

Coherence is key for guidance on risk factors

Companies shall not be required to draft different risk statements across different sets of capital markets regulation.

Introduction¹

Deutsches Aktieninstitut (transparency register number 38064081304-25) represents the interests of publicly traded companies, banks, stock exchanges and investors in Germany since 1953. Its members represent 80 percent of the market capitalization of stock corporations listed in Germany. Deutsches Aktieninstitut keeps offices in Frankfurt am Main, Brussels and Berlin (www.dai.de).

In its response to the ESMA consultation on Guidelines on risk factors under the Prospectus Regulation, Deutsches Aktieninstitut points out that guidelines on risk factors should strike the right balance between the objective to avoid overly generic/lengthy descriptions of risk factors and flexibility for issuers in their assessment of relevant risk factors to be included in the prospectus. Unfortunately, it can be observed that the latter is often not sufficiently taken into consideration in the political as well as technical discussions.

Furthermore, while we understand ESMA's intent to avoid any generic description of risk factors, we nevertheless stress the need for proportionality: For instance, the requirement for specificity should not result in the obligation for issuers to disclose trade secrets. Nor should issuers be prohibited to continue to use the presentations of the risk factors of their annual financial report for its prospectuses. This is also important in order not to confuse investors facing different risk factors in different reports/documents. The same description of the same risk factors also promotes comparability and thus serves to protect investors.

Last, it needs to be avoided that new burdens for issuers are created without any reasonable justification. It has to be reminded that prime objective of the overhaul of the previous prospectus regime was to facilitate better access to capital markets and to strengthen capital markets. This will not happen if new burdens are established. In the comments below, Deutsches Aktieninstitut strives to strike the right balance mentioned above and proposes adjustments to the draft guidelines accordingly.

¹This position paper summarizes the response of Deutsches Aktieninstitut to the consultation of European Securities and Markets Authority (ESMA) on Guidelines on risk factors under the Prospectus Regulation (ESMA31-62-996), <https://www.esma.europa.eu/press-news/consultations/consultation-draft-guidelines-risk-factors-under-prospectus-regulation>.

1 Specificity of risk factors

Question 1:

Do you agree with the suggested draft guidelines on specificity? If not, please provide your reasoning.

We agree that the risks disclosed in a prospectus should be specific to the issuer/guarantor and to the securities concerned and that their description should establish a clear and direct link.

As mentioned by ESMA in the draft guidelines, some risks are however specific to a type of entity (eg.: start-up companies, regulated entities, specialist issuers, etc.) and would be found in the risk factors section of the prospectuses published by the same type of companies. The same reasoning could also apply to securities of the same type. Investors considering the opportunity to acquire securities issued by a biotechnology company, for instance, should be aware that these companies in the first stage of their development usually “burn cash” and don’t make any revenue. Where these securities are equity securities, the risks linked to the fluctuations of the price of the securities and to the fact that investors can lose part or all of their investment also need to be mentioned. Would these risks be then considered as « boiler-plate risks » because applicable to all biotech companies and to all public offering/admission to trading of equity securities? We consider that a distinction should be made between boiler-plate language used to describe a risk and the fact that a risk could be relevant for different entities and/or securities depending on their nature. We are concerned that the suggested draft guidelines on specificity ignore the fact that some risk factors may apply to a wide range of similar companies, yet still be specific to every one of those companies.

The guidelines, as currently drafted, are written with the presumption risk factors are always binary, being either general or specific, but not both. Yet, certain risk factors relating to an industry or market sector may be relevant for all issuers operating in that space and if so, should also be included— notwithstanding that they may also be included in many other prospectuses. Therefore, we recommend ESMA clarify the approach issuers should take in this regard. The guidelines should recognise that there are certain generic risk factors which will be relevant to all prospectuses for a particular type of security and consequently, they should be included if relevant.

Plain vanilla securities (e.g. 10 year fixed rate bonds) even of different issuers can have identical securities features. It seems only logical that the description of the securities risks for such bonds are also very similar. Deviating descriptions of identical securities do not support a better understanding of the securities risks for these instruments and could be misleading especially for retail investors. ESMA should acknowledge that there can be standardized descriptions of securities risks for such plain vanilla securities.

