

GUIDANCE AND PRACTICE AROUND PROSPECTUS DISCLOSURE: WHAT TRENDS HAVE EMERGED FURTHER TO THE PUBLICATION OF THE ESMA GUIDANCE?

ESMA guidance has helped shape the Prospectus Regulation and contributed to its generally consistent application and interpretation. In this article, we illustrate some of the disclosure trends that have emerged from ESMA guidance as well as trends that we identified from the practice of certain competent authorities.

INTRODUCTION

It has been three years since the Prospectus Regulation¹ became fully effective across the EU and repealed and replaced the Prospectus Directive². Although many aspects of the Prospectus Directive regime were retained at the time, the direct effect of the Prospectus Regulation resulted in a more centralized and uniform set of rules for the drafting, approval, and distribution of a prospectus to be published when securities are offered to the public or admitted to trading on a regulated market in an EU Member State.

The scope of the Prospectus Regulation is further shaped by, amongst others, the European Securities and Markets Authority ("ESMA"), who has published several guidelines, Q&A's and final reports with the aim to help market participants comply with the disclosure requirements set out in the Prospectus Regulation and to enhance consistency across the EU.

This briefing focuses on certain key sections of prospectuses, setting out in each case an overview of the applicable Prospectus Regulation rules as well as ESMA's contribution to their development. We also highlight certain practices developed by competent authorities, although the scope and scale of their involvement and comments during a prospectus review process differs per jurisdiction.

Key issues

- Guidelines published by ESMA have provided helpful details on how national competent authorities should interpret the Prospectus Regulation.
- 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. There is an evolution in the practical requirements as a quantitative assessment is not necessarily to be included in risk factors.
- ESMA supports the development of the EU Taxonomy, but has not issued its own guidance on drafting ESG risk factors.
- Other sections of the prospectus receive specific attention from the relevant national competent authorities. This concerns the working capital statement, the pro forma section, the profit forecasts / estimates and the uses of proceeds. Both ESMA guidelines and the competent authorities' practice provide for practical guidance regarding the information to be included in the prospectus in this respect and regarding the assessment of the consistency of this information with the entire prospectus.

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/EC8 (the Prospectus Directive).

² Directive 2003/71/EC8.

ESMA'S VIEW ON CERTAIN PROSPECTUS SECTIONS

Risk factors

Current discussions regarding drafting and the prospectus approval processes seem to be mostly concentrated on risk factors. In 2021, ESMA published its helpful views³ on how it expects competent authorities to apply the rules set out in the Prospectus Regulation in relation to both the content and the presentation of risk factors in prospectuses. It is our experience that competent authorities take ESMA's recommendations seriously during their prospectus reviewing process, but also that there has been an evolution in the way they apply these recommendations. The criteria which are considered in ESMA's review are the following:

Content:

- **Specificity:** *competent authorities should challenge the issuer where the disclosure of a risk factor does not establish a clear and direct link between the risk factor and the issuer or securities or if it appears that risk factor disclosure has not been drafted specifically for the issuer or the securities. Risk factor disclosure that serves only as a disclaimer is not typically issuer or security specific.*⁴ This view has led to several issuers removing their standard risk factors on, for example, catastrophic events, terrorist attacks, general market risk or risk relating to the offering of specific financial instruments (i.e. decline of the market price or impact of the volatility) from their risk factors section. As to risk factors that are relevant for most, if not all, issuers (e.g. compliance risk and cybersecurity risk), it is particularly important to explain the specific reasons why such risk factors must be included in the prospectus. The justification can be based on the sector (e.g. banking/insurance, IT, Med-Tech or real estate), the type of issuer (e.g. start-up or regulated company) or the size of the issuer and of its market.
- **Materiality:** *competent authorities should ensure that materiality of the risk factor is clear from the disclosure.*⁵ The potential negative impact of the relevant risk must be clear from either quantitative or qualitative disclosure, and mitigating language should not conceal the materiality of the risk. This requirement substantially shortened issuers' risk factor sections, as more generic risks, which had previously been included but which according to ESMA essentially only served as disclaimers, were stripped out. By way of example, we have noted a reduction in the number of risk factors relating to Brexit, but also to COVID-19, as these developments are with less frequency considered to still be material to the issuer, as opposed to one or two years ago. On the other hand, since February 2022 many issuers have included risk factors relating to the Russia/Ukraine crisis. Competent authorities are not required to assess the materiality of a risk factor; rather, the assessment of materiality of risks remains the responsibility of the issuer who is free to use any method of its choosing for evaluating materiality.

