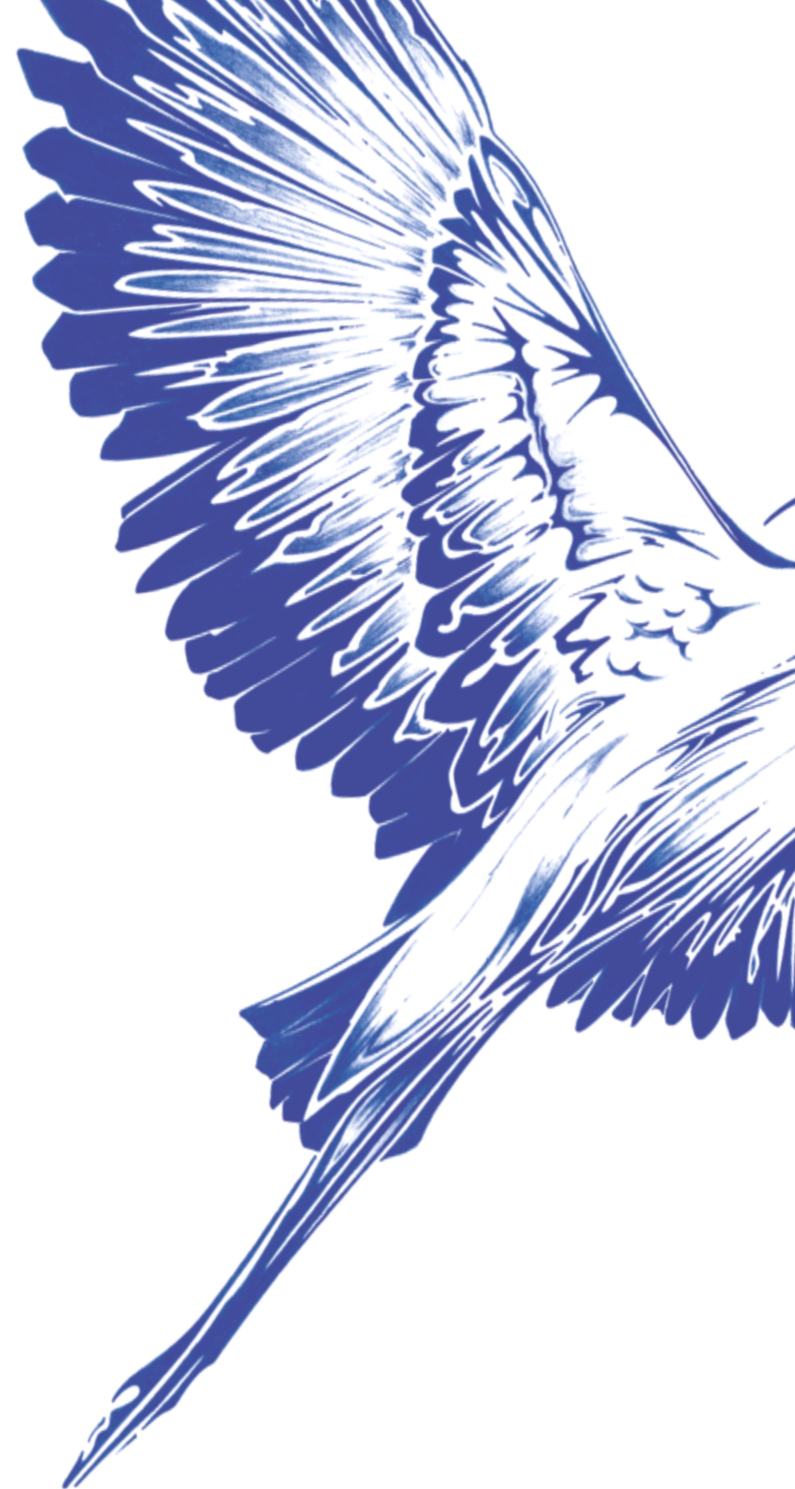
CLEVELAND & CO

External in-house counsel

CONDUCT RISKS DURING EQUITY FUNDRAISING PROCESS

May 2018



The International Organization of Securities Commission ("**IOSCO**") has published a Consultation Report with the aim of proposing guidance (the **"Guidance"**) to address the potential conflict of interest and associated conduct risks in the equity capital fundraising process. The Guidance reflects an expectation of high standards of conduct by market intermediaries and though it is not binding, IOSCO encourages its members to consider the extent this should be implemented in the context of their legal and regulatory framework, given the significance of the associated risks.

Conflicts of interest and associated conduct risk can arise at each stage of the equity capital fundraising process. This can translate into various types of harm to issuers and investors. The potential risks and harms of the equity fundraising process, as well as the proposed IOSCO measure are set out below.

Potential risks and harms	Key findings	Proposed IOSCO measure

1. POTENTIAL RISKS

	Potential risks and harms	Key findings	Proposed IOSCO measure
a)	**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**	It is 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 analysts' 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.	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.
b)	**Pressure on connected analysts to have a favourable view on an Initial Public Offering ("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:	In the context of pitches to secure a mandate to manage an equity securities offering, firms should take reasonable steps to prevent analysts coming under pressure to take a favourable view on the offering from the issuer's representatives. This includes:

Potential risks and harms	Key findings	Proposed IOSCO measure
	– 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. The issuer's management and/or independent corporate finance advisors (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 Financial Conduct Authority (**"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. Examples of corporate advisory and investment banking staff within the firm exerting pressure on analysts with respect to valuation information and forecasts include: – 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	– prohibiting explicit or implicit promises of favourable research coverage; and – preventing analysts from participating in pitches alongside corporate advisory or investment banking staff within the firm. 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.