While we understand ESMA's desire to avoid not necessary generic risk factors, the requirement for specificity should not result in the obligation for issuers to disclose details, especially trade secrets. It cannot be the intention of ESMA to require an issuer to identify, for instance, specific weak spots in the IT security (and thereby "invite" cyberattacks). In this example, the description of an IT security risk for the issuer should not be required to contain such details. ESMA should specify that issuers may resort to a more general description of risks if specificity would endanger their commercial success or create new risks.

Also, we see critical if companies are required to draft different risk reports according to different pieces of EU legislation. For example, it must be made clear that the descriptions of the risk factors in the annual financial report comply with the requirements of the Prospectus Regulation. According to the principle of better regulation and following the call for evidence on coherence and consistency of EU financial markets regulation, it should definitely be avoided that asymmetries in information provided are being caused. Otherwise, the proper functioning of markets will be deterred and retail investors might be harmed. Therefore, companies should be allowed to copy and paste risk factors stemming from other reports they have filed.

Moreover, the reference to boiler-plate risks or disclosures remains unnecessary. The term "boiler-plate" has no legal definition and could for this reason create undesirable legal uncertainty.

Therefore, we suggest to amend draft guideline 1 as follows: *"Each risk factor should identify and disclose a risk that is relevant for the issuer/guarantor or the securities concerned rather than simply disclosing 'boiler-plate' risks, or using 'boiler-plate' disclosures. However, the description of the risk factor does not require disclosure of any confidential information that would endanger the operations of the issuer/guarantor or create new risks."*

2 Materiality of risk factors

Question 2:

Do you agree with the suggested draft guideline 3? If not, please provide your reasoning.

Please refer to our answer to question 10: we consider that the sentence starting with *“The competent authority should not approve a prospectus where...”* should be deleted.

Question 3:

Do you agree with the suggested draft guideline 4 on quantitative information? If not, please provide your reasoning.

Article 16 of the Prospectus Regulation states clearly that there is no obligation to include quantitative information on the potential impacts of the risks disclosed in the risk factor section: *“Each risk factor shall be adequately described, explaining how it affects the issuer or the securities being offered or to be admitted to trading. The assessment of the materiality of the risk factors provided for in the second subparagraph may also be disclosed by using a qualitative scale of low, medium or high.”*

Disclosing quantitative information on potential impacts is very difficult for issuers taking into account that risks are rapidly changing and evolving. Furthermore, materiality is very difficult to assess, given the differing characteristics of risks (probability and timing of occurrence, as well as uncertain effects) and may be subjective. Finally, issuers have the obligation to provide the investors with all relevant details on the risks related to the issuer (and the guarantor, if any) and the relevant security and not with an estimated figure which might lead the investor into a wrong direction.

ESMA should consider that quantitative information, where disclosed in a prospectus, would need to be covered by the comfort letter to be provided for the banks that place the relevant securities by the auditors of the issuer. Auditors are very hesitant to cover (“tickmark”) figures not derived from the financial reporting of the issuer. We hence anticipate that it may cause a significant burden for issuers

or it may even be impossible, to have quantitative information (which is likely to be an estimate) covered by comfort letter. Therefore, no issuer should be required to produce quantitative information that can not be covered by a comfort letter.

Furthermore we believe that in some cases quantitative information would require a lengthy set of arbitrary assumptions which would divert attention from the underlying risk. Thinking of cyber attacks as an example, these may result in business interruption, property damage and also liability claims each of which could be huge – but nearly impossible to quantify. Considering the prospectus liability it can be very burdensome for issuers to quantify risks in a way presentable in a prospectus. Such information can often be expected to be an estimate for which an issuer may not want to fall under the prospectus liability. Therefore issuers should not be required to provide quantitative information for every case in which quantitative information is available.

Therefore, we suggest the following amendments to draft guideline 4 in order to correctly reflect the requirement laid down in article 16 of the Prospectus Regulation:

“The competent authority should review that the potential negative impact of the risk factor on the issuer/guarantor and/or the securities is disclosed.

