

Market Study

MS15/1.2

# Investment and corporate banking market study

Interim report



April 2016



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<b>1</b> Occasional Paper [OP 15]: What determines IPO allocations?	
<b>2</b> Discussion Paper [DP 16/3]: Availability of information in the UK IPO process	



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## Abbreviations used in this paper

<b>CMA</b>	Competition and Markets Authority
<b>COBS</b>	Conduct of Business Sourcebook
<b>DCM</b>	Debt capital markets
<b>ECM</b>	Equity capital markets
<b>EMEA</b>	Europe, Middle East and Africa
<b>FCA</b>	Financial Conduct Authority
<b>FIG</b>	Financial Institution Group
<b>FSMA</b>	Financial Services and Markets Act 2000
<b>IPO</b>	Initial public offering
<b>M&amp;A</b>	Mergers and acquisitions
<b>MiFID</b>	Markets in Financial Instruments Directive
<b>MiFID II</b>	The revised Markets in Financial Instruments Directive (2014/65/EU)
<b>PRA</b>	Prudential Regulation Authority
<b>SME</b>	Small and medium-sized enterprises
<b>SSA</b>	Sovereign, supranational and agency
<b>SYSC</b>	Senior management arrangements, Systems and Controls Sourcebook

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# 1.

## Executive summary

### Chapter summary

Primary markets play a vital role in the economy matching investors with corporates and public bodies who need to raise finance. The UK is a leader in equity capital markets (ECM), debt capital markets (DCM) and merger and acquisition (M&A) activity. These primary market activities comprise around a quarter of revenues earned by universal banks, and in 2014 total gross fees in primary markets generated by investment banks' UK operations amounted to approximately \$17bn.

During our Wholesale sector competition review last year, stakeholders raised a number of concerns in relation to primary markets. Many of these concerns centred on cross-subsidies in the universal banking model between corporate banking and investment banking as well as specific market practices such as syndication and reciprocity. While many clients feel well served by primary market services, we found some of the concerns were borne out in the evidence we have collected and we are inviting views on potential measures to address these.

### Interim findings

#### *Universal banking and cross-subsidies*

There is a wide range of banks and advisers active in primary market services. There are often between 20 and 40 banks active in any particular sector and for different types of client – sovereigns, supra-nationals and agencies (SSAs), financial institutions and corporate clients.

Lending and corporate broking are typically supplied at a low rate of return or below cost in exchange for a flow of transactional business, which is typically more lucrative. Nearly three-quarters of DCM primary market roles are awarded to a bank with whom the client has an existing corporate banking or lending relationship, however the link is significantly weaker for initial public offerings (IPOs).

From a client perspective, this model seems to work well for large corporate clients, who typically have a wide range of lending banks or joint corporate brokers that compete against each other for transactional mandates. However, medium-sized corporate clients (those of a size equivalent to the UK FTSE 250) and small corporate clients (those of a size equivalent to the UK FTSE Small Cap and AIM), who typically have fewer banking relationships, may feel the need to "reward" a lending bank or corporate broker with transactional business even when that bank would not otherwise have won a mandate. Pressure to award transactional business to a lending bank or corporate broker can be exacerbated by the widespread use of contractual clauses in client engagement letters restricting future choice of supplier.

The provision of cheap lending and corporate broking makes it harder for those banks providing only transactional services to compete. While boutique advisers have successfully entered in M&A, entry and expansion as book-runners in ECM and DCM has been mainly by banks that also lend. We have seen little evidence of emerging technology-driven disruption or disintermediation of primary market activities.

### ***Other market practices***

We looked at a range of market practices to assess whether they restrict or distort competition and adversely affect outcomes for clients. We found the following concerns:

- The 'blackout' period in the UK IPO process between publication of research by syndicate banks and the circulation of the 'pathfinder' prospectus means that the pathfinder and approved prospectuses, both key sources of information, are made available too late in the process to be used by buy-side investors, non-syndicate banks' analysts and independent research providers. When coupled with a lack of access to the issuer's management for non-syndicate bank analysts, this reduces the diversity and independence of information available to investors.
- Allocations of shares in IPOs are skewed towards buy-side investors from whom banks derive greater revenues from other business lines (e.g. trading commission). Although these investors may be long-term holders and of benefit to issuing clients, there is also a risk that allocations do not align with issuing clients' best interests and may shut out other investors.
- League tables that rank investment banks can be misleading because some banks carry out loss-making transactions purely to generate a higher position in league tables. Furthermore, banks routinely present league tables to clients in a way that inflates their own position. Many clients are aware of these practices; nonetheless we believe they impede effective client choice.

We also analysed the practices of reciprocity and syndication. We are not minded to pursue these issues further at this stage although we may revisit reciprocity if its prevalence or impact develops significantly:

- Reciprocity is a practice whereby a bank issuing its own financing awards mandates to another bank partly based on how much business it will receive in return. It is currently most prevalent in the bank financing market, particularly covered bonds, but at present this practice does not appear to be excluding other banks from competing.
- The size and composition of ECM and DCM syndicates are controlled by clients. Larger syndicates are not associated with higher fees, and they can broaden clients' relationship options and provide a route for smaller banks to enter and expand.

### Potential remedies

Based on these findings, we propose a targeted package of potential measures designed to ensure that competition takes place on the merits by reducing artificial incumbency advantages, improving clients' ability to appoint banks that best suits their needs, ensuring that conflicts are properly managed, and improving the IPO process. Specifically we aim to:

- remove the practice of banks using contractual clauses that restrict client choice
- improve the IPO process to ensure more diverse and independent information is available earlier
- investigate further with individual banks where our analysis raises questions about conflict management in IPO allocations
- improve the credibility of league tables

In addition it is crucial that the market remains open to entry and innovation. We are very keen to hear any concerns from stakeholders about barriers to such entry. We are also keen to hear views on our interim findings and potential remedies.

- 1.1** This report presents the interim findings of our market study of investment and corporate banking services. It is published alongside two other papers: Occasional Paper [OP 15]: *Quid pro quo? What factors influence IPO allocations to investors?*; and Discussion Paper [DP 16/3]: *Availability of information in the UK equity IPO process*. In this interim report, we set out our views based on our work to date on how competition works and on outcomes for clients. We also outline some potential remedies that might address some of the concerns we have found. We are keen to hear views on our interim findings and potential remedies.

### Background

- 1.2** On 22 May 2015, we launched our market study into investment and corporate banking by publishing our Terms of reference. This followed from our Wholesale sector competition review feedback statement, published in February 2015, which identified some potential competition concerns in investment and corporate banking, and also led to the launch of our asset management market study.
- 1.3** We have focused on primary market and related activities provided in the UK by the investment and corporate banking industry, particularly:
- the choice of banks and advisers faced by clients when selecting services
  - transparency in the provision of services
  - the practices of cross-selling and cross-subsidising services

**1.4** Since launch on 22 May 2015 we have:

- issued requests for information and received responses from over 90 stakeholders, including investment banks and corporate finance advisers, buy-side investors and corporate clients
- conducted data analyses of over 10,000 ECM, DCM, M&A and corporate loan transactions spanning a period of up to 5 years
- met with over 100 stakeholders in a series of roundtable and bilateral meetings

### **Our interim findings**

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**1.5** Our interim findings relate to:

- choice, universal banking and cross-subsidies
- other market practices
  - syndication
  - reciprocity
  - league tables
  - corporate finance advisers
  - transparency of scope of services and fees
  - the IPO process
  - allocation of shares in IPO book-building

#### **Choice, universal banking and cross-subsidies**

**1.6** We did not identify compelling evidence that any particular sector or category of clients faces a lack of available suppliers for corporate and investment banking services. Our analysis indicates that large and frequent issuers such as financial institutions, SSAs and large corporate clients are all well served by banks and advisers. There are often between 20 and 40 banks active in any particular sector and for different types of client. The largest four firms in the market account for 39%, 35% and 50% of the value of transactions in ECM, DCM and M&A respectively.

**1.7** Medium-sized corporate clients (those that are of a size equivalent to the UK FTSE 250) and small corporate clients (those of a size equivalent to sub-UK FTSE 350/UK FTSE Small Cap and AIM-listed companies) also have a reasonable choice of banks at present. However, we have seen evidence that larger banks opt to reduce their engagement with smaller, newer and/or riskier clients in response to market conditions and regulatory change. Future regulatory developments or an economic downturn could therefore cause some banks to withdraw from these types of clients to focus on larger, more attractive clients.

**1.8** Investment banking is very much a relationship business with relationships strengthened both by cross-subsidised lending and corporate broking (including daily coverage) and by past primary market transactions.

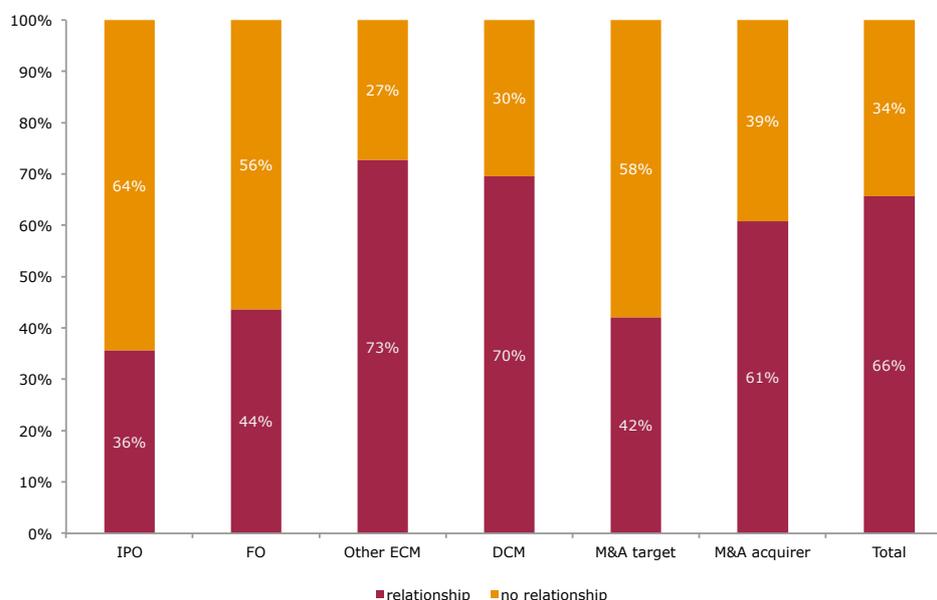
- Many investment banks lend at a low rate of return or below cost on the basis that a sufficient overall return will be made through cross-selling primary market transactional services. Lending committees often consider the share of future transactional business that the bank expects to win over the lifetime of the loan.
- Similarly, corporate broking services are typically provided for low or no fee in the expectation that the bank will be rewarded with future transactional activity.

**1.9** The concerns raised to us were not about the number of banks per se, but about the impact of this cross-subsidy on competition. In particular concerns were expressed that:

- clients may not always be free to award primary market mandates to the bank that best suits their needs, especially if there are barriers to using non-relationship banks
- it is difficult for new entrants to break into primary market services without also offering lending and/or corporate broking

**1.10** We looked at the link between lending/corporate broking and primary market roles awarded to banks, and found it to be strongest in DCM and other ECM (convertible debt) transactions and advice on M&A acquisitions. We found that around two-thirds of roles awarded in these transactions were awarded to those banks with whom the client had an existing relationship, however the link is significantly weaker for IPOs (see Figure 1).

**Figure 1: Proportion of roles awarded to banks which have and have not provided lending or other corporate banking services in the 2 years prior to the transaction, January 2014 to May 2015**



Source: FCA analysis of transactional data described in Annex 2.

Note: Other ECM comprises mainly convertible debt.

- 1.11** To a large extent this 'quid pro quo' is a commercial expectation, but we also found that the majority of the larger banks use or seek to use contractual clauses that restrict a client's choice in future transactions. The most restrictive and frequently used of these were right of first refusal or right to act clauses. We were told that these clauses have the intention of morally or legally obliging the client to award future business to the given bank. We received no clear evidence that clients were able to negotiate a benefit (such as lower fees) when committing to such clauses.
- 1.12** Consistent with the pattern of quid pro quo, we found that entry and expansion in book-running in ECM and DCM tends to be by banks that also lend, whereas a number of boutique advisers successfully provide M&A advice.
- 1.13** Large corporate clients, who want access to cheap lending, establish lending panels with a wide range of participating banks, who then compete against one another on primary market mandates. This enables the client to choose the best bank for a particular mandate provided that over time each bank wins sufficient business to warrant it continuing the lending relationship. On occasion, however, clients, particularly medium-sized and small corporate clients, who typically have fewer banking relationships than large corporate clients, may feel the need to "reward" a lending bank or corporate broker with transactional business even when that bank would not otherwise have won a mandate. Overall, although many clients are in a strong position to secure good outcomes across services as a whole, the bargaining position of many medium-sized and small corporate clients is likely to be less strong than that of large corporate clients.
- 1.14** We also found that clients are less sensitive to fees on primary market mandates and that they are primarily focused on maximising transaction value and minimizing the all-in cost of funds. In our view, therefore, the higher returns on transactional business and the lower returns on lending/corporate broking reflect a combination of cross-subsidy (where some of the higher returns are competed away in the lending business) and low fee sensitivity. When compared with transactions executed in other jurisdictions, primary market transaction fees in the UK are lower than in the US, but similar to or slightly higher than in Asia (see Chapter 8).
- 1.15** Overall, our evidence indicates that banks frequently cross-subsidise between lending/corporate broking and primary market services. Cross-selling and cross-subsidisation can bring benefits to some clients in the form of cost savings from the bank's more detailed knowledge of the client. However, we are concerned to the extent that these practices stifle competition.
- 1.16** We found that cross-subsidies influence the awarding of primary market mandates, particularly in DCM. This cross-subsidy affects both ease of entry and expansion for those providers not offering the cross-subsidised services, in particular lending. The cross-subsidy appears to make it harder – though not impossible – to offer ECM and DCM services on a standalone basis. However, there is sufficient evidence of entry from those already providing corporate lending and broking that we do not attribute the higher returns earned in transactional business to a lack of competition per se.
- 1.17** Based on these findings, we do not see grounds for widespread intervention at this time, but we are concerned about the practice of banks using contractual clauses to restrict client choice and propose to address this. We remain keen to ensure that the market remains open to entry and innovation and welcome further stakeholder views on this topic.

#### **Other market practices**

- 1.18** It was put to us that a range of market practices could distort competition or impede effective client choice. We looked at the following:
- syndication

- reciprocity
- league tables
- corporate finance advisers
- transparency of scope of services and fees
- the IPO process
- allocation of shares in IPO book-building

### **Syndication**

**1.19** Syndicates on ECM and DCM transactions involve banks taking on different roles in fulfilling the execution of the transaction. It was put to us that syndicate size has been growing in recent years and that this might not be in clients' best interests. We therefore looked at how syndicates are put together and at fees for different roles and the syndicate overall.

**1.20** We found no clear evidence that syndicate sizes have grown. Clients rather than banks drive syndicate size and composition and the total fees a client pays do not tend to increase with the number of syndicate members. Moreover, we found that, while senior syndicate roles are dominated by large banks, medium-sized banks secure junior roles and we were told that they provide a potential route to entry and expansion. For these reasons we do not propose to pursue issues around syndication any further at this stage.

### **Reciprocity**

**1.21** Reciprocity is a practice whereby a bank issuing its own financing awards mandates to another bank partly based on how much business it will receive in return. It generates revenue for banks and may help banks to build their credentials and league table credits. It is currently most prevalent in the bank financing market, particularly covered bonds. It was put to us that reciprocity could create barriers to entry and expansion for those banks that are not involved in the reciprocal arrangements (the non-reciprocal banks). At present reciprocity does not appear to be excluding non-reciprocal banks from competing because they can win mandates. The 41 issuers of covered bonds in 2015 that were not part of the reciprocal group had a choice of 36 non-reciprocal banks.

**1.22** We do not therefore propose to take any further action on reciprocity at this time but we welcome views on this. Should the practice become more widespread or show signs of restricting entry and expansion or distorting competition more widely in DCM, we will consider conducting further work.

### **League tables**

**1.23** Banks focus on league table positions when assessing staff performance and pitching to clients, and, to differing degrees, clients consider these positions when choosing which bank to use. League tables can promote competition when they aid comparability for clients between banks and where this drives banks to compete on the parameters that matter to clients. However, we have concerns that certain practices distort league table rankings and reduce comparability:

- Some banks engage in transactions which are undertaken with the main aim of gaining league table credit, even if they are executed at a significant loss to the bank.
- Many banks routinely present league tables to clients in a way that inflates their own position.

**1.24** As a result, unreliable league tables are, at best, ignored by clients and, at worst, distort clients' choices because they do not accurately signal banks' capabilities to undertake a comparable transaction. We will explore how to improve the credibility and usefulness of league tables.

#### **Corporate finance advisers**

**1.25** Corporate finance advisers have taken a prominent advisory role in many IPOs in recent years and many clients have valued their input. They advise clients on the selection of syndicate banks, assist with the running of the IPO process and advise on the allocations of equity proposed by the syndicate banks. However, it was put to us by the banks that the role of corporate finance advisers can give rise to conflicts of interest and that there is a lack of clarity over how the FCA's rules and guidance apply to them.

**1.26** We found no evidence of corporate finance advisers giving advice which would be against the client's best interests or trying to unfairly influence the research on IPOs, albeit a positive research message conveyed by analysts is one of the main factors considered when advising the issuer on which banks to appoint to a syndicate. The application of our rules to corporate finance advisers' activities is covered in Chapter 6 of this report.

#### **Transparency**

**1.27** During the Wholesale sector competition review, a number of concerns were raised about the transparency for clients of the scope of services and fees. Our review of engagement letters found that transparency is not a material area of concern at this time. The need for banks to ensure sufficient transparency of terms for clients is set out in the FCA Handbook and will be enhanced further by MiFID II.

#### **The IPO process**

**1.28** Current market practice for UK IPOs includes a 'blackout' period typically lasting 14 days between publication of research by syndicate banks (connected research) and the circulation of the pathfinder prospectus. Banks told us that they impose this 'blackout' period to manage potential legal liability and perceived regulatory risks. This 'blackout' period means the pathfinder and final approved prospectuses are often made available to investors late in the IPO process.

**1.29** The late availability of the prospectus, combined with a lack of access to the issuer's management, means that unconnected analysts from independent research providers and analysts within non-syndicate banks (unconnected analysts) have little or no information on which to produce research. Out of 169 IPOs we examined, only one transaction featured unconnected research published during the IPO process. This means that the only source of information during the investor education period is connected research. Such connected research is at heightened risk of bias due to potential pressure on connected analysts – during meetings with the issuer's management or the issuer's third party corporate finance advisers before a mandate is awarded – to produce favourable research.

**1.30** We are concerned that this approach reduces the diversity and independence of information available to investors during the investor education period. These issues, and the possible improvements to the IPO process under consideration, are set out in detail in the accompanying discussion paper.

#### **Allocation of shares in IPO book-building**

**1.31** There is potential for conflicts of interest to arise in the allocation of shares on IPOs as banks may seek to reward favoured investor clients, where this is not necessarily in the issuing client's interest. We expect banks to manage these potential conflicts of interest appropriately, including through the implementation of allocation policies. With one exception (which we will follow up with supervisory work), all of the banks in our sample have allocation policies in place.

- 1.32** We focused our analysis on the factors influencing IPO allocations made by banks to test whether such policies are effective. Our analysis of IPO allocations is described in detail in the accompanying occasional paper. We found that the way in which IPO allocations are scaled back shows some patterns consistent with issuer's interests. In particular, IPO allocations tend to favour investors who assist with the price discovery process, and long-only investors tend to receive more favourable allocations than other investors, including hedge funds. However, we also found that IPO allocations are skewed towards investors who account for significant revenues to the bank from other business lines (e.g. trading commission), suggesting the allocation decision may also reflect the interest of the bank.
- 1.33** The strength of the skew towards the bank's favoured investors varied significantly by institution, and, as part of our supervisory work, we will investigate those banks where the skew appears strongest to assess whether these outcomes align to issuing clients' best interests.
- 1.34** The skew may also prevent smaller buy-side investors from gaining access to IPOs in the primary market. We will consider barriers to entry and expansion for smaller buy-side firms more generally as part of our ongoing asset management market study. We welcome views on whether there is any read across of our findings on IPOs to DCM allocations.

### Potential remedies

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- 1.35** We propose a package of potential measures designed to be effective and proportionate and to ensure that competition takes place on the merits by reducing artificial incumbency advantages, improving clients' ability to appoint banks that best suit their needs, ensuring that conflicts are properly managed and improving the IPO process. Specifically we are aiming to:
- Remove the practice of banks using contractual clauses that restrict client choice.
  - Seek views on whether there are ways in which we can reduce barriers to entry and/or expansion for non-universal banks and other service providers without undermining the efficiency benefits of cross-selling.
  - Improve the IPO process to ensure more diverse and independent information is available earlier. The possible improvements to the IPO process under consideration are set out in Discussion Paper [16/3]. We consider three main models incorporating various combinations of the following two measures:
    - re-sequencing the publication of an approved prospectus and connected research, which is intended to make the approved prospectus the primary source of information available to investors
    - providing unconnected analysts with an opportunity to have access to the issuer's management
  - Investigate further with individual banks where our analysis raises questions about conflicts management in IPO allocations.
  - Improve the credibility of league tables by exploring ways in which they could be better presented so that they are more meaningful for clients and remove incentives for conducting trades carried out at a loss purely for the purpose of gaining league table credit.

**1.36** We are keen to hear views from stakeholders on these potential remedies.

### **Next steps**

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**1.37** We are publishing this interim report to give all interested parties an opportunity to comment on our emerging thinking and analysis. We invite comment particularly on:

- our interim findings on how competition works in investment and corporate banking
- the potential remedies, and, specifically, the questions set out in Chapter 11

**1.38** Please send your views to [icbmarketstudy@fca.org.uk](mailto:icbmarketstudy@fca.org.uk) by 25 May 2016.

## 2. Our approach

### Chapter summary

On 22 May 2015, we launched our market study into investment and corporate banking by publishing our Terms of reference. This followed from our Wholesale sector competition review feedback statement, published in February 2015, which identified some potential competition concerns in investment and corporate banking.

We have focused on primary market and related services provided in the UK by the investment and corporate banking industry, particularly:

- the choice of banks and advisers faced by clients when selecting services
- transparency in the provision of services
- the practices of cross-selling and cross-subsidising services

Since launch we have:

- issued requests for information and received responses from over 90 stakeholders, including investment banks and corporate finance advisers, buy-side investors and corporate clients
- conducted analyses of over 10,000 ECM, DCM, M&A and corporate loan transactions spanning a period of up to 5 years
- met with over 100 stakeholders in a series of roundtable and bilateral meetings

We are publishing this interim report to give all interested stakeholders an opportunity to understand and comment on our emerging thinking and analysis.

- 2.1** In this chapter we introduce our market study. We explain why we decided to do it, its scope and the evidence we have gathered to support our analysis. We explain the purpose of the interim report and its structure.

## Why did we decide to conduct a market study into investment and corporate banking services?

- 2.2** We decided to carry out a market study into investment and corporate banking services as a result of the feedback we received to our Wholesale sector competition review call for inputs.<sup>1</sup> External feedback received and our own analysis indicated that competition may not be working effectively in the sector, particularly due to limited transparency of price and quality, and bundling and cross-selling of investment and corporate banking services making it difficult for new entrants to compete.<sup>2</sup>
- 2.3** Benefits from effective competition for investment and corporate banking services may arise as a result of:
- Improvements in the cost and quality of these services for direct clients.
  - Indirect gains to:
    - End customers of investment and corporate banks' clients (this is because where ineffective competition raises clients' costs, these higher costs may be passed on to these clients' customers in the form of higher prices or lower quality).
    - UK consumers generally due to improvements to the flow of capital in the UK economy.<sup>3</sup> For example, where corporate clients requiring investment or corporate banking services fail to raise necessary capital or if clients pay more for financing and advisory services than they should, this may have a significant impact on their ability to operate or undertake investments.
- 2.4** The market study was launched on 22 May 2015, with the publication of our Terms of reference.<sup>4</sup> We sought views on our Terms of reference following its publication. The feedback received is captured as relevant in this interim report.
- 2.5** As set out in our Terms of reference and based on the concerns raised in the Wholesale sector competition review, we have focused on three principal areas:
- whether the choice of supplier for corporate and investment banking services is more limited for particular types of clients
  - whether clients are hindered from making effective choices as a result of a lack of transparency in respect of the scope of services provided and fees
  - whether the cross-selling, bundling and/or cross-subsidisation of services limits the effectiveness of competition

1 'Wholesale sector competition review – Call for inputs' (July 2014): [www.fca.org.uk/your-fca/documents/market-studies/wholesale-sector-competition-review--call-for-inputs](http://www.fca.org.uk/your-fca/documents/market-studies/wholesale-sector-competition-review--call-for-inputs)

2 FS15/2, 'Wholesale sector competition review 2014-15' (February 2015), page 11: [www.fca.org.uk/your-fca/documents/feedback-statements/fs15-02](http://www.fca.org.uk/your-fca/documents/feedback-statements/fs15-02)

3 We discuss the importance of investment and corporate banking services to the UK economy in Chapter 3.

4 MS15/1.1, *Investment and corporate banking market study: Terms of reference* (May 2015): [www.fca.org.uk/your-fca/documents/market-studies/ms15-1-1-investment-and-corporate-banking-market-study-tor](http://www.fca.org.uk/your-fca/documents/market-studies/ms15-1-1-investment-and-corporate-banking-market-study-tor)

### Scope of the market study

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- 2.6** The market study focuses on the provision of regulated primary market and relevant related services (insofar as they may affect competition for primary market services) carried out in the UK by investment and corporate banking service providers.

### Product scope of the market study

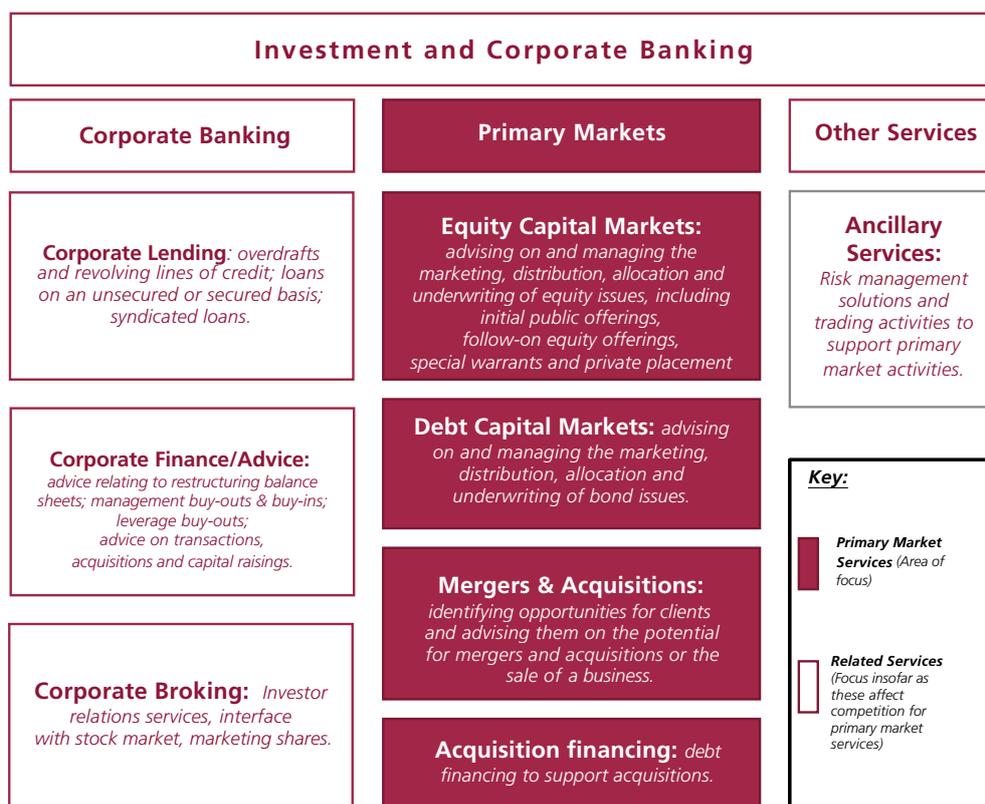
- 2.7** We have broadly categorised **investment banking** services into two principal areas – services in primary markets and services in secondary markets:
- **Primary market** services encompass the provision of advice to and financing of clients that wish to raise new capital. Issuer clients have a range of options available to them when seeking financing, such as issuing equity and/or bonds, or loan financing. An investment bank will often provide advice on which form of finance is most suitable for the client and facilitate such a transaction. Investment banks may also provide advice to clients when they are seeking to merge with or acquire another company (or when they are subject to a potential takeover) and can facilitate the provision of financing to fund an acquisition.
  - **Secondary market** services encompass instruments that have already been issued and are being actively traded. Investment banks may act as market maker<sup>5</sup> for various securities (including equities and bonds), currencies, commodities and their related derivatives. They may also provide asset managers with access to their trading infrastructure, and provide research on securities, as well as other services that their investor clients may require.
- 2.8** **Corporate banking** services largely consist of day-to-day transactional services provided to clients, for example, deposit services, traditional loans and overdrafts, and access to payment services. Corporate banking also includes the provision of products to meet the overall financing needs of a client, for example, trade finance, project finance and syndicated finance.

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<sup>5</sup> A market maker is a firm that accepts the risk of holding a certain number of shares of a security in order to facilitate trading in that security. Each market maker displays buy and sell quotations for a guaranteed number of shares in order to provide liquidity.

2.9 Figure 1 below summarises the types of services which are the focus of the market study.

**Figure 1: Services within the scope of the market study**



2.10 We have focused on primary market services because issues in these areas were raised in the Wholesale sector competition review. Concerns in secondary markets were also raised. However, as we set out in the Terms of reference, we did not consider now was the right time to pursue these issues due to significant imminent changes in European legislation that may affect competition in secondary markets.

2.11 For those primary market services falling within the scope of our market study, we have focused on the following:

- Capital raising in **ECM** and **DCM**. Primary market services in capital markets include: advising issuer clients on valuation, pricing and marketing an issue; syndication<sup>6</sup>; arranging placement of an issue; and the provision of underwriting services.
- **M&A** transaction services, such as identifying potential M&A opportunities and advising on restructuring and corporate recapitalisation.
- **Corporate advisory services** to clients seeking to engage in M&A and capital raising activity such as advice on capital and legal restructuring, and acquisition finance advice, such as on the provision of debt financing services to support planned acquisitions.

<sup>6</sup> See Chapter 6 for a discussion of ECM and DCM syndication.

**2.12** In assessing how competition works for primary market services, we have considered related services and their inter-relationship with primary market services<sup>7</sup>, including:

- **How clients access primary market services.** This includes assessing whether the provision of services such as corporate lending and corporate broking creates an advantage for investment banks when selling primary market services. It also includes assessing the extent to which an issuer client's existing corporate finance arrangements, or ongoing relationship with one or more investment banks, influences how and whom they approach for primary market services.
- **Whether, and if so, how competition in primary market services affects related services.** This includes the impact on other services that are sold alongside primary market services, including ancillary services such as foreign exchange contracts or interest rate hedging products that may be sold alongside a debt issuance or M&A transaction.

