financial Information of the joint venture partners, to supplement those of the joint venture and the Issuer.

Subsidiaries or Group Companies

Investors in securities issued by a subsidiary or member of a group would benefit from seeing the Financial Statements of both the Parent and the subsidiary or group member. Such information would provide insights into the ability and willingness of the Parent to not only support the subsidiary/group member, but also whether the Parent poses any risks to the subsidiary. For example, if the Parent has control over the financial condition and performance of the subsidiary, or the subsidiary/group member is jointly and severally liable for the debts of the Parent, the Parent’s bankruptcy or impairment could affect not only the credit rating of the subsidiary, but also the resources that are available to service the Issuer’s securities.

Likewise, investors in the securities offered by the parent company would benefit if they were provided information about important unconsolidated subsidiaries. The finance company

subsidiary of a large automobile manufacturer, for example, is often an important part of the marketing and distribution, not to mention financing, of retail automobile sales. Access to the Financial Statements and Financial Information of such a subsidiary, if not already consolidated with those of the Parent, would provide important information that could help investors determine whether they should buy the relevant securities and, if so, at what price.

(2) Taking into account the “building-block” organisation of the Regulation and the objective of proportionate regulation, would it be appropriate to take a different approach in relation to different kinds of securities?

As stated in our original response to the CESR’s consultation on the Prospectus Directive (http://www.cfainstitute.org/advocacy/pdf/03CESR_Directive.pdf), investors in company-specific equity, debt, and derivative securities all rely on similar Financial Statements and Financial Information of the Issuer and supplementary entities. It is imperative, therefore, that all investors in such company-specific securities receive this type of information, regardless of whether it is required as an amendment to existing building blocks or as a stand-alone amendment applicable to all building blocks.

The only exception to this argument relates to investors in Issuers that also act as Sponsors of SPEs. As described above, investors in securities with these characteristics would benefit from a specific type of Financial Information relating to the performance of the SPE’s pool of assets.

(3) Define what historical financial information must be included in a prospectus relating to securities the issuer of which has a complex financial history, taking into account the necessity of balancing investor protection with the need to avoid imposing unjustified costs on issuers, as competent authorities currently have the flexibility to do?

The following sections describe the type of information that is needed to supplement the information about the Issuer in each situation.

Mergers and Acquisitions

As stated in response to Question 1a above, investors will need the latest Financial Statements of the target company until the combined company is able to publish at least two full year’s worth of audited consolidated Financial Statements. After that, the more relevant information would relate to the surviving company. Specifically:

Time since merger or acquisition	Less than one year	One to two years	Two to three years	Three of more years
Information needed	- Consolidated Financial Statements for the combined companies on the date of consummation - Three years of audited Financial Statements for both acquirer and target - Unaudited interim Financial Statements for combined company, and comparable periods for acquirer and target	- Audited Financial Statements of combined company for latest year; - Audited Financial Statements of acquirer and target for two years prior to transaction - Unaudited interim Financial Statements for combined company, and comparable period from prior year for acquirer and target	- Audited Financial Statements of combined company for two latest years - Audited Financial Statements of acquirer for latest year prior to transaction - Unaudited interim Financial Statements for combined company and comparable period from prior year	- Audited Financial Statements of combined company for as many years as is available - Audited Financial Statements of acquirer for the number of years needed to have five years of audited financial information - Unaudited interim Financial Statements for combined company and comparable period from prior year

SPEs

As noted above under Question 1c, investors in the securities of Issuers that sponsor SPEs associated with a securitization of finance receivables will benefit from having access to five years of static-pool loss, delinquency, prepayment and income performance information related to those SPEs. If the SPE is associated with some other form of off-balance sheet activity, investors will need to have access to the Financial Statements related to that SPE for the full five-year period.

Investors in the securities issued by an SPE also would benefit from audited Financial Statements for three years on the Servicer in addition to the Financial Statements and other Financial Information about the SPE.

Structured Products

Investors in these securities need five years of audited Financial Statements about the Manager as a supplement to the Financial Statements and other Financial Information about the fund.

Joint Ventures

For investors in securities of companies with significant joint venture activities, five years worth of audited Financial Statements of the venture and of the joint venture partner are needed.

Securities of Subsidiaries/Group Members

Investors in securities issued by a subsidiary or member of a group or holding company would need five years of Financial Statements for both the Issuer and the Parent, or the Parent and important unconsolidated subsidiaries or group members.

3.2 Possibility of an exemption for small and medium-sized enterprises

(1a) Whether any amendment recommended in accordance with 3.1 above should apply in relation to all issuers, irrespective of their size and the nature of their business.

CFA Institute has long held that investors have similar information needs regardless of the size or nature of the Issuer's businesses, or the locations of its headquarters or exchange listing, or any other qualification. If the information is not adequate, whether by omission or exemption, investors will have to make decisions based on insufficient information and, ultimately, they and their clients could incur losses.

While the Council recognizes the hardship such supplementary information may have upon small and medium-sized enterprises ("SMEs"), it also believes that investors need this information to adequately understand the risks and burdens associated with such enterprises. Indeed, in many cases the information is more important in the case of SMEs because of limitations these entities have with regard to access to capital, new revenue sources, new sales markets, and specialized management expertise.

Consequently, the Council believes that all Issuers should adhere to the same disclosure requirements.

(1b) Whether an exemption from the requirements, or any part of the requirements, relating to historical financial information for small and medium-sized enterprises (as defined in Article 2(1)(f) of the Prospectus Directive) would compromise the investor-protection objectives of the Directive.

Please see the Council's response to the immediately preceding Question 1a for our response to this Question 1b.

Closing Remarks

The CFA Centre for Financial Market Integrity and its Capital Markets Policy Council appreciate the opportunity to provide comment to CESR's *Advice on Possible Amendment to the Requirements in Commission Regulation (EC) 809/2004 Regarding the Historical Financial Information Which Must be Included in a Prospectus*. If you or your staff have questions or seek

amplification of our views, please feel free to contact James C. Allen, CFA, by phone at +1.434.951.5558 or by e-mail at james.allen@cfainstitute.org.

Sincerely,

/s/ Frederic P. Lebel

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