esma European Securities and Markets Authority

Response form for the Consultation Paper on Guidelines on risk factors under the Prospectus Regulation

13 July 2018

European Securities and Markets Authority

Date: 13 July 2018

Responding to this paper

ESMA invites responses to the questions set out throughout its Consultation Paper on Guidelines on risk factors under the Prospectus Regulation. Responses are most helpful if they:

- respond to the question stated;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all responses received by 05 October 2018.

Instructions

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

- Insert your responses to the questions in the Consultation Paper in the present response form.
- Please do not remove tags of the type <ESMA_QUESTION_GRF_1>. Your response to each question has to be framed by the two tags corresponding to the question.
- If you do not wish to respond to a given question, please do not delete it but simply leave the text "TYPE YOUR TEXT HERE" between the tags.
- When you have drafted your response, name your response form according to the following convention: ESMA_GRF_nameofrespondent_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA_GRF_ABCD_RESPONSEFORM.
- Upload the form containing your responses, **in Word format**, to ESMA's website (www.esma.europa.eu under the heading "Your input – Open consultations" → "Consultation on Guidelines on risk factors under the Prospectus Regulation").

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. **Please clearly indicate by ticking the appropriate checkbox on the website submission page if you do not wish your contribution to be publicly disclosed.** A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection
Information on data protection can be found at www.esma.europa.eu under the heading “Data protection”.

Who should read the Consultation Paper

This Consultation Paper may be of particular interest to investors, issuers, including issuers already admitted to trading on a regulated market or on a multilateral trading facility, offerors or persons asking for admission to trading on a regulated market as well as to any market participant who is affected by the new Prospectus Regulation.

General information about respondent

Name of the company / organisation	Deutsche Derivate Verband e.V.
Activity	Banking sector
Are you representing an association?	☒
Country/Region	Germany

Introduction

Please make your introductory comments below, if any:

<ESMA_COMMENT_GRF_1>
This paper constitutes the response by the Deutsche Derivate Verband e.V. (DDV), **the German Derivatives Association,** to the European Securities and Markets Authority ("**ESMA**") in connection with its consultation paper on "Guidelines on risk factors under the Prospectus Regulation".

The DDV is the industry representative body for the 16 leading issuers of derivatives in Germany. The DDV's members are among the most important certificate issuers in Germany, representing more than 90 percent of the total market. Furthermore, the Association's work is supported by sixteen sponsoring members, which include the Stuttgart and Frankfurt Exchanges, as well as finance portals and other service providers.

The DDV's aim is to improve the general political and regulatory conditions for structured products in Germany and at European level, and to encourage increasing numbers of private investors to choose certificates and warrants. The objectives of DDV therefore include making the products more understandable and transparent, as well as protecting investors. Together with its members, the DDV advocates the establishment and promotion of industry standards and self-regulation. As a political advocacy group, the DDV is involved in various national and European legislative initiatives by issuing position papers and petitions.

DDV members have established various programmes for the issuance of structured products targeting retail investors in both the domestic German market and the markets in other EU Member States. In this context, the DDV and its members have a vital interest in the proper functioning of the retail structured products markets and, accordingly, in ensuring that retail investors are adequately protected. However, the DDV and its members also believe that such investor protection should not unduly limit the retail investors' freedom to choose which structured products to invest in and should, in particular, take into account the individual investors' experience.

Given its aims as an industry body, the DDV has provided answers to the questions as relevant to prospectuses for retail debt securities.

In general, the DDV agrees with the principles set out in ESMA's draft guidelines on risk factors to be included in (base) prospectuses drawn under and in accordance with the Prospectus Regulation. However, the DDV notes that the wording "competent authority should challenge" as used in the ESMA's draft guidelines might be misinterpreted by some competent authority to not only actively engage and challenge the risk factors included in (base) prospectuses, but to actually almost block the (prospectus) approval process where it does not fully agree with the issuer's risk assessment. In this context and as an overarching consideration, the DDV wishes to caution ESMA against the risk that national competent authorities in the various Member States could interpret ESMA's guidance to challenge the risk factors included in (base) prospectuses as a requirement to even challenge the benefit of a structured product for investors as a whole (e.g. the benefit of complex credit linked notes for retail investors), rather than focusing on appropriate risk disclosure), resulting an in a substantive "product approval / suitability" test (i.e., the notion of a "quality label") based on such competent authorities' understanding of the relevant products (please see the DDV's response to q.10 below).

