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DOI: 10.19195/1733-5779.25.5

The new Prospectus Regulation and the information efficiency of capital markets in the European Union

JEL Classification: G14, G15, K33

Keywords: prospectus obligations, Prospectus Regulation, information efficiency of the capital markets

Słowa kluczowe: obowiązki prospektowe, Rozporządzenie Prospektowe, efektywność informacyjna rynków kapitałowych

Abstract: The economic analysis of law suggests that one of the main obstacles to the strengthening of European Capital Markets are, on the one hand, the entry barriers for capital companies seeking financial support, and on the other, lack of proper information protection for investors, which discourages them from placing money on the financial markets. The current regulation is flawed for at least several reasons. First, there are many differentiating regimes within European Union. Second, the current regulation imposes too many requirements and information obligations on listed companies, which significantly increases transaction costs and makes searching for funding on the capital markets unprofitable for many players. As a result, some of them target other alternative methods of obtaining funds from investors (such as FinTechs, Blockchain, Tokens), which in turn weakens the investors protection. As a consequence, the capital outflow from capital markets makes them even less competitive. Third, most of retail investors are practically unable to digest the significant amount of detailed information presented by publicly-listed companies due to the current prospectus obligations, which, in consequence, discourages them from further investments on the capital market. The main goal of the paper is to evaluate numerous issues related to current regulation on European capital markets in terms of information requirements that create “barriers to entry” for public companies and, at the same time, fail to establish a proper information order and transparency obligations — therefore discouraging retail investors from investing in the capital markets. Another goal of the paper is to present the perspectives of the upcoming Prospectus Regulation within European Capital Markets which aims to harmonize the transparency obligations and thus, to unlock effective and cheap funding in the capital market, and as a consequence stimulate the Europe’s economic growth.

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Nowa Regulacja Prospektowa a efektywność informacyjna na rynku kapitałowym w Unii Europejskiej

Abstrakt: Ekonomiczna analiza prawa sugeruje, że jedną z głównych przeszkód wzmocnienia europejskich rynków kapitałowych są z jednej strony bariery wejścia dla spółek kapitałowych ubiegających się o finansowanie, z drugiej zaś brak odpowiedniej ochrony informacyjnej inwestorów, który zniechęca ich do lokowania pieniędzy na rynkach finansowych. Obecne regulacje prospektowe są wadliwe z co najmniej kilku powodów. Po pierwsze, w Unii Europejskiej istnieje wiele systemów różniących się od siebie w fundamentalnych kwestiach. Po drugie, obecne rozporządzenie nakłada zbyt wiele wymogów i obowiązków informacyjnych na spółki notowane na giełdzie, co znacznie zwiększa koszty transakcyjne i sprawia, że poszukiwanie funduszy na rynkach kapitałowych jest nieopłacalne dla wielu mniejszych graczy. W rezultacie niektóre z nich celują w inne, alternatywne metody pozyskiwania funduszy od inwestorów (takich jak FinTechs, Blockchain, Tokens), co z kolei osłabia ogólną ochronę inwestorów na rynku kapitałowym. W konsekwencji odpływ kapitału z rynków kapitałowych powoduje, że są one jeszcze mniej konkurencyjne. Po trzecie, większość inwestorów detalicznych praktycznie nie jest w stanie przeanalizować znacznej ilości szczegółowych informacji przedstawianych przez spółki notowane na giełdzie ze względu na obowiązki prospektowe, co w konsekwencji zniechęca ich do dalszych inwestycji na rynku kapitałowym. Głównym celem artykułu jest ocena licznych zagadnień związanych z bieżącymi regulacjami dotyczącymi europejskich rynków kapitałowych pod kątem wymagań informacyjnych, które tworzą „bariery wejścia” dla spółek publicznych, a jednocześnie nie ustanawiają odpowiedniego porządku informacyjnego i przejrzystości zobowiązania — zniechęcając tym samym inwestorów detalicznych do inwestowania na rynkach kapitałowych. Innym celem artykułu jest przedstawienie perspektyw nadchodzącego rozporządzenia w sprawie prospektu emisyjnego na europejskich rynkach kapitałowych, który ma zharmonizować obowiązki w zakresie przejrzystości, a tym samym uwolnić od efektywnego i taniego finansowania na rynku kapitałowym, a w konsekwencji stymulować wzrost europejskiej gospodarki.

Introduction

Public Offerings are a vital part of any capital market. They enable companies to raise finance in exchange for shares in future profits from a wide range of investors, then those collected funds allow them to conduct long-term investments, which in turn they can convert into jobs and growth. From the investors' point of view, public offers give them the possibility to put their accumulated capital to productive use as well as the chance for high profits in the case of successful investments made by the company. The strength and efficiency of capital markets, in particular in the fields of public offerings, have a huge impact on the development of the entire global economy. Public offerings constitute not only the most effective way to raise capital, but also create numerous jobs — statistically around 80–90% of the job growth in a company comes after initial public offer (IPO) and public listing¹.

