

## **AFME Research Working Group Response to CP 17/5 – Reforming the availability of information in the UK equity IPO process**

### **Connected Research Analyst Interactions with Issuers, Shareholders and Corporate Finance Advisers**

June 2017

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#### **Background**

The Association for Financial Markets in Europe (**AFME**) welcomes the opportunity to comment on **CP17/5 Reforming the availability of information in the UK equity IPO process** (the **CP**).

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME advocates stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is registered on the EU Transparency Register, registration number 65110063986-76.

As part of its overall consideration of the CP, AFME formed a research focused working group (the **AFME Research Working Group**) to consider the FCA's proposed Conduct of Business sourcebook (COBS) 12.2.21A G relating to the phrase "participating in 'pitches' for new business". The AFME Research Working Group comprises legal and compliance professionals responsible for coverage of the independent research divisions of their respective member firms and represents the views of those independent research divisions.

In parallel AFME has, together with the British Bankers' Association, set up an Equity Capital Markets focused working group to consider the CP more broadly. A general response to CP 17/5 prepared by this working group is being submitted together with the response of the AFME Research Working Group. There is agreement between the working groups on the proposed changes to COBS 12.2.21 A G.

The AFME Research Working Group is supportive of the CP's policy objective of formalising the standards of conduct expected of market participants during the IPO process as they relate to the preparation and distribution of connected research. It also appreciates the FCA's ongoing interest in the importance of the role of the connected research analyst in the IPO process. For the purposes of this response, **connected research analyst** or **research analyst** shall mean a research analyst from the independent research division of a firm offering or proposing to offer investment banking services, e.g., underwriting or placing services.

#### **Aim of this response**

The aim of this response is to:

1. provide a brief overview of:
  - (a) the role of the connected research analyst in the UK IPO process; and

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- (b) current controls and procedures regarding pre-mandate connected research analyst interactions with issuers, financial sponsors, other shareholders and corporate finance advisers; and
2. set out the AFME Research Working Group's recommendation for amending the proposed COBS 12.2.21A G relating to the phrase "participating in 'pitches' for new business".

This response is focused solely on the FCA's proposal regarding connected research analyst interactions with an issuer, financial sponsor or corporate finance adviser during the 'pitch' phase for underwriting or placing services.

### **Overview of the role of a connected research analyst in the IPO process**

The role of the connected research analyst in an IPO process is twofold as set out below in paragraphs 1 (Vetting the merits of a transaction); and 2 (Investor education).

Subject to appropriate controls and procedures (see section below), AFME member firms have historically permitted research analyst participation in pre-mandate meetings with potential issuers (together with financial sponsors or other controlling shareholders and/or corporate finance advisers) on the basis that those meetings (i) provide the research analyst with the opportunity to commence due diligence on the company (including the opportunity to meet in person, and assess the competence of, company management) for the purposes of the research analyst contributing to a firm's vetting process and (ii) assist in the independent research department's determination as to whether the research analyst should participate in investor education prior to launch of the proposed IPO (each as described below). For both these reasons, it is therefore critical that the research analyst is able to commence his due diligence as soon as possible.

#### ***1. Vetting the merits of a transaction***

The research analyst will often provide to the underwriting firm (including any relevant internal review committee(s) of the firm) his independent assessment of the issuer and the potential IPO transaction for the purposes of that firm's evaluation of the proposed IPO transaction and the firm's proposed underwriting commitment in connection with that transaction. This process is typically referred to as 'vetting'. Generally, as part of the vetting process a firm will determine whether: (i) to participate as an underwriter in the transaction; (ii) the proposed timing of the transaction is appropriate (i.e., whether the company is ready to be publically listed); and (iii) there are any reputational or other risks relating to the issuer and/or the proposed transaction that need to be addressed as part of the execution of the transaction and/or preparation of the company for a public listing. The vetting process may also draw on an analyst's views on the issuer's most relevant peer companies or industry sector or sub-sector – this question has become especially important in recent years with the emergence of new industry sub-sectors and the blurring of boundaries between traditional industry sectors e.g., would a challenger bank with innovative technology be considered an internet, financials or fin-tech company? A research analyst's views on comparable companies and how investors may view the company's business, prospects and valuation as a publically listed and traded company, provides the firm's investment banking team (and ultimately the issuer) with critical insights that benefit the overall IPO process.

