Market Intermediary Management of Conflicts that Arise in Securities Offerings

Consultation Report

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

FEBRUARY 2007

Preamble

The IOSCO Technical Committee (TC) has publicly released the consultative discussion paper entitled *Market Intermediary Management of Conflicts that Arise in Securities Offerings*. The TC invites all interested parties to comment on this paper, in particular on the questions raised in it. After the consultation process, the TC will review the comments received from the international financial community and present a final paper on how market intermediaries manage information to deal with conflicts in securities offerings.

How to Submit Comments

Comments may be submitted by one of three methods **at the latest on 25 May 2007**. To help us process and review your comments more efficiently, please use only one method.

1. E-mail

- Send comments to Ms. Tillie Rijk: t.rijk@iosco.org
- The subject line of your message should indicate "Public comment on Market Intermediary Management of Conflicts that Arise in Securities Offerings".
- Please do not submit attachments as HTML, GIF, TIFF, PIF, or EXE files.

OR

2. Fax

Send a fax to the attention of Ms. Tillie Rijk, using the following fax number: 34 (91) 555 93 68.

OR

3. Post

Send your comment letter to:

Ms. Tillie Rijk
IOSCO General Secretariat
C/ Oquendo 12
28006 Madrid
Spain

Your letter should indicate prominently that it is a "Public comment on Market Intermediary Management of Conflicts that Arise in Securities Offerings".

Important: All comments will be made publicly available, unless anonymity is specifically requested. Comments will be converted to PDF format and then posted on the IOSCO-website. Personal identifying information will not be edited from submissions.

Introduction

A. This Discussion Paper deals with the issue of addressing conflicts of interest that may arise when market intermediaries are involved in securities offerings, in particular the management of information flows in conflicted situations. While the Discussion Paper notes that legal obligations may exist in this context (whether arising from statutory, general law or industry standards), its focus is on the processes at the market intermediary that should be in place to appropriately address conflicts of interest in the offerings context.

The paper is divided into three parts:

(a) Part 1 outlines the background and purpose of this paper. It then describes the scope of the paper and the circumstances in which conflicts of interest may arise when market intermediaries are involved in securities offerings. It also discusses what is meant by "conflicts of interest" in this particular context.

(b) Part 2 describes proposed approaches for addressing conflicts and means of implementation reflecting sound practices. The proposed approaches and means for implementation are for consideration by regulators and market participants, and are not intended to serve as regulations or rules.

(c) Part 3 outlines examples of circumstances in which market intermediaries involved in securities offerings may face potential conflicts of interest, and discusses measures for handling the particular conflicts by reference to case studies.

B. This Discussion Paper is designed to facilitate a dialogue with industry about the circumstances in which conflicts may arise in relation to securities offerings and approaches for their management, including central management practices and the use of information barriers. The paper presents specific questions to elicit comment, but comments on any part of the paper are welcome.

As part of the review of the comments, the TC will consider whether to change the content of the italicized sections under each topic heading in Part 2; as well as whether and what parts of the topics should be designated as principles.

C. Next Steps: The public comment period for this Discussion Paper is open through May 25, 2007. The comments will be summarized and evaluated. The final report may lead to the publication of a final IOSCO Statement of Principles for Market Intermediary Management of Conflicts that Arise in Securities Offerings.

Part 1: Background and scope

A. Background

IOSCO Technical Committee Report

This Discussion Paper was prompted by the report of the TC entitled "Strengthening Capital Markets Against Financial Fraud" dated February 2005.[1] This report dealt with some recent financial failures and highlighted areas of securities market regulation requiring review. Among other action items for priority work, the report recommended the TC look at the role of market intermediaries in light of that report.

The Technical Committee mandated its Standing Committee on Intermediaries (SC 3) to undertake some work on this area, but to focus on:

(a) Information flows within market intermediaries as well as between them and issuers and investors to identify (1) potential conflicts of interest; (2) how information is managed within market intermediaries involved in securities offerings; and (3) the possible inappropriate use or withholding of relevant information related to those conflicts; and

(b) How inappropriate uses of information and possible conflicts of interest related to a securities offering could be addressed by information management arrangements within the market intermediary.

Relevant IOSCO Principles

IOSCO Core Principle 23 recommends the following of market intermediaries:

> *Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.*[2]

IOSCO has released *Principles for Addressing Sell-side Securities Analyst Conflicts of Interest.*[3] These Principles address conflicts arising from the individual capacity of the analyst. This discussion paper is intended to contribute to regulators', the industry's and the general public's understanding of potential conflicts of interest around the involvement of market intermediaries in securities offerings. The TC will consider whether to finalize Principles on this topic which would rest under Core Principle 23, in light of the responses to this Discussion Paper.

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1 <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD192.pdf>

2 Under section 12.5 of the IOSCO Objectives and Principles of Securities Regulation (May 2003)(http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf), it is stated that "[a] firm should try to avoid any conflict of interest arising but, where the potential for conflicts arise, should ensure fair treatment of all its customers by proper disclosure, internal rules of confidentiality or declining to act where conflict cannot be avoided." "A firm should not place its interests above those of its customers."

3 <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD150.pdf>

B. Basis and Purpose

This Discussion Paper was prepared primarily on the basis of responses from SC 3 member regulators[4] to a survey on the regulation and practices of market intermediaries involved in securities offerings. As part of the drafting process, SC 3 members also held informal consultations with a limited number of market intermediaries and self-regulatory organisations.

Investors need to have confidence that market intermediaries act with integrity and with appropriate regard to their interests, whether they are clients of the intermediary or simply invest in a securities offering that is underwritten or facilitated by the intermediary. Where a market intermediary has more than one client and/or where it has a proprietary interest in the outcome of a transaction, both of which may lead to conflicts of interest, investors and regulators rightly expect it to identify and address those conflicts appropriately. This Discussion Paper is intended to facilitate a dialogue between the financial services industry and regulators on a cross-border basis regarding possible principles that may be used by market intermediaries to guide their management of some of the conflicts that arise from activities related to a securities offering.

C. Scope

What is included?

The focus of this Discussion Paper is on the conduct of market intermediaries in securities offerings where:

- the market intermediary, (either alone or together with its related entities), is generally in the business of offering a number of services to individual clients (such as underwriting, lending, advising); and

- the market intermediary (either alone or together with its related entities) has more than one commercial relationship with an issuer (or its related entities) or has a relationship with other clients of the market intermediary that may be relevant to its involvement in a particular securities offering (such as an adviser to a merger or acquisition; a lender; a private equity fund; a counterparty to a credit derivative; or an adviser to retail clients); and

- the market intermediary is directly involved in a securities offering by the issuer. The market intermediary may act as arranger to the offer (either on a firm commitment[5] or best efforts[6] basis), placing agent, adviser to the offer or dealer

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4 SC3 member regulators are: OSC Ontario Canada, ASIC Australia, AMF Quebec Canada, AMF France , Bafin Germany, SFC Hong Kong, Consob Italy, FSA Japan, CNBV Mexico, AFM the Netherlands, SEC Pakistan, MAS Singapore, CNMV Spain, EBK Switzerland, FSA UK, SEC US, CFTC US.

