European Business Organization Law Review 7: 501-523 501
© 2006 T.M.C.ASSER PRESS DOI10.1017/S1566752906005015

The Prospectus Approval System

Pierre Schammo*

1. Introduction ... 502
2. The regulatory nature of the prospectus approval system ... 503
2.1 The prospectus approval, an *ex ante* enforcement system ... 504
2.1.1 The characteristics of an *ex ante* enforcement system ... 504
2.1.2 The approval system as envisaged under the Prospectus Directive ... 505
2.2 The limits of the prospectus approval system ... 508
3. The purpose of the prospectus approval system: a critical examination ... 511
3.1 Mandatory disclosure, the prospectus approval system and the quality of disclosure ... 511
3.1.1 The disclosure quality question in the context of a mandatory disclosure regime ... 511
3.1.2 The approval system as envisaged under the Prospectus Directive, an element in the 'quality enforcement chain'? ... 515
3.2 The prospectus approval system from the perspective of the recipients of the approved prospectus ... 517
3.2.1 The prospectus approval system from the perspective of the investor ... 517
3.2.2 The prospectus approval system from the perspective of the issuer ... 521
4. Conclusion ... 522

Abstract

Under the provisions of the Prospectus Directive, the publication of a prospectus for an offer of securities to the public, or an admission of securities to trading on a regulated market, is subject to the prior approval of the prospectus by the competent authority of the issuer's home Member State. This article examines the approval system as envisaged under the Directive. The aim is two-fold. First, the article conceptualises the approval system as a regulatory instrument. By studying the provisions relating to the prior approval in the Prospectus Directive, and by drawing on the literature on regulation, the approval system will be conceptualised as an ex ante *enforcement system. Second, the article examines*

* D.Phil. candidate at the University of Oxford (Magdalen College), LL.M. (Leiden), maîtrise en droit (Strasbourg III). I wish to thank Guido Ferrarini, Hubert Grignon Dumoulin, Georges Carton de Tournai, Karel Lannoo and my supervisors Stephen Weatherill and Joseph McCahery for helpful comments on earlier drafts.

the approval system critically as an investor protection measure and as a risk reduction strategy for issuers. Proceeding on the premise that in order to justify the prior approval, the approval system must not only improve upon the quality of disclosure but that this improvement must matter if considered from the perspective of the recipient of the approved prospectus, the benefits and costs of the prior approval will be assessed for investors and issuers. These two points will be developed hereunder by examining in turn the regulatory nature and the purpose of the approval system.

Keywords: Prospectus Directive, prospectus approval, disclosure regulation, public offer, admission to trading on a regulated market, enforcement, supervision.

1. INTRODUCTION

One of the cornerstones of the European Union's regulatory strategy for the creation of a single securities market is the Prospectus Directive (hereinafter, PD).[1] The Directive, which Member States had to transpose into national law by 1 July 2005, determines the prospectus disclosure requirements for issuers of securities which are to be admitted to trading on a regulated market or to be offered to the public. The PD replaces two disclosure directives: (i) the Listing Particulars Directive – integrated with the Admission Directive, the Interim Reports Directive and the Substantial Shareholdings Directive in the Securities Consolidation Directive – which set out disclosure requirements in relation to an admission of securities to official listing and (ii) the Public Offers Directive which covered disclosure requirements in relation to an offer of securities to the public.[2]

One of the distinguishing characteristics of the PD – certainly in comparison to its predecessors – is its 'maximum harmonisation' approach in relation to disclosure requirements. A Commission Regulation thus supplements the framework disclosure principles provided for under the Directive by more detailed information schedules which set out the disclosure items that issuers have to comply with if they wish to apply for admission of their securities to trading on a regulated market or if

---

[1] Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, *OJ* 2003 L 345/64.

[2] Directive 2001/34/EC of the European Parliament and of the Council of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities, *OJ* 2001 L 184/1; Council Directive 89/298/EEC of 17 April 1989 coordinating the requirements for the drawing-up, scrutiny and distribution of the prospectus to be published when transferable securities are offered to the public, *OJ* 1989 L 124/8.

they wish to offer their securities to the public.[3] Maximum harmonisation in this context means that Member States/national authorities are deprived of the discretion to request that prospectuses include information items additional to those of the Commission Regulation. With the PD now supposed to be transposed into the national laws of the Member States, attention turns increasingly to the day-to-day enforcement of the disclosure requirements at national level. This article focuses on the enforcement of disclosure obligations and, in particular, on the approval of prospectuses by national authorities. Under the provisions of the PD, prospectuses are subject to prior approval by the competent authority of the issuer's 'home' Member State (as defined in Art. 2(1)(m)) before they can be published and the securities can be admitted to trading on a regulated market or offered to the public. The aim of this article is to conceptualise the approval system as a regulatory instrument and to examine it critically by adopting a law and economics lens. In order to do so, the regulatory nature of the approval system will be examined first (section 2). It will be argued that under the PD the approval system is best viewed as an *ex ante* enforcement system. Next, the effectiveness of the approval system will be assessed by examining critically its purpose (section 3). While the costs of the approval system are in theory relatively straightforward to determine, it will be shown that the benefits of providing for prior approval by national authorities are far less straightforward to ascertain. Adopting a law and economics perspective, this article will consider the cost and benefits of the prospectus approval for professional and ordinary investors and for issuers. The findings will be summarised in the conclusion (section 4).

2. THE REGULATORY NATURE OF THE PROSPECTUS APPROVAL SYSTEM

'Regulation' is a term which is often stripped of any precise meaning.[4] In the absence of any accepted definition,[5] 'regulation' may thus be understood as referring either to 'rule-making' in a narrow sense or to market regulation in its widest sense. Hereunder, I refer to 'regulation' in its widest sense. This article argues that the prior approval of prospectuses by national authorities is best

---

[3] Commission Regulation (EC) No. 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements, *OJ* 2004 L 149/1 (hereinafter, Commission Regulation).

[4] C. Harlow and R. Rawlings, *Law and Administration* (London, Butterworths 1997) p. 295.

[5] A. Ogus and C. Veljanovski, *Readings in the Economics of Law and Regulation* (Oxford, Clarendon Press 1984) p. 233; R. Baldwin and M. Cave, *Understanding Regulation – Theory, Strategy, and Practice* (Oxford, Oxford University Press 1999) pp. 1-2; R. Baldwin, C. Scott and C. Hood, *A Reader on Regulation* (Oxford, Oxford University Press 1998) p. 2.

understood as a form of entry regulation and as such as an element of market regulation. More specifically, it will be argued that under the PD the approval system is best viewed as an *ex ante* enforcement system. Having examined it as an *ex ante* enforcement system (2.1), the limits of the approval system, as envisaged under the Directive, will be discussed (2.2).

