Conflicts of interest and associated conduct risks during the equity capital raising process

Final Report

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The Board

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Foreword

On 21 February 2018, the Board of the International Organization of Securities Commissions (IOSCO) published a Consultation Report, *Conflicts of interest and associated conduct risks during the equity capital raising process*, with the aim of proposing guidance to help IOSCO members address the potential conflicts of interest and associated conduct risks in the equity capital raising process. Comments were requested by 4 April 2018.

Ten comment letters were received and considered by IOSCO as it prepared this Final Report. The feedback statement in Annex 3 describes and addresses the major comments. This Final Report sets out guidance to IOSCO members in the form of a package of measures (hereinafter 'Guidance') and reflects an expectation of high standards of conduct by market intermediaries in the equity capital raising process. Although the Guidance is non-binding, IOSCO encourages its members to consider the extent to which this guidance should be implemented in the context of their legal and regulatory framework, given the significance of the associated risks.

Contents

Chapter 1 - Executive Summary

Capital markets play a vital role in the global economy. Effective capital markets are dependent on high standards of conduct within intermediaries. However, in the capital raising process itself, intermediaries may encounter conflicts of interests which, if not appropriately managed, can compromise the integrity and efficiency of the process. This can make capital markets a less effective route for issuers to raise finance.

In August 2017, the IOSCO Board approved a mandate for Committee 3 on Regulation of Market Intermediaries (C3) to examine conflicts of interest and associated conduct risks in the capital raising process. The work to be undertaken under the mandate is divided into two stages. The first stage focuses on the equity capital raising process, which is the subject of this Final Report. The second phase will consider conflicts of interest and associated conduct risks during the debt capital raising process. The mandate was a recognition that in some member jurisdictions, notwithstanding existing IOSCO guidance and existing rules, poor conduct practices may still exist, potentially impairing the integrity and efficiency of capital markets.

Conflicts of interest and associated conduct risks identified

A survey of C3 members reflected that conflicts of interest and associated conduct risks in the equity capital raising process were present in some jurisdictions.[1] The following key risks were identified:

- Conflicts of interest and pressures on 'connected analysts'[2] during the formation of their views on an issuer in the pre-offering phase of a capital raising;
- The prominence of conflicted connected research[3] during investor education and price formation in equity initial public offerings (IPOs); and
- Conflicts of interest during the allocation of securities.

The following additional risks were also present in some C3 jurisdictions:

- Management of underwriting risk by firms managing the offering and associated conflicts of interest in the pricing of securities; and
- Conflicts associated with personal transactions by staff employed within firms managing the offering.

IOSCO Guidance

This Final Report sets out Guidance to IOSCO members to address the identified risks. The Guidance reflects an expectation of high standards of conduct by market intermediaries in the equity capital raising process. Although the Guidance in the box below is not binding, given

[1] Some members reported that they have existing controls for conflicts of interest and associated conduct risks within their legal and regulatory regime that mitigate the concerns raised in this Final Report. As a result, the guidance contained in this Final Report may not be appropriate for, or permitted under, the specific legal and regulatory framework of each member.

[2] Connected analysts are those employed within firms managing the equity securities offering to produce research.

[3] Connected research is research produced by connected analysts.

the significant potential risks and harms they are intended to address, IOSCO members are encouraged to consider them carefully in the context of their legal and regulatory framework. When considering the implementation of Measures 1-4, it may be relevant for IOSCO members to have regard to proportionality in the context of transactions for small and medium-sized enterprises (SMEs) seeking to raise finance through equity capital markets.[4]

IOSCO Guidance

Measure 1: In the context of pitches to secure a mandate to manage an equity securities offering, regulators should consider requiring firms to take reasonable steps to prevent their analysts from coming under pressure to take a favourable view on the offering from the issuer's representatives.

Measure 2: Regulators should consider requiring that once an underwriting or placing mandate has been awarded, firms take reasonable steps to prevent a connected analyst's views and research on the equity securities offering from being improperly influenced and to ensure that the analyst remains independent.

Measure 3: Regulators should consider requiring that once an underwriting or placing mandate has been awarded, firms have appropriate controls to manage potential conflicts of interest and associated conduct risks arising from connected analysts performing an internal advisory role within the firm while also producing research on an equity securities offering.

Measure 4: Regulators should encourage the timely provision of a range of information to investors in an equity securities offering, where distribution of such information is permitted under local law.

Measure 5: Regulators should consider requiring firms to maintain an allocation policy that sets out their approach for determining allocations in an equity securities offering and to provide the issuer with an opportunity to be involved in the process.

Measure 6: Regulators should consider requiring firms to maintain records of the allocation decisions made in an equity securities offering to demonstrate that any conflicts of interest are appropriately managed.

Measure 7: Regulators should consider requiring firms to manage any conflicts of interest that arise in relation to pricing an equity securities offering, keep the issuer informed of key decisions or actions which can influence the pricing outcome, and give the issuer an opportunity to be involved in decisions regarding the pricing of an issue during the pricing process.

4 In one response to the IOSCO Consultation Report on conflicts of interest and associated conduct risks during the equity capital raising process, it was suggested that it might be appropriate for regulators to differentiate their approach to markets and/or securities offerings by SMEs. The Consultation Report is available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD593.pdf.

Measure 8: In the context of an equity securities offering, regulators should consider requiring firms to take all reasonable steps designed to prevent any employees who have access to confidential information on the issuer or the offering from entering into or causing any personal transactions in situations where such transactions would involve misuse or improper disclosure of the information. Regulators should also consider requiring firms to prevent any employees from entering into personal transactions where such transactions would otherwise give rise to any conflicts of interest.

Chapter 2- Background and scope

Conflicts of interest and associated conduct risks stemming from the role of intermediaries during the capital raising process can threaten its integrity and efficiency, reduce investor confidence, and impair the effectiveness of the capital markets as a route to support the funding needs of a large number of key participants in the global economy.

Previous IOSCO work in this area

IOSCO had previously considered conflicts of interest for sell-side analysts and related issues. In 2003, IOSCO released a Statement of Principles on analyst conflicts of interest[5] in both primary and secondary markets. The Statement 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. It also recognised that the integrity and objectivity of analysts is of crucial importance. The Statement sets out some principles and measures for regulators to implement domestically, following an earlier report which identified the risk of potential conflicts of interest.

In 2007 IOSCO published a report on conflicts of interest in securities offerings.[6] The report set out general guidelines for regulators and market participants when considering how to address conflicts of interest that may occur when firms manage securities offerings.

New IOSCO mandate

Notwithstanding the earlier IOSCO work, the United Kingdom's Financial Conduct Authority (UK FCA)[7] and the Australian Securities and Investments Commission (ASIC)[8] found evidence that, in their jurisdictions, conflicts of interest and associated misconduct were still present at various stages in the capital raising process. Collectively, the key findings were:

- Conflicts of interest during the production of connected research[9] on equity IPOs;
- Prominence of conflicted connected research throughout 'investor education' and price formation during equity IPOs;
- Conflicts of interest during the allocation of securities.

In light of these findings, C3 identified the need for a new mandate to complement the previous IOSCO work on this topic. The new mandate would address the potential harm caused by

5 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

6 Market Intermediary Management of Conflicts that Arise in Securities Offerings – Final Report, November 2007: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD235.pdf

7 Investment and Corporate Banking Market Study: Final Report, October 2016: https://www.fca.org.uk/publication/market-studies/ms15-1-3-final-report.pdf

8 Sell-side Research and Corporate Advisory: Confidential Information and Conflicts, August 2016 http://download.asic.gov.au/media/4213635/rep486-published-9-august-2016.pdf

9 Connected research refers to research produced by analysts employed within firms managing securities offerings.

specific, existing conflicts of interest and associated misconduct which can arise during the capital raising process.

The mandate aligns with IOSCO's core overarching objectives since it is intended to:

- Enhance investor confidence in the integrity of the capital raising process; and
- Improve cooperation between C3 members and the exchange of information at a global level on their respective experiences in relation to the capital raising process in order to assist the development of markets and implement appropriate regulation.