**2.13** To avoid overlap with other ongoing competition investigations, the scope of our market study does not include any business which is the subject of the CMA's retail banking market investigation. Specifically, it excludes banking services supplied to small and medium-sized enterprises (SMEs). SME means a business that, in respect of a given financial year applying to it, has annual sales revenues not exceeding £25 million.<sup>8</sup>

#### **Geographic scope of the market study**

**2.14** There are many international aspects of investment and corporate banking, as explained in Chapter 3. We have taken this into account in our analysis of how competition works. The market study covers investment and corporate banking services, specifically primary market and related services, carried out in the UK.

**2.15** When identifying services carried out in the UK, we have focused on the location of the activity, and have within our geographic scope all services undertaken in the UK, regardless of the location of the client or the legal entity into which the activity is booked for accounting purposes. This means that we have included within scope all services carried out in the UK and provided to either a UK or non-UK client or for a UK or non-UK transaction. We have not included within the scope of the market study those services carried out from outside of the UK to either UK or non-UK clients or for UK or non-UK transactions. We took into account the global context when reaching our conclusions.

#### **Evidence gathered to support our analysis**

**2.16** To gain an understanding of the demand for and supply of investment and corporate banking services, we gathered evidence and data from a wide range of parties. This included:

- investment banks
- corporate finance advisers
- investors
- issuing clients

<sup>7</sup> These issues are discussed in Chapter 7.

<sup>8</sup> Exclusive of VAT and other turnover-related taxes. See the CMA's *Retail banking market investigation – Terms of reference*: [https://assets.digital.cabinet-office.gov.uk/media/545a981c40f0b6130e000011/Terms\\_of\\_reference\\_retail\\_banking.pdf](https://assets.digital.cabinet-office.gov.uk/media/545a981c40f0b6130e000011/Terms_of_reference_retail_banking.pdf)

- corporate clients
- financial institution groups (FIGs)
- SSAs
- trade associations
- other interested parties, such as researchers and corporate brokers

**2.17** Table 1 summarises the extent of our external engagement and we set out the types of evidence gathered in further detail below.

**Table 1: Engagement with external stakeholders**

Type of interested party	Request for information	Bilateral and roundtable meetings and calls
Banks and advisers	70 respondents	13 universal banks 12 investment banks 1 corporate bank 4 corporate finance advisers
Buy-side investors	12 respondents	5 large investors 2 small investors
Clients	10 respondents	15 large corporate issuers 22 medium and small corporate issuers 10 SSA issuers 3 FIG issuers 5 private equity firms 3 housing associations
Other		3 independent researchers and corporate brokers 3 trade associations 6 international financial regulators 1 fintech company

#### **Request for information and data from investment and corporate banks and advisers**

**2.18** We sought to cover the breadth of those providing investment and corporate banking services. We obtained qualitative and quantitative information from investment and corporate banks, and corporate finance advisers. We focused on that information and data necessary to undertake an assessment of the principal areas of focus of the market study.

**2.19** Prior to issuing the request for information and to assist us in ensuring its reasonableness and practicality, we issued a draft version of the request to a sample of firms and representative bodies. We revised our request for information to reflect feedback received as part of this consultation. The final version of the request for information was issued on 26 June 2015 and sent to investment and corporate banks and corporate finance advisers.

- 2.20** Seventy firms submitted a response to our request for information. These firms included fixed and flexible portfolio firms (i.e. formerly C1 to C4 category firms). We are grateful to these firms for their efforts in responding comprehensively to our request.
- 2.21** The qualitative component of the request for information sought information and relevant supporting documents in respect of each firm's wholesale investment and corporate banking UK operations, the nature of the primary market services provided and how each firm manages client relationships.
- 2.22** The quantitative request for information provided us with detailed transaction-level data across each of ECM, DCM, M&A and lending (where a firm undertakes such services).

**Table 2: Summary of number and time period of transaction-level data**

Service	Time period	Total number of transactions over period
ECM	IPOs: January 2010 – May 2015 Other ECM: January 2014 – May 2015	1,403 (of which, IPO: 530)
DCM	January 2014 – May 2015	6,096
M&A	January 2014 – May 2015	1,085
Syndicated lending	January 2014 – May 2015	1,895
<b>Total</b>		<b>10,479</b>

Source: FCA analysis of transactional data described in Annex 2.

Note: For Other ECM, DCM, M&A and syndicated loans, we also collected one month of data for March in each year from 2008 to 2013 (i.e. March 2008, March 2009, March 2010, March 2011, March 2012, March 2013). For IPOs we also collected data for March 2008 and March 2009. The number of transactions above does not include this information.

- 2.23** Annex 2 sets out further detail of how we collected and analysed the transactional data. We believe that the scope of the request for information, together with the data collected, was reasonable and proportionate and provides a representative sample upon which to base our analysis, having regard to the scope of the market study and the FCA's statutory objectives.

#### **Request for information and data from buy-side investors**

- 2.24** We sought the views of buy-side investors on the IPO process and IPO and DCM allocations. We received twelve written responses to our buy-side investor request for information of 22 June 2015. We sought their views on the availability, timing and usefulness of different sources of information in the IPO process. This included access to connected and unconnected research, the connected analyst, management of the issuer and road-shows and related materials. We also received investors' views on the allocation process, particularly with regard to those factors which are important for receiving an allocation in an IPO and DCM issue as well as the main reasons for not receiving the allocation requested.

#### **Request for information and data from corporate issuer clients**

- 2.25** We sought the views of clients across a number of issues and received ten written responses to our issuer client request for information of 14 July 2015. These issuer clients ranged in size from long-established large corporate clients through to small corporate clients in the early stages

of business development.<sup>9</sup> For each of ECM, DCM, M&A and lending, we sought information and relevant supporting documents on the types of services procured from investment and corporate banking service providers, how these services are procured and whether the banking relationship is managed effectively by these providers.

### **Meetings with investment and corporate banks, corporate finance advisers, investors, issuing clients, trade associations and other interested parties**

**2.26** In conjunction with the evidence received in response to our requests for information, we sought to engage with a broad spectrum of stakeholders across the investment and corporate banking sector. The purpose of this engagement was to test the evidence and assist us in analysing where potential competition concerns may arise.

**2.27** As set out in Table 1, this stakeholder engagement included:

- Bilateral discussions with 30 universal banks, investment banks, corporate banks and corporate finance advisers. We met a range of different size of banks and advisers in order to provide a cross-section of firms with different operating models, strategies, and geographic focus.
- A roundtable discussion with large buy-side investors and an investor trade association on behalf of its members. This was followed by bilateral discussions with two smaller buy-side investors.
- Two roundtable discussions – one with large corporate issuers and one with SSA issuers. This was complemented by bilateral discussions with other SSA issuers, FIG issuers, private equity firms and small to medium-sized corporate issuers.
- Other interested parties who participated in roundtable and bilateral discussions included independent research firms, corporate brokers, and a fintech company.
- Discussions with international regulators. We conducted an international comparison exercise involving six countries: Hong Kong, the United States, Singapore, Japan, Australia and France. The principal purpose of the comparison exercise was to understand how other jurisdictions have sought to address issues giving rise to concern in the investment and corporate banking sector. We are grateful for their input and assistance. Where relevant, we refer to how other jurisdictions operate in this interim report and our discussion paper and occasional paper.

**2.28** We would like to thank participants for their time and constructive engagement to date.

### **Why are we publishing an interim report?**

**2.29** We are publishing this interim report in order to give all interested stakeholders an opportunity to understand and comment on our emerging thinking and analysis. The purpose of this consultation is to test the robustness of our interim analysis and findings and to continue to promote constructive engagement between the FCA and the wide range of interested parties involved in the market study.

<sup>9</sup> See Chapter 3 for our categorisation of corporate clients.

- 2.30** In this interim report, we set out our initial findings on how competition functions in primary markets. We also set out our initial thinking on potential remedies we may consider in light of our final findings.

### Structure of this interim report

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- 2.31** This interim report is structured as follows:

- Chapter 3 sets out a brief market overview, focusing on the global context of investment and corporate banking services, the services we have examined, the providers and clients of investment and corporate banking services, and the relevant parts of the regulatory framework.
- Chapters 4 and 5 focus on the supply-side:
  - Chapter 4 considers entry, expansion and exit.
  - Chapter 5 focuses on the availability of suppliers to clients of different types and sizes, and in different sectors, regions and countries. We focus specifically on the availability of suppliers for medium-sized corporate clients.
- Chapter 6 switches attention to the demand-side. We begin by considering how clients choose investment and corporate banks. We then assess specific aspects that influence the effectiveness of this choice:
  - use of league tables
  - transparency of scope of services and fees
  - formation and composition of syndicates
  - reciprocity when a client is a financial institution
  - the role of corporate finance advisers, particularly on IPOs
- Chapter 7 brings together the supply- and demand-side by focusing on practices of cross-selling, bundling and cross-subsidisation. We consider their prevalence, why they are used by investment and corporate banks and favoured by many clients, and whether they have any adverse competition effects.
- Chapter 8 focuses on outcomes by examining the fees charged to clients and the quality of service they receive.
- Chapter 9 brings the IPO process into focus. We cover two issues:
  - The availability of information to investors in the IPO process. Our work in this area is set out in detail in a discussion paper published alongside this interim report.
  - How shares are allocated in an IPO and whether there is a skew towards certain buy-side investor clients. Our analysis on IPO allocations is set out in detail in an occasional paper published alongside this interim report.

- Chapter 10 summarises our interim findings.
- Chapter 11 sets out proposed remedies to address those areas where we have identified concerns.
- Chapter 12 sets out our next steps.

## 3. Market overview

### Chapter summary

Primary market services are important for the UK, with investment banks' UK operations generating total gross fees of approximately \$17bn from nearly 6,000 DCM, ECM and M&A transactions in 2014. Primary market services comprise about a quarter of revenues earned by universal banks. The highest portion of primary market service revenues comes from DCM.

Throughout this report, we distinguish between banks and advisers according to their size and service offering – universal banks, investment banks, corporate banks and advisers, categorised into small, medium and large.

We also distinguish between clients according to their type (financial institutions, SSAs and corporate clients) and, in the case of corporate clients, their size (small, medium and large). Financial institution, large corporate and SSA clients make up approximately 95% of total primary market transaction value.

- 3.1** In this chapter we provide a brief overview of the global context in which corporate and investment banking services are provided, particularly following the 2008 financial crisis. We consider the types of providers of primary market services in the UK and the clients they serve, as well as how the regulatory framework in which investment banks operate has changed.

### Global context and events since the 2008 financial crisis

- 3.2** In this section we describe the global context in which primary market services are provided and how events of the 2008 financial crisis have affected the provision of these services.

### The global nature of primary market services

- 3.3** Primary market services are often provided to clients on a global basis. While transactions are often arranged, managed and executed in a major financial centre (such as London or New York), issuers and investors can be located anywhere in the world.

- 3.4** The global nature of primary market services is highlighted in Table 1. Leading providers have an extensive network of country offices; while not all country offices may have specific primary market capabilities, an extensive global footprint allows banks to originate transactions from governments, corporations and other issuers across all major financial markets. Similarly, banks' distribution platforms are typically capable of placing securities with asset managers, pension funds, insurers and other investors based around the globe.

**Table 1: Number of country offices for top-ranked global ECM, DCM and M&A banks and advisers by value, 2015**

<b>Bank</b>	<b>Country offices</b>	<b>ECM Ranking</b>	<b>DCM Ranking</b>	<b>M&amp;A Ranking</b>
Goldman Sachs	36	1	6	1
Morgan Stanley	36	2	7	2
JP Morgan	57	3	1	3
BAML	38	4	2	4
UBS	48	5	13	11
Citi	97	6	3	5
Credit Suisse	57	7	9	6
Deutsche Bank	64	8	5	8
Barclays	28	9	4	7
CITIC Securities	21	10	20	36
HSBC	71	15	8	18
Wells Fargo	14	14	10	25
Lazard	26	N/A	N/A	9
Centerview	2	N/A	N/A	10

Source: FCA analysis. Country offices from firms' websites. Ranking from Dealogic data for 2015 global ECM, DCM and M&A ranking based on total value of transactions.

Note: N/A means not applicable.

- 3.5** Global capital markets are dynamic and provide flexibility for issuers to structure their transactions in a manner which suits their needs. For example, in debt, issuers may look for banks that can assist them in distributing their securities to investors in a particular country, currency or structure that can minimise their funding costs in the prevailing market conditions.
- 3.6** The global nature of primary market services is relevant not only for firms with international operations. Issuers with a regional or national presence might also look to reach investors in jurisdictions that are outside of their country of operation. For example:
- In July 2014 the Royal Mail undertook its first bond issuance. Although the majority of the Royal Mail's revenues are generated in the UK<sup>10</sup>, it opted to issue the bond in Euros.

<sup>10</sup> Royal Mail PLC, 'Annual Report and Financial Statements 2014-15', [www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202014-15\\_0.pdf](http://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202014-15_0.pdf)

- Some UK housing associations have recently issued debt through US private placements. UK housing associations typically do not operate outside the UK or – indeed – outside their regional remit. However, US private placements are attractive due to their flexibility, competitive cost of funds and ability to accommodate smaller-sized issuances.
- Many non-UK domiciled companies have recently listed on the London Stock Exchange in order to access investment capital available in the UK and to attain the increased profile that a London listing may provide, as compared to national stock markets. In 2015, major examples included Wizz Air (a Hungarian low-cost carrier); Integrated Diagnostics (an Egyptian medical company) and Hostelworld (an Irish hostel booking and review website).

### The UK's role in primary market services

- 3.7** As seen in Table 2, the UK-based clients rank third, fifth and third globally in terms of value of transactions in ECM, DCM and M&A respectively. In comparison, the UK is the world's fifth-largest economy in GDP terms.<sup>11</sup>

**Table 2: Top 5 nationalities in ECM, DCM and M&A by total value of transactions in 2015**

Ranking	ECM	DCM	M&A
1	United States	United States	United States
2	China	China	China
3	United Kingdom	Germany	United Kingdom
4	Japan	Canada	Hong Kong
5	Australia	United Kingdom	France

Source: FCA analysis of Dealogic data for 2015.

Note: 'Nationality' is based on the categorisation criteria used by Dealogic. For DCM transactions, it is based on business nationality of the issuing entity. For ECM transactions, it is based on the nationality where most of the issuer's business takes place. For M&A transactions, it is based on the country where the acquirer is either headquartered or has the majority of its managerial operations.

- 3.8** The UK is also attractive as a location for investment banks to undertake a substantial proportion of their primary market origination, syndication, distribution and trading activities because it hosts a large asset management industry which includes major national and global investors. At the end of 2014, there were approximately £6.6 trillion<sup>12</sup> of assets under management in the UK.

### Impact of the financial crisis on primary market services

- 3.9** The financial crisis had a profound impact on demand for primary market services. This provides an important backdrop for the climate in which we have undertaken this market study.

#### ECM

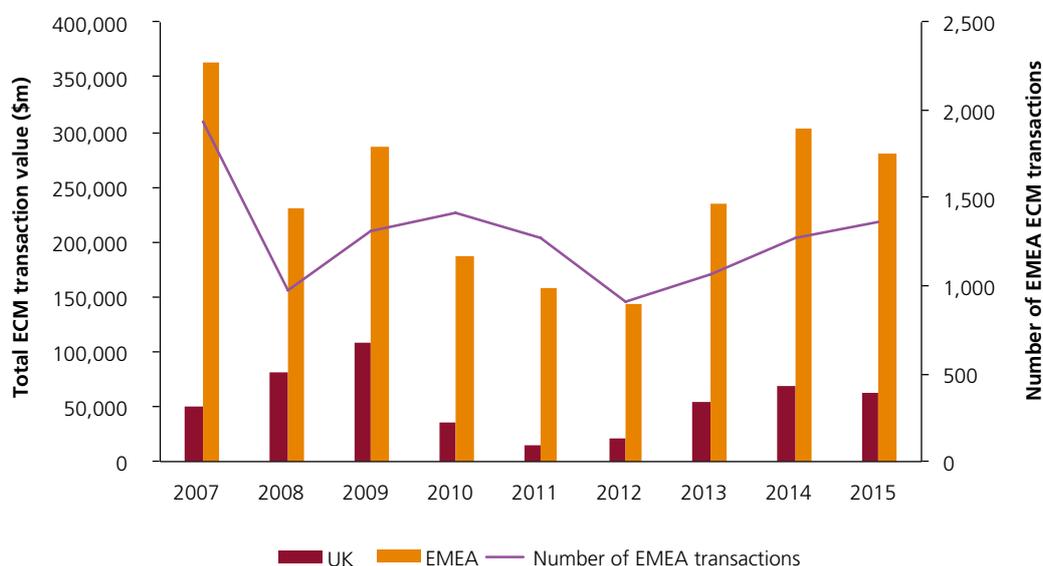
- 3.10** During the 2008 financial crisis, equity valuations fell markedly. Fewer companies issued equity at that time, opting to wait for confidence in financial markets to be restored so that their shares could obtain higher valuations. However, for those firms under financial pressure and unable to access other sources of funding, issuing equity may have been the only way to raise capital during the crisis. In order to address prudential requirements (see paragraphs 3.17 and 3.18), many large retail banks also undertook large rights issues to strengthen their capital base in 2008 and 2009.

<sup>11</sup> World Bank, 'Gross domestic product 2014', <http://databank.worldbank.org/data/download/GDP.pdf>

<sup>12</sup> FCA, 'Infographic: assets under management' [www.fca.org.uk/your-fca/documents/infographic-assets-under-management](http://www.fca.org.uk/your-fca/documents/infographic-assets-under-management)

**3.11** Figure 1 shows that in 2007, in Europe, the Middle East and Africa (EMEA), the value of ECM transactions totalled just over \$350bn.<sup>13</sup> In 2008 the total value of ECM transactions dropped by about a third, recovering in 2009. In the UK, ECM transactions grew from around \$50bn in 2007 to just over \$100bn in 2009; this was driven by the large amount of equity UK-based banks issued in 2008 and 2009 to increase their equity ratios.<sup>14</sup> Between 2010 and 2012, ECM activity in both the UK and the EMEA region experienced a decline due to the impact of the European debt crisis. The number of transactions in the UK and in the wider EMEA region began recovering from 2012 onwards. In 2015, the value of equity issuance in the UK stood at \$62bn, higher than the 2007 figure. In contrast, the value of EMEA ECM transactions, at \$280bn in 2015, was below its 2007 level by about a fifth.

**Figure 1: Number and value of ECM transactions in EMEA and UK, 2007-2015**



Source: FCA analysis of Dealogic data, 2007- 2015.

Note: The nationality of transactions is based on the categorisation criteria used by Dealogic. For ECM transactions, it is based on the nationality where most of the issuer's business takes place.

### DCM

**3.12** Debt capital markets remained relatively stable in the face of the 2008 crisis. Bonds are often issued to refinance existing debt and, unlike IPOs or mergers, there is often less scope to postpone a transaction. Central banks responded to the financial crisis by significantly reducing interest rates (see paragraph 3.21). This policy response offset the widening of credit spreads.<sup>15</sup> Lower interest rates helped maintain the attractiveness of debt markets to issuers in comparison with other funding alternatives (e.g. equity or covered bonds). DCM volumes were also increased by European governments increasing their bond issuance to fund fiscal deficits caused by the fall in economic activity following the crisis. Quantitative easing – introduced by the Bank of England in 2009 and the European Central Bank in 2015 – contributed to creating favourable market conditions for UK and Eurozone government issuance.

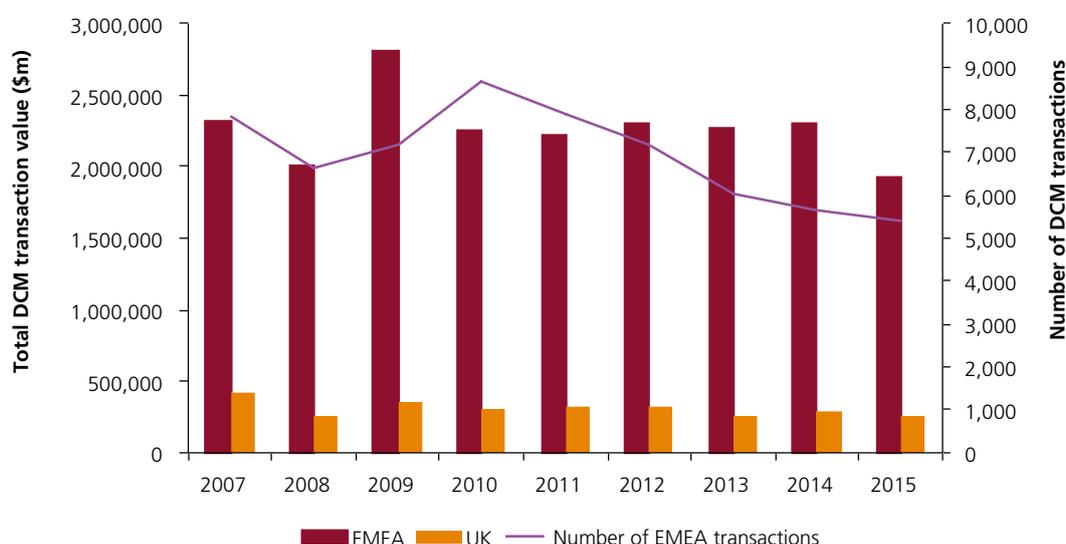
<sup>13</sup> In this section, when we refer to transactions in the UK, we refer to transactions undertaken by issuers based in the UK. As a result, we do not capture transactions carried out in the UK for non-UK clients.

<sup>14</sup> According to Dealogic data, in 2008 issuers categorised as 'Financial – Savings and Commercial Banks' issued equity worth \$47.4bn. This included \$24bn issued by the Royal Bank of Scotland (RBS). In 2009, banks issued a further \$46.2bn, which included a \$19.5bn issuance by HSBC.

<sup>15</sup> The credit spread is the risk premium investors are willing to pay over government debt. Uncertainty caused by the financial crisis had led the risk premium – or credit spread – to increase.

- 3.13** In the EMEA region, the value of DCM transactions contracted by around 15% in 2008, falling to \$2tn (see Figure 2). The value of transactions in the UK fell more markedly in percentage terms, from above \$400bn in 2007 to around \$250bn in 2008. Between 2009 and 2014, in the EMEA region, the value of transactions returned to above \$2tn per year. During that period, in the UK, the value of transactions remained stable at around \$300bn (except for a marked fall – to \$250bn – in 2013) but below the 2007 level. In 2015, the value of transactions in EMEA fell again, to below \$2tn. This was likely reflective of uncertainty caused by concerns over emerging market and high yield issues.

**Figure 2: Number and value of DCM transactions in EMEA and UK, 2007-2015**

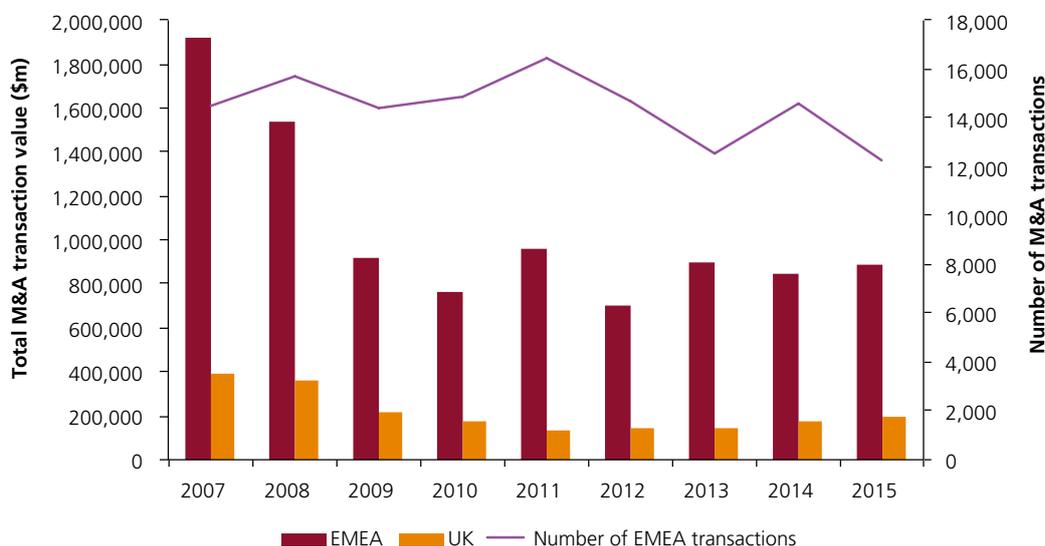


Source: FCA analysis of Dealogic data, 2007-2015.

Note: The nationality of transactions is based on the categorisation criteria used by Dealogic. For DCM transactions, it is based on business nationality of the issuing entity.

### M&A

- 3.14** M&A activity is highly sensitive to the prevailing economic environment. As with equity transactions, M&A activity was severely affected by the aftermath of the 2008 crisis. However, the value of M&A transactions in EMEA and the UK remain below their pre-crisis levels.
- 3.15** Between 2007 and 2012, in the EMEA region, the value of M&A activity fell by more than half, from \$1.9tn to \$700bn (see Figure 3). In the UK, M&A activity followed a similar trend, falling from just under \$400bn in 2007 to around \$145bn in 2012. The value of transactions in both areas has increased since 2012, settling at around \$800bn in EMEA in 2015 and at just under \$200bn in the UK in the same year.

**Figure 3: Number and value of M&A transactions in EMEA and UK, 2007-2015**

Source: FCA analysis of Dealogic data, 2007-2015.

Note: The nationality of transactions is based on the categorisation criteria used by Dealogic. For M&A transactions, it is based on the country where the acquirer is either headquartered or has the majority of its managerial operations.

### Regulatory reaction following the financial crisis

- 3.16** The period immediately following the financial crisis resulted in the introduction of a number of regulatory interventions at a national and supra-national level. This affected investment banks' operating models and, as highlighted by a number of stakeholders, the manner in which primary market services are provided (the implications of these changes for financial institutions as issuers, and for some SSAs are also discussed below). The principal aim of these initiatives has been to address the systemic weaknesses of the global financial system. We briefly outline the main regulatory and policy initiatives that have been implemented following the financial crisis and how they have affected primary market services.

#### Basel III rules

- 3.17** In 2010, many large economies<sup>16</sup> agreed on a revised set of prudential standards aimed at strengthening the regulation, supervision and risk management of the banking sector.<sup>17</sup> The 'Basel III' agreement introduced new and increased capital, leverage and liquidity requirements for banks.<sup>18</sup> These also affected primary market services, as activities that – directly or indirectly – support the provision of primary market services (e.g. underwriting, market making, proprietary trading, corporate loans, provision of derivatives, etc) consume regulatory capital.

<sup>16</sup> Members of the Basel Committee are: Argentina, Australia, Belgium, Brazil, Canada, China, the European Union, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Luxembourg, Mexico, Netherlands, Russia, Saudi Arabia, Singapore, South Korea, Spain, Sweden, Switzerland, Turkey, United Kingdom and the United States.

Bank for International Settlements, 'Basel Committee membership', [www.bis.org/bcbs/membership.htm](http://www.bis.org/bcbs/membership.htm)

<sup>17</sup> Bank of International Settlements, 'International regulatory framework for banks (Basel III)', [www.bis.org/bcbs/basel3.htm](http://www.bis.org/bcbs/basel3.htm)

<sup>18</sup> "Global Systemically Important Banks" (G-SIBs) will be subject to even more stringent capital requirements. Many G-SIBs are also active in the provision of investment banking services. Financial Stability Board, '2015 update of list of global systemically important banks', [www.fsb.org/wp-content/uploads/2015-update-of-list-of-global-systemically-important-banks-G-SIBs.pdf](http://www.fsb.org/wp-content/uploads/2015-update-of-list-of-global-systemically-important-banks-G-SIBs.pdf)

**3.18** Banks responded to these increased capital requirements in three main ways:

- They issued additional capital, via equity, debt and hybrid instruments (thus increasing the volume of transactions in the market).<sup>19</sup>
- They deleveraged by reducing lending to corporate clients, either by declining to renew lending commitments or by asking borrowers to repay their loans.
- In the face of higher costs of capital, they reviewed their business lines with a view to withdrawing from certain areas where returns could no longer meet the cost of capital. We discuss the extent to which banks have exited primary market services in Chapter 4.

#### ***Dodd-Frank and ring-fencing rules***

**3.19** New financial regulations in the US and in the UK reduced the scope for banks to invest their own capital in secondary trading.

- In the US, Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act introduced a general prohibition on proprietary trading.<sup>20</sup>
- In the UK, the Financial Services (Banking Reform) Act 2013 introduced rules aimed at 'ring-fencing' large UK-based retail deposit-takers. Ring-fencing rules, due to be introduced in 2019, aim to improve the resilience and resolvability of deposit-takers and reduce the disruption to customers and the system if a deposit-taker or insurer fails.<sup>21</sup>

**3.20** These requirements have also affected primary market services that banks provide to issuers, particularly DCM services. The secondary market performance of bonds is important for issuers, because the liquidity of their existing securities is likely to affect the price of future primary market issuance. That is, investors are likely to demand a higher yield for new issues if they expect that it will be difficult to sell them, should they wish to exit their investment. With reduced secondary trading activities, banks are less likely to be able to provide liquidity as part of their primary market offering.

#### ***Interest rates and quantitative easing***

**3.21** In order to support GDP growth in the wake of the 2008 financial crisis, many central banks significantly reduced interest rates, which currently stand at historic lows in major developed economies. Moreover, to deliver on their inflation targets and to stimulate growth further, some major central banks, including the Bank of England, embarked on quantitative easing programmes. Under this programme the Bank of England electronically creates new money and uses it to purchase treasury and other securities from private investors, such as pension funds and insurance companies.<sup>22</sup>

**3.22** These policies meant that the returns on low-risk investments (e.g. government bonds and highly-rated securities) fell significantly. At the same time, global assets under management continued to increase, reaching a record level of \$74tn globally in 2015.<sup>23</sup> The reduced yields

19 We discuss the implication of investment banks as increasingly important issuers (and therefore 'clients') of investment banking services in the section on reciprocity in Chapter 6.

20 Federal Reserve Board, 'Volcker Rule', [www.federalreserve.gov/bankinfo/volcker-rule/](http://www.federalreserve.gov/bankinfo/volcker-rule/)

21 Bank of England, 'News Release – Bank of England announces proposals to strengthen the financial system through structural reform', [www.bankofengland.co.uk/publications/Pages/news/2014/125.aspx](http://www.bankofengland.co.uk/publications/Pages/news/2014/125.aspx)

22 Bank of England, 'Quantitative easing – Frequently asked questions', [www.bankofengland.co.uk/monetarypolicy/Pages/qe/qe\\_faqs.aspx](http://www.bankofengland.co.uk/monetarypolicy/Pages/qe/qe_faqs.aspx)

23 Boston Consulting Group, 'Global Asset Management 2015: Sparking Growth with Go-to-Market Excellence', [www.bcgperspectives.com/content/articles/financial-institutions-global-asset-management-2015-sparking-growth-through-go-to-market-strategy/](http://www.bcgperspectives.com/content/articles/financial-institutions-global-asset-management-2015-sparking-growth-through-go-to-market-strategy/)

available to institutional investors triggered a 'search for yield', placing greater pressure on investors to identify higher-yielding investment opportunities, including primary market issuance, when seeking to deploy the funds they manage.

