

RISK FACTORS UNDER THE NEW EUROPEAN PROSPECTUS REGULATION: WHAT ARE THE NEW RULES AND HOW DO THEY APPLY IN PRACTICE?

When the draft of the new Prospectus Regulation was first circulated, one of the major talking points was the changes to the rules regarding risk factors. This article looks at the new regime, taking into account our experience in France since the entry into force of the relevant provisions of the Prospectus Regulation on 21 July 2019.

INTRODUCTION

In order to protect investors and facilitate the effective functioning of the European internal market in a wide variety of securities, Regulation (EU) 2017/1129 of the European Parliament and of the Council (the "**Prospectus Regulation**") sets out harmonised principles and rules on the prospectus to be drawn up, approved and published when securities are offered to the public or admitted to trading on a regulated market. Subject to limited exceptions,¹ pursuant to the Prospectus Regulation, a prospectus is required if the securities in question are to be (i) offered to the public in the European Union² or (ii) listed on a regulated market in the European Union.³

This article will examine one sub-set of these harmonised principles and rules: the risk factors. The Prospectus Regulation requires risk factors to be included in the prospectus to ensure that investors are aware of and can assess the relevant risks related to their investment and can therefore make informed investment decisions in full knowledge of the facts.

The risk factors, included in a distinct section of the prospectus, are split into two types: risk factors relating to the issuer of the securities (and any guarantor) and risk factors relating to the securities themselves. This article will focus exclusively on the former. This is because, since the entry into force of the relevant provisions of the Prospectus Regulation on 21 July 2019, a market

Key issues

- The rules relating to risk factors in securities prospectuses have changed with entry into force of the new Prospectus Regulation.
- Guidelines published by ESMA have provided helpful detail on how national competent authorities will interpret the new rules during their review of prospectuses.
- Risk factors need to be (i) **specific** to the issuer and/or the securities, (ii) **material** to an investor's informed investment decision and (iii) **corroborated** by the rest of the prospectus.
- Additional rules also govern the categorisation of risk factors and stress the need for risk factors to be comprehensible.
- Please see the end of the article for examples of compliant risk factors.

¹ These exceptions may be found in the Prospectus Regulation at Articles 1(2) (in relation to the types of securities offered), 1(4) (in relation to offers to the public), 1(5) (in relation to regulated markets) and 3(2) (in relation to non-passported prospectuses relating to securities totalling less than €8,000,000 over 12 months). The exception in Article 3(2) only applies if individual Member States decide to authorise it, as is the case with France.

² Article 3(1) of the Prospectus Regulation. This definition of offer of securities to the public is found in Article 2(d) of the Prospectus Regulation: "a communication to persons in any form and by any means, presenting sufficient information on the terms of the offer and the securities to be offered, so as to enable an investor to decide to purchase or subscribe for those securities."

³ Article 3(3) of the Prospectus Regulation. A 'regulated market' is defined in point (21) of Article 4(1) of Directive 2014/65/EU (MiFID II) and includes Euronext Paris.

practice has quickly developed with regards to the drafting requirements for the risk factors relating to the securities. The same is not true for risk factors relating to the issuer of the securities, mainly because each issuer has different risks specific to its business, industry and organisation and, unlike for securities risk factors, the drafting of such risk factors varies significantly between prospectuses.

WHAT DO THE RULES RELATING TO RISK FACTORS SAY?

Article 16(1) of the Prospectus Regulation says that risk factors featured in a prospectus shall be limited to risks which are:

- **specific** to the issuer and/or to the securities;
- **material** to an investor's informed investment decision; and
- **corroborated** by the rest of the prospectus (including documents incorporated by reference).

This article will take each of these three criteria, which are cumulative,⁴ in turn before looking at a fourth criterion, the requirement for the risk factor to be **comprehensible**.

As an aside from the rules regarding the content of risk factors, a key development is that the risk factors must now be presented in a limited number of **categories** depending on their nature.⁵ The categorisation of the risk factors should support their comprehensibility, assisting investors in understanding the source and nature of each disclosed risk factor. A risk factor should only appear once, in the most appropriate category.⁶ Examples of categories include (i) risks related to the issuer's financial situation, (ii) risks related to the issuer's business activities and industry, (iii) legal and regulatory risk, (iv) internal control risk and (v) environmental, social and governance risks.⁷ It is recommended in the ESMA Guidelines that no more than 10 categories and sub-categories of risk factor are used for a standard, single issuer and single security prospectus,⁸ and in our experience in France issuers have limited their risk factors to 5 categories (with the other 5 categories dedicated to the securities risk factors). The burden is on the issuer to justify the number of categories and sub-categories used, particularly in the context of prospectuses for small or non-complex transactions,⁹ and the very use of sub-categories should also be justified.¹⁰

1) "Specific to the issuer"

A clear and direct link must be established between the risk factor and the issuer.¹¹ This ties into the general requirement for risk factors to be adequately described, with a clear explanation of how the issuer is affected.¹² Generic disclosure, possibly copied from other documents published by the issuer,¹³ is not acceptable,¹⁴ nor are risk factors that seek to serve as disclaimers or shield

Where can the rules relating to risk factors be found?