5 "Firm commitment" underwriting (as understood in North America) involves guaranteeing the sale of an issue of securities by purchasing it at stated price from the issuing corporation. It devolves upon the underwriter to dispose of the securities to the investing public at a price sufficiently attractive to ensure their sale and yet yield the underwriters a profit. The underwriter is required to

in the securities offering. The market intermediary may also be indirectly involved as part of a syndicate jointly distributing the securities; and

- the securities offering is either a public or private offering; and

- the securities offering is either of equity or debt.

In the Appendix to this Discussion Paper, an example in flowchart form sets out briefly typical steps involved in an equity fundraising. This example provides some useful background to the context of this Discussion Paper.

What is not included in the scope?

Conflicts other than those described above are not covered in this Discussion Paper. As such, it does not address conflicts faced by sell-side research analysts employed by a market intermediary. These conflicts are already adequately dealt with in IOSCO's *Principles for Addressing Sell-side Securities Analyst Conflicts of Interest.*[7]

This Discussion Paper does not consider services related to the entry into derivatives contracts as a 'securities offering'. By a derivative contract we mean a financial instrument (other than a security) the value of which is dependent upon the value of an underlying instrument or asset.[8]

It may be that the manner in which a particular conflict could be best addressed is disclosure of the conflict in the offering document, or conducting particular enquiries when preparing the offering document. However, it is not the purpose of this review to discuss issues relating to:

(a) the required content of offering documents (typically regulated by specific statute or law) used in the securities offering; or
(b) due diligence arrangements under the offering.

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take the balance of securities that it cannot dispose. There may also be "standby underwriting" where the underwriter simply agrees to take any balance of securities unsubscribed in an offering. "Standby underwriting" is understood as "firm commitment" underwriting in Australia (The definition above is derived from the definition of "firm commitment" in Charles Woelfel Encyclopedia of Banking and Finance 10th Edn (1994) Probus Publishing Company).

6 "Best efforts" underwriting means that the underwriter makes no firm commitment but agrees to use its best efforts to sell as much of the offering as possible. (Charles Woelfel Encyclopedia of Banking and Finance 10th Edn (1994) Probus Publishing Company).

7 See footnote 3 for the relevant citation.

8 This approach is not intended to exclude some structured products, such as collateralized debt obligations and other synthetic products that are debt instruments.

D. Conflicts – Description and Importance

What are conflicts of interest?

Conflicts of interest are common in the activities of market intermediaries because of the different roles that an intermediary or companies within the same financial group as the market intermediary play. A conflict arises where the interests of a market intermediary may be inconsistent with, or diverge from, those of its clients, investors, or others. There may also be a conflict between the interests of one group of clients and those of another group. Conflicts of interest take various forms, i.e., they may be actual, apparent or potential (future). It is common for a market intermediary to have conflicts of interest in connection with securities offerings because the market intermediary often plays more than one role.

In addition, a market intermediary may be part of a group of companies or business units (the group), where different entities within the group undertake different services or activities for a range of clients. Although the market intermediary may be involved only in the offering of the securities, other entities in the group may perform other functions that are relevant to the market intermediary's role. These other members of the group and their functions can create conflicts of interest between them and other members.

Question 1: Do you agree with this description of conflicts? If not, please provide an alternative description or definition for consideration.

The focus of this Discussion Paper is on conflicts of interest where the market intermediary should consider, identify and manage those conflicts where the conflicts arise in relation to the market intermediary's participation in a securities offering and other activities of the market intermediary or of an entity within the group.

For example, there is a conflict of interest in a securities offering arranged by means of a book building. In such an offering, the market intermediary acts for the issuer in arranging the sale of securities to its own investment clients. These investment clients use the services of the market intermediary to trade securities. In this case, there is a conflict in terms of the offering price between the interests of the issuer and the interests of the investment clients. Another example of the type of conflict that may arise is a conflict between an entity or business unit that is the market intermediary responsible for the offering of securities and an entity or business unit of the same group which is responsible for lending activities. In this case, the conflict may arise if the funds being raised will be used for repayment of the loans.

Market intermediaries that are involved in a securities offering could have conflicts of interest if they or a company within the same financial group also provide services to clients other than the issuer, e.g., if they are advising potential investors about the offering. Another conflict may arise if the market intermediary or a company within the same financial group conducts business activities in which they have a proprietary interest that is not the same as the issuer's, such as where the market intermediary (or a company within the same financial group) is a commercial lender to the issuer.

In many cases, the potential conflict of interest becomes a real conflict because the market intermediary (or a company within the same financial group) acquires information about the issuer (for example, information on its prospects) for one purpose and this information will be relevant to the provisions of services in a separate context or to the market intermediary's own business.

The use of syndicates in securities offerings made up of unrelated market intermediaries, such as joint managers, may also give rise to potential conflicts of interest. For example, some members of a syndicate may possess information about the issuer which other syndicate members do not have, such as information obtained from separate business activities it conducts with the issuer.

There may be circumstances where the processes and procedures used by market intermediaries to identify and manage conflicts could be improved. Part 3, therefore, provides examples of conflicts that can arise and possible measures to address those conflicts and elicits comment on those measures and related issues.

While the focus of this Discussion Paper and the work of SC 3 is on the activities of market intermediaries, there can be group activities or interaction between the market intermediary and other group members which have an impact on the market intermediary and its clients. Approaches to conflicts need to deal with these issues. This Discussion Paper identifies some of the circumstances when there are conflicts between different group members and some proposed approaches for dealing with them.

Why addressing all types of conflicts of interest is important.

Addressing conflicts helps promote consumer protection and maintain market integrity. Without adequate arrangements to address conflicts, market intermediaries whose interests' conflict with those of a client or investors may have an incentive to put its own interests ahead of them in a way that may harm the client or investors and may diminish confidence in the market intermediary or the market in general.

In some jurisdictions, addressing conflicts is also required for legal compliance purposes, as market intermediaries may have a specific legal obligation to address, or there may be prohibitions against, certain conflicts of interest, which arise under statute, regulations, rules, common law, or industry standards.

Surveys in a number of jurisdictions[9] have shown a possible link between conflicts management and consumer protection and market integrity outcomes. Poor conflicts management tends to lead to poor consumer protection and market integrity outcomes.

While not all conflicts of interest may result in harm to particular clients or diminish market integrity, all conflicts increase the risk of these outcomes (both in terms of likelihood and impact of such outcomes). Conflicts of interest have a biasing or

[9] FSA, Consultation Paper 171 'Conflicts of Interest: Investment Research and Issues of Securities' (CP 171) May 2003
FSA Discussion paper 15 'Investment research – Conflicts and other issues' (DP 15) October 2002
ASIC 'Shadow shopping survey on superannuation advice – An ASIC report' April 2006

distorting effect – they create incentives for the market intermediary to put its own interests ahead of those of its clients, such as investment clients of the market intermediary, the issuer and/or the market as a whole.

E. Addressing Conflicts

Prudent market intermediaries take steps to address the conflicts of interest they are exposed to in their day-to-day operations. In some jurisdictions, they have a specific obligation to address, or prohibitions against, conflicts of interest. This may arise under statute, regulatory rules or industry standards. In other jurisdictions it is derived from the statutory obligations on market intermediaries to operate honestly and fairly, or from their duties under general law (*e.g.*, fiduciary duties, the law of tort and contract).