¹ D. Höppner, *Europe's broken IPO market*, <https://www.investeurope.eu/news-opinion/opinion/blog/2015/ipo/> (access: 15.06.2018).

In European Union, most companies that want to raise capital through public offers or have securities admitted to be traded on regulated markets need to provide investors with prospectus or information memorandum which are legal documents issued to potential investors about the securities being issued (or admitted to trading), the company's business, finances and shareholding structure. Naturally, such a solution fits in with global trends.

However, the EU capital market — both at the national level and under European law — was always characterized by an unusual number of strict regulations imposing complex and rigorous prospectus obligations (such as preparing a prospectus or information memorandum, submitting the documents to the capital markets authorities and notifying them before the issuance).

The economic analysis of law suggests that European solutions in the field of prospectus obligations in public offerings, theoretically designed to protect investors and specific information order on the capital market, in fact may seriously undermine its effectiveness and competitiveness compared to other competitors, like the United States². What is more, they can actually introduce information chaos and provide even weaker investor protection — effectively discouraging them from investing their funds on the capital markets.

It is believed that the removal of various legal barriers “to go public” in the form of appropriate simplification and flexibilization of the prospectus obligations for companies (including innovative companies and start-ups) would give them incentives to enter the capital market and derive significant benefits due to a broader access to cheap investor's capital and effective funding, which will have positive impact on the whole Europe's economic growth.

The significance of the presented issue is due to its exceptional timeliness, as a landmark reform of prospectus law approaches. The new Prospectus Regulation (EU) 2017/1129³ replaces the existing Prospectus Directives⁴ and will be binding

² EU IPO Report, *Rebuilding IPOs in Europe Creating jobs and growth in European capital markets*, issued by IPO Task Force, 23.03.2015, https://www.investeurope.eu/media/370031/IPO_Task_Force_Report.pdf (access: 15.06.2018).

³ Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC, <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32017R1129>. (access: 15.06.2018).

⁴ 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 (Text with EEA relevance), <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32003L0071>, amended by Directive 2010/73/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market Text with EEA relevance, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32010L0073>. (access: 15.06.2018).

and directly applicable in all EU member states. It is no exaggeration to say that the reform and its legal framework will soon determine the future of capital markets, as well as the economy of the entire European Union.

Because of that, it is worth conducting a thorough analysis of the main issues related to the previous Prospectus Directive as well as the basic motives and assumptions of the upcoming Prospectus Regulation.

Information effectiveness on the Capital Markets — the current state of the art

In order to understand the ratio and the essence of the contemporary legal framework of prospectus law in Europe, we need to take a closer look at the current state of the art, especially some basic assumptions and terms upon which the prospectus regime rests, such as market information asymmetry, information effectiveness, the hypothesis of the effective market as well as the model of the rational investor. These concepts are at the heart of the current regulatory model of public offerings and prospectus obligations and have an enormous impact on the today's shape of EU capital markets.

Information constitutes a key and desirable good, the access to which enables to make profitable investments on the capital market. According to many economists, appropriate access to information constitutes *a sine qua non* condition for a well-functioning market of financial instruments⁵. In the relation between investors and issuers, information asymmetry arises naturally in favor of the latter, especially concerning their financial situation, as well as the quality of the financial instruments they offer. The asymmetry arises from the fact that the issuer is in charge of all the relevant information about itself, whereas the costs of obtaining such information by individual investors would exceed the potential return on the average investment⁶. According to the prevailing opinion among the scholars, regulatory minimization of the asymmetry positively affects the capital market — especially concerning valuation and the capital allocation, allowing the inflow of capital to these issuers, who are able to use the capital in the most efficient way, and in return for providing it, offer the investors the best conditions in the form of i.e. ratio of expected profit to the level of risk⁷. Negative effects of information asymmetry have been well illustrated in the so-called “market for lemons” model

⁵ K. Oplustil, “Informacje przekazywane przez emitentów”, [in:] *System Prawa Handlowego*, vol. 4. *Prawo instrumentów finansowych*, ed. M. Stec, Warszawa 2016, p. 5.

⁶ M. Spyra, “Cele prawa instrumentów finansowych oraz system narzędzi ich realizacji”. In: M. Stec (ed.), *System Prawa Handlowego*, vol. 4, p. 10; N. Moloney, *EU Securities and Financial Markets Regulation*, Oxford 2014, p. 56.

