COMMENTS RECEIVED IN RELATION TO THE
CONSULTATION REPORT
ENTITLED

Market Intermediary Management of Conflicts that Arise in Securities Offerings

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

AUGUST 2007

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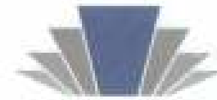
1. Investment Industry Association Canada



INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIERES

The Investment Industry Association of Canada (IIAC) appreciates the opportunity to comment on the above noted discussion paper. IIAC is the professional association representing over 200 investment dealers in Canada. Our mandate is to promote efficient, fair and competitive capital markets for Canada and assist our member firms across the country.

As demonstrated by the paper, the issue of conflicts in relation to market intermediaries is a complex topic requiring an in-depth and practical understanding of the interactions and competing interests of various market participants. We note that the paper focuses on potential and theoretical issues, but does not necessarily identify or provide evidence of an existing concern or a real market problem in this area. We hope that IOSCO will not recommend regulatory intervention in this area unless an actual market problem has been identified as significant, and all other possible solutions have been thoroughly explored and ruled out.

The paper discusses and attempts to catalogue various competing interests in the market. We are concerned that the paper characterizes all of the competing interests as conflicts or potential conflicts of interest requiring regulatory intervention or action to be taken by market intermediaries.

Buyers and sellers of products and services, inherently, have competing interests. Intermediaries, by virtue of their role in the market, often find themselves at the centre of these competing interests. We do not believe it is appropriate to suggest that intermediaries should be responsible for identifying and managing all conflicts and potential conflicts of interest that may exist in the ordinary course of business. This would place undue burden on the intermediary to assume responsibility for competing interests of other market participants, simply by virtue of its position as a middleman.

There is no doubt that there are areas of conflict that need to be identified and addressed by intermediaries. However, by focusing exclusively on potential conflicts, the business reality of the client relationship is ignored. For example, the paper expresses concern about potential conflicts where an intermediary offers both corporate banking and investment banking services to Company A. We would not characterize this as a conflict or real potential conflict of interest. Many intermediaries offer a full range of services to clients. Likewise, many clients seek out full-service firms to address, provide options and advise on their current and anticipated financial needs. Giving clients choices is not a conflict.

It may be helpful to examine the situation from the perspective of the client of the intermediary. Clients often choose to do business with an intermediary that offers a full slate of financial services, thereby consolidating their dealings and information in order to obtain an integrated approach to their business and financial needs. Although the divisions within an intermediary, such as cash management, lending and underwriting may operate as discrete units, they work towards the same objective, which is to establish, service and maintain a long-term mutually beneficial relationship with the client. Competitive market forces, which on the surface could suggest a potential conflict, actually serve a common interest, and provide the checks and balances to mitigate against any potential for intermediaries to take unfair advantage of its client relationships, without the need for regulatory intervention.

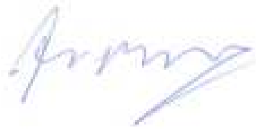
Clients are sophisticated and actively seek out expert advice and second opinions on complex business transactions. Intermediaries are professional service providers. If intermediaries put their short term internal objectives ahead of the interest and obligations owed to their clients, they will find that their credibility, reputation and relationships will be quickly compromised. This long term business relationship perspective acts to align the interests of clients and intermediaries.

The paper's recommendations that intermediaries should construct systems, extensive disclosures and processes to manage their dealings with clients for each different capacity in which they may serve them will create a complex and expensive bureaucracy and introduce inefficiencies and costs into the market that will ultimately be borne by the client for no clear benefit.

The IIAC recognizes that managing the issue of conflicts of interest is important to the integrity of the capital markets. However, we are concerned that the paper's academic perspective on this complex topic does not frame the issue in its proper business context. Ultimately, this may result in potentially unrealistic recommendations which do not take into account the expectations and sophistication of the various market participants. The paper appears to drive to conclusions about the necessity for solutions to problems that may not actually exist. Further, many of the proposed solutions could have the unintentional effect of impairing the effectiveness of the markets by introducing inefficiencies and additional costs on the very parties that the measures seek to protect.

Thank you for considering our submission. If you have any further questions or comments, please do not hesitate to contact me.

Yours sincerely,



2. The Japan Securities Dealers Association

The Japan Securities Dealers Association (JSDA) welcomes the opportunity to comment on the Consultation Report on Market Intermediary Management of Conflicts that Arise in Securities Offerings that was released by the Technical Committee in February of this year. We hope that our following comments and inputs will be of use in further consideration of this issue.

1. Scope of the Report

This consultation report covers a number of important issues related to conflicts of interest arising in securities offerings and serves as a useful material in considering systems and measures to cope with such conflicts. This said, market intermediaries are engaged in many other activities and processes, for example, merger and acquisition, or more comprehensively investment banking business in general, which involve the potential for conflicts of interest. Therefore, it is also necessary that IOSCO and securities market participants study the issues arising in other activities and processes to consider principles and measures to cope with such risks with broader perspective.

2. Description of Conflicts (P. 6, Question 1)

We believe that another reason why we need to address conflicts of interest is asymmetry of information existing between market intermediaries and investors or issuers, between clients, etc. We believe that this should be referred to somewhere in the section “D. Conflicts-Description and Importance”.

3. Examples of when to refrain from acting (P. 13, Question 6)

We have some doubt that the examples of when to refrain from acting on page 13 are all pertinent. It seems that example (a) should rather be a case that needs information barriers or restrictions and that example (b) should be addressed through disclosure of conflicts. Example (c) seems to be an example of a case where the intermediary should establish an appropriate firewall rather than refrain from acting. Also, example (d) can be responded to with rigorous examination and disclosure.

4. Reasons for overpricing (P.21-22)

Regarding possible reasons why a market intermediary may overprice securities, we think that pressures from issuers are also factors in overpricing. In Japan, there was a case in which an underwriting company overpriced the publicly offered securities under pressure from the president of the issuing company who demanded the public offering price and aggregate market value he wanted. In this case the regulatory authorities took disciplinary action.

5. Approach to allocation case (P.25, Question22)

Disclosure should be included in the approach to Example 3. In Japan, market intermediaries (all of which are members of JSDA) are required to seek wide and equal absorption of offered securities. Under this principle, they are obliged to distribute 10% or more of such securities by lot as a rule and publicize allocation procedures including criteria to distribute securities by methods other than lot. Following such transparent allocation procedures, they can reward their frequent clients to some degree to the extent that it would not considered as excessive unfair allocation to particular clients.

6. Approach to lending case (P.29, Question 32)

The Japanese regime manages such conflicts of interest as described in this case by separating a securities business entity and banking business entity and building strict information barriers between them. In our experience so far, setting up information carriers could be another possible and workable approach to such a case. In our view, the conflicts of interest in most of these cases can be managed through information barriers or appropriate penalties when failing to fulfill disclosure requirements, rather than by refraining from acting as an arranger. It seems, after all, too restrictive to limit the approaches to this case to the three that have been listed in the report.

We remain at your disposal for any further clarification.
Sincerely,

Koichi Ishikura
General Manager
International Affairs Division

3. British Bankers' Association

Introduction

The BBA is the leading UK banking and financial services trade association and acts on behalf of its members on domestic and international issues. Our 219 members are from 60 different countries and collectively provide the full range of banking and financial services. They operate some 130 million personal accounts, contribute £35bn to the economy, and together make up the world's largest international banking centre.

Than k you for the opportunity to respond to your public consultation on market intermediary management of conflicts that arise in securities offerings.

We are pleased that CESR wishes to facilitate a dialogue with industry about the circumstances under which conflicts may arise in relation to securities offerings and approaches to their management.

Principles-based approach

This consultation will be of interest to both market practitioners and investors alike. Two of the key areas both IOSCO and our members have identified in this area include management procedures and the use of membership barriers.

Our members believe that it would be more appropriate for IOSCO to develop some high-level principles in this area, in order to encourage cross-border convergence, rather than to provide a detailed set of rules.

Different jurisdictions have different ways of working, and indeed, specialise in different types of financial instruments, so a "one size fits all" would not be either workable or desirable in a global context.

Certainly, in the UK context, the Financial Services Authority is keen to develop a principles-based approach towards regulation, and we would recommend that IOSCO takes a similar approach.

IOSCO Core Principle 23

Certainly, we would be supportive of IOSCO's Core Principle 23, which requires that market intermediaries should be required to comply with standards for internal organisation and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.

This Core Principle embeds the principle-based approach, of which we are supportive. We would encourage IOSCO to set up a code of guidance in the area of conflicts of interest, so that each specific firm can develop its own internal procedures, specific to its own business model and validated by its own national

regulator, in order to ensure that whilst clients are protected, this is not achieved at the risk of an excessively commercially deleterious environment.

If you would like to discuss any of the issues raised in further detail, please contact my colleague John Ewan on 020 7216 8856 or john.ewan@bba.org.uk

Yours sincerely

Michael McKee
Executive Director – Wholesale and Regulation

4. Australian Financial Markets Association

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

The Australian Financial Markets Association (AFMA) appreciates the opportunity to provide comments on IOSCO's Consultation Report 'Market Intermediary Management of Conflicts that Arise in Securities Offerings'.

AFMA represents the interests of participants in the Australian wholesale banking and financial markets on regulatory issues that affect their business. Our members are industry leaders and comprise both Australian and foreign owned institutions, including banks and securities companies; traders in specialized financial services; and leading companies.

By way of background, we note that Australia has a comprehensive regulatory regime for the management of conflicts of interest by financial intermediaries and other financial service providers, consequent to law reform that took effect at the beginning of 2005. Our comments in this letter reflect our members' experience in the development and implementation of the law in this area.

The Report seeks information generally through questions directed towards individual firms. We address these issues from an industry association perspective, which naturally limits the scope of our response in some respects.

PART 1 – Background and Scope

The Report serves a useful purpose as a means for IOSCO and its constituent members to gain a better insight into the operation of capital markets across a range of jurisdictions. A sound understanding of market practices and discipline is an important input to the design of effective regulation, so potential benefits will flow from the exchange of information generated by the Report.

Potential IOSCO Principles

IOSCO has indicated that its work in this area may lead to it publishing a Statement of Principles for market intermediaries involved in securities offerings.
The Report does not explain why IOSCO principles might be required. The objects to be served by principles should be established and made clear before they are developed. We note that IOSCO principles are unlikely to add much value in an Australian context, given the substance of our existing regulatory regime. If IOSCO decides to issue principles, then it should consult separately on a draft set of principles.

Considerations in the Design of Principles

In our experience, the wide-ranging nature of conflicts of interest means that it is not practically possible to mandate detailed rules for their management.
Moreover, regulators in different jurisdictions would want to implement the law in a manner that is consistent with their own regulatory philosophy and the characteristics of the securities markets they regulate. Therefore, if IOSCO were to issue principles, they should be general and provide a framework for effective management of conflicts that may arise in securities offerings. For instance, detailed compliance mechanisms referred to in the Report would be out of place in such principles.

The Report recognises that retail consumers of financial services generally require a much greater protection than wholesale clients, who are more sophisticated and better placed to assess and act to protect their own interests. Wholesale markets are better placed to develop market-based solutions in response to potential problems that may emerge in the fair and efficient operation of the market. Therefore, Principles adopted in this area should specifically recognise the distinction between retail and wholesale clients, which is a cornerstone of an efficient regulatory system.

Similarly, if IOSCO were to offer detailed regulatory guidance, it would be important for regulators to distinguish between different markets in the implementation phase. In practice, the institutional and structural differences between markets affect the form and content of conflicts of interest that may arise between market intermediaries and their clients.

The Report also appropriately recognises that information barriers (Chinese walls) are an important instrument in the conflicts of interest management toolbox of financial intermediaries. They may be used to effectively manage conflicts of interest in a variety of situations so, while the general principles should confirm the valuable role of information barriers, the manner of their application is not a matter that is suitable for prescriptive guidance by IOSCO.

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

The Report states "A conflict arises where the interests of a market intermediary may be inconsistent with, or diverge from, those of its clients, investors, or others." This description of conflicts of interest is too wide to have a meaningful practical application, especially in the context of an intermediary with a diverse financial services business.

The description should be refined to reflect conflicts of interest where a financial intermediary has a duty of care to a client, there is a divergence of interest between the intermediary (or persons connected with it) and its client (or between two or more of its clients to which it owes a duty) and the conflict is of a material nature such that it might reasonably be expected to influence the behaviour of the intermediary in the provision of its services.

A better targeted definition of conflicts of interest would be consistent with the analysis in the other parts of the Report. It would also recognise that a financial intermediary may legitimately deal in some situations where their interests would differ from their client's.

We note that the Report in this section states "While not all conflicts of interest may result in harm to particular clients or diminish market integrity, all conflicts increase the risk of these outcomes (both in terms of likelihood and impact of such outcomes)"[1]. This statement could be balanced by reference to the fact that not all conflict of interest situations are bad from a client's perspective. For instance,

[1] Page 7.

some clients use full service firms because they offer a range of services and, thus, face greater conflict of interest management issues. In other words, a business structure that involves conflicts of interest (properly managed) will better serve the client in these instances than using a combination of services from independent firms.

PART 2 – Approaches for Managing Conflicts

Topic 1 – Whole of Group Approach

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?

The Australian Securities and Investments Commission (ASIC) has provided policy guidance on the law regarding the management of conflicts of interest. In addition, many international firms operating in Australia must comply with global policies. Thus, financial services licensees are conscious of their responsibilities in respect of conflict issues that might arise from their group-wide activities.

For example, one international member firm adopts a whole of group approach to conflicts management whereby business activities across all lines of business are subject to review and approval by a 'Conflicts Office'. The Conflicts Office is a centralised group with global decision making responsibility with Asia regional support. The Conflicts Office works closely with the regional Control Rooms who maintain the firm's grey and restricted lists to manage conflicts of interest around research and trading activities in the securities of companies where the firm is acting as an advisor in a Corporate Finance and/or mergers and acquisition transaction involving those companies. Business activities are also subject to approval by senior business representatives at the country/regional level.
Industry sector and product line heads provide local management oversight on conflicts management issues in addition to the centralised whole of group approach to conflicts. Monitoring of the effectiveness of the conflicts management policies and procedures is done by compliance, audit or the monitoring and surveillance functions. Senior management are also intimately involved and often make the final business decision.

More generally, the regulatory regime applying to a financial intermediary should recognise all compliance and regulatory policies that apply across a financial services group. Even if a jurisdiction, like Australia, does not have a group licensing regime for financial services providers, this should not deter the recognition of group compliance policies for conflicts of interest management and other obligations.

Care should be taken to ensure that the establishment and implementation of a group policy respects the functional independence of entities within a conglomerate, especially where they have been established to operate at arms length from the other parts of the group (as may be required by regulation in some instances). Therefore, judgement may be required in determining which entities should form part of the group for conflict of interest management purposes. Indeed, the Report suggests a group policy should reflect the nature, scale and complexity of a group's operations.

The suggestion that central conflict management committees should include independent directors may require further consideration or clarification. In particular, it would not be appropriate for directors charged with a firm's governance to become actively involved in the day-to-day business operations of a firm. In addition, the conflict management committee should have a strong

compliance presence with sufficient senior management backing to be a safeguard against conflicts of interest.

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

In a cross border context, difference in approaches between various countries may mean a consistent global policy is not possible. A global policy does not exist within the regime of a single global legal system but rather applies across many distinct legal regimes. Where necessary, the management of differences between regimes is managed by the "conflicts of laws" rules.

In addition, an entity's management in Australia would not always have authority to make decisions that would apply in other countries. The senior managers in those other countries may have an independent view.

Topic 2 – Decision Process for Addressing Conflicts

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

It may not always be possible to simply refrain from an activity without creating business or regulatory complications; for example, withdrawing from an activity may tip the market which brings the potential for conflict with market integrity rules and the interests that they represent.

Topic 3 – Refraining from Acting

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

While each of the examples suggests the need for careful consideration of business practice or transaction, we do not agree with an unequivocal statement that an intermediary should refrain from acting in each of these examples:

a. *The market intermediary is involved at the same time, in more than one corporate finance transaction, for directly competing entities* – The intermediary should not be required to refrain if the clients are properly informed and each freely agrees to the situation;
b. The distribution remuneration incentives for a securities offering are materially out of step with industry practices – While a departure from the industry norm for remuneration practices may indicate the need for closer scrutiny, it does not necessarily mean that the difference would warrant requiring the intermediary to refrain from an activity (eg a firm may promote practices that are superior to the industry norm from a regulatory perspective);
c. The employees would have access to material confidential information at or about the time of a securities offering involving the market intermediary – This example would benefit from further information (eg on the employees in question);
d. *The issuer is facing financial distress and has outstanding loans to a member of the group at the same time that the market intermediary undertakes to underwrite an offering of securities on behalf of the issuer* – See comments below on example 5.

While the exceptions we note to these examples reflect unusual circumstances, they do serve to illustrate the difficulty in developing prescriptive rules about the management of conflicts of interest when particular circumstances may vary from case to case.

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

There are many prohibitions and directives in the law that are directly relevant to the control of conflicts of interest by financial services licensees, as they explicitly set-out conduct that must be avoided – for instance:

- Insider trading;
- Dishonest, misleading or deceptive conduct;
- False and misleading statements;
- False trading and market manipulation;
- Client order priority.

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.

A checklist of information barriers is not an effective means of conflicts management. The application of such an approach could lead to a misunderstanding about the nature of conflicts management.

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

Depending upon the individual circumstances, some information barriers are more effective than others. An intermediary can have an effective framework of the conflicts management but the details vary depending upon the particular facts. To summarise, customised conflicts management procedures are the most effective.

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?

Financial intermediaries typically attach importance to the maintenance of effective internal controls, including robust information barriers between research and investment banking staff involved in a securities issue. Against this backdrop, the required legal disclosure document should be sufficient to ensure potential investors are properly informed and not exposed to unacceptable regulatory risks.

Question 12 – How do you determine what is effective disclosure?
Disclosure of conflicts should be clear, concise and effective.

In this regard, we agree with the proposition that the disclosure needs of retail and wholesale (or sophisticated) clients are different and the recommendation that this should be factored into the intermediary's assessment of its disclosure obligations.

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?

The disclosure document required by law in a securities issue should take precedence over previous research reports (where they exist) on the company issued by the intermediary. However, while reports containing industry level analysis may be issued by an intermediary, their research reports do not generally

cover private and unlisted companies and, hence, the need to withdraw research on a company that is subject to an IPO is not usual.

In some instances securities firms would only withdraw pre-existing research (research that is available on the firm's research website) where this was required by a regulatory authority.[2] We note that there is not, nor should there be, any general obligation to update research. By definition research reports have only a short "shelf life". Their relevance and usefulness erodes with time, something which is self evident.

PART 3 – Examples

The Report does not generally distinguish between debt and equity markets in its analysis, though in practice there are important structural differences between the markets (for example, in the tightness of pricing). These differences affect the form and content of conflicts of interest that may arise between market intermediaries and their clients and should be reflected in the analysis presented in the Report.

A. Advising

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?

The likelihood of such a scenario playing out is not high, as it is not reflective of general practices employed by banks and securities companies. Since the example is commercially improbable, it is not a great foundation for policy building.

In this situation the client would expect to be offered a range of funding alternatives and funding rates in the loan and debt securities markets are transparent. In addition, bank business divisions often operate independently at the client level and compete with each other internally. Moreover, as a sophisticated client, the company would be in a position to assess the quality of the advice being offered and the cost of funding (including the intermediary's margin). Besides, the example does not take account of the commercial reality of a company changing advisers if it is dissatisfied with the advice provided.

With regard to investors, once proper information disclosure is made to investors in securities (which is vital), they are aware of the investment risks. If the company in question was listed; it would be subject to continuous disclosure rules. Meanwhile, an issue of securities would be subject to separate disclosure requirements. The Report acknowledges that disclosures may be required, which in effect would deal with the conflict of interest in most situations.

In practice, the primary problem presented is not a conflict of interest issue; rather the company is not disclosing the risks appropriately. The example should be clear that it is not intended to suggest that the company's disclosure responsibility is to be shifted from the issuer to the intermediary.

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

None; remuneration should be a matter of negotiation between the parties in wholesale markets. There is no basis presented for regulation (or IOSCO

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[2] For example, the Hong Kong Takeover Code requires that in certain Mergers and Acquisitions transactions a company's financial advisor may be required to remove all published research on the target and/or bidder for the last six months from their research website following the public announcement of the transaction.

principles) to interfere in normal commercial relationships between large companies.

B. Pricing

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

The market process would determine pricing; an underestimate may reduce fees in some instances and would be transparent. Market practices such as industry and sector benchmarking provide comparisons for the purpose of pricing. A pricing range is typically agreed by the syndicate banks involved in an offer based on certain criteria including the last day's closing price and the volume weighted average price and a recommendation is made to the issuer.

More significantly, the issuer typically determines the final price for the offer in consultation with their business advisor and lead syndicate banks and having considered a number of factors (e.g. the level of demand for the offer, the pricing views of investors, market conditions etc). In addition, the business reputation of an investment banks hinges on it facilitating capital raising through effective distribution at a good price for its client. An issue will not be deemed a success if it is underpriced.

In practice, under and overpricing can only occur if there is a market failure and it is not clear that this exists here.

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.

Allocations are typically based on a number of allocation criteria agreed by the syndicate banks and the issuer and may include amongst other things:

- Price and quantity of investors' expressed interest;
- Behaviour of investors during the bidding process eg level of engagement in the marketing process, timeliness of bid;
- Expected aftermarket behaviour of investors;
- A desire for diversity of shareholder base eg institutions vs retail vs fund managers, long term vs short term shareholders, geographical mix;
- Any selling restrictions or other legal/regulatory restrictions that may apply to investors in certain jurisdictions

The final allocations are typically determined and approved by the issuer.

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?

A general framework or approach may be agreed but these can be (and often are) refined during the offer process. The "key elements" are more likely to be driven by the client than the market intermediary.

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

Question 25 – What review arrangements (if any) should the market intermediary put in place about the allocations? Who from the market intermediary should be involved in such review arrangements?
Question 26 – Who from the market intermediary should and should not make the decision about the allocation?

Any allocation preferences are normally agreed through discussions between the market intermediary and the issuer (client).

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.

Disclosure that is comprehensive and properly pitched for retail investors is an important safeguard in this situation. This should be supplemented by a range of other regulatory checks that are typically part of an effective investor protection system; for example, adequate training and support arrangements for retail client advisers.

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?

The scenario in example 5 is improbable. It is unlikely that the issuer's financial situation would not be properly disclosed in the prospectus without there being some breach of law or lack of due diligence. Apart from the legal issues, Bank X would want to consider the harm to its business reputation in the absence of proper disclosure. The likely scenario is that Bank X would be obliged to tell Infosec and it would have to refrain. It could structure and disclose the deal as distress relief and price it to compensate buyers for the risk they are undertaking. Disclosure of the bank's interest would be essential but buyers would build that into the price they would be willing to pay or terms they would demand.

Concluding Comments: A Shared Interest in Market Integrity

As an industry association, we have observed a significant commitment by senior industry participants to practices that are to a high standard and compliant with the law. Their actions in part reflect the effect of market discipline, as potential clients are reluctant to deal with entities that are have a poor track record in respecting the interests of their clients and competitors are quick to point out any deficiencies in this regard. Thus, financial intermediaries are sensitive to poor publicity, adverse comment by regulators and other consequences of a deficiency in their compliance systems. Moreover, financial intermediaries are aware that their business depends upon public confidence in their industry.

Nevertheless, it is also evident that reputation and market discipline will not always prevent dishonest or careless behaviour that leads to financial scandals, so there is an established need for industry regulation. However, regulation is costly and it is important that it is applied in the most efficient manner possible. In practice, regulators and financial services firms have a shared interest in strong financial markets and investor confidence.

Regulators can use this common ground to their advantage in the design and administration of regulation, especially with regard to the management of conflicts of interest. For example, regulators may work closely with securities firms and utilise their practical markets experience to develop the most effective response to regulatory risks. IOSCO should take account of this feature of financial markets compliance in its future analysis of the issues covered by the Report and in forming a view of the best way forward.

Thank you for considering our response to issues raised in the Consultation Report.

Yours sincerely

David Lynch
Director of Policy

5. European Federation of Financial Analysts Societies

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

Response by EFFAS - European Federation of Financial Analysts Societies

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.

<u>Topic 4 - Information barriers and restrictions</u>

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 Giampaolo
Trasi
Chairman of EFFAS Chairman of the EFFAS
MSC

6. Zentraler Kreditausschuss

ZENTRALER KREDITAUSSCHUSS

MEMBERS: BUNDESVERBAND DER DEUTSCHEN VOLKSBANKEN UND RAIFFEISENBANKEN E.V. BERLIN • BUNDESVERBAND DEUTSCHER BANKEN E.V. BERLIN
BUNDESVERBAND ÖFFENTLICHER BANKEN DEUTSCHLANDS E.V. BERLIN • DEUTSCHER SPARKASSEN- UND GIROVERBAND E.V. BERLIN-BONN
VERBAND DEUTSCHER PFANDBRIEFBANKEN E.V. BERLIN

Response of Zentraler Kreditausschuss (ZKA)[3] to OICV-IOSCO Consultation Report on "Market Intermediary Management of Conflicts that Arise in Securities Offerings" of February 2007

25. May 2007

[3] The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the *Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR)*, for the cooperative banks, the *Bundesverband deutscher Banken (BdB)*, for the private commercial banks, the *Bundesverband Öffentlicher Banken Deutschlands (VÖB)*, for the public-sector banks, the *Deutscher Sparkassen- und Giroverband (DSGV)*, for the savings banks financial group, and the *Verband deutscher Pfandbriefbanken (VDP)*, for the mortgage banks. Collectively, they represent more than 2,500 banks.

A. General remarks

We appreciate that with this consultation report IOSCO has continued the recent approach of including the market participants in the formulation of IOSCO specifications and recommendations. Therefore we gladly avail ourselves of the opportunity of commenting on the consultation report covering the management of conflicts of interests.

Generally we think it makes sense that IOSCO addresses this subject on an international level. In view of increasingly flexible, yet more complex financing arrangements for companies in the capital market and of service offers by market intermediaries based on division of labour, proper management of conflicts of interests is a big challenge for the market participants as well as for the regulatory authorities. Therefore it makes sense especially in view of the increasing cross-border integration of financing, marketing and consulting matters that the technical Committee of IOSCO endeavours to bring about an internationally consistent idea of proper handling of conflicts of interests.

Nevertheless, due to different market, legal and supervision structures in the different states the specifications issued should not be excessively detailed. IOSCO should rather restrict its activity to devising general principles (high-level principles). In this respect it is especially the examples given by IOSCO in Part 3 of the consultation report which imply a certain risk: On the one hand they are a good illustration of proper management of conflicts of interests, on the other, they tend to be too prescriptive because of their case-specific nature. IOSCO should exercise some restraint and do without excessive detail in their specifications.

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

Yes. No further comments.

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

These questions address individual market participants and can, therefore, not be answered in a general manner by banking associations such as ZKA.