In many jurisdictions, market intermediaries are not prohibited from engaging in transactions where conflicts of interest are present. Rather, market intermediaries are expected to address their conflicts of interest and minimise the adverse impact conflicts have on their clients or investors.

What constitutes adequate arrangements to address conflicts will depend on the nature, scale and complexity of the market intermediary's business. When a market intermediary or other entities within the market intermediary group are engaged in a range of activities associated with a securities offering, conflicts may also arise within the market intermediary or between the market intermediary and other members of the same financial group engaged in such activities. For ease of reference, unless otherwise stated, references in this paper to "market intermediary" will be taken to refer to the financial group of which the market intermediary forms part.

The approaches, i.e., mechanisms, for addressing conflicts of interest appropriate to the activities of market intermediaries engaged in securities offerings are discussed in further detail in Part 2 of this Discussion Paper.

Part 2: Approaches for addressing conflicts

Approaches for addressing conflicts may involve establishing specific structures or procedures, disclosure, or, less commonly, refraining from engaging in the conduct.

In this part of the Discussion Paper, specific mechanisms that may be used by market intermediaries to address conflicts are considered and in particular, how the mechanisms assist in promoting the regulatory objectives of investor protection and market integrity. It is also necessary to recognise that the level of investor sophistication may impact on the effectiveness of each mechanism.

As a general rule, a market intermediary that provides a range of different financial services should have policies and procedures on a whole firm or group basis that enable it to identify, assess and develop appropriate means of addressing conflicts or potential conflicts.[10] These could include refraining from participating in a transaction, establishing specific structures or processes, and disclosure. The following topics are discussed below:

(a) whole of group approach;[11]
(b) decision process for addressing conflicts;
(c) refraining from acting;
(d) information barriers;
(e) restrictions; and
(f) disclosure of conflicts.

<u>Topic 1 – Whole of group approach</u>

A market intermediary and its senior management should be aware that there is the potential for a conflict of interest to arise if it participates in a securities offering and also provides financial services to other clients and/or has a proprietary interest in the transaction. They should be aware that the potential for conflicts can also arise because of services provided by other entities of the group of which it is a member. The market intermediary needs to identify and address those conflicts so that client interests are not impaired. This will call for addressing conflicts on a whole of group basis.

Large financial and other groups[12] operate in a complex environment. Business units within a large group operate often as discrete profit centres. Managers of business units focus on the particular conflicts that their business unit confronts. Conflicts must not only be identified at the business unit level, but the group needs to consider

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10 IOSCO's report on the Compliance Function at Market Intermediaries (March 2006) (http://www.iosco.org/library/pubdocs/pdf/IOSCOPD214.pdf) sets out general principles for compliance that address how such policies and procedures should be developed.

11 This topic discusses the situation where conflicts arise because of activities performed by different business units or entities within a group as well as within a market intermediary.

12 While conflicts are more likely to occur between business units performing financial services, we use the more general term "group" to refer to any large business which includes a market intermediary as one of its business units or entities even if it has business units or entities that provide non-financial services or products.

the potential for conflicts outside that business unit and between different members of the group.

The group of which the market intermediary forms part should consider ways in which it can take a whole of group approach to the management of conflicts that arise in relation to or as a result of a securities offering managed by the market intermediary within the financial group. If the group does not take a whole of group approach there is greater potential for conflicts to be addressed inadequately.

An organisation's culture shapes the manner in which it deals with issues. A consistent "whole of group" approach that treats identification and management of conflicts with appropriate priority and importance is essential to address conflicts effectively. This is particularly so for organisations which operate through discrete business units that are members of the same group.

Compliance awareness training, effective information technology systems, a proactive compliance culture, comprehensive policies and appropriate recruitment and remuneration practices can also play an important role in achieving a whole of group approach.

Means for implementation: Specific mechanisms that may be used to achieve a whole of group perspective to the management of conflicts that arise in relation to or as a result of a securities offering include:

(1) Putting in place policies that will enable a market intermediary and the group of which the market intermediary forms part, on an ongoing basis to:

(a) identify the conflicts of interest (including potential conflicts) relating to its involvement in arranging issues of securities;
(b) assess and evaluate those conflicts;
(c) decide upon and implement an appropriate response to those conflicts; and
(d) evaluate the effectiveness of the implemented response.

(2) The whole of group approach should be tailored to the nature, scale and complexity of the group's business.

(3) The senior management of the market intermediary and the group are responsible for setting and preserving the culture of the market intermediary. Conflicts may in some cases need to be considered at a management level above the individual business unit or entity that has the relevant conflict. This would help to ensure that an appropriate assessment is made of the nature of the conflict and the response to such conflict.

(4) Effective identification and addressing of conflicts are facilitated through policies and procedures endorsed and supported by senior management. Such policies and procedures might use one or more of the following mechanisms:

(a) ***Review, approval or central conflict management committees*[13]:** One way for groups to identify and address conflicts that may arise between a market intermediary engaged in a securities offering and other entities in the group, is to establish review, approval or central conflict management committees which comprise people with sufficient authority and autonomy and independence to take decisions uninfluenced by the commercial pressures of the relevant business units.

Some committees comprise senior management representatives of all relevant parts of the organisation. The committees should include personnel who are above the level of individual business entities, such as the chief compliance officer, head of internal audit, head of the legal division and independent board members. If appropriate, the committee should also comprise senior representatives of those parts of the organisation that should be physically separated.

These committees may be established on a permanent basis or at the beginning of the market intermediary's (or the individual business unit's) involvement in a proposal. Their remit should continue throughout the market intermediary's involvement. These committees should also focus on unusual aspects of transactions.

Matters may be referred to the committees by individual business units or by personnel who are above the individual business units. Procedures should be put in place to deal with potential conflicts of interest of individual members of the committee and to help ensure that the committee's consideration of conflicts is timely and appropriately recorded.

(b) ***Control rooms:*** Some groups establish control rooms. The control room, as part of the compliance function, is responsible for providing a "whole of group" overview of the operations of the group. In particular, the control room identifies conflicts that may arise between different business units and provides information to the relevant committee(s).

(c) ***Conflicts checks:*** Groups typically conduct conflicts checks prior to the commencement of its involvement in a transaction. Such a check helps the market intermediary identify dealings with a competitor of the issuer using the market intermediary's service. Checks of individual staff conflicts may also be conducted throughout the intermediary prior to the commencement of its involvement in a transaction. The conflicts focus is usually on arrangements that may affect the independence and objectivity of the staff member, for example, an employee has an interest in the outcome of a fundraising because he/she holds shares in the issuer that the market intermediary is advising.

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[13] A central conflict management committee could be established with the charter of identifying areas where business units or entities have a relationship with the issuer or client and confirming that the business can be undertaken or whether particular measures need to be taken to manage the conflicts. The timely identification of issues that should be addressed other than at the business unit level or the individual entity level (where the entity is part of a group) and mechanisms for escalation of matters by the business unit or individual entity will be integral to the effective operation of any central conflict management committee.