Implementation of the new IOSCO mandate

A Working Group of C3 members was established to progress the work under the mandate. The Working Group comprised ASIC, the UK FCA, the Securities and Futures Commission of Hong Kong (HK SFC), Japan's Financial Services Agency (FSA), the Investment Industry Regulatory Organization of Canada (IIROC), and the United States Securities and Exchange Commission (SEC).

The Working Group conducted a survey of C3 members to gather detailed information on the equity capital raising process across different jurisdictions. The survey sought to identify the key stages involved in a typical equity capital raising, the regulatory and legal framework governing that process, and any conflicts of interest and associated conduct risks that might arise at various stages of the process. The survey covered both equity IPOs and secondary equity offerings.

Drawing on the information gathered through this survey, C3 identified aspects of market practice across different jurisdictions which could potentially result in conflicts of interest and associated conduct risks in the equity capital raising process, including in relation to the role of connected analysts in the process, the prominent role that connected research plays in investor education and price formation, and allocations of securities.

This has resulted in a package of IOSCO Guidance with measures designed to address the potential risks and harm identified.

Chapter 3- Description of the equity capital raising process

This chapter provides a general description of the equity capital raising process and is based on responses to the member survey. While the process as described is not uniform across all member jurisdictions, it serves as an example to highlight key stages of the equity capital raising process where conflicts of interest are likely to arise. Although the main focus is on equity IPOs, C3 identifies any material differences in a secondary offering context.

A short description of key participants in an equity capital raising process is set out in Annex 1. A general description of the regulatory and legal frameworks for an equity capital raising process in some jurisdictions is set out in Annex 2, but is briefly summarised in this chapter.

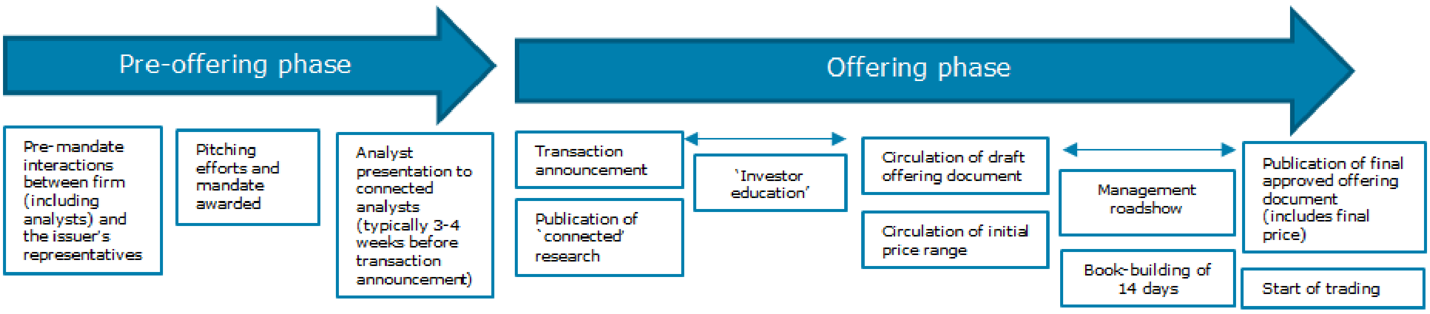
The equity capital raising process

In those C3 member jurisdictions that collect investor profile statistics, the majority of equity IPOs are targeted primarily at institutional investors, with limited direct retail participation. Specifically, in such jurisdictions, retail investors as a proportion of the overall investor base, range between 6% and 40% with the majority being around 20-25%.[10] In some jurisdictions, it is mandatory to reserve a fixed percentage of the offering for allotment to retail investors.

The likelihood of an equity IPO including a retail component typically depends on a number of factors such as the size and sector of the issuer, the preference of the issuer's management, the class structure of the equity shares being offered, and the retail investor ownership for peer issuers in the same sector.

In broad terms, the equity IPO process may be seen as comprising two stages, namely a 'pre-offering' phase and an 'offering' phase. These are described in turn below.

Figure 1: An equity IPO process[11]



[10] Based on the response to the survey from those securities regulators that collect this information.

[11] Note that this diagram is not representative of the IPO process in all IOSCO jurisdictions.

Pre-offering phase[12]

Using the example above (see Figure 1), prior to making a decision to pursue an IPO, the issuer may meet with prospective institutional investors to inform them on the company and gauge interest in any transaction, i.e. a 'market sounding'. These soundings can also take place at a later stage, once firms have been appointed to the syndicate to act in the IPO.

In some jurisdictions, the issuer's management may meet analysts of the firm before issuing a mandate. These meetings may be used by the issuer to gain an understanding of the analyst's views on the sector and its prospects. The issuer's shareholders and independent corporate finance advisers to the issuer may also be present. Analysts can also use these meetings to support an internally-facing 'vetting' and 'due diligence' advisory service to their firm. This may involve the analyst contributing their specialist knowledge of the industry sector, which may be taken into account by the firm in their decision on whether to pitch for a mandate to manage an offering.

Once the issuer has awarded the firm with a mandate to manage the offering, it is also common in some jurisdictions for the issuer's management to give an 'analyst presentation' to connected analysts. This presentation contains information on the issuer, some of which is to be included in the prospectus or offering document, and will help connected analysts develop views on the offering and prepare their research.

Also after the mandate has been awarded, an analyst may perform an internal advisory role to the firm to help it determine the extent to which any risks emerge as the transaction evolves.

Offering phase[13]

Some respondents to the survey of C3 members indicated that the offering phase begins with a public announcement of the transaction. In Hong Kong, Australia and the UK, for example, the announcement is accompanied by the release of connected research to selected institutional investors. By contrast, Pakistan and the US, for example, prohibit the publication of written connected research during the IPO process (for the US, unless an exemption under the JOBS Act is available). In addition, in the US, the Financial Industry Regulatory Authority's (FINRA) rules generally prohibit firms from publishing connected research on the issuer for a defined period following the commencement of certain offerings.[14]

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12 In this example, the pre-offering phase refers to the period prior to the formal offering of securities during which, for example, issuers and/or intermediaries may, depending on what is permitted in the member jurisdiction, conduct market soundings or initial soundings of prospective investors, award mandates, reach out to cornerstone investors, provide 'early-look' or 'pilot-fishing', make analyst presentations, and publicly announce a transaction. An 'analyst presentation' is a presentation from the issuer's management to connected analysts, containing information on the company based on material to be included in the prospectus or official offering document.

13 In this example, the offering phase refers to the period following the announcement of the offering, including, for instance, publication of the draft and/or final offering document /prospectus, management roadshows, book-building and pricing of the offering.

14 There are certain exemptions to these restrictions for emerging growth companies in the US. An emerging growth company is defined in the US as an issuer with total annual gross revenues of less than $1.07 billion during its most recently completed fiscal year.

Responses also suggested that in some jurisdictions there will be a period, typically lasting two weeks, during which connected analysts use their research to provide investors with their views on the issuer, in a process known as investor education.

Several respondents suggested that a price range is then circulated to certain institutional investors alongside a draft prospectus or offering document.

Some responses suggested that, once a prospectus or offering document (which may be in draft or final form) is released, the issuer's management and firms managing the offering will stage a management roadshow, typically lasting two weeks. During this roadshow book-building will usually take place, after which a final offer price will be determined and shares will be allocated to investors.

Secondary offerings

Secondary offerings can include rights issues, open offers, placings, and block trades. Shares issued in a rights issue are typically made available to existing shareholders, though this is not necessarily the case in open offers, placings and block trades. Some C3 members pointed out that this pro-rata allocation avoids dilution in the value of shareholdings.

Research on a secondary offering is likely to play a different role to connected research on an IPO. The secondary offering research would be based on publicly available information on the company and would be more widely distributed, similar to the role of research in a secondary market context. Another difference in the process between IPOs and secondary offerings is that roadshows are conducted less often.

An additional key difference is pricing. In the case of an IPO, significant emphasis is placed on price discovery during the investor education phase and book-build. However, during a secondary offering, the issuer already has shares admitted to trading that are priced on the secondary market, which form the basis of pricing the secondary offering.

The length and the general sequencing of key events during the offering phase in IPOs and secondary offerings may also be different across jurisdictions. Some responses pointed out that the process for a block trade is much simpler than an IPO and there would be no investor education or management roadshows involving analysts in the former. Some secondary offerings take place in the form of an accelerated book-build, with the whole process taking place very quickly.