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

Generally we consider these examples to be too prescriptive. There is no doubt that in the cases stated there is a conflict of interests which the intermediary must handle properly. However, this does not necessarily mean that "refraining from acting" is the only appropriate way of handling a conflict of interests. This may be the case in extreme situations, it is true, but the intermediary must have the chance to manage the conflict of interests by other means in his sole discretion (e.g. by erecting Chinese walls). For this reason we do not agree with the examples quoted.

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

This question as well cannot be answered by ZKA.

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.

We agree with IOSCO that the information barriers stated should be used under the circumstances in question (topic 4 I (i) to (iii)).

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

No. We consider the information barriers stated to be comprehensive and customary.

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

No.

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?

For issues in the European Union (EU) the Prospectus Directive (2003/71/EU) specifies the duty of comprehensive disclosure of conflicts of interests on the part of the issuer as well as the consortium bank. We think that this duty of disclosure which reflects especially the individual conditions important for placing of securities is sufficient.

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

We consider the criteria for an "effective disclosure" stated on page 16, last paragraph but one, to be appropriate and comprehensive. We do not have any more comments on this point.

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?

We do not think it makes sense to change or withdraw existing research reports prepared by the market intermediary on the issuer on the occasion of a securities issue. At any rate this applies when during preparation of the investment research care was taken to properly handle existing conflicts of interests: If at the moment of preparation of the research report there had already been a corporate finance customer relationship with the issuer, this must be pointed out in the report. Equally compliance must ensure that the preparation of the report is not influenced by special information which the market intermediary has received because of his corporate finance customer relationship with the issuer. If these specifications are observed, we do not see any reason to subsequently change or withdraw the investment report.

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

We do not think that this is a very useful example. We feel that here the subject of "conflicts of interests" is mixed up with the matter of an appropriate advice to company A. Especially the fact that Infosec receives remuneration "for arranging the offer" is not a conflict of interests to be disclosed. If equity financing by means of a share issue is not in accordance with the best interests of company A (as debt financing would be cheaper and faster), this is not a conflict of interests, either, but just inadequate advice. This may make Infosec liable to pay damages, but has nothing to do with proper handling of a conflict of interests. Thus the only relevant conflict of interests is the dual capacity of Infosec as creditor and corporate finance consultant. In our opinion this conflict should be managed by suitable countermeasures such as the erection of Chinese Walls and disclosed in the prospectus of company A.

In our opinion withdrawal from consultation is not necessary.

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 consider the IOSCO proposals for handling conflicts of interest in example 4 to be appropriate and comprehensive. We do not see any reasons why a market intermediary providing also the sales service should refrain from issue consultation. Instead, the potential conflict of interests should be managed by other suitable means (see also our answer to question 28).

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?

Market intermediaries are to ensure that the customer consultant on site advises the customer on investment with as little influence of commission payments as possible. This can mean for example that the customer consultant does not come to know the exact amount of his/her commission. However this measure can result in conflict with a potential duty to disclose the inducement to the customer (see also our answer to question 29).

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?

The European Markets in Financial Instruments Directive (MiFID) provides for such cases that the inducement granted to the investment firm by a third party (here: share issuer) is disclosed to the customer. Disclosure can be made in such a way that the customer is given a summary of the relevant commission agreement and receives detail information upon request. We consider this a coherent and adequate monitoring concept.

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 offer or the market intermediary's?

We do not consider a specific "monitoring arrangement" necessary. As long as a consistent policy of disclosure to retail investors is pursued, they are sufficiently protected as they can judge themselves whether the investment consulting they received was appropriate or not, considering the conflict of interests disclosed.

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7. Max Planck Institute

MAX PLANCK INSTITUTE
FOR COMPARATIVE AND INTERNATIONAL PRIVATE LAW

DIRECTORS: PROF. DR. DR. H.C. J. BASEDOW . PROF. DR. DR. DR. H.C. MULT. K.J. HOPT
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MAX PLANCK INSTITUTE WORKING GROUP*:

MARKET INTERMEDIARY MANAGEMENT OF CONFLICTS
THAT ARISE IN SECURITIES OFFERINGS

Comments on the Consultation Report by the Technical Committee of the International
Organization of Securities Commissions of February 2007

Hamburg (Germany), May 25th, 2007

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Introductory Remarks

Conflicts of interest are a core issue in the regulation of intermediaries. It is the very nature of the business of intermediaries to handle multiple interests. Due to the globalization of modern capital markets, conflicts of interests of intermediaries are not limited to their national business, but have also cross-border and hence global implications.

The IOSCO Consultation Report on Market Intermediary Management of Conflicts that Arise in Securities Offerings[4] is a step towards a global common core of principles in the legal treatment of intermediary conflicts of interests. Principles issued by the IOSCO will influence the approaches of security commissions and other regulators and will thus provide an important guidance for standards of good conduct by intermediaries.

The legal discussion on conflicts of interests is well developed in several fields of law. This is particularly true for conflicts of interests of company directors where comprehensive works have been presented, *inter alia*, by the English Law Commission,[5] the American Law Institute,[6] and by scholars.[7] The field has also been investigated from an interdisciplinary perspective that includes economic analysis and social theory.[8] Conflicts of interests of intermediaries have also become a focus of modern corporate governance research.[9] The future challenge for regulation will be to provide an operative framework for the ongoing changes that result from globalization, demographical developments, and the institutionalization of capital. For example, with a view to the demographic developments in Europe, the increasing need of capital market products as devices for private pensions is an important aspect.

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[4] IOSCO, Market Intermediary Management of Conflicts that Arise in Securities Offerings, Consultation Report, February 2007.

[5] Law Commission of England and Wales and Scottish Law Commission, Company Directors: Regulating Conflicts of Interests and Formulating A Statement of Duties, Law Com. no. 261, 1999, and Scot. Law Com. no. 173, 1999. See *Santow*, 2 ICCLJ 127, 129 et seq. (2000) The work of the Law Commission led to a statement of directors' duties in the new Companies Act 2006. For a discussion see the contribution to the 3rd European Jurists Meeting in 2005 by Lutter, ZSR 124 (2005) II, 415, 419, 459, and *Jänig*, RIW 2006, 270, 271.

[6] *American Law Institute*, Principles of Corporate Governance, Philadelphia 1994. See *Riley*, 16 Co. Law. 122-127 (2000), for a comparative account of the A.L.I.'s principles vis à vis the English Cadbury Code on Corporate Governance.

[7] *Hopt*, ZGR 2004, 1. Mongraphs by Krebs, Interessenkonflikte bei Aufsichtsratsmandaten in der Aktiengesellschaft, Köln 2002, and Wardenbach, Interessenkonflikte und mangelnde Sachkunde als Bestellungshindernisse zum Aufsichtsrat der AG, Köln 1996. On the ability to make dispositions on the property of others a legal fundament of fiduciary duties *Mestmäcker*, Verwaltung, Konzerngewalt und Rechte der Aktionäre, Karlsruhe 1958, p. 214, and later also *Zöllner*, Die Schranken mitgliedschaftlicher Stimmrechtsmacht bei den privatrechtlichen Personenverbänden, München, Berlin 1963, p. 342.

[8] *Hopt, Teubner*, eds., Corporate Governance and Directors' Liabilities, Berlin 1985.

[9] Several contributions in *Hopt, Wymeersch, Kanda, Baum,* eds., Corporate Governance in Context, Oxford 2005, part 5 on "Intermediaries – Functions and Responsibilities", p. 479-684, and earlier the contributions in *Hopt, Wymeersch,* eds., Capital Markets and Company Law, part 7 on "Conflicts of Interest", p. 527-570.

A theoretical fundament for the understanding of the legal role of intermediaries has been worked out by the gatekeeper debate.[10] Applications include the specific question of the intermediary's role in securities offerings.[11]

Key issues for an adequate treatment of conflicts of interests relate to the intermediary's incentives including deterrence from misconduct through liability. A cross-border assessment of liability risks should be a challenging task for the future. Liability issues have been widely excluded from the IOSCO Consultation Report. The Consultation will nevertheless lead to valuable progress in the treatment of conflicts of interest.

One of the major tasks is to work out a theoretical basis for a globally applicable description of what should be seen as amounting to conflicts of interest. Another task relates to shaping the approaches to address conflicts of interests on the basis of national and international experiences in law and practice.

The following considerations try to contribute to the achievement of these tasks in that they provide legal background-information on European and German law and, where feasible also on other national laws from both a legal and an economic perspective. For the purpose of a comprehensive answer to the questions posed by the IOSCO Consultation Report, the comments can of course only highlight some crucial issues and provide an eclectic assessment of the wider implications and functional context.

Part 1: Conflicts – Description and Importance

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

Conflicts of interest are an important issue in a variety of legal fields. Especially in the field of financial market regulation, the legal statements by IOSCO and also the European rules do not contain any comprehensive and proper definition of what constitutes a conflict of interest. Thus, the attempt to define conflicts of interest in a more general way as attempted by the Consultation Report is an important step forward.

To answer the first question, the definition provided in the Consultation Report will be examined in the following (a). Second, other sources that could be useful for a definition will be studied (b). These include other IOSCO statements, EU directives and German securities laws. Third, building on the foregoing parts, a definition for conflicts of interest will be developed that draws on the common core features of the already discussed sources (c). Fourth, the types of conflicts of interest will be discussed (d).

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[10] The term gatekeeper goes back to *Kraakman*, 2. J. L. Econ. & Org. 53, 61 (1986). For a detailed account *Coffee*, Gatekeepers, p. 1 .

[11] *Hopt,* Verantwortlichkeit der Banken bei Emissionen, München 1991.

a. The Definition in the Consultation Report

aa. The Need for a Definition
The Consultation Report undertakes the very necessary and important step of defining the term conflict of interest. So far, the regulatory and legislative institutions focused solely on certain areas where conflicts of interest could arise and thus tailored their approach always to the special issue at hand. They never developed a consistent approach to the regulation of conflicts of interest and thus never undertook to develop an abstract and comprehensive, but still operable definition for conflicts of interest. The need for such a definition is obvious and makes the currently undertaken effort by IOSCO to define the term in this Consultation Paper so important. Without a proper understanding of what a conflict of interest is, it is difficult to assess which situation amounts to a conflict of interest. Moreover, only a general definition will enable the development of a comprehensive approach to the regulation of conflicts of interest with respect to the various actors in the financial markets and their varying interests and conflicts.

bb. The Measure: The Need for Regulation
The need for a definition is determined by the need for an appropriate regulation of conflicts of interest. Thus, the need for a regulation of the phenomenon “conflicts of interest” sets the requirements and the shape of a viable and comprehensive definition. The need for a regulation of conflicts of interest is established by the regulatory aims to ensure market efficiency and protect investors. In that regard a specific focus should be laid on the economic arguments derived from the principal-agent model.

Market Efficiency and Investors' Confidence
Conflicts of interest are not limited to individual relationships. They are inherent in financial services because of the ubiquitous roles of agent and fiduciary, with their attendant duties to serve the interests of others.[12] If they are widespread, they can adversely affect the entire market. If issuers believe that intermediaries have conflicting interests and thus might offer biased services, they might look for other – perhaps less efficient – venues for their financing. Or, investors fearing the same might refrain from buying shares thus limiting the access of business to capital. From a macroeconomic viewpoint, those consequences can be dire in terms of misallocation of resources: capital markets may dry up and savings may vanish or be inefficiently invested. Conflicts of interest thus are a source of concern not only for individual principals, but also for the entire market.[13] Concerns about market effects are an important factor in the financial markets, where public confidence in the reliability of financial institutions is essential and loss of confidence in one institution can easily spill over to other institutions and the market as a whole.[14]

Principal-Agent Problems
Viewed from the perspective of economic theory, conflicts of interest pose an agency problem. Intermediaries, as agents, usually have an informational

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[12] *Boatright*, in: Davis, Stark, eds., Conflict of Interest in the Professions, Oxford 2001, 217, 219

[13] See for example *Bahar, Thévenoz,* in: Thévenoz, Bahar, eds., Conflicts of Interest, Alphen aan den Rijn 2007, 1, 4; *Hopt*, in: Ferrarini et al., eds., Reforming Company and Takeover Law in Europe, Oxford 2005, p. 51, 76.

[14] *Kruithof*, in: Thévenoz, Bahar, eds., Conflicts of Interest, Alphen aan den Rijn 2007, 277, 286.

advantage over their clients, the principals (information asymmetry). Their motives are only known to them and the outcome of many transactions are often affected not only by the agent but also by other influences, and it is difficult to discern what can be attributed solely to the agents. Hence, a principal-agent relationship always faces the risk of a moral hazard: the agent with conflicting motives has an incentive to undertake a hidden action with adverse consequences.

Faced with the risk of getting a disloyal agent, principals will adjust (meaning: lower) their expectations and the prices they are willing to pay for the agents' services. As a result, the market may suffer from so-called adverse selection: prices fall and loyal agents are priced out of the market if being honest is more costly to agents than being dishonest.[15] In these cases, due to informational inadequacies, the market is not a sufficient mechanism for managing all conflicts of interest. This will likely lead to failures in the allocation of financial resources, liquidity shortages, and other negative consequences. Hence, to ensure the efficiency of the markets, but also to protect individual investors who may not be able to fend for themselves and cannot enforce their rights alone, public regulation of conflict of interests is necessary.

cc. The Challenge: Narrowing the Definition of the Report

Against this background the challenge is to develop an abstract and comprehensive, but still narrow and operable definition of the term conflict of interest. Viewed from the perspective of the necessity of a regulation, the definition provided by the Consultation Report appears to be in need of being narrowed. According to the Consultation Report a conflict arises where the interests of a market intermediary may be inconsistent with, or diverge from, those of its clients, investors, or others.[16] In other words, a conflict of interest would be defined as a situation in which the protection or furtherance of different interests requires different actions.[17] In such a situation a choice of action necessarily implies preferring certain interests over others.

Such a definition comprises too much. Interests will conflict in any relationship, especially and necessarily in any business relationship. Every bargain, even a mere sale of goods, causes at least two different interests that are naturally opposed to each other. Each party has interests which conflict with those of the other parties. The seller wants to get a high price while the buyer wants to pay a low price. An intermediary when offering its services to clients wants to get as much business as possible and to maximize its income while the clients want to minimize their expenditures for the services rendered by the intermediary.

These situations of conflicting interests are the very reason why markets exist and why people contract with each other. Their conflicting interests do not prevent them from interacting in an exchange, because their conflicts are not as strong as their mutual interest in interacting. Thus, the desires of the buyers to buy are stronger than their desire to pay less, and the sellers' wishes to sell are stronger than their desire to be paid more. This view does change, though, when one party, i.e. the intermediary, has a discretionary margin in undertaking activities that the other party, i.e. the client, has to pay for and exploits this

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[15] *Akerlof*, 84 The Quarterly Journal of Economics 84, 488 (1970).

[16] See Consultation Report, p.6.

[17] *Kruithof*, in: Thévenoz, Bahar, eds., Conflicts of Interest, Alphen aan den Rijn 2007, 277, 278.

opportunity (e.g. in the case of "churning").[18] In a common exchange situation, however, the conflicting interests are quite clear, and each party is expected to fend for itself. Whether the parties should "help" each other in these situations is a matter of contract law. Here, the law already provides sufficient rules, like contractual rules, duties of disclosure, etc. that complement the solutions found by the parties themselves. Thus, it is not these situations that a specific "conflict of interest" regulation should address.

b. Other Sources for a Definition of Conflicts of Interest

To reformulate the definition in the Consultation Report, it would be best to use an already existing formulation for orientation. However, other IOSCO statements and reports do not contain an abstract definition. Neither do the directives of the European Union or German capital markets law. Some of them, however, contain lists of specific types of conflicts of interest. Thus, they are very helpful in developing an understanding of the common core of the various conflicts of interest.

aa. IOSCO

IOSCO has dealt with conflicts of interest with regard to various fields of capital [19]market regulation.[20] However, until today it has not issued a general definition of what should be understood as a conflict of interest. In a recent statement about financial analysts 'conflicts of interest, IOSCO addressed the specific conflicts of interest of sell side analysts.[21] For the analysis of conflicts of interest it referred to a report by its Technical Committee in preparation of this statement.[22] There the Technical Committee studied and compiled the types of conflicts of interest that analysts face.[23] However, that was done with a view towards the sources of analysts' conflicts of interest and thus remained rather specific. Another compilation of sources of conflicts of interest can be found in a report of the Technical Committee about conflicts of interests of CIS operators.

In another statement IOSCO addressed the conflicts of interest of self-regulatory organizations (SROs), especially when the SRO is responsible for the supervision of its members and the regulation of a market sector.[24] IOSCO also formulated conduct of business rules for investment firms:[25] A firm should try to avoid any conflict of interest. Where potential conflicts arise, it should ensure fair treatment of all its customers by proper disclosure, applying internal rules of confidentiality or declining to act where conflict cannot be avoided. In any case, a firm should not place its interests above those of its customers.

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[18] See e.g. *Kress*, Kapitalmarktregulierung, Wiesbaden 1996, p. 93; *Hopt*, Der Kapitalanlegerschutz im Recht der Banken, München 1975, p. 133.

[19] See e.g. the ISOCO statements discussed in the following and also IOSCO, Examination of Governance for Collective Investment Schemes, Final Report, Part I and II, June 2006 and Feb. 2007; IOSCO, Code of Conduct Fundamentals for Credit Rating Agencies, Dec. 2004.

[20] IOSCO, IOSCO Statement of Principles for Addressing Sell-Side Securities Analyst Conflicts if Interest, 25 Sept. 2003.

[21] IOSCO, Report on Analyst Conflicts of Interest, Sept. 2003.

[22] IOSCO, Report on Analyst Conflicts of Interest, Sept. 2003, p. 7 et seq.

[23] IOSCO, Conflicts of Interests of CIS Operators, Report of the Technical Committee, May 2000, p. 4 et seq. See also the conflicts of interest mentioned in IOSCO, Soft Commissions, Consultation Report, Nov. 2006, esp. p. 6 et seq.

[24] IOSCO, Objectives and Principles of Securities Regulation, May 2003.

[25] IOSCO, Objectives and Principles of Securities Regulation, May 2003, p. 35.

bb. EU Law
Similar to the IOSCO statements the EU has dealt with conflicts of interest in various fields of capital market regulation and has issued a substantial number of directives that contain provisions with regard to conflicts of interest. None of them, however, includes a definition of what a conflict of interest is.

Directives Pre-MiFID
The UCITS directive of 1985[26], as amended in 2002, provides that the UCITS management company is structured and organized in such a way as to minimize the risk of the UCITS' or the client's interests being prejudiced.[27] It tries to avoid conflicts of interest and in case that they cannot be avoided, it ensures that the UCITS or, respectively, the clients are treated fairly.[28]

The Investment Services Directive of 1993[29], the predecessor of the MiFID, contained almost exactly the same provisions as the UCITS directive.[30] The Market Abuse Directive[31] prohibits the misuse of non-public information and, more precisely, requires the disclosure of conflicts of interest in investment research and recommendations. Here for example, almost all restrictions on primary insiders are in some way related to conflicts of interest. The new rules applicable to financial analysts[32] also include provisions with regard to conflicts of interest. Analysts are not specifically forbidden to publish reports that reflect too closely the interests of the firm for which they work or hold securities. However, the analyst has to disclose significant interests and any conflict of interests[33] and his report must declare any potential conflict of interest.[34] Additionally, organizational measures, such as the separation of functions within an investment firm, are required.[35]

The MiFID
The Market in Financial Instruments Directive (MiFID) from 2004[36] and its implementing Commission Directive[37] contain the latest provisions in regard to

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[26] Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations andadministrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L 375/3 of 31 Dec. 1985, amended by Directive 2001/107/EC of the European Parliament and of the Council of 21 Jan. 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses, OJ L 41/20 of 13 Feb. 2002.
[27] Art. 5f (l)(b) of Directive 2001/107/EC.
[28] Art. 5h lit. a of Directive 2001/107/EC.
[29] Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, OJ 1993 L 141/27 of 11.06.1993.
[30] See Articles 10 and 11 of Directive 93/22/EEC.
[31] Directive 2003/6/EC of 28 January 2003, OJ, 2003 L 96/16.
[32] Commission Directive 2003/125/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest, OJ 2003 L 339/73.
[33] Art. 5 of Commission Directive 2003/125/EC.
[34] Art. 6 of Commission Directive 2003/125/EC. See also Preamble 7.
[35] Art. 6(2) of Commission Directive 2003/125/EC.
[36] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ of the EU 2004 L 145/1 of 30.04.2004, amended by Directive 2006/31/EC of the European Parliament and of the Council of 5 April 2006 amending directive 2004/39/EC on markets in financial instruments, as regards certain deadlines, OJ of the EU 2006 L 114/60 of 27.04.2006.

conflicts of interest and their regulation. No prior EU legislation has ever addressed conflicts of interest in the same depth as the MiFID. While the provisions in MiFID are of a more general nature, the implementing Commission Directive contains a number of detailed rules. The rules contain a three-step-approach. First, investment firms are required to take all reasonable steps to identify conflicts of interest.[38] Second, to prevent conflicts of interest from adversely affecting the interests of clients, investment firms have to maintain and operate effective organizational and administrative arrangements.[39] Where these organizational or administrative arrangements do not suffice, investment firms have to disclose the general nature and/or sources of conflicts of interest to the client.[40]

Neither MiFID nor the implementing Commission Directive contains a definition of a conflict of interest. The implementing Commission Directive only lists a number of situations in which a conflict of interest could arise.[41] These situations occur when the firm or a person directly or indirectly linked the firm: (1) is likely to make a financial gain, or avoid a financial loss, at the expense of its client; (2) has an interest in the outcome of a service provided to the client or of a transaction carried out on behalf of the client, which is distinct from the client's interest in that outcome; (3) has a financial or other incentive to favor the interest of another client or group of clients over the interests of the client; (4) carries on the same business as the client; (5) or receives or will receive from a person other than the client an inducement in relation to a service provided to the client, in the form of monies, goods or services, other than the standard commission or fee for that service.[42] Besides this list, the implementing Commission Directive mentions only one requirement for a conflict of interest in its preamble: There has to be a possible disadvantage or loss for the client that is affected by an investment firm's conflict of interest.[43]

cc. German Law

According to German law investment firms when acting on behalf of their clients have to observe the rule that the interests of their clients have primacy over their own interests.[44] Provisions with regard to conflicts of interests in the field of capital market law can be found in the Securities Trading Act

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[37] Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ of the EU 2006 L 241/26 of 02.09.2006. For details see also CESR, CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments 1st Set of Mandates, CESR/05-024c, Jan. 2005, esp. p. 40 et seq.; CESR, CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments 1st Set of Mandates where the deadline was extended and 2nd Set of Mandates, CESR/05-290b, April 2005, esp. p. 20 et seq.

[38] Art. 18 (1) of Directive 2004/39/EC.

[39] Art. 13 (3) of Directive 2004/39/EC.

[40] Art. 18 (2) of Directive 2004/39/EC.

[41] Art. 21 of Commission Directive 2006/73/EC. See also CESR, CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments 1st Set of Mandates, CESR/05-024c, Jan. 2005, esp. p. 42 et seq.

[42] Art. 21 of Commission Directive 2006/73/EC.

[43] Preamble 24 of Commission Directive 2006/73/EC.

[44] See *Hopt*, ZGR 2004, 1, 39. Also *Lang*, Informationspflichten bei Wertpapierdienstleistungen, München 2003, § 8 Rn. 1 m.w.N.; *Hopt*, Der Kapitalanlegerschutz im Recht der Banken, München 1975, p. 441.

(Wertpapierhandelsgesetz).[45] While insider trading rules and other provisions – implementing the Market Abuse Directive and other directives – could be regarded as conflict of interest rules, the Securities Trading Act does contain specific conflict of interest rules as well. Investment firms have to strive towards avoiding conflicts of interests, and if that is not possible they have to ensure the necessary protection of their client's interests when executing their orders.[46] Moreover, they have to be organized in a way as to minimize the risk of conflicts of interest.[47]

The Securities Trading Act does not contain a definition of what should be considered as a conflict of interest. In commentaries this term is interpreted to comprise only those interests that the client has approached the investment firm with when he placed his order.[48]

Similar to the European directives, the Securities Trading Act differentiates between avoidable and unavoidable conflicts of interest. "Unavoidable" does not mean absolutely or objectively unavoidable.[49] Such an interpretation would lead to unacceptable outcomes.[50] Hence, conflicts of interest do not have to be avoided at all costs, leading to the disintegration of established investment firms.[51] Instead, it is only necessary to avoid conflicts of interest with reasonable efforts.[52] Unavoidable conflicts of interest are those that cannot be avoided by disclosure, organizational measures, equal treatment, priority or reasonable abstention from the transaction.[53]

c. Defining conflicts of interest

The regulatory material examined so far does not contain any viable definition of conflicts of interest. However, it shows some common core features that appear to be necessary to consider when drafting a definition for the term conflicts of interest. They point towards narrowing the definition provided in the Consultation Report.

aa. Requirements for a definition of "conflict of interest"

First of all, for a conflict of interest to arise there must be a relationship between two or more persons due to which one of them has to make decisions on the behalf of the other(s).[54] Without a "decision" that has to be made, there is nothing that can be influenced. Moreover, the decision-maker must have a special interest that might prejudice – negatively affect – the decision within the relationship. Here "interest" has to be understood as any influence, concern, emotion, loyalty, etc. that makes a decision less reliable than it would have been

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[45] Gesetz über den Wertpapierhandel in der Fassung der Bekanntmachung vom 9. September 1998 (BGBl. I S. 2708), amended by Art. 1 des Gesetzes vom 5. Januar 2007 (BGBl. I S. 10). Section 384 of the Commercial Code contains a general rule on the duty of loyalty that is also applicable to investment Firms. However, the more specialized rules of the Securities Trading Act cover mostly the same issues.

[46] Section 31 (1) No. 2 of the German Securities Trading Act.

[47] Section 33 (1) No. 2 of the German Securities Trading Act.

[48] *Koller*, in: Assmann, U.H. Schneider, eds., Wertpapierhandelsgesetz, 4th ed., Köln 2006, § 31, no. 32.

[49] *Koller*, in: Assmann, U.H. Schneider, eds., Wertpapierhandelsgesetz, 4th ed., Köln 2006, § 31, no. 37.

[50] *Kümpel*, WM 1995, 689, 690; *Kümpel*, WM 1993, 2025, 2027.

[51] *Koller*, in: Assmann, U.H. Schneider, eds., Wertpapierhandelsgesetz, 4th ed., Köln 2006, § 31, no. 37.

[52] *Koller*, in: Assmann, U.H. Schneider, eds., Wertpapierhandelsgesetz, 4th ed., Köln 2006, § 31, no. 38.

[53] *Koller*, in: Assmann, U.H. Schneider, eds., Wertpapierhandelsgesetz, 4th ed., Köln 2006, § 31, no. 59.

