

NOTE OF MEETING WITH REPRESENTATIVES OF THE EU COMMISSION INTERNAL MARKET DIRECTORATE - GENERAL AND THE FINANCIAL SERVICES AUTHORITY

TO DISCUSS THE EU PROSPECTUS DIRECTIVE AND ITS APPLICATION TO EMPLOYEE SHARE PLANS

HELD AT THE OFFICES OF LOVELLS ON FRIDAY 25 NOVEMBER 2005

Ruth Walters - EU Commission Internal Market Directorate-General
Walter Goetz - EU Commission Internal Market Directorate-General
Adetutu Odutola - Financial Services Authority
Alexy Armitage - Mercer Human Resource Consulting
Fiona Downes - ifsProShare

Members of the ifsProShare Advisers EU Focus Group (listed in the appendix to this note).

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1. Purpose of the meeting

Ruth Walters and Walter Goetz of the EU Commission Internal Market Directorate-General had been asked by the ifsProShare Advisers Group to attend a follow up meeting to a meeting held on 12th July, 2005 to discuss the effects of the EU Prospectus Directive on the operation and implementation of employee share plans.

Following the implementation of the Prospectus Directive across a majority of EU Member States, companies are still concerned that they may be making public offers when launching employee share plans across Europe which trigger the requirement for a prospectus under the Prospectus Directive, and that they may not be able to rely on an exemption from prospectus requirements under that Directive. The ifsProShare Advisers Group had highlighted to the Commission = in advance areas of particular concern, including:

- A lack of a clear exemption for employee share plans of companies which do not have securities admitted to trading on an EU regulated market, including those which have securities traded on a market (such as a US market) which is not a 'regulated market' within the meaning of Community legislation;
- Legal uncertainty;
- Inconsistency in approach between Member States towards exclusions from and exemptions to the EU Prospectus Directive;
- Countries which have not yet transposed the EU Prospectus Directive;
- The determination of the Home Member State for third country issuers.

The meeting was attended on behalf of the EU Commission Services by Ruth Walters and Walter Goetz (together hereafter referred to as 'CS' or "Commission Services"). As with the meeting in July, the CS representatives were not in a position to give formal guidance. Rather, the meeting would be used:

- as part of an ongoing process to assess the issues which were being faced in the employee share plan context;
- to consider issues which either the EU Commission, the Committee of European Securities Regulators ("CESR") or national regulators such as the UK Financial Services Authority would need to resolve further; and
- to give an informal view on some of the issues which had been raised.

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The CS representatives also emphasised that the Commission Services cannot give a binding interpretation of a provision of Community legislation (only the European Court of Justice is competent to do that), and that the views expressed at the meeting do not bind the European Commission as an institution. In particular, the Commission would be entitled to take a different position in any future judicial proceedings, including infraction procedures, concerning the provisions discussed.

2. The Employee Offer Exemption - Article 4(1)(e)

Ruth Walters discussed the application of the employee offer exemption contained in Article 4(1)(e). Article 4(1)(e) provides an exemption from the obligation to publish a prospectus in relation to:

"securities offered, allotted or to be allotted to existing or former directors or employees by their employer which has securities already admitted to trading on a regulated market or by an affiliated undertaking, provided that a document is made available containing information on the number and nature of the securities and the reasons for and the details of the offer."

2.1 Ruth Walters noted that there was no substance in any rumour that the EU Commission was going to interpret the exemption in a way that made it available to all companies that had a listing on a market anywhere in the world. The exemption was clear in that it only applied to companies which had securities admitted to trading on an EU regulated market (which means a market as defined by Article 1(13) of Directive 93/22/ EEC (the Investment Services Directive).

The employee offer exemption would need to be amended if the employee offer exemption is to be extended to companies that did not have securities admitted to trading on an EU regulated market. Any possibility of an amendment to the Directive would be a considerable way off and it was likely that there would not even be a formal review of the exemption before 2007, although the Commission Services are taking note of the experience of issuers and their advisers in the application of the Directive).