(d) ***Internal controls:*** Groups have internal controls over the way in which the business is conducted. Internal controls seek to protect the market intermediary's financial position and business and assist in compliance and oversight of the staff of the market intermediary. Internal control procedures should therefore cover the management of conflicts to ensure that the market intermediary's conflict management process is followed. Examples of internal controls include the separation of roles and responsibilities, authorisation limits, review and reconciliation of information by other staff, internal audit and the development of policies and procedures for particular activities.

Question 2 – Does your firm use these and/or any other mechanism to identify and address conflicts arising out of the activities of the market intermediary in a securities offering and other relevant activities performed by other entities in the group?

Question 3 – Are there any special or particular issues in using a whole of group approach in a cross-border context?

Topic 2 – Decision process for addressing conflicts

Market intermediaries or the group should address conflicts by employing the following decision process:

(a) *First, if the conduct (which is likely to create a conflict) is such that the conduct would be prohibited by law, or the interests of a client cannot be properly protected, then the market intermediary should refrain;*
(b) *Second, if there is no initial substantial or obvious reason to refrain, the firm should utilize the appropriate conflict management structures (such as information barriers and/or dealing restrictions) and/or make any disclosures necessary in order to address the conflict adequately;*[14]
(c) *Third, monitor the effectiveness of the conflict approach, and if necessary, modify its approach;*
(d) *Fourth, if at any stage during (b) and (c) above, the market intermediary forms the view that the conflict cannot be adequately addressed by management structures and/or disclosure, the intermediary should refrain from the activity.*

Means for implementation:

(1) Market intermediaries should adopt policies and procedures to identify conflicts, take the appropriate measures to address the conflicts, and to monitor their effectiveness. Relevant matters that market intermediaries typically monitor and document as part of their approach to addressing conflicts include identifying:

(a) material interests in relation to a securities offering;

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[14] Some jurisdictions require one or both.

(b) the appropriate people to participate in committees concerning the identification and assessment of the conflicts;
(c) resources for implementing solutions; and
(d) mechanisms for monitoring compliance.

Question 4 – Do you agree with the decision process set out above? What decision process does your firm use?

Question 5 – What processes does your firm employ to determine if your conflict management process is effective?

<u>Topic 3 – Refraining from acting</u>

(1) The market intermediary should refrain if the conduct (which creates or is likely to create a conflict) is contrary to the interests of a client and other approaches are unlikely to be effective to adequately address the conflict.

(2) Policies and procedures should give clear guidance as to the process and the circumstances in which a conflict is unlikely to be able to be effectively managed and where the market intermediary or other group entity should refrain from acting, including as and when circumstances change.

When deciding whether to refrain, relevant factors include the size and structure of the relevant market and the intermediary, fiduciary or statutory obligations, and probability of harm.

Means for implementation: The market intermediary's policies and procedures should give clear guidance as to the circumstances in which the conduct is contrary to the interests of the client, or the conduct would be prohibited by law, that refraining from acting would be appropriate. Examples of when to refrain include where:

(a) The market intermediary is involved at the same time, in more than one corporate finance transaction, for directly competing entities;
(b) The distribution remuneration incentives for a securities offering are materially out of step with industry practices;
(c) The employees would have access to material confidential information at or about the time of a securities offering involving the market intermediary; and
(d) The issuer is facing financial distress and has outstanding loans to a member of the group at the same time that the market intermediary undertakes to underwrite an offering of securities on behalf of the issuer.

Question 6 – Do you agree that the examples above describe circumstances where the market intermediary should refrain? Please explain.

Question 7 - Has your firm identified particular processes and/or circumstances where the conflict cannot be effectively managed and the firm is likely to refrain from acting?

Topic 4 - Information barriers and restrictions

(1) Information barriers are a useful mechanism to manage information flows and possible conflicts that arise during a typical securities offering, such as:

- *(i) the period when a mandate for a securities offering is being explored between the corporate finance part of the firm and the potential issuer;*[15]
- *(ii) the due diligence period in drafting the issuer's prospectus;*[16]
- *(iii) the pricing period of issue (whether using a book building process*[17] *or not).*[18]

(2) Dealing restrictions should be considered to address conflicts where information may otherwise be used by the firm and/or its staff (and their family and householders) to the detriment of the interests of clients of the market intermediary.

Information barriers will be effective only where there are clear procedures to ensure that only those persons who should have access to relevant information do so such as, those working on the issue in the relevant business unit responsible for an issue. Procedures which provide for the authentication of the person accessing the information, particularly electronic information, can be useful although, with such procedures, it is important also to control the circumstances under which a person may be permitted to access information protected by a barrier to ensure the information is contained and protected.

A firm should understand the type of information and the sources of information that are used in a securities offering. Understanding the information flows helps when constructing information barriers and in monitoring the effectiveness of these barriers.

Information security is enhanced where there is an audit trail and appropriate records about the access and actions performed by a person who has been involved with preparing or using confidential information. Information security helps apply barriers to information. This may entail at least three components – physical barriers, document classification and security and computer protections. Information security measures are discussed in more detail below.

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15 In this case the barrier will often allow the other parts of the intermediary's business to operate without restriction.

16 Like the example in paragraph (i), those parts of the intermediary's business should not be tainted by the knowledge of the issuer gained by the corporate finance part of the firm's business.

17 Book building is the process of establishing the pricing for an issue, by contacting institutional investors before the offering to ascertain at what price and at what quantity the institutional investor would be prepared to take of securities subject to the offer.

18 During this period senior representatives across the intermediary (including the public broker/dealer side) may share information about the issuer, the market and likely interest of possible wholesale and retail investors. Even though engaged representatives may have their conduct restricted because of the information they are taken to know, barriers may help their business units to operate without restriction.

Means for implementation:

(1) Information barriers: Specific information barriers include:

(a) ***Physical barriers:*** Office design and office security arrangements are important ways in which confidential information may be protected from abuse within a market intermediary. The protection of confidential information within business units can be achieved where there are security measures to limit the access to business units that may be working on sensitive information about a securities offering. Records of who may have accessed an area where sensitive information may be stored should be maintained.

(b) ***Document classification and security*:** Arrangements to classify the security measures that should be applicable to documents can also be put into place as part of an information barrier. This can involve physical separation of documents and imposition of restrictions on access to the documents and copying of those documents.

(c) ***Computer protection*:** Where information is stored electronically, specific measures to help ensure information security should be adopted. For example:

(i) labelling files with lists of authorised users;
(ii) shielding computers to prevent interception;
(iii) enciphering of information sent over telephone lines or other means;
(iv) erection of firewalls to restrict non-public information being accessed by other staff of the market intermediary; and
(v) placing different parts of the market intermediary on different network and email security arrangements that would protect certain information in emails.

(d) ***Confidentiality agreements:*** These are agreements between issuers and market intermediaries as well as between intermediaries and their employees, which require the parties to preserve the confidentiality of information, particularly in the absence of applicable legal or contractual obligations relating to confidentiality that may protect clients from ensuring that information that could give the firm, its employees or another client an interest different to that of the client is not transmitted.

Individual staff of the market intermediary and other professionals associated with the securities offering are under obligation (usually contained in employment contracts or required by law) to keep information confidential. In some cases specific agreements imposing such an obligation may be used to help ensure that the staff maintains the confidence required for the information; while this will not prevent the employee holding the information from having a conflict, it may ensure that the information is not transmitted to employees that otherwise would not have a conflict.