In the DDV's view, the application of any such "product approval / suitability" test would differ between national competent authorities and, since there is no single prospectus liability regime applicable across the EU and since prospectus liability is determined at a national level, would expose issuers to the risk that, by complying with the preferred approach of the national competent authority in one Member State, they would fall foul of the requirements applicable in another Member State. The DDV considers that this greater prospectus liability risk for issuer's would not be conducive to investor protection and that ESMA should therefore expressly clarify that national competent authorities should not apply a "product approval / suitability" test when vetting the risk factors in (base) prospectuses.

In this context, the DDV wishes to stress the important role of the issuer in determining the risk factors to be included in a (base) prospectus and respectfully notes that in particular the issuer would generally be much better placed than a national competent authority – in terms of the time and resources available to it to carry out the relevant analysis – to assess the "materiality" of any risk factors. Leaving this determination with an issuer would then also allow issuers to properly reflect any specifics of multi-product base prospectuses.

The DDV is grateful for this opportunity to share its views on selected topics in respect of the guidelines on risk factors under the Prospectus Regulation as follows:<ESMA_COMMENT_GRF_1>

Specificity

Q1 : Do you agree with the suggested draft guidelines on specificity? If not, please provide your reasoning.

<ESMA_QUESTION_GRF_1>
The DDV is grateful for this clarification by ESMA and agrees that, in principle, a requirement for greater specificity of the risk factors included in (base) prospectuses would benefit investors and make (base) prospectuses easier to "digest". Further, the DDV notes that this approach accords with BaFin's current administrative practice and expects that, as a general rule, compliance should not prove too cumbersome or expensive.

However, the DDV also wishes to make two important practical observations – and should be grateful if ESMA would amend its guidelines accordingly.

First, non-SPV issuers which regularly issue debt securities under a number of (base) prospectuses frequently (i) prepare standalone registration documents containing information about the relevant issuer which is, to a large extent, extracted from such issuer's audited or unaudited financial statements and/or (ii) update the relevant (base) prospectuses with information extracted from such financial statements. Such issuer-specific risk information (extracted from such in financial statements) is often detailed, but should not be viewed as "boiler-plate", because it complies with the disclosure requirements of various regulatory and/or auditing regimes.

The DDV acknowledges that, although relevant in the context of equity securities (and even aimed at the shareholders of the relevant issuer), such information may be less relevant in the context of debt securities by the relevant issuer, especially structured debt securities referencing an underlying. Instead, in many instances, the information required by investors in debt securities is fairly high-level information on the structure, business activities and financial health of the relevant issuer.

However, it is important to consider that risk information extracted from financial statements are generally to be considered specific and material. Otherwise they would not be included in financial statements in the first place. Any issuer-specific risk information contained in financial statements concretises issuer risk. Although the issuer-specific risk information contained in financial statements could be, in theory, reviewed and pared down in the context of inclusion/incorporation in an individual (base) prospectus for the issuance of debt securities, in practice such review and/or editing is likely to be quite costly and time consuming (please see the DDV's response to q.11 below). Recognising that the information is still to be considered specific as well as material, this editorial reduction would not be proportional. Further and in addition, it would run contrary to market practice of using a single registration document for multiple (base) prospectuses – since the issuer-specific risk factors contained in such single registration document may not be deemed specific enough for all (base) prospectuses of such issuer – and would therefore unduly penalise the issuers of multiple products without adding much protective value for investors.

Secondly, with respect to Article 16 (3) of the Prospectus Regulation, it has been observed that, where a guarantee is attached to the securities, in practice national competent authorities have a heterogeneous view as to the form and content of guarantor related risk disclosure. This is particularly true when the guarantor acts as such for securities issued under base prospectuses approved by different national competent authorities (which is typically the case when securities are issued by SPVs in different countries). ESMA should clarify that the disclosure of guarantor related risks – as far as the nature of the securities and the nature of the guarantee are comparable – should not be subject to individual discussions in the approval process between an SPV and its national competent authority. As a rule the risk factors relating to the guarantor are set out in the guarantor's registration document which is either filed with or approved by a national competent authority. Other national competent authorities should accept the form and content of risk disclosure once it has been filed with or approved by the guarantor's national competent authority. If guarantor related risks are different in form and content in different base prospectuses it does not only lead

to deviations from the guarantor's registration document. It also means that investors in different countries are facing different risk disclosures even though risks and how their realisation affects the guarantor's ability to fulfil its obligations are basically the same.
<ESMA_QUESTION_GRF_1>

Materiality

Q2 : Do you agree with the suggested draft guideline 3? If not, please provide your reasoning.