2.2 Commission Services had considered further whether companies could rely on the employee offer exemption if they had only debt securities admitted to trading on an EU regulated market. The differences between the wording in Article 4(1)(e) (exemption from offers of securities to employees) and Article 4(2)(f) (exemption on the admission of securities to trading on a regulated market) were noted again. The exemption from prospectus requirements under Article 4(1)(e) applied where securities were offered "by their employer which has securities already admitted to trading on a regulated market or by an affiliated undertaking", while the exemption under Article 4(2)(f) applied where securities were offered "by their employer or an affiliated undertaking, provided that the said securities are of the same class as the securities already admitted to trading on the same regulated market".

The Commission Services had concluded that it is entirely legitimate for Member States to implement this exemption in such a way that would allow companies to rely on the employee offer exemption if they had only debt securities admitted to trading on an EU regulated market. As a result, the interpretation in some Member States could be that, in order to be able to use the employee share exemption from prospectus requirements for public offers, it was only necessary for a company to have a listing of debt securities (rather than having to have a listing of equity securities of the same class that was being offered to the employees).

Adetutu Odutola noted that the view that the Financial Services Authority had taken in the UK was that, to take advantage of the employee offer exemption under Article 4(1)(e), the company whose shares were being offered to the employees must have either shares or debt securities admitted to trading on an EU regulated market.

2.3 The CS representatives noted that the employee offer exemption under Article 4(1)(e) might be subject to a different interpretation in some Member States depending on the way the EU Prospectus Directive had been transposed in that jurisdiction (or, indeed, the official translation of the Directive applying to that jurisdiction).

Walter Goetz noted that the EU Commission Services would not regard a narrow interpretation of the exemption as a basis for infraction proceedings. This was partly because of the acknowledged deficiencies in the drafting of the employee offer exemption and partly because the EU Commission was more concerned to see prospectus requirements harmonised and to ensure the effective operation of the passport for prospectuses.

That said, the EU Commission was also concerned to encourage a coherent application of the law. If a particular state took an obviously unsustainable view, it might take infraction proceedings. The EU Commission would be concerned, for instance, if member states were imposing additional local law requirements to those set out in the employee offer exemption, thereby acting as an impediment to cross border incentives across the EU.

Adetutu Odutola noted that the Financial Services Authority was working with other regulators through meetings of CESR (Committee of European Securities Regulators) to reduce the extent of divergence in the interpretation and application of the employee offer exemption.

3. Legal uncertainty

Members of the ifsProShare EU Focus Advisers Group noted their concerns that it was still legally uncertain as to whether employee share plans are caught by the EU Prospectus Directive (and, if so, which types). The point was raised that in some provisions relevant to share schemes the wording in the Prospectus Directive is ambiguous and, without any guidance from the EU Commission / CESR, some local regulators are issuing inconsistent guidance, while other regulators will not provide any guidance at all. There was particular uncertainty in:

- The calculation of financial thresholds - for instance, some members have not implemented the exclusion (in Article 1(2)(h) of the Directive) for offers where the total consideration is less than 2.5 million Euros. Where the 2.5 million exclusion has been implemented, some Member States count just offers made within their own territory for the purposes of calculating this limit, while others count worldwide or EU wide offers.
- Whether particular types of employee share plans, such as option plans or free share award plans, are caught.

The lack of certainty was causing considerable difficulties for companies in assessing whether or not they were in breach of prospectus rules, with the result many companies were suspending or withdrawing their share plans. It was noted in particular that the EU Prospectus Directive was more likely to lead to a withdrawal of benefits under "all employee" plans than under plans for senior executives, because (in launching a senior executive plan) companies could generally rely on the exemption in Article 3(2)(b) for offers to fewer than 100 persons per EEA state.

Members of the ifsProShare EU Focus Advisers Group also noted their concern that it was still necessary for companies to assess the position in all the EU member states in which a share plan was being launched, because of the differences in approach being adopted by different regulators. This was a time consuming and expensive task.

Even where a particular regulator had expressed a view, it was uncertain as to the extent to which a company could rely on that guidance. Often the statements of the regulators were expressed as being non binding, which left companies with legal risk if they decided to implement plans after taking into account the published views of the regulators. This exposed companies and their directors to both criminal and civil liabilities.