³ See ESMA's guidelines on disclosure requirements under the Prospectus Regulation dated 4 March 2021.

⁴ See ESMA's guidelines on Risk factors under the Prospectus Regulation dated 1 October 2019.

⁵ See ESMA's guidelines on Risk factors under the Prospectus Regulation dated 1 October 2019.

- **Corroboration:** *the materiality and specificity of the risk factor must be demonstrated by either specific corresponding information or the general "overall picture" presented by the prospectus.*⁶ This allows for cross-references to be included in the description of the risk to make the link between the description of the risk and the overall situation of the issuer. The competent authorities may question a risk factor in light of the sentiment of other parts of the prospectus, such as the issuer's description of its activities and trends, as well as the financial reporting, the working capital statement and the use of proceeds as described in the prospectus. Their focus will be on the internal consistency of the prospectus, although we have not seen competent authorities commenting very regularly in respect of this criterium (except when it concerns the risk factor relating to a "qualified" working capital statement – see below).

We have witnessed an evolution in the way that competent authorities apply ESMA's specificity and materiality thresholds. Initially, the trend deployed by several competent authorities was to systematically require the risk factors to be concluded by a formal quantitative assessment of the specificity and of the materiality of the risk (for example, through the inclusion of numbers, scale, fork or percentage). We have noticed in more recent prospectuses, however, that this is no longer included in some jurisdictions and that the qualitative assessment of the risk through a description of the potential impact of the risk on the issuer's activities and financial situation, generally replaces the quantitative assessment.

Presentation:

ESMA furthermore elaborates on the presentation of risk factors. Risk factors must be categorized in order of materiality under appropriate headings. ESMA also recommends that competent authorities *limit the number of categories to ten for a standard, single issuer, single security prospectus, although ESMA would permit sub-categories and a degree of flexibility generally for larger, more complex prospectuses. Risk factors should be focused, and competent authorities should challenge the 'size inflation' of prospectuses.* Furthermore, the overview of risk factors in a prospectus' summary must be consistent with the presentation based on materiality per each category in the risk factors section. The Prospectus Regulation limits the maximum length of a summary itself to seven pages (or eight in case of a guarantee) and the number of risk factors described in the summary is limited to fifteen.

In addition, when challenging the comprehensibility of risk factors disclosure, competent authorities may take into account the type of investor to whom the prospectus is addressed.

Finally, in line with ESMA's view,⁷ the competent authorities generally try to avoid having mitigating factors/language included in the risk factors (and in all cases in the headings or titles of the risk factors or of the sub-sections). If a risk is not material, it should simply not be included in the risk factors section and if a risk is material, the explanation of the measures taken by the issuer should be included in another section of the prospectus (with, as the case may be, a cross-reference included in the risk factor).

⁶ See ESMA's guidelines on Risk factors under the Prospectus Regulation dated 1 October 2019.

⁷ See ESMA's guidelines on Risk factors under the Prospectus Regulation dated 1 October 2019.

Risk factors in equity transactions versus risk factors in bonds transactions:

The requirement applicable to a prospectus in terms of content will depend on the topic of the prospectus and is described in the annexes to the Delegated Regulation 2019/980 (the "**Delegated Regulation**").⁸ A description of the relevant risk factors is required for all types of prospectuses. However, the specific approach and the requirements applicable to the risk factors vary in function of the type of prospectus. The equity prospectus will include risk factors which are likely to impact the financial situation and/or the activities of the issuer in general while the debt prospectus will be limited to the risk factors likely to impact the creditworthiness of the issuer and of the guarantor. In particular, the risk factors to be included in a debt prospectus will need to consider the level of subordination, the impact on the expected size or timing of payments including under bankruptcy, or any other similar procedure and, as the case may be, information on risks likely to impact the issuer's or the guarantor's ability to fulfil its commitment. Further, we note that, in a debt prospectus, the risk factors related to the debt instruments are generally more detailed than the risk factors related to shares (e.g. description of terms and conditions, change of control provision, anticipated reimbursement, interest rate, market circumstances likely to impact issuer's creditworthiness, bankruptcy scenario and tax treatment) since the terms and conditions for debt securities generally leave issuers more flexibility whereas the features of shares are usually prescribed by law.