<ESMA_QUESTION_GRF_2>
Although the DDV welcomes and agrees in principle with the suggestion that only material risk factors should be included in (base) prospectuses, the DDV is concerned that the proposed guideline leaves room for (potentially significant) discrepancies in terms of the risk factors disclosed in (base) prospectuses approved in different EU Member States.

In particular, the DDV understands the draft guideline 3 as suggesting that it would be open to individual national competent authorities to determine what constitutes a "material" risk factor. In fact, however, it is in the DDV's view (only) the issuer itself – and not a national competent authority – that is best placed to assess and should determine what constitutes a "material" risk in respect of the relevant products. Leaving this determination with an issuer would then also allow consistent risk disclosure for issuers, that deal with various national competent authorities in their offerings.

Shifting now the determination of what constitutes a "material" risk factor to individual national competent authorities is particularly problematic when one also has regard of the fact that there is currently no single prospectus liability regime applicable across the EU and that prospectus liability is determined at a national level. Accordingly, there is a risk that the national competent authority in one Member State determines that a risk factor is not sufficiently material and the issuer of the relevant securities excludes such risk factor from its (base) prospectus – and that, subsequently, the issuer incurs prospectus liability in another Member State where the national competent authority subsequently takes a different view.
<ESMA_QUESTION_GRF_2>

Q3 : Do you agree with the suggested draft guideline 4 on quantitative information? If not, please provide your reasoning.

<ESMA_QUESTION_GRF_3>
The DDV is grateful for ESMA's suggestion and notes ESMA's considerations.

However, the DDV strongly disagrees that, where quantitative information is available, such quantitative information should be used in a risk factor to illustrate the potential negative impact of the relevant risk. Instead, the DDV considers that issuers and their advisers should be able to decide at their discretion whether to include quantitative or qualitative information in presenting the risks associated with an investment in a particular product.

Further and in addition, the DDV notes that ESMA's approach as described in the draft guidelines somewhat deviates from the primary legislation. In particular, Art 16 (1) of the Prospectus Regulation does not refer to quantitative measures when discussing the materiality assessment of the risk, but rather that such materiality may be disclosed using a qualitative scale. Therefore, the Prospectus Regulation leaves it open whether the materiality of risk factors should be disclosed on a quantitative or qualitative basis.

In order to fully comprehend a quantitative analysis, however, methods and assumptions (the basis of any quantitative modelling) might often need to be disclosed, too. The DDV considers that a (base) prospectus is not the adequate instrument for this kind of presentation, nor would it be appropriate and proportional to send respective information to national authorities so they could fully comprehend the risk information.

Instead – and in keeping with the optionality in the Prospectus Regulation – the DDV considers that issuers would not be prejudiced and investors would be potentially better protected if the persons responsible for

drawing up a (base) prospectus were able to determine whether the risk factors would include quantitative or qualitative information. The DDV notes that, as a practical matter, even where the risk factors include qualitative disclosure, such disclosure would often be based (and indirectly reflect) quantitative analysis.

The DDV agrees with ESMA's proposal that, in accordance with Article 16 (1) of the Prospectus Regulation, the persons responsible for drawing up a (base) prospectus should not be obliged to provide a scaled ranking of risks according to their materiality. In particular, having regard for the requirements of materiality and specificity and ESMA's concern about the size inflation of (base) prospectuses, the DDV wishes to avoid a situation where issuers are required to provide (potentially) lengthy explanations as to why they have made a judgement call that certain risk factor(s) are sufficiently material to be included in the (base) prospectus or have been ordered in a particular way.
<ESMA_QUESTION_GRF_3>

Q4 : Do you agree with the suggested draft guideline 5 on mitigating language? If not, please provide your reasoning.

<ESMA_QUESTION_GRF_4>
The DDV agrees with the suggested draft guideline 5. In particular, the DDV welcomes ESMA's approach that mitigating language could be included in a (base) prospectus where it illustrates the probability of occurrence and the expected magnitude of the negative impact of a risk factor.

The DDV, though, also sees the risk that national competent authorities in the various Member States could interpret the example provided by ESMA (*The following is an illustration of mitigating language which reduces the materiality of a risk factor and which obscures the remaining risk*; cf. item 30 of the Consultation Paper) on a literal basis rather than the principle described in draft guideline 5, and forbid any mitigating language even if the materiality is not compromised by it. It would, in the DDV's view be better, if the example were not included in the final Guidelines.
<ESMA_QUESTION_GRF_4>

Corroboration

Q5 : Do you agree with the suggested draft guideline 6 on corroboration of specificity and materiality? If not, please provide your reasoning.

