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THE ROLE OF PROSPECTUS DOCUMENTATION AND PROSPECTUS LIABILITY

Summary: *The basic means to ensure the investor protection and market efficiency in an initial public offering transaction is to provide full information concerning the securities and issuers of those securities. The appropriate way to make this information available is to publish a prospectus. The structure and content of the prospectus documents are subject to detailed legal regulation in the European Union. Furthermore, to facilitate the coherent and reliable drafting of prospectuses, a separate liability regime attaches to the content of these documents in the law of capital markets. This takes a fairly similar characteristic in the developed economies, such as in the European Union and the United States. Also the techniques of mitigating this kind of liability risk have evolved. With conducting a complex, so-called due diligence examination, belief can be acquired about the reliability and entirety of the published information, and so legal risks can be mitigated or avoided. In this Article the authors would like to provide insight into this core issue of initial public offering transactions, which could be relevant for all investors and capital market lawyers.¹*

Keywords: *initial public offering, due diligence, investor, prospectus, underwriter*

INITIAL PUBLIC OFFERING TRANSACTIONS

In case of initial public offering (IPO) the shares of a company are publicly offered² for the first time.³ One method for this is the selling of newly issued shares (primary shares) and the other one is the public selling of the shares that previously have been privately offered (sec-

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2 Griffith, Sean J., *Spinning and Underpricing – A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings*, Brooklyn Law Review Vol. 69. Issue 2. (2004) p. 585.

3 Utset, Manuel A., *Producing Information: Initial Public Offerings, Production Costs, and the Producing Lawyer*, Oregon Law Review Vol. 74. Issue 1. (1995) p. 280.

ondary shares). According to the Hungarian Capital Markets Act, public offering is a sale offer of securities aimed at investors not specified previously, which includes sufficient information on the conditions of the offer and on the securities in order to facilitate the decision-making of the investors.⁴

Because in an initial public offering transaction the company offers its shares to the investors publicly for the first time, it is rather simple to tell it apart from the subsequent secondary public offering. It is an indispensable issue in case of IPOs, that by which method are the publicly offered shares ensured. One basic aim of such transactions may be that a growing company obtains the necessary capital to finance its operation and to provide liquidity for the expanding business activity.⁵ To achieve this goal, the company should issue new shares, and offer them to the public with the concurrent increase of its share capital. The terminology calls this technique as primary offering⁶. There are numerous benefits of such transactions. For example, by applying such solution, the company makes income; also its capital structure is strengthened, as the transaction results in a preferable debt to equity ratio. However, the increase of the share capital cannot serve as the sole reason for initial public offerings. First of all, finance literature provides evidence that companies often carry out such transactions without a capital increase. Also, companies can find numerous other opportunities, to satisfy their need for capital. Such may be for example obtaining venture capital or taking out a loan. A complex transaction, like an IPO and the issuing of shares also entails significant transaction costs. Also an important concern that during an IPO transaction the underpricing of newly issued shares may leave plenty of money on the table. The public operation, dispersed ownership, etc. in turn may significantly increase the agency costs. Being present on the stock market also implies new expenses to the company. Because the above may produce a significant burden to the corporation planning to go public, it is necessary to carefully assess the costs and benefits. In addition a public company must guarantee a significant market return to the shareholders,⁷ in order to perform well in the competition of the market and to preserve the trust of the investors.

Another reason for performing an initial public offering may be that it enables the current owners to get out of the company or to diversify their investments by selling a part of their share⁸. The possibility of going public may have a substantial motivational effect towards entrepreneurs. According to professor Vijay Jog,⁹ going public provides entrepreneurs “with an additional impetus to start a business” in that it gives them “a reasonable expectation that, if

4 Dr. Tomori, Erika, *Értékpapírtörvény és a tőkepiac szabályozása* (Közép-európai Brókerképző Alapítvány, Budapest, 2008) pp 372. p. 168; Article 5 paragraph (1) point 94. of Act CXX of 2001 on capital markets; Kecskés, András, Halász, Vendel, *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance, and Hostile Takeovers*, Translated by: Anna Tolnai and the Authors, (HVG-ORAC-LexisNexis, Budapest-Wien, 2013.) p. 25.

5 Booth, Richard A., *Going Public, Selling Stock, and Buying Liquidity*, *Entrepreneurial Business Law Journal* Vol. 2. Issue 2. (2008) p. 661.

6 Tomori, *op. cit.* note 4, p. 163.

7 Booth, *op. cit.* note 5; Kecskés, Halász, *op. cit.* note 4, pp. 25–26.

8 See Draho, Jason, *The IPO Decision – Why and How Companies Go Public* (Edward Elgar Publishing, Northampton, 2005) p. 41 However empirical studies show little justification for the importance of the diversification of portfolios in case of initial public offerings. A research carried out by Marco Pagano, Fabio Panetta and Luigi Zingales in 1998 with respect to Italian companies shows that the founders of a company sold only 6% of their securities during the initial public offering and another 1.3% in the next 3 years.

