

The new Risk Factor Regime under the Prospectus Regulation

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After its entry into force on 20 July 2017, the new Prospectus Regulation ("PR3")¹ will become fully applicable from 21 July 2019. It will replace the previous EU Directive 2003/71/EC (the "Prospectus Directive").² The change that will have the greatest practical impact under PR3 is the presentation of risk factors in the prospectus which is addressed for the first time in detail.

Sources for the presentation of risk factors

PR3 is a Level 1 regulation which means it becomes immediately enforceable as law in all EU member states. The main provisions relating to risk factors are set out in Art. 16 with prospectus summaries provisions in Art. 7 paras. 6, 7 and 10 PR3.

Level 2 encompasses implementing measures, delegated acts and technical standards adopted by the Commission. For risk factors, however, no such measures are envisaged at present.

The European Securities and Markets Authority ("ESMA") published a consultation paper dated 13 July 2018 ("ESMA Guidelines")³ as draft Level 3 Guidelines on risk factors under the Prospectus Regulation, to ensure the consistent application by the National Competent Authorities ("NCAs") of the EU member states. The final guidelines on risk factors ("Final RF Guidelines") were published on 29 March 2019.⁴

Development of the requirements regarding risk factors

The prevailing prospectus regime defines risk factors as a list of risks which are specific to the situation of the issuer and/or the securities, and which are material for making investment decisions.⁵

PR3 expands this definition substantially in Art. 16 PR3. The main (cumulative) characteristics for the presentation of risks are their specificity, materiality and corroboration by corresponding information in the prospectus. Only risk factors that flag specific risks relating to the issuer and/or the securities and are material for an investor to make an informed investment decision – as corroborated by the content of the registration document and the securities note – may be included.

¹ <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R1129&from=DE>

² <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:345:0064:0089:EN:PDF>

³ https://www.esma.europa.eu/sites/default/files/library/esma31-62-996_consultation_paper_on_guidelines_on_risk_factors.pdf

⁴ https://www.esma.europa.eu/sites/default/files/library/esma31-62-1217_final_report_on_guidelines_on_risk_factors.pdf

⁵ See Art. 2 no. 3 of Commission Regulation (EC) No 809/2004: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02004R0809-20130828&from=EN>

The challenge of the disclosure of risk factors in a prospectus by NCAs should be an interactive discussion between a NCA and the person responsible for the prospectus. The latter should have the opportunity to respond or to amend the disclosure, as appropriate. Should the person responsible for the prospectus be unwilling or unable to provide supplementary information or make the requested changes, the NCA should use its powers pursuant to Art. 20 PR3 to ensure compliance with Art. 16 PR3.

When challenging the comprehensibility of risk factor disclosure, NCAs may also take into account the type of target investors (i.e. investing in securities with a denomination of at least EUR 100,000, or in securities which are traded on a regulated market (or segment thereof) that is only accessible to qualified investors).

Structurally, risk factors will need to be categorised according to their nature and should be presented in order of their materiality (a combination of probability of occurrence and magnitude of impact), with the most material risk factor to be presented first in each category. The issuer, offeror or the person asking for admission to trading on a regulated market may disclose its assessment of the probability of the risk materialising (low, medium or high), though it may be argued that this ranking – if used - could increase the risk of potential liability. The meaning of the requirements regarding specificity and materiality as well as the prerequisites for the presentation of the risk factors are further specified in the Final RF Guidelines and are described below.

Specificity

Specificity requires a direct link between the risk identified in the risk factor and the issuer/guarantor or the securities. NCAs will take into consideration the type of entity (e.g. start-up companies, regulated entities, specialist issuers etc.) and the type and characteristics of the security. The assessment of the specificity of a risk factor remains with the issuer. NCAs have to ensure, however, that the specificity of it is apparent from the disclosure of the same.

Most importantly, issuers should refrain from generic disclosures. Although industry/sector specific risks are often similar, they may affect issuers or similar types of securities differently. These differences also need to be reflected in the disclosure of a specific risk factor. Any possible interdependency of risk factors (e.g. a higher or lower risk associated with a security depending on the financial condition of the issuer) equally needs to be reflected.

Generic and disclaimer-like risk factors are not considered issuer, guarantor or security specific. Disclaimers merely aim at shielding the persons responsible for the prospectus from liability and will obscure the specificity and materiality of a risk factor. Therefore, only specific risks that are material for an investment decision and that are relevant to the issuer/guarantor and/or the securities should be included. Examples are environmental, social and governance circumstances⁶, the degree of liquidity of securities, the subordination of the securities (e.g. bail-in risks⁷) and exchange rate risks.