2.1 The prospectus approval, an *ex ante* enforcement system

The characteristics of an *ex ante* enforcement system will be identified first (2.1.1), after which the approval system, as envisaged under the PD, will be examined in the light of these findings (2.1.2).

2.1.1 *The characteristics of an* ex ante *enforcement system*

An *ex ante* enforcement system can be described as a system in which compliance with a set of requirements is reviewed by a regulatory authority *before* a product or an individual is allowed to enter a regulated market or a regulated sphere of activity.[6] The compliance technique consists in denying the product or the individual access if the product/individual fails to satisfy the regulatory requirements.[7] In other words, by making access to the market subject to prior approval, a regulatory authority seeks to enforce compliance with regulatory requirements *ex ante*. A licensing mechanism can be cited as an example of an *ex ante* enforcement system. By making provision for a product or a professional activity to be subject to a license, an authority ideally aims at making sure that only products or individuals that comply *ex ante* with a minimum level of quality or a level of competence enter the regulated market or sphere of activity. However, because the entry to the regulated market or activity is conditional, an *ex ante* enforcement system raises a number of cost issues which cannot be ignored. The prior approval thus gives rise to administrative costs borne by the authority in charge of policing compliance. Any delay before approval is granted may also give rise to opportunity costs for the applicant.[8] Finally, the costs for applicants (or the society as a whole) may be compounded in cases where the regulatory authority lacks resources or expertise, or where it is corrupt.[9]

---

[6] See A. Bhagwat, 'Modes of Regulatory Enforcement and the Problem of Administrative Discretion', 50 *Hastings Law Journal* (1999) p. 1275 (discussing *ex ante* and *ex post* enforcement systems).

[7] Ibid., at p. 1283.

[8] A. Ogus, *Regulation – Legal Form and Economic Theory* (Oxford, Clarendon Press 1994) p. 214 (highlighting administrative and opportunity costs in the context of a licensing system).

[9] S. Djankov, R. La Porta, F. Lopez-de-Silanes and A. Shleifer, 'The Regulation of Entry', 1 *The Quarterly Journal of Economics* (2002) p. 1 (on the relation between entry regulation and corruption).

2.1.2 *The approval system as envisaged under the Prospectus Directive*

Under the provisions of the PD, the prospectus approval shares the characteristics of an *ex ante* enforcement system. The prior approval by the competent authority is thus a *sine qua non* for the publication of the prospectus and hence the admission of securities to trading on a regulated market or the public offer.[10] Article 13(1) provides that '[n]o prospectus shall be published until it has been approved by the competent authority of the home Member State',[11] a requirement which applies equally to prospectus supplements pursuant to Article 16(1). The relation between the publication and the offer to the public or the admission to trading on a regulated market is clarified under Article 3(1) and (3). The former states 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', while the latter provides that 'Member States shall ensure that any admission of securities on a regulated market situated or operating within their territories is subject to the publication of a prospectus'. The obligation to obtain the authority's approval is a positive requirement in that the failure by the competent authority to provide a decision regarding the approval within the time limits provided for under Article 13 of the Directive is not deemed to constitute approval of the prospectus.[12] The prospectus approval system also raises cost issues typical of an *ex ante* enforcement system. Besides the administrative costs of policing compliance, the prior approval may thus also give rise to opportunity costs for issuers because of delays before approval is granted.[13]

---

[10] PD, Arts. 3(2), 4(1) and 4(2) set out a number of exceptions to the obligation to publish a prospectus.

[11] Two points are worth noting. First, Art. 5(3) states that a prospectus may either consist of a single document or be composed of separate documents (a registration document which includes the information regarding the issuer, a securities note which includes the information on the securities to be offered to the public or admitted to trading on a regulated market and a summary note). Pursuant to Art. 12(2), if the registration document has been approved earlier, the securities and the summary notes are subject to a separate approval. Second, in the case of programmes (e.g., MTN programmes), Art. 5(4) allows issuers to make use of a 'base prospectus' 'containing all relevant information concerning the issuer and the securities offered to the public or to be admitted to trading on a regulated market'. Art. 5(4) further provides that in cases where the final terms of the offer are not included in the base prospectus they 'shall be provided to investors and filed with the competent authority when each public offer is made as soon as practicable and if possible in advance of the beginning of the offer'. Interesting to highlight for the present purposes is that, while the base prospectus and any prospectus supplements are subject to the competent authority's approval, Rec. (21) of the Commission Regulation makes explicit that 'where the final terms are not included in the base prospectus they do not have to be approved by the competent authority'.

[12] PD, Art. 13(2).

[13] Admittedly, Art. 13(2) and (3) now provides for time limits within which an authority has to inform the applicant of its decision. Yet, *a priori*, these limits are of limited import. Art. 13(4) provides that if a competent authority considers that the information is incomplete or that

While the prior approval of prospectuses can be described as a means for authorities to police and enforce compliance with disclosure requirements *ex ante*, the *manner* in which authorities determine such compliance has to be examined more closely. Consider Article 2(1)(q). According to this article, approval means 'the positive act at the outcome of the scrutiny of the *completeness* of the prospectus by the home Member State's competent authority including the *consistency* of the information given and its *comprehensibility*' [emphasis added]. By defining the approval along these lines, Article 2(1)(q) attempts to harmonise prospectus review practices, the extent or the scope of which varied among Member States in the past.[14] At the time of the negotiations of the Directive, practices thus included 'box-ticking' approaches (i.e., a formal review of whether all the information items provided for by law or regulation are included in the prospectus) but also thorough and lengthy reviews of the substance of the information disclosed under each information item. Different review practices among Member States have attracted much attention over the years, notably because they were viewed as having a negative impact on market integration. Recital 30 of the PD states, for instance, that

> [d]ifferences regarding the efficiency, methods and timing of the checking of information given in a prospectus not only make it more difficult for undertakings to raise capital or to obtain admission to trading on a regulated market in more than one Member State but also hinder the acquisition by investors established in one Member State of securities offered by an issuer established in another Member State or admitted to trading in another Member State.

Some of the differences between Member States testify to deep-rooted differences over market regulation and how to best ensure compliance at the *ex ante* stage. For instance, at the heart of the UK approach to ensuring full disclosure has long been a market professional, the so-called 'sponsor'. Sponsors are regulated by the UK Listing Authority, which is part of the Financial Services Authority. The sponsor regime has long differentiated the United Kingdom from most other Member States. Arguably, the sponsor regime is best understood as a recognition

---

additional information is required the limits 'apply only from the date on which such information is provided…'. Arguably, an authority can thus always disable the time limits by requesting additional information, although, admittedly, there is a safeguard. Under the PD, the whole process is subject to a 'reasonable grounds' condition. In other words, an authority has to find on 'reasonable grounds' that the documents are incomplete or that supplementary information is required.

