BUDDLE FINDLAY

Swinging the pendulum - risk disclosures in regulated offers

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"October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February" - Mark Twain, Pudd'nhead Wilson.

For as long as people have been investing their money, there have been investment risks. How best to disclose those risks to investors is perhaps more akin to an art, than a science. The current legislation which governs the disclosure of risks in regulated (public) offers of financial products (like shares) in New Zealand, is the Financial Markets Conduct Act 2013 and its associated regulations (2014) (the FMC Laws). The approach under the FMC Laws is markedly different from under its predecessor, the Securities Act 1978 (and its regulations), particularly when considered in light of the Financial Market Authority's (FMA's) interpretative overlay (which is itself a dynamic process).

The treatment of risk disclosures under the Securities Act has been described as the 'kitchen sink' approach. The Securities Regulations 2009 were actually fairly brief in terms of compulsory disclosures around risks. Equity issuers (by way of example) were required to *briefly* describe the principal risks of the investor not recovering their money in full, not receiving the returns described in the disclosure document and/or being required to pay more money in respect of the security than as otherwise disclosed. There was also a specific disclosure required around the consequences of insolvency. Throughout the reasonably short regulation mandating risks disclosures (Regulations 11 and 12 of Schedule 13, Securities Regulations 2009), the word *brief* was used five times. Despite this, risk disclosures were (or at least, became) anything but brief.

Whilst only technically required to be contained in the Investment Statement (not in the Prospectus itself), risk disclosures under the Securities Regulations grew very lengthy and were commonly repeated in the Prospectus (in the guise of 'other material information'), in an attempt to address issuers' fears of not covering every base. Commonly, risk disclosures would run for multiple pages, covering not only actual and material risks, but also risks that might be considered theoretical, remote or inconsequential. The result was often the 'infoxication' or information overload of the reader.

Based on the theory that less can be more, the FMC Laws dramatically pared-back risk disclosures in regulated offering documents. Coupled with a mandated 'warning statement' about the risks of investing generally, equity issuers are now required to describe the most significant risk factors that could affect the value of the financial product right at the front of the disclosure document in a key information summary. Importantly, the issuer must make it clear why each risk is of particular significance in relation to the particular issuer or the particular shares (as compared to other issuers or other shares). In the body of the Product Disclosure Statement (PDS), the issuer must further describe any circumstances that exist, or are likely to arise, which significantly increase the risk to its financial position, financial performance or stated plans. Again, the circumstances described must be of particular significance to the issuer or the shares and must include particulars that assist an investor to assess the likelihood of any impact arising from the circumstances, the nature of the impact and the potential magnitude.

The FMA's interpretation of the FMC Laws (particularly the disclosure regulations) is, like everyone else's, still a work in progress. It's telling that, more than three years after the mandatory transition date for the new FMC Laws, the regulator is still (helpfully) offering to do pre-registration reviews of offering documents. This service was originally designed to help issuers align their disclosure documents with the FMA's expectations/interpretations of the new FMC Laws. Given the FMA's expectations/interpretations have themselves changed over the past three years, and continue to evolve, the pre-registration process is still very useful for issuers.

What used to be a pendulum swung too far towards the 'kitchen sink' approach to risk disclosure is now a pendulum swung in the opposite direction, favouring the 'particular significance to the issuer' approach. While no one is suggesting that Chicken Licken style 'the sky is falling' disclosures are helpful to potential investors, sometimes there are risks which could be described as general market risks, but which are also particularly relevant to an issuer because of the nature of the issuer's business. Examples include:

- A general or specific decrease in commodity prices for commodity-based business
- Commercialisation of new technologies where technology innovations are an important part of the business
- Currency fluctuations where the business has significant hedging risks
- Natural disasters where the business is agricultural or horticultural based.

However, these are risks which apply to many businesses and, as a result, the current favoured disclosure approach advocates *not* disclosing those risks in regulated offers because they are not risks which are 'specific' enough to the issuer. In some cases, that approach seems counterintuitive to good disclosure. It assumes that prospective investors have a good understanding of general business risks and don't need further explanation of those risks as they apply to the issuer. In our view, if a risk is particularly relevant to the issuer and the issuer can explain why it's particularly relevant, that risk should be included in disclosures, even if it's a risk which is also applicable to other businesses.

In addition to the new concept of specificity in risk disclosures, the FMC Laws also require issuers to include particulars such that a prospective subscriber can assess the likelihood of any impact arising from the circumstances occurring, the nature of the impact and the potential magnitude. Issuers originally interpreted that as requiring them to make (and disclose) an assessment of those things in the PDS. Risks were, accordingly, labelled as 'high', 'medium' or 'low' (or a combination thereof) as to likelihood and impact. Over the course of the last three years, the regulator has advised through pre-registration reviews that it does not consider it desirable for an issuer to determine likelihood and impact in this way, and that those are assessments that should be made by the investor on the basis of information provided by the issuer. Gone now are the labels, replaced by words which sometimes struggle to express the concept of 'high', 'medium' or 'low' in a way which would enable the average investor to make a thoughtful assessment. One would have thought that the issuer was in a uniquely advantaged position to make those assessments, although perhaps the regulator found that there was a lack of honesty/transparency in issuers doing so. That is, indeed, a tricky issue to tackle.

Risk disclosures are undoubtedly one of the most important and, as such, difficult areas of disclosure in regulated offers. Where to place the power of making judgements about risks (ie in the hands of issuers or in the hands of investors) and how to ensure risks are specific and material without being too narrow, are two key considerations for issuers to address when making regulated offers. The requirement to strictly comply with the regulations is also overlaid by the need to meet the regulator's evolving expectations for risk disclosures and ultimately to satisfy the issuer's board that all relevant risk disclosures are covered appropriately. After all, a failure of disclosure is ultimately a failure by the issuer and its directors. As a consequence and not surprisingly, issuers should expect some very thoughtful (and sometimes heated) debate around risk disclosures in their regulated offer documents.

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