Given the ambiguities in the EU Prospectus Directive (and implementing legislation in each jurisdiction), advisers could not give an unqualified legal opinion that particular types of employee share plan are not caught by the Prospectus Directive. US issuers without shares admitted to trading on an EU market were in a particularly difficult position following reforms to US legislation in recent years (for instance, Sarbanes Oxley). Without an unqualified legal opinion, many US issuers could decide to withdraw equity incentives.

Particular concern was raised that, if a regulator changed its view, an issuer that had previously relied on that guidance could find itself in breach of prospectus requirements.

The CS representatives and Adetutu Odutola of the Financial Services Authority acknowledged the concerns raised in relation to legal uncertainty. They noted that much effort was being made at both the EU Commission level and through CESR to achieve a consistent approach across the EU and to reach a common consensus among regulators as to whether employee share plans are caught. The CS representatives were now of the view that many share plans were simply not caught by the EU Prospectus Directive (see Section 4 below for the discussion relating to options and free share awards). The following points were made in particular:

In terms of reliance on the published views of the Financial Services Authority in the UK, Adetutu Odutola mentioned that the statements in List! did not constitute FSA Guidance, within the meaning of the Financial Services and Markets Act 2000. General guidance within the meaning of that Act is subject to formal requirements, and given through the Listing Rules, Prospectus Rules, Disclosure Rules or the appropriate part of the FSA Handbook. Those formal requirements, including requirements for consultation and a cost-benefit analysis, have not been followed in relation to material included in List!, and accordingly its different status needs to be made clear. However, issuers could take into account the comments of the Financial Services Authority in relation to the application of the EU Prospectus Directive (and exemptions and exclusions) to employee share plans, as set out in List!, in assessing the risk of any enforcement action by the Financial Services Authority.

- 3.1 Adetutu Odutola also noted that some progress had been made at the recent meeting of CESR (22nd November, 2005) in reaching a common consensus on the approach to employee share plans (see further below).
- 3.2 Ruth Walters noted that the EU Commission was considering issuing guidance on the EU Prospectus Directive and employee share plans. It was hoped that any such guidance would be persuasive in achieving a consensus among regulators that was favourable to the implementation of employee share plans, within the legal limits permitted by the Directive. The EU Commission did not have the power to issue binding guidance. Walter Goetz noted that legal certainty in relation to the meaning of a directive would only be achieved if the matter were brought before the European Court of Justice. However, litigation would only arise if the EU Commission took an infringement case against a Member State (which was unlikely, as normally such cases were only brought where there had been a failure to implement the Directive or a clear breach of Directive) or if litigation were initiated against individual regulators, and the matter were referred by the domestic court to the ECJ. It was acknowledged that the latter was unlikely, as companies were unlikely to wish to become embroiled in the expense and risk of litigation and (in the UK context) would wish to adopt a cooperative approach with regulators.

Adetutu Odutola was not in a position to share with the meeting the note of the CESR meeting of 22nd November, 2005, since the note had yet to be agreed formally within CESR. However, it may be published in due course on CESR's website. Ruth Walters noted that, if CESR decided not to publish its views, Commission Services would then consider issuing its own guidance. The publication of the note of this meeting could also be helpful.

Some members of the ifsProShare EU Focus Advisers Group noted that, to the extent there were still differences in approach between different regulators, it would be helpful for CESR or the Commission Services to publish a summary table outlining the views of each regulator on each type of principal plan (for instance, options, RSUs and ESPPs), the application of the employee offer exemption and the financial thresholds.

4. Free Share Awards

Ruth Walters noted that the Commission Services and CESR had considered further the application of the EU Prospectus Directive to free share awards since the previous meeting on 12th July, 2005.

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The consensus view had been reached by Commission Services and CESR that free share awards would not be caught on the basis that either:

- They would be excluded from the scope of the Prospectus Directive on the basis of Article 1(2)(h), which provides that the Directive does not apply in relation to "securities included in an offer where the total consideration of the offer is less than 2,500,000 Euros, which limit shall be calculated over a period of 12 months"; or
- They would be exempt by virtue of Article 3(2)(e) as being "an offer of securities with a total consideration of less than 100,000 Euros, which limit shall be calculated over a period of 12 months".