[14] According to the Commission the review practices ranged 'from a simple verification that a document has been sent to the competent authority, without reading the document, to an extensive verification of the clearness, the objectivity, accuracy and consistency of the prospectus on all items of information, including the financial statements'. Written Question E-1874-03 by Christopher Huhne to the Commission, *OJ* 2004 C 65E/97.

of the limits of what a regulatory authority with limited resources, time and expertise can achieve or be expected to achieve at the *ex ante* stage.[15]

The manner in which authorities scrutinise prospectuses prior to deciding upon their approval is obviously important for assessing the effectiveness of the approval as an *ex ante* enforcement instrument. This point will be addressed more fully in section 3. For now, I content myself with describing the review process as part of my effort to describe the regulatory nature of the approval system. Consider Article 2(1)(q) again. If considered in isolation, the compromise wording of Article 2(1)(q) is of limited importance. Admittedly a 'box-ticking' approach is now ruled out. Under Article 2(1)(q), authorities have to examine the content of the disclosure before deciding upon approving a prospectus. However, the wording of Article 2(1)(q) is ambiguous. Consider the meaning of the 'consistency' of the information. The extent of an authority's obligation to verify the consistency of the information is not specified under Article 2(1)(q). Hence, it is not clear whether pursuant to Article 2(1)(q) authorities are only required to verify that the prospectus is internally consistent,[16] or whether authorities are required to check that the information given in the prospectus is consistent with information outside the prospectus (e.g., information provided previously by the issuer or supplied by third parties). *A priori*, similar questions can be raised in respect of methods of evaluation. Adopting a wide reading, one could thus talk of the review of the internal consistency of the information (instead of the internal consistency of the prospectus) and debate whether authorities have to examine whether the methods employed are consistent if examined over time or whether they are consistent with the methods employed by issuers in the same sector of activity. The obligation to verify the 'comprehensibility' of the information is equally vague. The perspective which a regulatory authority adopts with regard to investor protection (e.g., ordinary investor or professional investor perspective) seems to be a likely determining factor in this context. Finally, the meaning of the 'completeness' of the prospectus is also ambiguous, as it can be interpreted differently depending on whether one adopts a literal reading or rather a principle-based reading. For instance, there is no doubt that, as part of the authority's obligation to scrutinise the completeness of the prospectus, an authority has to examine whether all the disclosure requirements have been complied with. But what is the precise extent of an authority's obligation to scrutinise the completeness of the prospectus? Some omissions may be apparent on the face of the documents and an authority will have no difficulty in identifying such omissions. Other omissions, however, may only be detected after a more thorough examination.

---

[15] It is worth noting that as part of the recent review of the UK Listing Rules, the sponsor regime and the role of the sponsor have also been reassessed.

[16] Whether, for instance, the information given on p. 5 of the prospectus is consistent with the figures disclosed on p. 50.

Indeed, some omissions can simply not be detected, unless an investigation akin to a due diligence is undertaken. Article 2(1)(q) leaves these questions unresolved. This is not to say that these questions should have been addressed in the PD. Indeed, the PD is a framework directive. For now, the relevant point is simply to note that, if viewed in isolation, Article 2(1)(q) levels the playing field only to a modest extent.

Admittedly, the actions of the Committee of European Securities Regulators (hereinafter, CESR) and the European Commission are important to highlight in this context. The recent level 2 and 3 measures thus matter because they detail the information requirements and provide additional recommendations to issuers and authorities.[17] Yet, the level 3 measures are only recommendations and Member States apply them on a voluntary basis.[18] Moreover, authorities are not exempted from taking a stand on the information provided when deciding whether or not the prospectus is complete and the information is consistent and comprehensible. In the future, the exact content or extent of an authority's obligation to scrutinise the content of the prospectus may be further specified. Article 2(4) of the PD provides that the Commission may take implementing measures in relation to the definitions set out in Article 2(1). CESR's level 3 actions may also prove important in the future. In relation to the enforcement of standards on financial information for instance, CESR has taken initiatives.[19] Yet, it is also important to recognise that discretion at national level is entirely desirable. A 'one-size-fits-all' approach is indeed difficult to justify in the light of differences between markets, investors, products and issuers.

2.2 The limits of the prospectus approval system

So far, it has been argued that the approval system is a regulatory instrument and that under the PD it is envisaged as an *ex ante* enforcement system. The compliance with the disclosure requirements is determined by scrutinising the *content* of the prospectus and more specifically the completeness of the prospectus, including the consistency and comprehensibility of the information. In this section, the limits of the approval system will be examined more closely. At the risk of stating

---

[17] Commission Regulation, op. cit. n. 3; Committee of European Securities Regulators, 'CESR's recommendations for the consistent implementation of the European Commission's Regulation on Prospectuses n° 809/2004' (Ref. CESR/05-054b, February 2005), available at: <http://www.cesr-eu.org> (hereinafter, CESR's Recommendations).

[18] CESR's Recommendations, op. cit. n. 17, at p. 5.

[19] Committee of European Securities Regulators, 'Standard No. 1 on Financial Information – Enforcement of Standards on Financial Information in Europe' (CESR/03-073, March 2003), available at: <http://www.cesr-eu.org> (hereinafter, Standard No. 1); Committee of European Securities Regulators, 'Standard No. 2 on Financial Information – Coordination of Enforcement Activities' (CESR/03-317c, April 2004), available at: <http://www.cesr-eu.org> (hereinafter, Standard No. 2).

the obvious, the prior approval by the issuer's home authority is at the heart of the approval system. By examining the definition of approval in Article 2(1)(q), the limits of the approval system, as envisaged under the Directive, will be traced.

First, under the PD the prior approval by authorities is not envisaged as a means for ascertaining the truthfulness of the information to be disclosed to the market. Article 2(1)(q) defines the approval as the positive act at the outcome of a review of the completeness of the prospectus, including the consistency and comprehensibility of the information. It follows that prior to deciding upon the approval, authorities are not required to examine whether the information disclosed in the prospectus is indeed true. It is easy to see why making provision for an authority to examine the truthfulness of the information would raise considerable difficulties in practice. While authorities may require additional explanations or documents when reviewing a prospectus,[20] at the *ex ante* enforcement stage, authorities arguably face a dilemma between trying to prevent wrongdoing by a low-quality issuer and ensuring that transactions by high-quality issuers are not hampered by excessive delays. What is problematic at the *ex ante* stage is, however, to detect potential inaccuracies (including potential omissions) within a limited period of time and on the basis of the documents that an authority is provided with (save, of course, for apparent inaccuracies which an authority may detect on the face of the documents). *Ex post*, once the harm is done, or bad news which was not expected by the market emerges, the issuer is singled out and authorities are in a position to use their investigative powers to ascertain inaccuracies or material omissions in the documentation submitted earlier. However, at the *ex ante* stage, detecting potential inaccuracies among all the documents which an authority is required to review is likely to require considerable skill, resources, efforts and time and may indeed prove impossible or at least difficult without performing exceptional investigations which may hamper market operations. Of course, if an authority has a suspicion (e.g., because of rumours circulating in the market), a low-quality issuer can be singled out at the approval stage. Nevertheless, considering the practical difficulties of detecting inaccuracies at the *ex ante* stage and the costs likely to be caused by excessive delays, it is not desirable to make the approval conditional upon a review of the truthfulness of the information by an authority.[21]

---

[20] Art. 21(3) provides for a minimum list of powers which national authorities have to be equipped with. These powers are of course critical in order to make sure that authorities can fulfil their review tasks.