[54] *Coleman,* Conflicts of Interest, Paper, Adelaide 2005, p. 2.

without the presence of that "interest".[55] Additionally, the conflict between the decision making and the influencing interest has to be inherent in the respective situation and not just accidental.[56]

Furthermore, the concerned individual must have a duty to decide how to act based solely on the interests of another person, whereby the choice he makes also has repercussions on his own interests (*conflict of interest and duty*) or on the interests of a third person that he is also legally bound to protect (*conflict of duties*).[57] However, the mere fact alone that someone has a personal interest in the choice he is legally required to make is not enough. Otherwise, anytime a person was under a legal duty to act in a certain way that person would by definition have a conflict of interest. In such a situation the personal interests of that person would always be affected by the choice of whether or not to abide by this duty, because breaching the duty may incur sanctions, while fulfilling the duty – and thus avoiding the sanctions – entails costs. In this sense, a person who has a legal duty will always have interests that potentially conflict with this duty.[58] Furthermore, that such duties are meant to protect the interests of others is also insufficient to constitute a "conflict of interest". All duties are intended to influence the actions of a person in order to protect the interests of others – thereby "representing" their interests. Thus, such duties owe their very existence to the fact that interests of others conflict with the actor's own interests.[59]

bb. A Necessary Requirement: Ethical or Legal Duty to Act in the Interest of Another

Hence, for a conflict of interest to arise the duty of the actor has to have a specific ccntent. It must be some kind of a ethical or legal duty to act in the interest of another.

Caveat: Different Understanding of Loyalty Duties

Such a duty has to be distinguished from the "duty of loyalty". The concept and understanding of the "duty of loyalty" differ among national laws. For example, the common law duty of loyalty and the duty of loyalty as understood in a civil law country like Germany (Interessenwahrungspflicht) are not of the same nature. In common law jurisdictions the duty of loyalty originated from the law of trusts. The duty of loyalty is a legal consequence of entrusting the trustee with the interests of the beneficiary. As it was connected to the transfer of property which the trustee originally received, the duty of loyalty possesses a distinct property law quality.[60] By contrast, civil-law jurisdictions connect the duty of loyalty to the obligations under a contract, as duties are derived from contractual agreements. Continental European jurisdictions usually do not consider conflicts of interest as such to be a problem. Decision making in a conflicted situation is not a breach of duty unless there is at least prima facie evidence of damage or undue profits.

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[55] *Davis,* 2001, 8-9; Coleman, Conflicts of Interest, Paper, p. 2.

[56] *Coleman,* Conflicts of Interest, Paper, Adelaide 2005, p. 3.

[57] *Kruithof*, in: Thévenoz, Bahar, eds., Conflicts of Interest, Alphen aan den Rijn 2007, 277, 279.

[58] *Kruithof*, in: Thévenoz, Bahar, eds., Conflicts of Interest, Alphen aan den Rijn 2007, 277, 279 et seq.

[59] *Kruithof*, in: Thévenoz, Bahar, eds., Conflicts of Interest, Alphen aan den Rijn 2007, 277, 280.

[60] *Frankel*, in: Thévenoz, Bahar, eds., Conflicts of Interest, Alphen aan den Rijn 2007, 363, 364-367.

The Ethical or Legal Duty to Act in the Interest of Another Defined
The various understandings of the "duty of loyalty" contain certain common features which are best captured by the wording "ethical or legal duty to act in the interest of another". It is very likely that such a wording could often be squared with the duty of loyalty as it is understood under the respective national law. However, to avoid any misunderstanding this definition should be regarded as independent from the respective national understanding of what constitutes a duty of loyalty.

A person who is under such a special ethical or legal duty usually has a "discretionary margin" within which he can legally judge which action is the most appropriate.[61] As long as the decision falls within the limits of his discretion, the actor cannot be accused of having breached his duty, even if the choice was not optimal.

Such a special duty constrains the actor's discretion to pursue his own interests.[62] It should prevent him from using his powers for goals other than those for which they were intended – the furthering of the interests of the beneficiary.[63] Thus, such a duty requires the person to determine his way of acting based solely or exclusively on the interests of another person. When making decisions, the person must weigh only the costs and benefits of the available alternative actions with regard to the person whose interests he is under a legal duty to protect and choose the action that maximizes those interests. He must ignore – completely disregard – the ways in which the available alternatives may affect his own interests, including those resulting from his duties to other persons.[64] Any deviation from this principle by allowing one's choice to be influenced by an interest other than the one to be protected implies a breach of the duty of loyalty. Here, there is no margin of discretion.[65]

cc. A Possible Definition
A potential definition for a conflict of interest could thus be: A conflict of interest occurs when an interest of a person interferes with the ability of that person to decide how to act in the interest of another party when that person has an ethical or legal duty to act in that other party's interest whereby interest means any influence, concern, emotion, loyalty, or other factor, that could affect the decision of that person.[66] These interests can arise for example due to financial ties, employment, business relationships, or family bonds.[67]

d. Types of Conflicts of Interest

aa. Multiple Clients: Various issuers

[61] *Cooter/Freedman*, N.Y.U.L. Rev. 66, 1045, 1046-1047 (1991); *DeMott*, 1988 Duke Law Journal 879, 908-910.
[62] *Kruithof*, in: Thévenoz, Bahar, eds., Conflicts of Interest, Alphen aan den Rijn 2007, 277, 281.
[63] *Kruithof*, in: Thévenoz, Bahar, eds., Conflicts of Interest, Alphen aan den Rijn 2007, 277, 281.
[64] *Kruithof*, in: Thévenoz, Bahar, eds., Conflicts of Interest, Alphen aan den Rijn 2007, 277, 281.
[65] *Kruithof*, in: Thévenoz, Bahar, eds., Conflicts of Interest, Alphen aan den Rijn 2007, 277, 282.
[66] See *Boatright*, in: Davies, Stark, eds., Conflict of Interest in the Professions, 2001, 217, 219.
[67] See Art. 21 of Commission Directive 2006/73/EC and Annex II of the Commission Recommendation of 15 Feb. 2005 on the role of non-executive or supervisory directors of listed companies on the committees of the (supervisory) board, OJ 2005 L 52/51 of 25 Feb. 2005.

Conflicts can arise between the interests of various issuer clients of an intermediary because opportunities and capacities of the intermediary are limited. This type of conflict may be an unavoidable cost accompanying the economies of scale created by pursuing investment banking. If intermediaries provide services for various issuers at the same time, it might be difficult for them to properly manage all the IPOs. Moreover, if it assists issuers that pursue the same or a very similar business, the issuers risk that the intermediary uses its knowledge about the issuer and its business in the IPO of the other issuer. However, due to the expert knowledge of the intermediary it might still be worthwhile for an issuer to consult an experienced intermediary, even if that intermediary handles an IPO for a competitor of the issuer.

bb. Multiple Clients: Issuer and Investors

As long as the intermediary acts solely as a selling agent to the issuer – meaning it does not have any investors as clients – it has to solely pursue the interests of its client, the issuer. However, if as in example 2 (p. 22) the intermediary (Infosec) has to care for an issuer as well as clients that want to purchase (some of) the newly issued shares, it has to serve opposing interests simultaneously, thus facing conflicts of interest. In a market transaction, seller and buyer would negotiate with each other, thereby pursuing their own interests.[68] In the situation of the pricing of an IPO the intermediary steps in between the two parties and "incorporates" these opposing interests: on the one hand it has to set a high price to cater to the interest of the issuer, and on the other hand to lower the price as much as possible to serve the interests of its investing clients. As the intermediary wants to attract business in the future, it might favor those clients that are repeat players who will bring more business in the future. Since the intermediary has to evaluate the current situation and to set the price accordingly, it has a discretionary margin. This exposes the issuer to the risk that the intermediary prejudices the issuers' interest. On the other hand, the intermediary's duty to further the interest of the issuer in trying to successfully complete the offering creates an incentive to "dump" the shares that cannot be sold into portfolios of customers that the intermediary manages.[69]

cc. Multiple Clients: Various Investors

The intermediary also faces a conflict of interest when it cannot execute all the orders of its clients that want to purchase the newly issued shares. Moreover, as in example 3 (p.24) the intermediary might be tempted to favor certain investors over others. Conflicts between differing interests of clients might also arise when some clients want to execute short sales of the newly issued shares – expecting and speculating upon a falling price.

dd. Different Services Offered

Conflicts can also arise between the interests of clients and the interests of a financial institution that also offers other financial services to the same clients. The more types of services an intermediary provides, the more conflicts of interest it will face. Whether these services are offered by the same institution or by related institutions, as in example 4 (p. 26), does not make a difference as long as the incentives to further interests other than those of the client exist. If, as in example 4, the issuance and the advice to retail clients is offered by the

[68] See supra a. cc.
[69] *Kruithof*, in: Thévenoz, Bahar, eds., Conflicts of Interest, Alphen aan den Rijn 2007, 277, 294 et seq.

same (or a related) company, clients might receive biased advice which might one-sidedly argue in favor of the issuance.

ee. Intermediary has a Stake in the Transaction
Moreover, if an intermediary also trades on its own account, it may have an interest in the consequences of the IPO, its pricing, allotment, etc. For example, if the intermediary purchases shares for itself, underpricing the issue will likely lead to a rising share price after the IPO, thus raising the value of the shares bought by the intermediary. A conflict of interest could also arise when the intermediary has granted credits and now counsels going public to recoup the credit, even though it might not be the best solution for the issuer.

Part 2: Approaches for Addressing Conflicts

As a matter of principle, the effectiveness of the approaches for addressing conflicts of interest depends on an operative definition of what conflicts of interest are. The evaluation of the approaches and answers to the questions raised in the consultation paper are provided on the basis of the foregoing description of the circumstances that should be seen as amounting to conflicts of interest. A few preliminary remarks need be made before turning to the legal approaches to address conflicts of interests:
Grouping of Legal Strategies to Address Conflicts
The legal strategies to address conflicts of interests should be evaluated according to their impact and to the restrictions they impose on individual freedom of contract and on party autonomy. A grouping of possible principles should therefore start with the duties to identify and manage conflicts as those duties involve the lowest degree of legal intervention and do not prevent the execution of a business opportunity the intermediary might have. The grouping would then turn to information barriers and dealing restrictions. The next step would be disclosure which, again, in principle does not impose any restrictions on the intermediary's business. The duty to refrain should be the last focus as such duty prevents business and thus materially limits party autonomy and freedom of contract. The extent to which these strategies require a groupwide application addresses a super ordinate issue that should be treated separately either at the beginning or at the end.

General Principles (E.G. Primacy of Client's Interest, Priority, Equality)
The evaluation of the approaches for the addressing of conflicts very much depends on fundamental principles such as the primacy of the client's interest. The primacy of the client's interest is an important principle underlying the MiFID[70] and is, for example, firmly rooted in German law[71]. It appears that this is also the spirit of the relevant international sets of rules, in particular those issued by IOSCO. For the IOSCO treatment of intermediary conflicts of interest it appears advisable to set out general principles indicating the fundaments of comprehension such as the primacy of the client's interest. Further, general principles could relate to conflicting interests of clients and to their treatment

[70] Directive 2004/39/EC of the European Parliament and of the Council of 21.4.2004 on markets in financial instruments, OJ L 145/1, 30.4.2004, Art. 19 et seq.
[71] *Hopt,* Der Kapitalanlegerschutz im Recht der Banken, München 1975, p. 440; *Schäfer,* in: Schwintowski/Schäfer, Bankrecht, 2nd ed., Köln et al. 2004, § 18 para. 33.

according to priority (first come first served) as well as to the equality of interests of distinct clients.

Topic 1 – Whole of Group Approach

The whole of group approach as set out by the IOSCO Consultation Paper in essence encompasses two aspects. One relates to the identification of conflicts of interests, the other relates to specific problems in groups of intermediaries.

Identification of Conflicts of Interest
The proposals in regard to the identification of conflicts of interest provide valuable guidance for any person with a risk of such conflicts. It therefore appears advisable not to include them into the whole of group approach but to set them out as a guidance independent of the specific group issues that are dealt with in the following paragraphs.

Whole of Group Approach
The whole of group approach is a necessary tool for addressing conflicts of interest arising within financial intermediary organizations. A group-wide policy for addressing conflicts of interest is of particular importance for bank intermediaries that operate within a universal banking system and combine credit and investment banking within one entity. Separating businesses with possible conflicts of interest would be an alternative approach. This alternative has been discussed with a view to separation of commercial and investment banking.[72]

The separation of businesses is costly and it has been argued that from an economic point of view the universal banking system is superior.[73] Traditionally, the opposition to the universal banking system was relatively strong in the U.S. With the abolition of the Glass Steagall Act in the U.S. in 1999, however, banking businesses today can also be combined in the U.S. Against this background the whole of group approach appears to be the right way ahead.

Definition of Group
One of the key challenges posed by the whole of group approach is to provide a definition of what should be considered to be a group. According to the IOSCO Consultation Paper[74] a group is any large business which includes a market intermediary as one of its business units or entities, even if it has business units or entities that provide non-financial services or products.
The MiFID[75] follows a similar approach and defines group as consisting of a parent undertaking, its subsidiaries and the entities in which the parent undertaking or its subsidiaries hold a right of participation. It is apparent that

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[72] *Hopt*, in: Festschrift Heinsius, Berlin, New York 1991, p. 289, 319.
[73] *Büschgen*, Das Universalbanksystem, Frankfurt 1971, but see also the doubts expressed by Steinherr/Huveneers, Universal Banks: The Prototype of Successful Banks in the European Market, Centre for European Studies, Brussels 1990.
[74] IOSCO, Market Intermediary Management of Conflicts that Arise in Securities Offerings, Consultation Report, February 2007, p. 9, n. 12.
[75] Directive 2004/39/EC of the European Parliament and of the Council of 21.4.2004 on markets in financial instruments, OJ L 145/1, 30.4.2004, p.1, Art. 2 No. 5.

both definitions build on the understanding of a control hierarchy known to those familiar with the concept of a law of groups of companies.

De-Facto Groups and Consortiums
Securities offerings are often handled assisted by consortiums whose members each can have their own distinct conflicts of interest. Such business co-operations can lead to a de facto group[76] — that, in regard to conflicts of interest should not be treated differently from a group in a legal sense. It could thus be advisable to expand the whole of group approach to financial intermediaries that are not part of a group characterized by a control hierarchy but of a de facto group characterized by common business goals and concerted action.

One intermediary does not have legal power to enforce good conduct by another consortium member. The intermediary should, however, be obliged to consider in his acts the conflicts of a group member. The Directive on implementation of the MiFID[77] formulates an approach that could be slightly modified and would read: Where firms act together, the policy to address conflicts of interest must also take into account any circumstances, of which the firm is or should be aware, which may give rise to conflicts of interest arising as a result of the structure and business activities of other members of a consortium or other business co-operation.

Means for Implementation
Central conflict management committees are a basic feature for addressing conflicts on a group wide basis.[78] A committee advising the intermediary in particular on a decision to refrain from arranging the offer will, however, only be a powerful monitoring device if it is able to make informed proposals which will be followed by management.

The basic problems and their possible solutions have been discussed in the international corporate governance debate and in particular in regard to audit committees on board level.[79] One of the core requirements for strong internal controls is unrestricted access to information. With regard to the critical level of internal authority the monitoring committee should be independent of management and should be subject to reporting duties only to the board of directors or its independent control committee.

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?

– no answer –

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[76] This term should not be understood in a technical sense.
[77] Commission Directive 2006/73/EC of 10.8.2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ L 241/26, 2.9.2006, Art. 22 para. 1.
[78] See the IOSCO, Market Intermediary Management of Conflicts that Arise in Securities Offerings, Consultation Report, February 2007, p. 10, para. 4 (b).
[79] Leyens, Information des Aufsichtsrats, Tübingen 2006, p. 331.

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

The practical difficulties in addressing conflicts of interests in a cross-border context are obvious. From a legal perspective, the main challenge is perhaps that the standards of addressing conflicts will differ between countries and the practice of their supervisory authorities. International principles like those discussed by the IOSCO will be a useful guidance for regulators, authorities and intermediaries. An intermediary, however, needs to set up a conflict management that will reduce the danger of misconduct to a minimum according to the applicable national law. Perhaps the most important prerequisite is a operable communication between an intermediary's control committees that operate in different countries.

Topic 2 – Decision Process for Addressing Conflicts

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

Decision Process

The process of decision making as set out in (a) to (c) is acceptable: conflicts should be identified and evaluated in regard to their severity prior to engaging in any business transaction and a possible consequence, if only as an ultima ratio, should be refraining (a).

Conflicts should be dealt with according to appropriate conflict management structures (b).

Monitoring is of particular importance and, if necessary, the approaches taken need to be modified (c).

Refraining within the Course of a Transaction

In principle, there are no doubts that the intermediary needs to refrain from handling the offer if the conflict cannot be addressed adequately (d). The decision to refrain in the course of an ongoing transaction, however, should be taken only in exceptional cases. The market will react to interruptions in an ongoing transaction and this will possibly be to the detriment of the issuer. An unexpected decision to refrain can thus considerably endanger the success of the transaction.

Against this background, it is therefore not surprising that an unexpected termination of the contractual obligations according to some national laws can cause severe liability risks. To take German law as an example, a long term contract may not be suddenly terminated if it would cause the other party harm that stands out of proportion to the conflict or benefits the avoiding party will possibly incur (Kündigung zur Unzeit). The protection from unexpected break-ups even extends to the pre-contractual period where it is unlawful to terminate negotiations without good cause (Abbruch von Vertragsverhandlungen).

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

– no answer –

Topic 3 – Refraining from Acting

Refraining as an Ultima Ratio

Refraining from taking over a business transaction is an ultima ratio approach towards conflicts of interests.77 [80]Refraining prevents dangers deriving from conflicts but it can also prevent useful synergies that could be achieved in the course of acting for two clients with similar businesses or from performing other interrelated tasks at the same time.[81] The problems surrounding a lack of objectivity or neutrality in cases of conflicting duties are well known from conflicts of interest of supervisory board members[82] and also from the ongoing discussion about the benefits or detriments of a full service concept of auditing companies performing statutory audits and accounting advice at the same time.[83]

Detrimental Effects

It is obvious that refraining can cause difficulties in the business relationship with the client. In addition it should be kept in mind that refraining by a reputable bank is a signal that can be misinterpreted by the market. Reactions by the market can undermine the success of an economically promising securities offer. Such reactions can result in negative consequences for the market as a whole, in particular if an offering in a highly competitive business sector is not executed and if the execution could have led to more accurate pricings of the already listed competitors.

Specifications of Duty to Refrain

With these possible consequences in mind it is not surprising that refraining has not yet become a specified duty under the relevant European regulatory instruments: the MiFID emphases the organizational duty to set up an operative compliance system and the duty of effective disclosure but, in principle, does not prescribe refraining.[84] Although the possible need for farther reaching measures are mentioned with a view to extreme cases there is no explicit treatment of the duty to refrain.[85] Similarly the CESR advice on the implementation of the MiFID puts a strong focus on organization and disclosure

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[80] *Bülow,* Die Bank 1993, 290, 291. With a view to financial analysts *Göres,* Die Interessenkonflikte von Wertpapierdienstleistern und -analysten bei der Wertpapieranalyse, Berlin 2004, p. 80.

[81] *Tuch,* 7 JCLS 51, 54 (2007).

[82] An example in regard to bank representatives on supervisory boards and financing a takeover will be discussed in more detail below in this section.

[83] From the perspective of gatekeeper theory *Coffee,* Gatekeepers, Oxford 2006 p. 108. See further *Cox,* in: Armour, McCahery, eds., After Enron, Oxford et al. 2006, p. 295. In detail *Marx,* Unabhängige Abschlussprüfung und Beratung, Baden-Baden 2002, p. 65.

[84] Directive 2004/39/EC of the European Parliament and of the Council of 21.4.2004 on markets in financial instruments, OJ L 145/1, 30.4.2004, p.1, Art. 18 para. 2, and Commission Regulation (EC) No. 1287/2006 of 10 August 2006, OJ L 241/1 of 2.9.2006, Art. 22.

[85] Commission Regulation (EC) No. 1287/2006 of 10 August 2006, OJ L 241/1 of 2.9.2006, Art. 22 para. 3.

but does not explicitly argue for a duty to refrain.[86] It should be mentioned, however, that the CESR advice on safeguarding the client's interests in regard to front running and on dealings of the intermediary on its own account could be read as a (indirect) reference to a duty to refrain.[87]

Against this European regulatory background the approach of the IOSCO Objectives and Principles of Securities Regulation[88] together with the proposals of the consultation paper on intermediary conflicts must be seen as an estimable try to provide operative rules for declining to act where conflicts of interests are not avoidable. Such guidance is particularly needed in a field where business interests can be materially affected as is the case where the intermediary is obliged to refrain.

The Need for Legal Certainty

Legal certainty is needed in particular for complex conflicts of interests and in cases where the conflict is unavoidable. To start with, the draft regulation by the German Federal Ministry of Finance of January 2007 reads as a word-by-word translation of the MiFID.[89] That means that – in accordance with the approaches of MiFID and also with CESR – there is no guidance on what specific measures should be taken in a situation of an unavoidable conflict. The problem of conflicting interests is dealt with in regard to the relationship between the bank and its client with a view to market manipulation and to the general standards of good conduct as set out under the German Securities Trading Act.[90]

As a general rule there is a duty of equal treatment which requires, *inter alia,* that the intermediary does not privilege institutional investors vis à vis private clients.[91] Whilst some scholars argue that there is no duty to refrain if the client has been properly informed about the conflict,[92] others argue that the bank has to refrain if it will not be able to protect the interests of the client due to conflicting interests of their own or of a third party.[93] Even this latter group of scholars finds that a legal duty to refrain will seldom occur and that it is more likely that the bank will be constrained in the marketing of a financial product and in the issuing of financial analysis and that it will have to disclose its

[86] CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments, April 2005, Box 16, p. 41, para. 2 (c): the information to clients must include, *inter alia*, a description of those practices and a discussion of how the firm manages the related conflicts.

[87] CESR's Technical Advice, ibid., Box 17, p. 43, para. 4.5.

[88] IOSCO, Objectives and Principles of Securities Regulation, May 2003, para. 12.5 (p. 37).

[89] Bundesministerium der Finanzen, Wertpapierdienstleistungs-, Verhaltens- und Organisationsverordnung WpDVerOV), Diskussionsentwurf, 30.01.2007, § 14 para. 3.

[90] See Section 31 of the German Securities Trading Act.

[91] *Koller,* in: Assmann, U.H. Schneider, eds., WpHG, 4th ed., Köln 2006, § 31 para. 76.

[92] *Grundmann,* in: Ebenroth, Boujong, Joost, eds., HGB-Kommentar, § 31 WpHG, Vol. 2, München 2001, BankR VI, para. 213.

[93] *Koller,* in: Assmann, U.H. Schneider, eds., WpHG, 4th ed., Köln 2006, § 31 Para. 58; *Einsele,* in: Schimanski, Bunte, Lwowski, eds., Bankrechts-Handbuch, Vol. 3, 2nd ed., München 2001, § 109 para. 22.

conflict[94] – an approach that is formulated in detail by the IOSCO Principles for Sell-side Analysts.[95]

Guidance to Open Issues
A set of rules on situations where refraining should be the proper reaction to conflicts of interest will also have to take into account those situations where the current state of discussion does not provide a clear answer on the question of what strategy could best serve the goal of preventing harm for the bank or the client. An example well known to company lawyers in Germany is the engagement of a bank in the financing of a takeover where the bank has a representative on the supervisory board of either the bidder or the target company.[96] This example is fitting as securities offerings can serve as a device for financing a takeover.

The Case of Deutsche Bank at the Thyssen/Krupp Takeover
An intense discussion of the issue developed from the attempt by Krupp to take over Thyssen in 1997.[97] The takeover attempt was financed by Deutsche Bank who had Ulrich Cartellieri, one of its executive directors, sitting on the supervisory board of Thyssen. This led to the conflict between the interests of the bank including those of its shareholders, the interests of the bidder company that relied on the advice of the bank, and the interests of the target company. It is obvious that a person in such situation will not be able to exclude the knowledge gained from advising the bidder when acting as a supervisory director of the target company. Cartellieri apparently "solved" the problem by pretending to be ill on the day the resolution was considered by the target's supervisory board. Indirectly, he thus gave priority to the interests of the bank and the bidder.

There is still not a clear consensus in the discussion as to what would be the optimal conduct. Some argue for full disclosure of the conflict and, on this basis, for a duty to vote on the resolution of the supervisory board.[98] The specific duties of the bank, however, are explored only by few commentators. Some recommend that the bank should refrain from the financing of the takeover but concede that – at least under German law – there is not a legal obligation to refrain.[99] Most scholars seem to (implicitly) take the view that refraining is rather an unrealistic alternative given the high profits a bank can expect from the financing of a M&A-transaction. In a broader context some even argue that refraining by the bank could lead to damage claims by the shareholders the bank represents through depository voting rights.[100]

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[94] *Koller,* in: Assmann, U.H. Schneider, eds., WpHG, 4th ed., Köln 2006, § 31 Para. 74. For a detailed treatment of examples cf. *Göres,* Die Interessenkonflikte von Wertpapierdienstleistern und –analysten bei der Wertpapieranalyse, Berlin 2004, p. 87.

[95] IOSCO, Statement of Principles for Addressing Sell-side Securities Analyst Conflicts of Interest, 25.09.2003. For details see *Göres,* Die Interessenkonflikte von Wertpapierdienstleistern und –analysten bei der Wertpapieranalyse, Berlin 2004, p. 308.

[96] See *Herkenroth,* AG 2001, 33; *Hopt,* ZGR 2002, 333, 364; *Semler/Stengel,* NZG 2003, 1, 7. In detail *Krebs,* Interessenkonflikte bei Aufsichtsratsmandaten in der Aktiengesellschaft, Köln 2002, p. 240.

[97] On the Thysssen/Krupp-Case *Herkenroth,* AG 2001, 33, 36 and 40; *Hopt,* ZGR 2002, 333, 365. In detail *Krebs,* Interessenkonflikte bei Aufsichtsratsmandaten in der Aktiengesellschaft, Köln 2002,

[98] *Hopt,* ZGR 2002, 369, 370. Cf. further *Hirte,* in: Köln. Komm. WpÜG, Köln 2002, § 27 Rn. 22. Arguing for a *right* to execute the supervisory function but against a *duty* to take part in the resolution *Harbarth,* in: Baums, Thoma, eds., WpÜG, Loose-leaf, Köln 2004 et seq., § 27 Rn. 31.

[99] *Lutter,* ZHR 145, 224, 244; *Oechsler,* NZG 2002, 817, 824; *Singhof,* AG 1998, 318, 325. For an overview of the discussion see *Lange,* WM, 1737, 1738.

[100] *Adams,* AG 19910, 243, 250.

