RISK FACTORS IN SECURITISATION PROSPECTUSES UNDER PD3

On 21 July 2019, the EU Prospectus Regulation (Regulation (EU) 2017/1129, commonly known as "**PD3**") began to apply in full, replacing the previous regime under the EU Prospectus Directive (Directive 2003/71/EC, known in its most recent version as "**PD2**"). As a result, prospectuses approved from that date will be required to comply with PD3. The main area of focus in the structured debt markets has been around PD3's new, much more prescriptive, rules relating to risk factors. In this briefing, we examine those new rules and discuss the practical effect they are likely to have on structured debt prospectuses.

Key issues

- PD3 became effective on 21 July 2019, bringing in refreshed and further guidance on risk factors sections in prospectuses
- PD3 will only be directly relevant where securities are listed on regulated markets, but will set a benchmark against which other deals will likely be measured in the future
- The new regime will require a considered assessment of existing risk factors and introduces a new requirement to set out the most material risk factors in each category first
- Extent of changes will largely depend on the appetite of the issuer and/or sponsor to re-evaluate their risk profile and the content of relevant sections

GENERAL OVERVIEW

Scope

As an initial scoping matter, PD3 in general will only apply formally when a prospectus is required under PD3 – that is to say, when a non-exempt offer to the public is being made or when admission to trading on an EEA regulated market is being sought. Structured debt transactions will almost never need a prospectus because of a non-exempt offer, since they are more or less uniformly offered on a wholesale basis (minimum denominations of at least EUR 100,000), which makes the offer exempt. This has been the case historically, but the Securitisation Regulation reinforces this with its strict rules limiting the offer of securitisations to retail investors anyway.

As a result, the main reason PD3 will be directly relevant to a structured debt deal is because admission to trading on a regulated market (such as the main markets of the London, Irish or Luxembourg stock exchanges) is being sought. Nonetheless, issuers and originators may wish to consider the PD3 principles when designing their risk factors because they align well with general principles of good disclosure (including rules generally followed in Rule 144A offerings).

It is also important to remember that PD3 introduces a number of other changes to the prospectus regime besides the risk factor changes discussed in this briefing. These include changes to the regime relating to advertisements and to the disclosure annexes specifying what information must be made available in prospectuses. Clifford Chance has prepared a wealth of materials covering these changes, which are available from the Prospectus Directive and Transparency Directive Topic Guide on our Financial

Markets Toolkit.[1] In the main, though, securitisation transactions will continue to benefit from the "wholesale" disclosure regime available under PD2, which limits the number of changes under PD3 that will be relevant to them. As such, the key area of focus for securitisation prospectuses is likely to be the new requirements relating to risk factors which we discuss below.

RECONSIDERING RISK FACTORS IN LIGHT OF PD3

On a broad level, PD3 and the associated ESMA guidelines for competent authorities highlight five key aspects for consideration by competent authorities when approving PD3 prospectuses. Risk factors must be specific, they must describe a material risk, they must be separated into categories (with the most material risks in each category presented first), they must be corroborated by the other disclosure in the prospectus and they must be focused and concise. We discuss each of these in turn below.

Beyond these requirements, though, one of the reasons market participants are concerned to have a good understanding of the new regime is the distinctly more interventionist tone to some of the legislation and regulatory guidance issued under PD3 as opposed to previous regimes. ESMA's guidelines explicitly encourage competent authorities to "challenge" issuers about the drafting of risk factors, going so far as to request amendments, request that risk factors not be included and, ultimately, refuse to approve prospectuses where they do not believe the new principles have been appropriately complied with and the issuer does not make appropriate changes.

As a general matter, though, and due in part to the influence of Rule 144A of the Securities Act 1933 ("Rule 144A") on transactions, risk factors in securitisation prospectuses have had to reflect similar principles for some time. As such it is likely that many issuers will be able to keep risk factor changes to comply with PD3 to a relatively minimal level if that is what they wish to do. Regardless, it does give both competent authorities and issuers an opportunity to step back and reconsider their approach going forward.

Specificity

Risk factors are required to be specific to the issuer or to the securities being issued. In practical terms, this means risk factors must disclose a specific risk to the issuer or the securities rather than speaking in generalities. General disclaimer type language which seeks to cast a wide net in disclaiming responsibility for generic unknowns without specifying the potential risk itself is no longer permitted as a risk factor under PD3. This may result in the relevant language being deleted or moved to a more appropriate section – for example, the important notices or general regulatory disclosure sections. It should however be noted that this requirement is not intended to preclude the disclosure of risk factors that are generally prevalent across or inherent to, the market, industry or nature of the transaction.

