AFMA

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Dear Ms Aldridge

ASIC Report 605 Allocations in equity raising transactions

The members of Australian Financial Markets Association (**AFMA**) have given careful consideration to the best practices provided in ASIC Report 605: *Allocations in equity raising transactions* (**Report 605**). This follows the extensive engagement AFMA has had with ASIC over the last eighteen months on allocation practices relating to equity capital raisings. Following conversations between ASIC senior executives and the AFMA Secretariat during which ASIC indicated that feedback from the market would be welcomed, we have prepared the following comments on Report 605 for your consideration.

Before highlighting some specific feedback on Report 605, AFMA members set out some general observations:

(a) AFMA members welcome ASIC's interest in this area and believe the market will benefit from the better practices outlined in the report. For AFMA members, the better practices generally align with existing policies and procedures governing the way in which they conduct themselves in the allocation and the bookbuild messaging processes. However, we note that practices differ between AFMA members and that in some areas raised by the report there is also mixed practice.

(b) The feedback in this letter relates to allocation and bookbuild messaging practices associated with equity capital markets transactions only. We note ASIC's suggestion at paragraph 6 that the findings and better practices in Report 605 may also have application to allocations in debt raising transactions. We would appreciate the opportunity to discuss this observation with ASIC further. In our experience and that of our members, the bookbuild practices for a debt raising transaction are different to those applicable to listed equity. This is not least because, in many cases, and in light of the far greater volumes, particularly often involving international offerings, debt raisings adhere more closely to international norms and practices as opposed to domestic listing rule and regulatory requirements. AFMA members welcome ASIC's on-going interest in this subject, but would caution against simply translating the findings and better practices for equity raising transactions to debt raisings without undertaking a broad consultation.

(c) Given the central role of the "issuer" to ASIC's better practices concerning allocations, and the different risk and process considerations that apply to secondary sales, AFMA members are approaching ASIC's better practice guidance towards allocations as applicable to primary and secondary issuances but not secondary sales, such as the sale of securities under block trades.

(d) Members observe that the allocation process and engagement with the issuer is a dynamic one and that because of this it will not be practicable to and ASIC should not expect that licensees should apply better practices in a formulaic way. For example, there may be transactions where there is no pitching stage or the broader syndicate is brought together immediately prior to transaction launch. So in both examples the ability of a licensee to engage on the issuer's allocation objectives and criteria, and to have this recorded in writing, may be constrained, and may result in a considered but nuanced application of the issuer's allocation objectives and the allocation criteria to reflect changes in market conditions, indicative demand or pricing.

With these general observations in mind, AFMA members make the following comments:

1. **Role of Compliance**

AFMA members fully support the proposition that there should be appropriate monitoring and review processes of a licensee's conduct in relation to allocations and bookbuild messaging. Ultimately, however, it is the responsibility of operational management, such as members of the syndicate, equity capital markets team and equities team, to ensure that allocations adhere to legal, regulatory and policy requirements and that any bookbuild messaging they are releasing is accurate and based on reasonable grounds. Such an approach is consistent with the "three lines of defence" risk management model. While compliance (or an equivalent review function) has a meaningful and important role to play in support, it is the first-line or front-line syndication managers who are charged with ownership and management of the bookbuild process as well as ensuring compliance with regulatory requirements and management of business conduct risk. While we acknowledge that ASIC has set out the better practices in C2 as examples of compliance activities that licensees *may* undertake, we stress that the role of compliance should not displace the responsibility of operational management and that ASIC should not consider that a compliance led framework that does not possess all the features of C2(a)-(e) would be deficient if addressed through other means.

2. Allocation recommendations

With respect to messages provided by licensees to investors in connection with an equity capital raising transaction, a better practice in Report 605 is that licensees should ensure there is a reasonable basis for any message stating that the transaction is 'covered' or 'cornered'. In determining whether a reasonable basis exists for such a message, ASIC observes that bids from related investment managers, employees and principal accounts and any bids deemed excessive should be excluded.