#### ***2. Investor education***

In advance of an IPO, the research analyst will often participate in investor education to investing clients of the firm, through the distribution of pre-deal research reports, where applicable, and subsequent meetings with clients (pre-deal investor education or "PDIE" meetings) to explain his

views and insights relating to the issuer. The investor education process provides investing clients with the opportunity to hear the analyst's views on the company and its position relative to its peers, separately and independently from the marketing or roadshow process conducted by the issuer and the underwriters. The process may also facilitate investor feedback on the company which, when communicated by the analyst to the investment banking team through the firm's control functions, may provide valuable input into pricing and valuation discussions.

### **Current controls and procedures regarding pre-mandate research analyst interactions**

In addition to the existing internal policies and procedures, AFME member firms have developed industry guidelines designed to protect the objectivity and independence of research analysts and manage the risk that an analyst's participation in a pre-mandate meeting with an issuer, financial sponsor or other shareholder and/or corporate finance adviser may be viewed as participating in a "pitch" for investment banking business contrary to COBS Guidance (12. 2.9) and similar prohibitions in other jurisdictions e.g., in the US under the FINRA rules.

#### ***AFME Industry Guidelines, July 2016 – Practices and Principles with Respect to Research meetings/Materials Prior to the Award of a Capital Markets Mandate***

Following the FINRA enforcement action against ten firms in the US relating to the proposed IPO of Toys 'R' US, AFME member firms have developed and published best practice guidelines for the conduct of research analysts in pre-mandate meetings relating to European IPOs (see Appendix 1). In particular, these guidelines address:

- the types of discussion topics appropriate for communications between company management and an analyst during the pre-mandate period (e.g. , due diligence topics; the analyst's knowledge of investor concerns in the sector); and
- appropriate meeting attendees – meetings without company management or shareholders without access to management information (e.g., a meeting solely with a corporate finance adviser) would not generally be appropriate since an adviser on its own would not be able to facilitate a due diligence discussion.

### **Internal measures**

While each AFME firm has its own internal policy, likely with some procedural variations, AFME firms have the following key common internal controls and procedures designed to ensure a research analyst does not become involved in pitching for investment banking business.

- Physical and information barriers are designed to manage the flow of information between equity research analysts and members of a firm's investment banking division.
- Additionally, firms require research analysts to be wall-crossed prior to receiving any material non-public information about a proposed investment banking pitch or potential transaction or upon determination by the firm that a research analyst is in receipt of such material non-public information.
- There are separate reporting lines for equity research analysts and investment banking personnel.
- Performance evaluations and compensation for equity research analysts are not linked to a specific investment banking transaction or based on input from investment banking personnel.

**Proposed COBS 12.2.21A G relating to the phrase “participating in ‘pitches’ for new business”**

The AFME Research Working Group is concerned that the CP’s proposed COBS 12.2.21A G relating to the phrase “participating in ‘pitches’ for new business” will have the effect of prohibiting ordinary course research analyst interactions that should properly be viewed as appropriate and outside the scope of activities that are inconsistent with the maintenance of a research analyst’s objectivity (COBS 12.2.9 G). Absent amendment, the proposed COBS 12.2.21A G, would therefore materially damage the function of a research analyst in providing investment research views to investing clients.

In particular, the AFME Research Working Group sets out below three categories of interactions that are not being carried out for any purpose related to a potential IPO transaction and therefore should not pose any of the market conduct risks identified in the CP. In particular, such interactions should not create a heightened risk that any pre-deal research will be subject to bias; or be capable of being used to improve a firm’s position in the syndicate.

***Private company interactions:***

- As part of the ordinary course function of research, an analyst will often meet and communicate with private companies in order to inform his views on the particular sector and on his companies under coverage (e.g., the private company may be the primary competitor of a covered company). If at any point during these interactions the analyst receives material non-public information relating to a proposed IPO transaction, the firm’s internal controls and procedures are designed to ensure such receipt of information is notified to the appropriate internal legal or compliance function so that they may evaluate the situation and, if appropriate, further action may be taken, which may or may not include wall-crossing the analyst.
- It may be the case that during the time a research analyst is involved in ordinary course interactions, separately and without the research analyst’s knowledge, investment banking personnel of the firm could be in discussions with the company about various strategic alternatives, including potential underwriting transactions, such as a plan to IPO even though it may be years before the company intends or will be ready to actually undertake such a transaction. It is therefore arguable that investment banking personnel could be viewed as always “*proposing to provide underwriting or placing services*” in so far as they will from an early stage begin to position themselves for a role on an eventual IPO .
- In addition, a research analyst will frequently discuss his industry and other published views at industry conferences and other events. Such events are also commonly attended by private companies as participants in the relevant industry sector, including at the invitation of research analysts as hosts of the event (for the same reasons as mentioned above). Again, these invitations may be extended during the same period when investment bankers, separately and without the analyst’s knowledge, are engaged in discussions with the company concerning potential transactions, including a possible IPO. Interactions at these types of industry events should not be viewed as part of the IPO pitching process. The participation of the analyst is unrelated to any potential transaction and motivated by the analyst’s need to keep informed of the latest developments in his industry sector, including developments relating to companies not currently covered by the analyst but which have relevance to the analyst’s covered companies (e.g., because the private company is a competitor in a certain market or product/service or is in a covered company’s supply chain).