### Services within scope of our study

**3.23** As set out in Chapter 2 we have focused on primary market services, considering secondary market services and corporate banking insofar as they are relevant to competition in primary market services. Annex 1 sets out further background on services relevant to this market study – both primary market services (ECM, DCM, and M&A) and related activities (corporate banking, corporate broking and sponsor and NOMAD services). In this section we consider the relative importance of primary market services in the context of all wholesale banking activities and the extent of concentration in each of these primary market activities.

#### The relative importance of primary market services

**3.24** Based on the transactional data submitted by banks (as described in Annex 2) we calculated the distribution of investment banking transactions and fees for the different types of services. Table 3 shows fees earned by banks in primary market activities in 2014. It shows:

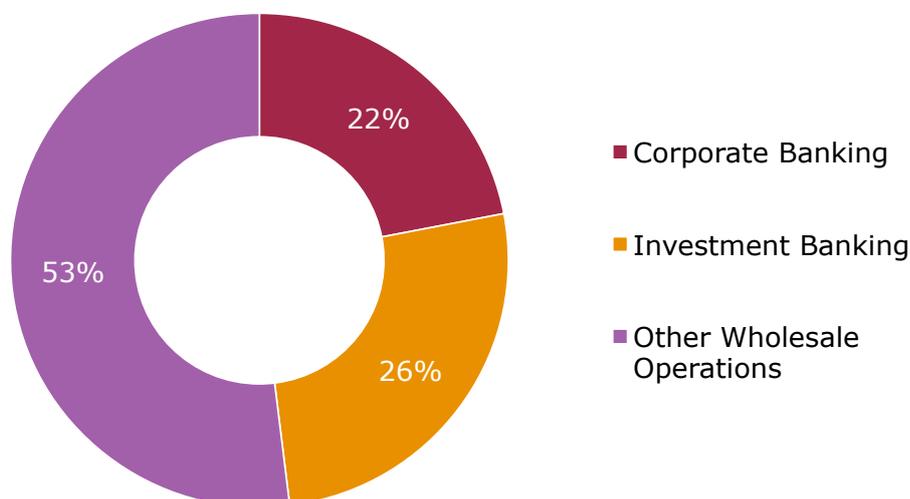
- The significance of primary market services for the UK, generating total gross fees of approximately \$17bn from nearly 6,000 DCM, ECM and M&A transactions in 2014.
- The highest portion of gross fees comes from DCM. ECM and M&A generate similar levels of fees. However, the average fee in an ECM and M&A transaction is higher than the average fee in a DCM transaction.

**Table 3: Number of transactions and gross fees for ECM, DCM and M&A transactions, 2014**

	ECM	DCM	M&A
Number of transactions	764	4,196	883
Total gross fee (\$m)	4,922	7,259	4,839
Average gross fee (\$m)	6.61	2.16	5.80
Median gross fee (\$m)	2.20	0.61	3.11

Source: FCA analysis of transactional data described in Annex 2

**3.25** Figure 4 uses the revenue data submitted by banks (as described in Annex 2) to show the distribution of revenues earned by universal banks by wholesale activity as a percentage of overall wholesale revenues. It shows that, despite the significance of revenues earned from primary market services, they comprise only 26% of revenues earned by universal banks. More significant revenues are earned from other wholesale operations, which include secondary market services. There is therefore a significant range of activities that have not been covered by this market study. As set out in Chapter 2, we have focused on primary market services because issues in these areas were raised in the Wholesale sector competition review. Concerns in secondary markets were also raised. However, as we set out in the Terms of reference, we did not consider now was the right time to pursue these issues due to significant imminent changes in European legislation that may affect competition in secondary markets.

**Figure 4: Distribution of total wholesale revenues of universal banks, 2014**

Source: FCA analysis of revenue data collected from 15 universal banks (see Annex 2)

Note: 'Investment banking' comprises primary market activities only; 'Other Wholesale Operations' includes secondary market activities. Allocations of revenues to each category based on responses of banks. Figures do not sum to 100% due to rounding.

### Concentration in primary market activities

**3.26** Table 4 shows concentration ratios for ECM, DCM and M&A. Concentration ratios represent the sum of the market shares for the number of firms, so a CR4 ratio represents the sum of the market shares for the four largest firms. These concentration ratios are based on the share of total value of transactions.

**Table 4: Concentration ratios for primary market activities and corporate lending based on value of transactions, 2014**

	CR1 – %	CR4 – %	CR10 – %
ECM	10-15	39	71
DCM	10-15	35	67
M&A	15-20	50	84
Corporate lending	5-10	35	68

Source: FCA analysis of transactional data described in Annex 2.

Note: We show ranges for the CR1 ratio given these shares relate to one firm only.

**3.27** Table 4 shows that:

- There is no one firm with a high market share. The highest share of a single firm is in M&A where the largest firm has a 15-20% market share.
- Concentration ratios of the four largest and ten largest firms are also not that high. In each of ECM and DCM, the concentration ratios of the ten largest firms are 71% and 67% respectively.

**3.28** Our focus throughout this market study has not been on overall market concentration, but on how well competition works for clients of different types and sizes.

### Providers of primary market services in the UK

**3.29** Providers of primary market services operate under a variety of different business models and there is no one categorisation of banks and advisers. However, for the purpose of this market study we distinguish between banks and advisers and categorise them according to their service offering (as further explained in Annex 2) and size (see Table 5):

- **Universal banks:** Offer both investment and corporate banking services as well as other financial services including, for example, asset management, insurance and retail banking. These banks are often large international banking groups with large scale asset financing and working capital.
- **Investment banks:** Primarily offer investment banking services, such as underwriting securities and trading and brokerage services, but are not associated with a commercial banking arm.
- **Corporate banks:** Deposit takers and loan makers for corporates and large businesses. These firms often only serve the domestic market in which they are based, and clients may include smaller corporates.
- **Advisers:** Provide advisory services to companies in respect of financing issues and M&A but do not raise finance for the client or underwrite or engage in securities trading.

**Table 5: Categorisation of providers of primary market services and number of firms in each category**

Size	Annual investment banking revenue	Universal Banks	Investment banks	Corporate banks	Advisers
Large	Above \$450m	10	2	1	0
Medium	Between \$45m and \$450m	7	14	3	2
Small	Below \$45m	0	13	2	6

Source: FCA analysis of transactional data described in Annex 2.

### Clients

**3.30** Corporate and investment banking services are accessed by a broad spectrum of clients. These clients include corporates, financial institutions, governments and supra-national corporations that seek advice in respect of M&A, capital structuring and how to raise debt or equity from the capital markets.

**3.31** There is no one uniform measure for categorising clients. However, for the purpose of this market study we have considered the following:

- Sovereigns, supra-nationals and agencies (SSAs), which comprise sovereign governments (e.g. the UK Government through the Debt Management Office or the US Treasury), supra-national institutions (such as the World Bank or the European Investment Bank) and agencies (such as the German development bank KfW).
- Financial institution groups (FIGs), which mainly comprise banks, insurers and other types of deposit-takers.
- Corporate clients, which we have further categorised by size (as further explained in Annex 2) into:
  - Large corporate clients – including large and multinational corporations of a scale equivalent to the UK FTSE 100 companies.
  - Medium-sized corporate clients – which mainly comprise corporates of a size equivalent to the UK FTSE 250.
  - Small corporate clients, which as noted in Chapter 2 excludes small and medium sized enterprises (SMEs), and comprise those ranging in size from the equivalent of the UK AIM market /FTSE SmallCap through to corporates of a size equivalent to the bottom end of the UK FTSE 350.

**3.32** Table 6 sets out how the clients in our transactional data are split by category. We use these categorisations throughout this report.

**Table 6: Number of transactions by client category, January 2014 – May 2015 (except for IPOs, which cover January 2010 – May 2015)**

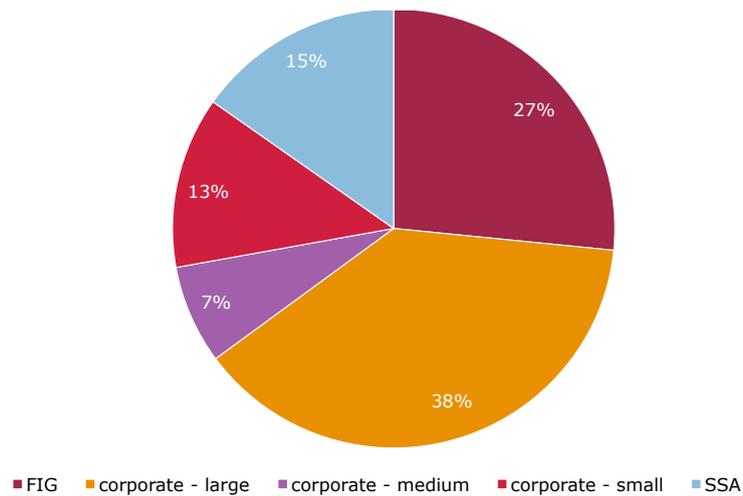
	Corporate – large	Corporate – medium	Corporate – small	FIG	SSA
ECM	266	225	513	378	-
IPOs	57	84	235	139	-
Follow-on offerings	158	112	258	224	-
Other ECM	51	29	20	15	-
DCM	999	165	317	3,324	1,171
Corp HY	91	54	103	48	-
Corp IG	279	58	95	426	-
Other DCM	629	53	119	2,850	1,171
M&A	264	152	479	96	2
Syndicated Loans	619	345	697	239	23
<b>TOTAL</b>	<b>2,148</b>	<b>887</b>	<b>2,006</b>	<b>4,037</b>	<b>1,196</b>

Source: FCA analysis of transactional data described in Annex 2.

Note: Corporate bonds comprise issues by both corporates and FIGs. The table sets out the number of transactions by service and by client category for January 2014 to May 2015, except for IPOs, for which we used data from January 2010 to May 2015. The number of transactions for each service included above is different to the total set out in Chapter 2 because we do not include those transactions where the client type/category is not available.

- 3.33** Figure 5 shows the proportion of total transaction value by client type. It shows that large corporate, FIG, and SSA clients accounted for most of the transaction value – covering 38%, 27% and 15% respectively.

**Figure 5: Proportion of total transaction value accounted for by clients of different types**

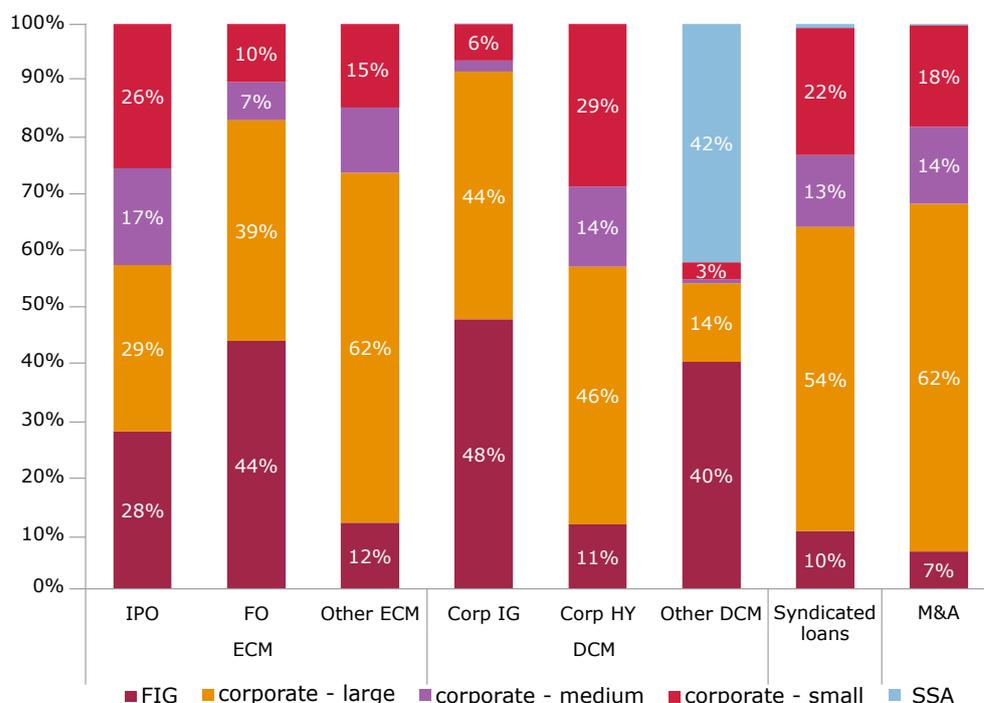


Source: FCA analysis of transactional data described in Annex 2.

Note: The chart is based on data for January 2014 to May 2015, except for IPOs, for which we used data from January 2010 to May 2015.

- 3.34** Figure 6 shows that the services that are most relevant to medium-sized and small corporate clients are IPOs, high-yield corporate bonds, syndicated loans and M&A.

**Figure 6: Proportion of transactions (by value) accounted for by different types of clients**



Source: FCA analysis of transactional data described in Annex 2.

Note: The chart is based on data for January 2014 to May 2015, except for IPOs, for which we used data from January 2010 to May 2015.

## Regulatory Framework

- 3.35** In paragraphs 3.35 to 3.41 we have set out how the regulatory framework changed following the 2008 financial crisis. This section gives a high-level overview of the general regulatory framework for the services we have examined as part of this market study. We address the regulations in greater detail where relevant in the report.
- 3.36** The regulatory framework for investment and corporate banks and corporate finance advisers when carrying out regulated activities is set out in the Handbook. The high level Principles for Businesses are contained in PRIN. The conduct of business obligations are contained in the Conduct of Business Sourcebook (COBS) and the organisational requirements are contained in the Senior management arrangements, Systems and Controls Sourcebook (SYSC). The COBS rules on acting honestly, fairly and professionally and on communications with clients and the SYSC rules on conflicts of interest are particularly relevant in the context of the issues we have examined as part of the market study. The regulatory framework also covers the behaviour of individuals carrying out certain functions within a firm, including customer dealing functions in relation to some investment activities and types of clients (CF30).<sup>24</sup>
- 3.37** COBS 2 sets out the disclosure requirements applicable to firms prior to offering a Markets in Financial Instruments Directive (MiFID) investment service to a prospective client and the requirement for firms to act honestly, fairly and professionally in their client's best interests.

<sup>24</sup> Contained in the FCA Approved Persons chapter of the Supervision Manual (SUP 10A).

Under the conflicts of interest rules in SYSC 10, firms are required to identify and manage any conflicts of interest between themselves and their client, or between one client and another. SYSC 10 also includes specific provisions applicable to the management of a securities offering by a firm.

- 3.38** The majority of the provisions in COBS 2 and SYSC 10 derive from European legislation, in particular MiFID. MiFID is the framework of European Union (EU) legislation for investment firms that provide services to clients relating to financial instruments such as shares, bonds and derivatives and for the organised trading of these financial instruments. MiFID has applied in the UK from November 2007, and it is now in the final stages of being revised to improve the functioning of the financial markets in light of the financial crisis. It will also further harmonise investor protection and market transparency standards throughout Europe. For corporate finance business that is not regulated under MiFID, COBS 18.3 sets out the relevant application of COBS provisions.
- 3.39** Although not yet finalised, MiFID II will among other things enhance the disclosures firms are required to make to their clients and require them to manage and prevent conflicts of interest that may arise when undertaking underwriting or placing activity. MiFID II will also enhance transparency around costs and charges, in particular requiring firms to supply additional information where bundled services are provided to clients.
- 3.40** Certain investment firms and banks are also required to comply with the legislative package of prudential requirements that is the Capital Requirements Directive IV (CRD IV). This is made up of the Capital Requirements Regulation, which is directly applicable to firms, and the Capital Requirements Directive, which the Prudential Regulation Authority (PRA) have implemented in their Rulebook. CRD IV applied from January 2014. It enhances the quantity and quality of capital that firms are required to hold.
- 3.41** Furthermore, the Capital Markets Union (CMU) is a European Commission initiative aimed at creating a single market for capital across the EU and making the European capital markets work more effectively. One of the first steps of the longer term CMU programme is the revision of the Prospectus Directive, intended to facilitate the ease with which firms may raise capital across Europe and lower the associated costs. The CMU's aims to make capital markets work more effectively and efficiently are broadly consistent with those of the market study; ensuring competition for investment and corporate banking is working effectively. In assessing the issues, we have been mindful about the extent to which some features of the markets which may not be working well could be resolved in the medium term by the CMU initiative.

## 4.

# Entry, expansion and exit

### Chapter summary

We examined entry and expansion into each of ECM, DCM and M&A by considering recent trends and evaluating barriers to entry and expansion.

We find that:

- The ease of entry and expansion into primary market services depends on a firm's business model and approach taken. Entry or expansion by a lending bank is likely to differ substantially from that of a broker or adviser.
- Some universal banks scaled back their investment banking activity post-financial crisis by closing their ECM, DCM or M&A business. Entry and expansion in ECM and DCM has been primarily by those banks that are already lending. There has been entry by smaller/niche providers in M&A.
- Banks seeking to enter ECM and/or DCM require at a minimum origination, sales, trading and research capabilities. The main barrier to securing these capabilities is the cost of hiring experienced staff. In M&A, capability requirements are lower because firms can enter with experienced professionals but minimal infrastructure.
- Reputation is a barrier to entry and expansion across primary market services generally. Clients value experienced banks and advisers. Leveraging relationships (for example, in lending) and acquiring firms with an established client base and track record are the main ways to overcome this barrier.
- Regulation does not seem to be a major barrier to entry and expansion, although capital adequacy requirements mean more capital is required than in the past to provide investment banking services.
- Cross-selling from lending and corporate broking can act as a barrier to entry and expansion for those that do not provide these services. This is particularly the case in ECM and DCM, but these issues are discussed in full in Chapter 7.

### Introduction

- 4.1** As set out in our Terms of reference, the threat posed by potential new entrants and more efficient rivals expanding can incentivise firms to offer higher quality services at a more competitive fee. In the Terms of reference we said that we would examine any significant barriers to entry and expansion.

- 4.2** In this chapter, we consider the extent of entry and expansion in the provision of primary market activities in each of ECM, DCM and M&A advice and set out our analysis of features that might constrain the ability of firms to do so.
- 4.3** Within DCM, ECM and M&A primary market services, different business models exist. For example, in helping firms raise capital in ECM, some small and medium-sized banks may specialise in particular industry sectors and/or on medium-sized or small corporate clients. On the other hand, large universal banks might offer ECM services to large corporate clients as part of a wider service offering that may also include lending. These different business models mean that the scale and nature of entry and expansion can vary significantly. Where appropriate, we highlight how barriers to entry and expansion may apply differently to ECM, DCM and M&A. By 'barrier' to entry or expansion, we mean a feature of the market that gives at least some advantage to incumbent firms over efficient rivals. These barriers can have an effect either by reducing the expected profit or increasing the expected costs of entry or expansion.
- 4.4** This chapter is structured as follows:
- First, we provide an overview of recent trends of entry and exit in primary market services. This includes consideration of relevant technological innovation.
  - Second, we consider potential barriers to entry and expansion:
    - the need to establish origination, sales/distribution and research capabilities
    - the importance of reputation and track record
    - regulation
    - banks' use of lending and corporate broking to facilitate primary market mandates (our discussion of these potential barriers to entry and expansion is set out in full in Chapter 7)
    - the role banks' treasury departments play in securing DCM mandates from FIG and SSA clients (our discussion of the issue of reciprocity is set out in full in Chapter 6)

### Recent entry, expansion and exit

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- 4.5** This section sets out recent evidence of entry and expansion into, and exit from, primary market services. Where appropriate, we link this evidence to the wider market trends discussed in Chapter 3. Consistent with our categorisation of banks and advisers in Chapter 3, we distinguish between:
- **Advisers and investment banks:** This group comprises firms providing primary market services, especially advice in ECM and M&A, but not lending directly to corporate clients.

- **Corporate and universal banks:** This group comprises banks with corporate lending capabilities, which, in the case of universal banks, complement their suite of primary market services. They may serve clients in many countries and are able to advise corporate issuers of all sizes. FIG and SSA clients, which represent a large share of DCM transactions, are part of their client base.

### New entrants

#### *Advisers and investment banks*

- 4.6** Despite a decline in M&A and ECM activity since the financial crisis (see Chapter 3) some new providers have emerged, primarily focusing on market-cap niches or on specialised industry sectors in order to gain a market presence.<sup>25</sup>
- 4.7** A number of successful 'boutique' advisers have emerged. These are firms that focus on providing M&A advice. Some have been able to win mandates ahead of established banks that traditionally advised merging parties on large scale transactions. Many M&A boutiques have been formed by senior professionals formerly employed by the advisory business of incumbent banks. Having formed or joined a boutique outfit, they are able to leverage their expertise and network of professional contacts to win mandates.<sup>26</sup>

#### *Corporate and universal banks*

- 4.8** Given the scale and complexity of establishing a bank capable of lending and providing primary market services (see paragraphs 4.26 to 4.28) there are no relevant examples of new entrants<sup>27</sup>. However, Industrial and Commercial Bank of China Ltd (ICBC), a large Chinese lender, obtained a UK banking license in 2014 and secured the lead arranger mandate for Heathrow Airport's Revolving Credit Facility in the same year.<sup>28</sup> ICBC purchased the London-based Global Markets business of Standard Bank in 2015 and re-named it ICBC Standard Bank Plc. We understand that as at the end of 2015 ICBC Standard Bank Plc UK operations had not participated in originating, advising on, or managing ECM, DCM and M&A transactions.

#### *Other*

- 4.9** In corporate lending, alternative credit funds and the use of non-bank lenders have become increasingly prominent, complementing – and sometimes competing with – bank lending. According to research firm Preqin<sup>29</sup>, the amount raised by direct lending funds for investment in Europe grew from less \$1bn in 2009, to more than \$12bn in the first nine months of 2015. Direct lending funds held \$42bn available for investing at the end of 2015. This represents around a third of the \$127bn in high yield debt issued in Europe during 2015.<sup>30</sup>

25 For example, FinnCap, an AIM focused adviser, entered the market in 2007 focusing on small and micro-cap companies. The firm has grown to be one of the largest AIM brokers and obtained market-making authorisation and sponsor status. Other examples of entry include SPAngel (2006), Liberum (in 2007) and Cairn (in 2009).

26 Examples include Zaoui & Co, Robey Warshaw, Perella Weinberg and Moelis & Co. Some advisers also provide advice on equity issues. We discuss the role of corporate finance advisers in Chapter 6.

27 Since the FCA/PRA's 2013 review of the requirements for entering or expanding in the banking sector, there has been a number of new 'challenger banks' focused on lending to SMEs (e.g. OakNorth, Aldermore, OneSavings Bank). However, these banks tend to focus lending to SMEs rather than to listed corporates, and do not appear to provide primary market services.

28 Industrial and Commercial Bank of China, 'ICBC London Branch Opens for Business', [www.icbc.com.cn/icbc/newsupdates/icbc%20news/ICBCLondonBranchOpensBusiness.htm](http://www.icbc.com.cn/icbc/newsupdates/icbc%20news/ICBCLondonBranchOpensBusiness.htm)

29 Preqin, 'Private Debt in Europe; Q4 2015', <https://d3k9pt3r5jsyv9.cloudfront.net/docs/reports/Preqin-Private-Debt-Europe-October-2015.pdf>

30 Source: Dealogic data

**4.10** Two factors have contributed to this growth:

- Banks lowered their high pre-crisis leverage levels as a result of stricter regulatory capital requirements<sup>31</sup>, and in the process reduced lending in certain areas, e.g. SME lending, project finance and acquisition financing.
- Low interest rates have made it difficult for institutional investors to meet target returns. As a result, asset managers, private equity firms and hedge funds have increased direct lending to corporates. By creating 'direct lending funds' with attractive returns these firms enable investors to channel funding towards corporate lending, bypassing banks as traditional intermediaries for these investments.

**4.11** Despite the development of non-bank lending, according to research by the European Investment Fund, European corporates are still funded predominantly (around 80%) by banks, rather than capital markets. In contrast, US corporates depend on bank lending for only 20% of their funding needs.<sup>32</sup> To develop access to capital markets for corporates (especially SMEs), the European Capital Markets Union was launched in February 2015.<sup>33</sup>

### **Expansion**

#### ***Advisers and investment banks***

**4.12** Foreign-based firms have expanded into the UK primarily through the acquisition of local broking houses. For example, the acquisition of Brewin Dolphin by Spanish investment bank N+1 in 2012; the acquisition of Seymour Pierce by US firm Cantor Fitzgerald in 2013; and the acquisition of Oriel Securities by US-based investment bank Stifel in 2014. We were told that some corporate financial advisers have also expanded in recent years (we discuss their growth in Chapter 6).

#### ***Corporate and universal banks***

**4.13** Some UK and European banks retreated significantly from investment banking in the aftermath of the financial crisis (see paragraphs 4.17 and 4.18). As noted by some banks and advisers, US investment banks consequently gained market share in Europe. To strengthen their offering, some US-based lending banks bought UK corporate brokers – notably JP Morgan's acquisition of Cazenove in 2009 and Jefferies' acquisition of Hoare Govett in 2012. Banks with historically a smaller UK presence also expanded the scope of their operations. Examples of such expansion include BNP Paribas (which bought Royal Bank of Scotland's equities derivatives business following its exit from the market), Canadian bank Royal Bank of Canada (RBC), and US bank Wells Fargo.

**4.14** Generally, lending banks are responsive to changes in market conditions and growth opportunities in primary markets. Of those banks that lend and responded to our information request, around half reported some expansion into new products/services, client segments or countries.

**4.15** One area of growth has been high yield debt. Low interest rates have increased investors' appetite for debt issued by less established issuers, including unlisted companies or those with a lower credit rating that would otherwise be financed via bank loans. Banks offering these loans are well placed to help corporates refinance their bank debt via debt capital markets.

31 See Organisation for Economic Co-operation and Development, 'Bank deleveraging, the move from bank to market-based financing, and SME financing', [www.oecd.org/finance/financial-markets/Bank\\_deleveraging-Wehinger.pdf](http://www.oecd.org/finance/financial-markets/Bank_deleveraging-Wehinger.pdf)

32 European Investment Fund, 'Institutional non-bank lending and the role of Debt Funds', [www.eif.org/news\\_centre/publications/eif\\_wp\\_25.pdf](http://www.eif.org/news_centre/publications/eif_wp_25.pdf)

33 European Commission, 'Unlocking Funding for Europe's Growth – European Commission consults on Capital Markets Union', [http://europa.eu/rapid/press-release\\_IP-15-4433\\_en.htm?locale=en](http://europa.eu/rapid/press-release_IP-15-4433_en.htm?locale=en)

This helps free up banks' capital and allows them to develop their DCM franchises. Based on Dealogic data, the number of banks that acted as book-runners in high yield transactions in Europe, the Middle East and Africa (EMEA) increased from 68 in 2012 to 88 in 2015. During that time, the total value of transactions increased by about 20%, to \$110bn.<sup>34</sup>

- 4.16** Several banks have also begun providing DCM services to financial institutions, especially to banks raising finance to comply with Basel III capital adequacy requirements. Based on data from Dealogic, the number of banks that acted as book-runners in transactions for banks and other financial issuers in the EMEA region increased from 146 in 2012 to 185 in 2015, despite the fact that the total value of transactions remained relatively stable (\$498bn in 2012 compared with \$512bn in 2015).

### Exit

#### *Advisers and investment banks*

- 4.17** Over the past five years, significant consolidation has taken place among advisers and investment banks providing primary market services in the UK. The number of UKLA sponsors and Nominated Advisers (NOMADs) has fallen since the financial crisis – some advisers said that the numbers of NOMADs had fallen by a third. This in part reflects the fall in the number of ECM and M&A activity in 2011 and 2012 (see Chapter 3). As some brokers noted, during this time larger competitors including lending banks began pitching for mandates on lower value IPOs that would previously have been too small for them to consider. As a result, a number of corporate brokers exited the market (e.g. Libertas Capital Corporate Finance Ltd. and Matrix Group Ltd.); some abandoned their market-making and secondary trading functions while others were acquired by larger competitors (see paragraph 4.12, and further examples are Ocean Equities and Evolution Group, which were bought by Pareto Securities and Investec respectively).

#### *Corporate and universal banks*

- 4.18** As seen in Chapter 3, following the financial crisis, the number of capital markets transactions – particularly in ECM and M&A – fell significantly. As a result, some UK lending banks scaled back their investment banking ambitions – RBS closed its ECM and M&A business in 2012, while Lloyds retracted from the same areas in 2011. Moreover, increased capital adequacy rules introduced by Basel III meant that many banks strengthened their capital base and carefully reviewed which business lines delivered the highest return on capital. Notably, in 2012 UBS discontinued their DCM primary market offering to SSA clients for this reason. Barclays<sup>35</sup> and Credit Suisse<sup>36</sup> also publicly announced plans to shrink capital-intensive areas of their overall investment banking operations.

### Technological innovation

- 4.19** In ECM and DCM transactions, the role of investment banks is ultimately to act as intermediaries between investors and organisations that issue equity or debt. In many parts of the financial services industry technology is automating and replacing the role of intermediaries. An example is personal loans, where internet platforms such as Zopa, Ratesetter or Fundingcircle match lenders and borrowers, replacing the role of banks as traditional middle-men. In contrast, in primary market services the process of matching buyers and sellers is bespoke, relationship-based and centres on the expertise and abilities of individual banking professionals. In relation

<sup>34</sup> The comparison with 2014 is more striking. In that year, EMEA high yield transactions had reached \$164bn, and the number of banks acting as book-runners was 100.

<sup>35</sup> Barclays PLC, 'Barclays announces Group Strategy Update', [www.home.barclays/content/dam/barclayspublic/docs/AboutUs/Strategy/announcement-group-strategy-update-8-may-2014.pdf](http://www.home.barclays/content/dam/barclayspublic/docs/AboutUs/Strategy/announcement-group-strategy-update-8-may-2014.pdf)

<sup>36</sup> Credit Suisse Group AG, 'Press Release', [www.credit-suisse.com/uk/en/about-us/media/news/articles/media-releases/2015/10/en/strategy-update.html](http://www.credit-suisse.com/uk/en/about-us/media/news/articles/media-releases/2015/10/en/strategy-update.html)

to the Royal Mail IPO, the Myners Report (2014) noted that “it is inevitable that the book-building process will transition to a more digital online auction based on binding bids”.<sup>37</sup>

- 4.20** We are interested in how technological innovation is affecting developments in primary market services. We want to understand whether there are any new technologies emerging and whether there are any barriers standing in their way.

***Relevant technological innovation in primary market activities***

- 4.21** Responses to our information request contained relatively few references to technological innovations affecting primary market services.

- **Electronic book-building:** Three banks and advisers referred to book-building software as a development that simplifies collating investor interest and performing price discovery. Some issuers noted that during an issuance they had access to a tablet application that allowed them to follow the book-building process in real time. They were satisfied with the transparency that this allowed.
- **Crowdfunding:** Four banks and advisers referred to equity crowdfunding as a business model that is likely to affect the way in which companies raise capital. Respondents’ views were high-level and no firm suggested that their revenues had been affected by this development. Among smaller issuers we spoke to, only one had considered mini-bonds<sup>38</sup> as a way to raise capital; the firm found however that traditional bank loans were cheaper. In general, equity crowdfunding platforms seem to be used by small enterprises and start-ups with a strong retail footprint. However, we note that some advisers focused on the small and micro-cap sector have begun advising clients on how to utilise crowdfunding platforms to raise capital.