[21] It is worth noting that there may be some overlap here. For instance, if the information in the prospectus is not true and sincere it may also be inconsistent with other sources of information to which an authority may have access. Hence, it is important to determine the precise extent of an authority's obligation to verify the consistency of the information and the completeness of the prospectus, which are quality characteristics an authority has to review and

Second, under the PD the prior approval by authorities is not envisaged as a means for assessing the economic or financial opportuneness (or desirability) of a securities transaction for investors.[22] To assess the opportuneness of a securities transaction, an authority has first to examine and decide upon the quality of the proposed transaction, including the financial or economic situation of the issuer. The scrutiny of the quality of the proposed transaction is, however, different in nature to the examination an authority has to perform prior to approving a prospectus. The approval is thus the act which follows an examination of the *quality of the disclosure* – or to be more specific, an examination of different disclosure quality characteristics which are the completeness of the prospectus, including the consistency and comprehensibility of the information – whereas to determine the opportuneness of a transaction, an authority has not only to examine the quality of the disclosure but also the quality of the proposed transaction. As for the question of the accuracy of the information, requiring an authority to decide upon the quality of a securities transaction (e.g., with a view to the opportuneness of the transaction for investors) would raise difficult questions. Besides the question of the authority's expertise, incentives and resources to complete such an assessment, the question of whether a paternalistic approach to securities regulation is justified would have to be examined more closely, in particular, if the authority's judgment as to the quality of the transaction were to pre-empt investors from forming their own judgment.[23]

Third, the approval, as envisaged under the PD, is not conditional upon an authority satisfying a particular standard of diligence, as may be the case for market professionals such as gatekeepers under applicable national law. The PD thus makes no provision for an authority to satisfy a particular standard of 'due care' or, for instance, a 'reasonableness standard' (e.g., to take all steps which it can reasonably be expected to take) when examining that the prospectus is complete and the information consistent and comprehensible. The question of the diligence an authority has to exercise is likely to be determined under national provisions governing the liability of authorities. In this context, it is worth noting that Article 13(6) of the PD states that '[t]his Directive shall not affect the competent authority's liability, which shall continue to be governed solely by national law'.

---

the failure of which may result in an authority being held liable depending on the applicable national law.

[22] In the literature, this form of assessment is also referred to as 'merit regulation'. See, for instance, G. Hertig, R. Kraakman and E. Rock, 'Issuers and Investor Protection', in R. Kraakman, P. Davies, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, eds., *The Anatomy of Corporate Law – A Comparative and Functional Approach* (Oxford, Oxford University 2004) p. 193 at pp. 207-208.

[23] The question of paternalism as a motivation for regulation is examined in Ogus, op. cit. n. 8, at pp. 51-53.

Having examined the prior approval as an *ex ante* enforcement instrument, the next question, which is the question of the purpose of a prior approval system, has already been touched upon. However, considering the cost aspects of the approval system in particular, a critical examination is warranted.

3. THE PURPOSE OF THE PROSPECTUS APPROVAL SYSTEM: A CRITICAL EXAMINATION

In this section, the approval system is critically examined as a regulatory instrument through a law and economic lens. The argument proceeds as follows. First, the relation between mandatory disclosure, the approval system and the quality of disclosure will be examined (3.1). Next, the benefits and costs of the approval system will be assessed for the various recipients of the approved prospectus (3.2). The argument proceeds on the premise that in order to justify the prior approval by authorities, the approval system must contribute to improving upon the quality of disclosure and that this must matter if considered from the perspective of the recipients of the approved prospectus.

3.1 **Mandatory disclosure, the prospectus approval system and the quality of disclosure**

Rather than highlighting a possible lack of expertise, financial resources or missing financial incentives for national authorities to act effectively and efficiently (all of which, it is acknowledged, are important issues), the approval system will be taken seriously and considered as an element in the disclosure quality enforcement chain (3.1.2). First, however, it is necessary to take a step back and situate the question of the quality of disclosure in the broader context of a mandatory disclosure regime (3.1.1).

3.1.1 *The disclosure quality question in the context of a mandatory disclosure regime*

Disclosure regulation mandates issuers to provide information. This may take different forms. A provision may set out a disclosure principle requiring an issuer to provide all necessary information for investors to make an informed assessment of the transaction being offered. In addition, a series of detailed provisions may require an issuer to disclose information on a multitude of specific information items.[24]

[24] Hertig, Kraakman and Rock, loc. cit. n. 22, at pp. 199-201 (dividing information requirements into (i) 'hard "benchmark" data', (ii) '"soft", "projective," or "forward-looking" information' and (iii) information relating to 'governance issues and agency problems').

Under the PD, a rule-based disclosure principle is provided for under Article 5(1), while specific information requirements are implemented via a Commission Regulation.[25] Typical examples of information items relate to the issuer's activities, its properties, plants and machinery, its risk factors, the remuneration of its directors, its assets or liabilities, its profit and losses, its investments, its research and development, trend information, and so forth.

Disclosure has costs and benefits for issuers. In the US literature, the cost-benefit relation has been at the heart of the debate on the merit of mandatory disclosure regulation. The different stages of this debate are now well known.[26] The mandatory nature of the US disclosure rules was thus first criticised in the 1960s by authors such as Stigler and Benston. In the 1980s, the discussion moved towards a qualified endorsement following contributions to the debate by authors such as Easterbrook/Fischel and Coffee. Recently, the debate on the merit of mandatory disclosure has been picked up by proponents and opponents of regulatory competition such as Romano and Fox in order to underpin their claims in favour of or against issuer's choice.[27] Mandatory disclosure also continues to be a fertile ground for academic research as new findings in the social sciences provide new conceptual approaches to its study.[28] While the debate does not yet seem to be settled, the general view, which is emerging after decades of controversy, is nevertheless that mandatory disclosure is warranted as, absent mandatory requirements, issuers are likely to disclose too little information.[29] Yet, if one accepts the view that issuers have incentives to disclose too little, one has to ask about the extent of the constraint which a mandatory disclosure regime can place on such conduct. For instance, if one sharpens the analytical lens and looks at specific information items, it is possible to make a rough distinction between

---

[25] Commission Regulation, op. cit. n. 3.