The rules relating to risk factors can be found in Article 16 of the Prospectus Regulation, in force in Europe since 21 July 2019, and in the European Securities and Markets Authority Guidelines on risk factors under the Prospectus Regulation published on 1 October 2019 (the "ESMA Guidelines").

What are the ESMA Guidelines and why are they relevant?

- The ESMA Guidelines, which were also included in identical form as an annex to ESMA's Final Report of guidance on risk factors under the Prospectus Regulation, published on 29 March 2019, were prepared pursuant to Article 16(4) of the Prospectus Regulation.
- ESMA was given a mandate to develop guidelines to assist national competent authorities in their review of the specificity and materiality of risk factors and of the presentation of risk factors across categories depending on their nature.
- The guidelines take into account the comments and suggestions raised by respondents to a consultation paper published in July 2018.
- The *Autorité des marchés financiers* formally confirmed in December 2019 that it intends to comply with the ESMA Guidelines.

⁴ ESMA Guidelines, V., paragraph 13

⁵ Prospectus Regulation, Article 16(1)

⁶ ESMA Guidelines, VI.4., paragraph 32

⁷ ESMA Guidelines, VI.4., paragraph 34

⁸ ESMA Guidelines, VI.4., paragraph 38

⁹ ESMA Guidelines, VI.4., Guideline 9

¹⁰ ESMA Guidelines, VI.4., Guideline 10

¹¹ ESMA Guidelines, VI.1., Guideline 1

¹² Prospectus Regulation, Article 16(1)

¹³ ESMA Guidelines, VI.1., paragraph 23

¹⁴ ESMA Guidelines, VI.1., paragraph 17

responsible persons from liability.¹⁵ Any language that could be described as generic or in the style of a disclaimer should be struck out or amended.

The risk factor must be drafted specifically for the issuer in question,¹⁶ which may depend on the type of entity (e.g. start-up companies, regulated entities, specialist issuers, etc.).¹⁷ Whilst issuers operating within the same industry may be exposed to similar risks, such risks may affect issuers differently, for instance, depending on their size or market shares, and therefore, where relevant, these differences should also be reflected in the risk factor.¹⁸

Given that most, if not all, issuers suffer from risks such as legal, compliance and cybersecurity risks, particular attention needs to be paid to ensuring any such risk factors are specific to the issuer. They must draw a clear link between the issuer's activities and the risk. For example, whilst a company that sells its products online and a company that specialises in artificial intelligence are both exposed to cybersecurity risk, the reasons and the consequences are quite different and should be detailed in the risk factor in question. The company selling its products online may hold large amounts of customer data by virtue of the nature of its activity and be concerned about the reputational damage that a theft of such customer data would entail; the technology company specialising in artificial intelligence may hold no customer data at all but be concerned about intellectual property theft, which could have more significant ramifications for its business and financial situation in the long term.

In our experience, issuers may be expected to justify the absence of risks regarding their legal form or status. For example, issuers benefitting from certain tax regimes (SIIC, SOCIMI or REIT) should be careful to highlight in the risk factors where such status is relevant, including where the loss of such status would have an impact. Similarly, any regulatory regimes affecting the issuer's business should be specifically identified in the risk factors.

2) "Material to an investor's informed investment decision"

The materiality of a risk factor, based on the probability of its occurrence and the expected magnitude of its negative impact,¹⁹ must be clear from the disclosure.²⁰ To the extent possible, quantitative information should be included to demonstrate such materiality, potentially by using information in previously published documents such as management reports, financial statements or press releases.²¹ Certain issuers use numbers and statistics to assist in making the materiality of a risk more clear. For example, the materiality of a risk factor stating that apple production might be affected by the weather could be made much more clear by providing a figure to show the extent to which the issuer's financial situation is dependent upon apple production or a figure showing how many apples are affected by bad weather on average each year as a percentage of total annual production.

Where the use of quantitative information is not possible or appropriate, the potential negative impact should be described using a qualitative approach. One method for doing this may be by reference to the scale of low, medium or high.²² Any such ranking must take into account both the probability of its

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¹⁵ ESMA Guidelines, VI.1., Guideline 2 and paragraph 22

¹⁶ ESMA Guidelines, VI.1., Guideline 1

¹⁷ ESMA Guidelines, VI.1., paragraph 16

¹⁸ ESMA Guidelines, VI.1., paragraph 18

¹⁹ Prospectus Regulation, Article 16(1)

²⁰ ESMA Guidelines, VI.2., Guideline 3

²¹ ESMA Guidelines, VI.2., Guideline 4, paragraph 26

²² Prospectus Regulation, Article 16(1) and ESMA Guidelines, VI.2., Guideline 4, paragraph 27

occurrence and the expected magnitude of its negative impact, not just one or the other.