- 4.22** While a number of equity and debt transactions have in the past been completed using internet platforms (including the IPO of Google in 2004), we are not aware of recent *primary* market transactions where issuers and investors were matched through a platform, without the intermediation of investment banks. There are, however, a number of firms attempting to disintermediate banks in primary market services, including:

- **Secondmarket:** Given the trend of US-based technology companies tending to remain private for longer, a number of firms have emerged offering early-stage investors and staff a venue to sell their equity to other investors. Despite its name, Secondmarket (which was acquired by Nasdaq in 2015) is also active in primary markets, facilitating “the execution of primary and secondary transactions on behalf of private companies and funds, including some of the largest private companies and investment funds in the world”.<sup>39</sup>

37 Department for Business, Innovation and Skills, ‘IPOs and Bookbuilding in Future HM Government Primary Share Disposals’, [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/388660/bis-14-1300-myners-independent-review-for-secretary-of-state-for-business-ipos-and-bookbuilding-in-future-hm-government-primary-share-disposals.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/388660/bis-14-1300-myners-independent-review-for-secretary-of-state-for-business-ipos-and-bookbuilding-in-future-hm-government-primary-share-disposals.pdf) (paragraph 1.4.8).

38 A mini-bond is “a type of debt security, typically issued by small businesses. Such securities run for around three to five years, in general, and offer an interest rate of between 6% and 8% a year. We have seen an increase in the number of small companies issuing mini-bonds on crowdfunding platforms to raise capital for their business. Such businesses may have found it difficult to secure a loan from a bank or could be start-up companies looking for funding.” See FCA, ‘A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media’, [www.fca.org.uk/static/documents/crowdfunding-review.pdf](http://www.fca.org.uk/static/documents/crowdfunding-review.pdf) (paragraph 60).

39 Secondmarket Solutions Inc., Company website, <https://www.secondmarket.com/resources/>

- **Origin:** This is a London-based start-up building an online marketplace for wholesale borrowing and lending that “directly connect[s] borrowers and lenders in the corporate bond market”.<sup>40</sup> The firm received support from the FCA’s Innovation Hub with regards to the FCA’s authorisation process.
- **Distributed ledger based solutions:** Investment banks are reported to be pursuing ‘distributed ledger’ technologies to simplify the post-trading clearing and settlement process. The potential impact of this technology, however, is likely to span beyond simplifying banks’ back-office functions. Recently, Finclusion Systems, a London-based start-up developed a platform to allow HEAL –a non-profit organisation backed by Microsoft, Intel, UC San Francisco and others – to issue up to \$10bn bonds to fund research into HIV.<sup>41</sup>

**4.23** In contrast to primary markets, in *secondary* markets, a number of platforms have emerged, aimed at allowing investors to trade securities among themselves, without the intermediation of banks as market makers or dealers. In particular, a number of platforms have been developed for the secondary bond market. The role of intermediaries is more pronounced for these securities because they are traded ‘over the counter’ rather than on public exchanges. Notably BondCube, a platform sponsored by Deutsche Boerse, was launched in April 2015 but went into liquidation four months afterwards. However, market commentators suggest that over 30 firms<sup>42</sup> are attempting to create online marketplaces for trading bonds.

#### *Request for further views*

**4.24** We would like to hear more about technological innovation in primary market services. We particularly want to understand further why technological innovation has not yet been as successful in primary market activities as in other aspects of banking. Where there are regulatory barriers that prevent the adoption of technological solutions, we are keen to consider them in the context of the market study.

### **Barriers to entry and expansion**

**4.25** In this section we consider the following potential barriers to entry and expansion:

- the need to establish origination, sales/distribution and research capabilities
- the importance of reputation and track record
- regulation
- cross-selling and cross-subsidisation from lending and corporate broking
- the role of banks’ treasury departments

40 Origin Primary Limited, article featured on company website, [www.institutionalinvestor.com/article/3492907/banking-and-capital-markets-trading-and-technology/former-trader-raja-palaniappan-sees-fintech-opportunity-in-bonds.html#.VIWg5N\\_hBE4](http://www.institutionalinvestor.com/article/3492907/banking-and-capital-markets-trading-and-technology/former-trader-raja-palaniappan-sees-fintech-opportunity-in-bonds.html#.VIWg5N_hBE4)

41 Finclusion Systems, company website, <http://finclusionsystems.com/press.html>

42 Financial Times, ‘Start up Bondcube files for liquidation’, <http://www.ft.com/cms/s/0/830db2f8-3084-11e5-8873-775ba7c2ea3d.html#axzz43JFgBxog>

### Capabilities

**4.26** A major factor affecting the chances of a firm to enter and expand is its ability to demonstrate that it has sufficient capabilities to execute a primary market transaction. There are three core 'front office' capabilities which banks and advisers identified as necessary in order to provide primary market services:

- **Origination<sup>43</sup>:** In order to place the bank in a position to generate mandates, a bank needs a team that has the experience and expertise to provide issuers with advice (e.g. on raising capital through equity or debt, or on M&A transactions) and that can secure (or 'originate') mandates based on that advice.
- **Sales and trading:** the provision of ECM and DCM services also requires a sales team that is capable of distributing the issuer's securities to investors who will ultimately own the issuer's debt or equity. Investors generally expect to be able to buy and sell securities in the secondary market, meaning that banks need to be able to act as an effective market-maker (with associated staff as well as systems and capital which meet regulatory requirements) and execute trades on behalf of issuers. Sales and trading capabilities also complement origination, because they provide a bank with a good understanding of market sentiment and trends; this adds credibility to a bank's advisory function.
- **Research:** to provide credibly ECM and DCM services, a provider may also be expected to have a team in place that can produce research about an issuer's business, so that their investment case is properly and thoroughly explained to the market. Having strong and well-respected research capabilities is also important for attracting investors to a bank's platform.

**4.27** The above 'core' functions need to be adequately complemented by middle office support (e.g. risk management, financial control, corporate treasury, corporate strategy and compliance) and back-office roles (e.g. IT and Human Resources). In relation to technology, universal banks stressed that IT costs are significant. Access to live market data can be expensive for banks with significant front office operations.

**4.28** Banks and advisers noted that recruiting highly-skilled and experienced professionals was the main cost incurred in establishing or expanding these capabilities. Some smaller firms remarked that to attract top talent they would need to offer proportionately higher remuneration packages to compensate new hires for the risk of joining a less established outfit.

**4.29** These capabilities are not uniform across different services and client types. The type and extent of capabilities required for example by an adviser to AIM-listed companies to cover a new industry sector will be different from, say, a universal bank seeking to provide DCM services to large SSA clients. The need for extensive infrastructure is less critical in M&A, where M&A advisers have been able to grow successfully based on the advisory capabilities and network of contacts their partners possess.

### *Approaches to expanding capabilities*

**4.30** Across 70 respondents to our information request, 38 banks and advisers (54%) stated that they had grown their business into new industry sectors, countries, niches or services and/or expanded the scale of existing operations.

<sup>43</sup> See definition of 'origination' in Annex 1.

**Expanding within services**

**4.31** The majority, 25 of the 38 respondents (65%), stated that they had grown their business within services they already offered by leveraging existing capabilities. This includes foreign investment banks with existing primary market capabilities expanding the number of industry groups covered, strengthening their London-based teams, and/or opening branches across Europe. Among banks with existing DCM capabilities, some have expanded their offering to sub-investment grade corporates. Others expanded by adding new currencies to their offering. Among medium-sized advisers, those who have successfully expanded their business targeted larger corporate clients and some highlighted their efforts to engage with private equity firms, as a way to generate mandates for M&A deals and IPOs. In these examples of expansion within given product categories, firms either grew using existing resources or by hiring the necessary expertise.

**Expanding via acquisition**

**4.32** Foreign firms seeking to expand their UK ECM footprint saw the acquisition of domestic corporate broking houses as a ready means to add new capabilities and track record, as well as an existing customer base (see paragraph 4.12). This form of expansion was more prominent following the financial crisis when a number of UK broking houses found themselves under financial pressure. In DCM, expansion through acquisition has been less common – although one exception is the acquisition of DCM specialist adviser KBW by US investment bank Stifel.

**Expanding into new services**

**4.33** Few firms have opted to enter new services by growing their capabilities organically.

- Only one bank, Investec, has established a DCM business in the UK from scratch.
- Some lending banks have tried to expand their ECM footprint by growing their corporate broking operations organically.
- A number of accountancy firms are also in the process of developing their ECM capabilities. However, their business models tend to focus on providing advisory services (without trading and research infrastructure) with a view to complement, rather than to replace, banks on ECM deals.

**Reputation**

**4.34** Successful entry and expansion relies on demonstrating a strong reputation in order to win primary market mandates. Reputation is important because the downside risk of a transaction not being successful can be significant for an issuer. In DCM, an unsuccessful bond issue may affect a firm's perceived credit outlook and increase the cost at which it issues debt in future. Similarly, in ECM, a poorly-received IPO may impact the price at which the firm can sell its equity in future follow-on ECM transactions. Selecting a bank and/or adviser with a strong reputation in comparable transactions is a means by which CEOs, treasurers and senior management seek to minimise a transaction's execution risk.

**4.35** Building a strong market reputation is perceived by almost all firms we engaged with to be a significant barrier to entry or expansion into primary market services. Unlike capabilities, which can be scaled up by hiring appropriately skilled and experienced staff and making investments, market reputation is built over time.

**4.36** Banks and advisers have sought to address the need for a strong reputation in a particular type of issue, country or sector in a number of ways:

- **Following domestic clients:** A common approach adopted by banks expanding beyond their domestic markets has been to execute foreign transactions undertaken by clients they serve in their domestic markets. For example, if a Japanese corporation wants to issue debt in dollars, a Japanese bank that already serves that client in Japan might be able to build a track record in US-denominated transactions by executing the issuance on that client's behalf.
- **Leveraging lending relationships:** Many banks with corporate lending portfolios entering into investment banking are able to leverage their position as lenders to pitch their capital markets offering. Banks and advisers and issuers said that lending banks often call on their clients to be included in syndicates in passive or junior roles (see Chapter 6 for a discussion of syndicates and Chapter 7 for a discussion of cross-selling). This is with a view to building their franchise, particularly with regard to DCM.
- **Acquisition:** In ECM, acquiring a local corporate broker with existing capabilities, client base and track record has been a further means by which new providers have acquired a market reputation.

**4.37** As described in the section on selection criteria in Chapter 6, reputation and the requirement for a demonstrable, substantial market track record is likely to represent one of the main drivers of choice in primary market services. This is particularly the case for complex transactions, such as IPOs and bond issuance, where execution certainty is highly valued by often risk-averse issuers.

### Regulation

**4.38** As part of our request for information, we asked banks and advisers to identify any regulations which act as a barrier to entry. Many respondents said that regulation represents a hurdle and made reference to compliance costs. Some respondents also noted that regulation prevents the development of new business models. We set out below the three main regulatory themes highlighted by respondents:

- capital adequacy requirements
- authorisation
- remuneration regulations

**4.39** While banks' and advisers' commentary was useful to understand how regulation underpins recent trends of entry and exit generally, we are keen to hear more about where specific regulations have had unintended consequences for competition for primary markets services. We are interested in suggestions on whether, and, if so, how it would be appropriate for our rules to be changed to reduce any barriers to entry in this market without undermining their intended impact.

### Capital adequacy requirements

**4.40** As described in Chapter 3, Basel III and its subsequent application through CRD IV increased the capital adequacy requirements for a number of activities that, directly or indirectly, support primary market services (e.g. underwriting, secondary market trading, provision of swaps/hedges, and lending).

**4.41** The effect of capital adequacy rules on competition was highlighted by around a fifth of respondents, mostly large universal banks. We are keen to hear further comments on two specific observations:

- **Temporary vs. long-term effects:** Following the introduction of Basel III, many investment banks had to strengthen their capital base while retreating from capital-intensive services. As some of the incumbent investment banks have now completed this process, we would like to understand the extent of any ongoing effect of increased capital requirements on competition.
- **Capital-light business models:** Some respondents remarked that increased capital adequacy rules have increased the attractiveness of primary market services, as some segments (e.g. financial institution issuers) may be served with little capital commitment. Similarly, one respondent noted that the inability of incumbent banks to provide secondary market liquidity removes a competitive advantage incumbents had over less-established investment banks. We would like to understand whether primary market services might be evolving towards such a 'capital-light' model.

**4.42** Basel III was introduced to reduce the risk of a future financial crisis. We are open to suggestions to how we might mitigate the impact, if any, of these rules on competition in the sector, especially on smaller providers, without compromising the intended objective of these rules.

#### **Authorisation**

**4.43** Around a tenth of respondents (mainly advisers) said that obtaining licenses and authorisations from relevant regulators is a barrier to entry to primary market services. Some firms provided feedback on the process of obtaining UKLA sponsor status, which they consider is necessary to compete for corporate broking appointments for LSE-listed companies, since companies with or seeking a listing on the premium segment of the official list require a sponsor in some circumstances. Some advisers noted that UKLA sponsor rules (introduced in 2013 in relation to sponsor 'competence') may mean that a firm wishing to become a sponsor prior to seeking entry into corporate broking will need first to hire professionals with the requisite past sponsor experience. In addition, the competence rules require sponsors to act as sponsor on at least one relevant transaction every three years in order to retain their license. Respondents said that this potentially makes it difficult for corporate brokers with a small client base or a business model which does not prioritise sponsor services to retain their sponsor status. We understand that similar rules apply to firms wishing to become 'Nominated Advisers' (NOMADs) on the AIM market.

**4.44** The views expressed on the UKLA's rules relating to sponsor status echo some of the feedback the FCA received<sup>44</sup> and considered ahead of strengthening the UKLA sponsor regime in 2014. However, having had regard to the comments received in response to the market study's request for information, we would welcome further comment on how the approval process for both NOMADs and sponsors may affect competition in primary market services.

#### **Remuneration regulations**

**4.45** As noted above, banks/advisers highlighted staff costs as the main cost for entering or expanding their primary markets capabilities. In this context, two respondents remarked that the bonus cap<sup>45</sup> introduced by CRD IV reduces their ability to retain top-quality staff and makes it easier for boutique advisory firms (to whom the cap does not apply) to recruit top talent.

<sup>44</sup> FCA, 'CP14/21 Feedback and Policy Statement on CP14/02, consultation on joint sponsors and call for views on sponsor conflicts', [www.fca.org.uk/your-fca/documents/consultation-papers/cp14-21](http://www.fca.org.uk/your-fca/documents/consultation-papers/cp14-21)

<sup>45</sup> To retain top-quality staff, some banks affected by the CRD IV bonus cap may have opted to pay higher fixed salaries to attract and retain the most highly-rated banking professionals, leading to an increase in fixed costs.

However, we are not aware of any evidence that the universal banks have had difficulty in attracting high-quality staff since CRD IV was introduced.

### **Cross-selling and cross-subsidisation from lending and corporate broking**

#### ***Lending***

- 4.46** Banks and advisers noted that a lending relationship plays an important role in securing primary market mandates from corporate issuers, particularly in DCM. This is because corporate loans often form part of a client's wider debt structure. This issue was a significant concern for banks and advisers that lack lending capabilities. The difficulty in displacing a client's incumbent lenders was also mentioned by a number of foreign lending banks as they have sought to expand their UK operations.
- 4.47** The extent to which the cross-subsidisation of lending and cross-selling from lending represents a barrier to entry is explored in Chapter 7. In that chapter we conclude that cross-selling from corporate lending creates some barriers to entry and expansion to primary market services.

#### ***Corporate broking***

- 4.48** In the UK, corporate brokers play an important role in assisting listed companies to place equity, for example to fund business expansion and/or to finance an M&A transaction. Corporate brokers act as an intermediary between listed companies and investors and provide ongoing advice to firms, ranging from feedback on stock performance, managing investor relations, and providing M&A ideas. In doing so, brokers develop a close relationship with a corporate's management.
- 4.49** Whilst clients may be charged a retainer fee for broking services, most brokers stated that the level of the retainer was insufficient to cover the cost of providing research and ongoing advice. For larger corporate clients, these services are typically provided free of charge. In return for their ongoing advice, corporates often award mandates for non-IPO ECM transactions (e.g. follow-on offerings, rights issues and convertible bond offerings, and/or M&A deals) to their corporate brokers.
- 4.50** We consider the role of cross-selling from – and cross-subsidisation of – corporate broking in Chapter 7. As for corporate lending, we find that cross-selling from corporate broking may create some barriers to entry and expansion to primary market services, but these are likely to be less pronounced than for corporate lending.

#### ***The role of banks' treasury departments***

- 4.51** As with other types of issuers, banks have treasury departments that are responsible for managing the firm's liquidity and capital structure. A bank's treasury may be involved with primary market services in two ways. First, when the bank executes any capital market transaction, the treasury department is responsible for awarding mandates for the transaction. Second, a treasury department might want to convert cash the bank generates (which earns little return) into very secure and highly liquid assets (which may offer some return) such as SSA debt and other money market securities. In this section, we consider how these two functions may affect entry and expansion into the provision of DCM services to FIG and SSA clients, respectively.

#### ***DCM services to FIG clients***

- 4.52** Financial institutions are high-volume issuers of debt, as they use debt capital markets (as well as retail deposits) to source the funds they need for lending. Capital adequacy requirements imposed by Basel III/CRD IV mean that the volume of securities issued by financial institutions has increased significantly since the financial crisis. According to our transactional data described

in Annex 2, in 2014, financial institutions accounted for 40% of the total value of banks' UK operations' DCM transactions.<sup>46</sup>

**4.53** The need to raise capital to satisfy new regulatory requirements has also elevated the role of banks' treasuries in developing smaller banks' DCM footprints. To establish a bank's market reputation in FIG DCM issuances, a bank's treasury may mandate the bank's own investment banking team and decide which other banks should be awarded joint lead or junior roles. When choosing which other banks should join a syndicate, the bank may select banks to conduct the issuance partly on the basis of how much business these other banks can offer them in exchange.

**4.54** We discuss this practice, known as reciprocity, and its role as a potential barrier to entry in detail in Chapter 6. We find that reciprocity is currently most prevalent in the bank financing market, particularly covered bonds. It does not presently appear to be having major exclusionary effects, but we may need to revisit this finding should the practice become more widespread or the impact within covered bonds exclude more banks from underwriting.

#### ***DCM services to SSA clients***

**4.55** SSAs include debt management offices of sovereign governments, as well as supra-nationals such as the World Bank, the European Investment Bank (EIB) and domestic agencies such as German development bank, KfW. Governments raise capital to finance public deficits while supra-nationals and agencies generally raise capital to lend or invest in accordance with their mandates. SSAs can be characterised as large and frequent issuers. According to our transactional data described in Annex 2, SSAs represented 30% of the total value of banks' UK operations' DCM transactions in 2014.<sup>47</sup>

**4.56** SSAs enjoy significant buyer power and typically expect the highest standards in terms of capabilities, track record and credit rating from the banks to whom they award lead mandates. Banks and advisers estimated that it can take between 2-3 years for a bank to successfully enter the SSA segment.

**4.57** A recent development noted by some stakeholders in the way in which banks compete for SSA mandates is the role of bank treasuries as buyers of SSA bonds. Securities issued by highly-rated SSAs qualify as 'high-quality liquid assets' (HQLAs) under Basel III. Bank treasuries seek to hold HQLA to meet capital requirements, meaning that banks' treasuries can sometimes be on the buy-side of SSA bonds. When pitching to clients on a transaction, investment banks can strengthen their proposition by pledging that a share of the debt issued by an SSA will be bought by the bank's own treasury investment funds.

**4.58** As noted by some banks and SSAs, SSAs give some consideration to the fact that a bank competing for a mandate may place a given proportion of the issuance into the bank's own treasury. This may represent a barrier to entry for banks that seek to expand their SSA DCM capabilities but are not able to deploy their balance sheets in this manner. On the other hand, at the margin, this might help banks with a weaker DCM track record but with capacity to accommodate SSA securities to gain traction in this client segment. While some banks referenced this trend in their response, they did not characterise it as a barrier to entry.

<sup>46</sup> By way of comparison, based on Dealogic data, financial institutions accounted for 37% of the total value of all DCM transactions in EMEA in 2014.

<sup>47</sup> By way of comparison, based on Dealogic data, SSAs represented 26% of the total value of all EMEA DCM transactions in 2014.

## 5.

# Availability of suppliers

### Chapter summary

We examined the range of suppliers available to clients of different types and sizes across each of ECM, DCM and M&A.

We focused our assessment on the extent to which small and medium-sized corporates are less well served by banks and advisers than large corporate clients because we were told that they may be less profitable to banks and advisers. We did not identify a lack of availability of banks and advisers for clients operating in any specific sector, or for SSAs, financial institutions and large corporate clients.

We found that most medium-sized and small corporate clients appear to have sufficient choice for primary market services. In particular, clients have not expressed significant concerns about the options available to them.

Despite this, we have seen evidence that larger banks opt to reduce their engagement with smaller, newer and/or riskier clients in response to market conditions and regulatory change. If the large banks were to retrench from serving medium-sized corporate clients in times of economic uncertainty or where they face substantial cost increases, this would be most likely to have an effect on choices for medium-sized clients in ECM.

- 5.1** In this chapter we present our findings on the availability of suppliers for investment and corporate banking services.
- 5.2** The main focus of our analysis, as highlighted in the Terms of reference, is on assessing the extent to which small and medium-sized corporate clients are less well served by banks and advisers than other types of clients.<sup>48</sup>
- 5.3** We first set out our high-level findings on the availability of suppliers for different types of clients. We identify small and medium-sized corporate clients as the groups likely to be more vulnerable to being less well served. We then assess whether different types of banks and advisers compete to serve clients of different sizes. We examine reported client engagement strategies and the range of clients that banks and advisers have served in recent transactions. Finally, we examine whether the strategies of banks and advisers have adversely affected the choices available to small and medium-sized corporate clients.

<sup>48</sup> We set out how we have classified banks, advisers and clients in Chapter 3 and Annex 2.

### Availability of suppliers for different groups of clients

**5.4** Our findings on the availability of suppliers for different types of clients are set out below. We examine the evidence we received from stakeholders and use our transactional data (as described in Annex 2) to calculate banks' and advisers' shares of supply. We consider:

- whether for each primary market service there is limited availability of suppliers for clients operating in different sectors
- whether different types of clients, such as SSAs, financial institutions or corporate entities face restricted access to particular services
- whether clients of a certain size, such as small or medium-sized corporate clients, are less well served by the market

**5.5** We also explore the commercial reasons why banks and advisers might opt to restrict the services and products they offer, or the types of clients they serve.

### Availability of suppliers across sectors for different primary market services

**5.6** To ascertain whether there are sectors in which clients are likely to face restricted choices we analysed shares of banks and advisers by sector for each of ECM, DCM and M&A.

**5.7** Our analysis did not uncover compelling evidence that choices are severely restricted in particular sectors for clients requiring services for different types of transactions.<sup>49</sup>

**5.8** Across all types of ECM services combined in 2014 there was no single sector in which a bank or adviser held more than 18% share of all roles, or in which there were fewer than 17 banks and advisers providing services (Table 1). When split out by different ECM services, there was no single sector in which a bank or adviser held more than 24% share of all roles, or in which there were fewer than 7 banks and advisers providing services.

**Table 1: Maximum share of roles and minimum number of banks and advisers by sector for different ECM services, 2014**

Type of ECM service	Maximum share of roles held by a bank or adviser in a sector (%)	Minimum number of banks and advisers in a sector
IPOs	23%	7
Follow-on transactions	20%	12
Other ECM transactions (mainly convertible debt)	24%	8
All types of ECM combined	18%	17

Source: FCA analysis of transactional data described in Annex 2.

<sup>49</sup> These results are based on our analysis of the transactional data described in Annex 2. Transactions were assigned to twelve sectors: agribusiness; consumer and retail; finance and insurance; government; healthcare; manufacturing, textiles and machinery; professional services; real estate, property and building; technology; telecommunications; transportation and utility, energy and natural resources. This analysis excludes sectors in which there were five or fewer transactions in 2014 and transactions for which no sector information was available. These excluded transactions accounted for less than 5% of the total transactions in each of ECM, DCM and M&A in 2014.

- 5.9** For all types of DCM services combined in 2014 there was no single sector in which a single bank or adviser held more than 18% per cent share of roles, or in which there were fewer than 15 banks and advisers providing services (Table 2). When split out by different DCM services, there was no single sector in which a bank or adviser held more than 35% share of all roles, or in which there were fewer than 12 banks and advisers providing services.

**Table 2: Maximum share of roles and minimum number of banks and advisers by sector for different DCM services, 2014**

Type of DCM service	Maximum share of roles held by a bank or adviser in a sector (%)	Minimum number of banks and advisers in a sector
Corporate investment grade bonds	17%	12
Corporate high-yield bonds	17%	14
MTNs	35%	15
All types of DCM combined	18%	15

Source: FCA analysis of transactional data described in Annex 2.

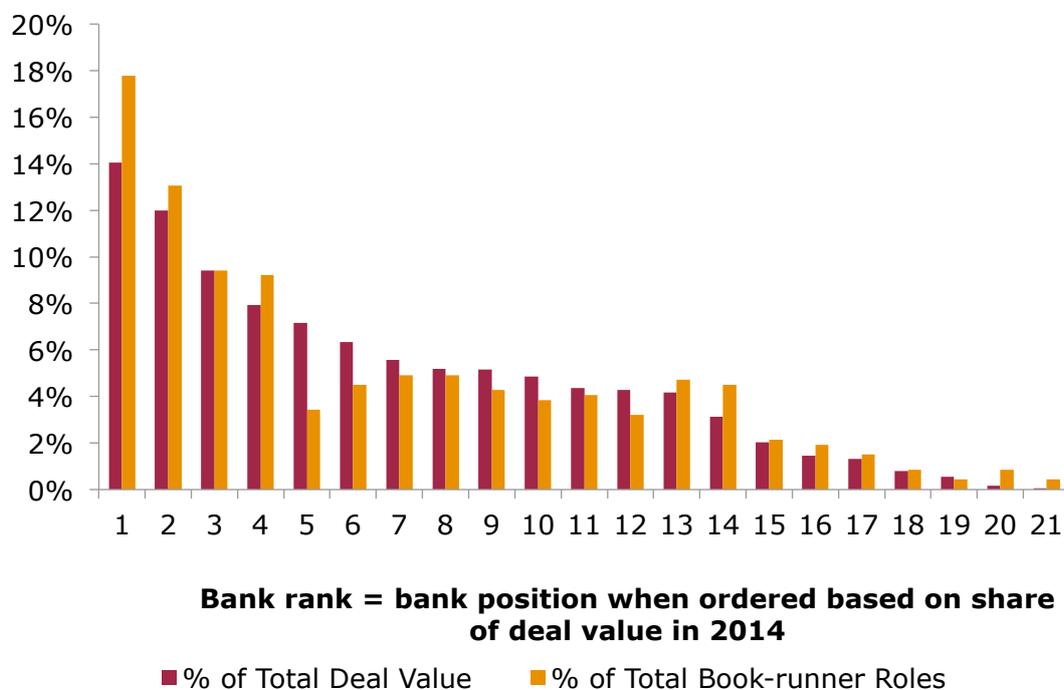
- 5.10** In M&A in 2014 there was no single sector in which a single bank or adviser held more than 23% per cent share of roles, or in which there were fewer than 13 banks and advisers providing services.
- 5.11** Moreover, the submissions we received from clients, banks and advisers, and the views we heard from stakeholders, did not raise substantive concerns that clients in particular sectors have been adversely affected by a lack of available suppliers. However, stakeholders should provide evidence if there are any specific sectors in which they do have such concerns.

#### **Availability of suppliers for different types of clients**

- 5.12** We also explored whether some types of clients might be less well served by banks and advisers than other types of clients. We examine the choices available to SSAs, financial institutions and corporate clients in turn.

#### **SSAs**

- 5.13** In our review of the range of banks and advisers that are available to SSAs and our engagement with SSA clients we have not found concerns that these types of clients have a lack of available suppliers.
- As set out in Annex 3, we heard from larger SSA clients that they typically have a range of large banks pitching for their transactions and in any given year they can work with 35– 40 banks in lead manager roles on different deals. SSAs also said that in general they have sufficient choice of banks.
  - In our transactional data, we found that in 2014 there were 25 banks active in SSA DCM issuance with no one bank having more than a one-fifth share of roles or transaction values. As Figure 1 shows, restricting our analysis to the lead manager and book-runner roles awarded on SSA transactions we found that not one of the 21 banks who were awarded these roles held shares above 18%.

**Figure 1: Banks' shares of book-runner roles on SSA transactions, 2014**

Source: FCA analysis of transactional data described in Annex 2.

Notes: The share of deal values is calculated by apportioning each of the banks in our sample that held a book-runner role on the transaction an equal share of the total value of the transaction. SSA transactions are those where the client was categorised as SSA and the deal type was categorised as SSA. The analysis was conducted separately for transactions where the deal was categorised as an MTN but revealed similar results (24 banks were active in SSA MTNs with no bank having more than a fifth share of roles or transaction values).

### **Financial institutions**

- 5.14** Our examination of the range of banks and advisers offering services to financial institutions did not indicate that financial institutions face limited supply options. There are a number of banks providing services for FIG transactions, and many financial institutions can use their own investment banking capabilities in the event that they should require primary market services. As Table 3 indicates, across services no one bank held more than 20% of roles on FIG transactions in 2014. Table 4 shows that when confining the analysis to book-runner roles, no one bank held more than 30% of roles.

**Table 3: Banks' shares of roles on FIG transactions, 2014**

Service	No of Banks	% Total Deal Value			% Number of Roles		
		C1	C4	C10	C1	C4	C10
ECM – IPOs	32	15-20	46	75	5-10	29	59
ECM – Follow On Transactions	35	10-15	43	73	10-15	34	59
ECM – Other (mainly convertible debt)	11	15-20	65	97	15-20	52	95
DCM – Corporate Investment Grade	26	5-10	31	63	5-10	29	63
DCM – Corporate High Yield	22	15-20	45	75	10-15	41	71
DCM – MTNs	28	10-15	35	68	10-15	32	63
M&A	27	30-35	68	92	10-15	42	76

Source: FCA analysis of transactional data described in Annex 2.

Notes: C1, C4 and C10 stand for one firm, four firm and ten firm concentration ratios respectively. The share of transaction values is calculated by apportioning each of the banks in our sample that were on the transaction an equal share of the total value of the transaction. Concentration ratios represent the sum of the market shares for the number of firms, so a C4 ratio represents the sum of the market shares for the four largest firms.

**Table 4: Banks' shares of book-runner roles on FIG transactions, 2014**

Service	No of Banks	% Total Deal Value			% Number of book-runner roles		
		C1	C4	C10	C1	C4	C10
ECM – IPOs	18	20-25	63	91	10-15	47	85
ECM – Follow On Transactions	23	15-20	61	93	15-20	48	77
ECM – Other (mainly convertible debt)	8	25-30	77	100	25-30	71	100
DCM – Corporate Investment Grade	23	5-10	32	69	5-10	33	67
DCM – Corporate High Yield	19	15-20	51	82	10-15	44	75
DCM – MTNs	27	10-15	35	70	10-15	32	65

Source: FCA analysis of transactional data described in Annex 2.

Notes: C1, C4 and C10 stand for one firm, four firm and ten firm concentration ratios respectively. The share of transaction values is calculated by apportioning each of the banks in our sample that held book-runner roles on the transaction an equal share of the total value of the transaction. Concentration ratios represent the sum of the market shares for the number of firms, so a C4 ratio represents the sum of the market shares for the four largest firms.