[26] E.g., G. Stigler, 'Public Regulation of the Securities Markets', 37 *J. Bus. Law* (1964) p. 117; G. Benston, 'The Value of the SEC's Accounting Disclosure Requirements', 44 *Acct. Rev.* (1969) p. 515; G. Benston, 'Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934', 63 *American Economic Review* (1973) p. 132; J. Seligman, 'The Historical Need for a Mandatory Corporate Disclosure System', 9 *The Journal of Corporation Law* (1983) p. 1; J. Coffee, 'Market Failure and the Economic Case for a Mandatory Disclosure System', 70 *Virginia Law Review* (1984) p. 717; F. Easterbrook and D. Fischel, 'Mandatory Disclosure and the Protection of Investors', 70 *Virginia Law Review* (1984) p. 669; R. Daines and C. Jones 'Mandatory Disclosure, Asymmetric Information and Liquidity: The Impact of the 1934 Act' (March 2003), available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=686888>.

[27] E.g., R. Romano, 'Empowering Investors: A Market Approach to Securities Regulation' 107 *Yale Law Journal* (1998) p. 2359; M. Fox, 'Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment', 85 *Virginia Law Review* 1 (1999) p. 1335.

[28] E.g., S. Bainbridge, 'A Behavioral Economic Analysis of Mandatory Disclosure: A Thought Experiment Turned Cautionary Tale' (January 2000), available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=204110>.

[29] Hertig, Kraakman and Rock, loc. cit. n. 22, at p. 204.

information items which essentially require issuers to provide standardised information (leaving issuers little discretion) and items which require issuers to provide a description of a particular business or situation (e.g., research and development, risk factors, related party transactions, trend information). As far as the latter type of items is concerned, the precise extent of the disclosure to be provided may not necessarily be straightforward to determine.[30] Moreover, issuers may not only 'gloss over'[31] material facts: they may 'lie outright'.[32] Accordingly, even under a mandatory disclosure regime, the *quality* of disclosure may still vary significantly.

To address the quality concern a number of strategies can be envisaged. One strategy is to make sure that issuers are subject to liability provisions and that the costs of litigation for investors are low.[33] In the United States, for instance, litigation (private enforcement) is facilitated by the shareholder class action. Misrepresentations, misleading financial reports or insider trading are types of wrongdoings which commonly result in class actions.[34] As a result, the extent of the disclosure is strongly influenced by the threat of litigation. Extensive disclosure on items such as 'risk factors' provide evidence to this effect. In Europe, however, the litigation threat is not as important.[35] The absence of procedural mechanisms such as the shareholder class action arguably further contributes to this.[36] The PD addresses the question of civil liability marginally. Under Article

---

[30] Admittedly, the more detailed the information items, the less discretion is left to issuers.

[31] L. Loss and J. Seligman, *Fundamentals of Securities Regulation* (New York, Aspen 2004) p. 129.

[32] Hertig, Kraakman and Rock, loc. cit. n. 22, at p. 204.

[33] See B. Black, 'The Legal and Institutional Preconditions for Strong Securities Markets', 48 *UCLA Law Review* (2001) p. 781 at pp. 796-797. On the importance of investor protection for the development of securities markets, see also the empirical work by R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R. Vishny, 'Legal Determinants of External Finance', 52 *Journal of Finance* (1997) p. 1131. See also R. La Porta, F. Lopez-de-Silanes and A. Shleifer, 'What Works in Securities Laws?', 61 *Journal of Finance* (2006) p. 1. The work of La Porta, et al., has notably been criticised for assuming too easily that strong investor protection laws cause strong securities markets to develop. See J. Coffee, 'The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control', 111 *Yale Law Journal* (2001) p. 1; E. Ferran, *Building an EU Securities Markets* (Cambridge, Cambridge University Press 2004) pp. 27-28.

[34] J. Cox and R. Thomas, 'SEC Enforcement Heuristics: An Empirical Inquiry', 53 *Duke Law Journal* (2003) p. 737 at p. 749.

[35] E.g., J. Coffee, 'Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms', 84 *Boston University Law Review* (2004) p. 301 at p. 343.

[36] The importance of private enforcement was recently discussed by G. Ferrarini and P. Guidici when examining the Parmalat scandal. In particular, the authors pointed to deficiencies in civil procedure law and stressed the need for reforms in civil procedure systems. G. Ferrarini and P. Guidici, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case*, ECGI Law Working Paper No. 40/2005 (May 2005), available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=730403>.

6(1) Member States must make sure that responsibility for the information provided 'attaches at least to the issuer, or its administrative, management or supervisory bodies, the offeror, the person asking for admission to trading on a regulated market or the guarantor, as the case may be', while Article 6(2) provides that Member States shall make sure that their national provisions on civil liability apply to those that are responsible for this information.[37] To address disclosure quality concerns, a number of complementary strategies can *a priori* be envisaged. The literature on (product) licensing and certification provides a helpful starting point for examining these strategies.

The quality question is at the heart of the literature on product licensing and certification.[38] Both mechanisms aim at making unobservable information about the quality of a product ascertainable and as such help to reduce the prospect of seeing a 'lemons market' develop.[39] Securities markets certainly raise the type of 'lemons market' issues which are usually put forward as a justification for certification or licensing.[40] To appreciate the quality of disclosure is indeed by no means straightforward. Even sophisticated investors will have difficulties differentiating low-quality disclosure from high-quality disclosure and as such determining the quality of the securities at offer.[41] To alleviate this problem one strategy is to rely on certification by third parties. So-called gatekeepers may thus verify the quality of the information to be disclosed or assess the quality of the securities to be offered. The auditor is the typical example of a professional gatekeeper. Rating agencies (on the debt side) but also investment bankers or potentially lawyers may also serve as gatekeepers. In the literature, the role of gatekeepers has been extensively examined and debated.[42] As Coffee notes:

---

[37] In relation to the prospectus summary the same article provides that '… Member States shall ensure that no civil liability shall attach to any persons solely on the basis of the summary, including any translation thereof, unless it is misleading, inaccurate or inconsistent when read together with the other parts of the prospectus'.

[38] See Ogus, op. cit. n. 8, at p. 214; J. Beales III, 'Licensing and Certification Systems', in P. Newman, ed., *The New Palgrave Dictionary of Economics and the Law*, Volume 2 (New York, Palgrave Macmillan 2002) p. 578.

[39] G. Akerlof, 'The market for "lemons": quality uncertainty and the market mechanism', 84 *Quarterly Journal of Economics* (1970) p. 488.

[40] See Black, loc. cit. n. 33, at p. 786.