9 Vijay Jog is the Chancellor Professor at the Sprott School of Business at Carleton University.

and when necessary, capital markets will provide them with monetary rewards by purchasing their equity in the firm at an attractive price”¹⁰

Also a possible method for providing shares to the public investors is that the previously privately offered shares are sold to them by way of public offering. The terminology calls this technique as secondary offering (or secondary placement in some markets). Having offered the previously privately offered security to the public and having it listed on the regulated market, it shall qualify as a publicly offered security thereafter.¹¹ In this case the income from the transaction flows not to the company, but to the selling shareholders, whose ownership concurrently decreases in the company. This method offers an exit opportunity for the existing owners of the company; however it has no effect on the balance sheet and the capital structure. The drawback of this method is that presumably the market does not prefer such conducts. Two basic arguments can simply confirm that. First of all, the personal purpose of the investors wishing to get out of the company to sell the shares for the highest possible price. Other viewpoints are of little relevance to them.¹² On the other hand it is an obviously wrong message to the market if the existing shareholders decide to leave the company by selling (most of) their shares. Clearly these investors and the management know the realistic situation of the company. Those leaving the company qualifies as a significant warning regarding the risks and the future profitability of the company.¹³ Therefore if the existing investors in fact wish to sell their shares, it is inexpedient to do so concurrently in one round. It is advisable to offer only a part of their existing shares during the course of the initial public offering and following a successful transaction sell the remaining shares gradually on the open market.

As primary offering (offering of primary shares) provides the company the possibility to grow, it is the most popular method. As a general rule a significant part of the shares offered in an initial public offering must be newly issued shares – even if the existing shareholders concurrently sell a part of their shares (secondary offering, offering of existing, so-called secondary shares). In such cases two types of shares participate in the initial public offering: in the primary component there are the newly issued shares, and the income of their sale goes to the company. The shares owned by the existing owners of the company, which have been issued before, are the secondary component. These shares shall be offered continuously and shall be listed on the regulated market. The income of their sale shall flow to the previous owners.¹⁴ It is possible that the market is willing to take a larger number of secondary shares as part of the total IPO volume, if special circumstances justify that.¹⁵

As the IPO represents the first time most firms raise equity from dispersed investors,¹⁶ disclosure obligations play an important role. Due to being public and being listed on the stock

10 Rosseau, Stephane, *The Future of Capital Formation for Small and Medium-Sized Enterprises: Rethinking Initial Public Offering Regulation after the Restructuring of Canadian Stock Exchanges*, *Revue Juridique Themis*, Vol. 34, Issue 3. (2000) p. 667.

11 Tomori *op. cit.* note 4, p. 163.

12 Booth, *op. cit.* note 5, p. 661–662.

13 Draho, *op. cit.* note 8, p. 186; Kecskés, Halász, *op. cit.* note 4, pp. 25–26.

14 Draho, *op. cit.* note 8, pp. 186–187.

15 Lahmann, Dirk, *Germany: The Investment Banker's View*, *International Legal Practitioner* Vol. 22. Issue 2. (1997) p. 60; Kecskés, Halász, *op. cit.* note 4, pp. 25–27.

16 Baker, Malcolm, Gompers, Paul A., *The Determinants of Board Structure at the Initial Public Offering*, *Journal of Law & Economics*, Vol. 46, Issue 2. (2003) p. 569.

exchange the company must comply with lot stricter disclosure obligations¹⁷, and reveal many pieces of information to the public.¹⁸ It is enough to highlight that the prospectus to be prepared for the transaction (which can be as long as 300–400 pages) must contain all information that are relevant regarding the operation of the company and are necessary for the decision-making of the investors. It is possible that the owners of the company do not see it appropriate to publish information like the remuneration of or the deals entered into with the management, or reveal its contractual relationships. Many companies are concerned that publishing essential information, such as their income, profit, market position or significant contracts may cause a disadvantage in competition.¹⁹

THE REASON FOR PREPARING PROSPECTUS DOCUMENTS

In the course of the offering the prospectus is a primary informational and marketing document for investors. In fact, the issuer tells the history of the company (and that of the security) in this document.²⁰ It contains all the information that might be needed by the investors for making a decision regarding the investment.²¹ As Directive 2001/34/EC (Prospectus Directive) phrases, the information, which needs to be sufficient and as objective as possible as regards the financial circumstances of the issuer and the rights attaching to the securities, should be provided in an easily analysable and comprehensible form.²²

During its preparation it also has to be taken into consideration that the prospectus must comply with the rules of the stock exchange where the securities are to be listed. For issuing shares at foreign markets it is advisable to prepare the prospectus in the language used in the international financial sector.

In principle, each state, securities commission and stock exchange has its own regulation concerning the content of the prospectus. At the same time, each has similar characteristics. In 1998 the International Organization of Securities Commissions (IOSCO) released its own international disclosure standards (International Disclosure Standards) in order to promote cross-border offerings. The standards are meant to guarantee the comparability of information and high levels of investor protection. As content requirements of the prospectus, 10 different categories are indicated. The order and organization of information can be changed, but each item has to be incorporated. This is important, because the effective Community regulation on prospectuses is also founded on the above standards with regard to the content requirements.²³

17 Forst, Bradley, *Going Public and the Implications of Corporate Control: the Modern Lawyer's Role as Counselor*, South Texas Law Journal, Volume 23. Issue 1. (1982) p. 75.

18 Draho, Jason, *op. cit.* note 8, p. 1.

19 Schneider, Carl W., Manko, Joseph M., *Going Public – Practice, Procedure and Consequences*, Villanova Law Review, Vol. 15. Issue 2. (1970) pp. 284–285; Kecskés, Halász, *op. cit.* note 4, p. 33.