Risk factors in the context of green bonds:

With green bonds playing an increasingly important role in financing and capitalizing green portfolios, debt prospectuses have started tracking the risks of investing in green assets and the (uncertainty of) applicable standards and future legislation⁹. ESMA supports the development of the EU Taxonomy¹⁰ as a prerequisite for reliable standards for green bonds¹¹, but has not yet published specific risk factor guidance regarding ESG. Several formats have in the meantime been accepted in the market, which according to certain competent authorities should also be driven by the International Capital Market Association Green Bond Principles¹² and, at least as it applies to regulatory capital, the European Banking Authority ("**EBA**") which published its considerations on own funds and eligible liabilities instruments with ESG features¹³. The EBA listed possible specific risks of investing in ESG bonds

⁸ The content of an equity prospectus is subject to Annexes 1 and 11 of the Delegated Regulation while the content of a debt prospectus will depend on the type of transaction: a retail debt prospectus is subject to Annexes 6 and 14 and wholesale debt prospectus is subject to Annexes 7 and 15. Specific annexes apply to prospectuses relating to asset backed securities or to convertible/derivative instruments.

⁹ Also see Clifford Chance's recent publication '*European green bond regulation*' of June 2022, see <https://www.cliffordchance.com/briefings/2022/06/european-green-bond-regulation-.html>.

¹⁰ Regulation (EU) 2020/852.

¹¹ See ESMA's response to the EU green bond standard consultation of 2 October 2020.

¹² See the International Capital Market Association's '*Green Bond Principles Voluntary Process Guidelines for Issuing Green Bonds June 2021*'.

¹³ See the '*EBA report on the monitoring of additional Tier 1 (AT1) instruments of European Union (EU) institutions – update*' of 21 June 2021.

from an own funds and eligible liabilities perspective, which risks have subsequently been included in many prospectuses.

The current trend we have seen is that risk factors in relation to green bonds are becoming more extensive (including information on e.g. the green bond framework, second party opinion and green segments of stock exchanges), and some competent authorities are actively asking issuers for more detailed disclosure on the potential impact of investing in green bonds and consequences should certain projects not be available. This also applies to disclosure on climate change and sustainability (not only in the risk factors but also elsewhere in the prospectus). However, it remains to be seen whether these risk factors will continue to expand, as one could argue that their format might eventually reach the status of being 'generic', in contrast with the Prospectus Regulation requirement that risk factors be specific.

Working capital statement

*A prospectus must include a declaration of the issuer stating whether the issuer has sufficient working capital to meet its present requirements during the next twelve months.*¹⁴ If the issuer cannot firmly state that it has sufficient working capital (without assumptions or caveats), it will need to provide a qualified working capital statement. The competent authorities will assess the consistency of this statement with the other sections of the prospectus (e.g. the financing and the risk factors sections). In case of a "qualified" statement, we see a trend among certain competent authorities to require the inclusion in the prospectus of a reference to the auditor's report and, in particular, to the question as to whether the auditor considers that the issuer is still acting "in going concern". Credits that are still to be negotiated and proceeds of the offering may not be included in the calculation basis of the working capital. Only proceeds of the offering for which the issuer has obtained an unconditional and irrevocable commitment may be included in the working capital calculation. In case of a "qualified" statement, the issuer will need to disclose in the prospectus the timing and magnitude of the expected shortfall and the action plan in place to rectify the shortfall. The competent authority will generally require such information to be included in a specific risk factor and certain competent authorities also require a disclaimer to be included on the cover page of the prospectus. Based on our experience, we note a trend among certain competent authorities to request the issuer to provide the calculation modalities of the statement, because they want to assess (or sometimes even challenge) the robustness of the working capital statement. Additionally, some underwriters may require a working capital report being provided by the auditor in the framework of the comfort package. The objective of this report is to obtain an assessment of the assumptions and calculations underlying the working capital statement. This report is neither to be included nor referred to in the prospectus.

Pro forma

Pro forma information is required when the issuer has entered into (or has irrevocably committed to enter into) a transaction which results in a significant gross change or a significant financial commitment (i.e. impact of at least 25%) and which has not yet been reflected in at least one full financial

¹⁴ Prospectus Regulation, Annex 11, section 3.1. See also ESMA's guidelines on disclosure requirements under the Prospectus Regulation dated 4 March 2021.

exercise.¹⁵ The assessment of the size of the transaction is based on figures which reflect the issuer's business before the transaction took place and by using appropriate indicators of size.

