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Financial Conduct Authority
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Sent by email dp16-3@fca.org.uk

12 July 2016

Dear Sirs,

**Discussion Paper DP16/3
Discussion Paper on the Availability of information in the UK Equity IPO Process
Comments – The European Association of Independent Research Providers (Euro IRP)**

I am writing on behalf of Euro IRP, the trade association which represents Europe's independent research providers, in response to DP16/3, your discussion paper on the availability of information in the UK Equity IPO process.

It is very hard to imagine that someone designing things from scratch would create an IPO process in which, as DP 16/3 (1.2) puts it, "the prospectus, the key source of information on the issuer for investors, is published too late in the process for investors to be able to rely on it in their decision-making". The finding (1.7) that it is the norm that the final prospectus is published on the first day of trading is, surely, a reflection of a completely backwards state of affairs.

On this basis Euro IRP welcomes DP16/3.

Our response mostly addresses:

- **conflicts of interest in research**
- **whether there is a need for regulators to intervene**
- **the timely availability of information to investors**
- **the role of broker research (and how that might be improved)**

The Environment for Research on IPOs

We believe it might prove helpful and instructive to step back to when Euro IRP was formed over a decade ago in order to set the context.

The late '90s tech bubble had thrown up some areas of profound concern in the handling of IPOs, with some particularly colourful examples of the difference between the analyst's private views and their 'connected' research. Following this, the US initiated the Global Analyst Research Settlement. The EU meanwhile commissioned a report, produced by the Forum Group in 2003, which, amongst other things, recommended that *"companies should encourage and not restrict the attendance of analysts at financial information meetings organised in connection with an offering (for example by making attendance conditional on agreement not to publish or to submit research for review by the issuer), nor discriminate in terms of provision of information to analysts."*

Two years later, in a Robeco-led report on independent research ('IRTT') submitted, to the Commissioner DG Internal Markets, the findings of a survey of investors with AUM of EUR 1.9 trillion made the point resoundingly: *"84% of respondents indicated that a properly researched independent report would be valuable during an IPO and respondents rated the input of the independent analyst as more useful versus the input of the syndicate analyst by a ratio of 17 to 1 ... However investors also frequently cited lack of access for non-syndicate analysts as a problem e.g. "More independent due diligence would be welcome. There is a lack of independent research pre-IPO. Advisers appear to stop IPO companies from utilising independent brokers."*

Euro IRP's foundation came in the aftermath of this report, and indeed some of its founder members were established in direct response to these clear conflicts around IPOs. More than a decade on, nothing much seems to have changed. The finding (1.8), that of the 169 IPO transactions which the FCA examined, only one featured 'unconnected' research published during the IPO process, proves that point. **On this basis, there is no doubt that it is necessary for the regulator to make an intervention.**

It may be even more urgent today than 10 years ago. The upcoming research payment rules are widely believed to not just make institutions more critical about what secondary research they purchase, but also to reduce the total size of the payment pot (or budget) for that research. Meanwhile, the fees for corporate issues of all types remain extremely generous, and even more so in the U.S. where no such independent access is contemplated. At the same time talk of monitoring and preventing the cross-subsidisation of research seems to have faded. This creates an environment where there can be enormous pressure on an analyst not to upset existing or potential corporate clients by overly critical published research, both at the time of an issue, but also more generally (writing about "industry trends"). Perhaps selected top institutional investors, granted wide access to the 'connected' analysts by phone or in meetings, could potentially benefit from hearing a more nuanced view, but those who simply rely on published research, typically smaller institutions, will only hear the "official" equity story.

This does not, of course, mean that all research written by investment banks is biased, in fact some is hard-hitting and to the point, but the potential for conflict is both unarguable and often undetectable. There is a “chilling effect” which should make even the dullest analysts think twice about what they say about potential corporate clients, and there is no mechanism to stop the cross-subsidisation of “research” by fees earned in equity issuance.

This potential for conflict all comes to the fore with IPOs, conducted on a compressed timeline, and with much money at stake. The observation that the timing of information, notably the blackout period, has been developed to manage potential legal liability and perceived regulatory risks (1.3) is telling. Is this really in the interest of investors? Do we end up with a feeding frenzy without all the required information yet being out there?

We believe this DP16/3 consultation provides an opportunity for a re-think, returning to first principles. If the normal process was instead to open the information to ‘connected’ analysts and ‘unconnected’ analysts *at the same time and to the same extent*, as the Forum Report recommended a decade ago, at a stroke ‘unconnected’ analysts could do a proper job. As investors signalled in the IRTT report, ‘unconnected’ IPO research would often be given more weight than ‘connected’, but this would only be of practical benefit where the ‘unconnected’ analyst is given sufficient time to do a thorough research job.