Even in jurisdictions where the Member State had chosen to regulate domestically offers with a total consideration of less than 2,500,000 EUR, as they are permitted to do since such offers are entirely outside the scope of the Directive, issuers would nevertheless be entitled *in all cases* to rely on the exemption for offers of less than 100,000 EUR.

Commission Services were of the view that the word "consideration" should be given its specific technical meaning. There was no reason to equate the word "consideration" with the value of the shares awarded to the employees. Indeed, it would be extremely difficult to quantify the additional consideration given by an employee for his free share award (over and above the services that the employee was contractually obliged to deliver). As both Article 1(2)(h) and Article 3(2)(e) used the word "consideration", it was unnecessary for companies to look further than the monetary amounts that the employee had to pay for their shares in assessing their application. Hence, if the employees did not have to pay any monetary consideration at any stage of the transaction, the offer would either be excluded from the Prospectus Directive by virtue of Article 1(2)(h) or exempt by virtue of Article 3(2)(e).

As a result, the Commission Services representatives considered that free share awards to employees would not be caught by prospectus requirements. On this basis, there would be no need for companies to prepare prospectuses when launching plans involving restricted stock awards, restricted stock units or other forms of conditional share awards.

The Commission Services representatives acknowledged that the inter-relation of Article 1(2)(h) and Article 3(2)(e) was potentially unclear. However, they took the view that the interaction was as follows. Article 1(2)(h) excludes offers with a total consideration of less than €2.5 million from the scope of the Directive entirely. This means that offers of this kind were not regulated under Community law, and Member States were free to regulate them at a domestic level if they chose to do so. However, that freedom for Member States was subject to the exemption in Article 3(2)(e) for offers of less than €100,000. Accordingly, even if Member States chose to extend prospectus requirements under national law to low value offers which were excluded from the scope of the Directive under Article 1(2)(h), offers under 100,000 Euros must nevertheless remain exempt (as a minimum harmonisation requirement). This would leave Member States free to decide whether to require a prospectus for offers between 100,000 Euros and 2,500,000 Euros.

The question was raised as to the effect of this interpretation on the determination of a home member state for a third country issuer that had only launched free share awards under its employee share plans in the EU since 31st December, 2003. This question is relevant since, under Article 2(1)(m)(iii) of the Prospectus Directive, the permanent home Member State of a third country issuer for the purposes of shares or low denomination debt can be fixed by the first offer of securities to the public made after 31st December 2003 – the date on which the Directive was published in the Official Journal of the European Union (and on which it came into force). The Commission Services representatives indicated that they would need to consider this further. It could be that an offer which fell within Article 1(2)(h) would not be a factor in determining the issuer's home member state, while an offer made in reliance of Article 3(2)(e) could.

The question was raised as to whether the Prospectus Directive would apply to a free share offer. It was suggested that such offers might not be covered by the definition of 'offer to the public' for the

purposes of the Directive (Article 2(1)(d)), on the basis that the share offer would not involve a "purchase" or "subscription" of shares, which appeared to be a constituent element of the definition. This question is less relevant to the regulatory requirement for a prospectus, since offers of shares which are entirely free of charge will in any event be exempt under Article 3(2)(e): rather, its particular relevance is to the determination of the home Member State of a third country issuer, since if such offers are not covered by the definition of 'offer to the public', they will not be capable of fixing the home Member State of the issuer under Article 2(1)(m)(iii). This question was not resolved in the meeting. Adetutu Odutola thought this was an open question given the use of the word "subscription" and different language versions of the EU Prospectus Directive.

5. Are options covered by the EU Prospectus Directive?

Ruth Walters and Adetutu Odutola noted that both Commission Services and CESR accepted that non-transferable employee option plans would not, at any stage in the transaction, involve a public offer of securities that would be caught by the EU Prospectus Directive.

Both the Commission Services and CESR took the view that the grant of the option did not involve the offer of a transferable security if (as was almost always the case) the option was not transferable. The Directive applies only to offers of *transferable* securities (Article 2(1)(a)), and there would be no offer of transferable securities at the time of the grant of the option. The subsequent exercise of the option should properly be regarded as the exercise of rights pursuant to a contract, and would not involve a public offer.