A quantitative approach and a qualitative approach can be used together and indeed even if a quantitative approach is taken, there is nonetheless a requirement for the most material risk factors to be presented first in each category of risk factors, even if it is not mandatory for all the remaining risk factors within each category to be ranked in order of their materiality.²³

In order to minimise or show the relative importance of a risk, mitigating language is allowed, albeit with caution. If used, it must be to illustrate the probability of the risk factor's occurrence or the expected magnitude of the risk factor's negative impact.²⁴ If the issuer has put risk management policies in place to mitigate a risk, and such risk can no longer be considered material, such risk factor should be excluded from the prospectus.²⁵ Risks which are considered as unlikely to occur and of minimal potential impact should not be included. In addition, sign-posting of mitigating language through headings or columns should be discouraged on the basis that the mitigating language should be illustrative of the expected magnitude or probability of occurrence of a risk, rather than supplementary or additional information.

Whilst the risk factors should give a clear idea of their materiality, including with regards to other risk factors, taking into account their potential negative impact and likelihood of occurrence, issuers are free to use any method of their choosing for evaluating materiality. The method must be clearly described in the introduction to the risk factors. Below is one such example of a description included in a prospectus in October 2019:

"The classification of the risks relating to the Issuer is the result of a regular analysis as part of the Issuer's internal risk management process, and in each category of risks the Issuer sets out first the most material risks, in its assessment, taking into account the expected magnitude of the negative impact of such risks on the Issuer, after also taking into account any mitigation measure resulting from such internal risk management process, and then taking into account the probability of their occurrence."

One additional point to note on materiality is that for EMTN base prospectuses or for standalone prospectuses during an offer period, if post-publication there is a change in the risks to which the issuer is exposed or a development which renders incorrect the weighting of the risk factors in the prospectus, this may be material enough to require the publication of a prospectus supplement.²⁶ Risk factors should always be up to date at the time of their inclusion in a prospectus and issuers should consider whether any recent developments have affected their risk factors, be it their materiality or content (for example, it may be worth including specific recent developments in the risk factors for illustrative purposes).

How do the risk factor rules compare to those for US offerings?

The risk factor requirements in the Prospectus Regulation are similar in many respects to the existing requirements for securities offered into the United States to qualified institutional buyers pursuant to the exemption under Rule 144A.

The key principles for the drafting of risk factors in a Rule 144A offering include the following:

- **Specific disclosure of risks tailored to the business, structure, geography and risk-profile of the issuer.** Rather than general or boilerplate statements of risk that could be applied to any issuer, the practice for a Rule 144A offering is to draft risk factors in "plain English" and in a manner that highlights for investors the material risks that the issuer actually faces, such as the risks that an issuer faces in a specific region or industry.
- **Highlighting risks that have materialised or are likely to materialise.** It is not sufficient for a Rule 144A offering to infer that a risk may occur if that risk has already materialised in the past or is likely to materialise in the future. Rather, where risks have materialised in the past or are likely to materialise in the future, it is important this is highlighted in the risk factor with a brief description of the event and the impact on company's results or operations, if any.
- **Risk factors should not include risk mitigation factors or efforts.** While it is important to provide investors with an accurate view of the extent of a specific risk that a company faces, it is important for a Rule 144A offering to avoid using language that downplays a material risk or suggests to investors that the risk described in the risk factor is not a real risk. Rather, any description of risk mitigation factors or efforts should be discussed in the other sections of the prospectus, including the description of the issuer's business.
- **Include in each risk factor a description of how that risk would impact the issuer if it materialises.** In addition to clearly describing the issuer's risks as described above, it is important that each risk factor includes a brief description of how the issuer might be impacted if a given risk were to materialise, in particular by reference to operational or financial metrics if relevant.
- **Ordering of risk factors by significance of risk to the issuer.** It is important to order the Rule 144A offering risk factors such that the most significant risks to the issuer come at the beginning of the risk factor section and the least significant risks come at the end. The significance of the risk should be determined by the issuer by considering (i) the magnitude of the potential risk multiplied by (ii) the probability of the risk actually occurring.

²³ Prospectus Regulation, Article 16(1) and ESMA Guidelines VI.4., paragraph 33

²⁴ ESMA Guidelines, VI.5., paragraph 29

²⁵ ESMA Guidelines, VI.5., paragraph 30

²⁶ Prospectus Regulation, Article 23

3) "corroborated by the content of the registration document and the securities note"

The materiality and specificity of a risk factor, examined in 1) and 2) above, must be corroborated by the overall picture presented by the prospectus.²⁷ This could be demonstrated via the inclusion of specific corresponding information elsewhere in a prospectus (including in the documents incorporated by reference, provided that the relevant information is explicitly incorporated by reference in the prospectus), or it could be sufficient that the materiality and specificity of the risk factors is identifiable by reference to the overall picture of the issuer/guarantor presented in the prospectus.²⁸

Where possible, issuers should consider adding cross-references in their issuer risk factors to draw links to other risk factors that cover the same or similar ground.