[41] Easterbrook and Fischel, loc. cit. n. 26, at p. 674; H. Scott, 'Internationalization of Primary Public Securities Markets', 63 *Law and Contemporary Problems* (2000) p. 71 at p. 75 ('… there is generally no way for an investor, sophisticated or otherwise, to know that he is missing information and to attach an appropriate discount to that risk'). See also Black, loc. cit. n. 33, at p. 786.

[42] E.g., R. Kraakman, 'Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy', 2 *Journal of Law, Economics & Organization* (1986) p. 53; S. Choi, 'Market Lessons for Gatekeepers', 92 *Northwestern University Law Review* (1998) p. 916; F. Partnoy, 'Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime', 79 *Washington University Law Quarterly* (2001) p. 491; Coffee, loc. cit. n. 35.

> … the professional gatekeeper essentially assesses or vouches for the corporate client's own statements about itself or a specific transaction. This duplication is desired because the market recognizes that the gatekeeper has a lesser incentive to deceive than does its client and thus regards the gatekeeper's assurance or evaluation as more credible.[43]

Licensing is, besides certification, another strategy relied upon in product markets. Like certification, licensing can *a priori* be justified because of asymmetric information between a seller and a buyer. Unlike a certification system, however, a product licensing system denies products entrance to the regulated market if they fail to satisfy the set requirements. I already noted that the approval system, as an *ex ante* enforcement system, shares this characteristic.[44] Under the PD, the approval is thus a *sine qua non* for the publication of the prospectus and hence for the securities to be admitted to trading on a regulated market or to be offered to the public. Moreover, the importance of a strong regulator capable of responding to information asymmetry problems is highlighted in the literature. Black, for instance, views an honest regulator with sufficient experience and resources as crucial to countering information asymmetries and as such as a 'core institution' (along with other institutions such as a good judicial system) for strong securities markets.[45] The remaining part of this article will examine the approval system as an enforcement strategy. First, however, the relation between the quality of disclosure and the approval process has to be clarified.

3.1.2 *The approval system as envisaged under the Prospectus Directive, an element in the 'quality enforcement chain'?*

So far, the justifications for a mandatory disclosure system have been examined. The question of the quality of disclosure was raised as well as the question of the precise relation between the approval system and the quality of disclosure. In order to clarify this relation and to proceed with the argument, I propose to sum

---

43 Coffee, loc. cit. n. 35, at p. 309.

44 The 'product' in this context is the prospectus and the subject of enquiry is the disclosure provided therein.

45 Black, loc. cit. n. 33, at pp. 789-790. On the relative importance of the regulator and courts in enforcing the law, see E. Glaeser, S. Johnson and A. Shleifer, 'Coase vs. Coasians', 116 *Quarterly Journal of Economics* (2001) p. 853; C. Xu and K. Pistor, *Law Enforcement under Incomplete Law: Theory and Evidence from Financial Market Regulation*, Columbia Law and Economics Working Paper No. 222 (April 2003), available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=396141> (distinguishing between 'proactive' law enforcement by a regulator and 'reactive' enforcement by courts). On the empirical side, La Porta, Lopez-de-Silanes and Shleifer, loc. cit. n. 33, at p. 27 provide a more ambiguous picture as to the importance of public enforcement: '… securities laws matter because they facilitate private contracting rather than provide for public regulatory enforcement').

up some of the analytical points made earlier when discussing the regulatory nature of the approval system.

The quality of disclosure can be viewed as a function of a number of different, more or less important and, admittedly, to some extent overlapping disclosure quality characteristics. Arguably, one of the most important determining factors of the quality of the disclosure is its accuracy. The accuracy of the disclosure depends on the information being correct/true. If investors, for instance, anticipate that issuers have incentives to lie and hence have doubts as to the truthfulness of the information, a lemons market may develop. Besides the accuracy of the information, the quality of the disclosure is further a function of the completeness of the information. In order to value the issuer and to assess the quality of the securities, it is crucial that the prospectus does not omit any material information. The comprehensibility or indeed the presentation of the information may also be important, as comprehensible and orderly presented information makes the disclosure easier to analyse and to compare with information disclosed across a sector. When discussing the limits of the approval system earlier, it was noted that under the approval system the compliance with disclosure obligations was determined by scrutinising specific disclosure quality characteristics. In this context, Article 2(1)(q), which refers to the review of the completeness of the prospectus and the consistency and comprehensibility of the information, was highlighted. It was also noted that it follows from the wording of Article 2(1)(q) that under the Directive an authority is not held to ascertain whether the information given in the prospectus is true.[46] Yet, it was also noted that the wording of Article 2(1)(q) is ambiguous as regards the exact scope of the prospectus review. The review of the completeness of the prospectus, which was identified as an important disclosure quality characteristic, or the consistency of the information may thus, depending on the interpretation given, require a more or less extensive examination by authorities and as such contribute more or less importantly to establishing the level of quality of the information disclosed. While a level of discretion at national level is entirely desirable, to pursue my line of enquiry further, the argument here is simplified by assuming that a narrower view of an authority's own role in establishing quality characteristics such as the completeness of the prospectus or the consistency of the information is adopted. In fact, this assumption is reasonable because of the difficulty of assessing disclosure characteristics such as the completeness of the information without an examination which is akin to a due diligence. Hence, the next question is to what extent

---

[46] Admittedly, the investigations by gatekeepers may contribute to establishing quality characteristics such as the accuracy of the information, and national authorities may rely on these enquiries before they decide upon the approval. Yet, establishing the importance of gatekeepers for ensuring the quality of disclosure does not provide support for the establishment of a prior approval system. Moreover, it should be borne in mind that the gatekeeper system may suffer from serious defects.

the review by the competent authority of such disclosure quality characteristics matters if considered from the perspective of the recipients of the approved prospectus.

3.2 The prospectus approval system from the perspective of the recipients of the approved prospectus

Recipients are obviously investors, who possess different degrees of expertise, means or resources to ascertain the quality of the disclosure (3.2.1), but also the issuer itself whose prospectus must be approved before publication and hence before that the admission to trading or the offer to the public can take place (3.2.2).