20 Geddes, Ross, *IPOs and Equity Offerings* (Butterworth-Heinemann, 2008.) p. 95.

21 Geddes, *op. cit.* note 20, p. 54.

22 Paragraph 20 of Preamble of Directive 2003/71/EC.

23 Geddes, *op. cit.* note 20, pp. 95–97.

The prospectus is indispensable during the transaction for three reasons. Firstly, it is a statutory obligation to prepare one. Secondly, it is an essential marketing tool. Thirdly, an accurate prospectus reduces possible liability deriving from misleading investors. Thus, it has to fulfil several functions. As it reduces the liability of the company's management, it will be long and to-the-point. Nevertheless, its marketing function should not be neglected either during the preparation.²⁴

The disclosure of the prospectus provides the investors the necessary data in order to evaluate the securities.²⁵ It gives an accurate picture of the shares offered for purchase, the financial situation of the company and its capital structure. It contains the description of the company's business activity, and the presentation of business results from the last period.²⁶ The composition of these data is primarily the task of the issuer and the investment service provider acting as lead bank. The basis of the prospectus is the information reviewed and compiled in the course of the due diligence investigation. Consultants of investment service providers participating in the transaction also review and complete the prospectus,²⁷ and auditors check all of its statements of financial relevance, and confirm their accuracy (this is the so-called comfort letter). Regarding questions of liability, the legal advisor assists in the preparation of the document. However at the end of the day the company is liable for the content and the accuracy of the data.

The legal advisor also reports on whether the prospectus can be regarded as complete, and whether the data included in it are accurate.

On the other hand the prospectus has a significant marketing role as well. It is advisable to make a favourable impact and to promote purchase intentions. Therefore, it contains the strategy of the company and its investment activity; it also indicates the position of the company within the industry. Preparing the prospectus is an important and time-consuming element of the IPO process. The full length of a prospectus might even be 300–400 pages. Accordingly one must devote sufficient time for its preparation in the timetable of the transaction. The preparation might last for one or two months depending on the company and the amount of data to be processed. As we already pointed out previously, the issuer, his legal advisor, the auditors and investment service providers also take part in preparing the prospectus. The drafting requires considerable experience in order to find the delicate balance of the different functions. On one hand, it has to meet legal requirements and the regulations connected to listing; on the other hand, it has to function as an effective marketing tool as well.²⁸

RELEVANT SOURCES OF LAW REGARDING PROSPECTUS DOCUMENTS

The preparation of the prospectus is regulated in the European Union by Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to

24 Geddes, *op. cit.* note 20, pp. 95–97.

25 Spindler, James C., *IPO Liability and Entrepreneurial Response*, University of Pennsylvania Law Review, Vol. 155. Issue 5. (2007) pp. 1195–1201; Kecskés, Halász, *op. cit.* note 4, pp. 69–70.

26 Geddes, *op. cit.* note 20, p. 95.

27 Coke, Michael, *Success in the Form of an IPO: A Brief Case Study of A123 Systems, Inc.*, Nanotechnology Law and Business, Vol. 6. Issue 4. (Winter 2009) p. 519.

28 Kecskés, Halász, *op. cit.* note 4, pp. 69–71. Moloney, Niamh, *EC Securities Regulation* (Oxford University Press, Oxford, 2008).

trading and amending Directive 2001/34/EC (Prospectus Directive). The purpose of the above Directive is to harmonise requirements for the drawing up, approval and distribution of the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market situated or operating within a Member State.²⁹ The Directive has been amended by Directive 2008/11/EC, Directive 2010/73/EU, Directive 2010/78/EU, Directive 2013/50/EU and Directive 2014/51/EU.

The regulatory regime of the Directive is completed by implementation regulations. Therefore, it is important to mention Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and disclosure of such prospectuses and dissemination of advertisements. Since it was created, this piece of legislation has been amended by Commission Regulation (EC) No 1787/2006, Commission Regulation (EC) No 211/2007, Commission Regulation (EC) No 1289/2008, Commission Delegated Regulation (EU) No 311/2012, Commission Delegated Regulation (EU) No 486/2012, Commission Delegated Regulation (EU) No 862/2012, Commission Delegated Regulation (EU) No 621/2013, and Commission Delegated Regulation (EU) No 759/2013. It is also important to note Commission Regulation (EC) No 1569/2007 of 21 December 2007, which regulates the establishment of a mechanism for the determination of equivalence of accounting standards applied by third country issuers of securities pursuant to Directives 2003/71/EC and 2004/109/EC of the European Parliament and of the Council. These regulations are directly effective and applicable in other Member States, for example in Hungary as well.

In Hungary – unless international treaties provide otherwise – Act CXX of 2001 on capital markets is applicable to the marketing of securities issued as part of a series in the Republic of Hungary and also to the securities issued by a Hungarian issuer but marketed abroad, as well as to the listing of a series of securities on the stock exchange operating in Hungary.^{30 31}

THE CONTENTS OF THE PROSPECTUS DOCUMENTS PURSUANT TO THE PROSPECTUS DIRECTIVE (2003/71/EC)

An indispensable part of the prospectus is the summary, which should be placed at the beginning of the document. As several investors – if they open the prospectus at all – read only this chapter, so special attention must be paid to its content.³²

In the effective regulation, the requirement for preparing a prospectus is a clear evidence for the attitude of taking the interests of small investors into consideration. Namely, the summary provides in a few pages the most important information included in the prospectus.³³ Its content covers information about the identity of directors, senior management, advisers

29 Article 1 paragraph 1 of Directive 2003/71/EC.

30 Article 1 paragraph a of Act CXX of 2001 on capital markets.

31 Kecskés, Halász, *op. cit.* note 4, pp. 73–74.

32 Geddes, *op. cit.* note 20, p. 97.

33 Moloney, *op. cit.* note 28, p. 144; Annex I – Prospectus - of Directive 2003/71/EC.

and auditors. It summarises the offer statistics and expected timetable. It contains essential information concerning selected financial data; the rate of capitalisation and indebtedness, reasons for the offer and use of proceeds; as well as relevant risk factors. It also discloses to investors information concerning the issuer. Thus, it presents the history and development and the business overview of the issuer. It also contains the operating and financial review and the prospects of the issuer, with special regard to research and development, patents, licences and prospective trends. It has to contain information about directors, senior management, and employees. It has to disclose the major shareholders and related-party transactions. It also has to include important financial information such as the consolidated statement (and other financial information), and the significant changes of the last period. It has to present the details of the offer and the admission to trading on a regulated market, such as the plan for distribution, relevant markets, selling shareholders, possible dilution and the expenses of the issue. As additional information, it has to contain the amount of the share capital, reference to the memorandum and articles of association and documents on display.³⁴ Based on the language regime of the Prospectus Directive, the supervisory authority of each host member state may require in the European Union that the summary be translated into its official language(s) in case of cross-border transactions.³⁵