⁷ M. Healy, K.G. Palepu, “Information asymmetry, corporate disclosure, and the capital markets. A review of the empirical disclosure literature”, *Journal of Accounting and Economics* 31, 2001, p. 405.

by G.A. Akerlof, who proved that the long-lasting information asymmetry may result in market failure, as it fails to fulfill its basic allocation function⁸. That is, among others, due to the fact that the value of financial instruments reflects the collective confidence of the purchasers in the current and future situation of the issuer (the credence goods, as distinct from the so-called experience goods)⁹. Therefore, it is recognized that aiming at efficient allocation of the capital on the market and transferring it in “good hands”, the investors should be able to get familiar with information that would allow them to assess the value of financial instruments — in order to decide on the good and reject the bad ones. Asymmetry results in non-optimal decisions of the investors — as based less on knowledge, whereas more on intuition — which, in turn, reduces the efficiency of the market on a macroeconomic level. The lack of information enabling to distinguish the value and quality of certain securities results in number of consequences¹⁰. First of all, it causes general uncertainty and investors’ reluctance to invest on the capital market and the withdrawal of some of them. Second, it results in the investors taking the high investment risk into consideration — and hence, a high discount, which leads to a negative selection on capital markets in the form of a downward spiral of prices and the quality of the offered financial products. The high discount required by investors in return for the provision to capital, causes a significant increase of cost for the issuers, and hence — less competitiveness and greater unprofitability of the investment. In the long term, information asymmetry leads to the destabilization and market failure, subsequently to the investors’ losing confidence and the outflow of their financial resources. Thus, the information asymmetry is particularly harmful also for the issuers themselves¹¹.

Due to the above, it is said that the general transparency of the market and the availability of as much information as possible about issuers and the financial instruments issued by them for the investors supports the valuation function and efficient allocation of capital — positively affecting the development of capital markets. Moreover, strong confidence of investors in the markets also allows the issuers to acquire the capital involving less resources, make more investments at a profit, and then share it with investors. The concepts of “information efficiency” and the “efficient capital market hypothesis” by E. Fama¹² (Efficient Capital Market Hypothesis) refer to the main problem of information on the market. According to E. Fama, the more the information about financial instruments and their issuers

⁸ G. Akerlof, “The market for ‘lemons’: Quality uncertainty and the market mechanism”, *Quarterly Journal of Economics* 84, 1970, no. 3, pp. 488–500.

⁹ S. Kalss, M. Oppitz, J. Zollner, *Kapitalmarktrecht. System*, Wien 2015, pp. 8–9; H. Fleischer, *Informationsasymmetrie im Vertragsrecht*, München 2001, p. 118.

¹⁰ K. Oplustil, op. cit., p. 6.

¹¹ Ibid., pp. 6–7.

¹² E. Fama, “Efficient capital markets. A review of theory and empirical work”, *Journal of Finance* 25, 1970, p. 383.

are reflected in the prices of financial instruments on the capital market, the more efficient the market is¹³. According to this theory, maximizing the access to information by the market participants increases its information efficiency, resulting in proper valuation and allocation, which is in the interest of the entire economy system. The efficient market hypothesis has had a great influence over transatlantic academic debates¹⁴, as well as the American capital market. M.C. Jensen even stated that “in economic sciences there is no other postulate which has been empirically proven as well as the efficient market hypothesis”.

The search, verification and comparison of individual financial instruments by the investors themselves would, however, lead to a significant increase of the transaction costs, and thus, to a decline in interest in the capital market. Economic analysis of the law indicates that the total costs the investors would have to bear in order to obtain information on a certain issuer and the financial instruments it offers, are much higher than in the case of issuing these information by the issuers themselves. Therefore, it is considered legitimate to burden various issuers with the information obligations (the cheapest cost avoider principle)¹⁵. According to the opponents of this approach, the issuers should insist on publishing as much information about themselves as possible, in order to gain investor's confidence (the so-called signaling theory¹⁶). According, in turn, to the supporters of this approach, the companies would not be willing to publish this information voluntarily, or at least would do it to a smaller extent¹⁷. The purpose of prospectus obligations is therefore to ensure information and allocation efficiency, as well as the protection of the integrity of the system, protection of investors and their general confidence in the markets¹⁸.

The hypothesis of effective capital market was however severely criticized after the outbreak of the Enron scandal¹⁹, as well as after the global crisis of 2008–2010, which according to its opponents revealed its “bankruptcy as a scientific financial institution”²⁰.

¹³ H. Brinckmann, [in:] *European Capital Markets Law*, ed. R. Veil, Hart Publishing 2017, p. 212; N. Moloney, op. cit., pp. 57–58.

¹⁴ *European Capital...*, pp. 212–213.

¹⁵ H. Brinckmann, op. cit., p. 217.

¹⁶ R. Romano, “The need for competition in international securities regulation”, *Theoretical Inquiries in Law* 2, 2001, p. 387, citing after: K. Oplustil, op. cit., p. 7.

¹⁷ H. Brinckmann, op. cit., pp. 215–216; T. Sójka, [in:] *Prawo rynku kapitałowego. Komentarz*, ed. T. Sójka, Warszawa 2015, pp. 40–41.

¹⁸ K. Oplustil, op. cit., p. 7.

¹⁹ J. Dybiński, “Zagadnienia ogólne ochrony inwestora na rynku instrumentów finansowych”, [in:] *System Prawa Handlowego*, vol. 4, p. 33; A. Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance*, Oxford 2000.

²⁰ J. Dybiński, op. cit. p. 34; R.J. Gilson, R. Kraakman, “Market efficiency after the financial crisis: It's still a matter of information cost”, *ECGI Working Paper Series in Law* 2014, no. 242, p. 1.