Of course, the next question is *‘who will pay for this ‘unconnected’ research work?’* In offering any potential solution we are mindful of both the need for simplicity and avoiding the creation of new conflicts. One possible first step would be for the FCA to make clear, in the form of a letter that it deemed paying for ‘unconnected’ IPO research one proper use of the research pot, while there was no point in paying for connected research that was essentially marketing material for the IPO. While the rewards for ‘connected’ research would still probably dwarf those of ‘unconnected’ IPO research, this could be a small nudge in the right direction. Looking again at cross-subsidisation and the implicit pricing of ‘connected research’ would be a step beyond that and is at the heart of the long-term fair pricing of research.

This is a battle worth fighting. Good independent or ‘unconnected’ IPO research has the opportunity to send a warning sign for both significantly under-priced issues (to the issuer’s or seller’s detriment) or to heavily over-priced ones (to the buyer’s detriment).

The Research Process

It is understood that in an IPO process, especially in volatile markets, the issuer wants to be able to act rapidly. That said, given the fees involved, it does not make sense that the banks and lawyers cannot deliver a prospectus in a timely manner, if they so wished. Nor is there any logical reason why material that is now published when shares begin trading could not be published several weeks before (unless that material was being tailored to suit the perceived weaknesses of the equity story by the issuers). The prospectus is the document where the issuer’s management are legally bound to reveal all salient details. Therefore, a researcher giving a pricing recommendation or opinion – just like any purchasers of the equity - should be expected to have both read and analysed it.

This process takes, in our view, at least a week.

The second input is access to management which provides, broadly, four things: first, an impression of the team running the business, secondly a chance to hear about how the business works, thirdly an opportunity to hear management's ambitions for the business, and finally a chance to ask questions arising from the prospectus, and from the wider knowledge base any good analyst should have about their industry. The analyst should then have time to digest any fresh information they glean from these meetings.

We would suggest the prospectus be published two weeks before the first day of subscription and access to management be made widely available one week before, giving the buy-side and sell-side ample time to form a balanced view. In any re-design, the interests of smaller investors should be especially taken into account.

Conclusion

The most sensible solution is to provide wholly equal access for the 'connected' analyst and 'unconnected' analyst at the same time and to the same extent, as that is the only true way to fulfil the Forum Group's ambition not to "discriminate in terms of provision of information to analysts."

The tech bubble and the recent financial crisis both offer clear lessons that market practice is not always beneficial for all involved and that is where a dose of common sense really helps. In starting not with what we have now - where independent and 'unconnected' research is near impossible – but instead looking at how to fully digest and analyse the information and making release timetables fit this, a great move can be made towards more efficient and fair markets.

Specific responses to DP16/3 Annex 1

List of questions

Q1

Our main concern is that the draft prospectus is not available to providers of unconnected research, and the final prospectus is only available after pricing. As a result, there is no opportunity for truly independent scrutiny of the documentation prior to pricing. We believe a stronger price formation process with a greater transfer of knowledge to investors is more likely to lead to a sustainable price post IPO.

We therefore believe that it is critically important that there is sufficient information available to both connected and unconnected parties to help in price formation and assessment of risks, and that this "official" information is provided at the same time, and with sufficient time so that it can be fully analysed in advance of management presentations and subsequent pricing.

We would favour a one-week minimum period of access to the prospectus before any management presentations.

Q2

It is a concern that connected research is the only form of research available to investors during the price formation period. Often the analyst team preparing the connected research forms part of the bidding team and as a result, valuation expectations set during the bidding process create a conflict of interest when publishing such material. Connected research also tends to be “approved” by the company, hence is simply a re-working of the prospectus.

Q3

No comment

Q4

The blackout period is an artificial construct to protect IBs and issuers because IBs have not sought to put appropriate controls in place to separate their analysts from the issuance process.

Q5

The two main barriers for providers of unconnected research is the lack of access to the draft prospectus and then any access to management at the same time as they are available to providers of connected research, and in advance of any price formation. There also needs to be a clear gap between the provision of the draft prospectus and the management meeting so that the information can be properly analysed in advance.

If it is determined that research should continue to form part of the IPO process, then unconnected research must also form part of the process.

Q6

Absolutely.

It is worth noting that whilst “independent” corporate finance advisers ensure that the management of the issuer is well advised, they are not truly without conflict. Many large M&A transactions include more than one financial adviser, and often the second financial adviser is an independent corporate finance adviser who is recommended to the corporate by their retained IB. As a result, it is in the independent corporate finance adviser’s interests to maintain good relationships with IBs during IPO processes. That said, the role of the independent corporate finance adviser is an important one and should be best practice with a clear mandate to ensure that the process follows the new rules stemming from this review. Access to unconnected research prior to price formation also helps reduce any conflict that could exist.