- 5.15** We did however want to explore whether some financial institutions' supply options for certain types of bonds could be restricted as a result of reciprocity among banks in FIG DCM. We consider this topic in detail in the section on reciprocity in Chapter 6.

### **Corporate clients**

- 5.16** Examining the availability of suppliers across all corporate clients, Table 5 and Table 6 indicate that across services there are at least 21 banks competing for mandates and at least 15 competing for book-runner roles. No bank had a greater than 30% share of transaction values or roles either for all role types or for book-runner roles only.

**Table 5: Banks' shares of roles on corporate client transactions, 2014**

Service	No of Banks	% Total Deal Value			% Number of Roles		
		C1	C4	C10	C1	C4	C10
ECM – IPOs	35	10-15	41	74	5-10	31	64
ECM – Follow On Transactions	40	15-20	47	77	5-10	27	50
ECM – Other (mainly convertible debt)	21	10-15	40	79	10-15	38	74
DCM – Corporate Investment Grade	25	25-30	51	77	5-10	33	68
DCM – Corporate High Yield	26	15-20	42	79	10-15	37	74
DCM – MTNs	24	10-15	35	66	5-10	29	63
M&A	43	15-20	48	83	5-10	32	65

Source: FCA analysis of transactional data described in Annex 2.

Notes: C1, C4 and C10 stand for one firm, four firm and ten firm concentration ratios respectively. The share of transaction values is calculated by apportioning each of the banks in our sample that were on the transaction an equal share of the total value of the transaction. Concentration ratios represent the sum of the market shares for the number of firms, so a C4 ratio represents the sum of the market shares for the four largest firms. These concentration ratios are based on the share of total value of transactions.

**Table 6: Banks' shares of book-runner roles on corporate client transactions, 2014**

Service	No of Banks	% Total Deal Value			% Number of book-runner roles		
		C1	C4	C10	C1	C4	C10
ECM – IPOs	23	15-20	64	93	15-20	51	84
ECM – Follow On Transactions	28	20-25	64	93	15-20	47	78
ECM – Other (mainly convertible debt)	15	10-15	51	91	10-15	47	87
DCM – Corporate Investment Grade	24	20-25	52	79	10-15	34	72
DCM – Corporate High Yield	24	20-25	52	88	10-15	46	81
DCM – MTNs	23	10-15	36	70	5-10	32	67

Source: FCA analysis of transactional data described in Annex 2.

Notes: C1, C4 and C10 stand for one firm, four firm and ten firm concentration ratios respectively. The share of transaction values is calculated by apportioning each of the banks in our sample that held book-runner roles on the transaction an equal share of the total value of the transaction. Concentration ratios represent the sum of the market shares for the number of firms, so a C4 ratio represents the sum of the market shares for the four largest firms. These concentration ratios are based on the share of total value of transactions.

- 5.17** Although our analysis above did not identify that overall corporate clients have few suppliers available, we were told that small and medium-sized clients may be less profitable to banks and advisers and less well served by the market. Large corporate clients also reported that they have sufficient choice of providers and that their needs are well served by the market (see Annex 3). We therefore focused our assessment on the extent to which small and medium-sized corporate clients are less well served by banks and advisers than large corporate clients. Nevertheless, we would be keen to hear from SSA, financial institution or large corporate clients if there are any specific primary market services in which they do have substantive concerns about the choice available to them.

#### **Availability of suppliers for corporate clients of different sizes**

- 5.18** The submissions we received from banks and advisers, and the views we heard, confirmed that there are commercial reasons for some banks and advisers to target their offering towards larger clients. These clients are often more attractive than medium-sized or small corporate clients insofar as the returns to serving them, relative to the costs of maintaining the relationship, are greater as a result of their:

- **Higher revenue potential:** Large corporate clients usually conduct primary market transactions that are larger and more frequent than small and medium-sized corporate clients. They therefore provide greater revenue generating opportunities for banks and advisers.
- **Greater cross-selling opportunities:** Large corporate clients are more likely to have a wide range of requirements for investment and corporate banking services. This provides banks and advisers with a greater incentive to build relationships with these clients.

- **Reputational/marketing influence:** Establishing relationships with large corporate clients may indirectly increase banks' revenues through the reputational value of these accounts. For example, having relationships with a number of FTSE 100 clients may help a bank to market its services to other prospective clients.
- **Lower risk:** It may be less risky for banks and advisers to serve large corporate clients as these clients often have greater experience, higher ratings and pose limited regulatory risk compared to those clients that have less primary market experience.
- **Higher return on resources deployed:** In comparison with large corporate clients, the resources required to serve a small corporate client may be disproportionately high relative to the revenues that the client can generate.

**5.19** For these reasons we wanted to explore whether larger banks and advisers tend to prioritise larger clients and, whether this affects the choices available to medium-sized and small corporate clients. We first examine the extent to which small and medium-sized corporate clients are less well served by banks and advisers than large corporate clients. We then consider the likely consequences for both small and medium sized clients. We wanted to explore:

- Whether smaller clients, even if they are less well served by the larger banks, might have a range of smaller banks and advisers to choose from.
- Whether medium sized clients might face limited choice because, in addition to not being well served by the larger banks, they are unable to use smaller banks and advisers because they require more resources (e.g. capital) or more sophisticated banking services than smaller banks can offer.

### Competition between banks and advisers for medium-sized and small corporate clients

**5.20** To assess the extent to which the different types of banks and advisers compete to serve clients of different sizes, we examined their client engagement strategies and the range of clients they have served in recent transactions.

#### Banks and advisers' client engagement strategies

**5.21** We examined the different strategies banks and advisers have developed for targeting and retaining clients of primary market services. Classifying the banks and advisers in our sample according to their investment banking revenues and business models (as described in Chapter 3 and Annex 2) we observed the following trends:

- **Large universal banks:** These banks stated that the main focus of their investment banking business was on serving large clients with sophisticated needs, often those in the FTSE 100 or higher end of the FTSE 250. It was reported that these clients account for the overwhelming majority of their revenues. Most banks emphasised that their current engagement strategy is to deepen their relationships with these clients to obtain a greater share of the client wallet rather than targeting new clients. Several noted however that they may establish new relationships with clients such as high growth, start-up or newly formed companies that are likely to present opportunities in the future. Some banks reported a general trend to reduce the client base. One bank stated that it had dropped thousands of clients in recent years, but observed that as the economy has recovered some clients on its 'watch list' may reach a sufficient scale to recommence using its services.

- **Large investment banks and corporate banks:** These banks also emphasised that they concentrate on serving and strengthening their relationships with key clients which meet their screening criteria (in terms of size, risk and business synergy), and that they do not routinely target smaller clients. They also noted that apart from larger clients they may also approach smaller companies that are performing well and are expected to grow. One bank noted that, while it largely competes with large universal banks to serve larger clients, it competes more with smaller investment banks for smaller, high potential clients (although the range of competitors varies depending on the industry in which the client is active).
- **Medium universal banks:** The banks in this group similarly stated that they focus on larger clients which meet certain minimum revenue or turnover requirements. However, on the whole these thresholds were lower than those described by the larger banks, and the banks in this category typically described the FTSE 250 as their target group. One bank stated that it focused specifically on sub-FTSE 100 companies, explaining that its strategy was to concentrate on medium-sized corporate clients because it had a small balance sheet and there were fewer suppliers in this segment. It believed it could offer a fuller service to clients than some of its competitors. In contrast to the larger banks, many banks in this category expressed intentions to enlarge their client base. Some banks also identified financial sponsors/private equity firms as a particular focus for their expansion plans.
- **Medium investment banks and corporate banks:** Banks in this category adopt a range of different business models and strategies. Some banks said that they focus on providing strategic advice to large clients, often in the FTSE 100, on complex/major transactions. Others stated that they are best placed to provide advisory and execution services to medium-sized corporate clients and predominantly serve clients in the FTSE 250. Equally, some banks reported that they target a wide range of clients, from SMEs up to medium-sized clients with valuations of up to £2 billion. One bank, which opted to focus on FTSE 250 companies, stated that it is less well placed to compete at the lower end of the market-cap spectrum as there are advisers (such as the accountancy firms) that have sufficient expertise to cover that segment of the market and can do so at lower cost. This bank also emphasised that an important consideration in determining whether to serve a smaller client was the liquidity of the client's issues as this would affect the opportunities available to earn revenues from subsequent sales and trading services.
- **Small investment banks and corporate banks:** Many of the banks in this category said that they focus on providing services to clients of a specific type (e.g. public sector institutions) or clients based in a particular region or industry. Many of these banks focus on offering services to small and medium-sized corporate clients. Some stated that they are looking to grow their operations to cover a wider range of clients, regions or sectors while others indicated that they had no immediate expansion plans. One bank noted that while it initially tended to work for smaller, riskier companies, since the financial crisis it had been able to shift its client base towards larger and more liquid companies.
- **Advisers:** Strategies adopted by advisers were either to focus on obtaining broker or NOMAD roles with smaller clients and then to expand their operations over time; or to concentrate on offering strategic advisory services to medium-sized corporate clients, private equity firms and/or large corporate clients on key transactions.

**5.22** We also considered whether the business models and strategies reported by banks and advisers varied according to the type of primary market service offered. We observed that there were differences across ECM, DCM and M&A both in the emphasis banks and advisers placed on segmenting clients into size categories, and in the size range of the banks that were pursuing mandates in each segment. The main differences across services were that:

- In DCM (and to a lesser extent M&A) large banks appeared to place less emphasis on providing services exclusively to clients which meet particular size thresholds than they did in ECM. Similarly, small and medium-sized banks made fewer references to specialising in providing services specifically to medium-sized corporates. One potential reason for this is that fewer small and medium-sized corporate clients use DCM services compared with other transactional services. We consider the extent to which this is the case in paragraphs 5.23 to 5.31 below.
- Few of the advisers offered advisory services in DCM, but rather tended to focus on the provision of services in M&A and in ECM (see our assessment of corporate finance advisers in Chapter 6).

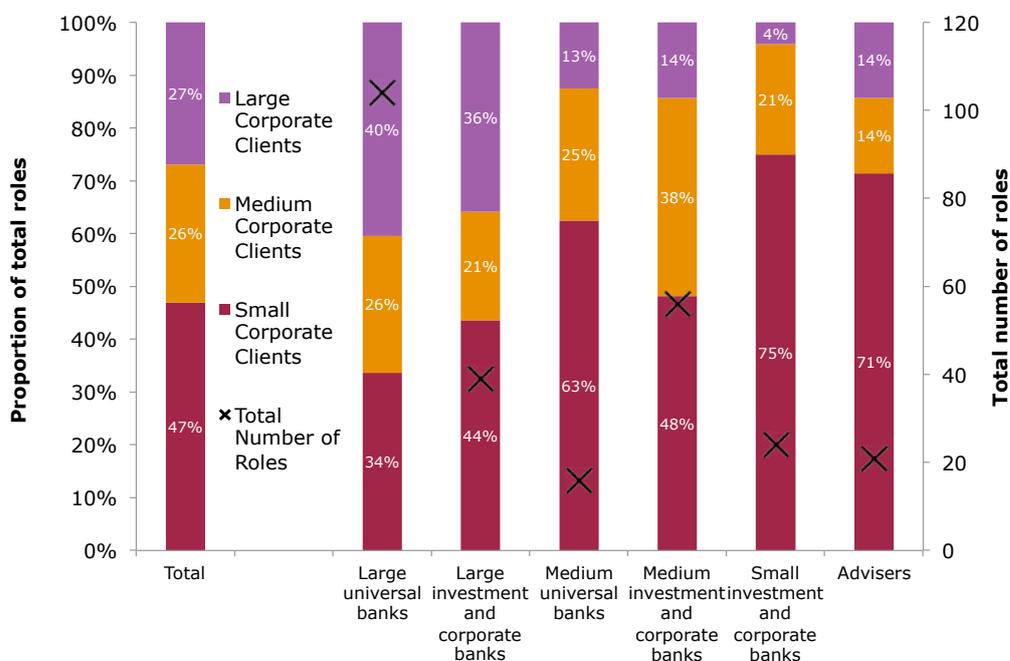
### Banks' and advisers' roles in recent transactions

**5.23** We examined the roles of banks and advisers in recent transactions to ascertain whether the roles actually won by different types of banks with different types of clients reflected the variation in engagement and growth strategies described by the different groups of banks and advisers.

### ECM

**5.24** We found that in ECM there were discernible differences between the types of corporate clients served by different groups of banks and advisers. First, examining the roles banks and advisers were awarded on IPOs, we compared the proportion of the total roles held in 2014 by each category of bank split by large, medium and small corporate clients' transactions.

**Figure 2: Distribution of IPO roles with different sizes of corporate clients for different types of banks and advisers, 2014**



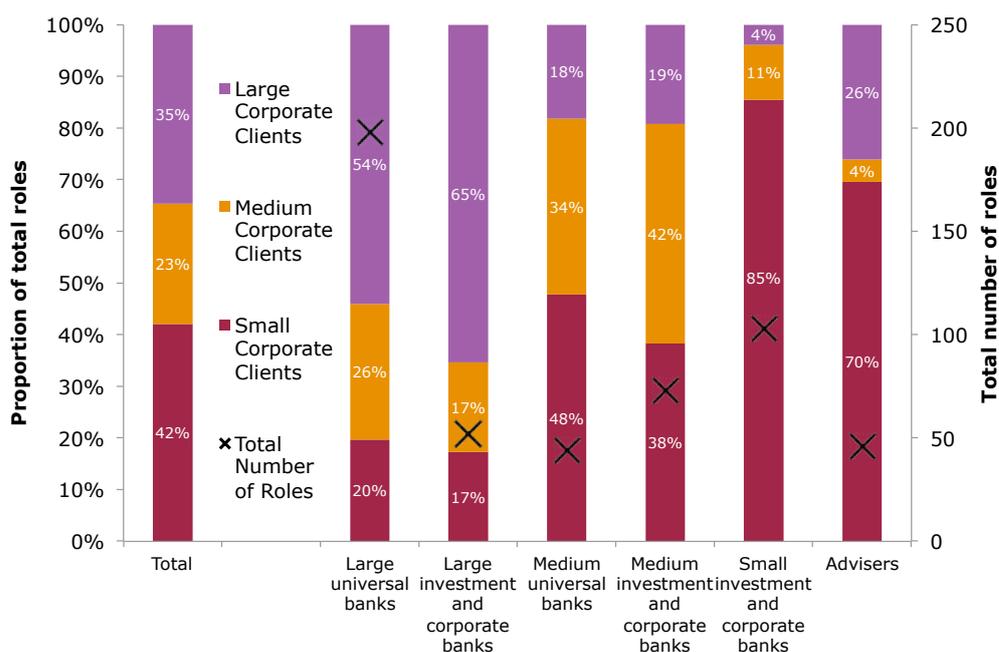
Source: FCA analysis of transactional data described in Annex 2. The sample included 260 roles in 2014 having excluded 13 roles for which client size was unavailable.

Note: The crosses in the chart refer to the total number of roles for each category of bank and can be referenced against the right-hand vertical axis.

**5.25** Figure 2 shows that a significant proportion of large universal banks' and large investment and corporate banks' roles on IPOs (40% and 36% respectively) were on transactions for large corporate clients. Medium and small banks typically had a higher proportion of mandates on IPOs for small and medium-sized corporate clients (86%-96%) than large corporate clients (4%-14%). While advisers had some roles on major transactions, 86% of the roles awarded to advisers in 2014 were on IPOs for medium-sized and small corporate clients.

**5.26** These differences are more discernible in the distribution of banks' and advisers' roles on follow-on ECM transactions. As shown in Figure 3, in 2014 54% and 65% of the roles on follow-on offerings taken by large universal banks and large investment and corporate banks, respectively, were for large corporate clients. While over 80% and 70% of the roles undertaken by small investment and corporate banks and advisers were for small corporate clients.

**Figure 3: Distribution of follow-on ECM roles with different sizes of corporate clients for different types of banks and advisers, 2014**



Source: FCA analysis of transactional data described in Annex 2. The sample included 516 roles in 2014, having excluded 13 roles for which client size was unavailable.

Note: The crosses in the chart refer to the total number of roles for each category of bank and can be referenced against the right-hand vertical axis.

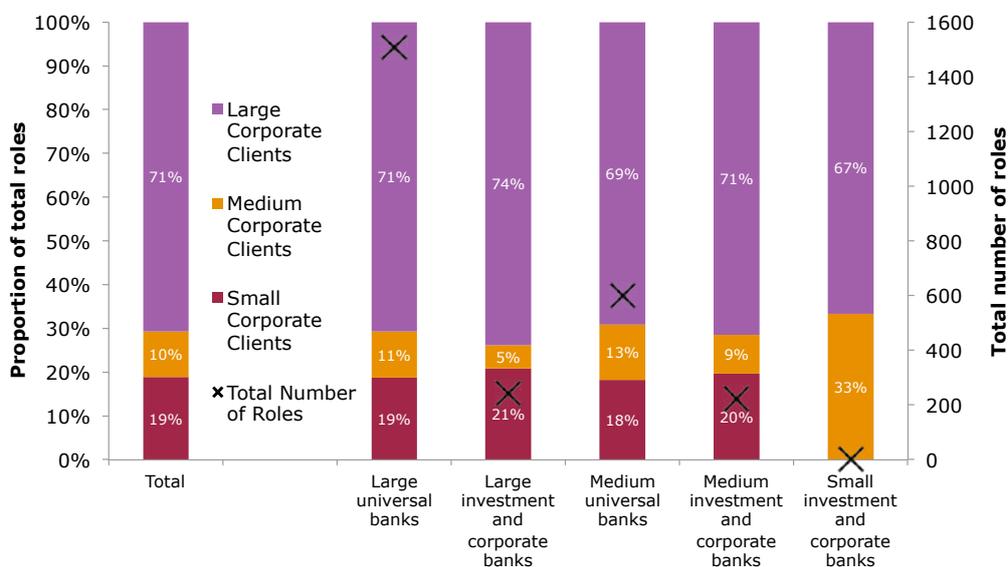
**5.27** Equally, both figures also show that in 2014, banks and advisers in all categories accepted roles with clients in every size grouping. In particular, the large universal banks and large investment and corporate banks did not exclusively take roles on large corporate clients' transactions but also conducted offerings for small and medium-sized corporate clients.<sup>50</sup>

<sup>50</sup> We considered whether large banks that had accepted roles with small corporate clients did so because these clients were sponsored by companies (e.g. private equity firms) with which they had existing relationships. While we found that a substantial proportion of the roles large universal banks and large investment and corporate banks held on IPOs for small corporate clients did involve a financial sponsor, the presence of financial sponsors did not account for all of the roles large banks took with small corporate clients. We also found that the involvement of financial sponsors accounts for a much lower proportion of large universal and large investment and corporate banks' roles on follow-on transactions, and on IPOs for medium-sized corporate clients.

**DCM**

- 5.28** In contrast to ECM, we did not observe distinctive variations in the profiles of the clients that different types of banks and advisers served in DCM. Rather, as Figure 4 shows, most DCM roles for corporate clients are for large corporate clients, and across size categories all groups of banks and advisers obtain most (67%-74%) of their roles from large corporate clients.
- 5.29** The vast majority of DCM roles were conducted by large universal banks (as shown by the asterisks and right-hand vertical axis in Figure 4). While over 70% of the roles these large banks were awarded were for large corporate client transactions, the large universal banks were also active at the lower end of the spectrum. In particular, almost 20% of the roles these banks were awarded in 2014 were on small and medium-sized corporate clients' debt issues.<sup>51</sup>

**Figure 4: Distribution of DCM roles with different sizes of corporate clients for different types of banks and advisers, 2014**



Source: FCA analysis of transactional data described in Annex 2. The sample included 2581 roles in 2014, having excluded 177 roles for which client size was not available.

Note: The crosses in the chart refer to the total number of roles for each category of bank and can be referenced against the right-hand vertical axis.

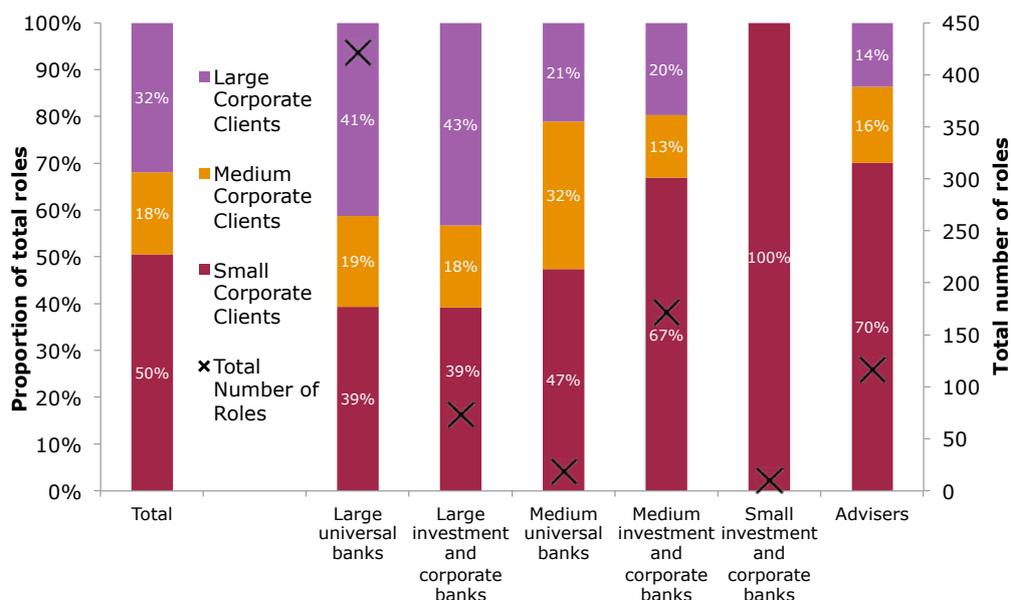
**M&A**

- 5.30** Similar to ECM, in M&A transactions we observed differences between the types of corporate clients served by different groups of banks and advisers. These differences were however not as marked as those identified in ECM, and particularly follow-on transactions.
- 5.31** Figure 5 shows that the majority of M&A roles were conducted by large universal banks and that a significant proportion of roles for these banks (41%) were for large corporate clients. Medium-sized banks typically had a higher proportion of roles on transactions for small and medium-sized corporate clients (approximately 80%) than large corporate clients (approximately 20%). While advisers had some roles on major transactions, 86% of the roles awarded to

<sup>51</sup> We also segmented large corporate clients further into three size categories to ascertain whether large banks typically obtained roles on transactions for the largest of the large corporate clients while smaller banks obtained roles on transactions at the smaller end of the large corporate client spectrum. We similarly found that there was not a marked difference in the distribution of roles for large corporate clients' transactions across the different size sub-categories.

advisers in 2014 were on M&As for medium-sized and small corporate clients. Small investment and corporate banks had very few (3) roles on M&A transactions.

**Figure 5: Distribution of M&A roles with different sizes of corporate clients for different types of banks and advisers, 2014**



Source: FCA analysis of transactional data described in Annex 2. The sample included 814 roles in 2014, having excluded 98 roles for which client size was unavailable.

Note: The crosses in the chart refer to the total number of roles for each category of bank and can be referenced against the right-hand vertical axis.

### Summary of evidence on availability of suppliers for mid-sized and small corporate clients

- 5.32** Our examination of banks' and advisers' client engagement strategies and the range of clients they have served in recent transactions, did not indicate that large banks are opting not to serve small and medium-sized corporate clients altogether or that smaller banks and advisers are unable to serve medium-sized corporate clients.
- 5.33** We did not find that the sizes of clients targeted by different sizes of banks were markedly different in DCM; but we did find that larger banks tend to conduct a greater proportion of their transactions with larger clients in ECM (see Figure 2 and Figure 3) and, to a lesser extent, in M&A (see Figure 5).

### Implications for small and medium-sized corporate clients' choice of suppliers in ECM

- 5.34** Having examined which banks are serving which types of clients, we wanted to explore whether the strategies banks and advisers have adopted could adversely affect the choices available to small and medium-sized corporate clients in ECM (as this is the service for which we found the difference between the types of clients served by different banks was most pronounced).

**5.35** We considered:

- The views expressed by small and medium-sized corporate clients that have used primary market services about the choices that were available to them.
- The range of banks and advisers that have been mandated by medium-sized and small corporate clients on their recent ECM transactions.

#### **Corporate clients' accounts of the choices available to them in primary markets**

**5.36** As set out in Annex 3, medium-sized and small corporate clients did not express significant concerns about the choice of banks and advisers that they faced when procuring primary market services.

- Small and medium-sized corporate clients were on the whole content with the number and range of service providers available to them. In particular, for services that clients typically tender (e.g. IPO mandates), we did not hear any concerns that issuers lacked choice. For other services such as corporate broking and M&A, clients observed that a variety of market participants regularly approach them with pitches.
- A small number of corporate clients did however note that they faced fewer suppliers to choose from than they would have wished, either because they were too small, too risky (from an execution perspective) or too specialised.

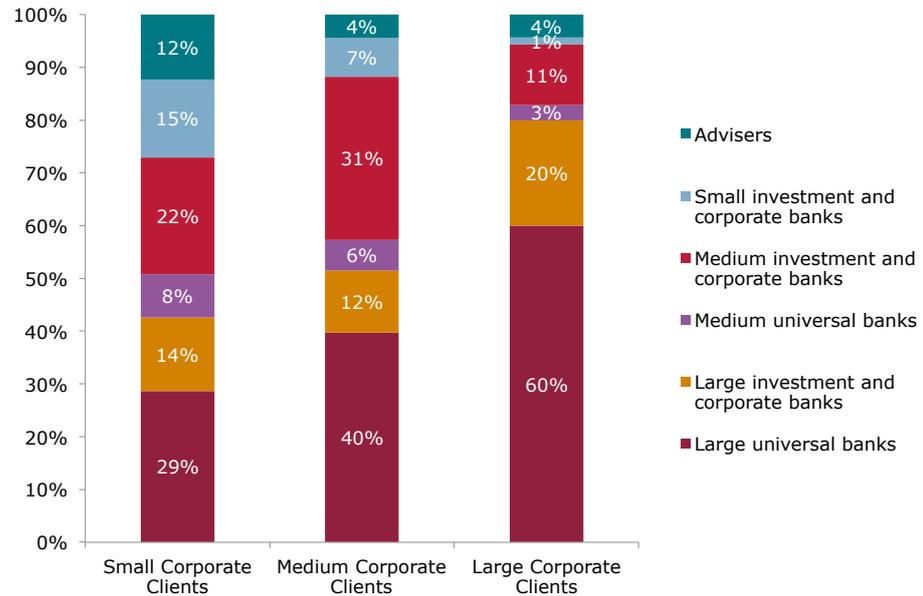
#### **Choices made by corporate clients in recent ECM transactions**

**5.37** To assess the range of banks and advisers that have been mandated on small and medium-sized corporate clients' recent ECM transactions we compared them with large corporate clients.

**5.38** Figure 6 and Figure 7 show how the roles awarded by small, medium-sized and large corporate clients were distributed among different groups of banks and advisers. They show that:

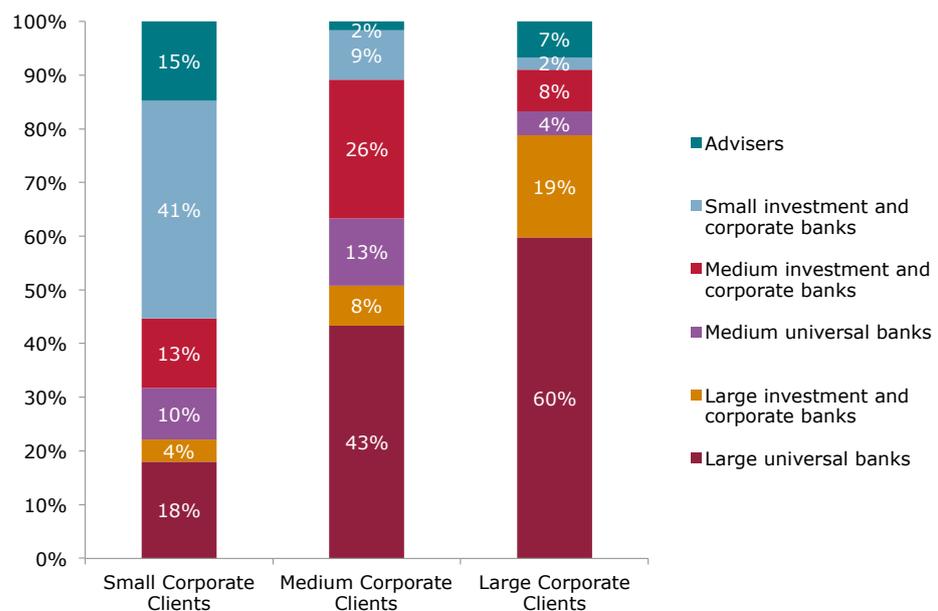
- Large corporate clients awarded a greater proportion (approximately 80%) of the roles on their transactions to large banks than small corporate clients awarded to large banks (43% and 22% of roles on IPOs and follow-ons respectively).
- Medium-sized corporate clients awarded approximately half of the roles on their IPOs and follow-on transactions to large universal or large investment and corporate banks and approximately 40% of the roles on their transactions to medium-sized banks.
- Medium-sized corporate clients did not use advisers often, appointing advisers for fewer roles and a lower proportion of their transactions than both large and small corporate clients.

**Figure 6: Distribution of roles on IPOs among different types of banks and advisers, split by corporate client size, 2014**



Source: FCA analysis of transactional data described in Annex 2. The sample included 260 roles in 2014, of which there were 122 small corporate clients, 68 medium corporate clients, 70 large corporate clients. It excluded 13 roles for which the client category was unknown.

**Figure 7: Distribution of roles on follow-on transactions among different types of banks and advisers, split by corporate client size, 2014**



Source: FCA analysis of transactional data described in Annex 2. The sample included 516 roles in 2014, of which there were 217 small corporate clients, 120 medium corporate clients, 179 large corporate clients. It excluded 13 roles for which the client category was unknown.

- 5.39** This analysis shows that large banks are used more frequently by large corporate clients and that medium-sized or small corporate clients have not been prevented from using large banks on their transactions.
- 5.40** We also wanted to understand whether small and medium-sized corporate clients have access to the full range of large banks or whether, because some banks elect not to serve small corporate clients, they are only able to appoint a subset of the large banks onto their transactions. We additionally wanted to understand whether there is a wide range of small and medium-sized banks available for these clients to choose from and whether the options available to smaller banks differ from those available to medium-sized banks.
- 5.41** Table 7 and Table 8 show the number of banks in each category that were awarded mandates with each client group. These figures show that while not all of the banks in our sample were awarded mandates with each client type, most of the large universal banks and large investment and corporate banks were active across all client types:
- Of the 10 large universal banks in our sample that provided ECM services in 2014, 9 were awarded mandates on small corporate clients' transactions. Moreover, most of the banks in all other categories were awarded at least one role on an issuance by a small corporate client.
  - Similarly, of the 10 large universal banks in our sample 9 were awarded mandates on medium-sized corporate clients' IPOs and all 10 were active in follow-on transactions for clients in this group.
  - Of the 8 small investment and corporate banks in our sample active in IPOs, all 8 were awarded mandates on small corporate clients' transactions, but only 1 or 2 were awarded mandates on large and medium-sized corporate clients' IPOs.