The prospectus contains a section devoted to the identity of directors, senior management, advisers and auditors. The purpose of this section is to identify the company representatives and other individuals involved in the company's offer or admission to trading. Basically, these are the persons responsible for drawing up the prospectus and for auditing the financial statements.

Another section contains the offer statistics and the expected timetable. Here, the purpose is to provide essential information regarding the conduct of any offer and the identification of important dates relating to that offer. Accordingly, it has two essential parts: offer statistics and the method and expected timetable of the offer.

The prospectus also presents specific essential information. The purpose is to summarise essential information about the company's financial condition, capitalisation and risk factors. If the financial statements included in the document are restated to reflect material changes in the company's group structure or accounting policies, the selected financial data must also be restated. The main parts of this section constitute selected financial data; indices of capitalisation and indebtedness; reasons for the offer and use of proceeds; and relevant risk factors.

Information on the company also constitutes a separate section in the prospectus. The purpose of this part of the prospectus is to provide information about the company's business operations, the products it makes or the services it provides, and the factors which affect the business. It is also intended to provide information regarding the adequacy and suitability of the company's properties, plant and equipment, as well as its plans for future capacity increases or decreases. Consequently, its main parts are the description of the history and development of the company; the business overview; organisational structure; and property, plant and equipment.³⁶

34 Annex I – Prospectus – of Directive 2003/71/EC.

35 Article 19 paragraph 2 of Directive 2003/71/EC; Kecskés, Halász, *op. cit.* note 4, pp. 83–84.

36 Annex I – Prospectus – of Directive 2003/71/EC; Kecskés, Halász, *op. cit.* note 4, pp. 83–84.

The operating and financial review and prospects of the company are also presented in the prospectus. The purpose is to provide the management's explanation of factors that have affected the company's financial condition and results of operations for the historical periods covered by the financial statements. It also contains the management's assessment of factors and trends which are expected to have a material effect on the company's financial condition and results of operations in future periods. Accordingly, this section covers operating results; liquidity and capital resources; research and development, patents and licences; and governing trends of the company's operation.

Information about directors, senior management and employees are introduced in the prospectus. The purpose is to provide information of the above persons that will allow investors to assess their experience, qualifications and levels of remuneration, as well as their relationship with the company. Accordingly, this part of the prospectus contains the register of directors and senior management, their remuneration and practices governing their activities. Data on employees and the presentation of share ownership of employees can also be found here.³⁷

It is essential that the prospectus discloses the major shareholders and related-party transactions. In this case, the purpose is to provide information regarding the major shareholders and those who may control or have an influence on the company. It also provides information regarding transactions the company has entered into with persons affiliated with the company and whether the terms of such transactions are fair to the company. Accordingly, information on major shareholders; related-party transactions; and interests of experts and advisers are put down in this section. Preparing this is basically the task of legal advisors.

An important part of the prospectus is the section on financial information. The purpose is to specify which financial statements must be included in the document, as well as the periods to be covered, the age of the financial statements and other information of a financial nature. The accounting and auditing principles that will be accepted for use in preparation and audit of the financial statements will be determined in accordance with international accounting and auditing standards. This section contains consolidated statements and other financial information and any significant changes. Its preparation is the main responsibility of auditors.

In order to inform investors, it is essential to disclose in the prospectus the details of the offer and admission to trading. Thus, relevant information in connection with offering and admission to trading, the plan for distribution, the markets, holders of securities who are selling, dilution and expenses of the issue must be disclosed in the prospectus.³⁸ In connection with this section of the prospectus Article 8 of Directive 2003/71/EC provides that – until it is finally determined – the final offer price and amount of securities, which will be offered to the public, can be omitted from the prospectus. At the same time, if the final offer price and amount of securities which will be offered to the public cannot be included in the prospectus, the criteria, and/or the conditions in accordance with which the above elements will be determined or, in the case of price, the maximum price, are disclosed in the prospectus.³⁹ If this is not required (or provided), it is has to be ensured that the acceptance of the purchase or subscription of securities may be withdrawn for not less than two working days after the final of-

37 Annex I – Prospectus – of Directive 2003/71/EC.

38 Annex I – Prospectus - of Directive 2003/71/EC; Kecskés, Halász, *op. cit.* note 4, pp. 84–85.

39 Article 8 paragraph 1 point a of Directive 2003/71/EC.

fer price and amount of securities which will be offered to the public have been filed⁴⁰. The final offer price and amount of securities shall be filed with the competent authority of the home Member State and published in accordance with the arrangements provided for in the relating provisions.⁴¹ In Hungary, Article 27 paragraphs (2) and (3) of the effective Capital Markets Act also provides this possibility in accordance with Article 8 of Directive 2003/71/EC.

The closing section of the prospectus contains additional information. This section covers data and documents, most of which is of a statutory nature, such as data on share capital, memorandum and articles of association, information on material contracts, factors of exchange controls and taxation, the presentation of dividends and paying agents, statements by experts and information on the documents on display and subsidiary information.^{42 43}

As we have already emphasized, also an important part of the Community legislation regarding the content of prospectus documents is the Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements contains the obligatory rules of the content of the prospectus in the European Union.