The example of financing a takeover in a situation where the bank has a representative on the supervisory board serves as an illustration for a conflict where all mechanisms available for the ad hoc solution of conflicts of interests – including refraining – prove inadequate. It can also serve as an example for the wider implications of conflicts of interests of banks vis-à-vis the issuer in a securities offering. Since the late 1990s German banks have withdrawn their representatives from supervisory boards.[101] For Europe this trend is strengthened by the February 2005 recommendation of the European Commission on the role of independent directors.[102] Independence at the board level is also a focus of the view taken by the Basel Committee of Banking Supervision.[103]

It has been argued that the protection of investors and retail clients will only be possible if the intermediary follows rules of good conduct that will prevent or minimize conflicts of interest from the outset.[104] This approach stands in line with those that emphasize organizational duties and the prevention of conflicts rather than setting up specific duties on refraining (MiFID, CESR and also German law).[105]

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

The IOSCO proposals for circumstances where refraining from business is the only suitable reaction to conflicts of interests need to be seen in light of the rather reluctant international position towards refraining. Guidance on circumstances where refraining is advisable will be valuable. The proposals for guidance by the IOSCO consultation paper are acceptable but should consider the following additional thoughts on:

Offerings of Competing Entities

In a situation where the intermediary is already involved in a public offering of a competitor, the intermediary will normally be able and should be obliged to handle a possible conflict on a "first come, first served" basis (priority principle). It is clear that insurmountable conflicts can arise in the course of book building and retailing of the shares of two "directly" competing entities

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[101] This development was announced on a Symposium at the Hamburg Max Planck Institute for Comparative and International Private Law in 1997 by the former CEO of the Deutsche Bank. See the contribution by the former CEO of Deutsche Bank *Breuer,* in: Hopt et al. (eds.), Comparative Corporate Governance – The State, p. 537. On the wider implications for the German corporate governance system *Leyens,* GLJ 6 (2005) 1407, 1415, and in more detail *Baum,* in: *Hopt, Wymeersch, Kanda, Baum,* eds., Corporate Governance in Context, Oxford 2005, p. 3, 15 et seq., 19 et seq.

[102] Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, OJ L 52/51, 25.2.2005.

[103] Basel Committee of Banking Supervision, Enhancing Corporate Governance for Banking Organizations, February 2006 (new version, first published 1999), para. 18, 23. For details see *Mülbert,* BKR 2006, 349, 355.

[104] Pioneer work by *Hopt*, Der Kapitalanlegerschutz im Recht der der Banken, München 1974, p. 219, who argues for a duty of banks to implement standards of good conduct (unternehmensverhaltensrechtlicher Ansatz), a legal obligation that is rooted between capital market and company law.

[105] See supra.

(according to the language employed by the proposal of the IOSCO consultation paper).

Definition of "Direct" Competition
With a view to global banking and to consortiums, the range of application will need further specification. This could be phrased in a way excluding circumstances where conflicts possibly will not affect the business decisions of the intermediary: "Direct" competition should not be applicable in a situation where the offerings relate to entities within the same business sector but where the business are situated in geographically separated markets (e.g. one offering conducted in Europe the other in Asia). With a view to the whole of group approach and with regard to financial assistance by globally operating banks or consortiums, it seems further advisable to specify that there will often be no duty to refrain if operable standards of independence are duly taken into account.

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

– see Question 6 –

Topic 4 – Information Barriers and Restrictions

Information barriers (Chinese walls) are an element of the common core of a modern compliance system.[106] Chinese walls are known in Europe (MiFID[107] and Basel Committee)[108] and internationally (IOSCO)[109] as a minimum requirement for the good corporate governance of banks. The approach taken by the IOSCO consultation is very similar to that of the European Commission Directive on the implementation of the MiFID[110] and, consequently, also to that of the forthcoming German transformation law[111] as well as to that of the German Securities Commission (BaFin)[112] in its guidance on the current provisions of the German Securities Trading Act.[113] The similarities relate to both the applicable information barriers as well as the restrictions on dealing.

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[106] *Buck,* Wissen und juristische Person, Tübingen 2000, p. 499, for a detailed analysis of the implications on general agency law and imputation of knowledge within corporations.
[107] Commission Directive 2006/73/EC of 10.8.2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ L 241/26, 2.9.2006, Art. 22 para. 3 lit. a.
[108] Basel Committee of Banking Supervision, Enhancing Corporate Governance for Banking Organizations, February 2006 (new version, first published 1999), para. 28. For details see *Mülbert,* BKR 2006, 349, 357.
[109] IOSCO, Objectives and Principles of Securities Regulation, May 2003, para. 12.5 (p. 37), on internal rules of confidentiality.
[110] Supra n. 104.
[111] Bundesministerium der Finanzen, Wertpapierdienstleistungs-, Verhaltens- und Organisationsverordnung WpDVerOV), Diskussionsentwurf, 30.01.2007, § 14 para. 3 no. 1.
[112] Bundesaufsichtsamt für den Wertpapierhandel (BaWe, now BaFin), Richtlinie zur Konkretisierung der Organisationspflichten von Wertpapierdienstleistungsunternehmen gemäß § 33 Abs. 1 WpHG, 25.10.1999, Bundesanzeiger No. 210, 6.11.1999, p. 18453, para. 3.3.1. For details see *Koller,* in: Assmann, U.H. Schneider, eds., WpHG, 4th ed., Köln 2006, § 33 para. 19.
[113] Section 33 of the German Securities Trading Act.

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.

The list of circumstances when information barriers should be used according to the IOSCO consultation paper is in line with international, European and, for example, the German approaches. Against this background of convergence a few general remarks on the benefits of Chinese walls will suffice.

Law and Practice of Chinese Walls

Information barriers help to prevent conflicts of interests. However, under the national law of most jurisdictions, including Germany[114] and England,[115] they do not provide a safe harbour from liability. Under certain circumstances they can even prove to be detrimental to the reputation of the bank in the market. This is illustrated by a case in 2001 in which Deutsche Bank dealt on its own account in Telekom shares.[116] The research department had issued a buy recommendation to the bank's clients. A day later the bank sold a block of its own shares in Telekom. Contradicting business action within distinct departments of one single bank is presumably a risk inherent to Chinese walls. The German public and the media including the financial press were nonetheless disquieted.

Key Issues

With the example of Deutsche Bank in mind, two questions appear to be important. The first relates to conflicts of interests related to the information flow between financial analysts and other departments of the bank. This question is dealt with by IOSCO in its Principles for Addressing Sell-Side Securities Analyst Conflicts of Interests[117] and has been excluded from the consultation on intermediary conflicts. The second question relates to the crossing and limits of information barriers, which are not addressed in the consultation paper and will be dealt with briefly below (see question 10).

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

– see Question 10 –

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

In its formulation of principles on the prevention and treatment of intermediary conflicts the IOSCO should address the following additional issues:

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[114] *Hopt,* ZGR 2002, 333, 368; *same,* in: Festschrift Heinsius, Berlin, New York 1991, p. 289, 320; *Heermann,* WM 1997, 1689, 1696; *Buck,* Wissen und juristische Person, Tübingen 2000, p. 499 et seq.

[115] *Hollander/Salzedo,* Conflicts of Interest and Chinese Walls, London 2000, para. 2-01 (cases and common law duties and liabilities), para. 11-29 (statutory duties and liabilities).

[116] *Hopt,* ZGR 2002, 333, 368.

[117] IOSCO, Statement of Principles for Addressing Sell-Side Securities Analyst Conflicts of Interests, 25.09.2003, principle 2.2, on robust information barriers between analysts and a firm's other divisions and on prohibiting analysts from participating in banking sales pitches and road shows.

Dispensability of Information Barrier
Information barriers are installed to protect the interests of the bank's clients. Therefore they are dispensable if the client waives his right of a treatment unaffected by other interests. In the normal course of business the client can, for example, be interested in an alignment of his dealings to those the bank executes on its own account.[118]

Wall Crossing and Extent of Information Exchange
There are cases where an information barrier causes more harm than that it helps to reduce the dangers deriving from conflicts of interests that . According to the guidance provided by the German Securities Commission (BaFin), a Chinese wall can be crossed if the exchange of information is required for the performance of a task of the financial intermediary, in particular in regard to complex or high risk transactions.[119] In such situations the exchange of information should be limited to a necessary amount of information (need to know principle).[120] A wall crossing should, however, only be taken into consideration if the expected benefits for one client strongly exceed the potential harm for other clients.[121]

Monitoring Compliance
Any evasion of a restriction on the information flow should be internally monitored. Following the EU Commission Directive implementing the MiFID,[122] it appears appropriate to require notice to the compliance officer on every case of wall crossing.[123]

Organization of Information Flows
Wall crossing by top executives has led to difficulties and to doubts on the effectiveness of Chinese walls.[124] Information barriers must not exclude the board directors from the information needed for business decisions or for supervision of management. Under a number of national company laws, including Germany and England, the board as a whole, i.e. the board directors collectively, are responsible for the operations of the company. Accordingly Chinese walls end where a decision has to be taken by the board.[125] For adequate information flows it should be explored how far executive directors or members of some board committees can be excluded from sensible information in regard to daily business decisions that are taken on lower levels.[126] In turn this will require powerful internal control procedures on and below the board level.

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[118] *Koller,* in: Assmann, U.H. Schneider, eds., WpHG, 4th ed., Köln 2006, § 33 para. 27.
[119] Bundesaufsichtsamt für den Wertpapierhandel (BaWe, now BaFin), Richtlinie zur Konkretisierung der Organisationspflichten von Wertpapierdienstleistungsunternehmen gemäß § 33 Abs. 1 WpHG, 25.10.1999, Bundesanzeiger No. 210, 6.11.1999, p. 18453, para. 3.3.2.
[120] For details see *Schwark,* in: same, ed., Kapitalmarktrechts-Kommentar, 3rd ed., München 2004, § 33 WpHG para. 18.
[121] *Koller,* in: Assmann, U.H. Schneider, eds., WpHG, 4th ed., Köln 2006, § 33 para. 27.
[122] Commission Directive 2006/73/EC of 10.8.2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ L 241/26, 2.9.2006, Art. 22 para. 3 lit. a. For details see *Schlicht,* BKR 2006, 469, 472
[123] See also *Schlicht,* BKR 2006, 469, 472.
[124] *McVea,* Financial Conglomerates and the Chinese Wall, New York 1993, p. 133.
[125] *Schwark,* in: same, ed., Kapitalmarktrechts-Kommentar, 3rd ed., München 2004, § 33 WpHG para. 16.
[126] *Hollander/Salzedo,* Conflicts of Interest and Chinese Walls, London 2000, n. 11-24.

Topic 5 – Disclosure of conflicts

Disclosure of conflicts of interests is at the very core of the fiduciary duties of an agent.[127] As formulated by the English Law Commission in regard to board directors, an agent is not entitled to accrue any secret profits.[128] Financial intermediaries involved in a securities offering are therefore not allowed to profit by privileging its own interests vis-à-vis those of the issuer. If a fair treatment is not possible, the intermediary has to disclose its conflicts of interest in order to provide a basis for an informed decision of the issuer. Whilst in general this result will not be disputable, disclosure can prove to be a difficult means in some situations that will be addressed below.

Regulatory Framework
To start with an overview of the regulatory framework: The IOSCO Objectives and Principles of Securities Regulation[129] list conflict disclosure as a primary tool to safeguard the fair treatment of clients. The MiFID[130] requires disclosure where managing the conflict will not be sufficient to ensure that risks of damage to client interests will be prevented. The German Securities Trading Act does not explicitly mention conflicts disclosure and it is generally understood that there is not a general disclosure obligation.[131] Under its rules on unavoidable conflicts the Act requires the intermediary to prevent damages to the client interests. This is generally understood as an obligation to choose the appropriate means to safeguard the client's interests including disclosure of a conflict.[132] According to the leading commentaries the scope of the disclosure obligation is however limited in several regards. First, in accordance with the MiFID, disclosure is required only where managing of the conflict does not suffice. Second, disclosure is not required where insider laws or professional secrecy duties would be violated. Third, and more problematic, disclosure is necessary only if there is a certain probability that the client will act upon it, i.e. disclosure is not necessary where the client will probably not act. It is apparent that this understanding of the disclosure obligation vests the intermediary with considerable discretion in regard to foreseeing the client's actions and in regard to evaluating its implications.

Interdisciplinary Research
The discretion of the intermediary leads to more general questions on the effectiveness of disclosure. From a law and economics perspective disclosure aims at reducing the information asymmetries deriving from the superior knowledge of the intermediary. Against this background, mandatory disclosure duties are justified to prevent (1) market failure that can result from adverse selection and (2) moral hazard problems if contractual or reputation

[127] *Hopt,* ZGR 2004, 25, 51.
[128] Law Commission, Company Director's, Appendix A: Draft Statement of Directors Duties (5).
[129] IOSCO, Objectives and Principles of Securities Regulation, May 2003, para. 12.5 (p. 37).
[130] Directive 2004/39/EC of the European Parliament and of the Council of 21.4.2004 on markets in
financial instruments, OJ L 145, 30.4.2004, p.1, Art. 18 para. 2.
[131] *Schwark,* in: same, ed., Kapitalmarktrechts-Kommentar, 3rd ed., München 2004, § 31 WpHG para. 33.
[132] *Schwark,* in: same, ed., Kapitalmarktrechts-Kommentar, 3rd ed., München 2004, § 31 WpHG para. 38.

mechanisms do not generate sufficient incentives to overcome information asymmetries.

Modern behavioral economics research estimates that disclosure often has a limited impact on the solution of conflicts of interests. Studies on betting behavior indicate that fans overestimate the chances of their teams. This alludes to a more general assumption on biases. It seems that the bank and the issuer will underestimate the negative implications of the disclosed conflict and will overestimate their capacity to handle the conflict.

The economic perspective can be illustrated with regard to a multi-party situation: A is already working with bank B when A's competitor C offers to mandate B with financing his securities offering. One could think that disclosure to A would solve the problem provided A would be given a veto right against B taking up business with a competitor. In fact there is a danger of an opposite result: A might not make use of his veto right as he feels under pressure to not jeopardize the business opportunities of B because that could be detrimental to his own business relationship with B. B will underestimate the impact the conflicts of interest will have on all his business decisions. Finally, A and C might overestimate the capacity of B to handle the conflict.

The law and economics perspective does not question the existence of disclosure duties as such. It rather explains that it can be dangerous to rely on a proper exercise of the discretion by the intermediary. As a general principle disclosure duties should therefore be clearly stated if possible.

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?

To be sure, prospectus disclosure and contractual disclosure under German law and the law of other European Member States are treated as two distinct sources of information duties although the information to be provided will often be the same. The intermediary can be contractually obliged to specify his own interests in the securities offering although there might not be an obligation of such disclosure in the prospectus.

12. How do you determine what is effective disclosure?

Disclosure by itself does not have any implications on the conflicting interests. Therefore the effectiveness depends on whether the addressee will be able to act upon the information disclosed. There are two basic requirements that should be treated by the IOSCO Principles:

General Disclosure Requirements

It is apparent that disclosure needs to be timely made to be true and complete.

Specific Disclosure Requirements

A client will only be able to take an informed decision if the disclosed information is sufficiently detailed.[133] The MiFID[134] requires disclosure of "the

[133] *Hopt,* in: Festschrift Heinsius, Berlin, New York 1991, p. 289, 318.

general nature and/or sources of conflicts of interest." According to the EU regulation implementing the MiFID[135] it is required to provide sufficient details, taking into account the nature of the client, to enable that client to take an informed decision with respect to the investment or ancillary service in the context of which the conflicts of interest arises. The Draft German Transformation Law[136] resembles this approach.

As a mater of clarification it should be stated that an informed decision can only be formed if the disclosure encompasses possible consequences of the conflict on the interests of the client.[137] The specific requirements of disclosure will, of course, depend on the nature of the client.

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?

A duty to withdraw or amend existing research reports could be envisioned in a situation where, according to new information gained from assisting in the securities offering, the results of an earlier analysis have drawn a too pessimistic picture of the issuer. In essence three perspectives are possible: the duties towards the market, the contractual duties towards the issuer and the duties towards retail clients. From the position of German law, in principle there is no duty to withdraw or amend existing research reports from either of the three perspectives.

Duties towards the Market

There is no basis for assuming a duty to amend or withdraw existing research reports provided the research was conducted in accordance with the applicable standards. According to the announcement of the German Securities Commission (BaFin) of 2003[138] there is, however, a duty to update all relevant information on conflicts of interest if the analysis leaves the impression to be a new one, for example, through a change of the creation date or the contents of an existing report. This rule protects the market against being misled in regard to new conflicts of interest in the person issuing the prospectus. The duty is not invoked by the mere fact that the analyst has gained some better knowledge in the meantime. Assuming a duty to withdraw or rephrase existing financial analysis would transfer monitoring costs on the analyst which would possibly need a clear backing by legislature. Such special duties exist, for example, for the issuer in regard to a prospectus but only until the end of the offer period or

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[134] Directive 2004/39/EC of the European Parliament and of the Council of 21.4.2004 on markets in financial instruments, OJ L 145, 30.4.2004, p.1, Art. 18 para. 2.

[135] Commission Regulation (EC) No. 1287/2006 of 10 August 2006, OJ L 241/1 of 2.9.2006, Art. 22, para. 4.

[136] Bundesministerium der Finanzen, Wertpapierdienstleistungs-, Verhaltens- und Organisationsverordnung WpDVerOV), Diskussionsentwurf, 30.01.2007, § 14 para. 4.

[137] *Koller,* in: Assmann, U.H. Schneider, eds., WpHG, 4th ed., Köln 2006, § 31 para. 44. Max Planck Institute

[138] Bekanntmachung der Bundesanstalt für Finanzdienstleistungsaufsicht zur Auslegung einzelner Begriffe in § 34b Wertpapierhandelsgesetz (WpHG) vom 11. März 2003, No. 4 c). For details see *Göres,* Die Interessenkonflikte von Wertpapierdienstleistern und -analysten bei der Wertpapieranalyse, Berlin 2004, p. 244.

the beginning of trading.[139] There is no basis for deriving a general rule on withdrawal or amendment of existing research reports.

Duties towards the Issuer
The relationship of the intermediary towards the issuer does not provide a basis for assuming a duty to amend or withdraw existing research reports. The intermediary will not have been in a breach of his duties towards the issuer at the time when the report was drafted because at this time there was no contractual relationship between the intermediary and the issuer. The parties are of course free to agree on a duty of the intermediary to issue a new research report.

Duties towards other Clients
The (insider) knowledge of the intermediary gained from assisting in the securities offering can lead to modifications of the disclosure duties towards new clients. On the one hand the law on insider trading forbids the intermediary from sharing the knowledge of a higher profitability with new clients. On the other hand the intermediary should be contractually bound to not recommend a security which according to his insider knowledge will not be an investment as profitable as indicated in an earlier research report.[140] Whilst in all situations the disclosure duties towards clients can need such or similar modification there are no duties in regard to withdrawing or amending the existing research report.

Part 3: Examples of Using Mechanisms to Address Conflicts

Example 1 – Advising to Undertake a Securities Offering

The first example relates to a situation where a credit bank and an intermediary are members of a group and where the bank advises its debtor, the issuer, to raise funds through a security offering assisted by the intermediary, although debt finance would have been in the better interest of the issuer. The conflict addressed by this example arises from the bank's and the intermediary's group interest in raising funds without increasing the credit exposure of the bank. The core question is to what extent a bank has a duty to provide its client with the best possible advice.

As a preliminary note it should be mentioned that the example is most applicable to a banking system which separates the credit banking function from that of investment banking. However, it also has some scope of application in regard to the universal banking system, for example, if the universal bank advises the issuer to consult one of its branches for the financing of a securities issue.

[139] Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, of 4 November 2003, Art. 16.
[140] *Koller,* in: Assmann, U.H. Schneider, eds., WpHG, 4th ed., Köln 2006, § 31 para. 50.

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?

The proposed approaches are 'disclosure' and 'whole of group'. Before turning to the evaluation of these approaches, attention should be drawn to the question as to whether the specific mechanisms for the treatment of conflicts of interest will provide a suitable solution to situations such as the one described in the example at all.

Liability for Inaccurate Advice

The answer depends on whether the example addresses a true conflict of interest. It has been highlighted above that there is a natural polarity of interests in any contract. Example 1 concerns a business relationship where both parties, the issuer and the intermediary, pursue the naturally opposing interests of saving financing costs (issuer) vis-à-vis making fee profits (intermediary).

Disclosure is a regulatory strategy which helps to overcome information asymmetries. In regard to the naturally opposing interests of the parties there is no scope of application for disclosure as the opposition of interests is naturally known to both parties. In a long term contract, disclosure can nevertheless help to mitigate the moral hazard problem, i.e. the danger that one party deprives the other of business opportunities as a result of the business opportunities being hidden from the other party. This issue has been intensively discussed in principal-agent relationships and can be counted among the theoretical roots of agency law. It finds its specific field of application particularly in the shaping of fiduciary duties of board directors, which can be seen as a reaction of the law to the problems caused by the long-term contract between shareholders and directors.

The situation in example 1, however, differs from a long-term principal agent relation. The bank has a legitimate interest in controlling its credit exposure, including reducing it. Further, the issuer is, in principle, free to consult any advisor it believes to be qualified. It is apparent that the issuer will be under a certain pressure to follow the advice of the credit bank. This is a result of the long-term credit relationship. Further, the bank often will be able to exercise material influence on the business of the issuer by extending or shortening the line of credit. In as far as the bank does not make use of its market power in a manner contrary to good faith or beyond the limits of morality, there should not be any legal intervention in regard to the duties of the bank or the intermediary.

Against this background inaccurate advice by the credit bank should be treated in the same way any inaccurate advice by an expert is treated under national law. As in many other jurisdictions under German law, for example, inaccurate advice can lead to damage claims by the advisee that are calculated according to the situation that would have been the situation if proper advice had been given as compared to the situation that resulted from the inaccurate advice.

Conclusion

To conclude, the credit bank and the intermediary are obliged according to their contractual or pre-contractual duties to give proper advice in a situation where they are consulted in their position as experts on the question as to what manner of financing will best serve the needs of the issuer. In a case of inaccurate advice, liability for failure in the performance of their consultancy duties provides an adequate legal remedy (breach of contract or breach of pre-contractual duties). The strategy 'disclosure' should apply only if it is not apparent to the issuer that the bank and the intermediary are members of the same group. Under German law, further disclosure duties can apply if the bank receives inducement fees from its group member that provide an incentive to advise against the client's best interest (for details see example 4).

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

– see question 14 –

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

The market intermediary will have to refrain if it has reasonable cause to suspect a fraud against retail clients. This can be the case if the issuer faces a financial crisis and tries to raise funds by making fraudulent statements regarding its financial situation. In contrast, there is no reason to refrain from the mere fact that the issue will be a highly risky investment for retail clients. Applicable disclosure duties form part of the laws of prospectuses. As long as there is no good reason to believe that the issuer or the bank will breach their disclosure duties in regard to the prospectus there is no need to refrain.

– see also Example 5 –

Example 2 – Pricing

Determining the price of shares in an IPO before any trading has occurred is a difficult undertaking. The book building process attempts to mitigate this difficulty. The advantage of the book building process is its attempt to mirror the market process where continuous trading secures appropriate prices. However, it can often be difficult to balance the naturally opposed interests of the issuer and the investors. Thus, example 2 illustrates a rather common issue of the pricing process.

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

The proposed whole of group approach is an appropriate instrument to manage conflicts of interest arising during the pricing process. Moreover, it would be helpful to have a disclosure obligation of the intermediary towards the issuer. The issuer should be able to monitor and control the intermediary to enable it to protect its interests. Thus, the first mentioned factor – the issuer demanding to see the books on which the book building price was arrived at – seems to be of great importance. Even if the issuer does not possess the necessary financial knowledge, disclosure to the issuer will put the intermediary under pressure to justify the price it arrived at. Thus, disclosure (towards the issuer) should also

be listed as an approach to counter negative effects of conflicts of interest during the price building.

Damage of reputation

The reputation damage due to underpricing (the fourth factor mentioned) might be of lesser importance to the issuer compared to the others. Usually, the issuer is only a onetime player while the (institutional) investors that might pressure the intermediary to underprice the shares are repeat players dealing with the intermediary on multiple occasions. As long as potential future issuers do not become aware of a consistent and continuing approach of the intermediary to underprice shares in IPOs – a single or perceived to be just a single underpricing of an IPO could always be attributed to a onetime mistake – the intermediary will gain more from underpricing favoring its investors.

Other objectives valued by the issuer

If the issuer values other objectives more than a good price (fifth arrow) the underpricing might even be in the interest of the issuer. That would not be a case of a conflict of interest. Hence, underpricing in itself does not justify regulatory intervention. Only if the interests of the issuer are prejudiced, (additional) regulatory measures should be considered.

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

Determining the price of shares in an IPO before any trading has occurred is a difficult undertaking. The book building process attempts to mitigate this difficulty. The intermediary and the issuer are the most important participants in that process – the intermediary because it has the financial knowledge and resources to collect and assess the data needed to evaluate the share price, and the issuer because it is its shares that have to be priced and sold to the public.

Since prices reflect the demand for and the supply of a good – here shares – an evaluation without any reference to the demand side will be doomed. Hence, the opinion of potential buyers – the investors – has to be evaluated and considered. However, their view can only indicate which price might be the most appropriate. They should not be able to directly influence the finally determined price. The price setting should be left to the intermediary and ultimately to the issuer.

The advantage of the book building process is its attempt to mirror the market process where continuous trading secures appropriate prices. Therefore, other market actors and regulators such as securities commissions should be excluded from the price setting. Their role should be limited to that of a referee who monitors the conduct and ensures that the rules are followed.

19. If one of the following situations applied to the offer of securities by Company A, would that affect the processes adopted in determining the appropriate pricing of the issue of the securities in Company A: (a) Infosec had a panel of sub-underwriters associated with the offering; or (b) Infosec's

underwriting was only on a best-efforts basis; or (c) a significant percentage of the securities will be allocated to existing clients of Infosec?

Sub-underwriter
Many offerings are so complex and widespread that an intermediary is not able to arrange the offering alone. However, with each additional underwriter the potential risk of a conflict of interest and of a potential misconduct increases. If the sub-underwriters merely act as a sales force and are not responsible for setting the price, this additional risk should be limited. Only when they participate in the actual price setting does this risk become a greater concern.

Best efforts
If the intermediary merely acts on a best-efforts basis its financial interests with regard to the current IPO itself are limited (no dealing on its own account). The intermediary does not face direct negative financial consequences. That excludes an important source for conflicts of interest, as direct negative financial effects are arguably one of the most severe sources for such conflicts. The intermediary will still face potential damages to its reputation if an IPO is not successful. However, it has to weigh these risks with the damages to its reputation in the eyes of potential issuers when it fiddles with the price setting.

Clients of the intermediary
The probability of a conflict of interest increases for the intermediary with each additional client buying shares in the IPO, because each additional customer increases the probability that one of the clients will attempt to influence the intermediary in the clients' favor. However, it might be worthwhile to assess whether the number of clients or their financial power is of greater importance. One large customer who intends to invest a huge amount (and has sufficient financial knowledge to fend for its interests) might be in a better position to pressure the intermediary for a "better" price than many small (less financially educated) customers who might be easily "talked into" the newly issued shares.

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?

At first sight, it seems to be best to follow the prices during the first trading day(s) to determine whether an offering has been excessively underpriced. However, sharp price drops during the first trading day are unlikely due to the intermediaries' price management in the aftermath of the offering.