The implementation of a complex system of information obligations derives from a specific system of values adapted to the behavior of the investors²¹. It is worth mentioning, that in the European Union regulations regarding prospectus obligations are based on a presumption, that there exists a model of rational investor (the *homo oeconomicus*)²². Such an investor has an average knowledge of the capital market and its functioning mechanisms, and makes the investment decisions objectively and rationally, with the use of all available information about issuers and their financial instruments²³, in order to maximize the profits on the market²⁴. As J. Dybiński points out, this concept laid the foundation of the neoclassical economics of the second half of the twentieth century²⁵ and was used, among others, to establish the rational expectations theory²⁶, rational choice theory, and the efficient-market hypothesis.

In recent years however, in the newest economics, interesting strands of behavioral economics, questioning the validity of the current general presumptions of the regulation of capital markets, including primarily the model of a rational investor, have started to burgeon²⁷. Behavioral economics, drawing on interdisciplinary research from the borderline of financial, psychological, sociological as well as empirical and statistical sciences, has resulted in a revision of current views.

Behaviorist strands criticize primarily all the presumptions on the rationality of investors, pointing to the fact that the human ability to analyze, perceive and process information is highly limited due to various internal and external factors (including short time and information)²⁸. Numerous cognitive, social, emotional and environmental conditions have a negative impact on the investors' thought processes on the capital market²⁹ — in order to understand these economically non-optimal decision-making processes, behavioral economics also uses prospect theory and cognitive heuristics³⁰.

²¹ J. Dybiński, op. cit., p. 24.

²² K. Oplustil, op. cit. p. 7.

²³ R. Veil, [in:] *European Capital...*, p. 66.

²⁴ J. Dybiński, op. cit., p. 24; J.S. Mill, op. cit.

²⁵ Citing after: J. Dybiński, op. cit.; R.A. Posner, *Economic Analysis of Law*, New York 2014; G. Becker, *The Economic Approach to Human Behavior*, Chicago 1978.

²⁶ J.F. Muth, "Rational Expectations and the Theory of Price Movements", *Econometrica* 29, 1961, no. 3, pp. 315–335.

²⁷ Citing after: J. Dybiński, op. cit., p. 25; D. Kahneman, "Behavioral economics and investor protection: Keynote address", *Loyola University Chicago Law Journal* 44, 2013, pp. 1323, 1333.

²⁸ R. Veil, op. cit., p. 66; P. Zielonka, "Czym są finanse behawioralne, czyli krótkie wprowadzenie do psychologii rynków finansowych", *Materiały i Studia NBP* 2003, no. 158; M. Nowak, "Finanse behawioralne jako nowy kierunek analizy racjonalności inwestorów na rynku finansowym", *Studia Lubuskie* 2007, no 3, p. 243.

²⁹ J. Dybiński, op. cit., p. 25.

³⁰ D. Kahneman, A. Tversky, "Prospect theory: An analysis of decision under risk", *Econometrica* 47, 1979, no. 2, pp. 263–291.

Behaviorist economics proves that the investors' decisions are not solely based on their financial literacy, but to a wide extent on factors such as cognitive abilities, views, personal situation, emotions or even temporary psychological states (so-called biases), for example, excessive risk aversion or procrastination.

The most interesting behavioral anomalies include, among others³¹:

— overconfidence, information overload, the so-called hindsight bias (a tendency to deem past events more predictable than they actually were), excessive choice hindering the decision-making process (choice preference), selective choice of data to confirm the choice (confirmation bias), also leading to overconfidence concerning your own decisions, loss aversion (in which investors prefer to make a small loss than a large profit), herding (when more investors make the same decisions, adhering the conduct of others), excessive influence of the initial stage over the idea of the final result (anchoring/adjustment), the disposition effect (the tendency to premature realization of profits and to protraction of the implementation of losses, also resulting in the so-called sunk-cost effect).

The above remarks regarding investors' making illogical, counter-productive and irrational decisions lead to the question of the rationale and sense of such an elaborate regulation in the prospectus law.

There are many ways to justify the need to protect investors' interests in the capital markets — primarily in the context of financial instruments proposed under the public offering. One of the most important theories in this field is the so-called theory of legal origins. It assumes that two fundamentally different legal traditions, i.e. common law and civil law, fundamentally influenced the shape of legal systems and capital markets or entire economies³². Empirical studies have shown that there is a close relationship between the level of investor protection in the capital markets and economic growth, as well as economic development. Countries with a better level of security for investors had more developed financial markets, including capital markets³³. Some economists have therefore concluded that the Anglo-Saxon system (especially in the US and the UK) is more efficient and better organized, in the context of capital markets' strength, than the continental system³⁴. However, this theory has recently been strongly criticized³⁵.

³¹ Behavioral Patterns and Pitfalls of U.S. Investors, A Report Prepared by the Federal Research Division, Library of Congress under an Interagency Agreement with the SEC, August 2010, pp. 1–20.

