

Guidelines on Risk Factors under the New Prospectus Regulation Published by ESMA

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Introduction

This memorandum provides an overview of the Guidelines on Risk Factors under the New Prospectus Regulation (the “**Guidelines**”), which were published by the European Securities and Markets Authority (“**ESMA**”) on 1 October 2019. The Guidelines are intended to assist national competent authorities of member states of the European Union (“**NCA**s”) in reviewing the specificity, materiality and presentation of risk factor disclosure included in prospectuses prepared under the New Prospectus Regulation¹. The Guidelines will apply from 4 December 2019.

Background

The New Prospectus Regulation came into force in full on 21 July 2019, repealing the Prospectus Directive² and replacing the previous Prospectus Regulation³. Article 16(1) of the New Prospectus Regulation requires risk factors to be limited to risks which are specific to the issuer and / or its securities and which are material for taking an informed investment decision. Under Article 16(4) of the New Prospectus Regulation, ESMA was mandated to develop guidelines to assist NCAs in their review of risk factor disclosure for compliance with the new provisions set out in Article 16.

Further to its mandate, ESMA published a consultation paper on 13 July 2018 seeking views on its draft guidelines on risk factors and then on 29 March 2019 published its final report (the “**Final Report**”) with amended draft guidelines reflecting feedback received during its consultation. The final Guidelines are substantively the same as the draft guidelines published in the Final Report; only minor drafting amendments have been made and the date of 4 December 2019 has been inserted as the date from which the Guidelines apply.

The Guidelines

There are twelve areas of guidance set out across six categories in the Guidelines: specificity, materiality, corroboration, categorisation, conciseness and the Summary. Appendix I of the Guidelines sets out illustrative examples of what ESMA considers appropriate risk factors together with explanations as to how they adhere to the Guidelines.

The Guidelines aim to encourage more streamlined and concise disclosure of risk factors in light of a growing trend of issuers including what was perceived by ESMA to be overly extensive risk factor

¹ Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market and repealing Directive 2003/71/EC.

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 on a regulated market and amending Directive 2001/34/EC.

³ Commission Regulation (EC) 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 the publication of such prospectuses and dissemination of advertisements.

disclosure in prospectuses which was more akin to general disclaimers rather than identification of specific risks.

Whilst the Guidelines are addressed to NCAs, they should be applied by issuers, underwriters and their counsel (“**persons responsible**”) when preparing a prospectus for submission to an NCA in order to expedite approval.

Below is a summary of the twelve key areas of guidance set out in the Guidelines.

Specificity

Article 16(1) requires that risk factors in a prospectus should be limited to risks which are specific to the issuer and / or the securities. The Guidelines make clear that NCAs are not required to assess the specificity of a risk factor; they must simply ensure that the specificity is apparent from the disclosure in the prospectus. Where the specificity of a risk factor is not sufficiently clear from the disclosure, [Guideline 1](#) requires NCAs to challenge the persons responsible for the prospectus and, where necessary, to request that a risk factor be amended to more clearly establish how a direct link can be made between the risk factor included in the prospectus and the issuer, guarantor or its securities.

Even though issuers operating within the same industry may be exposed to similar risks and therefore disclosure related to these types of issuers may indeed be similar, ESMA highlights that these industry / sector risks may affect issuers differently depending, for instance, on their size or market share. It is therefore ESMA’s expectation that such differences are reflected in the relevant disclosure.

Consequently, whilst looking at risk factors published by an issuer’s peers may be a useful starting point to help ascertain potential risks for a particular industry, any such risks will still need to be individually assessed and their impact on the particular issuer in question will need to be clearly and specifically drawn out in the relevant disclosure.

Moreover, the supporting guidance in the Guidelines provides that the disclosure of risk factors should reflect any interdependencies that risk factors may have; for instance, a particular risk associated with a security may be higher or lower depending on the financial condition of the issuer or the credit quality of a pool of assets underlying a series of notes.

[Guideline 2](#) reinforces the guidance in [Guideline 1](#) discussed above by making clear that any risk factor disclosure which serves only as a general disclaimer is not sufficiently specific to an issuer, guarantor or security and NCAs should therefore request that any such risk factor be amended or a clearer explanation provided. The inclusion of generic or “boilerplate” risk factors should therefore be avoided.

Materiality

It is not expected that the prospectus include a description of every single risk that is specific to an issuer or the securities being offered and / or admitted to trading. Any risk factor included in a prospectus must also be material for an investor to make an informed investment decision.

Article 16 of the New Prospectus Regulation does not define “materiality” in the context of risk factor disclosure, nor did ESMA include a definition in the final Guidelines. Instead, ESMA referred to paragraph 2.11 of the International Financial Reporting Standards Conceptual Framework in its Final Report to draw an analogous definition of material information being information that if omitted or misstated in a prospectus could negatively influence investment decisions made by investors based on such prospectus.

Article 16(1) requires materiality to be assessed based on the probability of a risk’s occurrence and the expected magnitude of its negative impact. Where materiality of a risk factor is not clear from the disclosure, [Guideline 3](#) requires NCAs to challenge its inclusion and or request that it be amended. Again, the Guidelines make clear that NCAs are not required to assess the materiality of a risk factor; they must simply ensure the materiality is apparent from the disclosure.