<ESMA_QUESTION_GRF_5>
The DDV notes ESMA's proposed draft guideline 6.

However, the DDV wishes to express its concern that it is currently unclear how the proposed draft guideline 6 would interact with the applicable national prospectus liability regimes. Having regard for the fact that the Prospectus Regulation does not provide for a common framework for prospectus liability regimes, the DDV considers that the draft guideline 6 could have two potentially unforeseen implications:

The DDV notes that, in light of the different national prospectus liability regimes to which issuers could be subject, it should be open to issuers to disclose all risk factors which they consider to be material with respect to a particular product. In that regard, a determination by a Member State's national competent authority (in addition to the Issuer's own determination) of what are sufficiently "corroborated" risk factors – and a corresponding request by such national competent authority that certain risk factors be modified and/or deleted – could increase the issuer's risk of prospectus liability in another Member State whose national competent authority takes a different view of the sufficiency of "corroboration".

Further and in addition, the DDV wishes to confirm with ESMA its understanding on how the requirement that the specificity and materiality of risk factors be corroborated should apply to multi-product (base) prospectuses. In particular, the DDV notes that the corroboration with respect to any risk factor should occur by reference to the entire product universe under the relevant (base) prospectus – and that even if the risk factor is material and specific only by reference to one product, the relevant issuer should still be entitled to include it.

<ESMA_QUESTION_GRF_5>

Presentation of risk factors across categories

Q6 : Do you agree with the suggested draft guidelines on Presentation of risk factors across categories? If not, please provide your reasoning.

<ESMA_QUESTION_GRF_6>
The DDV welcomes ESMA's suggestion that risk factors be presented across categories. In this context, the DDV appreciates the samples of categories outlined by ESMA and understands that the categories included in a (base) prospectus will in particular depend on the nature and business of the issuer and the product offered. In particular, the DDV agrees that the concept of categorisation would likely constitute a structural improvement, making it easier for investors to navigate (base) prospectuses and, therefore, ensuring that investors are better-placed to make informed investment decisions. The DDV notes that a number of issuers already structures the risk factors disclosed in their (base) prospectuses accordingly and, therefore, ESMA's suggestion is in keeping with market practice.

The DDV also agrees in principle with ESMA's proposal that the most material risk factors be presented first. However, the DDV also wishes to draw ESMA's attention to one practical consideration and to request a further clarification: When issuers are preparing (base) prospectuses in respect of a particular product or products, they should generally be in a position to assess what the most material risk factor in each category is and, in accordance with ESMA's proposed guidelines, place it at the beginning of the relevant section. The DDV is of the view that ESMA's draft guidelines should under no circumstances be interpreted as requiring the sequential numbering of risk factors to reflect their relative decreasing risk weighting. That is especially relevant in circumstances where, during the period of validity of a (base) prospectus, it is conceivable that new risks in connection with the product or products offered would become apparent and need be disclosed or that existing risks increase or decrease in materiality. For example, unforeseen political disturbances in a jurisdiction could lead to increased volatility of the price of any equity-linked products which reference the shares of companies active in such jurisdiction.

The DDV further welcomes and agrees with ESMA's considerations reflected in draft guidelines 9 and 10. In particular, the DDV strongly agrees that, in the context of multi-product base prospectuses, issuers should have ample flexibility to include such categories and sub-categories of risk factors as they consider appropriate to present the risks associated with investing in the relevant securities in a way which is most logical and easily understandable by investors and which would allow investors to make properly informed investment decisions. In this context the DDV understands that an issuer has the flexibility to freely arrange the sub-categories within each category in its reasonable judgement.
<ESMA_QUESTION_GRF_6>

Q7 : 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.

<ESMA_QUESTION_GRF_7>
Although the DDV agrees that there are many instances where 10 categories of risk factors should be sufficient, the DDV also notes that such limitation may not be appropriate in all circumstances. Rather, the suitable amount of risk factor categories should be determined in accordance with the principle of proportionality and on a case-by-case basis.

In this context, the DDV is of the view that, to ensure the most appropriate presentation of risk factors within a (base) prospectus – i.e., which is most logical and allows investors most easily to make informed investment decisions – issuers should be given broad discretion as to how they categorise and disclose any relevant risk factors. In particular, limiting the number of categories could prevent issuers from fully and sufficiently emphasising that risk factors belonging to the same category can be quite distinct.
<ESMA_QUESTION_GRF_7>

Focused/concise risk factors

Q8 : Do you agree with the suggested draft guidelines on focused/concise risk factors? If not, please provide your reasoning.