³² Citing after: J. Dybiński, op. cit.; R. La Porta et al., "Legal determinants of External Finance", *The Journal of Finance*, LII, 1997, no. 3, pp. 1131–1150.

³³ R. La Porta et al., "Investor protection and corporate valuation", *The Journal of Finance* LVII, 2002, no. 3, p. 24.

³⁴ R. Romano, *The Genius of American Corporate Law*, Washington 1993; H. Hansmann, R.R. Kraakman, "The end of history for corporate law", *88 Georgetown Law Journal* 2001, p. 439.

³⁵ J. Armour et al., "Shareholder protection and stock market development: An empirical test of the legal origins hypothesis", *Journal of Empirical Legal Studies* 6, 2009, issue 2, pp. 343–380;

According to another theory, the main goal of investor protection regime on the capital market is to build its trust and ensure its presence on the capital market, which creates a high availability of cheap capital for entrepreneurs³⁶. In other words, as a primary objective of capital market regulation, one can indicate the creation of conditions that will allow the capital to be directed to finance projects ensuring its optimal use³⁷. Therefore, it is necessary to maximize the information efficiency of the market by creating conditions of fair competition and increasing market transparency in order to obtain investor confidence and reduce the “information price” and thus transaction costs of capital available to issuers³⁸. Disclosure obligations and adequate supervision on the capital market serve to fulfill this goal.

Another way to justify the current rigorous and complicated form of disclosure obligations is the argumentation of a functional nature. It results from the fact that households are traditionally the basic source of capital in the economy, usually through financial intermediaries, and at the same time they bear the highest risk of loss in the event of the bankruptcy of entities to which they entrust their funds to invest in the capital market. The scope of losses of small investors during financial crises led to the creation of a specific protection concept called “too many to fail” similarly to saying “too big to fail”³⁹.

At the same time, it should be emphasized that the task of legislators is not a total elimination of risk, which is an immanent feature of the markets, as well as a *sine qua non* condition for generating profits on the capital market⁴⁰, but minimizing the risk resulting from the unfair conduct of issuers in primary market⁴¹. It is very important, both from the point of view of market functionality, as well as its information efficiency, to build lasting trust among retail investors. In Europe, low confidence in the markets results in poor participation of investors and the failure to use their economic potential. In Europe (including Poland), less than 15% of people hold shares or bonds, while in the US this number is 52% (which is still a record low, considering 65% in 2007). In the opinion of both the European Com-

R. Castro, G.L. Clementi, G. MacDonald, “Investor protection, optimal incentives, and economic growth”, *The Quarterly Journal of Economics* 119, 2004, issue 3, pp. 1131–1175.

³⁶ F.H. Easterbrook, D.R. Fischel, “Mandatory disclosure and protection of investors”, *Virginia Law Review* 70, 1984, issue 4, p. 669; N. Moloney, op. cit., pp. 786–787.

³⁷ Citing after: M. Spyra, op. cit., p. 5; P. Buck-Haeb, *Kapitalmarktrecht*, Heidelberg 2014, pp. 3–4.

³⁸ H. Scott, “Committee on Capital Market Regulation, *Washington Post*, 21.1.2016.

³⁹ J. Dybiński, op. cit.; N. Moloney, “Regulating the retail markets: Law, policy and the financial crisis”, [in:] *Current Legal Problems*, eds. G. Letsas, C. O’Cinneide, Oxford 2010, p. 375.

⁴⁰ J.A. Burke, “Re-examining Investor Protection in Europe and the US”, *Murdoch University Journal of Law* 16, 2009, no. 2, p. 6.

⁴¹ M. Spyra, op. cit., p. 57.

mission and the ESMA (European Securities Exchange Authority), trust is a more important incentive to invest in the capital market than the desire to make profits⁴².

European Prospectus Directive — the main obstacles to market effectiveness

The current EU rules on prospectus were introduced in 2003, with Directive 2003/71/EC (Prospectus Directive)⁴³, which underwent a major revision in 2010, with the adoption of amending Directive 2010/73/EU⁴⁴. Theoretically, these prospectus rules were to ensure that adequate and equivalent disclosure standards are in place in all EU countries so that investors can benefit from the same level of information. Although it has led to some harmonization of the rules concerning prospectuses in the Member States and created the cross-border “passporting mechanism”, the directive occurred to be an insufficient measure in tackling the challenges of modern capital markets. Despite strong axiological and theoretical assumptions, the current European prospectus law does not fulfill its role and is commonly considered as flawed for at least several reasons. In 2015 the European Commission conducted a series of consultations which identified various shortcomings in the regime introduced by the prospectus directive.

First, it creates artificial entry barriers for capital companies seeking financial support. This is due to the fact, that the current regulation imposes too many requirements and information obligations on listed companies, which significantly increases transaction costs and makes searching for funding on the capital markets unprofitable for many players. Moreover, most of retail investors are practically unable to digest the significant amount of detailed information presented by publicly-listed companies due to the current prospectus obligations, which in consequence, discourages them from further investments on the capital market. Also, there are many differentiating regimes within European Union which leads to the fragmentation of capital markets.