We have experienced situations where the 25% threshold was met not by one transaction, but by several transactions.¹⁶ In this situation, the competent authority may theoretically require *pro forma* figures to be included regarding all the considered transactions, unless producing *pro forma* figures for all these transactions would be disproportionately burdensome for the issuer. In such situations, we note from our experience that *pro forma* figures can generally be limited to transactions which reach, on a standalone basis, the 25% threshold or, when the 25% threshold is not reached by a separate transaction, to the most prominent transaction(s) (e.g. the transactions representing at least 10% of the EBITDA).

Another question is the period to be covered by the *pro forma* figures. Section 2.2 of Annex 20 to the Delegated Regulation provides that *pro forma* information may only be published in respect of: (a) the last completed financial period, and/or (b) the most recent interim period for which relevant unadjusted information has been published or are included in the registration document/prospectus. It is not uncommon that competent authorities require *pro forma* information to be included regarding both the last financial period and the most recent interim period despite the wording of the Delegated Regulation.

Profit forecasts and estimates

Under the Prospectus Regulation, a profit forecast is a statement that expressly or by implication indicates a figure or a minimum or maximum figure (or a range of figures)¹⁷ for the likely level of profits or losses (including measures of profitability derived from profit or loss account) for current or future financial periods, or contains data from which a calculation of such a figure for future profits or losses can be made, even if no particular figure is mentioned and the word "profit" is not used.¹⁸

The approach adopted by ESMA and by most of the competent authorities regarding profit forecasts/estimates is a "substance over form" approach and in their review of the prospectus, most competent authorities will assess the consistency of the entire prospectus in this respect. If profit forecasts/estimates may be predicted from other information included in the prospectus (e.g. trends, dividends policy, costs structure, business strategy, projected cash flow metrics, alternative performance measures partially calculated on profit/loss measures and commercial objectives), the requirements applicable in case of inclusion of profit forecasts/estimates will need to be complied with.

¹⁵ Prospectus Regulation, Annex 1, section 18.4 et Annex 20. See also ESMA's guidelines on disclosure requirements under the Prospectus Regulation dated 4 March 2021.

¹⁶ Frequently asked questions regarding Prospectuses: Common positions agreed by CESR Members 11th Updated Version, CESR/10-830, 9 July 2010. This document refers to previous regulation, but can still be helpful to interpret certain provisions of the current Prospectus Regulation.

¹⁷ For example: EBITDA, EBIT, EBT or Recurring Net income.

¹⁸ Also see Clifford Chance's publication '*Unpicking the prospectus regulation rules on profit forecasts, profit estimates, trend information and objectives in the covid-19 context*' of September 2020.

Following the introduction of the Prospectus Regulation, the inclusion of profit forecasts/estimates in the prospectus no longer requires an auditor's report or assessment. We note a trend among certain competent authorities to assess more generally the existence of ongoing profit forecasts not only from the information included in the prospectus, but also from other communications publicly released by the issuer (e.g. regulated press releases, financial reporting and guidance) and to request such profit forecasts (if any) to be included in the prospectus. This approach has become more common partly as a result of the fact that an auditor's report is no longer required, which makes the competent authorities consider that such inclusion is no longer burdensome for the issuer, even though in practice we note that issuers still rarely include profit guidance or forecasts (subject to some local exceptions), driven by comfort discussions and considerations around associated costs and timing.

Use of proceeds

Competent authorities require the issuer to include a description of the uses they contemplate for the proceeds from the offering. Competent authorities will generally challenge the description of the uses of proceeds in regard to the content of the other sections of equity prospectuses (i.e. the working capital statement, the *pro forma* information and the risk factors), but also with periodic and occasional information that may have been released by the issuer (e.g. ongoing acquisition, contemplated new development of its activities or M&A strategy). While this does not mean that the issuer must prepare a description of detailed projects that would be financed by the proceeds, most competent authorities will nonetheless challenge the description of the uses of proceeds in light of the activities and strategy developed and announced by the issuer.

Furthermore, the significant adoption of green bonds has led to an expansion of the use of proceeds section in debt prospectuses. The International Capital Market Association's ("**ICMA**") Green Bond Principles¹⁹ encourage issuers to, amongst others, clearly communicate in the prospectus: (i) the category of green project(s) the proceeds will be allocated to, (ii) the process for the green project evaluation and selection, (iii) the way the proceeds are managed, and (iv) how issuers will report information on the use of proceeds. We see some competent authorities requesting issuers to apply the ICMA Green Bond Principles, which request is generally addressed by including information from the issuer's green bond framework. Due to the nature of the information included in green bond frameworks, the disclosure focuses generally on key information contained in the green bond framework. A few competent authorities also encourage the issuer to incorporate its green bond framework by reference into the prospectus, but this depends on the jurisdiction and is not yet market practice.