***Carve-out/spin-off IPO by a parent company of a subsidiary or business division:*** Unless the analyst covering the parent company has been wall-crossed on the potential transaction or has been otherwise notified by the company that they are proceeding with an underwriter selection process in connection

with a carve-out IPO, the analyst will have no knowledge and should not be informed of the pitching process. It should also be noted that the analyst covering the parent company will not always be the analyst assigned to internal vetting and/or coverage of the IPO company (e.g., where the industry sector or sub-sector of the IPO company is different from that of the parent company). In these circumstances, when an analyst has not been wall-crossed or otherwise made aware of the proposed transaction, continued ordinary course conversations with the parent company management, which is an essential part of an analyst's on-going due diligence exercise, should be appropriate. Prohibiting such interactions (which may result in an analyst suspending coverage or removing his rating) could risk tipping off the market that a potential transaction is being contemplated by the parent company.

***Follow-on offerings/rights issues:*** As with the carve-out IPO situation described above, the analyst covering the company should have no knowledge of the proposed offering unless he has been wall-crossed. In these circumstances, ordinary course coverage interactions with management are appropriate and should be permitted in order for the analyst to be able to continue to provide investment research on a reasonable basis. Even if the firm's investment banking division is soliciting the underwriting business, those ordinary-course analyst interactions should not be viewed as the analyst participating in a pitch for an underwriting mandate. Prohibiting such interactions could also risk tipping off the market that a potential transaction is being contemplated by the company.

**Proposed amendments to COBS 12.2.21A G** (see Appendix 2)

In order to address the above concerns, the AFME Research Working Group would propose that COBS 12.2.21A G:

- (a) expressly excludes interactions not related to a potential IPO transaction (e.g., ordinary course research function interactions with a private company relevant to a research analyst's coverage universe or a covered company pursuing a carve-out IPO, unless the analyst covering the parent company has been wall-crossed in connection with the proposed IPO transaction). Such ordinary course interactions will include interactions initiated by the research analyst;
- (b) does not apply where investment banking personnel are pitching for a mandate in connection with a transaction other than an IPO (e.g., a rights issue, other follow-on offering or a merger or acquisition transaction);
- (c) applies to interactions with corporate finance advisers, financial sponsors and other shareholders as well as with the issuer (except currently covered parent companies in the context of a carve-out IPO – see paragraph (a) above);
- (d) applies during a period that commences only when two conditions are satisfied: (i) the IPO company has made it known to the firm that it has determined to proceed with an IPO and (ii) the research analyst has been wall-crossed in connection with that proposed IPO transaction. As mentioned above, the AFME Research Working Group is concerned that the proposed trigger of when investment banking “*is proposing to provide underwriting or placing*” will extend to ordinary course interactions not related to the proposed IPO transaction, particularly where the research analyst is not wall-crossed. Such ordinary course interactions should be permissible and not be restricted; and
- (e) applies to a period that ends as soon as the company (or one of its advisers or other representatives) has sent to the firm written confirmation (in any form) of that firm's (i) selection as an underwriter ; and (ii) role (e.g., global co-ordinator and lead bookrunner) in the proposed IPO transaction or syndicate .

- The AFME Research Working Group believes that the conduct risk identified in the CP as it relates to “the way that research could be used to improve a bank’s position in the syndicate” would no longer exist insofar as a firm’s role in the transaction or syndicate is confirmed by the issuer. We would therefore propose to delete the reference to “*the extent of the firm’s obligations to provide underwriting or placing services to the issuer as compared to the underwriting or placing services of any other firm that is appointed by the issuer for the same offering....*” since this would require the issuer to have determined the final relative underwriting obligations of the syndicate firms at a time in the process when the syndicate economics (as opposed to the role of each of the selected firms) may still change for reasons that are unrelated to the expected research of a particular firm’s analyst. For example, it is common and often commercially desirable for a tier of junior underwriters to be selected later in the IPO process thus causing an adjustment to the expected relative underwriting obligations of the underwriting firms initially selected to work on the transaction.
- The CP’s proposed requirement for the underwriter’s appointment and role in the syndicate to be contractually agreed would likely result in lengthy and unnecessary delays to the analyst being given due diligence access to the company which, as discussed, is of critical importance in terms of enabling the analyst to provide his independent input to a firm’s internal vetting of the proposed IPO and proposed underwriting commitment.