Adetutu Odutola noted that all the regulators who had attended the meeting on 22nd November had agreed with this analysis. A consensus had emerged in the meeting to adopt this approach. In practice, where such a consensus emerges in a CESR meeting, it was expected that all regulators throughout the EU would use their best endeavours to follow a similar approach. As noted earlier, Adetutu Odutola was not in a position to release the minutes of the CESR meeting.

There were two provisos to the position that the regulators had adopted, namely:

- Ruth Walters noted that the view that non-transferable employee options were not caught had led regulators to discuss whether there was an obvious regulatory hole in the EU Prospectus Directive whereby issuers could avoid prospectus requirements by structuring purchases of shares through non-transferable options. The regulators had specifically reserved the right to 'look through' any such structure if, in all the circumstances of the case, there was sufficient evidence to indicate that an offer of shares had been artificially structured in such a way in order to avoid the requirement for a prospectus, without any legitimate commercial reason for structuring the transaction in that way. The Commission Services supported this analysis, but considered that the implementation of an employee share plan would be a legitimate commercial reason for structuring the purchase of shares through an offer of options.
- Adetutu Odutola noted that certain types of convertible bonds may be considered to be an offer of the underlying equity (for instance if the conversion took place within a short period and the structure of the transaction was in essence an anti-avoidance mechanism)

In response to questions from members of the ifsProShare EU Focus Advisers Group, Ruth Walters agreed that the analysis which considered any offer or award of a non-transferable security as outside the scope of the Directive would apply in relation to any share based award which was non transferable (for instance, a restricted stock unit).

Ruth Walters also noted that there were no set guidelines as to the length of period between the grant of a non-transferable option and the exercise of that option. It was difficult to conceive that options subject to annual employment conditions before vesting could ever be regarded as an artificial device designed to avoid the requirement for a prospectus: rather, as a legitimately structured transaction, they would fall outside the EU Prospectus Directive. In dealing with non-transferable options that are exercisable over a shorter tie frame, the regulator would need to look at the commercial rationale for

the structure to determine whether there had been a deliberate avoidance of the requirement for a prospectus, justifying regulatory intervention.

6. Employee Stock Purchase Plans/ Share Incentive Plans

There was some discussion as to whether US style employee stock purchase plans ("ESPPs") would be caught by the EU Prospectus Directive given the analysis in relation to options described above.

Members of the ifsProShare EU Focus Advisers Group pointed out that some ESPPs were structured in such a way that the employees had an option or right to acquire shares after a 3 or 6 month accumulation period.

Other ESPPs could be structured as an opportunity to acquire shares (which was similar to the implementation of a Share Incentive Plan in the UK).

No conclusion was reached in relation to ESPPs or SIPs in the meeting. It was agreed that standard forms of ESPPs and SIPs should be forwarded to the Commission Services representatives for their further consideration.

7. Home Member State

Members of the ifsProShare EU Focus Advisers Group noted that there was still a great deal of confusion about the designation of a non- EU issuer's home Member State. It was noted that the Commission Services had previously stated their views on this issue. For a company that is not incorporated in a Member State, Article 2(1)(m)(iii) would apply to securities other than in those mentioned in Article 2(1)(m)(ii). Article 2(1)(m)(iii)¹ provides that the home Member State of such an issuer will be either:

- the Member State in which the company first makes an offer of securities to the public after 31 December 2003; or
- the Member State where the first application for admission to trading on a regulated market is made.²

According to the view already given by the Commission Services, an offer of securities made between 1st January 2004 and 30th June 2005 (the last day of the transposition period of the Directive) would only be capable of fixing the home Member State of the issuer if it had been both an offer to the public both within the meaning of the Prospectus Directive and for the purposes of the applicable law in the Member State in which the offer was made, at the time that it was made.