An alternative would be to analyze the grey market for the shares that are going to be issued. If the prices there are substantially above the officially determined price, that could speak in favor of an underpricing. But setting a certain percentage might prove to be difficult. There will always be a grey area where it is not possible to determine exactly when an offering is "excessively" underpriced and when it is not yet "excessively" underpriced. Thus, a percentage would have to be set rather high and could only serve as an outer limit. Such a percentage would suggest a clear dividing line, which it cannot be. It might even encourage underpricing, as such a percentage would seem to

clearly state that up to that point underpricing is not deemed to be excessive and thus not objectionable. This would in turn give every underpricing occurring up to that point a fashion of "official" justification.

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

– see remarks to question 20. –

<u>Example 3 – Allocation</u>

Example 3 addresses the difficulties in the allocation of shares if an offering is oversubscribed. In such a case the interests of the affected investors conflict as – depending on how the issue is solved – they will not receive all the shares they have ordered and/or some of them will not receive any shares at all. Moreover, the interests of the intermediary and the issuer with regard to which investors should be preferred might conflict as well.

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.

The proposed whole of group approach should help to deal with conflicts of interest arising during the allocation of securities. Moreover, disclosure could be thought about as another means to protect the interests of the issuer. As the investors become shareholders of the issuer, the latter is much more affected by the selection of prospective shareholders than the intermediary. Hence, to protect its interests the issuer should be able to monitor the allocation process.

Information barriers on the other hand will hinder the smooth and easy allocation of shares. As the investors constitute the demand side in the allocation process, it is necessary to communicate with them. Thus, any information that can be provided to them will prove helpful to square the interests of the demand side (investors) and the supply side (issuer). Information barriers would be a severe obstacle for such an attempt by preventing an informed communication, and they might even endanger the very function of the intermediary in facilitating the allocation process.

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?

– no answer –

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

As the issuer has to have the final word about who should become its future shareholders, it appears to be appropriate that the intermediary has to disclose to

the issuer all its preferences with regard to the allocation of the shares and any related conflicts of interest that somehow affect the issuer.

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?

Usually, the intermediary will have a compliance officer. If the compliance officer reviews the allocation, that should suffice. The establishment of an extensive review process would necessitate a thorough investigation into its costs and benefits. From the issuer's point of view that does not appear to be necessary. Its interests can be protected by ensuring that it has the last word with regard to the allocation and that the intermediary has to disclose all its preferences etc. to the issuer (see question 24).

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

If the intermediary has established a viable control mechanism, it should be left to the intermediary who from the intermediary should be responsible for the allocation. It could be considered having someone involved who has greater responsibility within the intermediary's organization. However, since taking care of that issue is in the personal interest of the intermediary, a rule in that regard should not be necessary.

Example 4 – Retail Advice/Distribution

Example 4 addresses a conflict that arises from the commission interest of the intermediary and from the remuneration interest of its individual employees on the one hand and the interest of the retail client on the other hand.

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.

The proposed approaches are 'whole of group' and 'disclosure'. The proposed factors that should be taken into consideration are in line with the Commission Directive implementing the MiFID[141] and thus accord to modern approaches towards conflicts of interest.

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?

An important challenge is to provide an adequate remuneration structure for retail advisers. Remuneration is a key incentive for individual advisers. The

[141] Commission Directive 2006/73/EC of 10.8.2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ L 241/26, 2.9.2006, Art.

incentives of individuals can be affected more strongly by commission payments than by the incentives attributed to the organization as a whole.

Performance related remuneration structures have been intensively discussed in regard to corporate governance and to company directors.[142] The perspective of a director, as of an employee, is focused on a much smaller period than that of the company. A strong link to the success of the company on the market, i.e. the share price, can make the director susceptible to short-sighted business decisions that ignore the long-term goals of the company (myopia problem). The retail adviser is in a similar situation. He can increase his individual profit on the short term by selling products that provide the highest commission payments. Such conduct will be profitable for a limited period only as retail clients will often not consult the intermediary again after they understood that the advice was not in their best interest. For the individual retail advisor, however, a loss of clients who are not regular customers but invest only occasionally is not necessarily a strong negative incentive.

As a basic rule remuneration should balance fixed payment and performance related elements. An independent committee should assess whether existing remuneration schemes are shaped in an optimal way (for details see question 30).

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?

As a basic principle disclosure is only effective if it enables the addressee to make an informed decision. An informed decision needs to build upon two aspects: first, the knowledge about the existence of the conflict and second, a basis for an evaluation of the consequences of the conflict, i.e. the extent to which the conflict will influence the intermediary's acts. With regard to the forthcoming implementation of the MiFID in the European member States and in particular with regard to recent developments in German case law, it seems advisable that the intermediary has a disclosure obligation if payments have been received and also the dimension of such payments.

MiFID

According to the European Directive implementing the MiFID, Member States shall ensure through minimum criteria that conflicts are identified which may arise if the firm receives or will receive from a person other than the client an inducement in relation to a service provided to the client other than the standard commission or fee for that service.[143]

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[142] *Ruffner,* Die ökonomischen Grundlagen eines Rechts der Publikumsgesellschaft – Ein Beitrag zur Theorie der Corporate Governance, Zürich 2000, p. 218.

[143] Commission Directive 2006/73/EC of 10.8.2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ L 241/26, 2.9.2006, Art. 21 lit. e.

German Case Law
Recently the German Federal Supreme Court in Civil Matters had to decide upon a case that would fall under the cited provision of the MiFID and whose facts were very similar to Example 4.[144] The court made a basic distinction between the interests of the bank that are or should be known to the retail client without specific disclosure and those that are not known to the retail client and thus will need specific disclosure.

The court assumed that the client knows about the interests of the intermediary in selling its own financial products. In the absence of contractually agreed duties of the intermediary to provide objective advice, it was held that it is not a breach of the disclosure duties if the intermediary exclusively recommends its own products without informing on the availability of alternative and/or superior products on the market. In contrast, specific disclosure is needed if the intermediary receives a commission that is linked to the volume of sales of the specific product. In such cases the retail client will only be able to make an informed decision if the intermediary discloses the dimension of the commission.

Assessment
A key challenge is to ascertain what a reasonable client will expect and what he will not expect. It has been argued that the distinction made by the German Court (and also by the MiFID) is somehow artificial.[145] To start with, a retail client knows that the intermediary has to finance the advice which is provided to the client free of charge. Therefore the retail client knows that the bank will make profits although he might not know where exactly such profits will come from. However, if a retail client expects that the intermediary has a preference to sell its own financial products, a reasonable client will also expect that the intermediary receives a commission payment.

In fact, it does not make a difference for the severity of the conflict whether the intermediary's profit interest relates to commission payments or to other sources of profits as, in particular, a group wide sharing of profits. Obliging the intermediary to disclose the dimension of its commission interest would thus lead to a general disclosure obligation in regard to the dimension of *any* profit the intermediary makes or expects. Such duty would probably go too far. It is thus advisable to address only those specific situations which are particularly likely to create conflicts of interest. With regard to the incorporation of the MiFID into the national laws of the European Member States it could become a general rule that commission payments will need to be disclosed as has recently become the position under German law.

Another aspect of the problem relates to the individual incentives of a retail adviser whose remuneration sometimes to a large part depends on commission payments and who can be under strong pressure to recommend products against the best interests of the client. Possible implications, however, should be addressed internally by a cautiously shaped remuneration structure for retail advisers and by monitoring arrangements (Question 28 and 31).

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[144] BGH, WM 2007, 487. The judgement led to a number of case notes: *Elixmann,* BB 2007, 904; *Assies,* BGHReport 2007, 408; *F. Schäfer/U. Schäfer,* BKR 2007, 163; *Hanten/Hartig,* EWiR 2007, 217; *Th. Möllers/Wenninger,* LMK 2007, 220857; *Lang,* ZIP 2007, 521.
[145] Schäfer/Schäfer, BKR 2007, 164, 165.

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?

An important focus of monitoring should be the assessment of the remuneration structures of retail advisers by an independent remuneration committee. The use of independent remuneration committees has been intensively discussed in regard to corporate governance and to director's remuneration. As a core requirement the committee needs to be as independent as possible from those who will be affected by its decisions or recommendations to the board.[146] In practice, there will be a strong need for including the remuneration levels of competitors into the assessment. Therefore the committee should consider consulting executive managers and also independent outside advisors.

Example 5 – Lending

The example concerns a severe conflict of interest between group members. The first core problem is whether and to what extent group interests should be safeguarded through an exchange of information between group members. The second problem relates to the question whether the intermediary, upon an exchange of information, should refrain from business. These issues are interwoven as the intermediary will not be able to adequately address the conflict without knowing about the extent of the financial crisis of the issuer and of the degree of engagement of the bank.

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?

Disclosure by the Issuer

It is apparent that in a situation like the one addressed by example 5 disclosure by the issuer will be unlikely. This is a consequence of the financially precarious situation of the issuer. Another aspect can be some financial pressure place upon the credit bank to pursue a securities offering. From an economic viewpoint such circumstances push the issuer into an endgame situation where financial survival depends on the success of a single alternative. In such situation reputation incentives are low and it is more rational not to disclose than to inform the intermediary about the true reasons for the offering plans.

Crossing of Information Barriers

[146] Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, OJ L 52/51, 25.2.2005, para. 3.1(2): The remuneration committee should be composed exclusively of non-executive or supervisory directors. At least a majority of its members should be independent.

The first issue to be dealt with is the information flow within the group. The intermediary is responsible only for what it knows or should know about the interests of other group members. To be sure, it should be noted that the more the intermediary knows about the real situation the more its decisions will be affected by the interests of the group and in particular by those of the bank.

A duty of the bank to cross the information barriers would lay a foundation for a (useful) gatekeeper function of the intermediary, i.e. the ability of the intermediary to assess the potential merits of the offering and, if necessary, to take a first step towards preventing an offering that could be adversarial to retail clients and to the market. If the situation is such that from a reasonable perspective any intermediary should refrain the intermediary should act accordingly. The question within the group, however is, whether the *intermediary belonging to that particular group* should refrain because of the conflicts of interest arising from the financial engagement of the bank or from other particular interests of a group member in the success of the offering.

In theory it could be assumed that information barriers will work and exclude the intermediary from any sensitive information such that it will conduct the offer in the same way any other intermediary would do. In practice, however, an intermediary will know about the credit relationship between its group member and the issuer through the results of a due diligence. Even in a situation where the financial situation of the issuer is not precarious, the intermediary should and will know that the repayment of the loans to a certain degree depend on the success of the securities offering. The conflict of interest thus appears to be hardly surmountable.

The intermediary should only assist in the offering if, according to its assessment, there is a reasonable chance for the success of the offering. This will require an objective assessment. Such assessment cannot be achieved without the information about the financial situation of the issuer and also the extent of the credit engagement of the bank including the consequences of a failure of the offering for that bank.

In consequence, a parallel lending relationship with a group member and an intermediary relationship as addressed by Example 5 requires a wall crossing by the bank (voluntary information) or by the intermediary (requesting information). The minimum informational exchange will likely encompass the information that a failure of the offering would materially impair the issuer's ability to repay the loans and also the dimension of the consequences upon the financial situation of the bank.

Refraining
Refraining is an ultima ratio. The intermediary should make an objective assessment of the financial situation of the issuer and of the extent to which the intermediary's group member depends on the success of the offering. The conflicts arising from the interest of a group member and the opposed interests of the intermediary's clients will hardly be surmountable. Therefore, it is recommendable that the intermediary refrains. Refraining will possibly be the only suitable answer to a situation where the repayment of loans to a member of the group depends to a considerable degree on the success of the offering.

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.

Disclosure to retail clients will probably not be an viable alternative.

Shortcomings of Disclosure
Retail clients normally receive adequate protection through the disclosure requirements applicable under the laws on prospectuses. To be effective in a situation as addressed in example 5, disclosure would need to be made at least on the membership of the intermediary and the bank in the same group. Retail clients, however, will still not be able to asses the extent to which the success of the offering determines the repayment of the loans to the bank. Further, retail clients can hardly evaluate to what extent the prospects of repayment will affect the intermediary's representations on the merits of the offering.

Equal Information Access
To be sure individual disclosure by the intermediary to its clients will prove unfair towards secondary purchasers or those who might purchase the product through another intermediary.[147] Arguably such information will, however, be taken up by the market and incorporated into stock prices.

Insider Dealing Restrictions
According to insider dealing restrictions the intermediary is not allowed to grant privileged information access to selected clients even if without such information they would make a financially disadvantageous decision. Under German law it has been heavily discussed whether an intermediary has a right and a corresponding duty to warn its clients through its access to privileged information of the precarious financial situation of an issuer. Some argued that such right and duty is a specific manifestation of the generally applicable legal institute of help in need (Nothilferecht). The legal basis, however, would have been the contractual relationship between intermediary and client. With the introduction of insider dealing regulations, this discussion has been overcome since a contractually based right or duty cannot overrule mandatory public laws such as those on insider dealing.

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)?

Any wall crossing will impair the effectiveness of information barriers. As example 5 illustrates information barriers sometimes can cause more harm than benefit for retail clients and markets. Wall crossings should be made on a

[147] Weber, NZG 2000, 113, 123.

regular basis in situations here insurmountable conflicts may arise. A parallel lending relationship to a member of the group is an example where a wall crossing by the intermediary and by the other group member is advisable.

Hamburg, 25 May 2007 Kumpan/Leye

8. International Council of Securities Associations

Re: Comment on IOSCO's *Market Intermediary Management of Conflicts that Arise in Securities Offerings*

We are writing on behalf of the members of the International Council of Securities Associations ("ICSA") which is composed of the trade associations and self-regulatory associations active in the world's major securities markets.[148] We would like to thank the members of Technical Committee for the work that they have done to produce the Consultation Report on *Market Intermediary Management of Conflicts that Arise in Securities Offerings* ("the Report") that was released in February of this year. We welcome the opportunity to comment on the Report.

ICSA represents organisations from a diverse range of jurisdictions and markets, each of which has its own tradition and regulatory distinctions. Because the Report addresses a relatively narrow subject in a detailed manner, this necessarily limits our capacity to provide comments on all of the specific issues that are raised in the Report. Instead, this letter will provide general comments on some aspects of the approach adopted in the Report. Individual ICSA members will provide their own more detailed comments on the Report, as appropriate.

General Principles Preferable to Prescription

Our first general comment is that the Report appears to promote an overly prescriptive, rule-based approach to managing conflicts of interest at market intermediaries arising from securities offerings. In our view the nature of conflicts of interest is such that it is not possible to mandate specific and detailed rules for their management that would adequately cover all of the potential risks. Moreover, given the wide differences that exist between regulatory regimes in different jurisdictions, ICSA members believe that if IOSCO were to contemplate principles in this area, it should focus on promoting general principles for managing conflicts of interest rather than specific rules. That approach would allow regulators in each jurisdiction to implement the principles in a manner that was consistent with their own regulatory philosophy, their domestic legal

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[148] The members of the International Council of Securities Associations (ICSA) represent and/or regulate the overwhelming majority of the world's equity and fixed income markets. ICSA's objectives are: (1) to encourage the sound growth of the international securities markets by promoting harmonization in the procedures and regulation of those markets; and (2) to promote mutual understanding and the exchange of information among ICSA members.

framework and the specific nature and characteristics of the securities markets that they regulate.

ICSA members are also concerned about the narrow focus of the Report, which looks only at conflicts of interest that arise in the IPO process. Conflicts of interest can arise in a wide range of circumstances in the provision of financial services and if IOSCO were to adopt a set of rules for each one of those situations it would lead to a great deal of unnecessary and costly regulation. Consequently, we are concerned that the Report might be a precursor to the consideration of detailed rules for the other activities of financial intermediaries. As noted above, ICSA members generally believe that conflicts of interest at market intermediaries should be addressed with broad principles that are directed toward the key risks.

Finally, if on the basis of the responses to the Report, IOSCO were to develop principles for the market intermediary management of conflicts of interest that arise in securities offerings, we believe that IOSCO should conduct a second consultation with the private sector specifically on those specific principles. We remain concerned, as noted above, that principles of this nature would be quite detailed and the Report does not explain, nor does it seem likely to elicit reasons, why such principles would be required as an alternative to allowing individual jurisdictions which have developed or are developing principles and/or rules for the management of conflicts of interest to implement those principles and/or rules within the framework of their own domestic legal and regulatory regimes. We believe that this issue needs to be considered in advance of more detailed work on global principles for managing conflicts of interest at market intermediaries.

Defining a Conflict of Interest

The definition of "conflict of interest" is a threshold issue for any form of regulatory guidance on the effective management of conflicts of interest. We note that the definition of conflict of interest used in the Report makes no reference to client relationships in the context of an intermediary with a diverse financial services business. Specifically, the Report states that, "a conflict arises where the interests of a market intermediary may be inconsistent with, or diverge from, those of its clients, investors, or others."

We believe that the definition of conflicts of interest used in the Report is incomplete since it omits potential prejudice to the client arising from a conflict of interest between the client and the market intermediary. Accordingly, we would suggest that the definition of a "conflict of interest" in the Report should be refined to reflect material conflicts of interest where a registrant has a duty of care to the client under its regulatory or common law obligations. One already developed definition of conflicts of interest that includes this broader concern is contained in the MiFID Level 2 Directive (2006/73/EC), Recital 24, which states that:

> The circumstances which should be treated as giving rise to a conflict of interest should cover cases where there is a conflict between the interests of the firm or certain persons connected to the

> firm or the firm's group and the duty the firm owes to the client; or between the differing interests of two or more of its clients, to whom the firm owes in each case a duty. It is not enough that the firm may gain a benefit if there is not also a possible disadvantage to a client, or that one client to whom the firm owes a duty may make a gain or avoid a loss without there being a concomitant possible loss to another such client.

While IOSCO may not want to use this specific definition for conflicts of interest, we would urge the Technical Committee to develop a more focused and meaningful definition of "conflicts of interest" than the one that is used in the Report.

Different Market and Client Characteristics

As noted above, ICSA members believe that IOSCO should develop global principles for managing conflicts of interest at market intermediaries, and those principles should be set at a general level. If IOSCO believes prescriptive rules are required, ICSA members would suggest that IOSCO should make it clear that the implementation of those rules in different jurisdictions would need to take into account the differences between different types of markets and clients, which may include behavioural and structural differences.

For example it would be important for any proposed rules to distinguish between debt and equity markets. In practice, the institutional and structural differences between these markets affect the form and content of conflicts of interest that may arise between market intermediaries and their clients. For example, in many jurisdictions, debt security issues do not exhibit the same degree of post-offer price volatility as equity issues, which may limit the risk of under or over pricing of those assets.

In addition, as the Report recognises, retail consumers of financial services generally require a much higher level of regulatory protection than wholesale clients, who are more sophisticated and better placed to assess and protect their own interests. Therefore it is important that rules or principles directed toward the management of conflicts of interest at market intermediaries specifically recognise the distinction between retail and wholesale clients, which is a cornerstone of an efficient regulatory system. Significant economic loss would result if retail consumer protection regulation were to be imposed on the wholesale market.

The Role of Robust Information Barriers

Information barriers ("Chinese walls") are an essential tool for the proper and efficient management of conflicts of interest by market intermediaries. Therefore, it is appropriate that the Report acknowledges the important role that is played by effective and robust information barriers in the management of conflicts of

interest. However, the manner of their application in given circumstances is not a matter that would warrant prescriptive guidance by IOSCO.

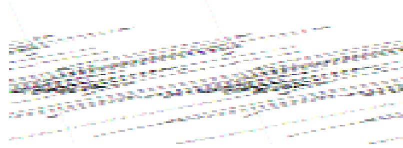
Importance of Brand or Reputation Risk

We would suggest that IOSCO should also incorporate into its analysis the effect of brand or reputation risk on the actions of market intermediaries. While reputation risk obviously does not obviate the need for regulation, nor will its presence eliminate scandals, it can assist the regulatory process by operating as an incentive to senior management to implement and enforce rigorous internal systems and controls to secure the adequacy of firms' management of conflicts of interest, especially for conglomerates and large businesses that have significant market reputations and long-term business relationships to protect. In our experience investment banks can on occasion go to exceptional lengths to protect their reputations, to the extent of placing restrictions on their activities above and beyond those that are strictly required by regulations. Firms take these actions out of self-interest, since bad publicity or client discontent from inappropriate behaviour can provoke a negative customer reaction and harm revenue streams. However, regulators can leverage off this aspect of "market discipline" to optimise the efficiency of the regulatory system, in particular when dealing with the management of conflicts of interest.

In closing, once again we would like to thank the members of IOSCO's Technical Committee for the work that they have done to produce the consultation report on *Market Intermediary Management of Conflicts that Arise in Securities Offerings.* We welcome the opportunity to comment on that report.

Representatives from the ICSA Task Force on Conflicts of Interest would be pleased to meet with IOSCO members to discuss any of the matters set forth in this letter, or to assist in any other way that would be helpful for its consideration of this issue.

Sincerely,



Marilyn Skiles
Secretary General

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Market Intermediary Management of Conflicts that arise in Securities Offerings

IOSCO Consultation – Comments by AFEI

Following its initial draft, which was put out to an informal consultation in July 2006 *(*to which AFEI submitted its preliminary comments of 21 July 2006*)*, the IOSCO Technical Committee has publicly released a consultative discussion paper entitled *Management of Conflicts that Arise in Securities Offerings*. The consultation runs until 27 May 2007.

AFEI welcomes again the opportunity to submit comments on this IOSCO consultation report, along with general observations and detailed answers to the different questions.

The French Association of Investment Firms (AFEI) represents investment service providers active in France. Its members include more than 120 investment firms and credit institutions authorised to provide investment services. Approximately one-third of AFEI members are subsidiaries or branches of foreign institutions. The AFEI is also an affiliated member of IOSCO since early April 2005.

The report touches on very important issues. The consultation process will clearly provide very valuable information regarding the existing rules and practices set up to deal with conflicts of interest in securities offerings.

In addition to this answer with specific comments related to the situation in France, AFEI participated directly in a Task Force created by ICSA (International Council of Securities Associations, which is composed of the trade associations and self-regulatory associations active in the world's major securities markets) in order to provide IOSCO with a common answer to the current consultation.

General comments

1. Background and scope – In its introductory comments, IOSCO indicates that the proposed rules concern the conduct of market intermediaries in securities offerings. Why specifically in this field? Because *"the (IOSCO) report dealt with some recent financial failures and highlighted areas of securities market regulation requiring review".*

AFEI perfectly understands that IOSCO could not let failures such as Parmalat, for example, pass without an international answer. This affair prompted much significant thinking in many countries. The common purpose of this thinking was to ensure that such situations could never happen again. However, limiting the discussion paper on conflicts of interest solely to securities offerings raises several issues:

In theory, it is clear that the discussion paper does not address conflicts of interest relating to other issues, such as investment research or derivatives trading. But looking at the proposed IOSCO report, AFEI questions the actual scope of IOSCO's conflict management proposals, which deal mainly with conflicts of interest in general and are in no way restricted to issues associated with securities offerings.
In addition, the report, which refers to securities in general, does not distinguish between debt and equity markets. In practice, there are important institutional and structural differences between these markets, which affect the form and content of conflicts of interest that may arise between market intermediaries and their clients. These institutional and structural differences should be reflected in the analysis presented in the report.

Consequently, there is a significant distortion between the objective that IOSCO appears to be pursuing and the actual content of its proposed report.

2. AFEI's proposal - dividing the document - Indeed, it seems more appropriate to divide the IOSCO proposals into two separate documents:

- A main document dealing with the management of conflicts in general, since this is the real purpose of more than 80% of the current IOSCO report.
- Supplemented as appropriate by a document detailing <u>additional</u> conflict management measures for securities offerings.

There is already a document dealing specifically with management of conflicts of interest in investment research. It would therefore make sense to have a second document for securities offerings, containing only measures linked specifically to that area, provided there is a more general document, as described above that would apply in all circumstances.

3. Compatibility of the IOSCO principles with those of MiFID and MAD – Since the Parmalat affair occurred in 2003, the situation in Europe has changed significantly, due in particular to two major European directives: the Markets in Financial Instruments Directive (MiFID) and the Market Abuse Directive (MAD). Given the local rules and principles put in place on the basis of this European legislation such failures could no longer occur.

It is important to reiterate that French and France-based market intermediaries already have appropriate principles and rules for dealing with conflicts of interest for market intermediaries in general *as well as those that may arise in the context of IPOs* ***<u>(cf appendices 1 & 2)</u>***.

But we are also aware that, occasionally, IOSCO has produced documents intended primarily for jurisdictions that do not have sufficient principles and rules for specific issues. If the principles (or rules) discussed in the report are intended principally for markets with less developed regulatory frameworks (which would include specifically the less developed emerging markets), the report should make this clear.

Furthermore it appears that the principles discussed in the report should apply to all jurisdictions. And several of its propositions, directly inspired by US regulations, are not compatible with European legislation ***(see answers to Q11, 12).*** In Europe, we need an approach that would allow regulators in each jurisdiction to implement the principles in a manner that is consistent with their own regulatory philosophy and domestic legal framework. This key issue has to be solved.

4. several important points to clarify

The same financial group – Given the central importance of this notion, it is necessary to clarify what is meant by "the same financial group" before commenting on the proposed definition ***(cf Q 1).***

The "group" concept assumes that:

- the parent financial institution can obtain information from subsidiaries through a feedback system and vice-versa,
- A member of the compliance team is responsible for preventing conflicts of interest at a “group level”.
- Under this approach, companies in which the parent holds a small equity interest are excluded from the "group".

Since this notion would have to be applied on a case-by-case basis, each "group" of financial institutions would be left to determine the scope of its own "group". AFEI calls for these ideas to be specifically incorporated into the IOSCO principles.

The bank secrecy obligation – Efficient management of conflict of interests situations at group level relies heavily on the availability of - and access to - relevant information, such as client information, etc.
Within international financial institutions, the flow of such information either between different entities of the Group and/or cross border activities is significantly impaired by the rules relating to bank secrecy or confidentiality of information and also by personal data protection rules.

Refraining from acting – To manage conflict of interest, IOSCO places the stress on the idea of not acting. Such an approach is not necessarily in the client's interest and goes well beyond the principles established by MiFID. That’s why AFEI is not in favour of overemphasising the idea of refraining from acting, which is the last resort in conflict management (with an exception, naturally, when acting is prohibited by law).

A great flexibility should be maintained regarding the choice of the approach (to decline to act, to make permanent arrangements such as information barriers or access to information, to disclose, etc.). This flexibility is essential to manage conflicts of interest situations, due to the extreme variety of situations, the parties involved, and/or the business activity within which they occur ***(as the consultation paper emphasises in p.8, section E),***

It should also be pointed that the same type of conflict of interest can be managed in very different ways because of the circumstances. As an example, to manage properly the conflicts of interests generated by multiple activities with a single client

(which are among the most current situations and an important item of the consultation paper - ***see p.4, section C among others***), one line of business could rely on information barriers (e.g. asset management) whereas another business line (e.g. general banking activities) would rely on information flows.

Over or underpricing – It is difficult to offer a principle-based response because what counts is not just the change in price but also the stability of longer-term investments. Even with good will and precautions and procedures designed to achieve the fairest possible price, market intermediaries cannot foresee every eventuality. Remember that the client has final say on the price, and that many IPOs fly initially and then collapse. The question of pricing cannot be dealt with at the level of compliance.