The UK FCA indicated that, subject to exemptions under the EU prospectus regime (see 'legal and regulatory frameworks governing the equity capital raising process'), rights issues in the UK would typically involve a prospectus but a placing may not and that, where a prospectus is produced, it would typically be available earlier in the process than it currently is during an IPO. IIROC noted that, in Canada, secondary offerings typically involve a short-form prospectus, which requires less due diligence by firms managing the offering, largely because the issuer is subject to continuous disclosure obligations in relation to its listed securities.

Legal and regulatory frameworks governing the equity capital raising process

There are a variety of regulatory and legal frameworks across different jurisdictions which govern the capital raising process. Some jurisdictions have a general overarching regulatory regime which addresses conflicts of interest. Firms in those jurisdictions rely on that regime for guidance on how conflicts of interest arising in the context of a securities offering should be addressed.

Some C3 members have requirements in relation to the production and distribution of research, intended to preserve the independence of analysts, including during their role in a securities offering. For example, in some jurisdictions, analysts are prohibited from participating in pitches for new investment banking business.

Most C3 members have specific rules governing the provision of information during a securities offering. These include rules on the timing and content of information included in the prospectus, which issuers are required to publish ahead of their shares being admitted to trading. They also include requirements on firms to prevent the flow of confidential and price sensitive information between investment banking staff providing services to an issuer client, and other areas of the firm.

While some jurisdictions have more general rules in place to promote investor confidence and to protect against certain misconduct in the way securities are allocated to investors, other jurisdictions have targeted regulatory requirements for the allocations process. These vary greatly across jurisdictions, but range from the requirement for firms to maintain an allocation policy and for allocations to be fair, equitable and transparent, to measures intended to ensure retail participation in IPOs. In the European Union, the Markets in Financial Instruments Directive II (MiFID II) has introduced targeted principles-based provisions governing underwriting and placing services, including conflicts management and disclosure of information requirements in relation to pricing and allocations.

Further detail on the legal and regulatory frameworks across C3 members are set out in Annex 2.

Chapter 4- Potential risks and harms identified in the equity capital raising process

The IOSCO survey suggests that the existing equity capital raising processes across different jurisdictions have considerable strengths. However, the survey also revealed that certain market practices continue to create potential conflicts of interest and associated conduct risks at each stage of the equity capital raising process, notwithstanding existing legal and regulatory frameworks and efforts made by some firms to mitigate these risks. This chapter explains how these risks can translate into harm for users of capital markets, and IOSCO's consideration of the need for the Guidance.

The key risks identified are in relation to the following:

- Conflicts of interest and pressures on connected analysts during the formation of their views on an issuer in the pre-offering phase of a capital raising;
- Timing, sequencing and level of information in the offering phase of an equity IPO capital raising, and the prominence of conflicted connected research during investor education and price discovery; and
- Conflicts of interest during the allocation of securities during an offering.

The following additional risks have also been identified, though these are not necessarily common across a wide range of C3 members:

- Management of underwriting risk by firms managing a securities offering and associated conflicts of interest in the pricing of securities; and
- Conflicts of interest associated with personal transactions by staff employed within firms.

Conflicts of interest during the formation of a connected analyst's views on an issuer in the pre-offering phase of an equity capital raising

Connected analysts can offer insights into markets, issuers and securities and, therefore, their views may be sought by issuers in an equity capital raising. It is therefore possible that, when connected analysts are developing their views on an issuer during the pre-offering phase of the process, they could be influenced and be at risk of bias. This can stem from a connected analyst's interactions with the issuer's representatives when underwriting or placing mandates are being considered, during the review processes for connected research, and as part of the wider role of connected analysts in the process.

Pressure on connected analysts to have a favourable view on an IPO and secondary offering

In jurisdictions where no prohibition exists, it is generally established practice for an analyst to participate in its firm's pitches to win a mandate to manage a securities offering. Even if this practice is prohibited, analysts have also been observed to interact with the issuer's management, independent corporate finance advisers (outside of the firm managing the offering), and shareholders alongside the formal pitching efforts by corporate advisory or investment banking staff within the firm. These are often referred to as 'vetting' meetings.

Some C3 members have found that the issuer's management and/or independent corporate finance advisers (outside of the firm managing the offering) may place pressure on analysts to take a favourable view on the issuer to help their firm win a mandate to manage the offering. The powerful commercial incentives within the investment bank itself can also further pressure analysts to indicate their support for the issuer. In the UK, once mandates have been awarded, analysts can continue to face pressure to be supportive of the issuer if their bank is to secure its desired position in the syndicate.

The UK FCA has evidence that connected analysts can be pressured by the issuer's management, independent corporate finance advisers or by investment banking staff within firms themselves, to publish a single common view and common forecasts and that this may take place during the factual accuracy checks on the research. Another jurisdiction had seen examples of corporate advisory and investment banking staff within the firm exerting pressure on analysts with respect to valuation information and forecasts, including:

- Suggesting that a peer group with higher valuation multiples be included;
- Re-writing previously published research so it was more favourable to a firm's commercial interests; and
- Re-writing research to increase revenue forecasts.

In principle, the conflicts of interest and associated conduct risks which may arise during the formation of a connected analyst's views on an IPO can also exist in a secondary offering context. For example, although in a secondary offering context it may be rare for analysts within firms hoping to manage an offering to interact with the issuer's representatives around the time that underwriting or placing mandates are being considered, it is still possible that, when producing research on the company (either as part of their on-going coverage of the company in the secondary market, or specifically in relation to the secondary offering itself), connected analysts could be put under pressure to produce a favourable message by the issuer's representatives or investment banking colleagues within the firm itself. This may be the case even if the connected analyst is unaware that equity capital market (ECM) colleagues are pitching for the underwriting or placing mandate.

Wider role of connected analysts in the equity IPO process

In some jurisdictions, in addition to preparing research for the purposes of investor education, connected analysts can have two further roles. The first is to support the firm's 'vetting' of the issuer and use information gathered as part of this exercise to provide an internal facing 'due diligence' advisory service to the overall firm, prior to underwriting or placing mandates being awarded.

As part of this role, connected analysts may advise on the market's likely interest in the issuer, assessing the issuer's operations, board and management, advising on the likely listed peer group and optimum timing for the transaction, and commenting on risks to the issuer or the sector in which it operates. As described above, the vetting meetings with the issuer's representatives can result in the connected analyst coming under pressure to have a favourable view on the company.

The second is an internal facing on-going due diligence advisory service to the overall firm, which is provided after an underwriting or placing mandate has been awarded. This role can create a conflict of interest because it means that the connected analyst becomes closely linked to the corporate advisory or investment banking function of the firm.

Timing, sequencing and level of information in the offering phase of the equity IPO process

As suggested in Chapter 3, market practices and legal and regulatory frameworks for the offering phase of an equity IPO differ across jurisdictions. In some jurisdictions connected analysts may share their written or verbal analysis on the issuer with select institutional investors during the investor education phase. In those jurisdictions where written research may be produced, the research itself may include the analyst's forecasts of the company's future prospects. Further, in some jurisdictions, term sheets and roadshow materials play a prominent role during investor education for institutional investors and in others, information other than connected research such as the prospectus, website announcements and press articles are available to all investors during this period and connected analysts do not appear to play a significant role.

In a number of jurisdictions, a draft prospectus or offering document containing an initial price range is only available to investors at the end of investor education. The final prospectus containing a final price is released at the conclusion of the offering phase once the book-build is complete.

As such, in a number of jurisdictions, the views of the connected analyst, which are at risk of bias, play a prominent role in investor education and initial price discovery during an equity IPO. This is because the prospectus or offering document is currently made available relatively late in the process. The late availability of a publicly available prospectus, together with a lack of access to the issuer's management, means that unconnected analysts[15] are unable to access the necessary information to produce unconnected IPO research.

Unconnected research may also be available in situations where the private company is already covered by an independent research provider or where such provider is hired by the issuer to assist in the due diligence and price discovery process (e.g., in Canada). Both instances are reported to be uncommon. This is not the situation in certain other jurisdictions, such as France, where unconnected analysts have access to all information provided to connected analysts and also to the issuer's management, once the offering document is made public.