CONCLUSION

The Prospectus Regulation has brought focus to the risk factors and both ESMA and the competent authorities increasingly pay close attention to which risk factors must be included in a prospectus and how issuers must present such risk factors. Other sections of the prospectus, for example the working capital statement, *pro forma* profit forecasts/estimates and uses of proceeds,

¹⁹ Green Bond Principles Voluntary Process Guidelines for Issuing Green Bonds June 2021 (with June 2022 Appendix 1).

remain subject to a detailed supervision from the competent authority. Competent authorities generally scrutinize these sections and assess their consistency with the other sections of the prospectus (including the business section and the risk factors). The ESMA guidelines on risk factors²⁰, the guidelines on disclosure requirements²¹ and the ESMA Q&A²² have been helpful in clarifying how legislation is to be interpreted and applied. However, important clarification is provided by the practice that has been developed so far by competent authorities based on ESMA's guidance. Indeed, we see, that the application of the various rules and guidance by the competent authorities can be nuanced across jurisdictions, such as, for example, the assessment and presentation of the risk factors, the supervision of the internal consistency of the prospectus and the increasing consideration given to ESG and taxonomy aspects.

²⁰ ESMA's guidelines on risk factors under the Prospectus under the Prospectus Regulation dated 1 October 2019.

²¹ ESMA's guidelines on disclosure requirements under the Prospectus Regulation dated 4 March 2021.

²² ESMA's questions and answers on the Prospectus Regulation dated 27 July 2021.

CONTACTS

Amsterdam

Han Teerink
Partner

T + 31 20 711 9132
E han.teerink
@cliffordchance.com

Jurgen van der Meer
Partner

T + 31 20 711 9340
E jurgen.vandermeer
@cliffordchance.com

Dewi Walian
Counsel

T + 31 20 711 9064
E dewi.walian
@cliffordchance.com

Brussels

Valérie Demeur
Counsel

T + 32 2 533 5062
E valerie.demeur
@cliffordchance.com

Frankfurt/Munich

George Hacket
Partner

T +49 69 7199 3103
E george.hacket
@cliffordchance.com

Sebastian Maerker
Partner

T + 49 69 7199 1510
E sebastian.maerker
@cliffordchance.com

Axel Wittmann
Counsel

T +49 89 21632 8014
E axel.wittmann
@cliffordchance.com

London

Simon Thomas
Partner

T + 44 207006 2926
E simon.thomas
@cliffordchance.com

Matt Fairclough
Partner

T + 44 207006 1717
E matt.fairclough
@cliffordchance.com

Adrian Cartwright
Partner

T + 44 207006 2774
E adrian.cartwright
@cliffordchance.com

Luxembourg

Christian Kremer
Senior Partner

T + 352 48 50 50 201
E christian.kremer
@cliffordchance.com

Lauren Harris
Senior Associate

T + 352 48 50 50 228
E lauren.harris
@cliffordchance.com

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www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street,
London, E14 5JJ

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London, E14 5JJ

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Madrid

Yolanda Azanza
Partner
T + 34 91 590 7544
E yolanda.azanza
@cliffordchance.com

**Javier García de
Enterría**
Consultant
T + 34 91 590 4102
E javier.garciadeenterria
@cliffordchance.com

Antonio Henriquez
Partner
T + 34 91 590 9426
E antonio.henriquez
@cliffordchance.com

Milan

Filippo Emanuele
Partner
T + 39 02 8063 4251
E filippo.emanuele
@cliffordchance.com

Gioacchino Foti
Partner
T + 39 02 8063 4335
E gioacchino.foti
@cliffordchance.com

Laura Scaglioni
Counsel
T + 39 02 8063 4254
E laura.scaglioni
@cliffordchance.com

Paris

Cedric Burford
Partner
T + 33 1 4405 5308
E cedric.burford
@cliffordchance.com

Aline Cardin
Partner
T + 33 1 4405 5222
E aline.cardin
@cliffordchance.com

Olivier Plessis
Counsel
T + 33 1 4405 5487
E olivier.plessis
@cliffordchance.com

Auriane Bijon
Counsel
T + 33 1 4405 2468
E auriane.bijon
@cliffordchance.com