Setting the right price is also a question balancing the needs of an issuer/seller with those of investors. As regards efforts to establish a fair price, one of the key questions is whether this is a genuine conflict of interest or a commercial issue. When it comes to pricing, the equilibrium level is found by matching supply and demand, in other words by matching the interests of the issuer and those of the investors, with the market having the final say.

Answers to questions:

Part 1: Background and scope

Q1: Do you agree with this description of conflicts?

Point of form – Before addressing the core question, AFEI would like request clarification on the proposed description of conflicts of interest, which does not appear in italics in the discussion paper. Will this definition be specifically incorporated in the final IOSCO document?

Core question – MiFID provides a solution. It could be noted that the definition of conflicts of interest used in the report is too wide to have a meaningful practical application, especially in the context of an intermediary with a diverse financial services business. Specifically, the report states that "a conflict arises where the interests of a market intermediary may be inconsistent with, or diverge from, those of its clients, investors, or others". However, under the terms of this definition, a market maker would encounter a conflict every time it deals with a client.

The definition of a "conflict of interest" should be refined to reflect material conflicts of interest where a registrant has a duty of care to the client under its regulatory or ordinary law obligations. One possible definition of conflicts of interest could be the definition contained in the MiFID Level 2 Directive (2006/73/EC), Recital 24: "*The circumstances which should be treated as giving rise to a conflict of interest should cover cases where there is a conflict between the interests of the firm or certain persons connected to the firm or the firm's group and the duty the firm owes to the client; or between the differing interests of two or more of its clients, to whom the firm owes in each case a duty. It is not enough that the firm may gain a benefit if there is not also a possible disadvantage to a client, or that one client to whom the firm owes a duty may make a gain or avoid a loss without there being a concomitant possible loss to another such client".*

This general definition, which would be included in the proposed general document, could be accompanied by an additional definition that would specifically cover conflicts of interest in securities offerings: *"A market intermediary could have conflicts of interest in connection with securities offerings because the market intermediary often plays more than one role".*

The same financial group – Given the central importance of this notion, it is necessary to clarify what is understood by "the same financial group" before commenting on the proposed definition. The "group" concept assumes that the parent financial institution can obtain information through a feedback system (and *vice-versa*) and that a member of the compliance team has the responsibility of preventing conflicts of interest at a "group level". Under this approach, companies in which the parent company holds a small equity interest are excluded from the "group". Since this assessment would have to be performed on a case-by-case basis, each "group" of financial institutions would have to be left to determine the scope of its own "group". AFEI calls for these ideas to be specifically incorporated in the IOSCO principles.

Comments on the proposed examples:

Example 1: The proposed example is symptomatic of the difficulty involved in separating a genuine conflict of interest from issues of a commercial nature. The example highlights problems inherent to the business of investment services providers (ISPs). A fair price cannot be achieved through internal procedures or policies. Rather, it is established through the interplay of supply and demand.

A distinction needs to be made between bona fide conflicts of interest and industry-related issues. Some issues sort themselves out, e.g. through the interplay of supply and demand, while means for implementation must be deployed to address genuine conflicts.

While there is no doubt that ISPs must introduce such means, issuers must establish them at the same time, since they too are subject to regulatory constraints in this regard. The effectiveness of the overall conflict management system is dependent on this.

Example 2: Europe's response to the proposed example comes from MiFID, which requires clients to be provided with detailed documentation covering with a range of issues, including possible risks (cf Art 19, D 2004/39/EC, art 3, 27-34, 40-43, D 2006/73/EC, ***in appendix 1***).

It is important to reiterate in this regard that the fact that a group of financial institutions offers multiple services does not automatically mean that a conflict of interests is created. The question must always be asked: is this a commercial issue or a genuine compliance or regulatory conflict? Some services may complement one another and not create conflicts. For example, while there may well be real competition issues between business units, these issues cannot be equated with conflicts of interest.

Example 3: This is a standard example of a conflict of interest and would be handled by means of the Chinese wall principle.

Part 2: Approaches for addressing conflicts

The proposed approach is extremely broad and concerns management of conflicts of interest generally, regardless of the activity in question. In other words, the proposed approach cannot be viewed as being restricted to issues connected with securities offerings or placement *(cf general comments on scope).*

Q 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?

The proposed procedures match those put in place by leading financial institutions.

Policies ***b*** and ***c*** could be grouped together, and the phrase "develop appropriate means" added, since the aim is to assess and manage a specific and clearly identified set of circumstances, rather than to produce a pointless general assessment.

Point 1, b&c: *Assess and evaluate those conflicts, decide upon and implement an appropriate response****, and develop appropriate means to address those conflicts.***

It would also be appropriate to specify that the assessment by senior management ***(point 3, p. 10)*** is intended to supplement the procedure established by the compliance function.

Point 3 *… to be considered****, in addition to the assessment by the compliance function,*** *at a management level ...*

Q 3: Are there any special or particular issues in using a whole of group approach in a crossborder context?

As explained in the general comments, efficient management of conflict of interest situations at group level relies heavily on the availability of - and access to relevant information, such as client information, etc. Within international financial institutions, the flow of such information either between different entities of the Group and/or cross border is significantly impaired by bank secrecy or confidentiality of information rules and by personal data protection rules.

Another key difficulty in a cross-border context lies in accommodating the regulatory constraints of other countries. Regulatory differences between Europe and the United States continue to complicate relations unnecessarily.

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

Again, we wish to point out that IOSCO proposes a very general decision process that does not concern placement only. The IOSCO process is broadly consistent with the one used by the large institutions that belong to AFEI.

In the description of the decision process, the term *"the interest of a client"* should be deleted because it is ambiguous and replaced by **"***if the interests of a client cannot be properly protected (among others by disclosure)".*

Secondly, it does not necessarily make sense to place *refraining* at **a,** given that refraining from acting is only one possibility and the last resort when it comes to resolving a conflict (with an exception, naturally, when acting is prohibited by law). This extreme solution should be replaced by the notion of avoidance, since the basic idea is to avoid acting against the interests of the client and/or to make disclosures. Further, ***a*** and ***b*** should be switched to show the order in which solutions should be considered.

On a more general basis, unless there are external constraints (such as a legal prohibition on, say, misuse of privileged information), great flexibility should be

maintained regarding the choice of the approach (to decline to act, to make permanent arrangements such as information barriers or access to information, to disclose, etc.). This flexibility is essential to manage conflicts of interest situations, due to the extreme variety of situations, the parties involved, and/or the business activity within which they occur *(as the consultation paper emphasises in p.8, section E),*

It should also be pointed that the same type of conflict of interest can be managed in very different ways because of the circumstances. As an example, to manage properly the conflicts of interests generated by multiple activities with a single client (which are among the most current situations and an important item of the consultation paper - *see p.4, section C among others*), one line of business could rely on information barriers (e.g. asset management) whereas another business line (e.g. general banking activities) would rely on information flows.

a*) First, if the conduct (..) is such that the conduct would be prohibited by law****, ~~or the interests of a client cannot be properly protected~~*** *or* **if the interests of a client cannot be properly protected *(among others by disclosure)*** *then the market intermediary should* ***~~refrain~~ avoid acting …, idem b) …****obvious reason to* ***~~refrain~~ avoid acting … d) …*** *the intermediary should* ***~~refrain~~ avoid acting (p. 12)***

Q 5: What process does your firm employ to determine if your conflict management process is effective?

An audit- and/or inspection-based control process is used. Compliance makes sure that potential conflicts have been properly identified and managed and that procedures have been complied with in the context of permanent controls.

Comments on means for implementation: The proposed approach should be adjusted to reflect the stage of the client relationship and the urgency of obtaining a response from the client. Convening committee meetings, as described at (b) on p. 13, for example, is not realistic in all cases.

Point d) should also be modified to make it clear that case-specific, not general, monitoring is required.

~~d) Mechanism for~~ *monitoring compliance* ***with the solution*** *(p. 13)*

Q 6: Do you agree that the examples above describe circumstances where the market intermediary should refrain?

As said under Q 4, unless there are external constraints (legal prohibition, ...), great flexibility should be maintained regarding the choice of the approach to managing conflict of interests situations because of their extreme variety. Accordingly, the examples described under Topic 3 might be appropriate under certain circumstances and inappropriate under others. It should be clearly stated that these examples are mere illustrations that would be valid only under certain circumstances, unless supported by a legal or professional prohibition (which is generally the case, see example c).

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

Once again, the stress is placed on the idea of not acting. Such an approach is not necessarily in the client's interest and goes well beyond the principles established by

MiFID. To avoid overemphasising the idea of refraining from acting, which is the last resort in conflict management, we propose combining Topics 2 and 3.

~~a)~~ see point d.
***b) ~~Second, if there is no initial substantial or obvious reason to refrain,~~ First**, the firm should utilize*
the appropriate management structures…..
***c) ~~Third~~, Second,** monitor the effectiveness of the conflict approach…..*
d) ~~Fourth~~, Third,** if at any stage…..the intermediary should **~~refrain~~ avoid engaging in** the activity**: if it is prohibited by law or contrary to the interests of a client or if other approaches are unlikely to be effective to adequately address the conflict. (combination of a) on p. 12 and 1) on p. 13)
e) ~~2~~)** policies and procedures should give clear guidance ….**2) p 13

The proposed examples of situations where firms should refrain from acting fall short if IOSCO intends them as examples of instances where firms should always refrain from acting.

They are general, unspecific examples whose response might differ depending on the circumstances. Although it is important to draw employees' attention to the cases cited, a case-by-case assessment will always be needed. These examples can and should be used as an additional warning level, but the solution should not be to refrain from acting in every instance.

Q 8: Do you agree with these circumstances when information barriers are used to address conflicts?
Q 9: Are there any other information barriers that are or should be used?
Q10 Are there any other restrictive mechanisms that may be used to address conflicts in the context of an offering of securities?

The description of information barriers as a useful mechanism for managing possible conflicts of interests that arise during a securities offering is accurate and precise and corresponds to the specific mechanisms used in the context of such offerings. However, a distinction needs to be made between the previous measures, which are extremely general in nature and concern the management of all sorts of conflicts of interest, and these measures, which deal specifically with securities offerings.

It should also be pointed that this mechanism, as described, is appropriate only under precise circumstances and could be inappropriate under others. To make this point clear, in a securities offering, information barriers will be adequate up to a certain point. During a public offering, other divisions of the market intermediary (e.g. its buy side analysts, asset managers, and retail distribution network) could become major actors of the offering and must manage other conflicts of interest situations. For this, however, they need maximum access to information.
Alongside the Chinese wall principles, clarification should be provided on:

- instances where crossing the wall may be authorised,
- the terms and conditions governing such crossings,
- monitoring of such crossings with respect to internal procedures.

Furthermore, the report does not touch on questions of market surveys or the management of conflicts of interest via insider lists.

p. 15: Physical barriers should be divided into two levels: the first level, which is set out in the IOSCO proposal, and a second level that needs to be added and that would consist of specific barriers to keep a given transaction separate within a business unit.

Addition 1), a) Between the 2nd and 3rd sentences: The protection of confidential information in a business unit can be achieved by putting up specific barriers to separate dedicated teams.

On point 2) p. 15: the aim of this point is unclear. Are we talking about disclosure? This measure is concerning proper dealings or personal transactions?

Q 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?

In France, the MAD applies in this regard. It stipulates in detail how disclosures need to be made. (cf *Market Abuse Directive 2003/06/EC, art. 3 & 6, and Directive 2003/125/EC, art.4, 5, 6,* ***in appendix 2).***

Q 12: How do you determine what effective disclosure is?

Within the meaning of MAD and MiFiD, disclosure, to be effective, must provide clients with precise, understandable information about the role of the market intermediary. The information must also be provided in a simple and instructive format.

Note that French regulations require prospectuses and/or research reports to include disclosures.

The European approach via MAD and MiFID, which is very precise and detailed, contrasts sharply with the US approach, which seems to be reflected in the IOSCO rules. The US approach provides for very general disclosures about potential conflicts, whereas in Europe, clients must be informed about very precise facts or events and about the specific role of the intermediary in the case in point (and not in general).

For example, in Europe it is necessary to make a separate disclosure about the impact of potential conflicts, regarding the case in particular, but not necessary to make a general disclosure, in contrast with point 1 on p. 17. Considering this difference of view, disclosure of this general nature would therefore be considered optional, since it is not a requirement under European rules ***(cf appendix 1 on MiFID and appendix 2 on MAD).***

Q 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?

Basically there are no circumstances that would warrant such measures. However, a research report might not be redistributed during and after an offering. The US imposes a 40-day post-offering blackout, which is observed by French and France-based institutions that do business and have clients in America.

Europe has no such requirement. To ensure that investors enjoy transparent information, a research report must be accessible, for example on the intermediary's website. However, it is accessible only to investors that already have an access code and not to new clients. Such reports should also contain a disclosure stating clearly when they were produced.

Part 3: Examples of using mechanisms to address conflicts

Q 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?

Example 1 is a textbook case from 20 years ago. There is absolutely no chance of problems like this occurring today in France thanks to two sets of safeguards:

- Regulatory (Monetary and Financial Code and AMF General Regulation)
- And organisational (internal procedures)

Market intermediaries must comply with strictly formalised client disclosure obligations and are additionally required to act in the client's interest (principle that the client's interest comes first, established by MiFID). Given these developments, the question is what this type of example can offer in today's environment.

Q 15: What remuneration or other restrictions should be put in place?

MAD and MiFID offer a response at the European level by establishing a detailed framework for managing conflicts of interest.

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

It is basically impossible to establish standard cases where the intermediary should refrain from acting because there is no way to avoid the need for a detailed individual assessment. So even if a market intermediary gets involved late in a transaction, e.g. by being invited to be part of a syndicate even though it was not involved in the entire origination process, and does not have much information about the deal, it must ask itself where the client's interest lies. Also, the intermediary cannot bypass the procedures in place to prevent and manage conflicts of interest. Accordingly, if the prevention procedures are complied with, it will become clear whether or not to refrain.

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

Comments on pricing and examples ***(p 20-22)*** place much greater emphasis on underpricing risk (example 2) than on overpricing risk. This is misleading because overpricing has been the major source of risk in recent years.

This is especially true when a secondary offering takes place (typically an IPO), when financial sponsors and/or private equity firms are involved and sell shares. It is well-known that financial sponsors "overprice" securities when they are sellers, especially when they do not remain shareholders in a company.

In addition, one of the proposed approaches to underpricing is unsuitable *(fee structure that provides the intermediary with an incentive to maximise rather minimise the price)*. This is a very dangerous approach and may end up being very bad for the aftermarket:

- *Incentive fees based on final valuation achieved* should be crossed out.
- Discretionary fees are also (although to a lesser extent) dangerous, as they put pressure on underwriters to achieve a very high price, which may be bad for the aftermarket – the share price drops and investors.

Setting the right price is a question balancing the needs of an issuer/seller with those of investors. Another frequent reason for underpricing is when management and/or employees are offered securities on preferential terms at the same time as investors (the lower the IPO price, the better it is for the staff).

Another comment concerns French regulations and/or practices, where pricing flexibilities are far narrower than in the example 2 above described. For example, in rights issues, the issue price is derived from the vwap (volume weighted average price) calculation over the 5 days prior to pricing. In IPOs, a range of 7.5% is within either side of the median price. In some other countries (e.g. USA), a 50% rise on the first trading day is a success? whereas in France it will seen as mispricing. In conclusion, the mispricing issue is less material in France than in many other countries.

As regards efforts to establish a fair price, one of the key questions is once again whether this is a genuine conflict of interest or a commercial issue. When it comes to pricing, the equilibrium level is found by matching supply and demand, in other words by matching the interests of the issuer and those of the investors, with the market having the final say.

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

The situation described is not a true conflict of interest, but the business of an intermediary.

a) The following should be involved: the origination and the syndication. Issuer is also involved by given access to the book. All price ranges are indicated by investors. Syndicate desks try to find the best compromise between issuers / sellers and investors).
b) The following should not be involved: research-analysts, sales teams, proprietary trading desks, market-makers, existing owners affiliated to the intermediary. Note that sales teams and analysts may be consulted by getting feedback from marketing trips and investor education programmes, but they should not be part of the decision process.

Q 19: If one of the following situations applied to the offer of securities by Company A, would that affect the processes adopted in determining the appropriate pricing of the issue of the securities in Company A:

a) Infosec had a panel of sub-underwriters associated with the offering; or
b) Infosec's underwriting was only on a best-efforts basis; or
c) a significant percentage of the securities will be allocated to existing clients of Infosec?

a) The involvement of several institutions in pricing the issue would not appear in and of itself to have an impact in terms of conflict management. Furthermore, sub-underwriting is very much specific to rights issues. The bookrunner is still at risk and underwrites a large portion of the offering in most cases.

b) The involvement of just one institution in pricing the issue would not appear to have an impact either. Obviously, if a deal is "hard underwritten", underwriters will tend to be more conservative on pricing. Most deals are however only "soft" underwritten.

c) France has a set of rules and common practices in place to govern the allocation of securities. They are described in most syndicate briefings. In principle, however, allocation takes place after the pricing stage and does not therefore affect the price, except where the securities are pre-placed. In this case it would be appropriate to make sure that all customers are treated fairly. In other words, allocation is possible in all circumstances, provided that it is governed by a framework of rules, as in France.

Q 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?

In the case of a potentially underpriced offering, if the securities trade 20% higher in the first week, this indicates that the securities could have been priced higher. But a sharp rise in price is not necessarily due to underpricing. Other factors may also play a part. In our view, a longer time frame has to be used (e.g. 6 months).

It is difficult to offer a principle-based response because what counts is not just the change in price but also the stability of longer-term investments. Even with good will and precautions and procedures designed to achieve the fairest possible price, market intermediaries cannot foresee every eventuality.

Remember that the client has final say on the price, and that many IPOs fly initially and then collapse. The question of pricing cannot be dealt with at the level of compliance.

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

This is the reverse of Q. 20, i.e. overpricing an offering. Whether the question is one of overpricing or underpricing, the answer is the same, since it is impossible to foresee every eventuality. It is also important to note that all the examples given concern the equity market and thus have little bearing on, say, the bond market.

Anyway, to limit overpricing, fees based on the equity value (or similar) eventually achieved should be prohibited. The same approach should apply to discretionary fees, which should not represent more than a certain amount of overall fees since they are a strong incentive for sellers/issuers to force underwriters to come up with an excessive price.

Another point should be when the share price remains close or below offering price, three months after the IPO, investors have to have an upside. If not, there is no incentive for them to subscribe to an equity offering.

Q 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.

France has stringent rules in place to protect retail and professional customers. The prospectus provides an additional way to make full disclosure to clients about offers with low demand. In any event, it is no longer possible to "dump" securities into discretionary accounts. And in any case, there is a very little benefit to place more shares, and if the share price drops on the aftermarket, investors will be unhappy.

Plus, the market intermediary must be able to explain the criteria on which it favoured one group of investors over another. Note that because several intermediaries are involved in most offerings, the allocation process is self regulated.

Aside from the rules in place to protect investors, it is not necessary to make a specific disclosure given that the allocation is managed as part of a Chinese Wall system. Note also that bond and equity market practices differ in this area.

Q 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?

In certain circumstances, issuers/sellers might want the highest possible price. They may be tempted to make the price the main criteria for allotments (the higher you bid, the more shares you receive).

As mentioned, price sensitivity cannot be the sole or main criteria for allotments; it is up to the syndicate desks to avoid conflicts between issuers/sellers and investors, and to work out a number of allocation criteria which apply to manage conflicting interests mentioned above: long term investors, price sensitivity, and so on. In other words, the syndicate briefing lists all the criteria to be taken into account during the allocation process, and the issuer is informed of the book on a daily basis.

In any case, the final decision should remain in the syndication's hands, independent of any other business lines.

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

When intermediaries' affiliates are part of the book (e.g. asset management, private banking, proprietary trading), their affiliation to the intermediary should be disclosed to the issuer.

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

There is no need for specific disclosure in this case.

Q 26: Who from the market intermediary should and should not make the decision about the allocation?

The allocation decision should be made by the syndication agent, never by sales personnel.

Q 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.

Q 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?
Q 29: What level of specific disclosure about conflicts of interests concerning the interest 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?
Q 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?

MiFID rules mean that the sort of unreasonable support seen in the Parmalat case would be impossible today. Also, the information required in prospectuses prevents "lending" banks from hiding information from investors.

So for example, client order should not be placed until received in written form. This makes them easier to monitor.

Q 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. Il 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?
Q 32: Are there any other approaches that would adequately address the conflicts described in Example 4? 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.
Q 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)?

If there is a failure risk, the market intermediary must refuse to carry out the transaction. Infosec should therefore refrain. Moreover, the image-related risk is too great.

In the case of bonds, since there are no prospectuses, the question is framed in terms of increased risk.

Appendix 1
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Business obligations & Information to clients
In MiFID - 2004/39/EC

- **Directive 2004/39/EC of 21 april 2004 « MiFID »**

Article 19: Conduct of business obligations when providing investment services to clients

1. Member States shall require that, when providing investment services and/or, where appropriate, ancillary services to clients, an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients and comply, in particular, with the principles set out in paragraphs 2 to 8.
2. All information, including marketing communications, addressed by the investment firm to clients or potential clients shall be fair, clear and not misleading. Marketing communications shall be clearly identifiable as such.
3. Appropriate information shall be provided in a comprehensible form to clients or potential clients about:
— the investment firm and its services,
— financial instruments and proposed investment strategies; this should include appropriate guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies,
— execution venues, and
— costs and associated charges

so that they are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis. This information may be provided in a standardised format.

- **Directive 2006/73/EC of 10 August 2006 implementing directive 2004/39/CE**

Article 3: Conditions applying to the provision of information

1. Where, for the purposes of this Directive, information is required to be provided in a durable medium, Member States shall permit investment firms to provide that information in a durable medium other than on paper only if:
(a) the provision of that information in that medium is appropriate to the context in which the business between the firm and the client is, or is to be, carried on; and
(b) the person to whom the information is to be provided, when offered the choice between information on paper or in that other durable medium, specifically chooses the provision of the information in that other medium.
2. Where, pursuant to Article 29, 30, 31, 32, 33 or 46(2) of this Directive, an investment firm provides information to a client by means of a website and that information is not addressed personally to the client, Member States shall ensure that the following conditions are satisfied:

(a) the provision of that information in that medium is appropriate to the context in which the business between the firm and the client is, or is to be, carried on;
(b) the client must specifically consent to the provision of that information in that form;
(c) the client must be notified electronically of the address of the website, and the place on the website where the information may be accessed;
(d) the information must be up to date;
(e) the information must be accessible continuously by means of that website for such period of time as the client may reasonably need to inspect it.
3. For the purposes of this Article, the provision of information by means of electronic communications shall be treated as appropriate to the context in which the business between the firm and the client is, or is to be, carried on if there is evidence that the client has regular access to the internet. The provision by the client of an e-mail address for the purposes of the carrying on of that business shall be treated as such evidence.

SECTION 2
Information to clients and potential clients

Article 27 (e.g. article 19(2) of Directive 2004/39/EC)**: Conditions with which information must comply in order to be fair, clear and not misleading**

1. Member States shall require investment firms to ensure that all information they address to, or disseminate in such a way that it is likely to be received by, retail clients or potential retail clients, including marketing communications, satisfies the conditions laid down in paragraphs 2 to 8.
2. The information referred to in paragraph 1 shall include the name of the investment firm. It shall be accurate and in particular shall not emphasise any potential benefits of an investment service or financial instrument without also giving a fair and prominent indication of any relevant risks.
It shall be sufficient for, and presented in a way that is likely to be understood by, the average member of the group to whom it is directed, or by whom it is likely to be received. It shall not disguise, diminish or obscure important items, statements or warnings.
3. Where the information compares investment or ancillary services, financial instruments, or persons providing investment or ancillary services, the following conditions shall be satisfied:
(a) the comparison must be meaningful and presented in a fair and balanced way;
(b) the sources of the information used for the comparison must be specified;
(c) the key facts and assumptions used to make the comparison must be included.
4. Where the information contains an indication of past performance of a financial instrument, a financial index or an investment service, the following conditions shall be satisfied:
(a) that indication must not be the most prominent feature of the communication;
(b) the information must include appropriate performance information which covers the immediately preceding 5 years, or the whole period for which the financial instrument has been offered, the financial index has been established, or the investment service has been provided if less than five years, or such longer period as the firm may decide, and in every case that performance information must be based on complete 12-month periods;
(c) the reference period and the source of information must be clearly stated;
(d) the information must contain a prominent warning that the figures refer to the past and that past performance is not a reliable indicator of future results;
(e) where the indication relies on figures denominated in a currency other than that of the Member State in which the retail client or potential retail client is resident, the currency must be clearly stated, together with a warning that the return may increase or decrease as a result of currency fluctuations;

(f) where the indication is based on gross performance, the effect of commissions, fees or other charges must be disclosed.
5. Where the information includes or refers to simulated past performance, it must relate to a financial instrument or a financial index, and the following conditions shall be satisfied:
(a) the simulated past performance must be based on the actual past performance of one or more financial instruments or financial indices which are the same as, or underlie, the financial instrument concerned;
(b) in respect of the actual past performance referred to in point (a), the conditions set out in points (a) to
(c), (e) and (f) of paragraph 4 must be complied with;
(c) the information must contain a prominent warning that the figures refer to simulated past performance and that past performance is not a reliable indicator of future performance.
6. Where the information contains information on future performance, the following conditions shall be satisfied:
(a) the information must not be based on or refer to simulated past performance;
(b) it must be based on reasonable assumptions supported by objective data;
(c) where the information is based on gross performance, the effect of commissions, fees or other charges must be disclosed;
(d) it must contain a prominent warning that such forecasts are not a reliable indicator of future performance.
7. Where the information refers to a particular tax treatment, it shall prominently state that the tax treatment depends on the individual circumstances of each client and may be subject to change in the future.
8. The information shall not use the name of any competent authority in such a way that would indicate or suggest endorsement or approval by that authority of the products or services of the investment firm.

Article 28 (e.g. article 19(3) of Directive 2004/39/EC)**: Information concerning client categorization**

1. Member States shall ensure that investment firms notify new clients, and existing clients that the investment firm has newly categorised as required by Directive 2004/39/EC, of their categorisation as a retail client, a professional client or an eligible counterparty in accordance with that Directive.
2. Member States shall ensure that investment firms inform clients in a durable medium about any right that client has to request a different categorisation and about any limitations to the level of client protection that it would entail.
3. Member States shall permit investment firms, either on their own initiative or at the request of the client concerned:
(a) to treat as a professional or retail client a client that might otherwise be classified as an eligible counterparty pursuant to Article 24(2) of Directive 2004/39/EC;
(b) to treat as a retail client a client that is considered as a professional client pursuant to Section I of Annex II to Directive 2004/39/EC.

