

## Risk Factors revisited – the new Prospectus Regulation (PR) (and ESMA Guidelines)



### Background

- PR applies in full from **21 July 2019** and seeks to influence a change of course in risk factor disclosure.
- **Grandfathering** – prospectuses approved before 21 July 2019 will be governed by the current regime until the end of their validity.
- New, **more prescriptive rules**, will be of significant interest to issuers.
- ESMA Guidelines to national competent authorities (NCAs) published 29 March 2019 - aim to encourage **appropriate, focused and more streamlined disclosure of risk factors**.
- NCAs encouraged to challenge risk factors, prompting discussion and the opportunity to respond or amend the disclosure.



### PR: Level 1

#### Article 16

- Risk factors must be limited to risks which **are specific** to the issuer and/or securities, and **material** for taking an informed investment decision, as **corroborated** by the content of prospectus.
- Risk factors shall be presented in a **limited number of categories** with the **most material factors in each category mentioned first**, according to an assessment of materiality based on the **probability of occurrence and expected magnitude of negative impact**.

#### Recital (54)

- The primary purpose of risk factors is to ensure that investors **"make an informed assessment of [the] risks"** and thus take investment decisions in full knowledge of the facts".
- Prospectus **should not contain generic risk factors** which only serve as disclaimers and prevent information being presented in an **easily analysable, concise and comprehensible form**.



### ESMA Guidelines: Key Points

#### Specificity (Guidelines 1 and 2)

- There must be a **clear and direct link** between the risk factor and the issuer/guarantor/securities and the specificity must be apparent from the disclosure.
- Risk factors which are generic and only serve as disclaimers should be challenged and tailored to the issuer/guarantor/securities.

#### Materiality (Guidelines 3 - 5)

- Risk factors must be limited to those **'material for taking an informed investment decision'** taking account of **'the probability of their occurrence and the expected magnitude of their negative impact'**.
- The **potential negative impact** of the risk factor on the issuer/guarantor/securities should be **disclosed**, using quantitative information (where available and appropriate), if not, using a qualitative approach.
- **NCAs should challenge** the inclusion of excessive or inappropriate **mitigating language** which **compromises understanding**. Mitigating language can be used if the significance of the remaining risk is clear.

#### Corroboration (Guideline 6)

- Materiality and specificity of the risk factor should be **corroborated**.

#### Presentation across categories (Guidelines 7 - 10)

- Risk factors should be presented across a **limited number of categories** to aid navigation.
- A risk factor should only **appear once**, in the most appropriate category.
- The **most material factors** must be **presented first** in each category with similar risk factors grouped together under appropriate headings.
- The **number of categories and sub-categories included should not be disproportionate** to the size/complexity of the transaction and risk to the issuer/guarantor.
- NCAs should challenge the **inclusion of more than 10 categories** for a standard, single-issuer, single-security prospectus.
- Sub-categories can only be used where it is justifiable on the basis of the particular circumstances.

#### Focused/concise risk factors (Guideline 11)

- Present risk factors in **as concise a form** as possible.
- NCAs should **address "size inflation"** (which may be linked to extensive risk factor disclosure) of prospectus.

#### Risk factors in the summary (Guideline 12)

- Where a summary is included in the prospectus, its presentation must be consistent with the order of risk factors in the risk factors section.

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“Risk factors must be specific, material and corroborated”

### Points for consideration:

- How to balance objectives of providing clear, concise and comprehensible investor disclosure (in line with policy objective of PR to reduce size-inflation of prospectuses) vs using risk factor disclosure to mitigate liability.
- How to maintain the consistency of risk factor disclosure across documentation (across regulatory filings and jurisdictions including the US). Potential tension with constraints of more prescriptive EU requirements?
- The approach of individual NCAs will be key. ESMA Guidelines allow for some NCA flexibility and the Level 1 text enshrines the concept of different approaches to disclosure being appropriate for wholesale and retail investors (Art. 6(1)).

### Specificity

- Can risk be contextualised with background information contained elsewhere in the prospectus e.g. in a regulatory or industry section?
- Risk factor itself can be specific to the circumstances of the issuer / securities. Can more generic / boilerplate disclosure be "rehomed" elsewhere?

### Materiality

- Challenges in trying to make an assessment of materiality: probability of occurrence vs expected magnitude of their negative impact (in particular in a base prospectus with 12 month validity).
- What is test for "materiality"? No definition in PR. ESMA considers Art. 16(1) "specific... and... material for taking an informed investment decision" as most relevant criteria.

### Presentation across categories

- How to order the most prominent risks first within each category? Test probability of occurrence vs expected magnitude of negative impact. This will be a "management belief exercise".
- Headings can be used as a device to avoid the need to repeat risk factors and reduce cross-referencing.
- Need to use judgement to present each risk once, in the most relevant category.
- Cross-referencing may be problematic from a comprehensibility perspective.

### Focused / concise risk factors

- Balance (a) requirement for disclosure to be limited to information necessary for assessing the risk presented to investors with (b) the issuer's objective of creating a defence against litigation with fulsome disclosure.



### Sources

Prospectus Regulation 2017/1129 (14 Jun 2017)

Final Report: ESMA Guidelines on risk factors under the Prospectus Regulation (ESMA 31-62-1217) (29 March 2019)



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