INTERNATIONAL PRIMARY MARKET ASSOCIATION

INTERNATIONAL SECURITIES MARKET ASSOCIATION

BRITISH BANKERS' ASSOCIATION

Guidance on Policies and Procedures for Managing Conflicts of Interest in the Context of Allocation and Pricing of Securities Offerings

1. INTRODUCTION

1.1 COB 5.10 of the FSA's Handbook of Rules and Guidance sets out the view of the UK Financial Services Authority (the ***"FSA"***) that, in complying with the FSA's Principles for Businesses and in particular with principle 8 (conflicts of interest), a firm will need to have in place systems, controls and procedures for identifying and managing conflicts of interest in relation to offerings of securities managed by the firm, and gives further guidance with respect to such systems, controls and procedures.

1.2 This guidance is given by the Associations to member firms to which COB 5.10 applies, with a view to giving such firms further assistance in relation to the principles which should be applied in determining the systems, controls and procedures referred to in COB 5.10 and the factors which firms should consider taking into account in this context. Members should be aware that the interpretation of the Principles for Businesses and of FSA guidance is ultimately a matter for the courts.

1.3 The particular systems, controls and procedures appropriate to a firm will depend on the individual circumstances of the firm. Likewise, the application of the FSA's Principles for Businesses and of a firm's own systems, controls and procedures in the context of a particular offering will depend on the circumstances and structure of the offering. Firms will need to bear this in mind both in determining their own systems, controls and procedures and in applying them in the context of an individual offering.

1.4 This paper is addressed to member firms of the Associations which are subject to the FSA's Principles for Businesses and its related rules and guidance. To the extent that other members may participate in offerings of securities together with such firms, the paper may be of interest to those other firms also.

2. CONFLICTS AND THE PURPOSE OF THIS GUIDANCE

2.1 Principle 8 of the FSA's Principles for Businesses provides as follows –

> "A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client."

2.2 In the context of a securities offering, a firm owes duties to its corporate finance client[1] and to its investment clients. In addition, it has interests of its own, both directly, where it undertakes a principal commitment or purchases securities in the offering otherwise than under such a commitment, and indirectly, because the interests and perceptions of both corporate finance and investment clients affect its "franchise" and reputation.

2.3 A firm's involvement in an offering for a client may therefore give rise to conflicts –

(a) between the corporate finance client and the firm's investment clients who are possible purchasers of the securities;

(b) between the corporate finance client and the firm;

(c) between the firm and its investment clients.

2.4 Both the nature and severity of such conflicts and the weight which it is appropriate to give the respective duties and interests involved may vary from offering to offering, for example because of differences in the structure or terms of the offering or the type of securities offered, and between different stages of the same offering. For example, the firm may have a direct principal interest at the outset (in a bought deal or fixed price or backstop underwriting), only after a certain point, or not at all.

2.5 In offerings where the firm undertakes market risk, for example by underwriting an issue or providing a backstop price or size of issue, its prudential responsibilities for managing and controlling that risk will be relevant to its conduct of the offering, and may in particular affect the determination and timing of allocations. This should be one of the matters explained to the firm's corporate finance client in accordance with section 3 below.

2.6 In transactions which do not constitute an offering there will be no conflicts with the interest of the corporate finance client that need to be managed. In such situations – for example, block trades not involving a bookbuilding and negotiated private placements of securities with identified investors – only section 6 of this paper, relating to unacceptable allocation practices, is likely to apply.

2.7 The FSA takes the view that "firms will need to have in place systems, controls and procedures, appropriate to [their] structure and business, and to the sorts of offerings in which they are involved, for identifying and managing conflicts of interest"[2]. This guidance is intended to help firms design systems, controls and procedures to enable them to identify effectively their responsibilities and the conflicts which they may face and to manage those conflicts in such a way as to discharge those responsibilities appropriately.

---

1 The firm may be acting for an issuer of new securities, a seller of existing securities or, in some cases, the guarantor of a securities issue or the originator of assets underlying an issue. The term "corporate finance client" should be read accordingly. The corporate finance client may be a corporate, a sovereign, any other kind of public or private sector body or a natural person.

2 COB 5.10.5 G.

2.8 The following paragraphs deal with –

(a) the firm's relationship with its corporate finance client;

(b) the factors relevant to allocation;

(c) the basis of pricing;

(d) unacceptable allocation practices;

(e) the firm's internal procedures.

