04 April 2018

GFMA Response to CR02/2018 – Conflicts of interest and associated conduct risks during the equity capital raising process

The Global Financial Markets Association[1] (GFMA) welcomes the opportunity to comment on the consultation paper from the International Organisation of Securities Commissions (IOSCO), CR02/2018 – Conflicts of interest and associated conduct risks during the equity capital raising process.

Introduction

Research analysts (Analysts) play an important role in the equity capital raising process by, *inter alia*, participating in meetings with potential issuers with the dual purpose of: (i) accessing information about the potential issuer that is necessary for an Analyst to educate the investor community; and (ii) enabling Analysts to provide insights on the merits of a potential issuer's equity capital raising transaction.

GFMA supports high standards of conduct for all participants in the equity capital raising process. We agree with IOSCO's previous statements[2] that recognised that the flow of timely and accurate information about issuers and securities is fundamental to ensuring fair, efficient and transparent markets, and that Analysts can provide valuable insights to investors and assist them in making an investment decision.

In that regard, we recognise the importance of integrity and objectivity in the research process. We acknowledge the existence of potential conflicts of interests related to research and the equity capital raising process, including in respect of Analysts' interactions with potential issuers during the pre-offering phase of a transaction. Accordingly, we support the development of guidelines and principles that recognise the jurisdictional differences in approaching conflicts related to the equity capital raising process, with a view to helping market participants successfully navigate such conflicts. There are merits in a number of the measures suggested in IOSCO's proposed guidance, but those merits should be weighed against the risk of measures inhibiting capital formation and introducing other market risks into the capital formation process. In formulating any new measures, it is important to recognise that firms have the ability and the means to effectively manage potential conflicts of interest through robust policies and procedures.

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[1] The Global Financial Markets Association (GFMA) brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, visit http://www.gfma.org.

[2] IOSCO Statement of Principles for Addressing Sell-side Securities Analyst Conflicts of Interest: Final Report, September 2003: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD150.pdf

We have structured the remainder of our response as follows:

I. Conflicts in the Pre-offering Phase (Measures 1-3)
II. Information Availability (Measure 4)
III. Allocation and Pricing (Measures 5-7)
IV. Personal Transactions by Staff (Measure 8)
V. Conclusion

I. Conflicts in the Pre-offering Phase

We support regulatory measures designed to ensure that firms manage the risk that an Analyst's participation in a meeting with an issuer, financial sponsor or other shareholder and/or corporate advisor in the pre-offering phase of an IPO, is conducted in a manner that does not give rise to conflicts of interest. During the design of such measures, it is important for regulators to take into account the valuable and appropriate role that Analysts play in pre-mandate meetings with potential issuers to: (i) assist their firms in assessing, from a risk management perspective, whether to seek a mandate from the issuer; (ii) provide perspectives that can inform potential issuers' decision to proceed with or delay a public offering; and (iii) obtain information that is necessary for the investor education phase of the offering. Analysts who attend pre-mandate meetings with potential issuers also have an opportunity to develop a better understanding of the industry dynamics that are specific to potential issuers and the competitiveness of potential issuers in comparison to the public companies that Analysts already cover, both of which benefit investors generally.

As such, measures that unduly restrict or prohibit Analysts from participating in *all* pre-mandate meetings may have a detrimental effect on the equity capital raising process by: (i) inhibiting firms' ability to properly assess potential issuers from a risk management perspective; (ii) limiting the information pool from which potential issuers can make informed decisions about whether to proceed with or postpone a public offering; and (iii) limiting the information about potential issuers that is available to potential investors during the price formation stage of the capital raising process. Robust policies and procedures that address the content and boundaries of an Analyst's interactions with issuer's representatives and with corporate advisory and investment banking colleagues can effectively manage potential conflicts. We agree that an Analyst's role should never be to "win" a mandate. Analysts serve as a valuable resource to educate and to inform the issuer about market expectations and sector conditions generally in relation to a prospective offering. For the avoidance of doubt, Analysts need to meet with industry experts as part of their normal course coverage of stocks within an industry (including private companies). Such activity is unrelated to pitching for corporate client business.

We also support regulatory measures aimed at ensuring that, once an underwriting or placing mandate has been awarded, firms take the necessary steps to ensure that connected Analysts remain objective and are not improperly influenced. In this regard, GFMA member firms have in place procedures to ensure that connected research is objective. We note that, in the United States, for example, the Financial Industry Regulatory Authority (FINRA) rule 5130 establishes restrictions with respect to the purchase and

sale of new issues and prohibits FINRA members from selling new issues to any account in which "restricted persons" have a beneficial interest; FINRA rules 2241 and 2242 ("the Research Rules") require member firms to establish certain policies and procedures related to equity (Rule 2241) and debt (Rule 2242) research reports and research analysts. Further, in the United Kingdom, connected research related to equity capital raising undergoes a highly detailed factual accuracy and verification process in compliance with the Financial Conduct Authority's Code of Business Sourcebook rules. It is important to note that such connected research is overseen by both external lawyers and firms' compliance teams, with a view to ensuring that it does not contain factual errors that would, if left uncorrected, conflict with the factual information provided in an offering document.

Accordingly, in our view, Analysts should be able to perform an ongoing internal advisory role in relation to the investment banking function of the firm, subject to the internal controls of their firms following the award of a mandate. We believe that their sector/industry-specific expertise and research is integral to facilitating broader investor education and price formation.