The concerns about connected analysts being the main source of information driving price discovery are less relevant in a secondary offering context. This is largely because the issuer's shares are already priced on the secondary market and, therefore, price discovery does not happen in the way that it does in an IPO. Moreover, the issuer should make periodic disclosures on key financial information on the company as part of its regulatory filings, which means that there is more official, factual information on the issuer available to investors to perform their own due diligence. Finally, given that all research (including that produced by connected analysts) is likely to be based on publicly available information on the company, there would

[15] "Unconnected analysts" are those employed within firms who are not managing the offering or by independent research providers. "Unconnected research" means research that is produced and/ or disseminated by those analysts.

be less of a barrier preventing unconnected analysts from producing research on the secondary offering.

Conflicts of interest during the allocation of securities

Firms across most jurisdictions generally consider a range of factors when determining the allocation of securities in an IPO. These include: the type, size and ranking[16] of the investor; the timing of bids; the degree of oversubscription; the investor's engagement with the firm and whether the investor has assisted in the price discovery process; the size of interest the investor has indicated and whether the firm considers that realistic; the issuer's preference; and applicable rules or codes of conduct.

Whilst firms in most jurisdictions typically maintain an overarching allocation policy, in practice they use this policy as guidelines and exercise significant discretion in allocating securities on a transaction-by-transaction basis. For example, in some jurisdictions, allocations can be made towards:

(i) A firm's most valued clients;

(ii) Investors who have contributed to the price discovery process;

(iii) Other parts of the firm's business (for example, their own asset management division) or their employees;

(iv) Clients or senior management of the issuer; and

(v) Investors who may generate a favourable after market for the shares.

Some of these types of allocation practices may indicate that allocation decisions can be influenced by conflicts of interest, and that those decisions might advance the firm's own interests (or those of its other clients) in a way which could potentially be inconsistent with the interests of the firm's issuer client at the relevant time.

Managing underwriting risk by firms managing securities offerings and associated conflicts of interest in the pricing of an equity capital raising

Where a firm is providing underwriting services on a firm commitment basis, it may have an interest in ensuring that all securities are subscribed to by investors. If these potential conflicts are not adequately managed, an equity securities offering may not be priced fairly and ultimately may not be consistent with the interests of the issuer client.

For example, during an equity IPO, a bank may seek to price the offering below its fair market value (i.e. under-price the offering) to increase the likelihood of a full take-up for the offering and to avoid having to purchase shares that have not been subscribed to by investors. This would increase the cost of capital for the issuer. Nevertheless, the firm managing the securities offering may engage with the issuer to discuss the trade-offs involved in the pricing of such an offering and it is then ultimately the issuer that decides whether to set a lower price in order to achieve specific allocation preferences.

[16] Recent work by the UK FCA has found that revenues generated to the bank by investors through other business lines are also a factor determining allocation decisions. The UK FCA found that investors in the top quartile of the book-runners' clients by revenue receive allocations, relative to the amount they bid, approximately 60% higher than those received by investors who are not clients of the book-runner.

A bank may also engage in a variety of hedging strategies to mitigate its underwriting risk. Hedging would seek to ensure that the costs of any required purchase of the securities would be offset by gains in another asset or instrument. However, a bank's hedging strategies may not align with the interests of the issuer client. For example, in a secondary offering context, a bank may hedge its underwriting risk by short-selling the existing shares that the issuer has admitted to trading, which could negatively impact the price of those existing shares and, therefore, the price of the secondary offering.

Personal transactions by staff employed within firms managing securities offerings

In the context of a securities offering, where employees of a firm undertake personal transactions in the securities of that issuer, they may have an interest in influencing the capital raising process in a way that advances their own interests, but to the detriment of the issuer's interests and also those of other investors. This may be exacerbated where the employees have access to confidential information on the issuer or the offering, since there is scope for employees to misuse that information for personal gain.

This potential conflict could occur in an IPO and secondary offering context. For example, during an IPO with a retail component, analysts and investment banking staff within the firm may seek to participate as investors in the transaction. However, they may misuse their professional role on the transaction to advance their personal interests as future shareholders of the issuer's securities.

Moreover, where employees of a firm managing a secondary offering for an issuer have a holding in those securities, they may wish to engage in trading activities to influence the price of the issuer's existing securities in a way which is potentially contrary to the firm's issuer client's interests. This could also, in turn, potentially influence the price of the secondary offering in a way that is inconsistent with the issuer's interests. In some jurisdictions, there are high levels of personal transactions amongst employees such as investment banking staff and connected analysts in an issuer's securities, especially within mid-sized firms.

Potential harm in the equity capital raising process

As set out above, conflicts of interest and associated conduct risk can arise at each stage of the equity capital raising process. This can translate into the following broad types of harm to issuers and investors:

- **Threats to the efficiency and integrity of price formation:** The prominence of connected analysts - whose views on the issuer can be biased or perceived as biased - during investor education and initial price discovery, can hamper the efficiency and integrity of price formation during a securities offering. This is particularly the case during equity IPOs where connected analysts are, in some jurisdictions, a main provider of information to investors, but can also be a problem during secondary offerings where a wider range of information may be available. This is exacerbated to the extent that pricing decisions and outcomes are seen to reflect the interest of the bank in a way that conflicts with the interests of the issuer. A reduction in the efficiency and integrity of price formation can impair the effectiveness of capital markets as a route for issuers to raise finance.

- **Reduced confidence in the integrity of allocations:** To the extent that allocations are seen to reflect the interests of the bank and it is not clear whether they are aligned with the issuer's interests, issuers may lose confidence in the process. Investors may also perceive allocations as lacking transparency and being conflicted, which reduces their confidence in the process and may reinforce the above harm.

Should these risks and harms be addressed by existing IOSCO Guidance?

It is important to consider previous IOSCO work in this area and the extent to which the potential risks and harms identified above are inconsistent with any existing Guidance.

As noted in Chapter 1 of this Final Report, in 2003 IOSCO published a report setting out principles for addressing sell-side analyst conflicts of interest. These principles applied to an analyst's role in both primary and secondary markets and have broader application than the topic being examined in this Report. However, there are two broad principles of particular relevance.

The first principle states that mechanisms should exist so that analysts' research and recommendations are not prejudiced by the business relationships of the firms that employ them. This is intended to address the risk that bias is imparted to an analyst's research. The principle includes a range of non-binding guidance for IOSCO members to consider implementing domestically, including requiring firms to establish robust information barriers between analysts and other areas of the firm where a conflict of interest may exist, and prohibiting analysts from participating in investment banking pitches and roadshows. However, despite this existing guidance, the member survey reflected that, in some jurisdictions, there continues to be a risk that analysts can be placed under pressure to produce favourable research.

The second existing principle states that mechanisms should exist so that analysts' trading activities or financial interests do not prejudice their research and recommendations. However, as noted above, in some jurisdictions there can be high levels of personal transactions around the time that a securities offering takes place, including by analysts.

IOSCO's 2007 report considered the types of conflicts of interest which can arise during securities offerings, including pricing and allocations, and provided general guidelines to be taken into account by market participants and regulators. The existence of the key risks identified from the IOSCO member survey suggested that additional guidance that specifically addressed these risks would be helpful to members in their regulation of market participants' involvement in the equity capital raising process.

What form should the new additional IOSCO Guidance take?

Responses to the survey of C3 members indicated that while there are some clear common characteristics between capital raising processes across different jurisdictions, there are variations in both market practice and the legal and regulatory frameworks governing the process. This means that the severity of the conflicts of interest and associated conduct risks, and the harm that they can generate, differ across jurisdictions.

The IOSCO Guidance would provide IOSCO members with flexibility over whether and how to implement the Guidance domestically, and ensure that any Guidance that they may adopt are appropriate for their legal and regulatory framework and the specific risks arising in their jurisdiction.

Chapter 5- IOSCO Guidance

This chapter contains Guidance with measures that IOSCO encourages its members to consider in their regulation of market intermediaries in equity securities offerings.

The Guidance reflects an expectation of high standards of conduct across market intermediaries in the equity capital raising process. This includes the:

- production and distribution of a connected analyst's views on the issuer;
- pricing of an offering; and
- allocations of securities.