(2) Restrictions on dealing can be used to address conflicts where information may otherwise be used by the firm or its employees to the detriment of the interest of the clients of the market intermediaries. Restrictions within a market intermediary include:

(a) ***'Watch' trading lists:*** An issuer is typically added to a "Watch" list when the role of the market intermediary in an offering is a possibility but has not been confirmed (*i.e.*, pre execution of the mandate). These lists are compiled to facilitate monitoring of trading in the entity's securities by the organisation and its employees[19];

(b) ***Restricted dealing lists:*** An issuer is typically added to this list once the mandate has been signed and announced. Staff of the market intermediary are made aware that trading in the securities (on their own behalf or for the market intermediary) of an entity on the restricted list requires prior approval.

Question 8 – Do you agree with these circumstances when information barriers are used to address conflict? Please identify all circumstances when the use of information barriers and restrictions are helpful in the context of addressing conflicts when participating in an offering of securities.

Question 9 - Are there any other information barriers that are or should be used?

Question 10 - Are there any other restrictive mechanisms that may be used to address conflicts in the context of an offering of securities?

Topic 5 - Disclosure of conflicts

(1) Where disclosure is used to address conflicts, such disclosure should be sufficiently complete and timely so that it is meaningful and comprehensible to the client.

(2) A market intermediary should consider making disclosures to its clients supplemental to the information required to be in the issuer's prospectus in order to address conflicts adequately.

Disclosure may reveal a conflict which has been identified to those persons who may make a decision about a securities offering (for example, the issuer and/or the firm's clients[20]). The information disclosed must allow the person who is relying on the market intermediary to assess the services of the market intermediary with an understanding of the background of matters that may affect the independence and objectivity of the market intermediary. Completeness and timeliness of the disclosure are key elements to making this an effective mechanism for dealing with conflicts.

The effectiveness of disclosure as a tool for addressing conflicts of interest may depend upon the level of sophistication of the client and the extent to which they are able to understand and act upon the information given to them.

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19 The term for a "watch trading list" may differ across jurisdictions. Watch trading lists may also be used in contexts other than securities offerings.

20 The term "client" includes an issuer for whom the market intermediary is acting, and an investor (whether retail or institutional) who purchases securities from the intermediary as part of the initial offering. It does not refer to investors that may purchase securities in the secondary marketplace.

Disclosure may involve disclosure by the market intermediary of financial benefits that it will receive as a result of the securities offering or of the multiple roles played in the offering.

Means for implementation:

(1) To be effective, disclosure of a conflict should explain the impact, the specific conflict, and the underlying facts. Unless the form, content and impact of the disclosure can be understood and acted on by the recipient, it will not be effective as a tool for addressing conflicts.

(2) Disclosure alone may not be enough to effectively address a conflict of interest, and other approaches may be necessary or required. [21]

(3) The market intermediary should consider whether to amend or withdraw earlier research reports that are inconsistent with its current knowledge of the issuer.

Question 11 – Are there ever circumstances where a market intermediary may need to make disclosures to its clients more generally to supplement the disclosures made in the issuer's prospectus, in order to address conflicts adequately? Please explain. For example, what format would be used for such disclosure?

Question 12 – How do you determine what is effective disclosure?

Question 13 – Under what circumstances, if any, do you believe that pre-existing research reports issued by the market intermediary about the issuer should be amended or withdrawn?

[21] In some jurisdictions, disclosure is not sufficient to address the conflict.

Part 3: Examples of using mechanisms to address conflicts

For the purpose of illustration, this part of the Discussion Paper outlines some types of conflicts that may arise when a market intermediary is involved in a securities offering. It sets out the behaviour that may be caused by the conflict of interest, the impact of the market intermediary acting in a conflicted manner and the reasons the market intermediary might be motivated to act in that manner. Proposed methods of addressing the types of conflict described in the fact case are also discussed.

In general, the number of potential conflicts that a market intermediary will need to address is greater where there is a large number of different products and services that the market intermediary and its affiliates provide to the issuer.

The conflicts of interest policy of the market intermediary and its group should be appropriate to the size of the organisation, and to the nature, scale and complexity of the services that the group provides to the issuers.

In many jurisdictions, market intermediaries may have a specific legal obligation to address conflicts of interest, which may arise under statute, regulations, rules, general law, or industry standards. Also, current regulatory restrictions may already preclude the behaviour that would lead to the market intermediary acting in a conflicted manner (for example insider trading laws).

We have also interspersed the discussion with relevant parts of examples (which appear in shaded boxes) in which a particular conflict arises. After the discussion of each example, there are specific questions intended to elicit comment about the appropriate mechanisms that the market intermediary could employ to manage the conflict (having regard to the approaches and mechanisms set out in more detail in Part 2 of this Discussion Paper).

A. Advising to undertake a securities offering

Conflicts of interest could cause a market intermediary to advise an issuer to raise capital in circumstances where another form of financing may be more appropriate. The conflict arises where the market intermediary will have a role in the fundraising and would earn more fees and face less risk in participating in the securities offering as underwriter compared to what a lender faces. The advice would be of detriment to the issuer if an alternative form of funding would be cheaper and more commercially suitable (*e.g.*, from the perspective of debt/equity ratios on its balance sheet).

Example 1 – Advising to undertake a securities offering

Company A is a leading goods manufacturer. It is an established and profitable company. Bank X is a commercial bank. Company A is a longstanding client of Bank X.

Company A becomes aware of a competitor which will shortly be entering its market. Company A is advised that the product being offered by the competitor is so superior to its own, that without improving its technology its operations would be at a significant commercial disadvantage.

Company A approaches Bank X seeking advice on how it could fund its looming cash flow difficulties and the purchase of its new technology. Bank X is Company A's largest creditor, having provided it with a number of credit and loan facilities over the years.

Bank X refers Company A to its affiliated market intermediary, Infosec, for funding advice. Bank X and Infosec are subsidiaries of Holding Company H. Infosec recommends that Company A raise the funds by way of a securities offering to the public. It recommends that it advise on the offering and act as arranger (best efforts).

Infosec may benefit from this recommendation as a result of: (a) fees earned by Infosec for arranging the offer; (b) raising funds from the securities offering (to avert financial difficulty) without further credit risk to Bank X and actually improving its existing credit exposure.

A conflict arises if raising funds through a securities offering is not in the best interests of Company A because, for example, debt funding may have been cheaper and more practicable because all that Company A required was short-term funding.

Proposed Approaches

- Whole of group
- Disclosure

In this case, Infosec should have in place mechanisms to identify, assess and decide how to address any conflicts arising out of the transaction. This conflict may be adequately addressed by a whole of group approach that puts in place processes that will support the recommendation of funding that is most suitable to Company A. Specific restrictions on form and conditions for remuneration may also be appropriate. In evaluating this conflict scenario, market intermediaries may wish to consider the following factors:

- ➢ The ultimate funding decision, both whether to proceed with funding and the type of funding rests with the issuer, Company A.

- ➢ Existing disclosure obligations for offering documents in some jurisdictions may appropriately address the conflict of interest.

- The extent of the market intermediary's mandate with the issuer, and the possibility for the parties to amend the mandate, may reduce the conflict.

- The issuer can obtain second opinions on the funding decision, and can seek advice from competing market intermediaries.

