

# ALLEN & OVERY

## German regulator BaFin publishes guidance notice on scrutiny of prospectuses for comprehensibility under PDIII

### Overview and context:

- On 10 September 2019, BaFin published a guidance notice setting out certain criteria it intends to apply when scrutinising securities prospectuses for compliance with the requirements of comprehensibility set out under Article 37 of Commission Delegated Regulation (EU) 2019/980 (**Delegated Regulation**). The guidance notice, which is currently only available in German, can be found [here](#). An English convenience translation of BaFin's guidance notice is attached.
- Article 37 of the Delegated Regulation, one of the central provisions of the new EU prospectus regime which has been in force since 21 July 2019, contains a detailed but non-exhaustive list of criteria which competent authorities need to consider as part of their prospectus review for comprehensibility. The criteria include aspects such as whether the prospectus has a clear and detailed table of contents, whether it has a structure that enables investors to understand its contents and whether it is written in plain language.
- The guidance notice sets out BaFin's current administrative practice regarding its scrutiny for comprehensibility of prospectuses filed with it for approval. BaFin clarifies in this respect that it reserves the right to further develop its administrative practice in this respect in the future.
- BaFin's guidance notice represents one of the first official statements by a competent regulatory authority covering a critical aspect of the new EU prospectus regime. It remains to be seen how other regulatory authorities will apply these criteria and whether ESMA considers that additional Level 3 guidance on this topic is warranted.

### Certain key considerations from the BaFin guidance notice:

- BaFin considers the comprehensibility of the information contained in the prospectus, in addition to its completeness and coherence, to be one of the material requirements for the approval of prospectuses. Any failure to comply with the requirements relating to comprehensibility can thus lead to the prospectus being rendered incomprehensible and, ultimately, to approval of the prospectus being refused. BaFin further stresses that one of the key objectives of PDIII is to enhance the comprehensibility of prospectuses.
- BaFin clearly speaks out against a prospectus structure that is too modular and warns issuers that prospectuses adopting a too modular approach may not be approved going forward. The reader of a prospectus must be in a position to clearly identify all products and product variations contained in a prospectus by reference to the prospectus' table of contents, which should guide the reader to the sections of the prospectus that are relevant to a particular product. The reader of a prospectus should not be presented with a puzzle and be required to piece together all the information relevant to a particular product from the entire information contained in a prospectus. BaFin also highlights that the overall comprehensibility of a prospectus can be enhanced if an issuer only includes similar products in one and the same prospectus and encourages using separate prospectuses for differing product types.

- Compared to BaFin’s new requirement to avoid a prospectus structure that is too modular, an earlier draft of the guidance notice, which was shared with trade associations and certain market participants in Germany, contained much stricter requirements. In that draft guidance notice BaFin requested that product structures contained in a prospectus must not exceed a certain maximum number of products. It is to be welcomed that BaFin has not pursued its original proposal which would have led to a significant increase in the number of prospectuses, and would not have taken into account that market participants have devoted considerable efforts to ensuring that base prospectuses remain comprehensible even where they cover a significant number of product structures.
- Following the practices in other EU member states, BaFin now also promotes the inclusion of a manual style section in base prospectuses that explains to the reader how a base prospectus, including the final terms, works and is structured.
- Further, BaFin emphasizes that only plain and uncomplicated language can lead to easily readable prospectuses. BaFin stresses that simple sentence structures should be used, lengthy sentences should be avoided and the use of technical terms and abbreviations should be avoided as far as possible. Furthermore, it recommends the introduction of glossaries in prospectuses where a lot of technical terms or abbreviations are used.
- BaFin notes that it will not adopt a ‘one size fits all approach’ when performing its comprehensibility review and acknowledges at various places in the notice the need to consider the individual case at hand, the subject of the prospectus and its structure as part of an overall assessment. Given that market participants currently apply different approaches as regards prospectus architecture and each approach is deeply embedded in the internal organisation (including IT) of the issuing entities, it is positive that BaFin recognises this. We expect BaFin to continue to exhibit such pragmatism in its review practices going forward.

## Key contacts

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# Annex

**Non-binding convenience translation from German prepared by Allen & Overy LLP**

*[Letterhead of the German Federal Financial Supervisory Authority*

*(Bundesanstalt für Finanzdienstleistungsaufsicht; **BaFin**)]*

## Guidance Notice

### Scrutiny of securities prospectuses for comprehensibility

Ref: WA 51-Wp 7115-2019/0099

BaFin wishes to offer guidance to market participants on how the new European requirements on scrutinising the comprehensibility of securities prospectuses are being applied in practice. The aim is to support market participants in preparing prospectuses and to facilitate compliance with the new requirements. The background of this guidance notice is the new prospectus regime under the EU Prospectus Regulation in force since 21 July 2019 and the potential need for modifying the language and structure of prospectuses as compared with the format used by issuers in the past. With this guidance notice, BaFin offers initial guidance for the implementation of these requirements. At the same time, it reserves the right to continue developing its administrative practices in the future.