A. <u>Exclusion of "inflated" or "exaggerated" bids</u>: ASIC provides at paragraph 133 that licensees should take into account their knowledge of investors to assess if an investor's bid is excessive (e.g. if the bid represents a large proportion of the investor's funds). Where a bid appears excessive, the licensee should discuss it with the investor before it is submitted to the ECM team. ASIC also suggests at paragraph 132 that ECM teams should not accept bids from the sales desk at face value.

The determination of whether a bid is excessive or not when taken at face value is very difficult. In the vast majority of cases, there is little reason to question a professional, experienced investor making a bid for securities. Information about whether an investor has sufficient funds under management relative to the size of its bid is difficult to ascertain in many cases because many investors have complex structures and use many different entities and vehicles for investing and trading activity. AFMA members are of the view that if the legal framework for investor bidding is clear, then this should be sufficient. As a general proposition the bidding guidelines for participation in equity capital raising transactions, as typically set out in the "launch" message, clearly state the basis on which investors participate and generally align with the ECM Master Terms (which are well known to professional investors and readily available on AFMA's website). It is customary to provide that any offer made for securities is binding and immediately capable of acceptance by the licensee at close of the book. Given the sophistication of professional investors who customarily participate in bookbuild processes and the fact that terms and conditions of the bookbuild process are clear and readily available, licensees should not be required, in the ordinary course, to interrogate the genuineness of each bid.

Secondly, a licensee is not privy to (nor in many cases should be) all of the factors that may drive an investor's bid. While licensees may query a bid from a non-credible source, to unilaterally exclude a bid based on the licensee's own assessment of an investor's motives, could conflict with the licensee's obligations owed to investors, including obligations that may be owed under the Market Integrity Rules as well as broader licensing obligations. Such conduct could also give rise to a risk of a client complaint or claim, in circumstances where the investor client challenged or disputed the determination.

B. <u>Exclusion of related investment managers and principal account bids from bookbuild messages</u>: Report 605 provides as a better practice that bids from related investment managers and principal account bids should be excluded when preparing a bookbuild message describing the transaction as "covered", "cornered" or similar. AFMA members consider that this could have the unanticipated result of creating a lack of transparency, confusion and uncertainty in bidders as well as undermining the integrity of the book. Where a book includes legitimate bids from related investment managers or principal accounts, to either:

- delay the release of a "covered" message until such point as further non-related investment manager or principal account demand has been received; or
- distribute a bookbuild message that excludes the relevant legitimate bids received to date and therefore give the impression that the book is not covered, when it is actually covered;

could expose the licensee to criticism for not being transparent as to the true state of the book. It could also adversely impact the success of the transaction for the issuer, given as ASIC points out at paragraph 172, "*[m]ost institutional investors advised us that they want to know if a transaction is 'covered' as it indicates the level of investor support for a transaction and, more importantly, means that the licensee will not be left holding shortfall securities in the after-market.*"

This becomes even more problematic where there is more than one licensee acting as bookrunner. If several licensees' related investment managers were to each independently make bids into the book and this legitimate demand, which collectively could equate to a not insignificant amount of demand in the transaction, cannot be included in covered messages, this could further lessen the transparency of the true state of the book.

In addition, AFMA members note that their related investment managers who bid into a book tend to be listed or unlisted AFSL holding entities or otherwise owe fiduciary obligations to third-party external asset owners or accounts. In many cases, these related investment managers are subject to:

- AFS Licence conditions;
- specific duties to their underlying clients (and, as already noted, these often include fiduciary duties);
- clear investment mandates; and
- are treated as third-party entities on a full arm's length basis by the relevant licensee.

Furthermore, in addition to related investment manager participation. AFMA members do not consider that principal account bids should be excluded from statements of coverage in a bookbuild message (noting there is a range of practices in respect of trading account allocations). To do so, excludes legitimate demand (refer to section 2(c) below).