The eight measures, which are grouped by the relevant stage in the equity capital raising process, address a specific conflict of interest or associated conduct risk identified in Chapter 4.

Given the significant potential risks and harms these measures are intended to address, IOSCO members are encouraged to consider the extent to which these measures should be implemented in the context of their legal and regulatory framework. When considering implementation of Measures 1-4, it may be relevant for IOSCO members to have regard to proportionality in the context of transactions for SMEs seeking to raise finance through equity capital markets.

Members should also carefully consider the Guidance in the context of existing IOSCO Principles and associated implementing measures of relevance to the capital raising process (see Chapters 2 and 4).

Guidance to address conflicts of interest and pressures on analysts during the formation of their views on an issuer during the pre-offering phase of a capital raising

One of the key priorities for firms during the pre-offering phase[17] should be to preserve the analyst's independence and the integrity of their research. Firms should appropriately manage any potential conflicts of interest arising during the formation of the analyst's views on the offering and the production of research. Where a conflict cannot be appropriately managed, it should be avoided altogether. This will help to ensure that an analyst's views and research are not compromised or at risk of bias. This will also reduce the likelihood that investors are provided with an inaccurate picture of the issuer's prospects.

Given the conflicts of interest which can arise during the formation of a connected analyst's views on an offering, firms should take appropriate steps to support the provision of a range of information to investors. This would help to mitigate any conflict of interest and support balanced price discovery.

[17] See Figure 1, page 10. In the earlier stages of the pre-offering phase, analysts will be "unconnected". Upon the firm being appointed to manage the offering, the analyst becomes a "connected analyst". Analysts, whether connected or unconnected, are at risk of having their independence jeopardised and the integrity of their views and research compromised or biased.

Measure 1*: *In the context of pitches to secure a mandate to manage an equity securities offering, regulators should consider requiring firms to take reasonable steps to prevent their analysts from coming under pressure to take a favourable view on the offering from the issuer's representatives.

IOSCO members should consider implementing this Guidance which, in the context of a firm's pitches for underwriting or placing mandates during the 'pre-offering phase' (see Figure 1 on page 10 in Chapter 3), would prevent analysts within that firm from being in a position where they could come under pressure to develop a favourable view on the issuer.

The purpose of the Guidance would be to:

(i) prohibit explicit or implicit promises of favourable research coverage; and

(ii) prevent analysts from participating in pitches alongside corporate advisory or investment banking staff within the firm.

To mitigate the risk that an analyst comes under pressure during interactions with the issuer's representatives in the period before the corporate advisory or investment banking staff within the firm decides to pitch for a mandate and up to the awarding of the mandate, regulators should consider requiring firms to address the following key issues:

(i) whether it is appropriate to allow analysts to answer questions that directly relate to the proposed capital raising transaction, from the issuer or its representatives, or whether questions should only be permitted to be asked by the analyst; and

(ii) in order to assist the analyst in forming a view on the issuer, but recognising the risk of improper influence on the analyst, what is the appropriate subject matter for questions; and

(iii) at what point should interactions cease and, if permitted under local law, recommence.

Paragraphs (i)-(iii) immediately above recognise the powerful commercial incentives for the awarding of mandates and the circumstances in which firms must be acutely aware of the need to manage their conflicts of interest during such interactions. In fact, since it may be difficult for firms to manage such conflicts, where permitted under local law, regulators may wish to consider introducing measures which restrict or prevent such interactions. This measure would have the benefit of reducing or avoiding the risk of soft pressures being placed on analysts, whilst also providing firms with comfort that there is a level playing field across industry.

This Guidance is intended to address the risk that analysts may be put under pressure to have a favourable view of the issuer to secure their firm a position on the syndicate. The Guidance, therefore, helps to address a key underlying conflict of interest which can arise during the development of a connected analyst's view on an offering. It is aimed at ensuring the independence of the analyst and the integrity of their research.

Measure 2*: *Regulators should consider requiring that once an underwriting or placing mandate has been awarded, firms take reasonable steps to prevent a connected analyst's views and research on the equity securities offering from being improperly influenced and to ensure that the analyst remains independent.

This Guidance is intended to prevent any improper influence on a connected analyst when forming their views on the issuer and the equity securities offering, once their firm has been awarded a mandate to manage the offering, but before the beginning of the offering phase and release of connected research (see Figure 1 on page 10 in Chapter 3).

Firms managing an offering should have controls in place which prevent corporate advisory or investment banking staff within the firm from acting in a way which would improperly influence a connected analyst, compromise the objectivity of a connected analyst, and undermine the integrity of connected research and the capital raising process more broadly.

Regulators should consider preventing regulated independent corporate finance advisers to the issuer[18] from conducting themselves in a way which could compromise the objectivity of an analyst, including improperly influencing or pressuring the analyst.

One example of improperly influencing the connected analyst's research would be to amend the connected research.

Measure 3: Regulators should consider requiring that once an underwriting or placing mandate has been awarded, firms have appropriate controls to manage potential conflicts of interest and associated conduct risks arising from connected analysts performing an internal advisory role within the firm while also producing research on an equity securities offering.

IOSCO members should consider introducing specific requirements for firms to manage conflicts arising from an analyst performing an internal advisory role within the firm once an underwriting or placing mandate has been awarded (see Figure 1 on page 10 in Chapter 3). As noted in Chapter 4, this wider role played by connected analysts can create a conflict of interest because it means that the analyst becomes closely linked to the corporate advisory or investment banking function of the firm.

Regulators should consider requiring firms to consider the nature of the activities to be undertaken by the analyst in performing such a role. Analysts may, for example, provide updates on the general outlook for and investor views on the sector and their views on investor demand. Once their research is released, connected analysts may also support broader investor education. While analysts may undertake these types of activities, regulators should consider requiring firms to have in place appropriate controls that prevent an analyst from performing an internal advisory role in relation to the investment banking function of the firm.

The Guidance is particularly relevant in jurisdictions where the views of connected analysts play a prominent role during investor education and initial price discovery. This is because, in such cases, the underlying conflict of interest is exacerbated by the fact that the analyst's views are a main source of information available to investors during this crucial stage in the capital raising process.

Measure 4: Regulators should encourage the timely provision of a range of information to investors in an equity securities offering, where distribution of such information is permitted under local law.

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18 Outside of the firm managing the offering.

To mitigate the conflicts of interest which can arise during the production and distribution of a connected analyst's views on an equity securities offering (see Figure 1 on page 10 in Chapter 3), regulators should encourage firms to support the provision of a range of information to prospective investors early in the equity capital raising process, where permitted.

In the context of an equity IPO, this could include, for example, referring to the official offering document as the primary source of information on the issuer during the offering. Firms should be encouraged to consider whether it would be appropriate for the firm to release a connected analyst's research on the issuer only once an official offering document has been published.

Regulators may also wish to encourage firms to help facilitate the emergence of more unconnected research in the IPO process, should an interest be expressed by unconnected analysts, and provided the required consents are in place. For example, firms could facilitate access for unconnected analysts to the necessary information required to prepare unconnected research, such as an offering document.

This Guidance is intended to help ensure that a range of high quality information is available to investors during investor education. Such information would support the development of a balanced price range to set the parameters for the price formation during a book-build. This would help to mitigate any bias which has been imparted to the views of connected analysts, which can otherwise be a dominant driver of price discovery.

Guidance to address conflicts of interest during the allocation of securities

A robust and transparent allocation process is fundamental to the integrity of equity capital markets, helping to ensure confidence amongst both investors and issuers.

. When providing services to an issuer client during the management of a securities offering, a firm may be critical in assisting its issuer client to successfully raise funds at optimal prices and provide access to a diverse investor base that the issuer may not otherwise be able to access. At the same time, the firm may be processing and accepting indications of interest from its investor clients, to whom it also has responsibilities.

When a firm places the shares of its issuer client it should appropriately manage any conflicts of interest between itself and the issuer client or between any two of its investor clients. The process for allocations should also be transparent, allowing the firm to demonstrate that it has effectively managed any conflicts of interest.

Where any conflicts of interest do arise, it is for the firm to demonstrate that it has appropriately managed the conflict. For instance, where allocations are skewed towards the firm's own asset management arm, or towards certain investor clients of the firm over others, any potential conflicts of interest in allocations should not compromise the issuer's interests or unfairly discriminate between its investor clients.