#### **I. LEGAL REQUIREMENTS:**

Commission Delegated Regulation (EU) 2019/980 of 14 March 2019 supplementing Regulation (EU) 2017/1129 as regards the format, content, scrutiny and approval of the prospectus (the "**Delegated Regulation**"), contains, among other things, more detailed requirements relating to the scrutiny of prospectuses by the competent authorities. The Delegated Regulation has been in force since 21 July 2019 and thus applies to all prospectuses that are scrutinised in line with the new legislation pursuant to the EU Prospectus Regulation.

Article 37 of the Delegated Regulation contains a list of specific criteria for the scrutiny of the comprehensibility of the information contained in the prospectus. According to this article, the following aspects must be taken into account:

- (a) whether the draft prospectus has a clear and detailed table of contents;
- (b) whether the draft prospectus is free from unnecessary reiterations;
- (c) whether related information is grouped together;
- (d) whether the draft prospectus uses an easily readable font size;
- (e) whether the draft prospectus has a structure that enables investors to understand its contents;

- (f) whether the draft prospectus defines the components of mathematical formulas and, where applicable, clearly describes the product structure;
- (g) whether the draft prospectus is written in plain language;
- (h) whether the draft prospectus clearly describes the nature of the issuer's operations and its principal activities;
- (i) whether the draft prospectus explains trade or industry specific terminology.

Pursuant to Article 40 of the Delegated Regulation, these criteria do not constitute an exhaustive list. Where necessary for investor protection, BaFin may apply in the individual case additional criteria for the purposes of scrutinising the comprehensibility of the information in the prospectus.

The purpose and intent of these new requirements is to achieve greater harmonisation, not only of the directly applicable legal provisions, but also in terms of their practical application in connection with the scrutiny of prospectuses exercised by competent authorities. One fundamental objective pursued by the European legislature in particular with the new prospectus regime is to improve the comprehensibility of prospectuses for investors.

## **II. FURTHER SPECIFICATION OF THE REQUIREMENTS**

The following paragraphs explain how BaFin takes account of certain criteria set out in Article 37 of the Delegated Regulation which it considers as particularly important in the context of its scrutiny for comprehensibility. In line with the standard for scrutiny that can be derived from the definition of 'approval' set out in Article 2 (r) of the EU Prospectus Regulation, the comprehensibility of the information contained in the prospectus is, in addition to its completeness and coherence, a material requirement for the approval of prospectuses. Any failure to comply with the requirements relating to comprehensibility as specified in Article 37 of the Delegated Regulation can thus lead to the prospectus being rendered incomprehensible and, ultimately, to a refusal of the approval of the prospectus.

Since, in practice, in particular base prospectuses have been regarded as problematic in terms of comprehensibility, particular focus is placed on such prospectuses in the following paragraphs. Where individual points are not specific to base prospectuses, however, they are to be complied with for all prospectuses.

It should generally be noted that when scrutinising prospectuses and compliance with the requirements in Article 37 of the Delegated Regulation, BaFin does not adopt an 'one size fits all' approach. The decisive factors in assessing comprehensibility are always the specific case at hand, the subject of the prospectus and its structure as part of an overall assessment.

### **1. Re Article 37 (1) (a) of the Delegated Regulation (clear and detailed table of contents)**

#### **Clearly structured table of contents which facilitates the identification of information on various products in base prospectuses**

- (a) In the case of base prospectuses for more than one product type, the table of contents must be structured such that the reader can identify the various products included in the prospectus. To achieve this, the table of contents should be broken down into an appropriate number of section levels to enable

the reader to directly identify the relevant (sub-)sections that relate to specific and definable subject areas.

- (b) The degree of detail in the table of contents depends on the content and structure of the prospectus. It appears appropriate that the risk factors in the table of contents should, for instance, always be divided into issuer and securities-related risks. A further subdivision of the securities-related risks into risks for certain products or product variations then depends on the content and structure of the prospectus. On the other hand, it should be noted that the clarity of the table of contents may be compromised if the subdivision is too detailed and contains too many sub-levels. As a general rule, the number of section levels should be appropriate in view of the structure and complexity of the prospectus.
- (c) The requirement of a clear and detailed table of contents on the basis of which the reader can identify the various products and product variations corresponds with the restriction placed on base prospectus structures that are too modular (see below for more details) as regards various products and product groups: If the structure of the prospectus in respect of the various products and product variations is so modular that it is no longer possible to identify the various products and product variations on the basis of a clear table of contents, such structure contradicts the requirement of comprehensibility for prospectuses. For example, individual products should be given numbers or other suitable identifiers in order to ensure that the provisions of the prospectus that are applicable to a specific product can be easily identified in the table of contents.
- (d) The various section levels should generally be given an alphanumeric (alphabetical and/or numerical) structure.

