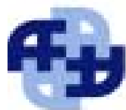


EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

Via E-mail
Ms. Tillie Rijk:
t.rijk@iosco.org

IOSCO
General Secretariat

Einsteinstrasse 5
DE - 63303 Dreieich

Contact: Claudia Stinnes
Direct number: +49 6103 5833-48
Fax number: +49 6103 / 5833-35
e-Mail: claudia.stinnes@effas.com
Internet: www.effas.com

25 May 2007

Public comment on Market Intermediary Management of Conflicts that Arise in Securities Offerings

Response by EFFAS - European Federation of Financial Analysts Societies

Dear Ms. Rijk,

The European Federation of Financial Analysts Societies, EFFAS, is the European umbrella organisation of national investment professional societies. It comprises 24 member associations representing more than 14,000 investment professionals in the areas of Equity and Bond Research, Asset and Portfolio Management as well as Investment Advice.

We take pleasure to comment on the Market Intermediary Management of Conflicts that arise in Securities Offerings.

D. Conflicts – Description and Importance
What are conflicts of interest?

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

The description is correct. We suggest, however, making one element explicit which is obviously implicit in all discussion on the regulation of financial markets and their intermediaries. Conflicts of interests in this context are conflicts of “financial” interests. Other conflicts of interests (political, cultural, macroeconomic – conflicts resulting from different degrees of development – etc.) are not a topic of the discussion of conflicts of interests of, or within, market intermediaries. They are relevant only when and if they lead also to conflicts of financial interests.

There is another inherent conflict of financial interests in an offering between the market intermediary and the issuer which should be excluded from the topic of conflicts of interests discussed in the context of offerings. It is the conflict of interests in the remuneration of services provided between the issuer-client, as recipient of services, and the market intermediary, as provider of services. The proper setting of this remuneration is a result of the forces of competition. With the market range, the service recipient is interested in paying as little as possible for the services. The service provider wants to

maximise its revenues. The size of the remuneration, in particular any disparity in the range of remuneration paid for such services, might only play a role as an indicator of circumstantial evidence for other conflicts which have played a role in stipulating a certain remuneration.

Another case, strictly connected with the one above, is that usually the remuneration is a certain percentage of the issue price of the securities. Therefore the market intermediary – who very often is also helping in setting the price – tends to set this price as high as possible, not because the value of the issuer shares is so high, but simply because he wants to receive a higher remuneration.

On the other hand, when the price is too high, the whole issue may fail and – as a consequence – the intermediary receives no payment at all (or rather only a low payment, set as a fixed part of the remuneration). This means that ultimately market forces decide the issue price, but there is still some place for the internal conflict of interests, which should be taken into account. The case is discussed in Part 3. B. “Pricing” of the Consultation Report, but in the context of underpricing only. The opposite – overpricing – is very often overlooked.

Topic 1 – Whole of group approach

Topic 2 – Decision process for addressing conflicts

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?

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?

These questions are not addressed to EFFAS as an industry association of financial analysts, asset managers and financial advisors. Therefore, our answer rests on a theoretical basis. Our answers are determined by the views of financial analysts, portfolio managers and advisors representing the interests of investors in an offering.

The whole group approach depends on how the group is organised. If and when the group is composed of independently operating group companies whose operations are not co-ordinated and centrally influenced by the holding or parent company, no whole group approach is required. The group companies might be treated as any other competitors operating at arms’ length.

Should the group, however, consist of an integrated network of companies whose operations are centrally co-ordinated with a corresponding flow of information between the croup companies, the group approach is mandatory. The group should be assimilated to a complex enterprise requiring the same information barriers and conflict management.

Topic 3 – Refraining from acting

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

If the examples are meant as an absolute requirement to refrain, we should disagree with such a requirement. We think that proper disclosure is the first appropriate answer to a conflict of interest issue. Refraining from providing an investment service in connection with a securities offering is the last resort to solve or manage a conflict of interest depending on the particular circumstances of each and every individual case. If harm to the issuer and to investors can be avoided by measurements other than refraining, the requirement should not reply. The point list provided by IOSCO is certainly an excellent tool for careful consideration of options for the intermediary, including the last resort, but it cannot replace a careful scrutiny of the individual aspects of each and every case. Selecting the last point, one should first ask, whether the distress situation of the issuer is an item to be disclosed. According to EFFAS, it is. If the information barrier between the unit involved in the offering and the unit handling the loans to the issuer is so tight that the offering unit does not know of the financial distress, it need not be discriminated compared to any competitor providing the same services. If it knows, it should insist on proper disclosure. If the issuer, even understandably refuses such disclosure, the unit might be forced to refrain in the best interests of the intermediary (or group). A competitor of the intermediary should have similar obligations.