Measure 5: Regulators should consider requiring firms to maintain an allocation policy that sets out their approach for determining allocations in an equity securities offering and to provide the issuer with an opportunity to be involved in the process.

IOSCO members should consider requiring that, once accepting a mandate to manage an offering on behalf of the issuer client, the firm has in place an allocation policy that sets out the overarching methodology it adopts for determining an allocation of equity securities. As part of this, regulators should consider requiring firms to provide the issuer with an opportunity to be involved in the allocation process depending on the type of offering being conducted.

This Guidance encourages transparency in the process before the provision of services, ensuring the issuer client can make an informed decision about the firm with which it intends to proceed. An allocation policy that the firm is required to maintain also provides a reference point against which the issuer can assess the quality of service provided by the firm

Although not all issuers will necessarily wish to play an active role in this process, providing them with an opportunity to be involved promotes transparency and can help to mitigate potential conflicts of interest in the process. By engaging the issuer at certain key junctures in the process, the firm ensures that it can take the issuer's views into account.

Measure 6: Regulators should consider requiring firms to maintain records of the allocation decisions made in an equity securities offering to demonstrate that any conflicts of interest are appropriately managed.

Regulators should consider requiring firms to record details of allocation decisions made.

The records the firm maintains should include:

- The firm's overarching allocation policy;
- Where appropriate, the firm's initial discussion with the issuer client and the specific approach adopted for allocating its shares;
- The subscription orders received from potential investors;
- Any relevant discussions, instructions or preferences provided by the issuer, other members of the syndicate or the firm itself, on the allocation process; and
- Details of the final allocation made to each investor.

Through these records, firms would typically be able to demonstrate how any conflicts of interests have been appropriately managed to ensure that the issuer's interests have not been compromised.

This Guidance is intended to significantly increase the transparency in the allocation process and support regulators in their supervisory activities in this area. The records may also help the firm in monitoring its existing arrangements for determining allocations and in reviewing allocations made.

Guidance to address conflicts of interest in the pricing of equity securities offerings

Conflicts of interest which may arise between the firm or its other clients and the issuer client must be appropriately managed. This includes any conflicts in relation to possible under-pricing or over-pricing of an offering.

Firms should consider involving the issuer client in the pricing process and make it aware of any decisions and actions which influence the pricing outcome.

Measure 7: Regulators should consider requiring firms to manage any conflicts of interest that arise in relation to pricing an equity securities offering, keep the issuer informed of key decisions or actions which can influence the pricing outcome, and give the issuer an opportunity to be involved in decisions regarding the pricing of an issue during the pricing process.

Regulators should consider introducing Guidance which explicitly requires the firm to manage any conflicts of interest in relation to the pricing of an equity securities offering, ensuring that pricing does not reflect its own interests or those of their investor clients in a way which compromises the issuer's interests. Firms should consider providing the issuer with an opportunity to engage in the decisions and actions that can influence the pricing of the securities offering, which may include providing the issuer with key information relevant to pricing as the transaction evolves. In addition, regulators should consider if firms should be required to provide the issuer an opportunity to be involved in pricing decisions.

In a secondary offering context, where the price of an issuer's security is already observable on the secondary market and where there is less discretion on the price of the new offering, regulators should consider requiring the firm to take steps to ensure that the issuer's interests in relation to pricing are not compromised. This includes, for example, ensuring that the bank manages any conflicts of interest that could arise through the hedging strategies and risk management transactions that the firm carries out to mitigate its own underwriting risk. Regulators should consider requiring firms to maintain a record related to how pricing outcomes are developed, how the issuer is involved, and how any conflicts of interest are managed to ensure that the issuer's interests have not been compromised. This would assist regulators in their supervisory work in this area.

This Guidance is intended to address potential detriment which can arise from the conflicts of interest stemming from firms' efforts to mitigate underwriting risk. It should help to ensure that the issuer's interests with respect to pricing are not compromised, and that pricing is as efficient as it can be. This would reinforce the benefits intended to be brought about by Measures 1-4, which should also enhance the integrity and efficiency of price formation by ensuring a range of high quality information is available to investors.

Guidance to address conflicts of interest and conduct risks stemming from personal transactions by staff employed within firms managing a securities offering

Ensuring a high standard of conduct among firms' employees is crucial to market participants maintaining confidence in capital markets. In a securities offering context, an important aspect of this is that firms managing a securities offering effectively manage or avoid any conflicts of interest between themselves and their clients. This includes any conflicts of interest arising from the conduct of firms' employees (e.g. investment banking staff and connected analysts), including during personal transactions by those employees.

There is a heightened risk of conflicts where employees involved in a securities offering have access to confidential information on the issuer or the offering and undertake personal transactions in the securities of the issuer. Firms should be particularly careful in these situations, and ensure that employees undertaking personal transactions do not misuse their position or any confidential information they have acquired through their position to the detriment of the issuer or of investors.

Measure 8: In the context of an equity securities offering, regulators should consider requiring firms to take all reasonable steps designed to prevent any employees who have access to confidential information on the issuer or the offering from entering into or causing any personal transactions in situations where such transactions would involve misuse or improper disclosure of the information. Regulators should also consider requiring firms to prevent any employees from entering into personal transactions where such transactions would otherwise give rise to any conflicts of interest.

This Guidance is intended to address any conflicts of interests arising from personal transactions by employees of firms managing a securities offering, which can have a detrimental impact on the issuer client or investor clients in a capital raising context. As described in Chapter 3, this can be of particular relevance to connected analysts and investment banking staff involved in an IPO and secondary offering.

Regulators should consider requiring firms to have controls in place which alert them to an employee's possession of confidential information concerning the equity capital raising which may give rise to conflicts of interest with their issuer client and investors. These controls should address whether, in these circumstances, it is appropriate for such employees to enter into a personal transaction in the offering being managed by the firm.

Chapter 6- Conclusion and next steps

The Guidance set out above is intended to address some significant potential conflicts of interest and associated conduct which can arise at various stages of the equity capital raising process. If implemented, the Guidance should bring about material improvements to the process. This includes enhancing the:

- range and quality of timely information that is made available to investors during the process;
- transparency of allocations; and, therefore the
- efficiency and integrity of overall process, boosting investor confidence and making capital markets a more effective route for issuers to raise finance.

This would help to ensure that capital markets continue to have a positive impact on the global economy.

IOSCO will now turn to the second stage of the project, which is to examine whether or not the issues and potential harms identified in this report are common to the debt capital raising process across different jurisdictions, and whether any regulatory response is necessary.

ANNEX 1 - Participants in the equity capital raising process

Across a number of jurisdictions, the main participants typically involved in the equity capital raising process are as follows:

- **Syndicate banks/stockbrokers:** These firms provide underwriting or placing services to the issuer and advise on key elements of the transaction (e.g. pricing and timing of the offering) and place the securities with investors. This is a separate advisory service to the one provided by independent (third party) corporate finance advisers.
- **Connected analysts:** These are research analysts who are employed by the syndicate banks or stockbroking firm. Connected analysts are typically tasked with producing research to provide investors with their views on the issuer, and in some jurisdictions, to support investor education and initial price discovery. These analysts also play an internal facing advisory role for the investment bank or firm, focusing on assessing whether it should participate in the IPO and also conduct on-going due diligence as the transaction evolves.
- **Legal advisers:** These advisers provide legal advice to the issuer on the transaction, typically assisting in drafting contracts with syndicate banks; drafting and verifying the information to be included in the prospectus or offering document; and making disclosures more generally. Syndicate banks and stockbroker firms will also have lawyers to act on their behalf, often to review the offering document or prospectus and conduct due diligence.
- **Accountancy and audit firms:** These firms express the audit opinion on the issuer's financial statements to be submitted to the competent authority.