~~Where available, the disclosure of quantitative information, in order to illustrate the potential negative impact of a risk factor should be included. However, where quantitative information is not available, t~~ *The description of the potential negative impact of the risk factors may be described using a qualitative approach.*

Question 4:

**Do you agree with the suggested draft guideline 5 on mitigating language?
If not, please provide your reasoning.**

We agree with draft guideline 5. However, we consider that it should be made clear that a description by an issuer of the measures and procedures in place to prevent and/or manage risks should not be considered mitigating language. Regarding for instance risks linked to financial instruments, issuers can cross-reference the content of the risk factors section with information disclosed in the notes of their financial statements established under IFRS. In accordance with IFRS 7, issuers are required to disclose information about management's objectives, policies, and processes for managing those risks.

Therefore, we suggest adding the following statement in the explanatory text following draft guideline 5:

“Any description of the measures and/or policies in place to prevent, manage and/or monitor the risks identified, should not be considered mitigating language.”

3 Corroboration of specificity and materiality

Question 5:

Do you agree with the suggested draft guideline 6 on corroboration of specificity and materiality? If not, please provide your reasoning.

Please refer to our answer to question 10: we consider that the sentence starting with *“The competent authority should not approve a prospectus where...”* should be deleted.

4 Presentation of risk factors across categories

Question 6:

Do you agree with the suggested draft guidelines on Presentation of risk factors across categories? If not, please provide your reasoning.

We agree with draft guidelines 7, 8, 9 and 10 regarding the presentation of risk factors across categories. As regards the different categories (draft guideline 7), we support ESMA’s approach to illustrate with examples the categorisation of risk factors and leave flexibility to issuers to determine their own categories. As a matter of fact, the choice of the categories does not only depend on the activities and/or nature of the company but also on its strategy, political or macroeconomic developments and even technological evolution: some companies have recently included, in their risk factors section, a description of risks linked to cybercrime. Other companies mention human resources risks linked to either the key role played by some senior managers or specific skills required in their activities.

Therefore, we agree that ESMA should not establish a mandatory list of categories. Companies should be able to determine themselves what categories suit them best.

As regards the presentation of the most material risk factors in each category, we would like to insist on the fact that there should not be any ranking of the risk factors whether most material or not.

We are suggesting some amendments to draft guideline 7 to clarify this:

“In accordance with Article 16 of the Prospectus Regulation, the most material risk factors must be presented first in each category, ~~but it is not mandatory to rank that all further risk factors within each category must be ranked~~ in order of their materiality.”

Question 7:

Do you agree with that the number of categories to be included in a risk factor section, should not usually exceed 10? If not, please provide your reasoning.

To our understanding, the ten categories limit put forward by ESMA constitutes a rebuttable presumption. Even when exceeded, the issuer shall have the possibility to explain that he has not breached the requirement to present the risk factors in a limited number of categories.

We are therefore suggesting some amendments to draft guideline 9:

“The competent authority should ensure that the number of categories included in the prospectus is not disproportionate to the size/complexity of the transaction and risk to the issuer/guarantor.

ESMA considers that there is a rebuttable presumption that including more than ten categories in the case of a standard, single-issuer, single-security prospectus, would go beyond the requirement in Article 16(1) of the Prospectus Regulation which states that the ‘risk factors shall be presented in a ‘limited’ number of categories’’. This figure of up to ten categories should be reduced where such a number of categories is not relevant or where fewer categories are necessary to categorise the risk factors in a comprehensible manner. ~~in other circumstances, the ten categories~~ could be extended depending on the case. ESMA understands, for instance, the case of a multi-product base prospectus as an example where further categories may be relevant.

~~Fewer categories should be included where that is all that is necessary to categorise the risk factors in a comprehensible manner.”~~

5 Focused/concise risk factors

Question 8:

Do you agree with the suggested draft guidelines on focused/concise risk factors? If not, please provide your reasoning.

We agree with draft guideline 11. ESMA should be aware that the « size inflation » of prospectus is also directly attributable to the practices of some competent authorities and of some counsels, in order to comply with (institutional) investors requests and/or international practices.

Since these guidelines are addressed to competent authorities, ESMA could in addition clarify/explain how competent authorities should address the “size inflation” by limiting requests for adding additional disclosure. Not every item discussed between the authority and the issuer during the review process needs to be included/reflected in the draft prospectus. ESMA should also consider implementing other measures to harmonise the practises of the competent authorities (please refer to our answer to question 10). As regards investors and counsels and other services providers involved in the drafting of prospectuses, ESMA could also envisage developing specific communication strategies to raise awareness.