By way of example, a risk factor disclosing uncertainty around whether a secondary market will develop in the securities will continue to be acceptable. Although this risk is true of every primary issuance of a new security, it is nonetheless a risk that specifically affects the securitisation bonds being offered under the prospectus. On the other hand, a general risk factor around

[1] https://financialmarketstoolkit.cliffordchance.com/en/financial-markets-resources/resources-by-type/topic-guides/prospectus-directive-and-transparency-directive.html

potential stock market disruptions might be challenged with a request that the specific risks to the stock market where the security is listed be addressed.

Therefore, it seems that the key focus will be on drawing out, as applicable, the specific manner in which the relevant risk may affect the issuer and/or payments on the securities. Although clearly identifying these links is of course a requirement for all risk factors, special attention should be paid to specificity when disclosing risks that are industry- or market-wide.

Materiality

The issuer must also assess the materiality of risk factors (which will also affect the order in which they are presented – see below), taking into account both the probability of their occurrence and the expected magnitude if they do occur. Following this assessment, disclosure should be clear as to the material nature of the risk. The legislation and guidance invites (but does not oblige) issuers to disclose the materiality of each risk factor by rating it "low, medium or high". In the limited experience so far, this does not appear to be an option being taken up with any enthusiasm by market participants.

Another element of materiality is that lengthy mitigating language is unlikely to be permitted. This is not to say that that mitigating language is prohibited in a blanket manner – in practice, mitigating language that seeks to draw out the materiality assessment undertaken by the issuer is likely to be considered helpful for investors. However, issuers should be careful to ensure that inclusion of language describing their risk mitigation measures does not lead to lengthy descriptions that blur – rather than clarify – the relevant risks for investors. It is also important that this not amount to an alternative to the previously included blanket disclaimers: both of which are not in line with other PD3 requirements. This is an area where US rules commonly followed for Rule 144A offerings (although only formally applicable to SEC-registered offerings) are in a similar vein.

By way of example in this case, it would be usual to have a risk factor around the risk that underlying obligors might not pay, meaning the issuer might default on its payments. In this circumstance, a lengthy description of the originator's credit underwriting policies and practices that mitigate underlying obligor credit risk might obscure the point of the risk factor. It might be more appropriate to disclose the risk along with a statement that those risks continue to exist despite the measures taken to control them, with a cross-reference to the description of the originator's credit underwriting policies and practices elsewhere in the prospectus.

Categorisation and Ordering

Categorising risk factors

Risk factors must be grouped into categories based on their nature and should only appear once, in the most appropriate category. ESMA has suggested a general rule of thumb that around ten categories and sub-categories of risk factors would be considered appropriate for a PD3 prospectus. That said, they allow for adjustment based on the circumstances, including the complexity of the relevant transaction, the number of issuers/obligors and the number of products offered under the prospectus (the latter mainly being relevant for base prospectuses). Given that, historically, securitisation prospectuses have already presented risk factors in a categorised manner, this requirement should not be new for issuers and market participants, but does suggest a greater focus on risk factors being organised into categories that assist investors in their reading.

Ordering risk factors

The legislation requires that in "each category, the most material risk factors shall be mentioned first". This has widely been interpreted to mean that the single most material risk must be presented first, but does not exclude the possibility that there might be a tie for most material risks, for example. In any case, it is not mandatory for the other risk factors in the category to appear in descending order of materiality. Regardless of explicit guidance to this effect from ESMA, investors are likely to read into the order in which an issuer has placed risk factors within a category and issuers would be wise not to put a particularly significant risk at the end of the list, for example. Similarly, although there is no requirement to order the categories of risk factors in descending order of materiality, issuers should be aware of the impression given to investors when the risk factors are read as a whole.

Another area of discussion is around how to determine the "most material risk". PD3 specifically directs issuers to consider "the probability of their occurrence and the expected magnitude of their negative impact", each of which is an obviously sensible consideration. Issuers should also consider, however, the effect of idiosyncratic risk specific to the particular deal (as compared to other similar deals) and the need to bring that specifically to investors' attention. The existence of such idiosyncratic risk may justify an assessment of that risk as more material than it otherwise would be since it will be particularly important for investors to have it drawn to their attention.

For example, using a servicer who has had recent regulatory enforcement action against it for failure to comply with consumer credit rules would not, in and of itself, be more "important" than the general risk factor about the issuer depending on third parties to do more or less everything for it. Nonetheless, it is unusual and would be the type of information investors would expect to have drawn specifically to their attention, and so this would likely justify presenting that risk in a more prominent way.