The AFME Research Working Group’s proposed amendments to COBS 12.2.21A G are set out in Appendix 2.

## **Appendix 1: AFME Industry Guidelines, July 2016 – Practices and Principles with Respect to Research meetings/Materials Prior to the Award of a Capital Markets Mandate**

### **1. Meetings between Research Analysts and Companies (including their owners, managers, IPO advisers) during a Solicitation Period**

#### **i) Background**

In connection with IPOs, research analysts' interactions with companies who are potential capital market issuers, financial sponsors and/or their advisors in advance of the banker selection decision (i.e., "pre-mandate meetings" during the "Solicitation Period") serve a number of useful purposes for the research analysts, their respective firms and the research analysts' investor clients. For example, these interactions provide the research analyst a forum in which to ask questions. Such questions assist the research analyst in beginning to understand the company's business model and in making a preliminary assessment of the merits of the company and the proposed transaction. The research analyst will then be more informed to provide independent views to support their firm's decision whether to participate in the transaction and for the benefit of potential investors. Additionally, the information gathered by the research analyst in these meetings may be helpful to research management in making decisions regarding coverage (i.e., whether to cover the company, the identification of the sector of which the company is a part, and the selection of the appropriate research analyst).

As part of this preliminary assessment and information gathering process, research analysts frequently discuss general market, sector and macro perspectives with the company in order to provide the company context for the questions being asked and facilitate a more interactive and fulsome diligence for the research analyst. However, these pre-mandate meetings need to be conducted appropriately to avoid the perception that the research analyst is participating in investment banking activities such as corporate finance business and underwriting or in 'pitches' for new business which could compromise the objectivity of research. It is clearly not permitted for a research analyst to offer favourable research coverage or to provide indications of likely ratings for the company once listed. Nor should a research analyst tout their firm's ability to successfully execute an investment banking transaction which would be inconsistent with the role of the research analyst. Whether a particular communication between a research analyst and a company rises to the level of improper behaviour will depend on the facts and circumstances of the communication. In order to facilitate compliance with appropriate practice and applicable regulatory rules, the following suggested practices have been developed to help provide guidance for firms and their research analysts in managing discussions and other communications relating to these meetings and to help promote appropriate research analyst participation in a securities offering more generally.

#### **ii) Content of meetings**

**Broadly, topics of discussion that are consistent with conversations research analysts would typically have with buy-side clients about their sector, or help provide background to frame their due diligence discussion should be viewed as appropriate communications during the pre-mandate period or solicitation period. These topics could include:**

- regional and sector coverage of the firm's existing research business;
- analytical framework and valuation methodologies usually employed in the sector;
- key drivers and risks for the region and sector;

- companies in the research analyst's sector of coverage and the research analyst's current published research view on such companies, including valuation methodology;
- investor concerns and sentiment on the sector and investor perception of companies in the sector, including key themes; and
- research analyst questions regarding the company's business and management and questions regarding the company's financing plans.

**The following topics of discussion and materials carry an elevated risk that they could be viewed in hindsight as inappropriate. They may also be impermissible depending on the context and content of the research analyst's discussion:**

- the research analyst's specific views of the company, including:
  - valuation or positioning of the company;
  - discussion of the company relative to comps (e.g. position or ranking of the company within the comps, expectation of trading to a premium/discount);
  - targets, forecasts or ratings of the company;
  - the ranking of the company in the sector; or
  - suggesting and/or providing company specific opinions or recommendation regarding optimal capital structures to the company.
- a selection of research reports brought to a pre-mandate meeting which suggest a likelihood of favourable coverage of the proposed IPO company, i.e. selecting to bring only buy-rated single name reports in the sector when there are appropriate neutral and sell single name reports recently published;
- discussing the company's intended marketing process (e.g. discussing how the company would best be positioned to investors, identifying how the company can improve investor sentiment towards them suggesting potential marketing themes or specifying key investor targets for the company).