In some jurisdictions, the following participants can also be involved:

- **Independent corporate finance advisers:** The primary role of these firms is to act as the intermediary between the issuer and firms managing the securities offering. They may be involved in the selection of the bank(s) and have oversight of them during the IPO process. Corporate finance advisers may also advise on different financing options; deal structure and timing; pricing and allocations. This is a separate advisory service to the one provided by firms managing the offering.
- **Financial due diligence consultant:** This will be an independent adviser that issues an independent financial due diligence report to the issuer and/or underwriter.
- **Ballotter:** These will conduct ballots for retail offers when oversubscribed.
- **Other advisers:** The issuer may engage a wider range of advisers, including for industrial relations, communications and strategy.
- **Listing/payment/issuing (or settlement, transfer and paying) agent:** This firm ensures that the securities are admitted on the exchange's book-entry system on time and acts as the listing agent. This is generally one of the underwriters.

ANNEX 2 - Legal and regulatory frameworks governing the capital raising process and controls and policies in place within firms to manage conflicts of interest

There are a variety of regulatory and legal frameworks governing various aspects of the capital raising process across different jurisdictions. We have broken these down by theme, reflecting the conflicts of interest and associated conduct risks identified in the UK FCA and ASIC's recent work, as referenced in Chapter 1 of this Final Report. This includes a description of the internal policies that firms typically have in place to manage conflicts of interest and meet certain regulatory or legal requirements.

Production and distribution of connected research

All jurisdictions have a regulatory framework that is intended to preserve the independence of analysts during the production and distribution of research. The most notable difference across these jurisdictions is that, while some have specific legal requirements or rules that expressly govern the production and distribution of investment research (including connected research used in securities offerings), others currently rely on broader legal and regulatory requirements (including statutory obligations) regarding conflicts of interest, the impartiality of investment advice and a disclosure regime.

In a number of jurisdictions, analysts are prohibited from attending pitches or otherwise participating in efforts to solicit investment banking business. There is an exemption in the US under the Jump Start Our Business (JOBS) Act for attending pitch meetings with an 'Emerging Growth Company', although analysts still are prohibited from soliciting investment banking business during such meetings. There is also an exemption in the European Union for producers of research that is not subject to such prescriptive conflicts of interest provisions provided that it is labelled as a marketing communication, which is most commonly produced on smaller IPOs.

A number of jurisdictions are in the process of enhancing their regulatory framework for the production of connected research. ASIC has recently introduced additional guidance on the management of conflicts of interest which can arise during the production of connected research, and on the structure and funding of the research function. The UK FCA has also recently made similar enhancements to its existing investment research regime, intended to clarify its expectations under its current guidance on analysts' involvement in pitches. In addition, the European Union's Markets in Financial Instruments Directive introduced a requirement in 2007 for firms to maintain physical separation between analysts and areas of the firm whose interests may conflict with those of the analyst. In the United States, the Financial Industry Regulatory Authority recently adopted extensive rules that foster objectivity and transparency in research reports, to provide investors with reliable information upon which to make investment decisions.

To manage and avoid conflicts of interest during the development of a connected analyst's views on an offering, firms have typically documented compliance procedures, physical and structural segregation arrangements and information barriers between analysts and other areas of the firm, e.g. corporate advisory or investment banking staff. In some cases, firms impose physical barriers and conduct surveillance of communications. Firms seek to ensure that communications between analysts and investment banking staff are monitored or chaperoned by legal and compliance staff. Where regulatory provisions are quite specific, firms will often establish controls directly in line with those requirements. This includes allowing the review of draft reports for fact checking only, ensuring employees declare compliance with the relevant requirements, wall-crossings, employee trading restrictions and ensuring supervisory analysts review and approve research before it is published.

Provision of information during the capital raising process

Most jurisdictions have specific rules governing the timing and content of information included in the prospectus, which issuers are required to publish ahead of their shares being admitted to trading. Under the current European Union prospectus regime, issuers are not required to produce a prospectus in situations where they are seeking to raise capital of less than 10% of their existing shares admitted to trading. However, this threshold increases from 10% to 20% under the new Prospectus Regulation.

It is also common for jurisdictions to have overarching rules requiring firms to manage any conflicts of interest and rules ensuring that firms prevent flows of confidential and price sensitive information between their corporate advisory team, corporate finance advisory team and other areas of the business.

Similarly, a number of jurisdictions have overarching antifraud and anti-manipulation provisions that prohibit misstatements and misleading omission of material facts, and fraudulent and manipulative acts and practices during the IPO process. Some have similar provisions which seek to ensure any information and representations received from the issuer, and made to the public are true, accurate, complete and not misleading.

Some jurisdictions plan to enhance their framework in this area, or have done so recently. Since 2015 the French AMF requires that after the analyst presentation, a second meeting take place as soon as the registration document is made public. During this meeting unconnected analysts have access to all information provided to connected analysts and in addition have access to the issuer's management, enabling in-depth discussions. The UK FCA has introduced new rules which would seek to ensure that, during an equity IPO, an approved prospectus or registration document is published, and unconnected analysts have access to the issuer's management, before any connected research is released. This is in addition to its proposed guidance outlined earlier. In Canada, the legal framework is contained in securities legislation rather than IIROC's own rules. IIROC reported that the focus of further work in this area will be on enhancing the existing framework specifically as it applies to investment dealer-only matters, i.e. confidential information containment, restricted securities and grey lists, information barriers, due diligence and fair allocation.

Allocations of securities

Regulatory requirements specifically for the allocations process, as distinct from requirements governing the prevention and management of conflicts of interest generally, vary greatly across jurisdictions. They include: a requirement for firms to maintain an allocation policy setting out the approach they adopt for determining allocations; a requirement for allocations to be fair, equitable and transparent; IPOs to include a mandatory public subscription tranche to facilitate retail participation; allocations by drawing lots (retail subscriptions); restrictions on who may receive IPO allocations; requirements with respect to allocations, pricing and trading of IPOs to prevent problematic practices, such as quid pro quo allocations; clawback mechanisms to increase public allocations in oversubscriptions; minimum shareholding spread post-IPO by public shareholders; limitations on subscriptions by connected parties; and mandatory disclosure of the volume of the public offering and, if applicable, the size of allocations to connected subscribers.

Specific plans to enhance the existing regulatory framework include:

(i) Singapore has introduced a requirement that all primary-listed Mainboard IPOs must allocate at least 5% or $50 million, whichever is the lower of the offer size, to the public subscription tranche.

(ii) ASIC have recently launched a review of allocation practices in the Australian market. Based on the results of the review, the regulator will consider whether updates to the relevant regulatory guidance are required.

(iii) IIROC is looking at specifically prohibiting certain allocation practices (practices that are not currently prohibited under general conflicts of interest management and avoidance requirements), including dealers withholding securities in a public offering for their own employees' benefit and dealers rewarding persons who are in a position to direct future business to the dealer with preferential allocations.

(iv) In the European Union, MiFID II legislation has recently introduced more targeted principles-based provisions governing underwriting and placing services. For example, firms will be required to do the following:

- Inform the issuer of the various financing alternatives available with the firm prior to accepting a mandate to manage an offering;
- Have in place a centralised process to identify all potential conflicts of interest arising from other activities of the firm or group, and implement appropriate management procedures;
- Secure the issuer's agreement to the proposed allocation per type of investor for the transaction in accordance with its allocation policy; and
- Maintain records of allocation decisions taken at each stage of the capital raising process, and to justify the final allocation made to each investor client.

Firms across various jurisdictions generally maintain policies on allocations and conflicts of interest. Some firms do carry out post-transaction allocation reviews but this does not appear to be common practice. In some jurisdictions, firms are required to assign staff to review all transactions relating to the firm's investment banking or securities business. Some firms may use a risk-based review approach to comply with these requirements. In Switzerland, after close of the transaction the lead manager must disclose the volume of the public offering, and if applicable, the size of allocations to groups of subscribers with a special relationship to the issuer as well as any exercise of the overallotment option.

Other controls that firms may use to meet their regulatory obligations and to manage conflicts of interests and conduct risk in the allocation process include:

(i) Keeping appropriate records (a requirement in some jurisdictions) such as records showing when, to whom and how securities were allocated in a particular transaction and records evidencing supervisory reviews to verify proper use of allocations policies;

(ii) Staff training on conflicts of interest (including reporting);

(iii) Information barriers between functions of a firm that determine allocations and other areas of the firm such as secondary trading; and

(iv) Certifications as to professional competence.