Potential risks and harms	Key findings	Proposed IOSCO measure
	– re-writing research to increase revenue forecasts. In principle, the conflicts of interest and associated misconduct 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 is 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.	
c) 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	Across a number of jurisdictions, the views of the connected analyst, which are at risk of bias, plays 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 are unable to access the necessary information to produce an 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	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 wide range of information to investors. This could help to mitigate any conflict of interest and support balanced price discovery. 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 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. This could also include helping to facilitate the

Potential risks and harms	Key findings	Proposed IOSCO measure
	such provider is hired by the issuer to assist in the due diligence and price discovery process. 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 a 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 be less of a barrier preventing unconnected analysts from producing research on the secondary offering.	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 information should 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.
d) Conflicts of interest during the allocation of securities during an offering	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 of the investor; – the timing and receipt of bids; – the degree of oversubscription; – the investor's engagement with the firm; – whether it has assisted in the price discovery and execution 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.	A robust and transparent allocation process is fundamental to the integrity of equity capital markets, helping to ensure confidence amongst both investors and issuers. While carrying on a mandate to manage a securities offering, a firm is providing a service to its issuer client and, when placing shares, a firm should reflect the interest of its issuer. However, when processing and accepting indications of interest from its investor clients, the firm also has responsibilities to these clients. 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

Potential risks and harms	Key findings	Proposed IOSCO measure
	Whilst firms in most jurisdictions typically maintain an overarching allocation policy, in practice they use this policy as a guideline and exercise significant discretion in allocating securities on a transaction-by-transaction basis. For example, in some jurisdictions, allocations can be made towards: – the firm's most valued clients; – investors who have contributed to the price discovery process; – other parts of the firm's business (for example, their own asset management division) or their employees; – clients or senior management of the issuer; and – investors who 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 firms' 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.	two of its clients. The process for allocations should also be transparent, allowing the firm to demonstrate that they have 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. IOSCO recommends that regulators should consider requiring firms to maintain records of the allocation decisions. 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 allocation 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

Potential risks and harms	Key findings	Proposed IOSCO measure
		issuer's interests have not been compromised.
e) Management of underwriting risk by firms managing a securities offering and associated conflicts of interest in the pricing of securities	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. This can mean that the way in which securities offerings are priced is inconsistent 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 by investors. This would increase the cost of capital for the issuer. A bank may also engage in a variety of hedging strategies to mitigate their underwriting risk. Hedging would seek to ensure that the costs of any such purchase would be offset by gains in another asset or instrument. However, bank' 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.	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 and make them aware of any decisions and actions which influence the pricing outcome to ensure that they are made aware of those decisions and actions. 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.

Potential risks and harms	Key findings	Proposed IOSCO measure
f) 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. This may be exacerbated where the employees have access to confidential information on the issuer, 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 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.	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 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. Firms and employees should consider whether the information that some employees have access to amounts to market sensitive or inside information, and should be mindful of their obligations under the relevant market abuse regime, i.e. whether employees are able if it would be appropriate for employees to enter into a personal transaction in the offering being managed by the firm.

Potential risks and harms	Key findings	Proposed IOSCO measure

2. POTENTIAL HARM

a) 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 issuer to raise finance.	
b) Reduced confidence in the integrity of allocations	To the extent that allocations are seen to reflect the interest 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 reduce their confidence in the process and may reinforce the above harm.	

DISCLAIMER

No individual who is a member, partner, shareholder, director, employee or consultant of, in or to any constituent part of Cleveland & Co Associates Limited accepts or assumes responsibility, or has any liability, to any person in respect of this document. Copyright in the materials is owned by Cleveland & Co Associates Limited and the materials should not be copied or disclosed to any other person without the express authorisation of Cleveland & Co Associates Limited. This document is not intended to give legal advice and, accordingly, it should not be relied upon. It should not be regarded as a comprehensive statement of the law and practice in this area. Readers must take specific legal advice on any particular matter which concerns them. If you require any advice or information, please speak to your usual contact at Cleveland & Co Associates Limited. Cleveland & Co Associates Limited is a limited liability company registered in England and Wales under company registration number 07871988 with its registered office at Unit B404, The Biscuit Factory, Drummond Road, London, SE16 4DG.

WHY WE'RE DIFFERENT

Cleveland & Co are specialists in financial services, investment management and commercial contracts and related courses. Our team's in-house experience means we understand client challenges and we work alongside you to create solutions. We can provide insight on real vs hypothetical risks and help your team evolve.

WE OFFER

Cleveland & Co offer you fixed fees and retainer structures that provide you with certainty of cost and we offer industry experience that cuts through common legal complexity.

CONTACT

EMMA CLEVELAND

Founder and Managing Director

+44.79.6387.8756
ecleveland@cleveland-co.com
www.cleveland-co.com

Cleveland & Co Associates Limited is incorporated in England and Wales, company No. 07871988. Unit B404, The Biscuit Factory, Drummond Road, London, SE16 4DG, VAT number 144 6988 70. Cleveland & Co Associates Limited is authorised and regulated by the Solicitors Regulation Authority (SRA) under no. 622069, as an alternative business structure, and as such all our solicitors are subject to the principles and code of conduct set out by the SRA. Please visit http://www.sra.org.uk/handbook/ for more information.