**Table 7: Number of banks in each category awarded roles on IPOs in 2014**

	All client types	Small corporate clients	Medium corporate clients	Large corporate clients
All Bank Types	35	33	22	20
Large Universal Banks	10	9	9	8
Large Investment and Corporate Banks	2	2	2	2
Medium Universal Banks	4	4	2	2
Medium Investment and Corporate Banks	8	7	6	6
Small Investment and Corporate Banks	8	8	2	1
Advisers	3	3	1	1

Source: FCA analysis of transactional data described in Annex 2.

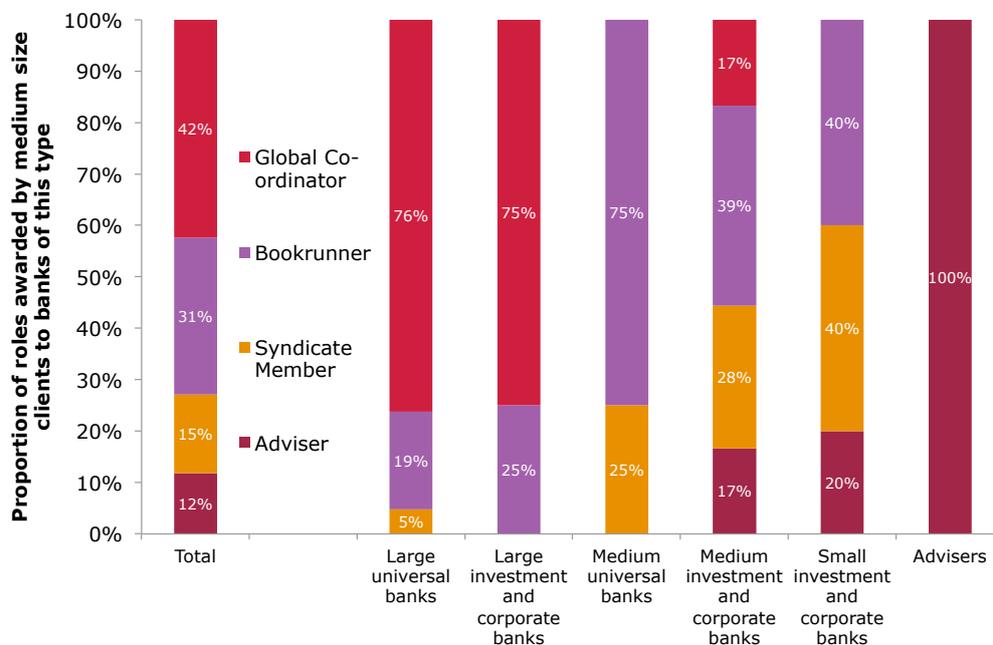
**Table 8: Number of banks in each category awarded roles on follow-on transactions in 2014**

	All client types	Small corporate clients	Medium corporate clients	Large corporate clients
All Bank Types	40	33	31	27
Large Universal Banks	10	7	10	10
Large Investment and Corporate Banks	2	2	2	2
Medium Universal Banks	4	4	4	4
Medium Investment and Corporate Banks	9	6	7	6
Small Investment and Corporate Banks	12	11	7	3
Advisers	3	3	1	2

Source: FCA analysis of transactional data described in Annex 2.

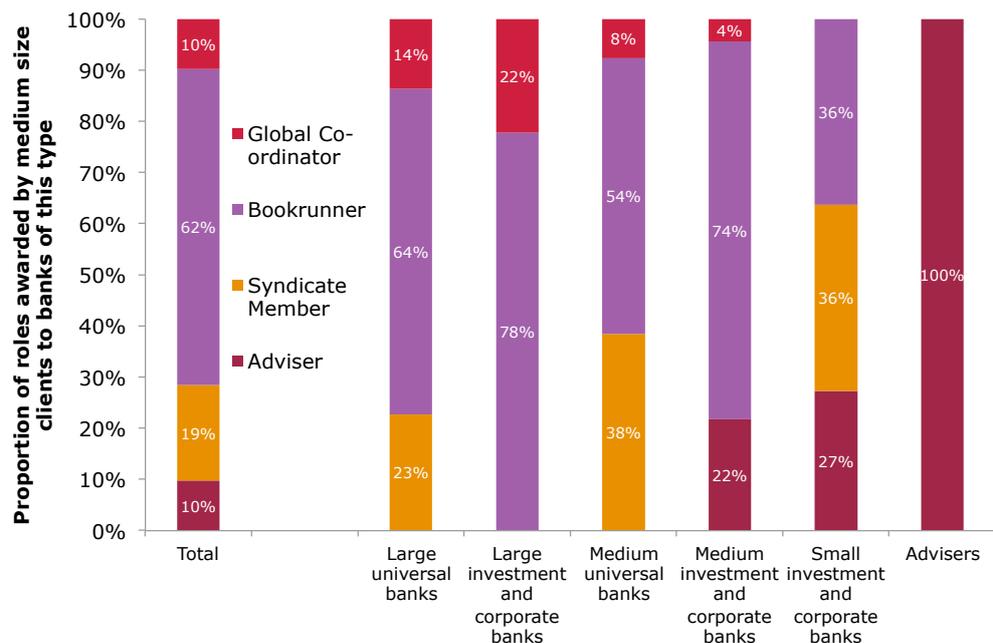
- 5.42** These results do not indicate that small and medium-sized corporate clients face material restrictions in the number of suppliers available to them. However, compared with small corporate clients, medium-sized clients have awarded mandates to fewer advisers and fewer small banks. This means that they have accessed the services of fewer banks overall than small clients. For example, less than two thirds of the banks acting on IPOs in 2014 were awarded roles on IPOs for medium-sized clients (22 out of 35 banks).
- 5.43** Given banks take different roles on transactions (see Chapter 6 on syndication for an explanation of the roles and dynamics of syndication), we sought to ascertain (i) whether medium-sized and small banks and advisers fulfil different roles to large banks on medium-sized corporate clients' transactions and (ii) whether medium-sized and small banks and advisers are always mandated alongside one of the large banks. Figure 8 and Figure 9 show how medium-sized corporate clients allocated roles among different types of banks in IPOs and follow-on transactions.

**Figure 8: Roles awarded by medium-sized corporate clients on IPOs, 2014**



Source: FCA analysis of transactional data described in Annex 2. The sample included 59 roles in 2014, having excluded 9 roles for which the role category was not available. Note that these figures reflect the roles of just the banks that submitted information to us, so if a transaction included a global coordinator which was not in our sample this would not be represented in the results above.

**Figure 9: Roles awarded by medium-sized corporate clients on follow-on transactions, 2014**



Source: FCA analysis of transactional data described in Annex 2. The sample included 102 roles in 2014, having excluded 18 roles for which the role category was not available. Note that these figures reflect the roles of just the banks that submitted information to us, so if a transaction included a global coordinator which was not in our sample this would not be represented in the results above.

- 5.44** These figures indicate that while book-runner roles were awarded to banks across a range of sizes, medium-sized banks were rarely awarded global coordinator roles (and small banks were never awarded such roles).
- 5.45** We wanted to understand therefore whether medium-sized clients typically require a large bank to act on their transactions, particularly on IPOs, where global co-ordinator roles are more prevalent. We found however that the presence of a large bank was not essential, as on the 31 IPOs for medium-sized corporates in our sample for 2014 only 19 of these involved a large bank.
- 5.46** Overall, therefore, we did not consider that there was compelling evidence that medium-sized corporate clients' choices in ECM have been adversely affected by the strategies some banks have been using to focus on large corporate clients.

### Interim findings

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- 5.47** We have not found that clients in different sectors have faced a lack of available suppliers. Nor have we identified substantive concerns in relation to the availability of suppliers for financial institutions, SSAs or large corporate clients. However, we are keen to hear from stakeholders if there are any specific primary market services in which they do have concerns regarding a lack of available suppliers.
- 5.48** We explored the choice of medium-sized and small corporate clients more closely in light of some banks' strategies to focus on larger corporate clients that can generate greater revenues. However, our analysis has indicated that most medium-sized and small corporate clients appear to have sufficient choice for primary market services. In particular, clients have not expressed significant concerns about the options available to them.
- 5.49** Despite this, we have seen some evidence that larger banks opt to reduce their engagement with smaller, newer and/or riskier clients in response to market conditions and regulatory change. If the large banks were to retrench from serving medium-sized corporate clients in times of economic uncertainty or where they face substantial cost increases, this is most likely to have an effect on choices for medium-sized clients in ECM at least in the short term. It is also likely to be exacerbated in these circumstances because there has been little recent entry and expansion into ECM book-running services, as evidenced in Chapter 4.

## 6. Choosing service provider

### Chapter summary

We analysed how clients choose which banks and advisers will provide them with their primary market services. We found that:

- Competitive tendering is common in some services (such as IPOs) but less common in others (for example, follow-on and DCM transactions). This can be explained by the nature of the transactions, such as accelerated timeframes or confidentiality concerns. Where it is not practical to undertake a formal competitive process, clients may still have a choice of several banks with whom they have an existing banking relationship and may be able to compete against each other.
- League tables are used extensively by banks when assessing their own performance internally and when pitching to clients, and also, to differing degrees, by clients when choosing their bank. We found that league tables can be misleading because some banks carry out sole-led, loss-making transactions purely to generate credit in league tables. Furthermore, banks routinely present league tables to clients in a way that inflates their own position. Many clients are aware of these practices, nonetheless we believe they impede effective client choice.
- Our review of engagement letters found that transparency is not a material area of concern. The need for banks to ensure sufficient transparency of terms for clients is set out in the FCA Handbook and will be enhanced further by MiFID II.
- The size and composition of the syndicate is driven by the client and not by banks. Syndication benefits clients primarily through wider distribution and reduced execution risk. While syndicates have a wide range of roles it is not clear that all syndicate members add value to a transaction. However, larger syndicates are not associated with higher fees and may broaden clients' banking relationships. Syndicates are also a route for smaller banks to enter and expand.
- Reciprocity is a practice whereby a bank issuing its own capital awards the business to another bank in exchange for a role on that bank's transactional business. It is largely restricted to the bank financing market in respect of covered bonds. At present reciprocity does not appear to be excluding banks that do not or cannot reciprocate from competing because non-reciprocal banks can compete for mandates. We do not therefore propose to take any further action on reciprocity at this time. However, should the practice become more widespread or show signs of the potential detrimental effects we have highlighted, we will conduct further work with a view to intervening to prevent this type of behaviour.

- Corporate finance advisers can help reduce the information gap and potential for conflicts of interest between the issuing client and its bank. We found no evidence of corporate finance advisers giving advice which would be against the client's best interests or trying to unfairly influence the research on IPOs, albeit a positive research message conveyed by analysts is one of the main factors considered when advising the issuer on which banks to appoint to a syndicate. As part of this report, we have clarified how our existing regulatory regime applies to the activities of corporate finance advisers.

**6.1** Having considered entry and expansion in Chapter 4 and the availability of suppliers in Chapter 5, in this chapter we assess clients' purchasing behaviour. This includes how they choose the bank or adviser that will provide their primary market services and specific aspects that influence the effectiveness of that choice. We consider the following:

- selection processes and criteria
- the role of league tables
- transparency of scope of services and fees
- syndication
- reciprocity
- the role of corporate finance advisers

### **Selection processes and criteria**

**6.2** In the Terms of reference we said that we wanted to understand whether the choices clients make are affected by practices and processes they adopt when selecting banks and advisers, including the use of competitive tenders.

**6.3** In this section, we consider:

- selection processes used by clients, including the extent to which clients use formal or informal competitive processes
- selection criteria used by clients, including the extent to which clients focus on fees or quality of service and how that affects banks' and advisers' competitive positioning in the market

### **How do clients select banks for different services?**

**6.4** In this section we assess the selection processes adopted by clients. Whether a client uses a formal or informal competitive selection process when mandating a bank to undertake a primary market transaction may affect the level of competition between banks. Where clients do not undertake competitive processes, including when choosing from their existing relationship banks, this may reduce the incentives for these banks to reduce fees and/or improve the quality of service. We consider the extent to which banks that provide lending or corporate broking also provide primary market services in Chapter 7.

**6.5** There are a number of approaches that may be adopted by a client when awarding a mandate:

- **Competitive processes:**

- Formal competitive tender process: This is typically a two-stage process. In the first stage, clients issue to selected banks a Request for Proposal (RfP) to which those banks submit a written response. In the second stage, banks are invited to pitch and attend a 'beauty parade'. To secure an opportunity to participate in an RfP, a bank may need to have covered the client for a number of years, or have strong credentials in the sector.
- Informal competitive process: This may have a similar effect to a formal competitive tender. Under this approach clients informally invite a number of banks to attend pitch meetings or 'beauty parades'. Clients typically approach some or all of their relationship banks.

- **Direct approaches from or to a client:**

- Direct appointment by a client: Clients may award a mandate directly without undertaking a formal or informal competitive process. This typically occurs when confidentiality of the transaction is important and/or when the transaction has to be completed in a short timeframe. In these cases, a client may choose an existing relationship bank or a bank that the client does not have a relationship with but that has got a strong track record and expertise relevant to the transaction.
- Proactive pitch by a bank: Banks may proactively approach new or existing clients with proprietary ideas and proposals (e.g. an M&A idea). Where the client values the idea, it may award the mandate to the pitching bank without a competitive process.

**6.6** In the remainder of this section we consider differences in the use of selection processes between different types of services and different types of clients.

***Differences between different types of services***

**6.7** There is considerable variation in how clients select banks for ECM, DCM and M&A services. We summarise the selection processes that banks and advisers told us clients typically use in Table 1 below.

**Table 1: Typical selection processes used by clients for different types of investment banking services**

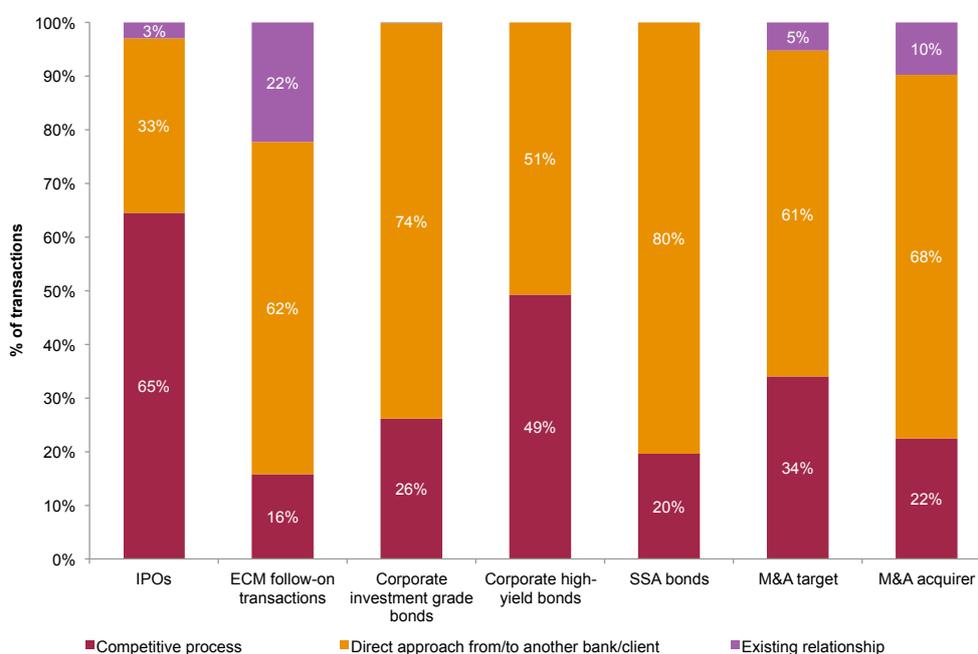
Type of service		Typical provider selection processes
ECM	IPO	<p>The majority of IPO mandates are awarded by way of a formal process involving an RfP.</p> <p>In some cases, a client may undertake an informal process, inviting existing relationship banks to pitch.</p> <p>On rare occasions, a client may choose not to undertake a competitive tender and award mandates on the basis of previous transactions undertaken by a bank for the client.</p>
	Primary follow-on	<p>Given accelerated timetables and confidentiality concerns, clients typically award mandates to existing relationship banks.</p> <p>Competitive tender processes are uncommon. However a client may issue an RfP to a small number of banks in rare cases.</p>
	Secondary follow-on, block trade	<p>Mandates are awarded following a pro-active pitch by banks or via an auction process.</p>
	Rights issues	<p>Clients often pursue rights issues for strategic reasons, such as acquisition financing, so confidentiality of the transaction is important. As a result, mandates are often awarded to relationship banks. Clients may invite a small number of banks to pitch and may use RfPs to select junior syndicate members.</p>
DCM	Bond issue by new or infrequent issuers	<p>Mandates typically involve a formal RfP, or sometimes may be awarded following a proactive approach by a bank.</p>
	Bond issue by frequent issuers	<p>Mandates are mostly awarded without a formal RfP.</p> <p>However, clients often engage in bilateral negotiations with multiple banks.</p> <p>Banks maintain a continuous dialogue with clients, and clients usually have a roster of banks with which they regularly work.</p> <p>Some SSA may undertake RfPs because of state procurement obligations.</p>
M&A		<p>There is no standardised process by which clients award M&amp;A mandates. The most common forms include a bank proactively approaching a client with an M&amp;A idea and the direct appointment of an existing relationship bank. Mandates may also be awarded on the basis of a formal or informal competitive process, as described above.</p>

Source: FCA analysis of responses of banks and advisers.

Note: The categorisations of different types of services are based on those used by the banks and advisers.

**6.8** For each transaction in the data submitted in response to our request for information (see Annex 2), we asked banks and advisers to specify whether the mandate was awarded on the basis of a competitive tender, or as a result of a direct approach from or to the client or a bank. Figure 1 shows selection processes used for different types of services. Consistent with views heard from banks and advisers, we found that competitive processes, both formal and informal, are most commonly used when selecting banks for IPOs (at 65% of transactions) and corporate high-yield bonds (at 49% of transactions), but less so when selecting banks for other types of ECM, DCM and M&A services.

**Figure 1: Selection processes used for different types of services, January 2014 to May 2015**



Source: FCA analysis of transactional data described in Annex 2.

Note: The sample included 3039 transactions (200 IPO, 684 follow-on, 684 corporate investment grade, 262 corporate high-yield bond, 352 SSA bond, 488 M&A target and 369 M&A acquirer transactions). For most transactions, more than one bank was involved and responded to our information request. Where banks involved in the same transaction provided different responses for award process used, we have taken the most competitive approach (e.g. competitive tender). This is because 'direct approach from or to client' may still involve a competitive process followed by the direct approach. Similarly, where some banks referred to 'existing relationship' and others said 'direct approach', we have assumed that the process involved a direct approach. The chart excludes transactions for which we had no information about the award process used by the client.

**6.9** In summary, clients are less likely to undertake a formal or informal competitive selection process when:

- **Confidentiality of the transaction is particularly important.** Maintaining the confidentiality of the transaction is particularly important for certain limited types of ECM (e.g. follow-on rights issues), DCM (e.g. hybrid debt issues for capital purposes) and M&A

transactions.<sup>52</sup> For these transactions, clients typically do not issue a formal RfP but may informally approach a small number of existing relationship banks.

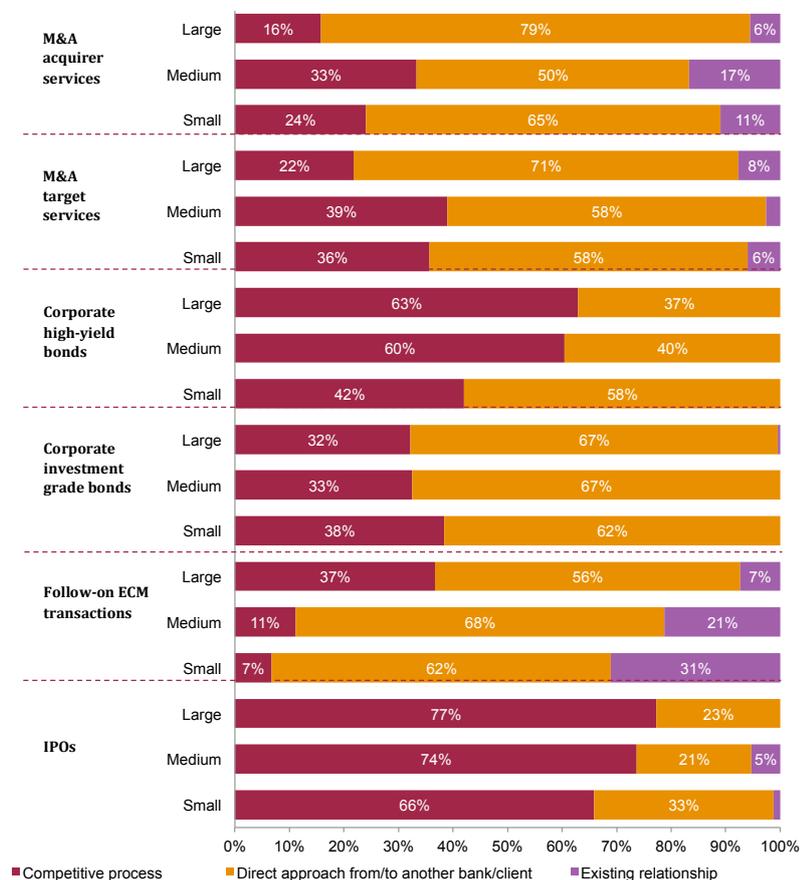
- **The transaction must be completed on an accelerated basis (e.g. within a day).** For transactions such as block trades, it may not be practical for clients to issue detailed RfPs. A client may obtain informal fee or 'all-in price' quotes from several of its relationship banks and award the mandate to the most competitive offer.
- **The client maintains a panel of banks.** In DCM, frequent issuers maintain a panel of banks with whom they engage on a continuous basis. As a result, they are less likely to undertake an RfP process. However, the appointment of a bank to a client's panel may involve a formal competitive tender and banks on the panel may need to accept fees proposed by the client on a 'take it or leave it' basis (see Chapter 8).
- **The idea for the transaction originates from a pitching bank or adviser.** The mandate for a transaction may be awarded to a 'pitching bank' as a 'reward' for originating an idea and presenting it to the client.
- **Clients prefer or are under pressure to reward mandates to existing relationship banks.** For example, a client may be under pressure to reward a lending relationship or a client's choice may be limited by contractual clauses (see Chapter 7).

#### *Differences between different types of clients*

- 6.10** We sought to understand whether all clients tend to use similar selection processes for each service or whether there are differences between types of clients, such as SSAs, FIGs and different size corporate clients.
- 6.11** Our analysis of clients' views and responses by banks and advisers indicates that there is no standard process for awarding a mandate. Different types of clients adopt a variety of processes for different types of service (see Annex 3). For DCM services, a number of banks stated that competitive tender processes are more common when dealing with infrequent issuers and SSA clients that are subject to state procurement obligations, but are less common for frequent issuers. Some banks also observed that, for IPOs, large corporate clients are more likely to use formal competitive processes than small corporate clients.
- 6.12** Consistent with our size categorisation of corporate clients in Chapter 5, we analysed the relative use of selection processes by small, medium and large corporate clients, Figure 2.

<sup>52</sup> Note that by this we do not imply that the regulatory and/or contractual requirements for confidentiality do not apply in these circumstances.

**Figure 2: Selection processes used by corporate clients of different sizes, January 2014 to May 2015**



Source: FCA analysis of transactional data described in Annex 2.

Note: The sample included 195 IPO transactions, 676 follow-on transactions, 667 corporate investment grade bonds, 244 corporate high-yield bonds, 345 SSA bonds, 467 M&A target and 316 M&A acquirer transactions.

### 6.13 Figure 2 shows that:

- ECM services:** For IPOs, large and medium-sized corporate clients are marginally more likely to adopt competitive selection processes than small corporate clients (77%, 74% and 66% of transactions, respectively). The difference is more apparent in ECM follow on transactions, where large corporate clients had used a competitive process in 37% of transactions compared with 11% of transactions undertaken by medium-sized corporate clients and 7% by small corporate clients.
- DCM services:** For corporate investment grade bonds, competitive processes are marginally more likely to be used by small corporate clients than medium-sized and large corporate clients (38%, 33% and 32% of transactions, respectively). However, in corporate high-yield bond transactions, large and medium-sized corporate clients are more likely to use competitive processes than small corporate clients (63%, 60% and 42% respectively).
- M&A services:** For both target and acquirer M&A services, large corporate clients are less likely to use competitive selection processes than small and medium-sized corporate clients. For example, for M&A acquirer services, 16% of large corporate clients had used a competitive process compared to 24% of small and 33% of medium-sized clients.

### Interim findings

- 6.14** For some services, such as IPOs, formal competitive tendering is very common, but less common for others such as ECM follow-on and some types of DCM transactions. This can to some extent be explained by the nature of the transaction. Due to short timeframes and/or confidentiality of the transactions, it may be impractical or create a commercial risk for clients to approach a large number of banks. However, even in cases where a client's ability to tender is constrained by confidentiality concerns or a need to reward a relationship, it may still have a choice of several banks with whom it has a strategic relationship and may be able to introduce competitive tension between those relationship banks. The link between award of primary market mandates and corporate lending and corporate broking services is further considered in Chapter 7.
- 6.15** **Selection criteria used by clients** Where a market is functioning effectively, we would expect a client to be able to appoint banks that offer services which best meet its needs and requirements. Where banks have an understanding of characteristics that clients most value they should be incentivised to compete on that basis.
- 6.16** We set out our detailed analysis of selection criteria in Annex 4. The evidence received from stakeholders indicates that banks have a good understanding of service characteristics that clients most value. This understanding is reflected in the value propositions that banks present to their clients.
- 6.17** Overall, clients select banks to undertake ECM, DCM and M&A transactions based on three broad but interdependent criteria: quality of service, level of fees and broader relationship factors. The most commonly valued criteria are summarised in Figure 3 below.

**Figure 3: Factors considered important by clients when selecting banks for ECM, DCM and M&A services (based on views heard from banks and clients)**

Type of criteria	Criteria
<b>Service quality related factors</b>	<ul style="list-style-type: none"> <li>• overall credentials and experience of the bank (including league table position)</li> <li>• knowledge of the client</li> <li>• sector and/or transaction specific expertise</li> <li>• comprehensive research coverage by highly ranked analysts (ECM and DCM only)</li> <li>• good investor coverage, including geographic and sector reach (ECM and DCM only)</li> <li>• where relevant, adequate presence and coverage in other countries and regions</li> <li>• ability to manage potential conflicts of interest</li> <li>• ability to work constructively with the issuer's management to achieve efficient execution</li> </ul>
<b>Fees</b>	<ul style="list-style-type: none"> <li>• proposed fee levels (and how they compare with fees for comparable transactions/fees proposed by other banks)</li> </ul>
<b>Broader relationship related factors</b>	<ul style="list-style-type: none"> <li>• provision of past and ongoing relationship services (most importantly, corporate broking and/or corporate lending)</li> </ul>

Source: FCA analysis of responses of banks, advisers and clients.

- 6.18** While clients' choice of banks is based on a combination of all three broad criteria described above, both clients and banks emphasized that clients often consider the service quality related factors and broader relationship related factors as more important than proposed fee levels. This is because the clients' need to obtain best execution for the transaction (including a good price for the issue) often significantly outweighs the perceived benefit of obtaining a lower fee. Clients' concern about the quality of service and bank's ability to ensure best execution will also make them less likely to mandate a bank less experienced in the relevant type of transaction.
- 6.19** Notwithstanding the importance of service quality and relationship-based factors, selection criteria used by clients may adversely affect the nature of competition:
- clients may choose banks with whom they have existing relationships and may find it difficult to achieve best quality of execution, particularly where they are obligated or feel compelled to award mandates to their lending banks
  - clients may apply insufficient pressure on fees due to their focus on quality of service over fees
- 6.20** We consider the impact of cross-selling from relationship services and fee outcomes in Chapter 7 and Chapter 8, respectively.

### League tables

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- 6.21** In the Terms of reference we said that we wanted to understand what metrics clients use to assess reputation and how use of these metrics affects competition (for example, in the use of league tables).
- 6.22** In this section we consider:
- What are league tables and who uses them?
  - How important are league tables to the way in which banks and advisers compete?
  - What potential benefits and concerns arise from the use of league tables?
  - Do league tables create incentives for banks to focus on the right aspects of competition?
  - Do league tables create incentives for banks to present information to clients in a way that may not be in clients' best interests?

#### **What are league tables and who uses them?**

- 6.23** League tables are produced based on data from companies such as Dealogic and Bloomberg. League tables are produced both by data companies themselves and by banks and clients when ascertaining the ranking of investment banks and advisers in different activities. League tables can be aggregated to encompass all investment banking activities, or split according to the needs of the analysis being made (for example, by ECM, DCM, M&A and syndicated loans, or at a more granular regional or industry level). Typically, firms are ranked based on total fee revenues or total deal values over a specific time period.

**6.24** Leagues tables are used by banks both internally and externally:

- Internally, banks use league tables as a means of measuring their performance in a particular service, sector, region or country. When we reviewed investment banks' internal strategy documents, many contained analyses of their league table position and set targets for the position they aspired to attain.
- Externally, banks and advisers often present league tables when pitching to potential clients for a mandate so as to demonstrate their capabilities, benchmarked against other providers.

**How important are league tables to the way in which banks and advisers compete?**

**6.25** We received mixed views on the weight that clients place on league tables when selecting a bank or adviser.

**6.26** Annex 4 shows that league table position, in combination with other qualitative factors, is a criterion used by clients to compare banks and advisers. The importance of league table position varies depending upon client type. More weight is typically placed on league table position by new clients and/or those who infrequently access capital markets. This is because league tables are perceived as an objective indication of a bank's capabilities, sector knowledge and experience. Conversely, less weight is often attached to league table position by existing clients and/or clients who are sophisticated and frequently access capital markets. For these clients, greater emphasis is placed on their knowledge of a bank's past performance. Banks and advisers' evidence confirms that league table positions are also a factor in their value propositions, albeit general credentials and experience of precedent transactions may be more important.

**6.27** Some clients told us that league tables can be important in their selection of banks. For example, one medium-sized corporate client, who had conducted an IPO on the AIM market, said it paid significant attention to league tables when it selected banks for its IPO. League tables are also sometimes used as a pre-qualifying condition for a bank or adviser to be invited to pitch. One bank told us that some clients ask for league tables as part of their RfP.

**6.28** However, other clients said that they place relatively little weight on league tables, particularly those presented in pitches:

- **Private equity firms:** one firm stated that banks are known to 'massage' league table data in order to present the best possible result. Another said that league tables are not irrelevant, but it did not consider them and instead focuses more on the individuals and teams within banks.
- **Large, frequent issuers:** one issuer commented that it was 'sick of pitches' that featured league tables. Another said it was unlikely it would assign significant work to a bank it had never worked with, even if it were number one in a league table. Nevertheless, one large corporate client stated that while league tables were not important for frequent issuers, debut issuers may be more cautious and place greater reliance on league table position.
- **Housing associations:** one housing association said it did not have regard to league tables because it knows they can be gamed. Another stated it paid more attention to a bank's secondary market activity and how it would support its bond.

**What potential benefits and concerns arise from use of league tables?**

**6.29** League tables are usually considered positive in terms of facilitating competition in that:

- Clients can compare different banks and advisers and potentially make a more informed choice about which one is most suitable for their needs.
- Banks and advisers can compare their performance with one another. If a bank's league table position is deteriorating, it can be an incentive to improve their offering in the form of lower fees or better service in order to retain and increase business.