⁴² J. Dybiński, *op. cit.*, p. 34.

⁴³ 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 (Text with EEA relevance), <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32003L0071> (access: 15.06.2018).

⁴⁴ Directive 2010/73/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market Text with EEA relevance, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32010L0073> (access: 15.06.2018).

The 2015 Impact Assessment Working Paper⁴⁵ evaluation has identified numerous issues which seem to hinder the raising of capital in the EU.

First, the costs of compliance with the Prospectus Directive are extremely high (on average at EUR 1 million, and up to 15% of the capital raised)⁴⁶. The prospectuses and their summaries became extremely long documents (hundreds of pages) often focused solely on avoiding liability risks. Because of that, legal fees are accounting for 40% or more of the compliance costs. This makes the drafting and approval process an expensive, complex and time-consuming exercise.

Second, the investor protection is ineffective⁴⁷. According to the Working Paper, the length of prospectuses and the fact that they are often drafted with the objective to address any potential legal liability rather than to inform investors in a suitable way, undermine the objective to protect investors through the provision of suitable and appropriate information to protect them from being attracted into investments they would not have made had they fully understand the offer.

For example, the prospectus summary which was intended to provide investors with simple way to understand information about the product is considered “too long, unwieldy and too comprehensive” — causing investors dissatisfaction.

Thirdly, the regulatory framework under Prospectus Directive is neither flexible nor suitable for SMEs as well as some types of securities⁴⁸. According to the Working Paper, the insufficient differentiation and proportionality of the requirements between specific situations and issuers results in an inappropriate administrative burden and might even deter companies from accessing capital markets. Consequently, the SMEs have a very limited access to finance and are forced to rely heavily on banks. As of 2015, the vast majority of their financing was conducted by banks and only 20 per cent of capital or less was obtained from capital markets. In the entire EU the average for using equity as a source of funding was at only 3%, which is even below the world's average.

Fourth, the harmonization achieved by the Prospectus Directive is perceived as insufficient⁴⁹. The Working Paper stresses out that the Directive leaves Member States with considerable discretion in its implementation and application which hinders the emergence of a truly integrated EU capital market. The problems are also reflected by the fact that finding and comparing issuances is very hard, as there is no IT-tool to allow this. Moreover, there is “no sufficient alignment of more recent EU law with the Prospectus Directive”, which makes the investor

⁴⁵ European Commission, The Commission Staff Working Document Impact Assessment accompanying the document Proposal for a Regulation of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading, Brussels, 30.11.2015.

⁴⁶ Ibid., pp. 8–9.

⁴⁷ Ibid., p. 9.

⁴⁸ Ibid.

⁴⁹ Ibid., p. 10.

protection even more ineffective and thus discourages them from placing their savings and funds on capital markets⁵⁰. This means nothing but missed investment and funding opportunities for investors and companies in the Union. Financial fragmentation is believed to have a significant effect on the possibility to share economic risks across borders — this is due to the fact that capital markets and bank credit markets play an important role in cushioning the impact of economic shocks⁵¹. There is a clear link between financial integration, risk sharing and higher economic growth through a “risk-amelioration” channel. Financial market fragmentation is believed to be one of the main causes of the low economic growth within the EU⁵².

The colossal gap between US and EU capital markets efficiency and effectiveness

Another justification for the urgent need to tackle the problem of prospectus obligations in Europe results from the fact that European capital markets are failing in comparison to the EU’s main competitors. The European public offer market has been wasting its potential for years and was slowing the economic development of EU countries. In particular, there is a huge gap between the IPO market in the European Union and the homeland of the capital markets — the United States, where the most efficient model of capital markets operates. New Financial 2018 Report⁵³ proves that currently — despite a relatively small difference in GDP (19 trillion USD to 17 trillion USD)⁵⁴, the American public offer market is even 3 times larger than the European one. The Report, after analyzing 24 sectors of the capital markets, comes up with conclusion that capital markets in the EU are on average smaller and less developed relative to GDP than they were a decade ago — and the gap in market’s depth between Europe and the US has significantly widened. In the EU, around 88% of all funding comes from bank lending, while in US around 74% comes from corporate bonds. It is estimated that if capital markets in the EU were to close the gap in depth with the US, it would mean an additional €10 trillion in long-term capital that could be raised by the companies and thus

⁵⁰ Ibid.

⁵¹ N. Anderson et al., “A European Capital Markets Union: implications for growth and stability”, *Bank of England Financial Stability Paper* 2015, no. 33; Y. Demyanyk, C. Ostergaard, B.E. Sørensen, “Risk sharing and portfolio allocation in EMU”, *DG ECFIN Economic Paper* 2008, no. 334.

⁵² M. Obstfeld, “Risk-taking, global diversification, and growth”, *American Economic Review* 84, 1994, no. 5, pp. 1310–1329; G. Femminis, “Risk-sharing and growth: The role of precautionary savings in the ‘Education’ model”, *Scandinavian Journal of Economics* 103, 2001, pp. 63–77.