3.2.1 *The prospectus approval system from the perspective of the investor*

It was noted above that the premise underlying this article is that, in order to justify the prior approval by authorities, the approval system must contribute to improving upon the quality of disclosure and that this must matter if considered from the perspective of the recipients of the approved prospectus. The improvement matters for investors if it reduces verification costs or facilitates the processing of the information,[47] or simply if the prior review and approval strengthens investor confidence, a concern underlying the PD but also CESR's recent actions on the enforcement of standards on financial information, for instance.[48] Moreover, the benefits of the approval system for investors have to be assessed in light of those information quality characteristics which a national authority is held to review before approving the prospectus (that is, the completeness of the prospectus and the consistency and comprehensibility of the information). This is because investors can be only confident that these quality characteristics are indeed reviewed prior to approving the prospectus. Arguably, if the approval system was based on a selective approach under which some issuers are singled out at the approval stage and made subject to an exceptional examination by authorities, the mere threat of being singled out could incentivise issuers to fully disclose all information. In theory, the *ex ante* enforcement by the authority could thus hold benefits for investors, even though authorities would in most cases only perform a lighter examination. Such a 'selective review' is carried out by the SEC. Under this procedure some registrants are not reviewed

---

[47] The relation between verification and processing costs (as types of information costs) and market efficiency is discussed in R. Gilson and R. Kraakman, 'The Mechanisms of Market Efficiency', 70 *Virginia Law Review* (1984) p. 549 at pp. 592-614. The same authors provide a sobering assessment of the Efficient Market Hypothesis in R. Gilson and R. Kraakman, 'The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias', 28 *Journal of Corporation Law* (2003) p. 715.

[48] PD, Rec. 18; Standard No. 1, op. cit. n. 19, at p. 3.

while some others are singled out according to selection criteria which the SEC chooses not to disclose.[49] This is unlike the approval system as envisaged under the PD. Moreover, the strength of the selective review approach crucially depends on its deterrence effect on issuers. In turn, the deterrence effect depends on the sophistication of the selection procedure and factors such as the expertise, resources, skills but also the vigour with which an authority pursues its mission. All of these factors are difficult to assess with any certainty. Hereunder, I continue examining the provision which specifies the information quality characteristics an authority has to review prior to deciding upon the prospectus approval. Investors can thus be confident only that prior to approving a prospectus an authority has scrutinised the completeness of the prospectus, the consistency of the information and its comprehensibility. Having specified the terms of this enquiry, the approval system is considered next from the perspective of the professional investor and from the perspective of the ordinary investor.

Starting with professional investors, the first point to note is that they have expertise, resources and means to appreciate and process information.[50] This means that while an authority may, for instance, contribute to improving the quality of disclosure by reviewing the comprehensibility of the information, such a review has little added value for professional investors who themselves are in a position to appreciate this quality characteristic. Admittedly, the capacity and willingness of professional investors to assess disclosure quality characteristics may be limited if more intense investigations are required.[51] Professional investors may thus be unwilling or unable to establish whether the prospectus is without material omissions or inaccuracies which are not apparent on the face of the document. However, the crucial point is that professional investors can neither be confident that, because the prospectus has been approved, there are no such omissions or inaccuracies in the document. To attempt to remedy shortcomings and gain some comfort as to the quality of disclosure, investors may instead decide to rely on market professionals such as gatekeepers who examine the quality of the information or value the quality of the securities.[52]

---

[49] Loss and Seligman, op. cit. n. 31, at p.128.

[50] Cf., Romano, loc. cit. n. 27, at p. 2378 (noting that '[t]he institutional investors who dominate today's markets have far greater ability, as well as financial incentives, to process information and price securities than does the SEC staff').

[51] Easterbrook and Fischel, loc. cit. n. 26, at p. 675 (noting that '[i]nvestors do not even want to inspect; they seek to be passive recipients of an income stream, not to be private investigators'); Scott, loc. cit. n. 41, at p. 75 (noting that '… there is generally no way for an investor, sophisticated or otherwise, to know that he is missing information and to attach an appropriate discount to that risk').

[52] Admittedly, corporate scandals such as Enron have revealed the limits of the gatekeeper system. Yet, highlighting the failures of such a system in the present context misses the crucial point which is that the approval system does not contribute to making the gatekeeper more effective.

Arguably, the approval system may still hold benefits for professional investors in terms of information standardisation. When reviewing documents an authority could thus request issuers, applying for approval, to further detail the disclosure provided. By requesting all issuers to provide the same information complements, an authority could, in theory, work towards a greater standardisation of the content of prospectuses across sectors of activities. This, in turn, could improve the comparability and comprehensibility of the disclosure provided by issuers and among issuers of the same sector of activity.[53] Yet, this argument is problematic. First, following the adoption of the PD, the level 2 Commission Regulation and CESR's level 3 recommendations now specify information requirements in greater detail and as such contribute to a greater level of standardisation. More fundamentally, the need for greater information standardisation hardly justifies the setting up of a prior approval system. This is because, at the approval stage, an authority exercises individual decision-making (enforcement) power. Standardisation efforts are, however, best addressed by exercising general decision-making power (e.g., by regulation or issuing recommendations). Aside from this, one may also question whether it would be legitimate for national authorities to standardise information in such a manner following the adoption of the PD. This is because the PD adopts a maximum harmonisation approach in relation to disclosure requirements. Member States are generally not allowed to lay down additional disclosure requirements, although the PD provides that an authority may require issuers, applying for approval, to include supplementary information in the prospectus.[54] Articles 3 and 22(1) of the Commission Regulation attempt to clarify this by providing that, while a competent authority cannot request additional information *items* to be included, it may nevertheless, when approving a prospectus, require that the information provided is completed 'for each of the information items, on a case by case basis'. The Commission Regulation thus draws a fine line on the basis of the information items set out in the annexes to the Commission Regulation. Yet, even if an authority's standardisation efforts would not result in new items being included, the question whether an authority was truly acting on a 'case by case basis' when requesting information complements with a view to standardising information among issuers in such a manner would have to be raised. Standardisation efforts of this kind would certainly be hard to justify if considered in the light of the underlying objective of levelling the playing field among Member States.

Hence, the prior approval by national authorities is unlikely to be of much benefit to professional investors. It follows that, if considered on a cost-benefit

---

[53] Hertig, Kraakman and Rock, loc. cit. n. 22, at p. 206 (noting that '[s]tandardization improves comprehensibility and comparability, thus increasing the value of information to investors').

[54] PD, Art. 21(3)(a).