## **2. Re Article 37 (1) (e) of the Delegated Regulation (structure of the prospectus must enable investors to understand its contents)**

### **2.1 Avoiding a base prospectus structure that is too modular and relates to a large number of very different products, various products in the prospectus must be defined and recognisable in a clearly identifiable manner**

- (a) As a general rule, the legislature's objective in implementing the new prospectus regime is to ensure that prospectuses are 'more streamlined' and more comprehensible and easily accessible for investors; very extensive prospectuses containing numerous very different products are not investor-friendly and, particularly for retail investors, difficult to handle.

This applies even more where such base prospectuses also display structures that are too modular or too convoluted in respect of the various products and product variations. By combining the numerous modular elements and options it is possible to generate a large number of different products. It is often very difficult for investors and/or readers of the prospectus to understand the potential product variations and to identify and associate the relevant information, which can ultimately lead to a prospectus being rendered incomprehensible. Irrespective of this, the issuer is free to decide on how granular it distinguishes between products, provided that the individual product variations can be separately identified throughout the prospectus.

If the inclusion of too many different products and/or product variations in a base prospectus is avoided, this will generally result in the structure and scope of a prospectus being more comprehensible and more accessible to investors. The same applies if primarily similar products are grouped in a single base prospectus and for significantly different products separate base prospectuses or, in the case of base prospectuses comprising several parts, separate securities notes are used.

- (b) Ultimately, the prospectus must not appear to the investor to be a puzzle of many parts where the investor is required to piece together the various information items relevant to a particular product. This would not represent a structure that enables investors to understand the contents. This can be problematic not only in the case of an overly modular prospectus structure but also where a large amount of very detailed information is incorporated by reference from many different sources. In this respect the following shall be taken into account:

The larger the number of different products and the more modular the structure, the greater the likelihood that the prospectus is considered incomprehensible.

- (c) Avoiding a structure that is too modular corresponds to the requirement for a clearly structured table of contents (see above): A modular structure that cannot be represented by a clear table of contents allowing the individual modules to be unambiguously identified and attributed to the various products does not comply with the requirement of the prospectus being comprehensible.

## **2.2 Brief description of how the base prospectus and its elements, including the final terms, work and are structured**

Including a brief description (in the sense of an 'operating manual') explaining to the investor the basic structure of the base prospectus and how it works can increase comprehensibility and is thus advisable in particular in respect of more complex base prospectuses. In this context, it should be noted that if this description requires extensive explanations, this is an indication that the structure of the base prospectus is too complex.

## **3. Re Article 37 (1) (g) of the Delegated Regulation (plain language)**

### **Use of clear and comprehensible language in the narrow sense**

- (a) The use of plain and uncomplicated language is the basic requirement in preparing easily readable prospectuses. When preparing a prospectus, the following points should be taken into particular account:
- comprehensible grammatical expression
  - simple sentence structures, avoiding lengthy, complicated sentences
  - avoiding the use of technical terms and abbreviations as far as possible; where technical terms are required, they should be explained (in line with the requirement contained in Article 37 (1) (i) of the Delegated Regulation)
  - where a large number of technical terms and abbreviations is used, it is recommended that they are set out in a glossary
  - a clear and logical structure
  - use of scenarios, examples and graphics to illustrate more complex content and to facilitate comprehension
  - avoidance of misleading product names
- (b) In the context of scrutinising the comprehensibility, BaFin does not adopt the points set out above in order to 'proof-read' the prospectus; the decisive factor here is an overall assessment of the prospectus. Issuers should take the points into account when drafting the prospectus in order to meet the requirement for simple language in general.

- (c) The requirement for clear and comprehensible language applies to all parts of a prospectus. If a prospectus uses so-called 'working instructions' to explain how placeholders or options are to be selected or filled in, they must also be clear and unambiguous to the reader.

#### **4. Re Article 37 (1) (f) of the Delegated Regulation (clear description of the product structure)**

##### **Inclusion of sample calculations/scenarios in order to describe how derivative securities work, including graphics**

In the case of more complex derivative products in particular, it may be advisable, in the interests of comprehensibility, to explain how they work using sample calculations or scenarios.