In some jurisdictions, however, allocation policies have been found to not necessarily translate into good allocation practices. In particular, the UK FCA found a clear relationship between the revenue generated by the investor to the firm through other business lines and allocations, despite the vast majority of firms' allocation policies explicitly prohibiting quid-pro-quo arrangements. The analysis conducted by the FCA controlled for the various bid and bidder characteristics that could otherwise explain the allocation made.

In the context of secondary offerings, whilst the conflicts of interest and associated conduct risks in the process depend on the type of the offering, the regulatory requirements and controls firms have in place to meet their regulatory obligations are largely the same as in the context of IPOs.

ANNEX 3 – Feedback Statement: IOSCO Consultation Report *Conflicts of interest and associated conduct risks during the equity capital raising process*

Introduction and overview

IOSCO received 10 responses to the consultation proposing guidance to address conflicts of interest and associated conduct risks in the equity capital raising process. Respondents represented a range of market participants. They included, for example, an exchange, trade associations representing both sell-side and buy-side market participants and national regulatory bodies.

Respondents were overwhelmingly supportive of IOSCO's efforts to enhance standards of conduct in the equity capital-raising process and generally agreed with the proposed guidance to address conflicts of interest and associated conduct risks in the process.

The key points raised by respondents were generally targeted at regulators when considering the extent to which the final IOSCO guidance should be implemented in the context of their legal and regulatory framework given the signficance of the associated risks. In this regard it is important to note that the guidance by IOSCO is principles-based and provides regulators with significant flexibility to implement the measures in line with the risks observed in their domestic markets.

Below is a summary of the key feedback received on each piece of proposed guidance (referred to as 'measures').

Measure 1: In the context of pitches to secure a mandate to manage an equities securities offering, regulators should consider requiring firms to take reasonable steps to prevent their analysts from coming under pressure to take a favourable view on the offering from the issuer's representatives.

Respondents were broadly supportive of this measure. One respondent noted that IOSCO should take into account specific characteristics of local markets. That respondent thought that Measure 1 may not necessarily be appropriate in the context of transactions for SME issuers. The respondent believed that, provided that internal policies are in place to prevent analysts coming under pressure to produce favourable research, regulators should take into consideration the role performed by analysts in educating issuers on future market expectations as an important source of information during price discovery, especially with respect to SME issuers.

Another respondent suggested that IOSCO should limit the definition of a 'pitch' to a meeting or exchange that has the sole purpose of allowing a firm and the issuer to discuss a potential transaction and where the firm is trying to win a mandate. It noted that, otherwise, this measure could prevent the issuer from having any access to analysts in order to stay connected with market trends and to vet analysts.

A third respondent indicated that Measure 1 (as well as Measures 2 and 3) should take account of the important role played by connected analysts during the capital raising process.

IOSCO considers that the Final Report is clear in that regulators should consider implementing the measures in the context of their legal and regulatory framework. The different measures in the report are also drafted in a way that gives significant flexibility to regulators to implement the measures in a way which appropriately caters for SME offerings, for example.

IOSCO notes that analysts could come under pressure from the issuer's management at any point of interactions, including before the ECM division within the firm begins formally pitching to win a mandate. It is for regulators to consider whether they wish to require firms to make judgements on how analysts should interact with the issuer 'in the period before they decide to pitch for a mandate and up to the mandate' or whether such interactions should be permitted at all.

The purpose of Measure 1 is to address the conflicts of interest and pressures on analysts during the formation of their views on an issuer during the pre-offering phase of a capital raising, notwithstanding any benefits that connected analysts bring to the process. The wider roles performed by analysts are covered in Chapter 3 of the report. Since consultation, IOSCO has updated Chapter 4 to reflect the fact that connected analysts are considered to add value to the equity capital raising process.

Measure 2: Regulators should consider requiring that once an underwriting or placing mandate has been awarded, firms take reasonable steps to prevent a connected analyst's views and research on the equities securities offering from being improperly influenced and to ensure that the analyst remains independent.

Respondents broadly supported Measure 2 and its objective to preserve the independence of analysts.

Measure 3: Regulators should consider requiring that, once an underwriting or placing mandate has been awarded, firms have appropriate controls to manage potential conflicts of interest and associated conduct risks arising from connected analysts performing an internal advisory role within the firm while producing research on an equity securities offering.

Comments to this measure were broadly supportive.

One of the respondents warned against the measure entirely preventing analysts from performing an internal advisory role to the investment banking function of the firm.

Another respondent asked IOSCO to clarify the scope and purpose of the measure.

IOSCO considers that the Final Report is sufficiently clear in that Measure 3 is intended to address conflicts of interest in relation to analysts performing an internal advisory once an underwriting and placing mandate has been awarded. That is, it is suggesting that firms need to manage conflicts of interest arising from analysts performing an internal advisory role. The measure recognises that certain specified aspects of this internal advisory role would be permitted (though any conflicts of interest would need to be managed), but that firms should prevent any such role to the extent that it relates to investment banking business carried out by the firm (i.e. relates to services the firm provides to the issuer client). The risk this measure is intended to address is clearly identified in Chapter 4 of the report.

It is for regulators to determine the extent to which the final IOSCO guidance should be implemented in the context of their legal and regulatory framework..

Measure 4: Regulators should encourage the provision of a wide range of information to investors in a timely manner, where distribution of such information is permitted under local law.

A number of respondents commented on this measure. Feedback was broadly positive. A number of points were raised which are summarised below.

One respondent suggested that, when implementing Measure 4, regulators should consider the proportionality of the requirements and whether a differentiated approach should be adopted for markets dedicated to SMEs. The respondent stated concerns that applying rigid, one-size-fits-all requirements could disproportionately affect SME offerings and reduce the attractiveness of undertaking an IPO by SMEs in comparison to alternative financial options.

Another respondent was sceptical over whether any unconnected research would emerge despite efforts taken through Measure 4, based on experience in its own jurisdiction.

A fourth respondent asked IOSCO to define precisely what information should be provided under this measure.

Measures in the Final Report are designed to give flexibility to regulators to implement them in a way that is appropriate for their markets.

IOSCO considers that a wider range of high quality information on an offering, which measure 4 is seeking to facilitate will enhance the efficiency and integrity of price formation, boost investor confidence and make the equity capital raising process a more effective route for businesses, including SME issuers, to raise finance.

IOSCO considers that it is not necessary or desirable to precisely define what information should be provided under this measure, since this will ultimately be specified by regulators in their consideration of the extent to which the final IOSCO guidance should be implemented in the context of their legal and regulatory framework if they choose to implement .

Measure 5: Regulators should consider requiring firms to maintain an allocation policy that sets out their approach for determining allocations and to provide the issuer with an opportunity to be involved in the process.

No objections were raised against this measure, nor against Measure 6 which also relates to allocations. However, one respondent indicated that firms managing offerings should be given flexibility to decide how best to make allocation decisions and manage conflicts of interest.

IOSCO considers that the measures in the report give firms flexibility to manage the allocation process and to manage any conflicts in the process.

Measure 6: Regulators should consider requiring firms to maintain records of the allocation decisions to demonstrate that any conflicts of interest are appropriately managed.

One respondent expressed concern that increased record keeping of allocation decisions could result in banks adopting an overly cautious approach to determining allocations and lead to straight-lining allocations, which could create a disincentive for investors to provide early feedback on the transaction ahead of and during price discovery.

IOSCO believes that Measure 6 provides sufficient emphasis on the need for firms to take account of the issuer's allocation preferences, and that this should help to mitigate the risk identified by the respondent.

Measure 7: Regulators should consider requiring firms to manage any conflicts of interest that arise in relation to pricing an equity securities offering, keep the issuer informed of key decisions or actions which can influence the pricing outcome, and give the issuer an opportunity to be involved in decisions regarding the pricing of an issue during the pricing process.

No material comments were received on this measure.

Measure 8: In the context of a securities offering, regulators should consider requiring firms to take all reasonable steps designed to prevent any employees who have access to confidential information on the issuer from entering into or causing any personal transactions in situations where such transactions would involve misuse or improper disclosure of the confidential information. Regulators should also consider requiring firms to prevent any employees from entering into personal transactions where such transactions would otherwise give rise to any conflicts of interest.

No material comments were received on this measure.