As the Regulation stipulates, if an issuer, an offeror or a person asking for the admission to trading on a regulated market chooses – according to Article 5 (3) of Directive 2003/71/EC – to draw up a prospectus composed of separate documents, the securities note and the registration document shall be each composed of the following parts in the following order: a clear and detailed table of contents; as the case may be, the risk factors linked to the issuer and the type of security covered by the issue; the other information items included in the schedules and building blocks according to which the prospectus is drawn up. The order of these parts cannot be altered.⁴⁴

However, the issuer, the offeror or the person asking for admission to trading on a regulated market shall be free in defining the order in the presentation of the required information items included in the schedules and building blocks according to which the prospectus is drawn up.⁴⁵ Where the order of the items does not coincide with the order of the information provided for in the schedules and building blocks according to which the prospectus is drawn up, the competent authority of the home Member State may ask the issuer, the offeror or the person asking for the admission to trading on a regulated market to provide a cross reference list for the purpose of checking the prospectus before its approval. Such list shall identify the pages where each item can be found in the prospectus.⁴⁶

The Regulation applies so-called schedules, which mean a list of minimum information requirements adapted to the particular nature of the different types of issuers and/or the

40 Article 8 paragraph 1 point b of Directive 2003/71/EC.

41 Article 8 paragraph 1 of Directive 2003/71/EC.

42 See Annex I. of Directive 2003/71/EC and Moloney *op. cit.* note 28 p. 151; and compare Geddes, *op. cit.* note 20, p. 98.

43 Kecskés, Halász, *op. cit.* note 4, pp. 83–86.

44 Article 25 paragraph 2 of Commission Regulation (EC) No 809/2004; Kecskés, Halász, *op. cit.* note 4, pp. 85–86.

45 Article 25 paragraph 3 of Commission Regulation (EC) No 809/2004.

46 Article 25 paragraph 4 of Commission Regulation (EC) No 809/2004.

different securities involved.⁴⁷ A prospectus shall be drawn up by using one or a combination of the schedules and building blocks set out in the Regulation.⁴⁸ Building block means a list of additional information requirements, not included in one of the schedules, to be added to one or more schedules, as the case may be, depending on the type of instrument and/or transaction for which a prospectus or base prospectus is drawn up.⁴⁹

THE ROLE AND METHOD OF DUE DILIGENCE EXAMINATION

The due diligence examination is aimed at the verification of the accuracy and completeness of the information published in the course of the initial public offering in the prospectus.⁵⁰ From legal aspects the due diligence may mitigate civil law (or even criminal law) liability resulting from the failure to appropriately publish the relevant information. The liability of participants varies according to jurisdictions; however, in terms of basic elements (as indicated also by the above examples) it is a uniform procedure. The requirements specified in relation to due diligence examinations are also specific for each transaction. They depend on the type of offering, the issuer, the investors (institutional or retail investors), available external market information and the requirements following from the legal regulations and legal practice of the given state/market. Although there exist basic issues (and check-lists for such issues), which have relevance in the case of all enterprises and transactions, transactions are highly individual. Therefore, it is advisable for the participating experts and the managers of the company to consider the scope of the examination for each transaction individually, and thus determine the actual scope of the due diligence examination.⁵¹ Since due diligence requirements are difficult to define and the management of the company proposing the public offering is typically not sufficiently familiar with this procedure, it is necessary to engage investment firms and legal counsels with an expertise in the field of similar transactions.⁵²

Not all investment firms can provide the same level of security for the future shareholders. Investment firms differ from each other as regards their professional expertise and prestige, and such difference may influence investor confidence in the securities. Therefore, issuers are interested in involving highly prestigious investment firm(s) in the transaction, so that potential subscribers give more credit to the appropriateness of the documentation. Relying on their resources, prestigious investment service providers strive to provide high quality services, and this difference in quality has special relevance in respect of compliance with the due diligence requirements. Although the legal requirements can be identical for all investment firms participating in public offerings, their actual performance can considerably vary. Expe-

47 Article 2 paragraph 1 of Commission Regulation (EC) No 809/2004.

48 Article 3 of Commission Regulation (EC) No 809/2004.

49 Kecskés, Halász, *op. cit.* note 4, pp. 86–87.

50 Espinasse, Philippe, *IPO – A Global Guide* (Hong Kong University Press, Hong Kong, 2012) pp. 83–84.

51 Geddes, *op. cit.* note 20, p. 108.

52 Ferris, Stephen P, Hiller, Janine S., Wolfe, Glenn A., Cooperman, Elizabeth S., *An Analysis and Recommendation for Prestigious Underwriter Participation in IPO's*, *The Journal of Corporation Law* (Spring 1991-1992) pp. 587–588 Kecskés, Halász, *op. cit.* note 4, p. 66.

rience gained in respect of due diligence requirements, as well as the expert and analyst background available in the course of the examination may have a positive effect of the result of the transaction.⁵³ As a condition of their participation, institutional investors require a higher standard due diligence examination, than retail investors.⁵⁴ Consequently, while the team set up by the company is working on the drafting of the prospectus, the investment service provider coordinating the transaction and its legal counsel simultaneously conduct the company's due diligence examination.⁵⁵ In the course of such examination they review for instance, the documents regarding the company's organization and operation, financial statements and forecasts, material contracts, the composition of the management and the information concerning suppliers and customers.⁵⁶