Q7

Yes, regulatory intervention is required to enforce change, particularly if two related issues, both of which relate to conflicts of interest within the IPO process, are considered.

Firstly, the FCA has highlighted elsewhere that the total revenues accruing to the investment banks from the buy-side significantly outweigh the revenues earned by the banks from their corporate clients. This means that the IBs have an incentive to under-price IPOs in order to provide enhanced returns to their profitable buy-side clients at the expense of their corporate clients. The introduction of a more robust independent scrutiny of the valuation of IPOs would therefore help eliminate a major conflict of interest and improve the efficiency of a process designed to direct capital to the most efficient uses.

Secondly, the FCA's occasional paper 15 has identified that IPO allocations are routinely skewed towards buy-side firms that generate the largest research commission flows to the IBs. Again, there is a significant conflict of interest issue and a priori evidence that FCA rules are being broken. It would appear that there is an incentive for buy-side firms to use commissions to attract favourable IPO allocations, rather than using them exclusively to pay for execution or research services. This skewing of allocations demonstrates and reinforces a major failure in the investment research market, skewing payments away from independent research providers towards providers who also have a primary market business. IBs are using their concerns about legal risks to structure a process that is not in issuers/investors best interests. These risks are perfectly capable of being managed, and the fact that they have not done so, suggests no desire to create a market-led solution.

Q8

Yes, we support the high level aims as set out in DP16/3. However, the drafting refers to access to management by unconnected providers of research on a "perhaps" basis – it should be mandatory for unconnected providers of research to have equal access to management and at the same time as connected providers of research. In other markets this is accomplished in a "town hall" style meeting to which all parties are invited.

Q9

The process needs to operate in the best interests of issuers and investors, and should be enhanced by the availability of high quality analysis of the risks and prospects of an issuer prior to price formation. Connected and unconnected research can form part of the process as long as all providers have equal access to the same information and management. Research should take two forms – unconnected research – which must be separate from any IB involved in the issuance; connected research – an IB involved in the issuance, but with the analyst having a clear separation from both the bidding/"pitching" and issuance processes. Other material, where the analyst has been involved in the bidding process and/or the issuance process, should be classified as conflicted marketing material.

Q10

Yes, we agree that the simultaneous publication of the prospectus and connected research does not address the problem, which is to ensure that price is formulated with the benefit of unconnected analysis, which requires equal access to information and management to providers of connected and unconnected research. Simultaneous publication would be even worse for investors and does nothing to foster independent views.

Q11

Yes, the availability of information, and then equal access to management prior to the publication of research and then pricing, is the correct sequence of events.

Q12

Yes, equal access to management would significantly enhance the IPO process for investors.

Q13

We believe that an amended Model 3 would provide the best basis for reform:

Step 1 – ITF announcement and publication of approved registration document, followed by a gap of c.1 week allowing analysis of documents and preparation for the management presentation

Step 2 – Management presentation open equally to connected and unconnected analysts

Step 3 – Publication of connected and unconnected research as soon as practicable after meeting, say within one week

Step 4 – Marketing and pricing

Step 5 – Publication of approved securities note and start of trading

Q14

We believe that an amended Model 3 (as above) is the best approach, and any model should be underpinned by:

- 1. Information available to connected and unconnected parties prior to pricing;**
- 2. The availability of equal information at the same time to connected and unconnected parties;**
- 3. Information available sufficiently early prior to management meetings/presentations open equally to all parties; and**
- 4. IB analysts who prepare connected research to have clear separation from the bidding and issuance process and their work more clearly marked as potentially conflicted.**

Q15

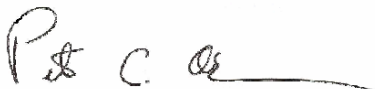
Amendments to Model 3 as set out above.

Q16

Yes, it needs to be clear whether the IB analyst is producing connected research or conflicted marketing material. IBs should decide which role they want their analyst team to perform and it should be clear to investors. If they opt for their analysts to be connected analysts those analysts must not form part of the pre-mandate team and should remain separate to the issuance team throughout the process. They should then be able to produce their research alongside unconnected research. If their analysts form part of the bidding team and/or issuance process their material should be explicitly marked as marketing material, i.e. not meeting the standard of connected research.

We will of course be available for any questions arising.

Yours sincerely,



Peter Allen, Chairman
The European Association of Independent Research Providers Limited