The Guidelines encourage the inclusion of quantitative information within the relevant prospectus disclosure to demonstrate the materiality and potential negative impact of a specific risk factor particularly where such quantitative information is available in previously published documents (e.g. management reports, financial statements, disclosures under Article 17 of the Market Abuse Regulation⁴). However, where quantitative information is not available or where its inclusion is not appropriate, the description of the potential negative impact of a risk factor should be described with qualitative disclosure. Where the potential negative impact of a risk factor on the issuer, guarantor and / or the securities is not disclosed, [Guideline 4](#) requires this to be challenged by NCAs.

Article 16(1) provides that the materiality of risk factors may be disclosed by using a qualitative scale of low, medium or high. The Guidelines state that whilst persons responsible for the prospectus are not obliged to provide such a scaled ranking of risks, where a qualitative approach is undertaken, the impact of the risks should be adequately explained and be consistent with the order of the most material risk factors appearing first within each category.

Where mitigating language is included in risk factor disclosure which compromises a risk factor's materiality, [Guideline 5](#) states that this should be challenged by NCAs. Mitigating language should only be used to illustrate a risk factor's probability of occurrence and the expected magnitude of its negative impact. It should not be used as a general disclaimer which reduces an investor's perception of the materiality of the risk to which the issuer is exposed and leaves the remaining risk unclear.

Corroboration

In order for a risk factor to be included in a prospectus, Article 16(1) also requires that the information contained elsewhere in the prospectus corroborates that the risk factor is indeed material and specific to the issuer or the securities. For example, the disclosure in the Business section of a prospectus should corroborate the risks described in the Risk Factors section as relating to the issuer's business. Where there is insufficient corroboration, [Guideline 6](#) requires this to be challenged by NCAs. Whilst the inclusion of specific corresponding information elsewhere in the prospectus is a clear corroboration of the materiality and specificity of a risk factor, ESMA recognises that in certain cases it is sufficient that a risk factor's specificity and materiality is identifiable by reference to the overall picture of the issuer, guarantor and the securities presented in the prospectus. In light of this guidance, in practice it may be helpful to include cross-references to specific corroborating sections of the prospectus to the extent practicable and appropriate.

Categorisation

Article 16(1) of the New Prospectus Regulation also requires that risk factors be presented in a limited number of categories depending on their nature and presented in order of their materiality. Where risk factors have not been categorised, [Guideline 7](#) states that NCAs should request that this be amended. The supporting guidance in [Guideline 7](#) clarifies that whilst the most material risk factors should be described first in each category as required under Article 16(1) of the New Prospectus Regulation, it is not mandatory for all the remaining risk factors within each category to be ranked in order of their materiality.

[Guideline 8](#) requires risk factors to be categorised with the use of headings, bold font and spacing.

[Guideline 9](#) encourages NCAs to challenge the persons responsible for the prospectus and request amendments to the number of categories and sub-categories included in the prospectus where they are

⁴ Regulation No 596/2014 on market abuse, repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC and Directive 2014/57/EU on criminal sanctions for market abuse.

disproportionate to the size and complexity of the transaction and risk to the issuer or guarantor. ESMA proposes that any more than ten categories would likely exceed the requirement in Article 16(1), although this should be assessed on a case-by-case basis depending on the nature of the risks and the issuer.

ESMA suggests the following categories:

- *Relating to the issuer*: risks relating to the issuer's financial situation; risks related to the issuer's business activities and industry; legal and regulatory risks; internal control risks and environmental, social and governance risks; and
- *Relating to the securities*: risks related to the nature of the securities and risks related to the offer to the public and / or admission of the securities to trading on a regulated market.

According to [Guideline 10](#), categories should only be further divided into sub-categories in cases where sub-categorisation can be justified on the basis of the particular type of prospectus. In the event sub-categories are used, the principles that apply for the presentation of risk factors discussed above should apply.

Although it is existing market practice in the United Kingdom to present risk factors broadly according to their materiality, issuers will understandably be wary of the potential for increased liability resulting from the order of risk factors having been formalised in Article 16 and careful consideration will need to be given by directors of issuers together with their key business managers in formulating the categories and order in which risk factors are presented.

Conciseness

Where the disclosure of a risk factor is lengthy and not presented in a concise form, [Guideline 11](#) requires NCAs to challenge this and / or request that the disclosure be amended so that the materiality and specificity of the risk factor are clear and its presentation is appropriate and focused. As an example, ESMA notes that it is not necessary to describe the background to any relevant legislation in risk factor disclosure.

Summary

Whilst the Summary in a prospectus is not required to include all risk factors from all categories included in the Risk Factors section of a prospectus, [Guideline 12](#) makes clear that the presentation of risk factors in the Summary should be consistent with the order of their presentation in the Risk Factors section.

Final Thoughts

The Guidelines will apply from 4 December 2019. If, by that date, the United Kingdom has left the European Union, with or without a deal, the UK Financial Conduct Authority will have the discretion to regard the Guidelines as relevant guidance for the purposes of the UK prospectus regime then in force.

Finally, whilst the aim of the Guidelines to steer issuers away from over-inclusion and lengthy Risk Factors sections is understandable, this needs to be balanced against the judgement call which ultimately lies with issuers and directors who have responsibility and potential legal liability to investors for the accuracy and completeness of the prospectus.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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