⁵³ W. Wright, P. Asimakopoulous, *New Financial Report: the size, depth and growth opportunity in EU capital markets*, issued: 03.2018.

⁵⁴ [https://en.wikipedia.org/wiki/List_of_countries_by_GDP_\(nominal\)](https://en.wikipedia.org/wiki/List_of_countries_by_GDP_(nominal)) (access: 15.06.2018).

put to work in the EU economy, and around €600 bn in additional equity and bond market funding each and every year (which is double the annual budget of whole Germany). Such funds could potentially help solve structural problems that have been affecting the Old Continent for years, including unemployment, inflation or high public debt. Capital markets in the EU are only around one third as deep as in the US, and this transatlantic gap in depth has widened over the past decade in two thirds of the sectors in our sample. While capital markets in the US have grown relative to GDP over the past decade, they have shrunk in 80% of EU member states. US capital markets are nearly three times larger as a share of GDP than those in Europe, while the depth of EU capital markets has fallen relative to GDP by 8 per cent in the decade to 2016. The scale of the US markets, measured in proportion to the level of economic activity, has grown by 8 per cent in the same period. Total corporate funding has fallen from 112 per cent of EU GDP in 2006 to 106 per cent in 2016, New Financial Report says. By contrast, in the US that figure has risen from 134 per cent of GDP to 177 per cent. As a consequence, it leads to the under-utilization of the economic potential of capital markets and hindering of growth of the entire economy, which forces economic entities to rely on more expensive and less effective debt financing (by banks). In Europe, over 85% have to use debt capital (banks, etc.), while in the US almost 80% of investments come from capital markets. The only bright side of the Report is that it confirms the enormous growth potential of capital markets (and especially public offers market) in the European Union.

The practical and international significance of this issue stems from the fact that finding exact legal obstacles and causes of the presented situation and addressing them in a proper way, can unlock the economic potential of the European capital markets and the whole European Union.

Prospectus regime of the upcoming Prospectus Regulation — selection of key changes

The significance of the problem is also due to its exceptional timeliness, as a landmark reform of prospectus law approaches. The new law on prospectus is introduced by Prospectus Regulation which replaces the existing Prospectus Directive and will be binding and directly applicable in all EU member states. The main objective of the prospectus Regulation (EU) 2017/1129 is to improve the current prospectus regime and prospectus obligations. The Regulation will effectively come into force in July 2019. New legislation is also a realization of the European Capital Markets Union (CMU)⁵⁵. According to the European Commission, the CMU is one of the flagship projects which reflects a long-term ambition to

⁵⁵ European Commission, *The Commission Staff Working Document Impact Assessment...*, Brussels, 30.11.2015, Annex 3, p. 6.

expand and diversify alternative sources of funding to bank lending and to help EU companies to better finance their expansion and therefore to create jobs and growth. The regulation is also part of the Commission's more general commitment to simplifying EU laws and making them more effective and efficient (REFIT).

The Prospectus Regulation is designed to facilitate access to financial markets for companies, particularly small and medium-sized enterprises (SMEs). Generally speaking, the regulation aims to make it easier and cheaper for smaller companies to access capital through public offerings, to introduce simplification and flexibility for all types of issuers, in particular for secondary issuances and frequent issuers which are already known to capital markets. It also aims to improve prospectuses for the convenience of the investors by introducing a retail investor-friendly summary of key information, catering for the specific information and protection needs of investors.

First, the new rules exempt the smallest capital raisings as they do not apply to issues of securities with a value below €1 million (previously €100,000)⁵⁶. In addition, in order to promote SMEs in their struggle for raising capital, member states will now be able to exempt issuers they consider to be small from the obligation to publish a prospectus by setting a higher threshold — up to €8 million — for their domestic markets⁵⁷.

Second, under the new rules there will be a special fast-track and simplified frequent issuer regime. Companies that frequently issue securities will be able to use the 'Universal Registration Document' (URD), which will contain all the necessary information about the company⁵⁸. Issuers that regularly maintain an updated URD with their supervisors can count on five day fast-track approval when they immediately need to raise capital on the markets.

Third, the regulation specifies, with much greater clarity, the amount of information needed in order to make prospectuses both shorter for issuers and at the same time — clearer for investors. Moreover, the companies that are already listed on a public market will have a possibility to issue additional shares (secondary issuance) or raise debt (corporate bonds) using special Simplified Prospectus⁵⁹.

Fourth, the special EU Growth Prospectus will be established, which will provide smaller companies with a considerably lighter regime and less complex requirements for issuing a prospectus⁶⁰. This entirely new type of prospectus, will be available for SMEs, companies with up to 499 employees admitted to an SME growth market or small issuances by unlisted companies.

⁵⁶ Article 1(3).

⁵⁷ Article 3(2)(b).

⁵⁸ Article 9.

⁵⁹ Article 14.