In both cases, rather than focusing on the inclusion or exclusion of such interests from the bookbuild messages we think that the concerns that ASIC raises with related investment manager and principal account participation would be appropriately managed by requiring that these bids are:

- consistent with the issuer's objectives;
- transparent to the issuer;
- subject to the same bidding terms as other investors participating in the transaction; and
- treated on the same basis as other comparable investors; and
- any allocation to such bids must be consistent with the issuer's objectives.

C. <u>Allocations to parties connected to the licensee</u>: AFMA members note the better practice in section F2 provides that allocations to employee and principal accounts should be avoided except where an offer is undersubscribed. It is generally the case that the allocation policies of AFMA members prohibit allocations to employees and AFMA members support this better practice. However, AFMA members are of the view that the suggestion that allocations to principal accounts should be avoided is too restrictive. In many cases, like related investment managers, these principal accounts have their own mandates and investment thesis and their bids represent genuine demand.[1]

The allocation policies of many of our members adhere to global standards and set out in detail how allocations to principal accounts, including trading desks should be treated in the context of avoiding and managing perceived or potential

[1] We also note that, in the alternative, the principal allocation could represent an allocation taken as principal for investors requesting synthetic exposure to the securities. While we mention this for completeness, we do not consider that such an allocation would be considered a principal account "bid" into a bookbuild in the context of Report 605.

conflicts of interest. AFMA members believe that any perceived or potential conflicts arising from allocations to principal accounts can be managed appropriately under such policies where the allocation is consistent with the issuer's objectives, the issuer is fully informed about and agrees to the final principal allocation.

Accordingly, AFMA members consider that there is adequate protection and protocols around principal allocations. Many of these protections and protocols are enshrined in the better practices set out in section F2(a)-(g), subject to the following caveat. Members do not agree that there will be a material benefit in the disclosure to investors *ex post* of an allocation to a principal account. The conflict should be managed through issuer engagement prior to the point the allocation is made.

3. Pricing

AFMA members note the observation in the note to paragraph 46 that based on ASIC's analysis of post-offer pricing performance, issuers may not be focussing on the terms of raising as "actively as they should". This is at odds with the experience of our membership. The experience of AFMA members is that issuers are typically very focused on the issue price and minimising the discount, maximising proceeds and/or minimising the dilution impact for non-participating holders. In addition, pricing is only one relevant consideration. Other factors will often be of equal or greater importance to all parties involved in an offering, such as managing market risk, funding certainty, the desire for a successful raising, and the desire for a successful aftermarket and also the issuer's interests in the long term health of its share register.

AFMA members do not agree that the statistics produced necessarily evidence mispricing. In the experience of our members, the price discovery process is a robust and thoughtful process that draws information from a variety of different sources. Pricing is also subject to variables beyond the control of issuers and JLMs, including external events. In addition, it is important to keep in mind many offerings trade down. For example, during 2018 eight of the top ten IPOs traded below the final offer price on the first day of trading, with an average loss of 23.9% by 31 December 2018. Offerings are also withdrawn, downsized or re-priced if the price and/or structure are not attractive to investors. Price setting involves many different variables that are inherently challenging to manage and requires careful consideration and critical judgement.

The offering process also inevitably entails discovery of whether the price and/or structure offered by issuers and licensees is aligned with investor interest and demand. The ability to gather this interest in advance of the commencement of a bookbuild process is often constrained by the restrictions that apply to sounding investors. In addition, investors typically have an expectation that they will obtain a return on their investment and risk taking activities. This is a critical expectation and incentive that informs pricing and the effective functioning and liquidity of capital markets. Being asked to commit a large dollar or percentage commitment to an offering for an IPO or other primary capital raising is inherently risky and requires incentives, and it is reasonable to expect that investors make a reasonable investment return, in party by seeking to acquire securities at a discount to the post-offer price. Investor appetite is substantially reduced when offerings trade down or below the issue price.

Please contact David Love either on 02 9776 7995 or by email dlove@afma.com.au if further clarification or elaboration is desired.

Yours sincerely

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