Materiality

Probability and impact

A prospectus should only contain risks that are material for making an informed investment decision. The assessment of materiality remains with the person responsible for the prospectus. NCAs have to ensure, however, that the materiality of a risk factor is apparent from the disclosure of the same. Materiality derives from the probability of the occurrence of a particular risk and the expected magnitude of the negative impact.

The potential negative impact of the risk factor on the issuer/guarantor/ securities may be illustrated by including quantitative information, which may be available in previously published documents (e.g. management reports, IFRS financial statements, ad hoc disclosures). Should quantitative information not be available, or if its inclusion in the prospectus is not appropriate, qualitative information to illustrate the potential negative impact should be included, e.g. by reference to a scaled ranking of low, medium or high risks.⁸ The inclusion of such ranking, however, is not mandatory. Where qualitative information is included, the impact of

⁶ Recital 54 PR3

⁷ Recital 29, Art. 16 (3) PR3

⁸ Art. 16(1) sub-para. 3 PR3

the risks should be sufficiently explained and the order be consistent with the order of the most material risk factors within each category.⁹

However, the inclusion of quantitative information in this context may lead to additional liability risk for the person responsible for the prospectus, as auditors will generally not confirm this information and it has the potential to be misinterpreted by investors.

Mitigating language

Generally, the use of risk mitigation language is not prohibited. Nevertheless, it may only be used to illustrate the probability of the occurrence of a particular risk or the expected magnitude of its impact. General descriptions of risk management practices should not be included if they entirely obscure the materiality of a remaining risk.

Corroborating information

Both materiality and specificity of the risk factor have to be directly related to specific information in other parts of the prospectus or documents incorporated by reference, such as the description of the issuer/guarantor and/or the securities.

Categorisation

To strengthen investor protection, the risk factors should be presented in categories according to their nature, beginning with the most material risk factor first in each category. It is not mandatory for the remaining risk factors in each category to be ranked in the same way. Where a particular risk is relevant in more than one category, it should only be presented once in the most relevant category.

Headings and other formatting choices such as bold font and spacing should further aid investors in navigating the risk factors section. The Final RF Guidelines suggest a limit of ten categories and sub-categories of risk factors (for a single issuer with a single security prospectus), as the number of categories and sub-categories should be proportionate to the size and the complexity of the transaction. Further (sub-) categories may be included, for example, in the case of multi-product/multi-issuer base prospectuses.

Risk Factors in the Summary

The order and the presentation of risk factors in the summary of a prospectus should be aligned with the order of risk factors in the main body of the prospectus. While this includes the most material risk factors, it does not mean that the risk factors from all the categories in the prospectus need to be replicated in the summary section.

Gaps remain

Some gaps remain under the new prospectus regime.

In Europe, there is still no harmonised regime of prospectus liability in place. The new provisions regarding weightings and categorisation of risk factors has the potential to increase prospectus liability for the persons responsible for the prospectus, and it remains to be seen how great this risk is once PD3 beds down.

The presentation of risks under EU law also still differs substantially from the standards applicable to issuances under Reg. S and Rule 144A in the US, where for instance no limitation to the presentation of risk factors applies, as is the case for risk factors in the summary of a retail prospectus. The different standards make global issuances under both regulatory regimes difficult, as different liability standards apply.

Equally, the change of the weighting of a particular risk (e.g. its categorisation based on materiality) after approval of a prospectus, but prior to closing or listing, may trigger the necessity of a prospectus supplement. This will also apply in the context of a base prospectus for an EMTN programme.

⁹ Art. 16(1) PR3 ; Para. 33 Final RF Guidelines

The choice of relevant risk factors and their categorisation under PD3 will be more of a challenge for multi-product base prospectuses; issuances from special purpose vehicles; and prospectuses that allow for both wholesale and retail issues as different standards may apply.

Next Steps and Conclusion

Before PD3, issuers had a tendency to present risk factors in a non-specific and lengthy manner which sometimes included mitigation language. The new provisions will oblige persons responsible for the prospectus to:

1. Categorise risks within a limited amount of categories by using appropriate headings;
2. Apply a risk weighting within each category (beginning with the most material risk);
3. Delete or refine existing risk factors failing the specificity and materiality tests and remove mere disclaimers;
4. Review the presentation of risks: ensuring they are precise and succinct; include quantitative and/or qualitative information; avoid any excessive or inappropriate use of mitigating language;
5. Reflect materiality and specificity of risk factors in the content of the description of the issuer/guarantor and/or the securities; and
6. Limit the number of risk factors in the summary of a retail prospectus to 15 of the most material risks.

The aim of the new provisions on risk factors is to enhance investor protection by making risks more transparent and comparable between different securities, which is thought will assist investors in making informed investment decisions. However, the risk factors sections of some prospectuses will necessitate careful consideration and redrafting to comply with the new requirements in the months to come.

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