Question 14 – Do you have any comments on the proposed approach or the factors listed above for addressing Example 1? Please explain. If you do not agree with the approach or factors, why not?

Question 15 - What remuneration or other restrictions should be put in place?

Question 16 - How likely is it that the market intermediary will need to refrain from participating in the offering and under what circumstances?

B. Pricing

Inherent conflict

There may be an inherent conflict within some market intermediaries when participating in the pricing of an offering. In many securities offerings, the process of book building is used to ascertain the likely pricing and demand for the securities to be offered.[22] The book building process relies on the relationship between the market intermediary and the institutional investors from whom the market intermediary seeks the pricing indication. It also requires that information be available to the institutional investors for them to make their assessment of the pricing of the offer.[23]

The issuer will also be involved in pricing since no issue will occur without the issuer's agreement on price.

Underpricing

Some possible reasons why a market intermediary may underprice securities include[24]:

(a) to increase the demand for those securities. This could occur where the market intermediary is arranging the offer on a “best efforts” basis, with the fee being calculated by reference to the *value* of securities purchased, and the market intermediary may believe that a lower per share price will lead to a larger total number (and value) of shares sold, thus increasing the net fee amount.

22 See Footnote 17 for a definition of book building.

23 It has been observed that on average the offering price under a book build is 15-20% less than the price at which the share begin trading in the secondary market. See W.I. Wilhelm *Book building, Auctions and the Future of the IPO Process* Vol 17(1) Journal of Applied Corporate Finance 2-13 at pg 3.

24 In some jurisdictions, market misconduct provisions (including insider trading regulations) may also prohibit certain pricing practices.

Moreover, a lower priced but better sold offering could be beneficial to the reputation of the market intermediary;

(b) to reward and retain the clients of its distribution/selling (Equities) operation. Ensuring their participation in an offering which provides these clients with a profitable security would have this effect;

(c) to obtain a lower price when its proprietary trading desk wishes to purchase the securities itself;

(d) if the market intermediary is also acting in a market making capacity, and the market maker is aware that a discounted issue is imminent, to obtain benefits by quoting to sell securities at market prior to the capital raising and purchase cheaper securities following the offering or by entering into short sales based on its anticipation of demand following the offer. However, existing regulatory measures in many jurisdictions against insider trading may deter the conduct in this scenario. Other jurisdictions may also prevent such conduct through existing regulatory measures[25]; and

(e) to satisfy the expectation of clients to be able to make "stag" profits[26] on securities issued under an offering.

The incentive to underprice may however be limited in cases where the market intermediary's fee is contingent on a successful issue and placement (*e.g.*, the fee structure provides an incentive for the market intermediary to achieve a higher issue price). In secondary sales of existing securities, it is not uncommon for the vendor to pay a fee based on the excess of the sale price over a minimum price. This mechanism provides a tangible incentive to the market intermediary to maximise the sale proceeds. Also, when the issue price is determined by way of a book build, the level and quality of consultation with the issuer may reduce the incentive to underprice as may the extent of the issuer's oversight of the process.

Overpricing

Some possible reasons why a market intermediary may overprice securities include:

(a) where the market intermediary or other group entities (such as funds management, proprietary trading or private equity) are existing owners and possibly sellers of the securities, to protect the value of those investments;

(b) where the market intermediary or its related entity has lent money to the issuer, and it is seeking to retire the maximum amount of debt with the proceeds of the offer; and

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25 For example, 'Designated sponsoring' market making is regulated in Germany by the Frankfurt Stock Exchange's rules.

26 A stag is a party or individual who purchases new shares expecting their price to rise. Thus, stag profit is the financial gain accumulated by the party or individual resulting from the value of the shares rising.

(c) where the pricing of a debt issue would enable the market intermediary to revalue other holdings of the issuer's debt securities and possibly liquidate the holdings at inflated prices.

Example 2 – Pricing *Infosec has undertaken enquiries of a number of its major clients and other broker-dealers as part of the book build process for an initial public offering of securities in a mid-sized Company A. During this process, some of its major clients criticize Infosec for overpricing a recent securities offering which had performed very poorly. They infer that they will reduce the amount of business they will give to Infosec if the price of the offering is not more favourable this time. Infosec has a range of prices which vary by 30%. Infosec decides that the final price for the offering will be at the bottom of the range of the prices suggested by the book build process. Infosec has taken this view as a result of the road show and book build (including feedback from investment client-facing staff), which indicate the possibility of less demand for securities at higher potential prices. Infosec's view is that the market concerns arise from there being other equity fundraisings that may come to market in the near future and the general conditions of the economy, following a recent series of interest rate increases.*

Proposed Approach for underpricing

- Whole of group

In this case Infosec should have in place mechanisms to identify, assess and decide how to address any conflicts arising out of the transaction. We consider that this conflict may be appropriately addressed by a whole of group approach that puts in place agreed processes for setting the price that are transparent to Company A. Infosec should also monitor and evaluate the effectiveness of the processes implemented.

In evaluating this conflict scenario, market intermediaries may wish to consider the following factors:

- Where the book building process is used, the ability of the underwriter can be constrained by the issuer demanding to see the books on which the book building price was arrived at.

- In some jurisdictions there are existing rules in place that address pricing.

- Some fee structures may provide the intermediary with an incentive to maximise rather than minimise the price.

- The ramifications for underpricing, including damage of reputation, and legal/regulatory action may limit the incidence of underpricing.

- Price is not always the only objective for the issuer. Thus, the possibility of underpricing may be more likely to occur where the issuer's aim in undertaking a securities offering is to increase the number of security holders of the stock.

Question 17 – Do you have any comments on the proposed approach or factors listed above for Example 2? If yes, please elaborate.

Question 18 – When Infosec sets the price of Company A's shares to be issued:
(a) who should be involved in determining the price?
(b) who should not be involved in setting the price?

Question 19 – If one of the following situations applied to the offer of securities by Company A, would that affect the processes adopted in determining the appropriate pricing of the issue of the securities in Company A:
(a) Infosec had a panel of sub-underwriters associated with the offering; or
(b) Infosec's underwriting was only on a best-efforts basis; or
(c) a significant percentage of the securities will be allocated to existing clients of Infosec?

Question 20 – How would you determine if the offering had been excessively underpriced? (i.e. what percentage above the issue price that the securities trade on the first day of trading would suggest excessive underpricing of the issue, or, would you use a longer time frame?) What post-issue compliance work is appropriate?

Question 21 – How would you determine if an offering had been excessively overpriced? What processes or approaches do you use to prevent overpricing?

C. Allocation

Oversubscribed Issue

Where a market intermediary has discretion in the allocation of securities, conflicts of interests may cause the market intermediary to prefer certain subscribers in an oversubscribed issue. This could be to the detriment of other clients of the market intermediary who miss out on securities, or to the detriment of the issuer of securities, if there were more appropriate allottees (e.g. the issuer may wish to minimise “short-term” holders of the securities offered).

Some reasons (although they may be illegal in some jurisdictions) why a market intermediary may prefer certain subscribers include[27]:

(a) the promise of future business by the subscriber, if it is allotted securities;

(b) the payment of an additional commission to the market intermediary or a related entity of the intermediary (or the entitlement to other benefits such as priority subscription to an offer managed by the subscriber or a related entity of the subscriber) by the subscriber, if it is allotted securities;

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27 In some jurisdictions conduct of business and market misconduct rules may prohibit certain allocation practices.