It is expedient to distinguish, based on their subject matter, business, financial and legal due diligence examinations,⁵⁷ which are time consuming, but nevertheless necessary preparatory steps of an initial public offering. In preparation for the due diligence examination, the investment service providers and legal counsels participating in the transaction frequently use questionnaires. The information obtained this way may serve as basis for the personal meetings and discussions with the management of the company. In the course of the discussions with the management, they thoroughly review the company's business activity. On the one hand, such reviews provide assistance to the participants with understanding and evaluating the company's position and activity. It also provides an opportunity for identifying risks and issues that can possibly arise in relation to the initial public offering. In the course of the review questions can be posed to the management, and such questions can also prove useful in the course of preparation for the subsequent meetings with investors.⁵⁸

Within the framework of the business due diligence examination all aspects of the company's business activity needs to be reviewed. This complex task can frequently be implemented only in several phases, in the course of which the origins and development of the company are examined. The company's strategy is reviewed; its weaknesses and the possible risks are analyzed. The examination also identifies the company's strengths, opportunities, development directions and prospects.⁵⁹ The foregoing aspects are frequently specific from the perspective of both the company and the given industry. The company's ownership structure, as well as its capital structure is also subject to the examination. The company's scope of activity, suppliers and customers also need to be reviewed. Significant creditors are also identified.⁶⁰ The experts conducting the examination review the market relevant for the company and the competition in such market, including, in particular, the major trends and the circumstances affecting

53 Ferris, *et. al.*, *op. cit.* note 52, p. 602.

54 Ferris, *et. al.*, *op. cit.* note 52, p. 588.

55 Sher, Noam, *Underwriter's Civil Liability for IPO's: An Economic Analysis*, University of Pennsylvania Journal of International Economic Law (2006/2) p. 434.

56 Sjostrom, William K. Jr., *Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?* Florida Law Review (2001/3) pp 537–538.; Kecskés, Halász, *op. cit.* note 4, pp. 66–67.

57 Barondes, Royce De Rohan, *Correcting the Empirical Foundations of IPO-Pricing Regulations*, Florida State University Law Review (2005-2006/3) p. 443; Espinasse, *op. cit.* note 50, p. 84.

58 Espinasse, *op. cit.* note 50, pp. 84–85.

59 Espinasse, *op. cit.* note 50, p. 85.; Kecskés, Halász, *op. cit.* note 4, pp. 67–68.

60 Espinasse, *op. cit.* note 50, p. 85.

competitiveness. They review external factors having an influence over past and future results. They conduct a detailed examination of the company's operation⁶¹ and corporate governance system. The experts assess the qualification of the management and the employees and the set of policies affecting the company's business activity. In the course of the due diligence examination, significant conclusions can also be drawn from the review of the actual operation of the company. For this reason, the inspection by the participating experts of the main premises of the company's activity (such as offices, production units, significant equipment) frequently constitutes a part of the business due diligence. In the course of such inspection they can ascertain that the equipment and supplies necessary for the business activity are actually available to the company.⁶² Personal meetings and the assessment of the qualifications and capabilities of the company's management and key employees may also have relevance.⁶³ The business due diligence also assists the participating investment firms with better understanding the company's business activity, which, in turn, may contribute to the subsequent successful sale of the company's shares.⁶⁴

The examination of financial activity (financial due diligence) focuses on the company's past and future financial results. In the course of the financial due diligence, practically all issues of financial relevance are reviewed. During such examination the auditors review the company's balance sheet and profit and loss statement retrospectively. Furthermore, in several cases the company is required to adapt its financial reporting policy to the requirements of the investor community.⁶⁵ Upon completion of its examination, by delivering a so called comfort letter, the auditor certifies that the financial data contained in the prospectus are accurate.⁶⁶ The company's accounting policy, the auditor's activity and the relation with the auditor are also subject to the examination.⁶⁷

The review (legal due diligence) of all documents of the company of legal relevance is the task of the lawyers and legal counsels of the issuer company and the investment firm coordinating the transaction. These two lawyer teams may divide the tasks, thereby facilitating the process. The company is to set up a legal data room for the examination in order to assist the lawyers with the review of the documents. In the course of the examination the documents relevant from the perspective of the company need to be reviewed. Thus, for instance, the articles of association and the internal policies; the minutes of general meetings and board meetings, as well as the resolutions delivered at such meetings; loan agreements and debt security offerings; all material contracts and other agreements;⁶⁸ trademarks and trademark registrations; intellectual property and compliance with the rules applicable to copyright protection; pending or threatening (legal) disputes; the documentation and conformity of treasury share repurchase transactions; employment related contracts as well as engagement and

61 Geddes, *op. cit.* note 20, p. 109.

62 Espinasse, *op. cit.* note 50, p. 85.

63 Geddes, *op. cit.* note 20, p. 109.

64 Geddes, *op. cit.* note 20, p. 109; Espinasse, *op. cit.* note 50, p. 85.; Kecskés, Halász, *op. cit.* note 4, pp. 67–68.

65 Shefsky, Lloyd E., *Financial and Structural Preparation for Initial Public Offering*, The Compleat Lawyer (Spring 1987) p. 64.

66 Espinasse, *op. cit.* note 50, p. 286.

67 Geddes, *op. cit.* note 20, p. 110.; Espinasse *op. cit.* note 50, pp. 85–86; 231–232; Kecskés, Halász, *op. cit.* note 4, pp. 68–69.