<ESMA_QUESTION_GRF_8>
The DDV agrees with the principle reflected in ESMA's guidelines that any risk factors disclosed should be focused and concise. However, the DDV also wishes to reiterate its view that, in light of the different national prospectus liability regimes to which issuers could be subject, it should be open to issuers to disclose all risk factors which they consider to be material with respect to a particular product. In that regard, a determination by a Member State's national competent authority (in addition to the Issuer's determination) of what are sufficiently "focused/concise" risk factors – and a corresponding request by such national competent authority that certain risk factors be modified and/or deleted – could increase the issuer's risk of prospectus liability in another Member State whose national competent authority takes a different view of such sufficiency.

In addition, where issuers prepare multi-product (base) prospectuses, they would, almost by default, include a greater number of risk factors to ensure adequate disclosure of all material risk factors relevant to a particular product and, accordingly, enable investors to make properly and fully informed investment decisions.
<ESMA_QUESTION_GRF_8>

Summary

Q9 : Do you agree with the suggested draft guideline on risk factors in the summary? If not, please provide your reasoning.

<ESMA_QUESTION_GRF_9>
The DDV welcomes and generally agrees with ESMA's proposed approach as reflected in the draft guidelines. Further, the DDV notes that, in the German market, issuers already tend to ensure relative consistency of presentation between the risk factors in the summary and in the main body of the prospectus.
<ESMA_QUESTION_GRF_9>

General

Q10 : 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?

<ESMA_QUESTION_GRF_10>
The DDV is highly concerned that allowing national competent authorities unfettered discretion to determine what are and what are not the "material" risk factors in the context of a particular product could unfortunately result in national competent authorities not only actively engage and challenge the risk factors included in (base) prospectuses, but to actually almost block the (prospectus) approval process where it does not fully agree with the issuer's risk assessment. In this context, the DDV wishes to caution ESMA against the risk that national competent authorities in the various Member States could interpret ESMA's guidance to challenge the risk factors included in (base) prospectuses as a requirement to even challenge the benefit of a structured product for investors as a whole (e.g. the benefit of complex credit linked notes for retail investors), rather than focusing on appropriate risk disclosure), resulting an in a substantive "product approval / suitability" test (i.e., the notion of a "quality label") based on such competent authorities' understanding of the relevant products.

Although that is less of an issue in the context of vanilla products, the DDV very respectfully notes that, for structured products and, in particular, for structured products whose (anticipated) performance is based on complex economic models and analysis, the issuer(s) of such products would generally be much better

placed than a national competent authority – in terms of the time and resources available to it to carry out the relevant analysis – to assess the "materiality" of any risk factors in connection with such products. The DDV is therefore concerned that allowing such very wide discretion to national competent authorities could have the unforeseen result of unequal treatment by national competent authorities of the (base) prospectuses relating to, in particular, structured products when compared to (base) prospectuses relating to vanilla products.

In addition, the DDV also wishes to highlight the increased risk of prospectus liability for issuers as a result of differing approaches to the vetting of risk factors by different national competent authorities. The DDV considers that this greater prospectus liability risk for issuer's would not be conducive to investor protection and that ESMA should therefore expressly clarify that national competent authorities should not apply a "product approval / suitability" test when vetting the risk factors in (base) prospectuses.

Finally, the DDV highly appreciates that ESMA has made effort to also reflected the specifics of multi-product base prospectuses in its draft guidelines, but at the same time recognises that an even deeper reflection of, e.g, the corroboration of specificity and materiality in case of a multi-product base prospectus would be helpful for issuers in making it easier for investors to navigate (base) prospectuses and, therefore, ensuring that investors are better-placed to make informed investment decisions.
<ESMA_QUESTION_GRF_10>

Q11 : 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.

<ESMA_QUESTION_GRF_11>
In the DDV's view, the application of the suggested draft guidelines by the national competent authorities might even result in significant additional costs to issuers, e.g. in case issuers are required to edit and adapt risk factors in connection with a relevant issuer which are based on the financial statements of such issuer and which may have to be modified to be made more product-specific. In this case or where issuer related risk factors are excessively challenged, auditors might even be needed to be involved to ensure final consistency between the risk disclosure adapted for the purposes of the (base) prospectus and of the financial statements. The application of the suggested draft guidelines might in the DDV's view even result in an increased number of (base) prospectuses for a specific issuer and its products universe, leading to increased costs and administrative burden for issuer. Please also see the DDV's considerations set out in the response to q.1 above.
<ESMA_QUESTION_GRF_11>