3. THE FIRM'S RELATIONSHIP WITH ITS CORPORATE FINANCE CLIENT

3.1 It is important that the firm's relationship with its corporate finance client should be transparent and that the client should have the opportunity to keep itself informed about the process of offering and allocation.

3.2 The steps appropriate to achieve this objective will need to be assessed in the light of all the circumstances, including in particular the client's experience of and familiarity with the offering process. For clients which are frequent or experienced users of the capital markets, firms may conclude that much of the detailed suggestions made below are largely unnecessary or inappropriate.

3.3 With less frequent or experienced issuers, it will normally be desirable for the firm to discuss the client's objectives and the most important aspects of the offering process with the client at an early stage. In some cases firms may choose to cover this in the discussions leading to the award of the mandate and to deal with some key points in the agreed terms of the mandate.

3.4 The matters covered at this stage are likely to include –

(a) the process for identifying prospective purchasers of the securities and the amount and price level of demand (for example, where the offering is to involve a bookbuilding, an explanation of the bookbuilding process);

(b) the factors relevant to recommendations and decisions on the pricing of the offering and the process by which the firm proposes that such recommendations and decisions will be arrived at;

(c) the factors relevant to recommendations and decisions on allocation (including recommendations and decisions on the identity of investors and the apportionment of allocations among them) and the process by which the firm proposes that such recommendations and decisions will be arrived at. Where relevant, this should include the effect of any confidentiality constraints to which the firm is or expects to be subject;

(d) the fact that purchasers of the securities are likely to include investment clients of the firm to whom the firm provides other services and, where relevant, may also include the firm's own proprietary book or associates of the firm, and that this represents a potential conflict of interest which the firm will manage in accordance with FSA requirements and its internal procedures.

3.5 The client should be offered the opportunity of active involvement in the process of allocation, including the opportunity to express any requirements, wishes or preferences regarding allocation to specific purchasers. In particular, the client should, if it wishes, be kept informed of developments in the book of demand. This is of particular importance where, as may happen for many reasons, actual investor demand fails to match expectations, or exceeds expectations, to an extent which necessitates some departure from previous understandings with, or instructions from, the client about allocation. The firm should take the client's interests and views into account in assessing how to deal with any such variation.

3.6 Experience suggests that the client's desire to be involved in the allocation process varies widely. Where the client does not take the opportunity to become actively involved, it is recommended that the firm explain that it proposes to make recommendations and decisions on pricing and allocation on the basis of its judgment, in accordance with its procedures described below and taking into account the factors referred to in those procedures.

3.7 In cases where the firm itself incurs market risk, this may be taken into account. The firm should ensure that the impact of this is made clear to the client. If, therefore, the firm regards it as necessary to make allocations at its own discretion in the case of an offering where it will buy the securities from the client or undertake a "hard" underwriting commitment at or before launch, this should be made clear at the outset. Similarly if the arrangements are such that the firm incurs market risk that may crystallize at a later stage (for example, where the firm assumes a "backstop" commitment to take up securities at the backstop price) and the firm reserves the right to make subsequent decisions on allocation at its own discretion, this should be communicated to the client.

3.8 Within the constraints imposed by client confidentiality and any applicable laws or regulations, the lead manager(s) should offer to provide the client with details of the final allocations made. Where the lead manager(s) is/are aware that there may be limitations on their ability to do so, for example because of the offering structure, this should be explained to the client at an early stage.

3.9 Where an offer includes a "friends and family" or similar tranche to be allocated by the client, the firm should make it clear that the client is responsible for the identification of participants and allocation of the final tranche (once the size of the tranche has been agreed with the lead manager). The firm should explain the procedural and timing implications of this at an early stage.

3.10 Where a number of firms are involved in different capacities in the management and distribution of an offering, this guidance will apply to a firm only to the extent (if any) that it is responsible to the client for managing the offering; it will not therefore apply, for example, to firms to which retention securities are allotted. Firms which do not have such a responsibility should follow any applicable guidance issued by the lead manager(s).

3.11 For the reasons explained in paragraph 2.4 above, the guidance set out in this section may need to be modified to take account of the nature of the transaction in question. For example, where the firm is managing a pure secondary offering of existing securities, or the securities to be offered include both existing and newly issued securities, the level of interest of sellers in the spread of ownership of the securities and in the performance of the securities in the aftermarket will vary. Firms will need to take this into account in assessing their approach in each case.

4. FACTORS RELEVANT TO ALLOCATION

4.1 The basic objective of allocation will normally be to produce an appropriate spread of investors (for example between long term holders and providers of liquidity, between institutional and private holders and between investors in different sectors and geographical areas), with a view to achieving an orderly aftermarket with sufficient liquidity and reasonable price stability.