Article 29 (e.g.article 19(3) of Directive 2004/39/EC)**: General requirements for information to clients**

1. Member States shall require investment firms, in good time before a retail client or potential retail client is bound by any agreement for the provision of investment services or ancillary services or before the provision of those services, whichever is the earlier, to provide that client or potential client with the following information:
(a) the terms of any such agreement;

(b) the information required by Article 30 relating to that agreement or to those investment or ancillary services.
2. Member States shall require investment firms, in good time before the provision of investment services or ancillary services to retail clients or potential retail clients, to provide the information required under Articles 30 to 33.
3. Member States shall require investment firms to provide professional clients with the information referred to in Article 32 (5) and (6) in good time before the provision of the service concerned.
4. The information referred to in paragraphs 1 to 3 shall be provided in a durable medium or by means of a website (where that does not constitute a durable medium) provided that the conditions specified in Article 3(2) are satisfied.
5. By way of exception to paragraphs 1 and 2, Member States shall permit investment firms, in the following circumstances, to provide the information required under paragraph 1 to a retail client immediately after that client is bound by any agreement for the provision of investment services or ancillary services, and the information required under paragraph 2 immediately after starting to provide the service:
(a) the firm was unable to comply with the time limits specified in paragraphs 1 and 2 because, at the request of the client, the agreement was concluded using a means of distance communication which prevents the firm from providing the information in accordance with paragraph 1 or 2;
(b) in any case where Article 3(3) of Directive 2002/65/EC of the European Parliament and of the Council of 23 September 2002 concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC (1) does not otherwise apply, the investment firm complies with the requirements of that Article in relation to the retail client or potential retail client, as if that client or potential client were a 'consumer' and the investment firm were a 'supplier' within the meaning of that Directive.
6. Member State shall ensure that investment firms notify a client in good time about any material change to the information provided under Articles 30 to 33 which is relevant to a service that the firm is providing to that client. That notification shall be given in a durable medium if the information to which it relates is given in a durable medium.
7. Member States shall require investment firms to ensure that information contained in a marketing communication is consistent with any information the firm provides to clients in the course of carrying on investment and ancillary services.
8. Member States shall ensure that, where a marketing communication contains an offer or invitation of the following nature and specifies the manner of response or includes a form by which any response may be made, it includes such of the information referred to in Articles 30 to 33 as is relevant to that offer or invitation:
(a) an offer to enter into an agreement in relation to a financial instrument or investment service or ancillary service with any person who responds to the communication;
(b) an invitation to any person who responds to the communication to make an offer to enter into an agreement in relation to a financial instrument or investment service or ancillary service. However, the first subparagraph shall not apply if, in order to respond to an offer or invitation contained in the marketing communication, the potential retail client must refer to another document or documents, which, alone or in combination, contain that information.

Article 30 (e.g. article 19(3) of Directive 2004/39/EC): **Information about the investment firm and its services for retail clients and potential retail clients**

1. Member States shall require investment firms to provide retail clients or potential retail clients with the following general information, where relevant:
(a) the name and address of the investment firm, and the contact details necessary to enable clients to communicate effectively with the firm;

(b) the languages in which the client may communicate with the investment firm, and receive documents and other information from the firm;
(c) the methods of communication to be used between the investment firm and the client including, where relevant, those for the sending and reception of orders;
(d) a statement of the fact that the investment firm is authorised and the name and contact address of the competent authority that has authorised it;
(e) where the investment firm is acting through a tied agent, a statement of this fact specifying the Member State in which that agent is registered;
(f) the nature, frequency and timing of the reports on the performance of the service to be provided by the investment firm to the client in accordance with Article 19(8) of Directive 2004/39/EC;
(g) if the investment firm holds client financial instruments or client funds, a summary description of the steps which it takes to ensure their protection, including summary details of any relevant investor compensation or deposit guarantee scheme which applies to the firm by virtue of its activities in a Member State;
(h) a description, which may be provided in summary form, of the conflicts of interest policy maintained by the firm in accordance with Article 22;
(i) at any time that the client requests it, further details of that conflicts of interest policy in a durable medium or by means of a website (where that does not constitute a durable medium) provided that the conditions specified in Article 3(2) are satisfied.
2. Member States shall ensure that, when providing the service of portfolio management, investment firms establish an appropriate method of evaluation and comparison such as a meaningful benchmark, based on the investment objectives of the client and the types of financial instruments included in the client portfolio, so as to enable the client for whom the service is provided to assess the firm's performance.
3. Member States shall require that where investment firms propose to provide portfolio management services to a retail client or potential retail client, they provide the client, in addition to the information required under paragraph 1, with such of the following information as is applicable:
(a) information on the method and frequency of valuation of the financial instruments in the client portfolio;
(b) details of any delegation of the discretionary management of all or part of the financial instruments or funds in the client portfolio;
(c) a specification of any benchmark against which the performance of the client portfolio will be compared;
(d) the types of financial instrument that may be included in the client portfolio and types of transaction that may be carried out in such instruments, including any limits;
(e) the management objectives, the level of risk to be reflected in the manager's exercise of discretion, and any specific constraints on that discretion.

Article 31 (e.g. Article 19(3) of Directive 2004/39/EC)**: Information about financial instruments**

1. Member States shall require investment firms to provide clients or potential clients with a general description of the nature and risks of financial instruments, taking into account, in particular, the client's categorisation as either a retail client or a professional client. That description must explain the nature of the specific type of instrument concerned, as well as the risks particular to that specific type of instrument in sufficient detail to enable the client to take investment decisions on an informed basis.
2. The description of risks shall include, where relevant to the specific type of instrument concerned and the status and level of knowledge of the client, the following elements:

(a) the risks associated with that type of financial instrument including an explanation of leverage and its effects and the risk of losing the entire investment;
(b) the volatility of the price of such instruments and any limitations on the available market for such instruments;
(c) the fact that an investor might assume, as a result of transactions in such instruments, financial commitments and other additional obligations, including contingent liabilities, additional to the cost of acquiring the instruments;
(d) any margin requirements or similar obligations, applicable to instruments of that type. Member States may specify the precise terms, or the contents, of the description of risks required under this paragraph.
3. If an investment firm provides a retail client or potential retail client with information about a financial instrument that is the subject of a current offer to the public and a prospectus has been published in connection with that offer in accordance with Directive 2003/71/EC, that firm shall inform the client or potential client where that prospectus is made available to the public.
4. Where the risks associated with a financial instrument composed of two or more different financial instruments or services are likely to be greater than the risks associated with any of the components, the investment firm shall provide an adequate description of the components of that instrument and the way in which its interaction increases the risks.
5. In the case of financial instruments that incorporate a guarantee by a third party, the information about the guarantee shall include sufficient detail about the guarantor and the guarantee to enable the retail client or potential retail client to make a fair assessment of the guarantee.

Article 32 (e.g. article 19(3) of Directive 2004/39/EC)**: Information requirements concerning safeguarding of client financial instruments or client funds**

1. Member States shall ensure that, where investment firms hold financial instruments or funds belonging to retail clients, they provide those retail clients or potential retail clients with such of the information specified in paragraphs 2 to 7 as is relevant.
2. The investment firm shall inform the retail client or potential retail client where the financial instruments or funds of that client may be held by a third party on behalf of the investment firm and of the responsibility of the investment firm under the applicable national law for any acts or omissions of the third party and the consequences for the client of the insolvency of the third party.
3. Where financial instruments of the retail client or potential retail client may, if permitted by national law, be held in an omnibus account by a third party, the investment firm shall inform the client of this fact and shall provide a prominent warning of the resulting risks.
4. The investment firm shall inform the retail client or potential retail client where it is not possible under national law for client financial instruments held with a third party to be separately identifiable from the proprietary financial instruments of that third party or of the investment firm and shall provide a prominent warning of the resulting risks.
5. The investment firm shall inform the client or potential client where accounts that contain financial instruments or funds belonging to that client or potential client are or will be subject to the law of a jurisdiction other than that of a Member State and shall indicate that the rights of the client or potential client relating to those financial instruments or funds may differ accordingly.
6. An investment firm shall inform the client about the existence and the terms of any security interest or lien which the firm has or may have over the client's financial instruments or funds, or any right of set-off it holds in relation to those instruments or funds. Where applicable, it shall also inform the client of the fact that a depository may have a security interest or lien over, or right of set-off in relation to those instruments or funds.

7. An investment firm, before entering into securities financing transactions in relation to financial instruments held by it on behalf of a retail client, or before otherwise using such financial instruments for its own account or the account of another client, shall in good time before the use of those instruments provide the retail client, in a durable medium, with clear, full and accurate information on the obligations and responsibilities of the investment firm with respect to the use of those financial instruments, including the terms for their restitution, and on the risks involved.

Article 33 (e.g.Article 19(3) of Directive 2004/39/EC)*:* **Information about costs and associated charges**

Member States shall require investment firms to provide their retail clients and potential retail clients with information on costs and associated charges that include such of the following elements as are relevant:
(a) the total price to be paid by the client in connection with the financial instrument or the investment service or ancillary service, including all related fees, commissions, charges and expenses, and all taxes payable via the investment firm or, if an exact price cannot be indicated, the basis for the calculation of the total price so that the client can verify it;
(b) where any part of the total price referred to in point (a) is to be paid in or represents an amount of foreign currency, an indication of the currency involved and the applicable currency conversion rates and costs;
(c) notice of the possibility that other costs, including taxes, related to transactions in connection with the financial instrument or the investment service may arise for the client that are not paid via the investment firm or imposed by it;
(d) the arrangements for payment or other performance. For the purposes of point (a), the commissions charged by the firm shall be itemised separately in every case.

Article 34 (e.g.Article 19(3) of Directive 2004/39/EC): **Information drawn up in accordance with Directive 85/611/EEC**

1. Member States shall ensure that in respect of units in a collective investment undertaking covered by Directive 85/611/ EEC, a simplified prospectus complying with Article 28 of that Directive is regarded as appropriate information for the purposes of the second indent of Article 19(3) of Directive 2004/39/EC.
2. Member States shall ensure that in respect of units in a collective investment undertaking covered by Directive 85/611/EEC, a simplified prospectus complying with Article 28 of that Directive is regarded as appropriate information for the purposes of the fourth indent of Article 19(3) of Directive 2004/39/EC with respect to the costs and associated charges related to the UCITS itself, including the exit and entry commissions.

SECTION 4
Reporting to clients

Article 40 (e.g. article 19(8) of Directive 2004/39/EC)**: Reporting obligations in respect of execution of orders other than for portfolio management**

1. Member States shall ensure that where investment firms have carried out an order, other than for portfolio management, on behalf of a client, they take the following action in respect of that order:
(a) the investment firm must promptly provide the client, in a durable medium, with the essential information concerning the execution of that order;
(b) in the case of a retail client, the investment firm must send the client a notice in a durable medium confirming execution of the order as soon as possible and no later than the first business day following execution or, if the confirmation is received by

the investment firm from a third party, no later than the first business day following receipt of the confirmation from the third party.
Point (b) shall not apply where the confirmation would contain the same information as a confirmation that is to be promptly dispatched to the retail client by another person.
Points (a) and (b) shall not apply where orders executed on behalf of clients relate to bonds funding mortgage loan agreements with the said clients, in which case the report on the transaction shall be made at the same time as the terms of the mortgage loan are communicated, but no later than one month after the execution of the order.
2. In addition to the requirements under paragraph 1, Member States shall require investment firms to supply the client, on request, with information about the status of his order.
3. Member States shall ensure that, in the case of orders for a retail clients relating to units or shares in a collective investment undertaking which are executed periodically, investment firms either take the action specified in point (b) of paragraph 1 or provide the retail client, at least once every six months, with the information listed in paragraph 4 in respect of those transactions.
4. The notice referred to in point (b) of paragraph 1 shall include such of the following information as is applicable and, where relevant, in accordance with Table 1 of Annex I to Regulation (EC) No 1287/2006:
(a) the reporting firm identification;
(b) the name or other designation of the client;
(c) the trading day;
(d) the trading time;
(e) the type of the order;
(f) the venue identification;
(g) the instrument identification;
(h) the buy/sell indicator;
(i) the nature of the order if other than buy/sell;
(j) the quantity;
(k) the unit price;
(l) the total consideration;
(m) a total sum of the commissions and expenses charged and, where the retail client so requests, an itemised breakdown;
(n) the client's responsibilities in relation to the settlement of the transaction, including the time limit for payment or delivery as well as the appropriate account details where these details and responsibilities have not previously been notified to the client;
(o) if the client's counterparty was the investment firm itself or any person in the investment firm's group or another client of the investment firm, the fact that this was the case unless the order was executed through a trading system that facilitates anonymous trading.
For the purposes of point (k), where the order is executed in tranches, the investment firm may supply the client with information about the price of each tranche or the average price.
Where the average price is provided, the investment firm shall supply the retail client with information about the price of each tranche upon request.
5. The investment firm may provide the client with the information referred to in paragraph 4 using standard codes if it also provides an explanation of the codes used.

Article 41 (e.g. article 19(8) of Directive 2004/39/EC)*:* **Reporting obligations in respect of portfolio management**

1. Member States shall require investments firms which provide the service of portfolio management to clients to provide each such client with a periodic statement

in a durable medium of the portfolio management activities carried out on behalf of that client unless such a statement is provided by another person.
2. In the case of retail clients, the periodic statement required under paragraph 1 shall include, where relevant, the following information:
(a) the name of the investment firm;
(b) the name or other designation of the retail client's account;
(c) a statement of the contents and the valuation of the portfolio, including details of each financial instrument held, its market value, or fair value if market value is unavailable and the cash balance at the beginning and at the end of the reporting period, and the performance of the portfolio during the reporting period;
(d) the total amount of fees and charges incurred during the reporting period, itemising at least total management fees and total costs associated with execution, and including, where relevant, a statement that a more detailed breakdown will be provided on request;
(e) a comparison of performance during the period covered by the statement with the investment performance benchmark (if any) agreed between the investment firm and the client;
(f) the total amount of dividends, interest and other payments received during the reporting period in relation to the client's portfolio;
(g) information about other corporate actions giving rights in relation to financial instruments held in the portfolio; (h) for each transaction executed during the period, the information referred to in Article 40(4)(c) to (l) where relevant, unless the client elects to receive information about executed transactions on a transaction-by-transaction basis, in which case paragraph 4 of this Article shall apply.
3. In the case of retail clients, the periodic statement referred to in paragraph 1 shall be provided once every six months, except in the following cases:
(a) where the client so requests, the periodic statement must be provided every three months;
(b) in cases where paragraph 4 applies, the periodic statement must be provided at least once every 12 months;
(c) where the agreement between an investment firm and a retail client for a portfolio management service authorises a leveraged portfolio, the periodic statement must be provided at least once a month.
Investment firms shall inform retail clients that they have the right to make requests for the purposes of point (a). However, the exception provided for in point (b) shall not apply in the case of transactions in financial instruments covered by Article 4(1)(18)(c) of, or any of points 4 to 10 of Section C in Annex I to, Directive 2004/39/EC.
4. Member States shall require investment firms, in cases where the client elects to receive information about executed transactions on a transaction-by-transaction basis, to provide promptly to the client, on the execution of a transaction by the portfolio manager, the essential information concerning that transaction in a durable medium. Where the client concerned is a retail client, the investment firm must send him a notice confirming the transaction and containing the information referred to in Article 40(4) no later than the first business day following that execution or, if the confirmation is received by the investment firm from a third party, no later than the first business day following receipt of the confirmation from the third party. The second subparagraph shall not apply where the confirmation would contain the same information as a confirmation that is to be promptly dispatched to the retail client by another person.

Article 42 (e.g. article 19(8) of Directive 2004/39/EC)*:* **Additional reporting obligations for portfolio management or contingent liability transactions**

Member States shall ensure that where investment firms provide portfolio management transactions for retail clients or operate retail client accounts that include an uncovered open position in a contingent liability transaction, they also

report to the retail client any losses exceeding any predetermined threshold, agreed between the firm and the client, no later than the end of the business day in which the threshold is exceeded or, in a case where the threshold is exceeded on a non-business day, the close of the next business day.

Article 43 (e.g. article 19(8) of Directive 2004/39/EC)*:* **Statements of client financial instruments or client funds**

1. Member States shall require investment firms that hold client financial instruments or client funds to send at least once a year, to each client for whom they hold financial instruments or funds, a statement in a durable medium of those financial instruments or funds unless such a statement has been provided in any other periodic statement. The first subparagraph shall not apply to a credit institution authorized under Directive 2000/12/EC in respect of deposits within the meaning of that Directive held by that institution.
2. The statement of client assets referred to in paragraph 1 shall include the following information:
(a) details of all the financial instruments or funds held by the investment firm for the client at the end of the period covered by the statement;
(b) the extent to which any client financial instruments or client funds have been the subject of securities financing transactions;
(c) the extent of any benefit that has accrued to the client by virtue of participation in any securities financing transactions, and the basis on which that benefit has accrued. In cases where the portfolio of a client includes the proceeds of one or more unsettled transactions, the information referred to in point (a) may be based either on the trade date or the settlement date, provided that the same basis is applied consistently to all such information in the statement.
3. Member States shall permit investment firms which hold financial instruments or funds and which carry out the service of portfolio management for a client to include the statement of client assets referred to in paragraph 1 in the periodic statement it provides to that client pursuant to Article 41(1).

Appendix 2
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Disclosure obligations in Market Abuse Directive 2003/6/EC

- **Directive 2003/6/EC of 28 January 2003 « MAD »**

Article 3

Member States shall prohibit any person subject to the prohibition laid down in Article 2 from:
(a) disclosing inside information to any other person unless such disclosure is made in the normal course of the exercise of his employment, profession or duties;
(b) recommending or inducing another person, on the basis of inside information, to acquire or dispose of financial instruments to which that information relates.

Article 6

1. Member States shall ensure that issuers of financial instruments inform the public as soon as possible of inside information which directly concerns the said issuers.
Without prejudice to any measures taken to comply with the provisions of the first subparagraph, Member States shall ensure that issuers, for an appropriate period, post on their Internet sites all inside information that they are required to disclose publicly.
2. An issuer may under his own responsibility delay the public disclosure of inside information, as referred to in paragraph 1, such as not to prejudice his legitimate interests provided that such omission would not be likely to mislead the public and provided that the issuer is able to ensure the confidentiality of that information. Member States may require that an issuer shall without delay inform the competent authority of the decision to delay the public disclosure of inside information.
3. Member States shall require that, whenever an issuer, or a person acting on his behalf or for his account, discloses any inside information to any third party in the normal exercise of his employment, profession or duties, as referred to in Article 3(a), he must make complete and effective public disclosure of that information, simultaneously in the case of an intentional disclosure and promptly in the case of a non-intentional disclosure.
The provisions of the first subparagraph shall not apply if the person receiving the information owes a duty of confidentiality, regardless of whether such duty is based on a law, on regulations, on articles of association or on a contract.
Member States shall require that issuers, or persons acting on their behalf or for their account, draw up a list of those persons working for them, under a contract of employment or otherwise, who have access to inside information. Issuers and persons acting on their behalf or for their account shall regularly update this list and transmit it to the competent authority whenever the latter requests it.
4. Persons discharging managerial responsibilities within an issuer of financial instruments and, where applicable, persons closely associated with them, shall, at least, notify to the competent authority the existence of transactions conducted on their own account relating to shares of the said issuer, or to derivatives or other financial instruments linked to them. Member States shall ensure that public access

to information concerning such transactions, on at least an individual basis, is readily available as soon as possible.
5. Member States shall ensure that there is appropriate regulation in place to ensure that persons who produce or disseminate research concerning financial instruments or issuers of financial instruments and persons who produce or disseminate other information recommending or suggesting investment strategy, intended for distribution channels or for the public, take reasonable care to ensure that such information is fairly presented and disclose their interests or indicate conflicts of interest concerning the financial instruments to which that information relates. Details of such regulation shall be notified to the Commission.
6. Member States shall ensure that market operators adopt structural provisions aimed at preventing and detecting market manipulation practices.
7. With a view to ensuring compliance with paragraphs 1 to 5, the competent authority may take all necessary measures to ensure that the public is correctly informed.
8. Public institutions disseminating statistics liable to have a significant effect on financial markets shall disseminate them in a fair and transparent way.
9. Member States shall require that any person professionally arranging transactions in financial instruments who reasonably suspects that a transaction might constitute insider dealing or market manipulation shall notify the competent authority without delay.
10. In order to take account of technical developments on financial markets and to ensure uniform application of this Directive, the Commission shall adopt, in accordance with the procedure referred to in Article 17(2), implementing measures concerning:
— the technical modalities for appropriate public disclosure of inside information as referred to in paragraphs 1 and 3,
— the technical modalities for delaying the public disclosure of inside information as referred to in paragraph 2,
— the technical modalities designed to favour a common approach in the implementation of the second sentence of paragraph 2,
— the conditions under which issuers, or entities acting on their behalf, are to draw up a list of those persons working for them and having access to inside information, as referred to in paragraph 3, together with the conditions under which such lists are to be updated,
— the categories of persons who are subject to a duty of disclosure as referred to in paragraph 4 and the characteristics of a transaction, including its size, which trigger that duty, and the technical arrangements for disclosure to the competent authority,
— technical arrangements, for the various categories of person referred to in paragraph 5, for fair presentation of research and other information recommending investment strategy and for disclosure of particular interests or conflicts of interest as referred to in paragraph 5. Such arrangements shall take into account the rules, including self-regulation, governing the profession of journalist,
— technical arrangements governing notification to the competent authority by the persons referred to in paragraph 9.

- **Directive 2003/125/EC of 22 December 2003**

Article 4: Additional obligations in relation to fair presentation of recommendations

1. In addition to the obligations laid down in Article 3, where the relevant person is an independent analyst, an investment firm, a credit institution, any related legal person, any other relevant person whose main business is to produce recommendations, or a natural person working for them under a contract of employment or otherwise, Member States shall ensure that there is appropriate regulation in place to ensure that person to take reasonable care to ensure that at least:

(a) all substantially material sources are indicated, as appropriate, including the relevant issuer, together with the fact whether the recommendation has been disclosed to that issuer and amended following this disclosure before its dissemination;
(b) any basis of valuation or methodology used to evaluate a financial instrument or an issuer of a financial instrument, or to set a price target for a financial instrument, is adequately summarised;
(c) the meaning of any recommendation made, such as buy, sell or hold, which may include the time horizon of the investment to which the recommendation relates, is adequately explained and any appropriate risk warning, including a sensitivity analysis of the relevant assumptions, indicated;
(d) reference is made to the planned frequency, if any, of updates of the recommendation and to any major changes in the coverage policy previously announced;
(e) the date at which the recommendation was first released for distribution is indicated clearly and prominently, as well as the relevant date and time for any financial instrument price mentioned;
(f) where a recommendation differs from a recommendation concerning the same financial instrument or issuer, issued during the 12-month period immediately preceding its release, this change and the date of the earlier recommendation are indicated clearly and prominently.
2. Member States shall ensure that, where the requirements laid down in points (a), (b) or (c) of paragraph 1 would be disproportionate in relation to the length of the recommendation distributed, it shall suffice to make clear and prominent reference in the recommendation itself to the place where the required information can be directly and easily accessed by the public, such as a direct Internet link to that information on an appropriate internet site of the relevant person, provided that there has been no change in the methodology or basis of valuation used.
3. Member States shall ensure that there is appropriate regulation in place to ensure that, in the case of non-written recommendations, the requirements of paragraph 1 are adapted so that they are not disproportionate.

Article 5: General standard for disclosure of interests and conflicts of interest

1. Member States shall ensure that there is appropriate regulation in place to ensure that relevant persons disclose all relationships and circumstances that may reasonably be expected to impair the objectivity of the recommendation, in particular where relevant persons have a significant financial interest in one or more of the financial instruments which are the subject of the recommendation, or a significant conflict of interest with respect to an issuer to which the recommendation relates.
Where the relevant person is a legal person, that requirement shall apply also to any legal or natural person working for it, under a contract of employment or otherwise, who was involved in preparing the recommendation.
2. Where the relevant person is a legal person, the information to be disclosed in accordance with paragraph 1 shall at least include the following:
(a) any interests or conflicts of interest of the relevant person or of related legal persons that are accessible or reasonably expected to be accessible to the persons involved in the preparation of the recommendation;
(b) any interests or conflicts of interest of the relevant person or of related legal persons known to persons who, although not involved in the preparation of the recommendation, had or could reasonably be expected to have access to the recommendation prior to its dissemination to customers or the public.
3. Member States shall ensure that there is appropriate regulation in place to ensure that the recommendation itself shall include the disclosures provided for in paragraphs 1 and 2.
Where such disclosures would be disproportionate in relation to the length of the recommendation distributed, it shall suffice to make clear and prominent reference in

the recommendation itself to the place where such disclosures can be directly and easily accessed by the public, such as a direct Internet link to the disclosure on an appropriate internet site of the relevant person.
4. Member States shall ensure that there is appropriate regulation in place to ensure that the requirements laid down in paragraph 1 are adapted in order not to be disproportionate in the case of nonwritten recommendations.
5. Paragraphs 1 to 3 shall not apply to journalists subject to equivalent appropriate regulation, including equivalent appropriate self regulation, in the Member States, provided that such regulation achieves similar effects as those of paragraphs 1 to 3.

Article 6: Additional obligations in relation to disclosure of interests or conflicts of interest

1. In addition to the obligations laid down in Article 5, Member States shall require that any recommendation produced by an independent analyst, an investment firm, a credit institution, any related legal person, or any other relevant person whose main business is to produce recommendations, discloses clearly and prominently the following information on their interests and conflicts of interest:
(a) major shareholdings that exist between the relevant person or any related legal person on the one hand and the issuer on the other hand. These major shareholdings include at least the following instances:
— when shareholdings exceeding 5 % of the total issued share capital in the issuer are held by the relevant person or any related legal person, or — when shareholdings exceeding 5 % of the total issued share capital of the relevant person or any related legal person are held by the issuer. Member States may provide for lower thresholds than the 5 % threshold as provided for in these two instances;
(b) other significant financial interests held by the relevant person or any related legal person in relation to the issuer; (c) where applicable, a statement that the relevant person or any related legal person is a market maker or liquidity provider in the financial instruments of the issuer;
(d) where applicable, a statement that the relevant person or any related legal person has been lead manager or co-lead manager over the previous 12 months of any publicly disclosed offer of financial instruments of the issuer;
(e) where applicable, a statement that the relevant person or any related legal person is party to any other agreement with the issuer relating to the provision of investment banking services, provided that this would not entail the disclosure of any confidential commercial information and that the agreement has been in effect over the previous 12 months or has given rise during the same period to the payment of a compensation or to the promise to get a compensation paid;
(f) where applicable, a statement that the relevant person or any related legal person is party to an agreement with the issuer relating to the production of the recommendation.
2. Member States shall require disclosure, in general terms, of the effective organisational and administrative arrangements set up within the investment firm or the credit institution for the prevention and avoidance of conflicts of interest with respect to recommendations, including information barriers.
3. Member States shall require that for natural or legal persons working for an investment firm or a credit institution, under a contract of employment or otherwise, and who were involved in preparing the recommendation, the requirement under the second subparagraph of paragraph 1 of Article 5 shall include, in particular, disclosure of whether the remuneration of such persons is tied to investment banking transactions performed by the investment firm or credit institution or any related legal person.
Where those natural persons receive or purchase the shares of the issuers prior to a public offering of such shares, the price at which the shares were acquired and the date of acquisition shall also be disclosed.