68 Utset, *op. cit.* note 3, p. 306.

consultancy agreements; employee shareholder schemes and remuneration arrangements; the availability of adequate insurances; the existence of the licenses and official permits required for the relevant activity; compliance with the effective legal regulations; possible tax law considerations; and finally, the latest press releases.⁶⁹ The existence of a comprehensive inventory is also essential. The legal due diligence concludes with the preparation of a legal opinion, which is included in the prospectus.⁷⁰

DUE DILIGENCE AND PROSPECTUS LIABILITY

As a result of being a private company, confidential (insider) information about the company's activities are usually not accessible to the community of investors. However, having knowledge of these pieces of information is necessary in order to evaluate the publicly sold shares. It only takes a minor inaccuracy, and the price of shares is determined inaccurately, and investment decisions might be made on the basis of incorrect grounds. Therefore, the sufficient and accurate information verified by the participating investment service providers increases the efficiency of allocating capital resources to the appropriate firms. Due diligence is a preliminary verification procedure when the appropriateness of the disclosed information is examined.⁷¹

Pursuant to the regulation of securities in most countries, the issuer and its managing directors are liable for the accuracy and completeness of information included in the prospectus. Moreover, a separate liability might also lie upon the intermediaries (managers) of the offer (e.g. investment service providers): they must investigate the accuracy of information included in the prospectus with due care. Therefore investment service providers and their legal advisors generally conduct a due diligence investigation in connection with the business activity of the company. The investigation covers the accuracy of all the statements in the prospectus, as well as any other information which might be important with regard to investment decisions.⁷² Therefore, the presence of prestigious investment service providers (investment banks) is an effective marketing tool during the sale of a company's securities. Therefore with regard to the due diligence investigation, investment service providers participate not only as organisers of the transaction, but with their engagement they also verify that the content of the prospectus corresponds to the facts.⁷³

In the European Union, at community level the issue of prospectus liability is regulated by Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC. Under the regulations specified in Article 6 of the Directive, member states shall ensure that responsibility for the information given in a prospectus attaches at least to the issuer or its administrative, manage-

69 Geddes *op. cit.* note 20, p. 110.

70 Kecskés, Halász, *op. cit.* note 4, pp. 66–69.

71 Ferris, *et. al.*, *op. cit.* note 52, p. 585; Kecskés, Halász, *op. cit.* note 4, p. 63.

72 Geddes, *op. cit.* note 20, p. 108.

73 Sjostrom, *op. cit.* note 56, pp. 536–537; Kecskés, Halász, *op. cit.* note 4, p. 64.

ment or supervisory bodies, the offeror, the person asking for the admission to trading on a regulated market or the guarantor, as the case may be. The persons responsible shall be clearly identified in the prospectus by their names and functions or, in the case of legal persons, their names and registered offices. The prospectus shall also contain a declarations by them that, to the best of their knowledge, the information contained in the prospectus is in accordance with the facts and that the prospectus makes no omission likely to affect its import.⁷⁴ In addition, member states shall ensure that their laws, regulations and administrative provisions on civil liability apply to those persons responsible for the information given in a prospectus. Member States of the European Union shall also ensure that no civil liability shall attach to any person solely on the basis of the summary, including any translation thereof, unless it is misleading, inaccurate or inconsistent when read together with the other parts of the prospectus, or it does not provide, when read together with the other parts of the prospectus, key information in order to aid investors when considering whether to invest in such securities. The summary shall contain a clear warning to that effect.⁷⁵

Consequently in the European Union, community level legislation ensures that individuals can hold the party at fault accountable for inadequate disclosure. Besides the public control represented by supervisory authorities, this can have a stimulating effect on complying with the disclosure obligations. The approaches to civil liability regimes vary significantly across Member States, regarding the basis for liability (fraud or negligence), causation, the nature of the remedy (statutory or common law nature) and those persons entitled to initiate a lawsuit. On one hand, this variety poses risk to issuers in case of offering shares in a pan-European level. Multi-Member State liability could lead to prospectuses getting more and more detailed for the sake of complying with the different regulations (and for avoiding potential legal risks), thus they become less useful for retail investors. At the same time, in practice private liability lawsuits are rare, owing to the restricted possibilities to initiate class actions, and also the lack of a strong equity culture. Therefore, until class actions become more prevalent in Europe, the Directive's failure to harmonize⁷⁶ liability regimes is unlikely to represent significant risk in practice to issuers.⁷⁷

In Hungary, the Capital Markets Act also regulates the liability originating in the content of the prospectus. Under this act, the issuer, the broker/dealer (the lead bank in case of a banking syndicate), the person acting as surety (guarantor) for the rights included in the security, the offeror or the person initiating the listing of the security on a regulated market are liable for any damages caused to the owner of the security by the misleading content of the prospectus and the concealment of information. The name (indication), the role in marketing and address (registered office) of the person, who is liable for the prospectus or for any part thereof, shall be indicated in the prospectus accurately and in a clearly identifiable way. The above person shall be liable for all pieces of information, as well as the lack of information

74 Article 6 paragraph 1 of Directive 2003/71/EC.

75 Article 6 paragraph 2 of Directive 2003/71/EC; Kecskés, Halász, *op. cit.* note 4, pp. 63–64.

76 This is specifically included in Article 25 paragraph 1 of Directive 2003/71/EC stating that without prejudice to the right of member states to impose criminal sanctions and without prejudice to their civil liability regime, member states shall ensure, in conformity with their national law, that the appropriate administrative measures can be taken or administrative sanctions be imposed against the persons responsible, where the provisions adopted in the implementation of the Directive have not been complied with. Member states shall ensure that these measures are effective, proportionate and dissuasive.