4) Comprehensible

The risk factor should not be too long. It should be concise,²⁹ with an appropriate and focused presentation, and any acronyms used should be defined. The comprehensibility of the prospectus should not be compromised by the risk factor and the risk factor itself should not be obfuscated by large quantities of information,³⁰ even if such information is quantitative.

In our experience, attention has been paid by competent authorities as to whether risk factors describe clearly enough how a risk affects the issuer. For example, a risk factor that focuses on a company's failure to reach its strategic objectives must clearly identify for the investor how and with what immediacy such failure would impact the company in its capacity as an issuer of securities. *Non-sequiturs* should be avoided and 'topping and tailing' risk factors, to better introduce the risk factor and better conclude as to the risk, is one way of ensuring that the risk factors are comprehensible.

Furthermore, the comprehensibility of the risk factor should be appropriate for the investor in question.³¹ The ESMA Guidelines states that competent authorities may take into account the nature of the investors targeted by the offer of securities when reviewing risk factors, citing in particular investors in wholesale securities (securities with a denomination per unit of at least €100,000) and qualified investors investing in securities listed on a regulated market (such as Euronext Paris). Such investors are seen as 'sophisticated' and due to their experience and expertise they will be more familiar with certain risks than other investors.

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"Topping and tailing risk factors, to better introduce the risk factor and better conclude as to the risk, is one way of ensuring that the risk factors are comprehensible."

²⁷ Prospectus Regulation, Article 16(1) and ESMA Guidelines, VI.3., Guideline 6

²⁸ ESMA Guidelines, VI.3., paragraph 31

²⁹ ESMA Guidelines, VI.5, Guideline 11

³⁰ ESMA Guidelines, VI., paragraph 42

³¹ ESMA Guidelines, V., paragraph 15

EXAMPLES OF SPECIFIC AND MATERIAL RISK FACTORS

The below examples of compliant risk factors are taken from the ESMA Guidelines. We have identified in the footnotes the ways in which the example risk factors satisfy the requirements of the Prospectus Regulation.

Example 1: Risk related to natural disasters

The main production site of the issuer (factory ABC)³², which produced 30% of the issuer's turnover last year³³, is situated close to a river which floods almost every spring³⁴. The overflow of water may impair the transport of inventory to distribution centres and consequently may interrupt the delivery of goods to end-customers³⁵. Contracts with several of the issuer's key customers give those customers the right to pay a reduced price for the issuer's goods if goods are not delivered on time.³⁶ In addition, the majority of the issuer's contracts with its customers are for periods shorter than one year.³⁷ Late delivery may adversely affect the issuer's reputation with its customers and result in their turning to the issuer's competitors for their future requirements.³⁸

³² Identifying the main production site helps make the risk factor specific to the issuer.

³³ The use of quantitative information helps the investors gauge the materiality of the risk.

³⁴ This information helps the investors gauge the likelihood of the occurrence of the risk.

³⁵ This sentence identifies the risk and the consequence of the occurrence of the risk.

³⁶ This sentence makes clear that should the risk occur there would be an immediate impact on the financial situation of the issuer.

³⁷ The sentence provides context for the final sentence and shows that the occurrence of the risk would affect the issuer in the short and medium term future.

³⁸ Note that the risk factor is not too long. An effort has also been made to keep the sentence length short.

Example 2: Risk related to environmental, social or governance matters

The issuer is required to comply with a rigorous set of sustainability criteria, in order to maintain its ISO certification³⁹. The issuer is subject to a bi-annual evaluation⁴⁰ by (authority XYZ)⁴¹ which may decide to revoke the issuer's ISO certification on a failure to comply basis. The issuer is dependent on maintaining its ISO certification in order to maintain its contract as a supplier for its two largest customers.⁴² Goods supplied to these two customers generated 40% of the issuer's operating profits last year.⁴³

³⁹ Identifying the regime to which the issuer is subject helps make the risk factor specific to the issuer.

⁴⁰ This information helps illustrate the immediacy of the risk.

⁴¹ Identifying any relevant regulatory authority helps make the risk factor specific to the issuer.

⁴² This sentence clearly identifies the risk in a manner which allows the investor to see the materiality of the occurrence of the risk.

⁴³ The use of quantitative information helps the investors gauge the materiality of the risk. This sentence makes clear that should the risk occur there would be an immediate impact on the financial situation of the issuer.

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