The consideration to refrain is most relevant when and if the market intermediary is an institution of a smaller size in which the different service functions are not easily physically separated. In such a setting, there is always a risk that formal information barriers are overcome by informal contacts and communications between staff members of different unit departments or service functions of the market intermediary (e.g. joint lunches). If the harm caused by existing conflicts of interests cannot be sufficiently mitigated by disclosure of such conflicts, the market intermediary should refrain. The highest risk areas are security offerings to the general public, meaning retail investors. Even proper prospectus disclosure is no guarantee against the negative impacts of such conflicts of interests on this category of investors. Even if the conflicts of interests and their potential effects are fully and comprehensibly explained for retail investors, the risk of harm remains, due to the generally known fact that retail investors rarely read prospectuses and warnings. The decision depends on a basic policy, either within the jurisdiction at large or within the market intermediary, whether this passive attitude of a majority of investors must be the guiding concern, or whether the information opportunity through proper disclosure is sufficient to allow the market intermediary to participate in the preparation and execution of the offering.

Topic 4 - Information barriers and restrictions

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?

We agree with the description of circumstances.

Topic 5 - Disclosure of conflicts

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?

Answer: A supplemental disclosure beyond the prospectus disclosure may be necessary in those cases where the market intermediary participating in the offering does not control the content of the prospectus disclosure. The issuer or the institution determining the prospectus disclosure may not include a disclosure of the market intermediary's conflicts of interest in the offering because such conflicts are of interest only to clients of such a market intermediary. If the market intermediary considers the prospectus disclosure insufficient, it ought to disclose separately.

A supplementary disclosure must be in writing or another durable medium (according to the European Market of Financial Instruments Directive), at least if addressed to retail clients.

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

Answer: The IOSCO paper has correctly stated what constitutes an effective disclosure: 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. The recipient is the average recipient of the investor category to which the offering is addressed. An offering addressed to a retail investor requires a more elaborate disclosure than an offering to professional or institutional investors or investors independently advised by market intermediaries.

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?

Answer: A market intermediary regularly covering the issuer should amend or withdraw any research which, either in the factual basis or in the recommendation, no longer reflects the present, updated situation of the issuer. If no new research report is issued, the market intermediary would have to inform the public for reasons of discontinuing the coverage i.e. the participation in the offering. If the research unit is operating at arms' length of the unit participating in the offering and the information barriers and restrictions are effective, the research unit should not be treated as any other research provider covering the offering. The management might decide to continue the coverage by the independently operating research unit. This should be a policy decision of the market intermediary.

Part 3: Examples of using mechanisms to address conflicts

A. Advising to undertake a securities offering

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?

EFFAS does not feel comfortable with the approach suggested in Example 1. If Bank X is approached by Company A for advice on its financing, it is the obligation of Bank X to determine whether a loan financing or equity financing is the better solution. If a loan financing is the proper result, Bank X ought to advise Company A accordingly. If Bank X is not willing to take the additional credit risk, it ought to advise Bank X accordingly and advise it to look for another institution to provide loan financing. If the sister company

Infosec is approached directly by the issuer, it would have to make a similar determination and possibly refer Company A to Bank X.

If the example is to be read as meaning that the group has centralised its corporate financing advice with Infosec, Infosec must give proper advice. This includes a disclosure of the conflicts of interests involved, if not already known to Company A.

The advice might not only consider equity or loan financing. There might be other forms of securitized debt financing or mixed financing.

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

Answer: The ideal remuneration structure would be a separate fee for the advice as such to be offset with the remuneration for the loan financing or the offering services if this were the result of the advice.

If Company A is not willing to pay such a fee, the respective group company or unit might charge its standard fees and rates or commissions for the services resulting from the advice. An intercompany or interunit charge should solve the problem of properly remunerating the entity or unit providing the initial advice resulting in the financing or offering or underwriting business.