**6.30** However, it was put to us that league tables may:

- incentivise banks to execute transactions, potentially at a loss, purely for the purpose of moving up or entrenching their position in the league table
- be presented by banks in pitches based on criteria that are favourable to them

**6.31** In both cases, as some clients use league tables as a factor in selecting banks for a transaction, these concerns could distort competition by leading clients to choose banks that are not best placed to meet their needs.

**6.32** Given these concerns, we have considered further:

- Whether league tables create incentives for banks to focus on the right aspects of competition.
- Whether league tables create incentives for banks to present information to clients in a manner that may not be in the clients' best interests.

**Do league tables create incentives for banks to focus on the right aspects of competition?**

**6.33** We were told that some banks undertake transactions for low or no fees, and often at a loss, primarily in order to improve their position in league tables. These are known as 'league table trades'. One bank said that some rivals had increased the 'flexibility' of their balance sheet in order to boost their league table position or market share. Another bank stated that league tables are a consideration when it decides to undertake a loss-making transaction.

**6.34** Investment banks accept that some transactions may be conducted at a loss. However, the reasons for loss-making transactions are likely to be varied and may not be purely in order to gain league table credit. For example, it may be to service the client relationship in order to win future business from them (which we discuss in Chapter 7) or it may simply be due to adverse market conditions or an over-estimate of market appetite.

**6.35** We sought to identify what types of transactions were undertaken for the purpose of purely boosting league table position and whether they could cause any detriment for issuing clients. We were told that the principal types of transactions in DCM and ECM that can be conducted at a loss for league table credit are certain corporate bonds and block trades respectively.

### **Corporate bonds**

**6.36** There are a number of bonds which may be issued by investment banks on behalf of clients at a loss and for the purpose of league table credit. These include medium term notes (MTNs<sup>53</sup>).

**6.37** It is difficult to identify league table trades by analysing ex-post transactional data. For example, some transactions may occur at a loss for the bank, even if the transaction was not originally conducted with the sole purpose of gaining league table credit. For example, one bank said that arranging MTNs is an easy way to service client relationships and another bank said that MTNs are one piece of the holistic relationship with a client.

**6.38** Corporate bonds that are league table trades typically have the following characteristics:

- a short-dated maturity between one and three years, potentially produced as part of an MTN programme
- a floating rate note
- a sole book-runner and no syndicate
- the issuer is a financial institution

**6.39** There are a number of ways in which a bank may intentionally underwrite an MTN at a loss:

- One method may be for the issuer to canvas the banks which underwrite its MTN programme and indicate the terms (i.e. maturities and rates) at which it is willing to issue notes from the programme. One of the underwriting banks may then underwrite a note at the issuer's target rate and distribute it to investors at a discount, thus taking a loss on the transaction.
- Investors may approach an investment bank, which underwrites an issuer's MTN programme, and indicate to the bank the characteristics of bonds it wants to invest in. The underwriting bank may then show the investors' enquiries to the issuer, which may include a subsidy from the underwriting bank. If the issuer agrees to the transaction, the bank will underwrite and distribute the bond to investors at a loss.

**6.40** One such example of a transaction that we observed that satisfies many of the league table trade criteria specified in paragraph 6.38 was where a financial institution issued a bond during 2015. On this transaction:

- a large universal bank was the sole book-runner
- the bond itself was a short-dated floating-rate note
- the book-runner bought the bonds and then sold all the bonds below the buy price over a period of just over 30 days, thus making a loss on the transaction

### **Block trades**

**6.41** Block trades are a form of accelerated secondary equity offering. In a block trade, investors are not given a prospectus and the shares are marketed to institutional investors. We were told that block trades are often traded by the bank at a loss in order to boost its position in ECM league tables.

<sup>53</sup> MTNs are defined in Annex 1.

**6.42** For example, we were told by one medium-sized investment bank of a block trade where it was suggested the transaction, which was undertaken by other banks, was loss-making for the purposes of obtaining league table credit. We have not published more details of this transaction due to confidentiality reasons.

**6.43** Some industry participants expressed concerns around block trades. One medium-sized investment bank told us that block trades were being undertaken by larger banks as a means of gaining league table credit and creating barriers to entry and expansion. It suggested that the process of winning a block trade mandate is competitive among the large universal banks with those banks willing to price such transactions at a loss. However, it said that medium-sized banks do not have sufficient balance sheet capacity to price such transactions at a loss, thus rendering them unable to compete. The bank suggested that large universal banks place importance on league table credit and regularly buy league table credit by undertaking such loss-making trades. One private equity firm that regularly uses investment banking services commented that block trades are seldom profitable for banks and didn't understand why they were undertaken.

#### **The impact of league table trades on clients and competition**

**6.44** We have not identified any evidence that league table trades cause direct detriment to the issuer of that debt or equity, because it is the bank that is assuming the loss and the issuer is a willing counterparty to the transaction. However, we have considered whether league table trades may have wider consequences for competition and cause indirect detriment to issuers.

**6.45** A strategy of league table trades may be beneficial to banks in the medium term if it encourages clients to use their services. Where clients are selecting banks based on league tables which include league table trades, they may be selecting banks based on misleading criteria since they do not reflect a bank's capabilities to undertake a comparable transaction.

**6.46** Although some medium-sized banks told us that league table trades create barriers to entry and expansion to banks that do not wish to engage in such transactions, it is not clear that the costs of such transactions prevent smaller banks from carrying them out.

#### **Do league tables create incentives for banks to present information to clients in a way that may not be in clients' best interests?**

**6.47** The way in which league tables are presented can be changed in a number of different ways, for example by:

- Altering the time period for considering transactions. At one extreme we saw a league table which was based on transactions over a ten year period while at the other extreme we saw league tables based on transactions during the year-to-date, for example covering ten months.
- Changing the geographic area for the transactions. For example, some league tables were based on transactions in a specific country, some were based on a wider region such as EMEA, and some were based on transactions globally.
- Using different data to calculate the league table. Some banks used Dealogic to calculate league tables while others used Bloomberg or Thomson Reuters.<sup>54</sup>

<sup>54</sup> Although these software packages may use the same or similar data to calculate league tables, the tools available to calibrate the league tables may lead to different results across software packages.

- Setting criteria for the value of the transactions included. For example, sometimes banks excluded transactions that fell below a certain value threshold.
- Changing the scope of the type of transactions. For example, some league tables may focus on IPOs only while others may consider ECM transactions more generally.
- Considering different industry groupings. Sometimes banks may focus only on transactions that occurred in a specific industry, e.g. financials, consumer retail, etc.

**6.48** In many cases these choices may be helpful in presenting a picture to the client that demonstrates the bank's capabilities in a particular sector or issue type and aligns with the client's needs. However, in other cases, the choices may create a league table that does not meet with the client's needs but presents the bank in a favourable light.

**6.49** We requested pitching materials that banks and advisers had used when seeking to win business from clients. Many of these presentations contained league tables which showed the pitching bank in the number one position. Often, the banks stated the parameters by which the leagues are created. However, there were also examples where the parameters were not clear, such that it would not be possible to verify the accuracy of data relied upon.

**6.50** In our review of the internal documents submitted by banks, we identified a stark example that demonstrated the manner in which the bank considered league tables internally compared with how it chose to present its credentials to its client:

- Internal strategy documents showed the bank ranked between 5th and 15th in ECM, DCM and M&A respectively. In these league tables, the banks were ranked based on the value of all transactions they had conducted over an 11-month period.
- However, when the bank pitched to a UK-based client, its presentation to the client showed it in first position in ECM, DCM and M&A. In the presentation, the criteria for each table varied between services. The variations included different time periods, different industries, and inclusion/exclusion of self-led transactions.

**6.51** Based on the evidence we have received, we consider that many league tables are not always presented in a way that best aligns with a client's needs:

- Many league tables in client presentations given by banks show the presenting bank in first position – clearly not all banks can be in first place.
- The criteria used to construct league tables can sometimes differ substantially between the various league tables in a single client presentation.
- The criteria used to construct the league tables were not always clear. This makes it very difficult for clients to verify the accuracy of the league table.
- The criteria used to construct the league table do not always appear relevant to the client or the transaction that will be undertaken.

**6.52** The impact of these practices is that clients who are not aware of the different ways in which league tables can be presented may be making less effective decisions when choosing between banks.

### Our interim findings

- 6.53** Banks focus on league table positions when assessing staff performance and pitching to clients. To differing degrees, clients consider these positions when choosing which banks to use. League tables can promote competition when they help a client to compare the services banks offer and where this drives banks to compete on the parameters that matter to clients. However, we have concerns that certain practices distort league table rankings and reduce comparability:
- Some banks engage in transactions which are undertaken with the main aim of gaining league table credit, even if they are executed at a significant loss to the bank.
  - Many banks configure league tables in pitches to clients so as to present themselves in the most favourable light.
- 6.54** As a result, unreliable league tables at best are ignored by clients and, at worst, distort clients' choices because they may be selecting banks based on misleading criteria that do not reflect banks' capabilities to undertake a comparable transaction.

### Transparency of scope of services and fees

- 6.55** In the Terms of reference we said that we wanted to understand the adequacy of information that is provided to clients by assessing whether banks and advisers disclose sufficient and appropriate information to enable clients to make informed choices, and whether any regulations or existing practices serve to reduce this transparency.
- 6.56** Lack of transparency may distort competition and lead to inefficient choices. For example, where clients select their providers based on limited information, they may not know the exact services being included by their bank for the agreed fee and how those compare with the scope of services and fees offered by other banks. Where clients lack sufficient transparency, banks may be able to charge higher fees than would otherwise prevail.
- 6.57** We set out below the relevant regulatory framework and the scope of our assessment. We then summarise our findings on how transparent banks are in communicating to their clients firstly the scope of services and secondly the fees for primary market activities.

### The regulatory framework

- 6.58** The current and future regulatory landscape is relevant when assessing transparency of investment and corporate banking services for clients. We consider the FCA's Conduct of Business Sourcebook – COBS, which is largely derived from MiFID, and MiFID II provisions that affect transparency.<sup>55</sup>
- COBS**
- 6.59** The FCA's rules set out at a high level how firms should provide information to their clients. These rules, which apply to firms offering services, such as underwriting or placing, to professional clients, include:
- PRIN 7, which provide that a firm must pay due regard to the information needs of its clients, and communicate information to them in a way that is clear, fair and not misleading.

<sup>55</sup> Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

- the rules in COBS 2.2, such as the requirement to provide appropriate information in a comprehensible form about, amongst other things, the firm and its services and its costs and charges, such that the client is reasonably able to understand the nature and risks of the service in order to make an informed decision (COBS 2.2.1R(1)).

### **MiFID II**

**6.60** When the European Commission adopts the final delegated acts based on the conflicts of interest provisions in the Level 1 legislation, we expect MiFID II will require firms to have in place specific organisational arrangements to provide enhanced disclosures to their clients in relation to underwriting and placing. Banks will be required to maintain systems, controls and procedures to identify and prevent or manage conflicts of interest arising from firms undertaking these activities.<sup>56</sup> Among the enhanced disclosure requirements, firms will be required to inform issuer clients of the various financing alternatives available with the firm, and an indication of the amount of transaction fees associated with each. When providing underwriting and/or placing, banks will have to inform the client of the approximate cost of all potential alternatives that are offered by the bank for the capital raising service provided.<sup>57</sup>

**6.61** There will also be an enhanced requirement in MiFID II in respect of firms' disclosures on costs and charges.<sup>58</sup> Firms will be required to disclose all costs and charges across the value chain of the investment service and financial instrument they provide. Firms will also be required to aggregate this information so that clients may understand more readily the total costs of the service and/or the instrument and the cumulative impact of these costs. These requirements will change the manner in which information is presented to clients at the outset of providing investment services and, under certain circumstances, on an ongoing basis. We envisage these changes will improve transparency in respect of fee disclosures.

### **Our approach to reviewing transparency**

**6.62** We assessed whether banks disclose adequate information to their clients on the scope of services and fees. We reviewed a considerable number of documents provided to us in response to our request for information. These documents included tender requests (or equivalent client communications), engagement letters and underwriting and placing agreements. We also discussed the level of transparency with issuing clients.

**6.63** We have considered information provided both prior to the engagement letter and in the engagement letter. The former is important because clients will make a decision on which banks to select before they sign the final engagement letters.

**6.64** We set out our findings in detail in Annex 5. In summary, our review has found that:

- For any primary market activities banks or advisers pitch to new clients, the focus of the discussions is invariably on the structure of the transaction. In a competitive process, the focus is on the credentials of the bank or adviser.
- Information on the specific services to be provided is generally only made clear at the engagement letter stage or, occasionally, in the relevant agreement. Sophisticated and frequent issuer clients appear to have sufficient knowledge to understand what they need, irrespective of a bank's disclosure being comprehensive. Less sophisticated clients tend to assume they will be provided with all the necessary activities to carry out the relevant transaction successfully.

<sup>56</sup> Article 16(3) of MiFID II.

<sup>57</sup> [https://www.esma.europa.eu/system/files\\_force/library/2015/11/2014-1569\\_final\\_report\\_-\\_esmas\\_technical\\_advice\\_to\\_the\\_commission\\_on\\_mifid\\_ii\\_and\\_mifir.pdf?download=1](https://www.esma.europa.eu/system/files_force/library/2015/11/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf?download=1)

<sup>58</sup> Article 24(4)(c) of MiFID II.

- Fee information is generally informally communicated ahead of services being provided and in the overwhelming majority of cases fees are clearly set out in the engagement letters and agreements. The dynamics affecting the level and timing of disclosure of fees are primarily client-driven. Examples of poor fee disclosure are in most cases due to speed of execution or uncertainty around the scope or type of the transaction (for example, which capital raising option is most suitable for the client in the circumstances).

### **Our interim findings**

- 6.65** Our review of engagement letters suggests transparency is not a material area of concern. The need for banks to ensure sufficient transparency of terms for clients is set out in the FCA Handbook and will be enhanced further by MiFID II. There are some cases where banks and advisers should consider whether they are providing enough transparency in order to demonstrate compliance with our existing rules as well as with the relevant MiFID II provisions, when they come into force. Such compliance will ensure clients are provided with sufficient information at an appropriate time to enable them to make an informed decision when selecting banks for primary market activities.

### **Syndication**

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- 6.66** In the Terms of reference, we said that we would examine:
- When and why clients opt for syndication, and whether there are differing processes of syndicate formation. In particular, we said that we would consider the extent to which syndicate sizes are determined by the client.
  - Whether there are benefits of syndication for clients, such as access to a wider investor network, or whether there are circumstances in which the syndication process restricts clients' ability to introduce competition between banks.
- 6.67** In this section, we consider why and how syndicates are formed, and the size and potential negative effects of syndicates that are larger than necessary to effectively execute the transaction.
- 6.68** We focus on IPOs and follow-on issuances in ECM and corporate investment grade bonds, corporate high yield bonds and SSA bonds in DCM.<sup>59</sup> We consider loan syndicates in Chapter 7.<sup>60</sup>

### **Why and how are syndicates formed?**

- 6.69** Syndicates are groups of banks that are formed to execute ECM and DCM transactions, primarily for clients to benefit from:
- wider distribution of the offering to a more diverse range of investors
  - expanded research coverage
  - access to the skills and expertise of a diverse range of banks
  - secondary market making

<sup>59</sup> Syndication is not relevant in the context of M&A. Due to the small number of deals and/or deal volume in our sample we do not include other types of ECM and DCM services. We also do not consider MTN syndicates as we understand that syndicate roles differ to those in other types of ECM and DCM syndicates.

<sup>60</sup> In Chapter 7, we comment on the importance of loan syndicate sizes in creating competitive pressure between lending banks. We do not cover lending syndicate formation in this chapter as lending is not a primary market service.

- 6.70** Banks, advisers and clients that we engaged with as part of the study stated that the composition and size of the syndicate is ultimately determined by the client. The decision may be undertaken in consultation with the client's corporate finance advisers (where appointed) and/or the lead bank(s). We did not receive any evidence that indicated a specific syndicate composition or size was forced upon a client.
- 6.71** Clients apply a variety of criteria when determining the size and composition of syndicates. These criteria include transaction characteristics, such as the type of issue, size, complexity, geographic aspects and economic climate, the different banks' ability to add value to the syndicate in terms of distribution, research capabilities and relevant experience, and existing relationships (see Chapter 7).
- 6.72** In the following sections, we assess the different types of roles within the syndicate, which banks tend to be awarded which types of roles, and the fees allocated to different roles.
- Roles within a syndicate**
- 6.73** Clients typically appoint banks to different roles within a syndicate. Different roles involve different levels of responsibility and generally fall into two broad categories: active/senior roles and passive/junior roles.
- 6.74** Banks in active/senior roles usually manage the execution of the transaction and, specifically, the building of the book. Banks in passive/junior roles do not generally manage the book-building process. A number of banks said that passive/junior roles, particularly in DCM, may be a means by which clients reward banks with whom they have an ongoing relationship and often do not add value to the execution of the transaction.
- 6.75** It is difficult to categorise roles by titles because different clients use different titles and, as noted by some banks, there has been 'title inflation' as a result of which titles previously associated with senior roles can refer to a passive junior role. Nevertheless, we have set out a description of the most common roles and typical responsibilities in Table 2.

**Table 2: Typical syndicate roles and responsibilities**

<b>Roles and common titles</b>	<b>Responsibilities</b>
<p><b>Active/senior roles:</b></p> <ul style="list-style-type: none"> <li>• global co-ordinators ('glo-cos') or lead book-runners (on ECM transactions)<sup>60</sup></li> <li>• lead managers (on DCM transactions)</li> <li>• active book-runners</li> </ul>	<ul style="list-style-type: none"> <li>• most senior syndicate members (glo-cos or lead managers) oversee the issue and co-ordinate syndicate activities</li> <li>• due diligence, investor road-shows, book-building, and allocation/placement</li> <li>• may underwrite issuance (if applicable)</li> <li>• market making in secondary markets</li> <li>• research coverage</li> </ul>
<p><b>Passive/junior roles:</b></p> <ul style="list-style-type: none"> <li>• passive book-runners</li> <li>• co-managers</li> <li>• syndicate members</li> </ul>	<ul style="list-style-type: none"> <li>• distributing the issue, particularly to niche investors (either by sector or geography)</li> <li>• expanding research coverage</li> <li>• expanded due diligence (DCM)</li> <li>• market making in secondary markets</li> </ul>

Source: FCA analysis of banks' responses to the request for information.

<sup>61</sup> The title of 'lead left' is sometimes used to indicate the bank that has played the most active senior role within the syndicate, generating investor demand and being willing to underwrite a greater proportion the transaction, or has been involved at an early stage of the transaction.

### **Roles of different type banks within a syndicate**

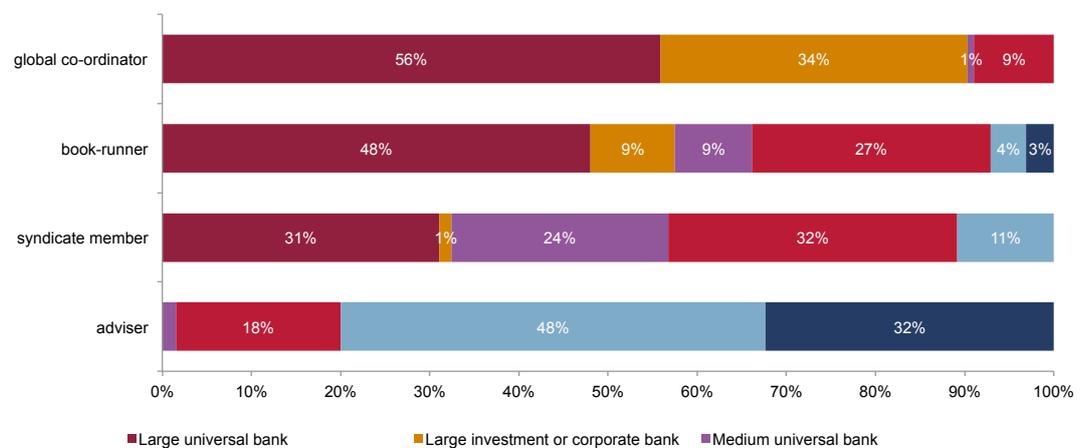
- 6.76** The role within a syndicate awarded to each bank will depend on the nature and size of the transaction. A number of large banks stated that they typically pitch for and receive mandates for the most senior roles within a syndicate. This was consistent with the view of one corporate finance adviser which noted that large universal banks rarely accept appointments to junior roles.
- 6.77** Although it is less common for large universal banks to accept passive/junior syndicate roles, several banks stated that they would be willing to do so in certain circumstances. This may include cases where the economics of the transaction justifies doing so, where a client may be expected to generate subsequent more lucrative business or where a client seeks to reward the bank for advice or services provided in the past. Another large bank commented that, in the context of DCM, it will accept co-manager roles from its larger clients because it is important that it is seen as supporting them in transactions. It also noted that accepting passive roles on a transaction may act as an entry point for providing other DCM services.
- 6.78** A number of small and medium-sized banks stated that they accept mandates for junior roles as it helps to establish their name and overall credentials in a sector. Accepting junior roles may also assist a bank in developing or further strengthening the client relationship. For example, one medium-sized universal bank commented that where it 'does a good job' in a junior syndicate role, it hopes to be awarded with a more senior role in the future.
- 6.79** We used the transactional data described in Annex 2 to assess whether large banks are more likely to be mandated for senior syndicate roles than medium-sized and small banks. For the purpose of our analysis we grouped ECM and DCM roles into the following categories:
- **ECM:** global co-ordinator, book-runner (active, passive and unspecified), syndicate member and adviser (mostly NOMAD).
  - **DCM:** lead manager, book-runner (active, passive and unspecified) and passive role.

### **Roles in ECM syndicates**

- 6.80** In ECM, we compared the proportion of each type of syndicate role awarded to different types of banks. Our analysis indicates that the most senior roles in our sample tend to be awarded to large banks, while junior and passive roles tend to be awarded to small and medium-sized banks.

**6.81** Figure 4 shows that 90% of global co-ordinator roles were awarded to large banks (56% to large universal banks and 34% to large universal or corporate banks), with only 10% awarded to medium-sized banks. Small and medium-sized banks accounted for a larger proportion of syndicate member and book-runner roles.<sup>62</sup> We observed a similar pattern in our analysis of ECM follow-on syndicate composition.

**Figure 4: Proportion of IPO syndicate roles in the sample awarded to different types of banks by type of role, January 2014 to May 2015**



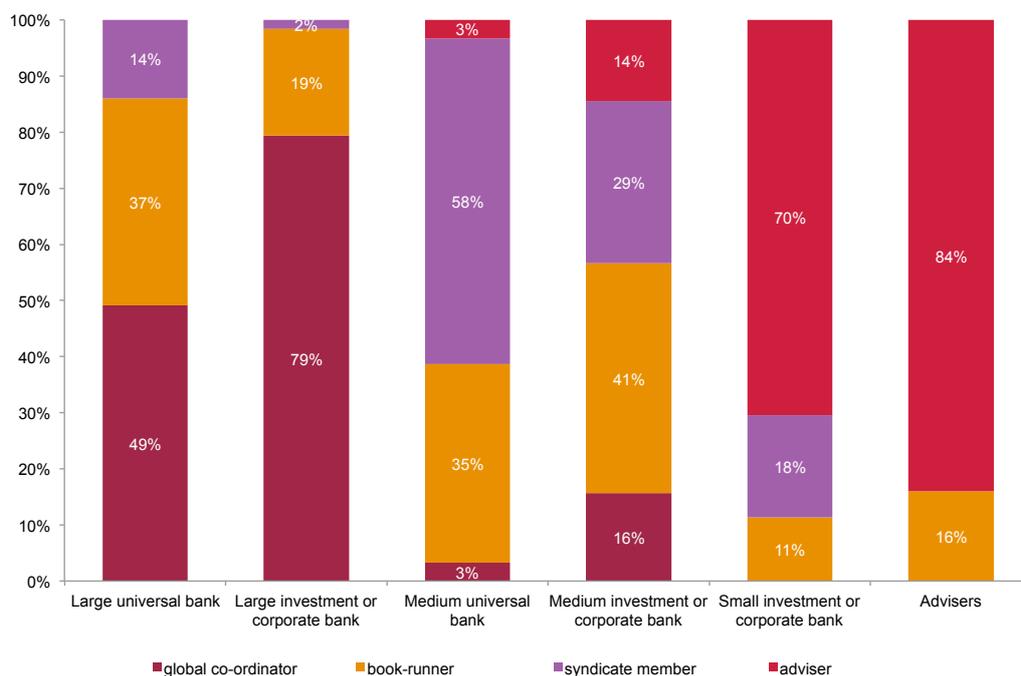
Source: FCA analysis of transactional data described in Annex 2.

Note: Excludes roles for which we had no information. The sample included 411 roles (65 adviser roles, 127 book-runner roles, 145 global co-ordinator roles and 74 syndicate member roles).

<sup>62</sup> Note that the category 'book-runner' includes both active and unspecified roles, so may be either senior or junior.

**6.82** Figure 5 presents the same data as Figure 4 but split by bank type. Figure 5 shows that large banks are primarily awarded global co-ordinator roles and book-runner roles, medium-sized banks are typically awarded book-runner and syndicate member roles and small banks are awarded a mix of book-runner, syndicate member and advisory roles (primarily NOMAD roles). We observed a similar pattern in our analysis of syndicate composition for follow-on ECM transactions.

**Figure 5: Proportion of IPO syndicate roles in the sample awarded to different types of banks by type of bank, January 2014 to May 2015**



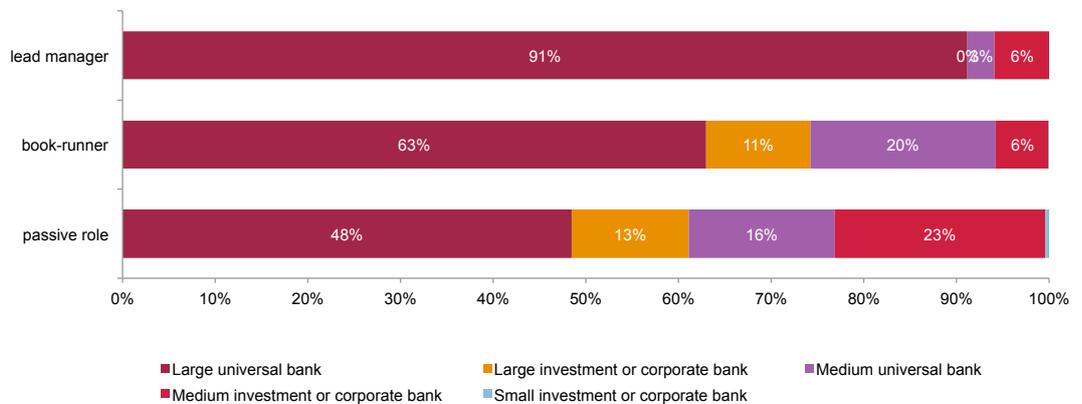
Source: FCA analysis of transactional data described in Annex 2.

Note: Excludes roles for which we had no information. The sample included 411 syndicate roles (165 taken by large universal banks, 63 by large investment or corporate banks, 31 by medium-sized universal banks 83 by medium-sized investment or corporate banks, 44 by small investment or corporate banks and 25 by advisers).

### *Roles in DCM syndicates*

**6.83** For each of corporate investment grade, corporate high-yield and SSA bond syndicates, we compared the proportion of different types of roles awarded to medium-sized and large banks.<sup>63</sup> Figure 6 shows that, in contrast with ECM, for corporate investment grade bonds large banks were awarded a large proportion of both senior roles (91% of lead manager roles and 63% of book-runner roles) and passive roles (48%). We found similar results for corporate high-yield and SSA bonds.

**Figure 6: Proportion of corporate investment grade bond syndicate roles in the sample awarded to different types of banks by type of role, January 2014 to May 2015**



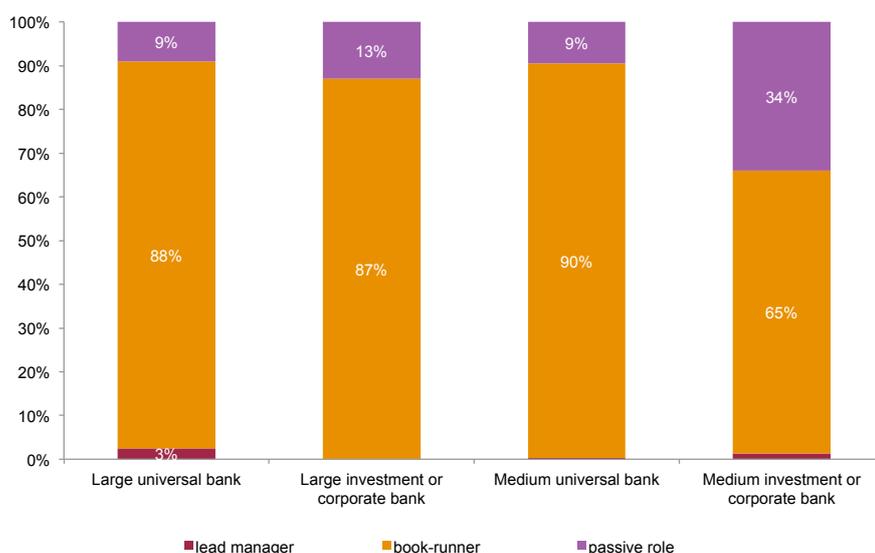
Source: FCA analysis of transactional data described in Annex 2.

Notes: Excludes roles for which we had no information. The sample included 1991 role (1728 book-runner roles, 34 lead manager roles and 229 passive roles).

<sup>63</sup> Note that small banks are not significant participants in DCM markets (see Chapter 3).

- 6.84** Figure 7 presents the same data as Figure 6 but splits roles of different types by bank type. Figure 7 shows that both large and medium-sized banks are primarily awarded book-runner roles, though medium-sized investment banks or corporate banks are more likely to be awarded passive roles than medium-sized universal banks. We found similar results for corporate high-yield and SSA bonds.

**Figure 7: Proportion of corporate investment grade bond syndicate roles in the sample awarded to different types of banks by type of bank, January 2014 to May 2015**



Source: FCA analysis of transactional data described in Annex 2.

Notes: Excludes roles for which we had no information and roles taken by small investment or corporate banks due to small samples (2 roles). The sample included 1989 roles (1230 taken by large universal banks, 224 by large investment or corporate banks, 382 by medium-sized universal banks and 153 by medium investment or corporate banks).

### Fee allocation to banks in different roles

- 6.85** It is our understanding that when forming syndicates fees are first determined for the transaction as a whole, and the percentage allocated to each role and the split between banks is then determined. This means that the fee allocation received by a particular bank depends on the size of the syndicate, type of role undertaken and the number of syndicate members in that particular role.
- 6.86** Given data limitations, it was not possible to undertake a detailed assessment of the fee allocation for different roles.<sup>64</sup> However, we assessed the average fee allocation per bank by type of role for the main ECM and DCM services. Table 3 and Table 4 can be used to compare the senior roles with the junior roles<sup>65</sup> and show that, as may be expected, banks undertaking more senior roles, on average, received higher fees than banks in junior

<sup>64</sup> First, our data does not include information on fees allocated to syndicate members that were not covered by our information request and syndicate banks that responded to our information request but did not provide information on their fee allocation. Second, banks used different terms to describe their role titles. The description of roles undertaken by banks in a particular transaction and across different transactions may not be consistent and reflect seniority of the role (and therefore also the fee allocation). Third, banks could not always identify what percentage of the fee they received as a percentage of the gross fee and so may not have been able to estimate the fee allocation accurately.