Members of the ifsProShare Prospectus Advisers Group explained that this requirement to apply local law to determine whether or not an offer of securities triggers the choice of home Member State might have difficult consequences for third country issuers which made offers to employees during the relevant period before the Directive was transposed into the national law of Member States. This is because under the national regimes which were in force during the relevant period, employee share offers were treated inconsistently. While under the law of Member States offers to employees were not treated as offers to the public, a few did treat them as public offers. The result is that an offer made by a third country issuer to employees in a number of Member States might have the result of fixing the home Member State of that issuer as the State where offers to employees were treated as offers to the public under national law in force at the time. The competent authority of that State would then be responsible for approving a prospectus produced by that issuer for any offer or admission to trading of shares, low value debt, or options over shares. This would be the result, even if the issuer

¹ Except where the issuer has made an Article 30 election.

² CS has taken the view that for the purposes of fixing the home MS of a third country issuer under Article 2(1)(m)(iii) in cases where Article 30(1) does not apply, that first application for admission to trading must take place after 1st July 2005. Article 30(1) applies to non- EU issuers which had equity securities or low denomination debt securities admitted to trading on an EU regulated market at 1st July 2005.

had only a small number of employees in that State, and a far greater economic connection with the States where it had also made employee share offers at the same time, but which had not treated those offers as offers to the public under national law. This is of concern to third country issuers, who may be constrained to accept as their home Member State a State which is not otherwise appropriate to their general commercial focus or capital-raising activities in the EU.

The Commission Services recognised the potential difficulties that their view might cause, but explained that it had been based on legal advice.

8. Private Company Shares

The question as to whether offers by private companies would constitute an offer of transferable securities was discussed. The EU Prospectus Directive applies to a public offer of transferable securities. A transferable security is currently defined in Article 1(4) of the Investment Services Directive as follows:

"Transferable security shall mean:

- shares in companies and other securities that are equivalent to shares in companies;
- bonds and other forms of securitised debt;

which are negotiable on the capital market; and

- any other securities normally dealt in giving the right to acquire any such transferable securities by subscription or exchange or giving rise to a cash settlement;

excluding instruments of payment".

The argument that shares in a private company would not constitute shares which are negotiable on a capital market was discussed. The issue was important, as there were some significant examples of private companies who offered shares to their employees, especially in connection with private equity acquisitions.

CS considered shares in private companies could be caught by the EU Prospectus Directive. Their preliminary view was that the shares should be considered as being capable of being negotiated on a capital market. Shares in private companies are not a *sui generis* category of securities which are, by their nature, restricted from being negotiable on the capital market. Rather, they are a sub-category of shares which, as a class, are negotiable.

The argument was put to the CS representatives that shares in private companies would not be caught if the shares were restricted by their very nature and therefore not capable of being negotiated on a capital market.

The CS representatives acknowledged that there was uncertainty under the Investment Services Directive as to whether shares restricted by their nature would be capable of being negotiated on the capital market. They also acknowledged that, even if the shares were capable of being sold to an employee benefit trust, this would not constitute trading on a capital market.

It was left that members of the ifsProShare EU Focus Advisers Group and the CS representatives would consider the position of shares in private companies further.

8. More examples

Walter Goetz emphasised that it would be helpful if the EU Commission received more examples of adverse effects on employees arising from the EU Prospectus Directive. The examples could be given on a no-names / non identifiable basis. The examples were useful to highlight internally within the Commission the issues companies were facing.

Appendix

Members of the ifsProShare Advisers EU Focus Group and others present at the meeting

Alexy Armitage	Mercer Human Resource Consulting	Chair of the ifsProShare EU Focus Group
Fiona Downes	ifsProShare	
Felicity Gemson	Allen & Overy	
Jeremy Edwards	Baker & McKenzie LLP	Note taker
Julie Richardson	Capita Share Plan Services	
Daniel Hepburn	Clifford Chance	
Jocelyn Mitchell	Freshfields	
Alison Hughes	KPMG LLP (UK)	
James Jaques	Linklaters	
Allison Winship	Lloyds TSB Registrars	
Jessica McMichael	Lovells	Host of the Meeting
Hilary Jones	McDermott Will & Emery	
John Franklin	New Bridge Street Consultants	
Nicholas Stretch	Norton Rose	
David Pett	Pinsent Masons	
Sally Robinson	PricewaterhouseCoopers	
Jo Weston	Simmons & Simmons	
Victoria Nicholl	Travers Smith Braithwaite	