6 Focused/concise risk factors

Question 9:

Do you agree with the suggested draft guideline on risk factors in the summary? If not, please provide your reasoning.

We agree with draft guideline 12 and that the disclosure of the risk factors in the summary (if applicable) should be consistent with the presentation in each category of the prospectus.

7 General

Question 10:

Do you agree with the proposed draft guidelines? Have you any further suggestions with regard to draft guidelines addressing a particular section or the guidelines in general?

The approval of a prospectus is defined by the Prospectus Regulation as “*the positive act at the outcome of the scrutiny by the home Member State’s competent authority of the completeness, the consistency and the comprehensibility of the information given in the prospectus*”. At the end of the day, and after having reviewed the entire prospectus, competent authorities are solely responsible for deciding whether the prospectus should be approved or not. We thus consider that it is inappropriate, in a “level 3” measure, to recommend to competent authorities to refuse the approval of a prospectus. Bearing in mind that the nature of the Level 3 measures is non-binding, and regarding more specifically draft guidelines 2, 3, 6 and 7, we consider that the sentence starting with “The competent authority should not approve a prospectus where...” should be deleted.

As regards the disclosure of risk factors, a key challenge for regulators when reviewing risk factors is to ensure that disclosures by different companies operating in a same business sector and/or of the same nature are consistent (i.e. mining companies, for instance, should be faced with the same risks or type of risks). Competent authorities therefore should guarantee that these companies are all subject to the same requirements and level of disclosure of risk factors in order to ensure a level playing field. These guidelines may not be the right tool to address this issue. ESMA should therefore strive to handle this issue through other means such as training programs, workshops, etc. To ensure an efficient and harmonised implementation of article 16 of the Prospectus Regulation it is essential that each competent authority should have a clear policy regarding risk factors and that this policy be harmonised at EU level. The tools mentioned could achieve this goal. On the other hand, too tight guidelines will produce unnecessary burdens on issuers and there is still the problem that supervisors will handle the guidelines differently, as they have to respond to their national circumstances.

Also here, we ask for clarification that the descriptions of the risk factors in the annual financial report can be simultaneously used for the risk section in prospectuses.

Question 11:

Do you believe that market participants will bear any additional cost as an indirect effect of the suggested draft guidelines? If yes, please indicate the nature of such costs and provide an estimation.

Yes, we anticipate a significant increase of direct costs due to the requirements to “rephrase” risk factors year by year and to prioritize them, in particular for the purpose of developing the top risk factors for the summary. These additional requirements will create a massive administrative burden for the issuers and require more coordination between the involved departments (Treasury, Accounting, Legal, Tax, IR, HR etc.).

In addition to that, also external costs will most likely rise due to the increased complexity. The prospectus is a liability document and is always to be reviewed by external advisors (lawyers, tax lawyers, auditors, etc.). Increasing complexity automatically leads to rising fees. A total estimate of the effects is difficult. However, doubling of the prospectus costs seems likely.

The indirect deterrent effect of increased complexity and legal risks created by the new regulation has also to be taken into account and should not be underestimated. There is an increasing number of issuers that even accepts a financial disadvantage of an estimated 50 to 100 basis points in less heavily regulated financial products.

Last but not least, the required due diligence for an issuance as well as any update of or supplement to a base prospectus will take longer now. So certain market opportunities will not be available for issuers anymore.

All in all, we expect that more and more issuers will look for alternative capital markets outside the EU to satisfy their funding needs. The bigger investors will follow them.

Contact

Sven Erwin Hemeling
Attorney-at-Law
Head of Primary Market Law
Deutsches Aktieninstitut e.V.
Senckenberganlage 28
60325 Frankfurt am Main
Phone + 49 69 92915 - 27
Fax + 49 69 92915 - 12
hemeling@dai.de
www.dai.de

Maximilian Lück, LL.M.
Head of EU Regulatory Affairs
Deutsches Aktieninstitut e.V.
EU Liaison Office 58, Rue Marie de Bourgogne
B-1000 Bruxelles
Phone +32 2 7894102
lueck@dai.de
www.dai.de