(c) the promise by the allottee to provide liquidity and support for trading of the securities in the secondary market, if it is allotted securities. Maintenance of a high "aftermarket" price is of reputational benefit to market intermediaries.

These conflicts would arise where the market intermediary has the ultimate discretion in placing the securities which are the subject of the issue, whether on a "firm commitment"[28] basis or a "best efforts"[29] basis.

Offer with low demand

Where there is anticipated low demand for securities in an offering, conflicts of interest may cause a market intermediary to allocate securities to those of its clients over whose accounts it has discretionary authority. If the reason for the lack of demand is that the securities are overpriced, this allocation would be particularly to the detriment of those clients.

Some reasons why a market intermediary may effect this kind of allocation include:

(a) where the market intermediary has underwritten the offer, the allocation reduces the number of securities it may have to acquire in the event of a "shortfall". This reduces its financial exposure to an unsuccessful offering;

(b) where the market intermediary is acting in a "best efforts" capacity, the greater number of securities taken up under the offer would be of reputational benefit to the market intermediary.

> ***Example 3- Allocation***
>
> *The offering for the securities of Company A is oversubscribed. In allocating the securities, Infosec intends to identify criteria for the allocation. It would like to reward certain of its clients that frequently use the market intermediary as its broker-dealer*.

Proposed Approach

- Whole of group

In this case Infosec should have in place mechanisms to identify, assess and decide how to address any conflicts arising out of the transaction.

The market intermediary should establish in written form the principles and process which it intends to follow in determining the allocation. The process should include a system documenting the allocation processes applied, the key allocation decision-makers, the assumptions applied and objective factors taken into account by the decision-makers. The market intermediary could also have an independent

28 See Footnote 5 for a simple definition of "firm commitment".
29 See Footnote 6 for a simple definition of "best efforts".

underwriting committee to review the criteria. We consider that this conflict may be appropriately addressed by a whole of group approach that separates the allocation decisions from trading and sales staff that manage relationships with clients. Infosec should also monitor and evaluate the effectiveness of the processes implemented.

In evaluating this conflict scenario, market intermediaries may wish to consider the following factors[30]:

- Transparent allocation processes including discussion with the issuer of allocation criteria.

- Risk to reputation may be influential in ensuring the market intermediary acts fairly when allocating the issue.

Question 22 – Do you have any comments on the proposed approach or factors listed above for Example 3? Should disclosure or information barriers be included in the approach to Example 3? If yes, please elaborate.

Question 23 – Do market intermediaries typically agree up front with the issuer about the principles for allocation of securities, including the basis for any preferences? If so, what are the key elements of these kinds of agreements or understandings? Will this approach alone manage any possible conflict arising with allocations?

Question 24 – What disclosures (if any) should the market intermediary make to the issuer about its allocation preferences and any related conflicts of interest?

Question 25 – What review arrangements (if any) should the market intermediary put in place about the allocations? Who from the market intermediary should be involved in such review arrangements?

Question 26 – Who from the market intermediary should and should not make the decision about the allocation?

D. Retail Advice/Distribution

A conflict of interest may arise where the members of the distribution side of a market intermediary sell to or advise their retail clients to acquire the securities, in circumstances where the market intermediary is also paid a commission arising out of the underwriting of the securities being offered. This may influence the market intermediary to provide advice that is not in the best interests of the retail client because of the market intermediary's or group's interest in a successful underwriting (selling all of the securities that are available under the offering).

[30] Some jurisdictions may have existing rules on allocation that must be followed including required disclosure in the offering documents.

Example 4 – Retail advice/distribution

A retail adviser is paid a commission for advice that it provides to a retail client about the offering of the securities of Company A. The retail adviser is an employee of an entity related to Infosec which is the underwriter for the offering. The commission being offered to the adviser for recommending securities in Company A is higher than what the adviser receives for other products, such as those available in the secondary market or other primary market products. The adviser is also able to receive volume bonuses for the sale of large volumes of the Company A offering.

Proposed Approaches

- Whole of group
- Disclosure

In this case, Infosec should have in place mechanisms to identify, assess and decide how to address any conflicts arising out of the transaction. We believe that this conflict may be adequately addressed by a whole of group approach that puts in place processes that seek to ensure that the client receives advice that is suitable. For example, remuneration could be based on the provision of suitable advice and client retention. The market intermediary involved in the sales activity should also disclose all fees and commissions paid to any member of the group. Infosec should also monitor and evaluate the effectiveness of the processes implemented.

In evaluating this conflict scenario, market intermediaries may wish to consider the following factors:

- Existing disclosure obligations relating to the provision of advice in some jurisdictions may help to address the conflict.

- Existing obligations on salespersons (sometimes referred to as advisers) to conduct, among other things, suitability and appropriateness tests in some jurisdictions may adequately address the conflict.

- Where remuneration of salespersons is in no way linked to the financial products they recommend.

- Remuneration of salespersons is linked to the profits of the retail business rather than profits of the underwriting business.

- Ensure that appropriate advice is being given by advisers through implementing robust compliance and advice review mechanisms and ensuring that all conflicts and commissions are disclosed to clients.

- Structure the market intermediary so that the wealth management/client advisory business is independent of the institutional arm.

Question 27 – Do you have any comments on the proposed approach or factors listed above to address Example 4? Are there circumstances when the market intermediary providing the sales services should refrain? If so, please elaborate.

Question 28 – How can market intermediaries in this situation seek to ensure that interests of retail clients are not subordinated to those of the issuer client or entity providing offering services?

Question 29 – What level of specific disclosure about conflicts of interests concerning the interests of the market intermediary should be made to retail clients? Is disclosure alone an effective conflict management tool when dealing with retail clients? What disclosures are appropriate in addition to disclosures made in the issuer's prospectus?

Question 30 – What monitoring arrangements should be put in place to seek to ensure that interests of retail clients are not subordinated to those of the securities offeror or the market intermediary's?

E. Lending

Conflicts of interest may cause advisers employed by a market intermediary who has lent money to an issuer, but is also arranging a securities offering for that issuer, to fail to provide complete information to their clients subscribing under the offer. The omission of the information could adversely affect the investment decision made by the subscribing clients of the market intermediary. The responsibility for the content of the disclosure generally lies with the issuer of securities, and the market intermediary may seek assurances from the issuer that all relevant information has been provided by the issuer.

There may be an incentive for a market intermediary to condone or ignore the failure by an issuer to disclose extensive details of certain unflattering facts concerning the issuer's financial situation. In addition, the market intermediary might make less robust inquiries of the issuer or its related entities, both of which may lead to a decreased demand for the issuer's securities (although this may be illegal in some jurisdictions), for the following reasons:

(a) the market intermediary may need to acquire shortfall securities;
(b) the market intermediary's remuneration could be affected;
(c) the reputation of the market intermediary could be adversely affected; and/or
(d) if the purpose of the fundraising is to relieve debt owed to the market intermediary (or to the lending business unit within the group owning the market intermediary) and thereby reduce the credit risk to which the market intermediary is exposed, the decrease in demand would reduce the amount of funds raised for that purpose.