This internal remuneration system should be disclosed to Company A.

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

Answer: The market intermediary would have to refrain from participating in the offering

1) if loan financing be the preferable financing tool unless Company A insists on satisfying its financing needs by an offering, despite proper advice of Bank X or Infosec; even then, Infosec might have to refrain for the reason given under 2).

2) if Company A not be willing to include such information in the offering prospectus which is relevant to an investor.

B. Pricing

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

Answer: Pricing of an IPO does not have the benefit of an existing secondary market evaluation of the company's value. It can only be a bona fide determination by the person(s) determining the offering price. The book building process is a method to assimilate to a price to be expected in the secondary market.

Fair pricing, overpricing and underpricing are only terms which bear a relation to such bona fide determination. They are – to speak in legal terms – wilful and intentional to determine the price according to the bona fide evaluation or to deviate from it. As long as a market intermediary uses the bona fide evaluation approach, EFFAS would not blame the pricers for over- or underpricing, regardless of what the subsequent prices in the secondary market trading are. Subsequent prices might only be one element of circumstantial evidence among many others to find out whether the pricing was bona fide or not. The indicator of such circumstantial evidence would be better represented by the medium development of secondary market prices and not the market prices in the short term after the market entry of the new issue.

Differences between a bona fide offering price and subsequent market prices are not a result of conflicts of interests, but rather of a possible lack of competence.

Overpricing or underpricing understood as an intentional deviation from the fair price found in a bona fide pricing process, affect the interests of all parties involved.

Overpricing or underpricing might benefit the market intermediary, depending on the circumstances of the case remuneration structure, client reaction, etc.).

Underpricing tends to benefit the investor's side. On the issuer's side, underpricing might benefit the management and employees and possibly short term creditors in succeeding in providing liquidity. Underpricing would be, however, to the detriment of the owners (or present share- or stakeholders) of the issuer. The values of their values would be diluted. If, however, the liquidity aspect were of such a great importance that even share- and stakeholders would willingly accept underpricing, the fair price valuation might be questioned. The underprice might be the actual fair price. Underpricing must be disclosed not only to the management of the issuer, but also to their supervisors (supervisory board, outside directors and/or share- and stakeholders).

Overpricing tends to benefit the issuer. It would lead to a dilution, to the detriment of the new investors. It must be disclosed to the public.

The disclosure of over- and underpricing must also contain the reasons and the effects, according to the requirements listed by the paper for an effective disclosure.

Underpricing due to pressure in the book building process by important clients threatening not only the success of the new issue as such, but rather the overall business of the market intermediary, must be either disclosed to the issuer or ignored by the market intermediary, preferably both.

Question 18 – When Infosec sets the price of Company A's shares to be issued: (a) who should be involved in determining the price?

Infosec's operating staff working on the offering, its management, the responsible supervisory committee or body, the compliance officer.

The issuer, including its supervisory committee or body and shareholders, if they are taking the formal decisions in a name of the issuer (resolution to increase capital).

Underwriting syndicate members, if any.

(b) who should not be involved in setting the price?

Infosec's proprietary dealing unit, sales unit, any other group companies.
Infosec's investor clients (besides their participation in a regular book building process).

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

Yes, the subunderwriters or their panel should be able to make recommendations disclosing, however, their own conflicts of interests, if any.

(b) Infosec's underwriting was only on a best-efforts basis; or

We do not know whether it would influence the process in some specific cases, but in our opinion it should not influence the appropriate pricing process.

(c) a significant percentage of the securities will be allocated to existing clients of Infosec?

It should not influence pricing.

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?

In our definition of over- and underpricing, the discrepancy of the trading price is not governing. For circumstantial evidence purposes, see above. Post-issue compliance would have to determine the reasons for the discrepancies – negligence (incompetence) or intention (influence of conflicts of interests).

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

n/a

C. Allocation

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.

We agree with IOSCO that the allocation principles should be determined in writing before the start of subscription. The principles should be formulated in a manner to preclude any arbitrary decision of allocation. As long as it is not in conflict with the interests of the issuer, the reward motive is legitimate.

We do not think that any information barriers are necessary or even possible in the allocation process. See below, regarding the different functions to be involved in the process.