basis, the costs of the prior approval are likely to weigh quite strongly in the balance. The next question to examine is whether ordinary investors (i.e., retail investors) may benefit from the authority's prior approval. While intermediated investment is still the major type of retail investor activity in the European Community, the PD certainly provides evidence as to the existence of an EC agenda which seeks to stimulate retail investment activities.[55] Ordinary investors can be assumed to lack the expertise, resources and means which were associated earlier with professional investors. Moreover, their investment behaviour is likely to be less sophisticated. Possibly, it is also more likely to be affected by cognitive biases. Accordingly, examining the approval system from the perspective of ordinary investors, rather than from the perspective of professional investors, is perhaps a better starting point. *A priori*, the obligation placed on authorities to review the comprehensibility of the information can be justified if examined from the perspective of retail investors. If retail investors have difficulties comprehending 'legalese' writing and as such fail to appreciate the risks involved with a transaction, even the fullest and most accurate disclosure is unlikely to serve investors. The SEC, for instance, has addressed this concern in the form of its 'Plain English' initiative.[56] Moreover, unlike professional investors, ordinary investors are unlikely to possess the expertise and skills necessary to appreciate for instance whether the prospectus is, even on its face, complete. Hence, the obligation placed on authorities to review the completeness of the prospectus may *a priori* also prove to be important for the protection of retail investors. Yet, the merit of these arguments depends critically on the appropriateness of disclosure regulation as a regulatory strategy for the protection of ordinary investors. Ordinary investors can thus only benefit from an authority's efforts to improve upon the quality of disclosure if they are able to appreciate themselves, on the basis of such disclosure, the quality of the securities transaction at offer. At the outset, this presupposes that investors fully read the prospectus.[57] In fact, it is possible that the prior approval may have perverse effects if ordinary investors fail to appreciate the precise scope of an authority's *ex ante* review. The prior approval by national authorities may, for instance, create overconfident investors. For many years, the French regulatory authority – that is, the *Commission des opérations de bourse* (Cob) which has now been replaced by the *Autorité des marchés financiers* (AMF) – has thus added a specific statement onto approved

---

[55] See also N. Moloney, 'New Frontiers in EC Capital Markets Law: From Market Construction to Market Regulation', 40 *Common Market Law Review* (2003) p. 809 at pp. 822-833 (referring to a 'paradigm shift' in relation to investor protection at EC level).

[56] E.g., A. Serafin, 'Kicking the Legalese Habit: The SEC's "Plain English Disclosure" Proposal', 29 *Loyola University Chicago Law Journal* (1998) p. 681.

[57] Scott, loc. cit. n. 41, at p. 73 (noting that most individual investors are not reading prospectuses).

prospectuses with the aim of attracting the attention of investors to the limited scope of the prospectus review.

Admittedly, the PD now requires a summary to be included in the prospectus (save in the case of non-equity securities of at least €50,000 where Member States are left with an option).[58] However, the inclusion of the summary does clearly not exempt investors from reading the prospectus. Article 5(2) makes it clear. Moreover, even if retail investors do read prospectuses, disclosure as a regulatory strategy in the context of securities regulation will always require a certain technical understanding and hence a level of sophistication on the part of the investor. It follows that efforts to protect ordinary investors, by seeking to improve upon the quality of the disclosure, may prove to be ineffective absent separate actions aimed at educating investors. Yet, despite the difficulties which the above analysis reveals, national authorities, in their daily practice, continue to view the approval system as an important instrument for the protection of ordinary investors.[59]

3.2.2 *The prospectus approval system from the perspective of the issuer*

Examining the benefits of the prior approval from the perspective of issuers may at first seem surprising, considering that it is generally understood as an investor protection measure. The approval system certainly bears costs for issuers. I think, in particular, of the cost of delays caused by the approval process. Yet, it can be argued that if the approval system is not unduly inefficient (for instance, by creating excessive delays), it may hold benefits for issuers. Central to this argument is that legal risk is a concern for issuers and that issuers will seek to limit such risk. Legal risk refers to the risk of being found in breach of regulatory requirements. Easterbrook and Fischel for instance note that '[f]irms that disclose what they think appropriate for investors may be surprised to learn, a few years later, that they did not disclose enough things or the right things. This is needless risk, and greater risk increases the firm's cost of capital.'[60] In theory, issuers should be interested in determining the extent of such risk before that the securities are admitted to trading or offered to the public. The question which has to be

---

[58] PD, Art. 5(2).

[59] It is worth noting that in the literature it is argued that ordinary investors may be protected by professional trading in the market. Yet, this point should not be overrated. Hertig, Kraakman and Rock, loc. cit. n. 22, at p. 206, for instance, note that '… the empirical literature suggests that liquid share markets mitigate this problem of unsophisticated investors, since professional trading efficiently reflects public information into share prices, and so (inadvertently) protects poorly informed traders. Yet there is no such protection when markets are thin and illiquid because, for example, they lack a clientele of professional traders dealing in the shares of small and mid-sized issuers' [footnotes omitted]).

[60] Easterbrook and Fischel, loc. cit. n. 26, at p. 699.

examined now is whether the approval system, as provided for under the PD, can be envisaged as such an *ex ante* risk reduction strategy.[61] As for investors, this line of enquiry takes as a starting point the definition of prospectus approval in Article 2(1)(q). Issuers can thus only be confident that, prior to deciding upon the approval, the authority will scrutinise the completeness of the prospectus, the consistency of the information and its comprehensibility. As for investors, it is assumed that the obligation placed on an authority to scrutinise the content of the prospectus along these lines is interpreted narrowly.

Although the prior approval of the prospectus does not protect the issuer from subsequent actions by the authority or from subsequent court proceedings, it can be argued that issuers benefit from the fact that an authority checks, as part of its obligation to examine the completeness of the prospectus, the technical compliance with the disclosure requirements set out in the PD and the Commission Regulation. In theory, the approval should thus provide the issuer with the certainty that the regulatory authority is satisfied with the disclosure. Hence it should give the issuer comfort that the competent authority will not, once the securities are admitted to trading or offered to the public, take action against it. Yet, the strength of this argument depends critically on the efficiency of the approval system. If authorities require lengthy approval times, the costs of the system are indeed likely to outweigh the benefits.[62] Nevertheless if this point is borne in mind, it can be argued that the approval system, as envisaged under the PD, benefits issuers if considered as a risk reduction strategy.

4. CONCLUSION

This article examined the nature and purpose of the prospectus approval system as envisaged under the PD. In section 2, it was argued that under the PD the approval system is best viewed as an *ex ante* enforcement system. Having identified the characteristics of such a system and having considered the prior approval in the light of these findings, the limits of the prospectus approval system, as envisaged under the Directive, were traced. In section 3, the purpose of the approval system was critically examined. The approval system was first situated in the broader context of a mandatory disclosure regime. In this context, the crucial question of the relation between the quality of disclosure and the prospectus approval was raised. Taking as a premise that the prior approval must not only improve upon the quality of disclosure but that this improvement must matter for the recipients of the approved prospectus, the costs and benefits of the approval system were assessed. It was argued that the prior approval was unlikely to be of

---

[61] Cf., ibid., at pp. 704-705.

[62] The PD now provides for time limits. See n. 13 *supra*.

much benefit to professional investors. In relation to ordinary investors, it was argued that, while the prior approval could *a priori* be justified if considered from this perspective, such an argument was not without difficulties. The risk of overconfident investors was mentioned and difficulties associated with disclosure regulation as a regulatory strategy for the protection of ordinary investors were highlighted. Finally, the prior approval was examined from the perspective of the issuer. It was argued that the approval system should be considered as a risk reduction strategy for issuers. If considered as such, it was argued that the prior approval could benefit issuers, provided that the approval process was not unduly inefficient.