Example 5 – Lending

Company A is in a precarious financial situation. Bank X is aware of this because it is a major lender to Company A. Indeed, Bank X is unsure whether its loans to Company A will ever be repaid. The proceeds of the offering will be available to Company A for repayment of the loans to Bank X. Infosec is underwriting an offering of Company A securities. Bank X and Infosec are subsidiaries of Holding Company H. Infosec staff are generally unaware of the seriousness of Company A's deteriorating financial situation both because of an information barrier set up between Bank X and Infosec, and because, notwithstanding Infosec's best "due diligence"[31] *efforts (which have met the legal standards for a due diligence defense in Infosec's jurisdiction), Company A has not directly described a deteriorating picture of itself to Infosec staff. Company A's communications with Infosec, however, do not meet the legal definition of fraud. Company A's offering prospectus contains some very general language that any investment in its securities is highly risky and that an investor might lose the full amount of his or her investment, thus arguably meeting its legal obligations to disclose all material information.*

Proposed Approaches

- Whole of group
- Disclosure or refrain from acting

Bank X, and indirectly its holding company, have an interest in the issue proceeding. However, the investment clients of Infosec would likely take a different view of the attractiveness of the securities if they were aware of the information about the financial situation of the issuer and loans held by Bank X. Also Infosec would be interested in the information regarding the issuer's financial condition and ability to repay the loans as its participation in the offering could be damaging for its reputation.

As part of the analysis of this example, we considered whether current disclosure requirements (through material change reporting requirements or prospectus requirements) might adequately address the conflicts. Another view is that the conflict between Bank X's and Infosec's interests and those of Infosec's clients requires Infosec to refrain from acting as an underwriter or distributor of the securities, whether or not the issuer has met its legal disclosure requirements. In this example, effective management of conflicts may require the market intermediary to be concerned about activities of another group entity – through a whole of group approach. In any case, investment clients of the market intermediary would expect conflicts to be identified and addressed.

In this case, Infosec should have in place mechanisms to identify, assess and decide how to address any conflicts arising out of the transaction. The market intermediary may need to have recourse to a process in order to cross the information barrier between Infosec and Bank X[32], thus being in a position to see clearly that Infosec is

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[31] The concept of "due diligence" may, depending on the applicable jurisdiction, encompass both an underwriter's affirmative responsibilities and the defense that it may assert to avoid liability for any material misrepresentations or omissions contained in a registration statement or prospectus.

[32] In some jurisdictions, the sharing of information across separate legal entities is not permitted.

underwriting a company that may soon fail (thus creating a conflict of interest between clients who are investors in the offering and Infosec). Bank X (and indirectly Infosec as part of Holding Company H) has an interest in seeing the underwriting go forward (to the detriment of clients), which creates a conflict as this may well enhance the likelihood that Company A will have monies available to repay loans. These processes may lead Infosec to form the view that conflict management structures and disclosure are unlikely to address this conflict adequately and to decide to refrain from acting as arranger for the securities offering.

In evaluating this conflict scenario, market intermediaries may wish to consider the following factors:

- Disclosure must be complete and accurate and explain any impact relevant to the disclosure in order to be effective. Omission of relevant facts may constitute a misrepresentation or may prevent intermediaries from providing accurate advice to investors. Lack of information prevents investors from making good investment decisions.

- Confidentiality of information (and any relevant agreements) and the possible need for an issuer to authorize the sharing of confidential information between entities that are subsidiaries of Holding Company H in order for Infosec to go forward with the underwriting.

Question 31 – Do you agree with the proposed factors relating to Example 5? Please explain, e.g., how, in your view, a firm should manage the conflicts raised by this example, including whether disclosure is likely to occur and is sufficient to address the conflicts or whether Infosec should refrain from acting as an arranger for a securities offering in these circumstances. If you think Infosec does not need to refrain, what circumstances would need to exist to make refraining the only option that could adequately address this conflict?

Question 32 – Are there any other approaches that would adequately address the conflicts described in Example 5? Please explain, including any specific processes or restrictions that should be adopted as part of an acceptable approach. For example, should Infosec disclose or clarify information to clients in addition to that required in the offering prospectus, even though the prospectus disclosures arguably meet the applicable legal requirement? How should Infosec address the situation should the disclosure not be meaningful? Please explain.

Question 33 – Under Example 5, in order to address the conflicts, should crossing or overriding of information barriers be required? If so, should it be approved and by whom? Please explain. At what, if any, point do you believe that such approvals, if sufficient in number, might substantially eliminate the effectiveness of the information barrier(s)?

Appendix

Activities associated with an Equity Fundraising

The table relates to the scenario where there is a financial group that has the following members each of which is a separate legal entity (although the broker-dealer may be a division of the Market Intermediary):

- Bank – responsible for ordinary commercial lending and other financing arrangements
- Market Intermediary – an investment bank responsible for equity fundraising
- Broker/dealer – trades securities both on behalf of others and on its own behalf

Activity	Description
BANK **Long term relationships with client** ↓	The Bank provides ongoing banking services, including the provisions of fixed terms loans and working capital finance for the client.
Referral by Bank to related Market Intermediary to identify appropriate method of fundraising and negotiate mandate ↓	The Market Intermediary has expertise in corporate finance and uses its expertise to advise the client on the most appropriate approach to fundraising.
MARKET INTERMEDIARY **Parties accept terms of mandate for fundraising** ↓	In many cases an agreement between the client and the Market Intermediary is entered into, in which the scope of the activities that the Market Intermediary will undertake are agreed and the fees and costs are also settled.
Due diligence and preparation of offering documents ↓	When the offer is to be made to retail investors, ordinarily a document containing relevant information about the equity fundraising is prepared. The Market Intermediary is involved in assisting in the preparation of the offering document. Part of the process will involve the Market Intermediary undertaking enquiries of the entity raising the funds to ensure that the content of the offering document is correct.
Marketing/roadshows ↓	This process is to raise interest in the equity fundraising, particularly with non-retail investors. There may also be some marketing of the offer to retail investors.

Assessment of pricing and sizing of offer ↓	Market Intermediary makes enquiries both within the firm and with third parties to make an assessment of the likely demand for securities and whether there are significant matters that may affect the pricing of the issue. The Broker/dealer may provide some opinion on the pricing and demand for the offering.
Book build ↓	The book build is often interrelated with roadshows. A book build is undertaken by the Market Intermediary to ascertain from institutional investors the likely demand for the securities and pricing for the offer. Book building is the process of establishing the pricing for an issue, by contacting institutional investors before the offering to ascertain at what price and the quantity the institutional investor would be prepared to take securities that are the subject of the offer.
Final price determination ↓	The Market Intermediary, using the information from the book build process determines the price at which the securities will be issued to the market. Once pricing is agreed with the issuer, the Market Intermediary will get their investment clients to confirm their interest at the issue price. Then, once interest is confirmed the underwriting agreement will be signed.
Allocation/issue ↓	This activity involves the Market Intermediary determining who will be entitled to shares at the close of the fundraising.
Market Stabilisation	The Broker/dealer may engage in trading securities to try to minimise price movements in the securities during the early phase of the securities being listed on a market on which the securities are traded.