### iii) **Structure of meetings**

- Investment banking and research staff should not attend the same meeting with the company and its advisors during the Solicitation Period (for the avoidance of doubt this does not include attendance at widely attended events, such as conferences).

Research analysts' meetings during the pre-mandate phase may also include meeting with significant shareholders (e.g., financial sponsors) as such shareholders can provide detailed information and a different view on the company from company management; however, given the purpose of such meetings as set out in the Background section above, attendance by analysts at meetings with advisers or other representatives at which neither company management nor significant shareholders are present are discouraged.

## **2. Responses to common RFP questions**

- RFP responses should not commit to a specific research analyst for a transaction unless such research analyst has been assigned by research management;

- Biographical information of the research analysts should be limited to basic information, such as years with the firm, sector and coverage universe and may include published rankings if that information is generally available to investor clients;
- Responses should not commit to specific activities/process for the research analysts beyond a general intention to produce pre-deal research or pre-deal investor education (“PDIE”), i.e. broad statements of firm policy would be appropriate and the expectation that if a research analyst is appointed to provide pre-deal research such research analyst would normally conduct PDIE, however, responses should not provide specific commitments, for example to conduct a specific number of PDIE meetings, or to dedicate a certain number of hours to the process/presentations.
- Any exclusivity or conflict of interest clauses requested from firms in the RFP should not bind research; for example, a prohibition on involvement in any other IPO PDIE in the same sector during a certain period of time; and
- Firms should not respond to requests for an estimation/indication of research analysts’ views, including expected valuation ranges. Investment banking should not represent the views of research.

Any request by companies, financial sponsors and/or their advisors to a research analyst seeking information or commitments that are not consistent with these principles or otherwise inappropriate should be rejected and such rejection communicated to the requesting party.

## Appendix 2: Proposed amendments to COBS 12.2.21A G

### 12.2 Investment research and non-independent research

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#### 12.2.21A G

In connection with an initial public offering, the phrase “participating in ‘pitches’ for new business” in Recital 56 to the MiFID Org Regulation includes, during the Relevant Time Period (as defined below), a financial analyst of a relevant *firm* interacting with an *issuer* (including the *issuer’s* representatives ~~outside of the relevant *firm*<sup>1</sup>~~) to whom the *relevant firm* is proposing to provide underwriting ~~or placing~~<sup>2</sup> services (including the *issuer’s* representatives outside of the *firm*).

The relevant firm shall mean the *firm* that employs the financial analyst.

The *issuer’s* representatives include its shareholders, advisers (including any corporate finance adviser) and other party acting on behalf of the *issuer*.

The Relevant Time Period commences from the time (i) the issuer makes known to the *relevant firm* it has determined to proceed with the selection of underwriters in connection with an initial public offering; and (ii) the relevant research analyst has been wall-crossed in connection with that proposed initial public offering transaction.

The Relevant Time Period ends when both:

(1) the *relevant firm* ~~that employs the financial analyst~~ has been selected ~~agreed~~ to carry on regulated activities that amount to underwriting ~~or placing~~ services for the *issuer*; and

(2) the extent of the *firm’s* obligations to provide underwriting ~~or placing~~ services to the *issuer* as compared to the underwriting ~~or placing~~ services of any other *firm* that is appointed by the *issuer* for the same offering that *relevant firm’s* role in the proposed transaction or syndicate has been determined.

and each of (1) and (2) has been communicated in writing (in any form whatsoever) by the *issuer* (or one of its representatives) contractually agreed and documented between to the *relevant firm* and

<sup>1</sup> The AFME Research Working Group is unaware of any circumstances in which a firm would be acting in the capacity of an issuer’s representative in connection with a potential IPO. We would therefore propose deleting the words in square brackets.

<sup>2</sup> The AFME Research Working Group is unaware of any circumstances in which a firm would act as placement agent, rather than underwriter, in connection with an IPO. We would therefore propose deleting references to placing services.

*issuer.*

For the avoidance of doubt, this 12.2.21A G shall not apply to any interactions between a *financial analyst* and an *issuer* (including the *issuer's* representatives):

- (i) to whom the *relevant firm* is proposing to provide underwriting or placing services in connection with a transaction that is not an initial public offering (including a rights issue or other follow-on offering); or
- (ii) for the purposes of a *financial analyst's* role in producing or disseminating *investment research* on an *issuer*, including in circumstances where the financial analyst covers an *issuer* that proposes to carve-out or spin -off a subsidiary or business of the *issuer* through an initial public offering and the *financial analyst* is not wall-crossed on such a proposed transaction.