⁶⁰ Article 15.

Fifth, The European Securities and Markets Authority (ESMA) will be obliged to provide totally free of charge and searchable online access to all prospectuses approved in the European Economic Area. Therefore the information effectiveness of the capital markets will be enhanced. Also paper prospectuses will be required only under specific investors' requests.

The newest adoption of the Prospectus Regulation has an opportunity to facilitate CMU as well as make it easier for companies to enter capital markets and take an advantage of diversified sources of funding across the EU. As the European Commission underlines, the new regulation on prospectuses "will simplify the rules, streamline related administrative procedures, and make it more convenient for small businesses to access capital markets".

The Prospectus Regulation is undoubtedly a firm step in the right direction and will certainly be the subject of numerous analyzes and scientific research in the future. However, in my view, the solutions proposed by Prospectus Regulation are not sufficient, and the reform of the capital markets of the European Union requires more drastic measures in order to evolve in the more desired direction.

Concluding thoughts

In conclusion, the European solutions in the field of prospectus obligations in public offerings, theoretically designed to protect investors and specific information order on the capital market, in fact may seriously undermine its effectiveness and competitiveness compared to main competitors like the United States. The current European regulation on prospectus obligations creates various "entry barriers" for capital companies seeking financial support, and meanwhile, might actually fail to establish a proper information order and transparency obligations — therefore discouraging many retail investors from placing their funds on the capital markets. This dilemma leads to the under-utilization of the economic potential of the capital markets and affects the growth of the entire economy, which forces economic entities to rely on more expensive and risky, hence less effective, bank lending.

What is more, strict European prospectus obligations can actually introduce information chaos and provide even weaker investor protection — effectively discouraging them from investing their funds on the capital markets. The removal of various legal barriers "to go public" in the form of appropriate simplification and flexibilization of the prospectus obligations for companies (including innovative companies and start-ups) would give them incentives to enter the capital market and derive significant benefits due to a broader access to cheap investor's capital and effective funding, which will have a positive impact on the whole Europe's economic growth.

Although the abovementioned Prospectus Regulation is a sign of a very promising trend, the solutions proposed by Prospectus Regulation are quite careful and

not yet sufficient, as the reform of the capital markets of the European Union requires more revolutionary and ground-breaking measures in order to compete with more efficient and booming capital markets, such those in United States or Asia.

In my opinion, there is still a growing need to propose a landmark and original vision of the framework of the prospectus obligations in public offerings so they can best address the particular needs of numerous market players — including the companies' need for cheap and easy funding, the need for appropriate investor information protection, and finally — the general need to increase the competitiveness and attractiveness of the EU Capital Markets Union. Appropriate solutions and legal policy in this area would not only contribute to strengthening and increasing capitalization of the markets, but also promote the sector of SME's (Small to Medium Enterprises), and consequently — help to unlock the potential of growth for the entire European Union economy.

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The new Prospectus Regulation and the information efficiency of capital markets in the European Union

Summary

Public Offerings are a vital part of any capital market. They enable companies to raise finance in exchange for shares in future profits from a wide range of investors, then those collected funds allow them to conduct long-term investments, which in turn they can convert into jobs and growth. The economic analysis of law suggests that European solutions in the field of prospectus obligations in public offerings, theoretically designed to protect investors and specific information order on the capital market, in fact may seriously undermine its effectiveness and competitiveness compared to other competitors, like the United States. What is more, they can actually introduce information chaos and provide even weaker investor protection — effectively discouraging them from investing their funds on the capital markets. It is believed that the removal of various legal barriers "to go public" in the form of appropriate simplification and flexibilization of the prospectus obligations for companies (including innovative companies and start-ups) would give them incentives

to enter the capital market and derive significant benefits due to a broader access to cheap investor's capital and effective funding, which will have positive impact on the whole Europe's economic growth. The significance of the presented issue is due to its exceptional timeliness, as a landmark reform of prospectus law approaches. The new Prospectus Regulation (EU) 2017/1129 replaces the existing Prospectus Directives and will be binding and directly applicable in all EU member states. It is no exaggeration to say that the reform and its legal framework will soon determine the future of capital markets, as well as the economy of the entire European Union. Although the abovementioned Prospectus Regulation is a sign of a very promising trend, the solutions proposed by Prospectus Regulation are quite careful and not yet sufficient, as the reform of the capital markets of the European Union requires more revolutionary and ground-breaking measures in order to compete with more efficient and booming capital markets, such those in United States or Asia. In my opinion, there is still a growing need to propose a landmark and original vision of the framework of the prospectus obligations in public offerings so they can best address the particular needs of numerous market players — including the companies' need for cheap and easy funding, the need for appropriate investor information protection, and finally — the general need to increase the competitiveness and attractiveness of the EU Capital Markets Union. Appropriate solutions and legal policy in this area would not only contribute to strengthening and increasing capitalization of the markets, but also promote the sector of SME's (Small to Medium Enterprises), and consequently — help to unlock the potential of growth for the entire European Union economy.