Ultimately, the assessment of competing considerations around materiality will be a question of judgment and will be highly dependent on the nature of the assets, issuer and originator of the transaction and the type of investor targeted by the managers. Provided that the question has been properly considered and a reasoned judgment arrived at, this is unlikely to become a problem. That said, market participants will likely continue to be interested in, and monitor how, market practice develops in its assessment of appropriate ordering.

Corroboration

The requirement for corroboration of risk factors is essentially a prohibition on inclusion of risk factors that are not supported by and consistent with the rest of the disclosure in the prospectus. For example, the inclusion of a Brexit risk factor in a domestic Italian securitisation that has no obvious connection to the UK might fall foul of the corroboration requirement The problem could be solved, for example, by pointing out the presence of an UK-based swap provider whose continued ability to play its role was dependent on UK-passported authorisations.

That said, if the other key PD3 principles for risk factors have already been adhered to, corroboration is unlikely to be an issue. Cross-references to other disclosure sections or risk factors within the prospectus may be helpful in evidencing corroboration, but these will not usually be required if the risk factor already establishes the materiality of risk and links the risk to the issuer and overall transaction.

Focused and Concise

Finally, in implementing the requirements of PD3, issuers should be mindful of the requirement for risk factors to be "focused and concise". This requirement is a natural part of the overarching spirit and direction of PD3, which encourages risk factors that are short, precise, relevant and easy to understand. In a structured debt context, probably the worst offending risk factors are so-called "once upon a time" risk factors that give a lengthy summary of the current regulatory situation.

Where the risk disclosed, for example, is that securitisations may be subject to higher regulatory capital charges as compared to corporate debt, there has been a practice in some corners of the securitisation markets to give a lengthy historical account of the various iterations of the Basel Framework leading up to that risk. Under PD3, legislators and regulators are making clear that a more concise and focused approach would be preferable. For example, issuers could simply disclose the risk of higher capital charges, together with a short description of the relevant factors to consider and a recommendation for affected investors to seek specialist advice.

In considering the concision of risk factors, an important counterbalancing factor for some issuers will come from Rule 144A in the US. Although Rule 144A disclosure requirements are more flexible than for an SEC-registered issuance of securities, there remains a certain level of disclosure, in particular with regards to disclosure of due diligence undertaken on the underlying portfolio and the results thereof, that is required to effectively manage liability. Issuers should be alert to these considerations to ensure that rewriting risk factors to be more in line with PD3 does not create additional liability risks on Rule 144A offerings.

Next steps

The extent to which PD3 changes the form and substance of risk factors on a transaction will inevitably depend on the extent to which an issuer's risk factors already comply with the principles of the new regime. In addition, while PD3 certainly presents a welcome opportunity to rationalise the approach to risk factors in structured debt prospectuses, the requirements are mostly principles-based, meaning that issuers concerned to maintain consistency of approach with their historical offering documents will generally be able to keep changes to a minimum. We certainly do not expect that all issuers will seek to completely rewrite their risk factors as a result of the new regime.

At the end of the day, being able to demonstrate to both investors and competent authorities that issuers have duly deliberated on whether the content and structure of risk factors is in line with PD3 is likely to be key. Assessment of PD3 requirements, particularly those that are subjective, are ultimately the responsibility of the issuer and although competent authorities are invited to challenge and question such assessment, it is unlikely that competent authorities will unilaterally require removal of risk factors or specific amendments to particular risk factors where an issuer is able to demonstrate that it has considered the issues and has made a sound, reasoned decision. Issuers may wish, for example, to consider including a mention of having considered these issues in their board minutes approving the transaction. With respect to this, market participants will be keen to observe what vetting process changes are brought into effect by competent authorities, and/or whether a standardisation in approach will develop across the market and among competent authorities.

Conclusion

PD3 has brought new focus to risk factors and it is likely that there will be heightened focus from both competent authorities and investors on how issuers have chosen to present them. The ESMA guidelines for competent authorities are helpful in clarifying how the legislation will be interpreted and applied, but there will inevitably be substantial areas left to be determined by market practice, including the practice of national competent authorities.

Finally, while the PD3 changes only formally apply to a restricted section of the structured debt markets (those with securities admitted to trading on regulated markets), the changes led by PD3 will nonetheless be of interest to the rest of the market because the new rules will inevitably have the effect of creating a benchmark against which to judge the quality of other disclosure.

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