4.2 The basis of allocation in an individual case will depend on the particular facts and circumstances and will be the result of discussion and the exercise of judgment. No one factor will be determinative, but factors which will often be relevant include the following -

- the size of an investor's expressed interest (both absolutely and relative to the investor's portfolio or assets under management)
- the extent to which the investor's expressed interest and the size of the allocation requested appears consistent with the investor's investment strategy and objectives and purchasing capacity
- the investor's behaviour in and following past issues generally
- the investor's interest in, and past dealings in, other securities of the issuer
- the investor's interest in, and past dealings in securities of, other issuers in the sector
- the nature and level of interest shown by the investor in the issuer and the particular offering, for example its involvement in road shows and other direct contacts with the issuer or seller of the securities
- the timing of the investor's interest, especially if interest is expressed only at a relatively late stage
- the possibility that the investor may be using the offer as a means of building a strategic stake or platform
- any statement by the investor about its intentions and the perceived credibility of any such statement
- any indication or reasonable belief that the investor has exaggerated the true extent of its interest in the expectation of being scaled down
- the category or description into which the investor falls (e.g. retail fund, pension fund, tracker fund)
- the geographical location of the investor

- the sector or sectors of the investor's main business
- any selling restrictions or other relevant legal or regulatory restrictions in jurisdictions with which the investor is connected
- the desirability of avoiding allocations in inconvenient or uneconomic amounts.

4.3 Allocation recommendations should not be determined by the amount of trading, commission or other income received or expected by the firm from business with a particular investor client.

5. BASIS OF PRICING

5.1 Valuation and pricing are complex processes which normally involve a strong element of judgment and experience. In the context of an issue of securities, there will often be a tension between the wish to maximize the proceeds of the offering and the issuer's interest in the future performance and investor perception of and interest in its securities. It is therefore of key importance that firms explain and discuss with their corporate finance clients the basis of pricing and (unless the price is agreed at the outset) how the final decision on pricing is to be reached. It is also important to keep the client fully informed of developments relevant to pricing during the offering process.

6. UNACCEPTABLE ALLOCATION PRACTICES

6.1 The following are regarded as unacceptable practices which firms are recommended explicitly to prohibit as part of their internal procedures –

(a) requiring investor clients to purchase additional securities in the after-market as a condition of being allocated securities in an offering ("laddering" or "tie-in" arrangements);

(b) other "*quid pro quo*" arrangements under which the allocation of securities to an investor client in an offering is made conditional on or linked with a compensating benefit such as the client's undertaking to accept allocations in another offer of securities or payment of excessive commissions on after-market dealings in the offered securities or on dealings in other securities;

(c) "spinning" arrangements under which the firm uses an allocation as an inducement to the recipient to award or procure the award, or as a reward for the past award, of other business to the firm.

7. INTERNAL PROCEDURES

7.1 Firms should structure their internal procedures with a view to ensuring that decisions about recommendations on pricing and allocation to corporate finance clients are not made by employees of the firm responsible for the firm's sales and trading relationship with investor clients.

7.2 Accordingly, while sales and trading personnel may (and generally will) provide information and guidance, including information and guidance about investor demand and views, during the process of bookbuilding, pricing and allocation, they should not determine the final recommendation on pricing and allocation. However, where the firm is making decisions on its own behalf about accepting or managing risks on a transaction (for example, the price at which it is prepared to purchase securities or underwrite an offering), it should follow its usual risk management systems, controls and procedures, including involving sales and trading personnel in decision-making as appropriate.

7.3 Any allocation to private customers of the firm should be made as a block allocation, the decision on allocation to individual clients being left to those responsible for the firm's relations with the private customers concerned to determine in accordance with the firm's procedures applicable to the private client department, without any involvement of individuals advising the corporate finance client.

7.4 Any request for the allocation of securities to the firm's proprietary or market making book, or to the asset management division of the firm or an associated entity, should be submitted under the same arrangements as apply to requests for allocations from customers, having regard to section 4 above.

7.5 In view of the complex and judgmental nature of decisions on allocation, we do not recommend that firms' procedures require an attempt to record the basis of each individual allocation decision. It is however recommended that the person with overall responsibility for the allocation process should record, with reasons, any case where regard is had to an unusual factor not mentioned in the firm's general procedures, or where there is some other material exception or departure from the firm's normal practice.