4. Member States shall require that investment firms and credit institutions disclose, on a quarterly basis, the proportion of all recommendations that are ‘buy’, ‘hold’, ‘sell’ or equivalent terms, as well as the proportion of issuers corresponding to each of these categories to which the investment firm or the credit institution has supplied material investment banking services over the previous 12 months.
5. Member States shall ensure that the recommendation itself includes the disclosures required by paragraphs 1 to 4.Where the requirements under paragraphs 1 to 4 would be disproportionate in relation to the length of the recommendation distributed, it shall suffice to make clear and prominent reference in the recommendation itself to the place where such disclosure can be directly and easily accessed by the public, such as a direct Internet link to the disclosure on an appropriate internet site of the investment firm or credit institution.
6. Member States shall ensure that there is appropriate regulation in place to ensure that, in the case of non-written recommendations, the requirements of paragraph 1 are adapted so that they are not disproportionate.

10. National Association of Financial Market Institutions

ANDIMA's Answer to IOSCO Report – Conflicts of Interest in Securities Offerings

Introduction

In response to the report "Conflicts of Interest in Securities Offerings", ANDIMA – The National Association of Financial Market Institutions, based on a series of meetings held with a sampling of its associates, reached the conclusion that, to a greater or lesser degree, the financial institutions identify the existence of potential sources of conflicts of interest, with respect to security offerings conducted by these financial market intermediaries, although the mitigation mechanisms of these conflicts seem to vary among them.

Thus, what became clear in the research is that the financial institutions that participate in underwriting processes present differentiated degrees of control and/or internal processes to address conflicts of interest, in function of both their scale and nature. It was observed, in the interviewed sample, that the larger institutions – given the greater number of activities they exercise – are more concerned about addressing conflicts, since, in these institutions, potential conflicts emerge more frequently.

On the other hand, it seems that the foreign banks show a greater degree of "formalization" of their mechanisms and processes to address conflicts of interest, when compared to national banks. The latter, according to the sample, are directed more by standards of ethical conduct, regulation and self-regulation than by the defined internal mechanisms. This observation can be explained by both the relatively recent evolution of the regulatory environment in the country compared to that of the more developed countries (below are the dates of the norms issued by the regulatory agency and the self-regulatory codes relative to the matter in Brazil), and by the "importation" by foreign institutions of mechanisms and/or procedures already employed in their headquarters, located in countries that present more developed and deeply rooted risk (and conflict) control structures.

It should also be emphasized that not always does the adoption of formal mechanisms for addressing conflicts of interest, in the different financial institutions, guarantee the efficacy of this treatment.

Certain particular aspects of the Brazilian market merit emphasis: first, with respect to the "market size", more specifically, to the reduced number of institutions acting as *underwriters* in public offerings. Second, which is also a consequence of the previous item, the processes of security offerings frequently emerge within a broader and longer context of relationship between the issuing company and the financial intermediary, which ends up influencing the definition of the characteristics and the conduction of the offering. These two characteristic facts of the Brazilian market can, up to a certain degree, potentialize the occurrence of conflicts of interest.

What was perceived in the interviews conducted with financial intermediaries that act in public offerings is that there is, despite the degree of internal "formalization" of processes and mechanisms to address conflicts of interest, a continuous concern to comply with the determinations imposed by the regulatory agency, CVM – Securities Exchange Commission, and with the self-regulatory codes. Moreover, all the financial intermediaries showed excessive care in guarantying that their actions do not enter into direct conflict with the other market participants, or that they do not cause losses to any party, especially their clients. The objective is to avoid the "image risk", which inevitably arises from badly resolved conflicts of interest. Negative examples from the past were even mentioned, in which the inadequate addressing of conflicts of interest and their consequences were stored in the memory of investors and the market.

The institutions believe, and we corroborate – that the progress in the level of transparency, the advance of information technology and the higher level of maturity of the Brazilian market have contributed to an increase in ethical concern. However, it was a consensus among the interviewed institutions that, in first place, a cultural attitude in the adoption of formal control mechanisms of conflicts of interest and, secondly, mechanisms that assure the efficiency of these adopted processes still deserve more attention by the financial institutions in Brazil. Below, we seek to answer, in blocks, the questions presented in the report.

Regulation and Self-Regulation

Although the material to be disclosed in the prospectus of a public offering is not included in the scope of the research, it should be mentioned that the legislation that addresses the matter in Brazil was reformulated at the end of 2003, when it began to contain a greater level of requirements, strengthening disclosure in the prospectus of transactions with related companies and with institutions acting as coordinators of the public offering. Moreover, ANBID Code of Self-Regulation with respect to public security offerings, which also deals with the content of the prospectus – and deals directly with the requirement to disclose information about conflicts of interest – had its first version issued in 2005.

The excerpts related to the topic taken from the ANDIMA Code of Ethics and Market Operational Code[149], and from the ANBID[150] Code of Self-Regulation are presented below. In Annex A we include the parts from CVM Ruling no. 400[151] related to the topic.

ANDIMA's Market Operational Code

"Chapter 4 – Negotiation Practices

Recommendation of Prudent Nature

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[149] The full documents are available at www.andima.com.br

[150] The full document is available at: www.anbid.com.br.

[151] A complete text of CVM Ruling no. 400 is available at: www.cvm.gov.br.

Article 7 *- The Associated Institutions are recommended to adopt the following practices of prudent nature, without prejudice of others that may be compulsory or even that may contribute to the safety of the operations handled herein:*

f) adoption of measures to eliminate conflicts of interest;"

ANDIMA's Code of Ethics

"Chapter 2 – Standards of Conduct of Associated Institutions

Article 4 *- Associated Institutions are expressly prohibited to:*

I – fail to protect the legitimate interests of the client or fail to take advantage of a business opportunity that is of legitimate interest to the client, with the objective of achieving undue advantages for oneself or others;"

ANBID´s Code of Self-Regulation or Public Offerings for the Distribution and Acquisition of Securities

"Chapter III – Public Offerings

Article 15 *– Upon participating in Public offerings, the Participating Institutions shall explain in detail potential conflicts of interest.*

Article 16 *– The Participating Institutions that, in the context of a Public Offering, have access to any confidential information, should safeguard the necessary secrecy, committing themselves to not disclose or employ the information in the counseling of third parties or as a parameter for conducting transactions with securities issued by the issuer an/or offerers or with the securities object of the Public Offering.*

Sole Paragraph *– All information not belonging to public domain shall be considered confidential."*

Answer to Questions 1 to 13

Definition of Conflicts of Interest

Respecting the considerations made above, ANDIMA and the sample of interviewed financial institutions agree with the definitions of conflicts of interest presented in the report. The financial institutions that report having mechanisms and procedures to address conflicts of interest confirm having adopted, depending on the different real or potential conflicts presented, all five approaches mentioned in the text: whole of group approach, decision processes, information barriers and restrictions, disclosure of conflicts and even, to a lesser degree, refraining from acting.

Some interviewed financial intermediaries, mainly foreign institution affiliates operating in the country, utilize most of the specific terms presented in the text,

such as "*control room*", "*restricted list*" and "*engagement committee*", the latter being responsible for checking all risks involved in the operation (such as conflicts of interest and legal risks).

Types of Approaches to Address Conflicts

Whole of group approach

The "whole of group approach" frequently occurs in the Brazilian market, mainly due to the fact that it is common for the financial intermediaries and issuers to be involved in other operations, such as credit, upon realization of offering. This is a particular aspect that can be pointed out in the adoption of this approach in the Brazilian context, in comparison with the international context.

Decision Process

Concurrently, on the average, in accordance with the information collected from interviewed sample, the "decision process", as suggested in the IOSCO report, was the type of approach that most distanced itself from the procedures adopted by Brazilian institutions to address conflicts of interest, especially due to the absence of mechanisms capable of determining and guarantying if, at the end of the evaluation by the people involved, the treatment applied to the conflict was effective.

Refraining from acting

With respect to the "refraining from acting" approach, this has proven to be less common in Brazil. In most of the cases, this is the result of an initial evaluation by the financial institution, which does not produce a proposal for participation in the offering. Some financial intermediaries point out that this approach to conflicts occurs in the participation in offerings for direct competitors. However, the institutions argue that the reduced number of underwriters in Brazil justifies the participation of the same institution for two issuers of a same industrial group, although not at the same time.

Information barriers and restrictions

The "information barriers and restrictions" were among the most mentioned mechanisms in all the interviews conducted with financial intermediaries in Brazil. There is, to a greater or lesser degree, the concern with confidentiality and with the flow of information within an institution. The observance lists and restrictions lists for transactions are quite common in institutions, however, as in all approaches, the not so rooted cultural question can compromise the efficiency of the mechanism, since there are limits to the restriction imposed by the institution for the exchange of information by its employees and persons involved in the operation.

Disclosure of Conflicts

"Disclosure of Conflicts" was also a much mentioned item during the meetings with the intermediaries. Its use in addressing conflicts takes place in the two more common forms: the concern to include in the issuing prospectus all and any

information that could impact the investor's decision, even those not required by regulation or self-regulation, and the exception in research reports that the intermediary is acting in an offering process for issuer. There is a special concern in relation to making disclosures to retail clients, but mechanisms are not always adopted to check if the information was clearly disclosed, or that it was truly perceived by the investing client.

Answer to Questions 13 to 33

- **Possible Cases of Conflicts of Interest**

Advising to undertake a securities offering

According to reports from Brazilian institutions, with respect to advising for the undertaking of a public offering by the intermediary to the issuer, there is an intense involvement of the two related companies, mainly in function of the close relationship usually observed between the two. Under these circumstances, the occurrence of conflicts of this type is rare. Moreover, most of the time, in the offering process, it is common that there be a regimen of solid guaranty by the financial intermediary, which means that some of the issuer's credit risk remains with the financial intermediary.

Pricing

The Brazilian institutions point this out as being the most difficult means of occurrence of conflicts of interest. According to the consulted intermediaries, the market processes are efficient in determining the price of an asset, and cases of underpricing or overpricing, motivated by conflicts of interest, rarely occur, even in the extreme cases mentioned in the report. The pressures exerted by the issuer to determine price, and by the investors - the majority of whom are institutions that dictate the demand for assets-, are equivalent to the point of generating a balanced price, recognized by market. "Errors" or "flaws" in offering evaluation can be corrected in the book building processes, but the preliminary consultation made with investors minimizes this occurrence.

Allocation

This aspect was recognizably mentioned by the visited institutions as being that of greatest fragility in the occurrence of conflicts of interest in public offering processes in Brazil, both for shares and debt securities. The fragility resides mainly in the discretionary power of the financial intermediaries in the allocation of the offering assets within the book building processes. The discretionary power occurs in function of the concern to satisfy the interests of issuers, tends to benefit the investing clients that have long and close relationships with the financial intermediaries, and can also occur with the objective of guarantying greater dynamism to the secondary asset market. Due to the current Brazilian market characteristics, this discretionary power in allocation takes place more frequently in share offerings than in debt security offerings. This factor is explained by the greater concern with the secondary stock market, since it is common in Brazil for the majority of subscribers of debt securities in the primary market to hold the

assets until their maturity date, and also by the form of settlement of debt market auctions.

There are mechanisms created by electronic negotiation platforms that permit the realization of electronic book buildings that guarantee a greater level of transparency and less discretion by intermediaries, guarantying investing clients equitable treatment. However, to date, the utilization of these mechanisms is quite limited, which would contribute to the reduction of potential conflicts of interest.

Many questions associated to allocation are also directly related to the stage and degree of development of the local market. In Brazil, for example, where there is currently a high demand by foreign investors in public offering processes, there is a clear concern by some financial intermediaries – manifested to issuers – with respect to the limit of participation of these investors in the offering, since at certain times the foreigners tend to present a more volatile behavior than the local investors do. Moreover, with respect to the question of allocation, it is considered, at the current good moment of the Brazilian market, that the relationship of the intermediary with the issuer is stronger than that of the intermediary with the investor, since the latter tends to be less loyal to a sole financial institution, which is not the case of the issuing company.

Thus, responding to the questions presented in the report in relation to this topic, there is indeed in Brazil an effective participation of the issuer during the placement of assets by the financial intermediaries. Nevertheless, the joint decision by issuers and intermediaries does not seem to be sufficient in itself to administer the possible conflicts of allocation.

Retail Advising / Distribution

Despite having been mentioned by a large part of the financial institutions as a strong source of conflicts of interest, all the intermediaries showed a high degree of concern and diligence for the management of conflicts of interest originating from the relation between the position of *underwriter* and of advising for the sale of assets.

Even though in Brazil the retail investors still do not have a relevant role in the total amount of public offerings, mainly with respect to the definition of the offering price, problems resulting from purchases of inadequate assets by suggestion of the intermediary can create great lack of satisfaction and complaints by retail investors. This is viewed as a high image risk, and the majority of financial intermediaries, if not all, are not willing to run this risk.

In the consulted distribution areas, there is concern over the definition of adequate remuneration policies, which influence the sales process. There is also a commitment for disclosure, in the research reports, to clarify that the financial intermediary is participating in the offering as underwriter. It should also be emphasized with respect to this point, that a norm that addresses suitability is currently under analysis by the regulatory agency of the securities market in the country, which shows, although recently, that the topic is already receiving attention.

With respect to the research reports, the financial institutions highlighted a large concern in relation to the preparation of the reports, to the commitment to independence and capacity of the analyst and the sole use of public information. In the cases of initial offerings (IPO), the lack of available public information can compromise this relation, increasing the area of conflicts of interest, leading the analyst to use information that is held by the financial intermediary. It is also necessary to emphasize that in Brazil there is a strict period of silence, which significantly limits the statements of the intermediary with respect to the offering.

Another possible area of conflict related to distribution emerges from the allocation of offering assets in the area of the banks' third party resource management, but the institutions have demonstrated that they have increasingly efficient evaluation and analysis control mechanisms and, also with respect to this point, the same concern was observed with respect to image risk, to guarantee that nothing will be done against the interests of investing clients. It was observed that there are processes that are internal to the areas of structuring, distribution, research and funds, which conduct analytical research and establish criteria for actuation (approval processes). The greater or lesser degree of establishment of rules for compliance and conduct will influence the level of possible conflicts of interest, but, still in function of the preservation of external image, all of these conflicts are avoided (for example, the risk of negative impact on the profitability of funds).

Lending

As said above, it is not uncommon in Brazil for the processes of public offering of assets - shares or debt securities - to be classified within the context of closer and longer relationship between the issuing company and the financial intermediary. This context involves a credit relationship most of the time. To address these conflicts of interest, most of the institutions pointed out the use of information barriers and restrictions between the different areas of performance of the financial intermediary, but, as described in the question related to this topic in the report, this mechanism is not always totally strict. There is the transposition of information barriers in situations in which the offering involves solid guaranty regimens, where the credit risk of the issuer will be analyzed by other bank areas. Many institutions also report that in some cases the limits of the imposed barriers are not clear, and new employees become involved in the operation, in accordance with the evolution of the offering process.

One mechanism that has proven to be quite efficient for addressing this type of conflict of interest, and which is widely employed by the interviewed institutions, is the disclosure of information. There are recommendations presented by the regulatory and self-regulatory instruments that there should be disclosure in the offering documents, especially in the prospectus, of all and any relation among the related companies which can influence the decision to hold the offering and the decision to acquire assets by the investors. At meetings held, a high degree of care was observed by the financial intermediaries to disclose all available information, even that which is not obligatory by law or by self-regulation codes. It was also emphasized that, in the cases of offerings of debt securities in the Brazilian market, the rating classifying agencies acts as strong risk mitigators, and consequently assist in addressing this type of conflict of interest.

Annex A

Despite not being the focus of report, we point out below certain points of CVM Ruling no. 400 – main regulation of bond and security offerings in country– which also contribute to addressing cases of conflicts of interest approached in report.

Scope and purpose

Art. 1 This Instruction regulates public offers of securities in the primary and secondary markets and is intended to ensure the protection of investor interests and the market in general through equal treatment of bidders and by requiring a broad, transparent, and adequate disclosure of information on the offer, including: securities offered, the issuing company, the issuer, and any other people involved.

Offer content

Art. 21. The distribution public offers shall be made under conditions that assure equal treatment for recipients and accepters of offers, with priority concessions being given to older stockholders, without harming the provisions of arts. 23 and 33, paragraph 3.

Corporate brokers

Art. 33. The relationship between the Issuer and the Corporate Brokers shall be formalized through a securities distribution contract, which must contain the clauses contained in Appendix VI.

Paragraph 1 The distribution contract shall explicitly outline all forms of remuneration due to the Issuer, as well as any remuneration, even indirect, including the discount and/or re-lending granted to investors, if such is the case, supported by the Corporate Brokers.

Paragraph 2 In the situation of direct or indirect partnership binding the Issuer or its controlling shareholder and the underwriter or its controlling shareholder, such situation shall be outlined with emphasis in the Prospectus.

Paragraph 3 The distribution leader, with the express approval of the Issuer, shall organize a distribution plan, which should take into account the relationship with clients and other considerations of commercial or strategic nature of the leader and of the Issuer so that the Corporate Brokers can assure:

I - that the treatment of investors is fair and equitable;

II – that the adaptation of the investment to the risk profile of its respective clients is good; and

III - that the sales representatives of the institutions participating in the distribution consortium receive a sample of the Prospectus for mandatory reading prior to involvement, and that their questions can be clarified by a person appointed by the leading distribution institutions.

Art. 37. The distribution leader has the following obligations:
VII - actively participating, together with the Issuer, in elaborating the Prospectus (art. 38) and in verifying the consistency, quality, and sufficiency of the information it supplies, being responsible for the information rendered according to the terms of art. 56, paragraph 1;

Prospectus

Art. 39. The Prospectus must not omit relevant facts or contain information that can induce investors to error. The Prospectus shall include data and information on:

I - the offer;

II - the securities object of the offer and the rights inherent in them;

III - the Issuer;

IV - the issuing company and its equity, economic, and financial situation;

V - third parties guaranteeing obligations related to the securities object of the offer; and

VI - third parties that come to be recipients of the resources funded with the offer.

Paragraph 1 In the event the previsions relative to the evolution of the activity and the issuer results, as well as the evolution of the prices of the securities object of the offer are included, they shall:

a) be clear and objective; and

b) be supported by the opinion of an independent auditor on the presuppositions, criteria used, and their consistency and coherence with the previsions.

Paragraph 2 CVM can require from the Issuer, and insist on its inclusion in the Prospectus, any additional information it considers appropriate, as well as advertences and considerations that it considers reasonable for the analysis and comprehension of the Prospectus by the investors.

Paragraph 3 In the case of public offers that involve the issuance of securities to which there is no prevision of specific procedures, information, and documents, CVM can, at the request of interested parties, establish the content of the respective Prospectus.

Consultation on the feasibility of the offer

Art. 43. The consultation to potential investors by the issuer and by the institution leading the distribution is permitted to verify the feasibility or interest of an eventual public offer distribution, provided this consultation does not exceed 20

investors and maintains reasonable criteria for the control of confidentiality and secrecy, in the event the issuer has already previously contracted a intermediary institution.

Paragraph 1 The consultation to potential investors cannot bind the parties under penalty of characterizing an irregular distribution of securities, and the accomplishment or acceptance of offers is vetoed, as is the payment or receipt of any value, good, or rights by any of the parties.

Paragraph 2 During the consultation to potential investors, the issuer and the institution leading the distribution shall warn their interlocutors that the intention to accomplish public distribution of securities is maintained in privacy until its regular and wide release to the market, in the terms of CVM Instruction CVM nº 358, of January 3, 2002.

Paragraph 3 the issuer and the institution leading the distribution shall maintain a detailed list with information about the people consulted, the date and time they were consulted, as well as their answer regarding the consultation.

Paragraph 4 In the event a request for registration with CVM is effectively filed, the issuer shall present, together with the documents listed in Appendix II, the list mentioned in paragraph 3.

Conduct norms

Art. 48. The issuing company, the issuer, the corporate brokers, the latter since the signing of the contract, involved in any finalized or projected public offer distribution, and the people working with them or advising them in any way, shall, without contravening the provisions of CVM Instruction nº 358, from 2002:

I - while the public offer has not been released to the market, limit:

a) The release of information related to the offer to what is necessary for the objectives of the offer by alerting the recipients of the reserved character of the information transmitted; and

b) The use of the reserved information strictly to the purposes related to the preparation of the offer.

II - up to the publication date of the Distribution Closure Notice, abstain from negotiating with securities issued by the issuing company or the issuer, except in the case of:

a) Execution of stabilization plan duly approved by CVM;

b) Total or partial disposal of securities lot that is the object of firm commitment;

c) Negotiation for the account and order of third parties; or

d) Operations clearly meant for accompanying a share index, certificate or receipt of securities;

III - presenting CVM research and public reports about the company and the operation it has developed;

IV - abstaining from communicating in the media about the offer or Issuer until the issuance of the Distribution Closure Notice; and

V - from the moment the offer becomes public, when releasing information related to the issuer or offer:

a) Observing the principles relative to the quality, transparency and equality of access to information; and

b) Clarifying connections with the issuer or their interest in the offer, their communication on subjects that involve the offer, the issuer, or the securities.

Art. 49. For all effects of art. 48, the issuing company, the Issuer, and the Corporate Brokers shall assure the precision and adequacy of any information supplied to any investor, regardless of the medium used, with the information contained in the Prospectus, being subject to direct such documents and information to CVM, in the form of art. 50.

Advertising material

Art. 50. The use of any advertising text for the offer, call, or promotion of the distribution through any form or medium, including audiovisual, shall depend on previous approval by CVM, and can be done only after the Preliminary Prospectus has been presented to CVM.

Disclosure and distribution period

Art. 55. In the event an excess of demand one third higher than the quantity of securities offered, the placement of securities with controllers or managers of the Corporate Brokers and the issuer, or other people connected to the issuance and distribution, as well as their spouses or companions, ascendants, descendents, and collateral relatives up to the 2nd degree is vetoed.

Veracity of information

Art. 56. The Issuer is responsible for the veracity, consistency, quality, and sufficiency of the information rendered when registration is made and when it is disclosed to the market during distribution.

Paragraph 1 The underwriter shall take all possible measures and act with the highest standards of diligence as well as take responsibility for any lack of diligence or omission to assure that:

I - the information offered by the Issuer is true, consistent, correct, and sufficient, allowing investors to make solid and reasoned decisions on the offer; and

II - the information disclosed to the market during all distribution terms, including possible or periodic terms necessary for the company registration updating and those necessary for the economic-financial feasibility study for the undertaking, if applicable, that come to integrate the Prospectus, are sufficient, allowing the investors to take well reasoned decisions on the offer.

Paragraph 5 The Issuer and the underwriter shall declare that the Prospectus contains the relevant information needed to the understanding of the offer by investors, the securities offered, the issuer, its activities and economic-financial situation, the risks inherent to its activity, and any other relevant information, as well as noting that the Prospectus was developed in accordance with the pertinent norms.

Paragraph 6 In case the issuing company doesn't belong to the group controlling the issuer, or is not acting as representative of the same of controlling shareholder interests as the issuer, and this one denies access to the documents and information necessary for the development of the Prospectus, the Issuer shall supply all relevant available information or communicate that it can be obtained in public registers and documents, and include this fact in the Prospectus, being subject to the request from CVM of the requirement from the issuer of the complementation of the information indicated by the Issuer, necessary for the registration of the public offer.

Paragraph 7 The registration does not imply, on CVM's part, a guarantee of truthfulness of the information rendered or a judgment on the quality of the company, its feasibility, management, economic-financial situation, or the securities to be distributed, and it is granted according to formal criteria of legality.

APPENDIX III

Information That Shall Be Contained in the Prospectus

3. Information related to the offer
3.2 Characteristics and terms

3.2.2 In the case of primary issuance of stock, a justification on the issue value for the securities to be distributed, as well as of the criterion adopted for its value fixing.

3.2.4.1 develop a description comparing the issue value to the price paid by managers, controllers, or holders of options who acquired stock in the last five years;

3.2.7 Statement of inadequacy of the investment for certain types of investors, in the event the investment is inadequate for certain types of investors, by specifying them and stating such inadequacy with emphasis;

3.3 Securities distribution contract

3.3.1 Specify the conditions of the distribution contract in relation to the placement of the securities with the public and eventual guarantee of subscription rendered by the leader and the participants in the consortium, by specifying the quota of each one, if it is the case, besides other clauses considered relevant for the investor, indicating the place where the contract copy is available for consultation or copy; and

3.3.2 Relationship of the issuing company with the distribution leader and coordinators participating in the distribution consortium, such as loans, investments, and other relations eventually existing, including those with financial institutions that have corporate relations with the participants of the consortium; and

3.3.3 Exhibit of the Distribution Cost - inform:

3.3.3.1 the percentage in relation to the distribution unit price;

3.3.3.2 the Coordinating Commission;

3.3.3.3 the Placement Commission;

3.3.3.4 the Subscription Guarantee Commission;

3.3.3.5 Other Commissions (specify);

3.3.3.6 the Distribution Unit Cost;

3.3.3.7 the Expenses resulting from the Registration; and

3.3.3.8 other related costs.

3.4 Contract of liquidity guarantee, price stabilization, and/or contract of suplementary lot placement option: In case they have been signed, inform their

main characteristics, in accordance with the norms issued by CVM, by indicating the place where a copy of the contract can be obtained.

3.6 Information to be given in the hypothesis of setting up of a company:

3.6.6 solution previewed for the case of subscription excess;

APPENDIX IV

Distribution commencement notice

VI - Procedure previewed for the distribution, which clearly explains the type of treatment to be given to those interested;

VIII - Statement of inadequacy and/or adequacy of the investment for specific investors, if any;

APPENDIX VI

Securities distribution contract

Mandatory clauses

5. Sale conditions of the securities by the lead institution or by the other Intermediary Institutions involved in the distribution, in the event of placement with the solid guarantee regimen;

6. Remuneration of the lead institution and other Intermediary Institutions involved in the distribution, discriminating the commissions due;

7. Description of the procedure adopted for distribution; and

8. Mentioning of price stabilization contracts and guarantee of liquidity, if applicable.

APPENDIX VIII

Call for stock auction in stock exchange (Information That Shall Be Contained in the Edict of Auction of Shares on the Stock Market)

1.3 Stock distribution contract

1.3.2 Relationship of the Issuer and the issuing company with the distribution leader and coordinators participating in the distribution consortium, such as loans, investments, and other relations eventually existing, including those with financial institutions that have corporate relations with the participants of the consortium;

1.3.3 Exhibit of the Distribution Cost - inform:

1.3.3.1 the percentage in relation to the distribution unit price;

1.3.3.2 the Coordinating Commission;

1.3.3.3 the Placement Commission;

1.3.3.4 the Distribution Guarantee Commission;

1.3.3.5 Other Commissions (specify);

1.3.3.6 the Distribution Unit Cost;

1.3.3.7 the Expenses resulting from the Registration; and

1.3.3.8 other related costs.