II. Information Availability

GFMA supports the provision of information on potential issuers to potential investors in an unbiased and timely manner that helps to facilitate investor education and price formation. While connected Analysts are an important source of information for price discovery, it is an overstatement to consider them the "main" source at any given point in time. Global capital markets reflect broad participation by knowledgeable investors that perform their own due diligence on the competitive positioning and potential revenue growth for issuers and connected Analysts' views are often only one input into a multifaceted investment process.

We note that in the United Kingdom, the Financial Conduct Authority (FCA) has recently amended its rules to require, from 1 July 2018, issuers to facilitate access to equity capital raising-related issuer information for unconnected Analysts, with the aim of providing investors with a wider variety of research on potential issuers. The changes to the FCA's rules in significant part reflect the tenor of the guidelines set out in IOSCO's 'Measure 4', which calls for "regulators […] requiring firms to support the provision of a wide range of independent information to investors in a timely manner […]". While the FCA's approach is designed to stimulate unconnected research, such an approach is new and it remains to be seen to what extent such research will materialise and provide a meaningful contribution to investor education. However, it should also be noted that, except for France, no other jurisdiction requires firms to facilitate access to equity capital raising-related issuer information for unconnected Analysts. Most jurisdictions continue to rely on competitive market forces and issuers' choice to determine if, how, and when unconnected Analysts access potential issuers' information related to the equity capital raising process.

III. Allocation and Pricing

GFMA acknowledges that investment firms work on an issuer's behalf to achieve a range of objectives including, but not limited to, ensuring that: (i) the issuer successfully raises funds; (ii) the funds are raised

at the optimal price permitted by market conditions and the issuer's circumstances; (iii) there exists a healthy aftermarket for the issuer's securities; and (iv) the issuer has access to a diverse investor base. In GFMA's view, firms should be and are in a position to be able to substantiate their allocation decisions and demonstrate that they adequately manage potential conflicts of interest associated with the allocation process. However, the manner in which firms substantiate their allocation decisions and manage potential related conflicts of interest should take into account the context of different jurisdictions, leaving firms with the necessary flexibility to implement measures in compliance with local regulations.

Certain jurisdictions have enacted specific regulations to ensure that firms have in place procedures to prevent the allocations process from resulting in firms' interests being placed ahead of the issuer client's interest. By way of example, in the European Economic Area (EEA), firms that provide services to clients linked to financial instruments are required by the second Markets in Financial Instruments Directive (MiFID II) to maintain a record of allocation decisions, including, *inter alia*: (i) a copy of the firm's "overarching allocation policy" in force at the time of the commencement of the firm's initial discussions with its issuer client; and (ii) the agreed proposed allocation per "type" of investment. In addition, firms must provide a justification for the final allocation made to each investment client. In the United States, FINRA Rule 5131 ("New Issue Allocations and Distributions") addresses potential misconduct in the allocation and distribution of new issues. In GFMA's view, it is important for firms to implement internal policies related to allocations—policies that reflect overarching principles such as transparency as well as frequent and meaningful consultation with the issuer. Such policies should also reflect the firm's commitment to take into account issuers' preferences even in firm commitment offerings. Furthermore, policies on allocation should always reflect different legal and market conditions.

GFMA supports firms engaging in effective communication with issuers in relation to the pricing of equity securities offerings. In April 2016, the FCA published an interim report on its market study of investment and corporate banking, which included a statement that "banks highlighted that it is ultimately the issuer that decides whether it wishes to set a low issue price in order to achieve specific allocation preferences. Banks noted that this trade-off is always discussed with the issuer. Banks said that they often demonstrate to the issuer how the quality of the order book changes at different price levels."[3] In GFMA's view, the FCA's findings reflect the tenor of IOSCO's proposed 'Measure 7' and demonstrate that firms recognise the importance of both keeping the issuer informed of key decisions and/or actions that can influence pricing outcome and giving the issuer an opportunity to express preference regarding the pricing of an issue during the pricing process.

We also note that after-market appreciation is not *prima facie* evidence of underpricing of an issuance or a firm not acting in the issuer's best interest.

[3] FCA Investment and corporate banking market study: Interim Report (paragraph 9.22), April 2016: https://www.fca.org.uk/publication/market-studies/ms15-1-2-interim-report.pdf

IV. Personal Transactions by Staff

GFMA recognises the importance of firms developing internal policies aimed at ensuring that employees who are privy to material non-public information related to securities transactions do not misuse such information. We also support firms developing and implementing policies covering the tracking of material non-public information and requiring analysts to be wall-crossed prior to receiving any material non-public information about a proposed investment banking pitch or potential transaction or upon determination by the firm that an Analyst is in receipt of such material non-public information.

GFMA supports the development of clear policies for employees governing securities transactions undertaken.

V. Conclusion

GFMA recognises the important role that capital markets play in the global economy and acknowledges that intermediaries may encounter conflicts of interest which, if not properly managed, could compromise the integrity and efficiency of the equity capital raising process. GFMA believes that investors should have access to information about potential issuers from multiple sources and in a timely manner.

Further, GFMA believes that Analysts' pre-mandate interactions with potential issuers are important both for the facilitation of information for investor education and for firms' assessment of potential issuers. In this context, GFMA's members support the development of both firm-specific and industry-driven guidelines to assist firms in successfully navigating any potential conflicts arising from the equity capital raising process.

Please let us know if you have any questions, or if GFMA can serve as an additional resource to you in this important effort.

Sincerely,

Allison Parent
Executive Director
GFMA