77 Moloney, *op. cit.* note 28, pp. 164–166.

in the prospectus.⁷⁸ Each liable person shall attach a separate signed declaration of liability to the prospectus. The declaration shall include that the prospectus contains real data and statements, and it shall state that it does not conceal any facts and information, which bear importance regarding the situation of the issuer and the person acting as surety (guarantee) for the obligations in the security.⁷⁹ Liability cannot be validly excluded or limited for five years as of the disclosure of the prospectus or the notice.⁸⁰ However, it is to be noted that solely on the basis of the summary being part of the prospectus (including any translated version) liability cannot be established on the basis of Hungarian regulations either. An exception to this is the case when the summary is misleading, inaccurate or contains data, which are not in accordance with the information included in the prospectus.⁸¹ Based on the analysis of the regulation we can state that in Hungary – in contrast to the former regulation – the liability of issuers and intermediaries is not joint and several according to the Capital Markets Act, but it depends on their agreement. However, pursuant to the law, liability shall be taken for every piece of information (and also for the lack of them). Nevertheless, if the liability of issuers and intermediaries is not joint and several, public offering of securities from the investors' point of view contains an unusual risk based on Article 4 Paragraph 38 of the Capital Markets Act. In this case the Supervisory Authority obligates the broker/dealer and the issuer, the offeror or the person initiating the listing on a regulated market to indicate this fact at the beginning of the prospectus and in their commercial communication in a prominent way.⁸²

In the United States, similar liability is established by the provisions of the Securities Act of 1933.⁸³ Section 11 of the act states that the issuer and any other professional, who took part in issuing shares (including the underwriter), is liable⁸⁴ for false statements regarding any material facts found in the registration statement or for the omission of these facts.⁸⁵ In the United States, the underwriter can avoid liability to subscribers (and any person acquiring such security) by conducting a reasonable investigation⁸⁶ with respect to the material facts found in the documents to be published (in order to filter out possible misstatements, or the omission of facts).⁸⁷ The underwriter can also avoid liability by refusing to cooperate in the transaction,⁸⁸ in case he disagrees with the information found in the registration statement.⁸⁹

78 Article 29 paragraph (1) of Act CXX of 2001 on capital markets.

79 Article 29 paragraph (2) of Act CXX of 2001 on capital markets.

80 Article 30 of Act CXX of 2001 on capital markets.

81 Article 29 paragraph (3) of Act CXX of 2001 on capital markets.

82 Tomori, *op. cit.* note 4, pp. 176–177; Kecskés, Halász, *op. cit.* note 4, pp. 64–65.

83 Spindler, *op. cit.* note 25, pp. 1194–1195.

84 Baumgart, Kari Millan, *Lights, Camera, Capital: Considerations in Taking a Film Company Public*, *Duquesne Business Law Journal*, Vol. 6. Issue 2. (2004) p. 190

85 Section 11. (a) of the Securities Act of 1933 Accessible at: <http://www.sec.gov/about/laws/sa33.pdf>

86 Sher, *op. cit.* note 55, p. 493

87 Section 11. (b) of the Securities Act of 1933 Accessible at: <http://www.sec.gov/about/laws/sa33.pdf>

88 Ferris, *et. al.*, *op. cit.* note 52, p. 584; Section 11. (b) of the Securities Act of 1933 Accessible at: <http://www.sec.gov/about/laws/sa33.pdf>.

89 Kecskés, Halász, *op. cit.* note 4, pp. 65–66.

CONCLUSIONS

In our Article we intended to demonstrate the central role of prospectus documents, and consequently, the appropriate drafting of these documents, in the success of initial public offering transactions. As prospectuses have several, however to a certain extent competing functions, special expertise is needed for their proper framing. For example, as primary information documents, they should attract the investor community. However, they also should be credible, and accurately contain all relevant information for the assessment of the investment opportunity (without any omission). This later consideration is also unavoidable, because the legal regulation of modern capital markets prescribes liability for the content of these documents. So during the initial public offering transaction, in preparing the prospectus document, special expertise is needed. Prestigious investment service providers, legal advisers, and audit firms should assist the company which is going public. According to their professional sophistication, they can perform a sound due diligence examination, which may provide a solid basis for the unobjectionable drafting of the prospectus document. By discovering the strengths and weaknesses of the company during the due diligence process, the key messages and possible enquiries of the marketing activity are also envisaged.

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LIST OF REGULATIONS, ACTS AND COURT DECISIONS

1. Act CXX of 2001 on Capital Markets.
2. 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.
3. Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements.
4. Securities Act of 1933 – As Amended Through P.L. 112-106, Approved April 5, 2012.

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ULOGA PROSPEKATA ZA ULAGANJE KAPITALA I ODGOVORNOST ZA NJIHOV SADRŽAJ

Sažetak

Osnovni je način pružanja zaštite investitoru i osiguranja tržišne učinkovitosti u poslovima inicijalne javne ponude omogućiti cjelovitu informaciju o vrijednosnicama i onima koji ih izdaju. Prikladan način pružanja takvih informacija objavljivanje je prospekta za ulaganje kapitala. Struktura i sadržaj prospekta precizno su pravno regulirani u Europskoj uniji. Također, kako bi se potaknulo cjelovito i pouzdano sastavljanje prospekata, postoji i poseban režim odgovornosti za sadržaj takvih dokumenata. On ima slična obilježja u razvijenim gospodarstvima, kao što su Europska unija i Sjedinjene Američke Države. Razvijene su i tehnike ublažavanja ove vrste rizika od odgovornosti. Provođenjem složene, tzv. *due diligence* provjere (provjere boniteta poduzeća), može se zaključiti o pouzdanosti i cjelovitosti objavljenih informacija, čime se može ublažiti ili izbjeći pravni rizik. Namjera je autora ovim člankom omogućiti uvid u ovo ključno pitanje inicijalne javne ponude, što bi moglo biti relevantno za sve investitore, kao i pravnike u području tržišta kapitala.

Ključne riječi: inicijalna javna ponuda, due diligence, investitor, prospekt, potpisnik