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?

n/a

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

These allocation principles should be cleared with the issuer. The issuer's interests might be affected by certain allocation practices. The issuer might be interested in having the issue widely distributed, to have a balance between retail and institutional investors, to avoid unfriendly or competitor shareholders or similar considerations. Depending on the agreement with the issuer, the market intermediary might have a contractual and/or fiduciary duty to take issuer's interests into account.

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?

The compliance function of the market intermediary should be involved in the allocation process in order to prevent any market manipulation practices. Depending on the nature of the involvement (firm or best effort underwriting, intermediary's own interest in the shares for the trading or investment book), the risk management function to evaluate the influence of the allocation on the intermediary's risk exposure must be involved in the process.

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

The decision should be made by a panel or committee consisting of members of all functions affected by the allocation, including, if relevant, sales, trading, treasury, legal & compliance.

D. Retail Advice/Distribution

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.

We should like to address an additional sensitive area of distribution: intermediary's discretionary managing client portfolios. There are several options for coping with conflict of interest issues.

The intermediary can stipulate contractually with the client in the portfolio managing guidelines that a certain share of the client's assets may be invested in issues in the offering of which the intermediary is involved or in which the intermediary acts as underwriter, provided the investment complies with the general suitability requirements and other parameters of the investment guideline. The stipulation is accompanied by a proper disclosure of the conflicts of interests arising.

In the absence of such an advance contractual stipulation, the intermediary should refrain from exercising any discretion and clear such investment in the new issue with the client before investing, on an ad-hoc basis and with the necessary suitability consideration and proper disclosure of conflicts of interest. The manager should act as an arranger and not as a discretionary manager.

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?

Exercising effective internal control and heightened compliance review.

Furthermore, we question the legitimacy of providing higher inducements for the distribution or sale of the issue in question compared to similar products. The sales force will be automatically biased in favour of the offering issuer, possibly to the detriment of the sales client.

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?

If the recommendation of the issue is otherwise suitable for the retail client, a disclosure of the conflicts of interests is an effective management of conflicts. The disclosure should contain: the fact that the intermediary is involved in the offering, the explanation of the nature of the offering (e.g. firm or best effort underwriting, advice to issuer etc.), the nature and relative size of remuneration, the impact of distribution and sales on such remuneration (e.g. in the case of best effort underwriting), the nature and size of remuneration - of the sales force compared to other products and the potential conscious or subconscious lack of objectivity of the investment recommendation.

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?

Internal control and compliance review of all steps of the process, in particular fair pricing, suitability of sales recommendation.

E. Lending

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?

We agree with the proposed factors.

The management of conflicts of interests depends on the information barriers set up within the intermediary and/or its group.

If a strict information barrier exists between the lending unit and the underwriting or advising unit, the responsibility for the disclosure of the precarious situation known only to insiders rests exclusively with the issuer. Infosec need not refrain from acting unless it doubts that the issuer properly informed it on its financial situation. In such a case, Infosec should refrain from acting.

If there is no information barrier or no effective information barrier between the two units, Infosec shares the responsibility for the disclosure of the financial situation and the resulting conflict of interests. Should the issuer refuse to properly disclose both elements (financial situation and resulting conflict of interest), Infosec must refrain from acting. There is not other possibility because Infosec may not be able legally to disclose the financial situation as insider knowledge without the consent of the issuer. Before disclosure of all relevant facts, Infosec cannot reasonably set a price which reflects the situation and cannot recommend the issue to any client.

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

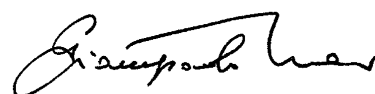
disclosures arguably meet the applicable legal requirement? How should Infosec address the situation should the disclosure not be meaningful? Please explain.

Yes, under the premises of our answer to Question 31, Infosec might have to disclose more than the mere prospectus information to its own clients. The legal requirement of prospectus disclosure must be distinguished from the contractual or fiduciary duties Infosec might have to its clients.

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)?

We do not support any requirement for crossing or overriding barriers. Such an approach discredits the institution of information barriers. It jeopardises the containment of insider knowledge. Furthermore, it creates an additional area of uncertainty of whether and when the threshold is reached which requires the crossing of the information barrier.

Yours sincerely,



Fritz H. Rau
Chairman of EFFAS

Giampaolo Trasi
Chairman of the EFFAS MSC