<sup>65</sup> We have not compared fees paid for different senior roles (i.e. global co-ordinator roles and book-runner roles) due to small sample sizes. The results in the tables therefore should not be seen to show that in ECM banks are paid more for book-runner roles than for global co-ordinator roles and that in DCM book-runners are paid more than lead managers.

roles. For example, for corporate investment grade bonds, each bank which undertook a lead manager or a book-runner role, on average, received 25%-27% of the gross fee, whereas each bank in a passive role, on average, received 8% of the gross fee.<sup>66</sup>

**Table 3: Average ECM fee allocation per bank by type of role, January 2014 to May 2015**

Role	Average % of gross fee received by each bank in the role	
	IPOs	Follow-ons
Global co-ordinator	35%	43%
Book-runner	38%	53%
Syndicate member	11%	18%

Source: FCA analysis of data provided by firms

Note: Excludes roles for which we had no information. Role 'book-runner' includes active book-runner roles and book-runner roles where banks had not specified whether it was an active or passive role. The sample included 320 IPO roles (64 adviser, 110 book-runner, 86 global co-ordinator and 60 syndicate member roles) and 679 follow-on roles (134 adviser, 406 book-runner, 63 global co-ordinator and 76 syndicate member roles).

**Table 4: Average DCM fee allocation per bank by type of role, January 2014 to May 2015**

Role	Average % of gross fee received by each bank in the role		
	Corporate investment grade bonds	Corporate high yield bonds	SSA bonds
Lead manager	25%	Small sample	24%
Book-runner	27%	25%	26%
Passive role	8%	13%	3%

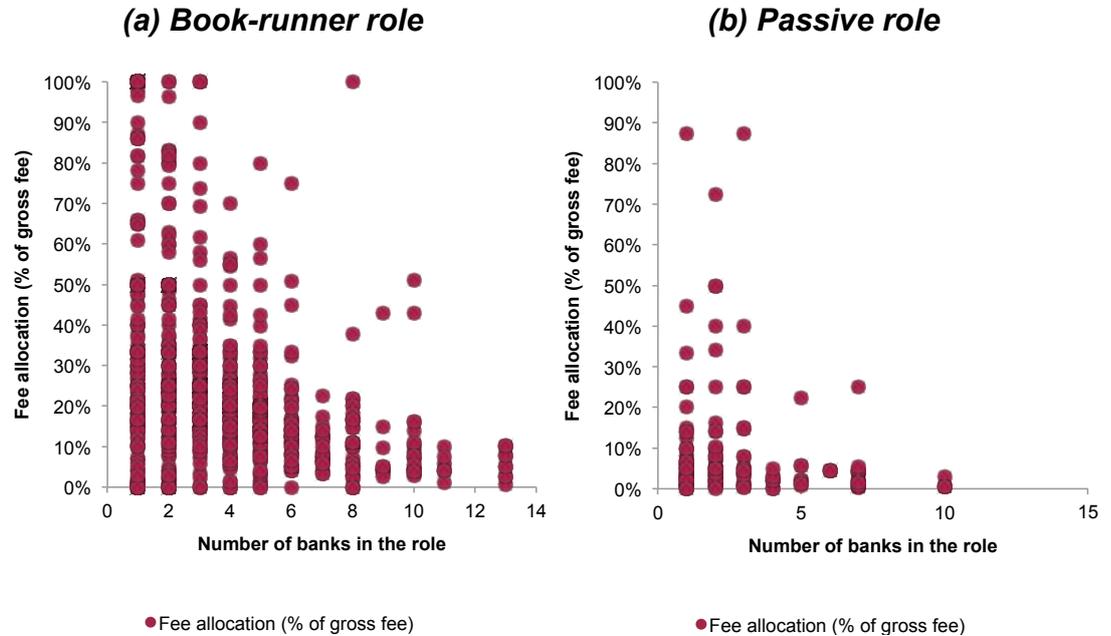
Source: FCA analysis of transactional data described in Annex 2.

Note: Excludes other roles or observations where there was no information about the role. The sample included 1543 corporate investment grade bond syndicate roles, 703 corporate high-yield bond syndicate roles and 873 SSA bond roles. We have not reported the average fee for lead manager roles in corporate high yield bonds due to a small sample size (9 observations).

**6.87** We also analysed the extent to which the average fee allocations received by a bank decrease as the number of syndicate members undertaking the same role increases. For corporate investment grade bonds, Figure 8 illustrates how the spread of fee allocation to book-runners and passive roles decreases with the number of banks in the role.<sup>66</sup> Similarly, Figure 9 shows that average fee allocations received by banks in book-runner and passive roles tend to decrease with the number of banks in the role, though most notably so for book-runner roles.

<sup>66</sup> Note that in Chapter 8 we also assessed the amount of discretionary fees awarded to different roles and found that the level of discretionary fees awarded to senior roles is higher than for junior roles.

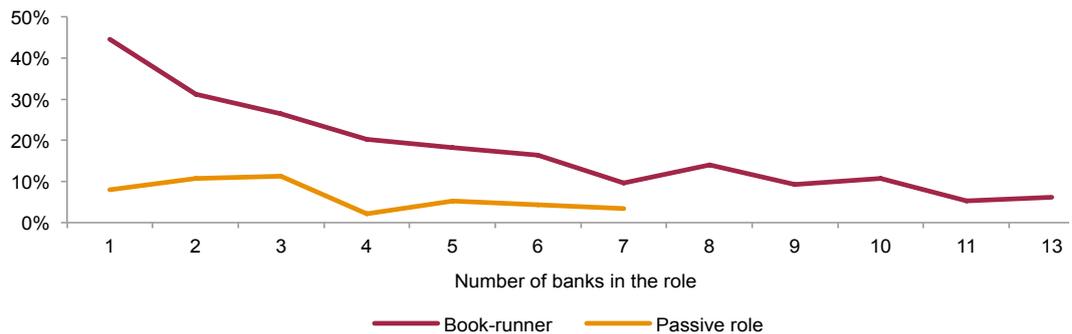
**Figure 8: Distribution of percentage of gross fee received by banks in book-runner and passive roles in corporate investment grade bond syndicates, January 2014 to May 2015**



Source: FCA analysis of transactional data described in Annex 2.

Note: The number of banks in the role underestimates the total number of banks in the role as it does not include those banks in the role that did not respond to our request for information. The sample includes 1342 book-runner roles and 171 passive roles.

**Figure 9: Decrease in average fee allocation for book-runner and passive roles in corporate investment grade bond syndicates, January 2014 to May 2015**



Source: FCA analysis of transactional data described in Annex 2.

Note: The number of banks in the role underestimates the total number of banks in the role as it does not include banks that were not in our sample. The sample includes 1342 book-runner roles and 171 passive roles.

### The size and potential negative effects of large syndicates

**6.88** A number of banks noted that clients' willingness to 'reward' their relationship banks with syndicate roles (see Chapter 7) may lead to ECM and DCM syndicates that are larger than necessary to distribute the securities. We assessed whether syndicates have grown over time, the average size of syndicates and what the negative effects are of larger syndicates (in particular, whether overly large syndicates lead to poorer execution and/or higher fees).

### Syndicate growth over time and average syndicate sizes

**6.89** A number of banks stated that there has been a trend towards larger syndicate sizes as a result of clients rewarding relationship banks by awarding them junior roles. We used our transactional data to analyse the change in syndicate sizes over time. We were only able to do this for IPOs, as our data for other types of transactions only covered a consecutive period of 17 months rather than five years (see Annex 2). Our analysis suggested that for the period January 2010 to May 2015 average IPO syndicate sizes, including both senior and junior roles, had remained relatively stable with between 3 and 4 syndicate banks.

**6.90** We also examined how the number of syndicate banks, both senior and junior, changes for different transaction sizes in IPOs, follow-on ECM transactions and DCM transactions. Table 5 shows that larger value transactions have larger syndicates, and DCM transactions tend to have larger average syndicates than ECM.

**Table 5: Average number of syndicate banks, both senior and junior, in ECM and DCM by deal size, January 2014 to May 2015**

ECM				DCM					
IPOs		Follow-ons		Corporate investment grade bonds		Corporate high yield bonds		SSA bonds	
Below \$70m	2	Below \$20m	1	Below \$280m	2	Below \$260m	3	Below \$400m	3
\$70m to \$240m	3	\$20m to \$100m	2	\$280m to \$630m	4	\$260m to \$430m	5	\$400m to \$700m	4
\$240m to \$570m	4	\$100m to \$320m	2	\$630m to \$1190m	6	\$430m to \$680m	5	\$700m to \$1710m	5
Above \$570m	7	Above \$320m	4	Above \$1190m	9	Above \$680m	8	Above \$1710m	7
<b>Total</b>	<b>4</b>	<b>Total</b>	<b>2</b>	<b>Total</b>	<b>5</b>	<b>Total</b>	<b>5</b>	<b>Total</b>	<b>5</b>

Source: FCA analysis of transactional data described in Annex 2.

Note that we have split all deals of a particular type into four groups by transaction size (\$m). Each group contains around 25% of observations, so group thresholds reflect the 25th, 50th and 75th percentiles in distribution by transaction size. The sample included 213 IPOs, 716 follow-on transactions, 796 corporate investment grade bond transactions, 303 corporate high-yield bond transactions and 428 SSA bond transactions.

**6.91** We have not sought to assess what proportion of ECM and DCM syndicates may be 'overly large' because banks that responded to our information request stated that the optimal syndicate size will depend on a range of transaction characteristics (for example, size, complexity, timing, geographic region). However, one corporate finance adviser suggested that, for IPOs, smaller transactions require one to two syndicate members, medium-sized transactions need two to six banks and large transactions require four to eight banks. With regard to DCM, several banks suggested that approximately two to five lead banks would be sufficient to distribute a bond issuance.

***What potential concerns arise from larger syndicates?***

- 6.92** We have already noted that larger syndicates can have the benefits described in paragraph 6.69. They may also allow clients to ‘reward’ some of their relationship banks with syndicate roles (see Chapter 7). Larger syndicates may also have pro-competitive effects because receiving junior role mandates may help smaller firms build credentials and client relationships and thus reduce barriers to expansion.
- 6.93** We considered whether larger syndicates may increase total fees or have negative effects on the outcome of the transaction.
- 6.94** We do not expect larger syndicates to result in an increase in total fees paid on a transaction. As described in paragraph 6.85, fees are usually negotiated for the transaction as a whole between the client and the glo-co(s) or lead manager(s). The total available fee, therefore, tends to be determined prior to the syndicate size being finalised.
- 6.95** This was confirmed by our analysis of fees. For ECM, we assessed how fees vary with the number of syndicate members for transactions of different sizes, and, for DCM, how fees vary with the number of syndicate members.<sup>67</sup> We did not find that average fees increased markedly as the number of syndicate members increased. In the few examples where we observed very small increases in average fees, this was explained by small sample sizes and/or other transaction characteristics.
- 6.96** We also sought to identify whether increasing syndicate sizes have a negative effect on the outcome of an issue. We were told by the majority of banks that overly large syndicates may lead to inefficient, cumbersome and unwieldy processes due to:
- dampened incentives for individual syndicate members to provide high quality execution because of a reduced share of fees
  - diluted leadership and accountability
  - ineffective engagement with investors, including duplication of effort as a result of banks pursuing the same investors for orders<sup>68</sup>
  - banks gravitating towards the lowest common denominator
  - increased risk of confidential information being disclosed
- 6.97** A number of banks provided us with examples of transactions where they considered the syndicate had been too large and which had resulted in less effective and cumbersome processes. However, they were not able to identify situations where they considered that the size of the syndicate had negatively affected the outcome of the transaction, such as pricing. This is because it is difficult to identify the effect of syndicate size on outcomes over and above other factors, such as market conditions. Furthermore, a number of banks stated that potential negative effects of overly large syndicates are likely to be minimal in benign market conditions, but may be more significant in volatile markets.
- 6.98** We were told that the potential inefficiencies referred to above are most likely to arise where too many senior/active roles have been awarded on a syndicate and the distinction between

<sup>67</sup> We considered transaction size in ECM because we found that fees (in terms of percentage of transaction value) decreased with transaction size, while we did not find that fees were affected by transaction size in DCM (see Annex 7).

<sup>68</sup> Several banks noted that, in ECM, for some transactions investors have complained of overly large syndicates leading to ineffective use of investors’ time, creating the perception of diluted sponsorship by participating banks.

roles is not well defined. In contrast, we were told that a long 'tail' of passive/junior roles, which is common on DCM transactions, is unlikely to result in these inefficiencies.

### **Interim findings**

- 6.99** Banks, advisers and clients stated that the size and composition of syndicates is driven by the client and not by banks, although the lead bank(s) may be asked to make recommendations. We observed that large banks are more likely to be chosen for senior syndicate roles, with medium-sized and small banks being awarded more junior roles. Clients sometimes award junior roles to 'reward' relationship banks, and in these cases junior roles may not be expected to contribute to the execution of the transaction. The practice of awarding roles to relationship banks may lead to larger syndicates than necessary to execute the transaction.
- 6.100** Larger syndicates have clear benefits for clients when they enable clients to access a greater pool of investors, gain access to a range of research analysts and build relationships with a broader range of banks. Conversely, however, larger syndicates may lead to less efficient processes, particularly if syndicate roles are not clearly defined. However, we have not been provided with sufficient evidence of material and direct detriment on transaction outcomes as a result of syndicate size. Furthermore, we understand that the fees involved are relatively low.
- 6.101** The practice of awarding roles to reward relationships may even have pro-competitive effects where junior syndicate roles provide a way for smaller banks to build their credentials.
- 6.102** Given the lack of evidence on detriment arising from larger syndicates, we do not consider it necessary to take any action although clients and financial advisers should be wary of the inefficiencies that can be created by appointing too many banks in syndicate roles.

### **Reciprocity**

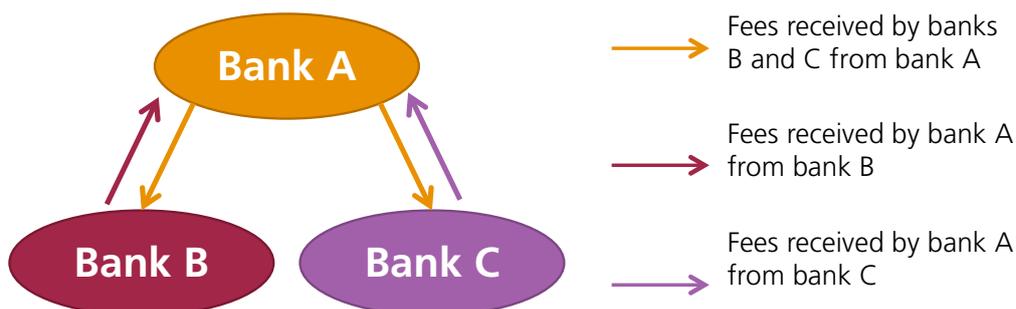
- 6.103** Reciprocity is the practice of banks awarding mandates to other banks partly based on how much business they will receive in return. In the Terms of reference we said that we wanted to explore whether reciprocal arrangements between banks providing investment and corporate banking services might restrict the entry or expansion of banks which are not party to these arrangements.
- 6.104** In this section we present our findings on reciprocity. We outline first the types of reciprocal arrangements that we have examined. We then discuss the reasons why these arrangements might restrict entry or expansion in primary markets. Next, we assess the significance of reciprocity among issuers of covered bonds as this is the market in which we heard reciprocity is most prevalent. Finally, we present our interim findings on the impact of reciprocal arrangements on competition in debt capital markets.

#### **Types of reciprocal arrangements**

- 6.105** Investment banks that issue debt and equity must determine whether to use their own issuing capabilities and whether to appoint other banks onto their transactions. The issuing bank may want or need to appoint several banks onto its transaction to broaden the distribution network or to benefit from the expertise of other banks in different types of issues (e.g. bonds in another currency).
- 6.106** We were told that banks may select other banks for their primary market transactions based not only on the value these banks will add to transaction, but also on how much business they expect to receive in return. For example, as shown in Figure 10, bank A may select banks B and

C to work on its own stock or bond offering on the basis that when these banks issue debt or equity, they will be expected to appoint bank A in return and generate fee income.

**Figure 10: Simplified example of fee transfers among banks in reciprocal arrangements**



Note: For simplicity we have not illustrated the potential for multiple reciprocal arrangements, so we have not shown any reciprocal arrangements between bank B and bank C, which may also exist.

**6.107** A number of benefits may accrue to issuers which form these types of reciprocal arrangements compared to issuers which appoint other banks on their transactions but do not engage in reciprocity. Using bank A as an example:

- it will receive a fee income from the other banks
- it may benefit from building up the experience of its own investment bank (by securing mandates from banks B and C)
- it will gain league table credit (where it is awarded a role eligible for credit)
- it will develop its relationships with banks B and C, which could become clients of bank A for other types of services

**6.108** We observed that a bank can take account of its relationships with other financial institutions when awarding mandates in a variety of ways. The types of reciprocal exchanges that banks identified included:

- A bank's treasury department directly considers past and potential future business from other banks when determining the syndicate for its own DCM transactions.
- A bank's treasury department selects the lead banks for its issue independently of the rest of the bank, but – in response to recommendations from its investment banking business – adds a number of banks to the syndicate in junior roles to reward these banks for previous business (or to encourage the award of future business).<sup>69</sup>

<sup>69</sup> In one example, we were told that the fees the bank pays come out of the investment banking division's budget, and that this is seen as part of the DCM business' capital markets advertising expenditure.

- An issuing bank considers the strength and length of its relationships with other financial institutions across a range of services.<sup>70</sup> For example, the provision of an ECM mandate may be rewarded with future DCM business.
- A bank is selected on a transaction in reward for having supported the other bank on previous transactions, such as private placements or MTNs, or for having offered to use its treasury to buy up a significant proportion of the debt issued in a transaction.

**6.109** We were informed that the practice of reciprocity is most prevalent in DCM transactions and that it is particularly widespread in covered bond transactions (although we were told that the practice also arises in the unsecured senior and subordinated markets). We have focused our examination on the potential implications of the reciprocal arrangements for DCM mandates, and particularly covered bond transactions.

**6.110** To date we have only received evidence that such arrangements are common in FIG transactions. We have not received evidence that such arrangements between banks exist in corporate and SSA transactions. We heard from both banks and clients that syndicate members are selected by the issuing client and not the lead bank(s) in the transaction (see the section in Chapter 6 on syndication). Consequently banks are not or would not be in a position to reciprocate roles on these types of transactions. However, we would be interested in receiving any further views and evidence on whether the practice of reciprocity is expanding into other areas.

#### **Potential implications of reciprocal arrangements for competition in debt capital markets**

**6.111** We analysed whether the reciprocal arrangements between banks providing DCM services might have adverse implications for banks which are not party to these arrangements.

**6.112** Reciprocity might impede banks who are not involved in the practice from growing their own DCM businesses. This could happen by excluding these banks from transactions covered by reciprocal arrangements, and making it more difficult for them to attain the experience and/or credentials required to secure mandates from other FIG clients (which do not engage in reciprocity) or mandates for other types of products/services.<sup>71</sup>

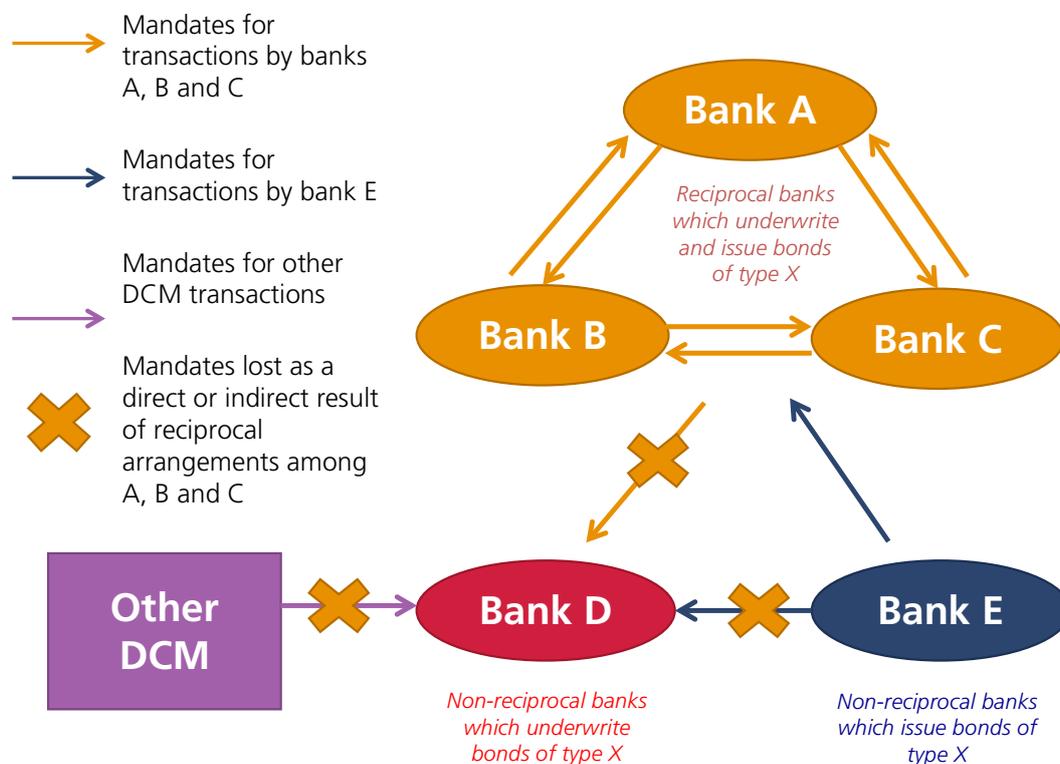
**6.113** Figure 11 shows an example of the potential implications of reciprocity. In the figure, we assume there is reciprocity among banks A, B and C (which we term the 'reciprocal group' and the 'reciprocal banks'). In the market for bonds of a particular type 'X' these reciprocal banks are both clients, issuing bonds of type X, and service providers, offering investment banking services for bonds of type X (which we refer as 'underwriting').

**6.114** Banks which are not involved in reciprocal arrangements (which we term the 'non-reciprocal banks') are represented in two categories, D and E. Type D banks are service providers, underwriting bonds of type X. Type E banks are clients, issuing bonds of type X. Depending on their activities in the market for type X, non-reciprocal banks may fall into either category or both categories, for example where a bank both issues and underwrites but does not award mandates to other banks or awards mandates only to those banks that do not also issue (type D).

<sup>70</sup> In the past, we understand, one way of assessing the relationships with other banks has been through a reciprocity committee within a bank.

<sup>71</sup> See the section in Chapter 6 on selection criteria and Annex 4 which highlight the importance of credentials and experience in winning primary market service mandates.

**Figure 11: Potential implications of reciprocal arrangements among banks A, B and C**



**6.115** Figure 11 shows three ways in which the reciprocal arrangements could restrict entry and expansion in the market for bonds of type X or could distort competition more widely in DCM:

- Underwriting banks (bank D) which are not involved in reciprocity may struggle to win DCM mandates from the reciprocal banks (banks A, B and C).
- Underwriting banks (bank D) which are not involved in reciprocity may be unable to achieve the scale or experience required to obtain mandates from other FIG clients (bank E) or for other types of DCM issuance.
- Issuers (bank E) which do not participate in reciprocity may not be willing or able to award mandates to banks of type D (if there are few type D banks or for the reasons cited above type D banks are unable to attain the requisite experience/credentials). These issuers (bank E) may be restricted to choosing from the reciprocal banks (banks A, B and C) and over time could potentially face higher fees and/or lower service quality.

**6.116** We considered that a range of factors would influence whether the reciprocal arrangements could lead to such restrictions and detrimental effects both in the market covered by the arrangements and in wider DCM. These may be broadly categorised as:

- **The size of the market:** The greater the size of the market covered by the arrangements the greater the scope for the arrangements to lead to material detrimental effects. Also, the more important the market is in wider DCM the greater the scope for the arrangements to adversely affect wider markets (as described in paragraph 6.112).

- **The number of market participants:** The scope for reciprocal arrangements to restrict entry and expansion in the ways described in paragraph 6.115 is likely to be greater where a small number of reciprocal banks account for the majority of the activity in the market.
- **The prevalence of reciprocal arrangements:** The impact of reciprocity is likely to be greater where the arrangements cover a high proportion of the total transactions in the market (e.g. the market for bonds of type X), leaving limited business that could still be secured by underwriting banks (bank D) that do not engage in reciprocity.
- **The restrictiveness of reciprocal relationships:** Reciprocal arrangements are likely to have a greater impact on non-reciprocal banks where they prevent reciprocal banks from also including non-reciprocal banks on the syndicate for a transaction, or preclude banks from awarding the more senior roles on a transaction to those outside the arrangements.

**6.117** We use this framework to assess the potential implications of reciprocal arrangements for covered bond transactions in the section that follows.

#### **Impact of reciprocal arrangements in covered bond transactions**

**6.118** In order to test the factors outlined in paragraph 6.116, we examined the size of the market for covered bond transactions in Europe, the number of participants and the prevalence and restrictiveness of the reciprocal arrangements for these transactions.

**6.119** Throughout this reciprocity section we use data from Dealogic rather than our transactional data described in Annex 2. We used Dealogic data because reciprocity in covered bonds may extend beyond UK operations such that focusing on our data may have missed some of the interactions among participants in the market.

**6.120** We used the data from Dealogic to estimate the numbers of reciprocal banks and to assess how many transactions could be affected by reciprocal arrangements. We considered that a reasonable approximation for the portion of the market that could potentially be influenced by reciprocity was the group of banks which acted as both issuers and underwriters. The corresponding method used to identify the reciprocal banks is set out in Table 6 below.

**Table 6: Method for identifying reciprocal and non-reciprocal banks in covered bond transaction data**

<b>Reciprocal/ Non-Reciprocal bank</b>	<b>Bank Type in Figure 11</b>	<b>Issuer/ Underwriter</b>	<b>Classification method/ proxy used</b>
Reciprocal bank	ABC	Issuer and underwriter (i.e. both client and service provider for covered bonds).	Bank which issued at least one covered bond and had at least one role on a covered bond transaction in a given year.
Non-reciprocal bank	D	Underwriter only.	Bank which had a role on at least one covered bond transaction in a given year but did not issue any covered bonds in that year.
Non-reciprocal bank	E	Issuer only.	Bank which issued at least one covered bond in that year but had no roles on covered bond transactions in that year.
Non-reciprocal bank	DE	Issuer and underwriter.	Not identified.

**6.121** While we considered that this classification method was satisfactory, given the limited data available, we noted that it would not precisely identify the reciprocal banks or transactions affected by reciprocal arrangements. In particular:

- We could overstate the number of reciprocal banks as there may be banks (banks DE) which both underwrite and issue covered bonds but do not appoint banks based on business that they will receive in return, for example by only appointing banks that just issue or not appointing any other banks at all. These banks are captured in our definition of reciprocal banks (banks ABC).
- We could overstate the number of transactions affected by reciprocity if reciprocal banks only have reciprocal arrangements in place for a subset of the covered bond transactions they are involved in.
- We could understate the number of reciprocal banks if reciprocal arrangements span more than a single year. For example, if an underwriting bank which is engaged in reciprocity issued a covered bond in 2014 but not in 2015 when examining 2015 data we would classify this bank as non-reciprocal (bank D).

***The size of the market for covered bond transactions***

**6.122** We found that the market for covered bonds is sizeable and that covered bond transactions account for a material proportion of FIG transactions in DCM. For example, as shown in Table 7, the value of covered bond issues in EMEA in 2015 was \$203 billion, which accounted for 19% of the total value of FIG DCM transactions in EMEA in this period. However, in the context of DCM as a whole, covered bond issues are less important, accounting for 7% of the total value of DCM transactions in 2015.

**Table 7: Value and number of covered bond transactions in EMEA 2014-2015**

Year	Value of covered bond transactions \$bn	Number of covered bond transactions	% Total value of FIG DCM transactions	% Total number of FIG DCM transactions	% Total value of DCM transactions	% Total number of DCM transactions
2014	179	458	15%	13%	5%	7%
2015	203	557	19%	15%	7%	8%

Source: FCA analysis of Dealogic data

**6.123** Given the size of the market and the significance of covered bond issues in FIG DCM, we considered that there was scope for the effects of reciprocity on competition in covered bonds to be material, and potentially to have a wider impact in FIG DCM.

**6.124** To assess the potential impact of reciprocity we focused our assessment on *syndicated* covered bond transactions (so as to exclude minor transactions where reciprocity is unlikely to be applicable). As Table 8 indicates, these transactions account for the majority of the value of covered bond transactions (87% in 2015) and just under half of the number of covered bond transactions (45% in 2015).

**Table 8: Value and number of syndicated covered bond transactions in EMEA 2014-2015**

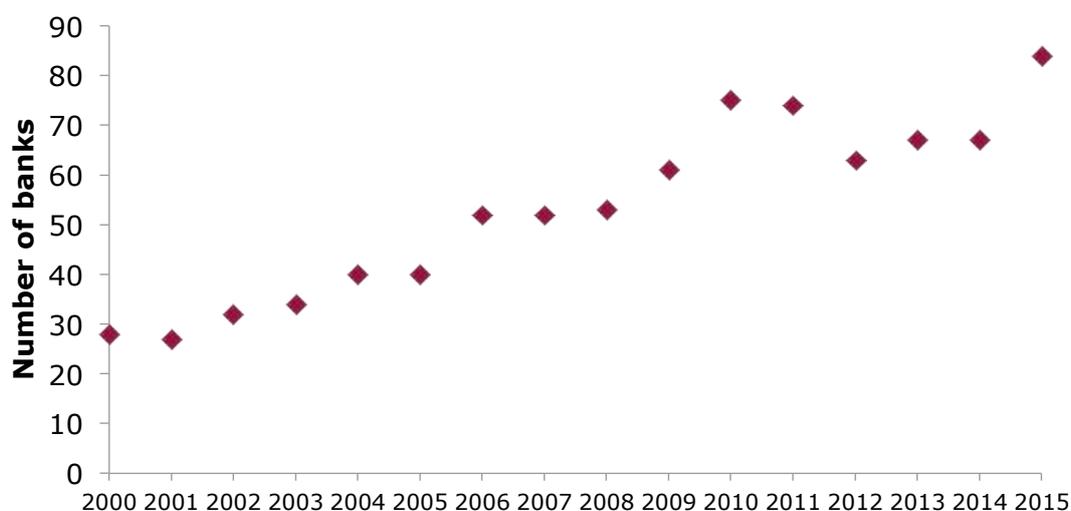
Year	Value of syndicated covered bond transactions \$bn	Number of syndicated covered bond transactions	% Total value of all covered bond transactions	% Total number of all covered bond transaction
2014	154	186	86%	41%
2015	176	253	87%	45%

Source: FCA analysis of Dealogic data

**The number of market participants**  
**Issuing banks**

- 6.125** We observed that there have been many issuers of syndicated covered bonds active in EMEA in recent years with 84 banks issuing covered bonds in 2015. As Figure 12 shows, the number of issuers has increased steadily since 2000 as covered bonds have been used by an increasing number of banks as a funding instrument.

**Figure 12: Banks issuing syndicated covered bonds in EMEA 2000-2015**



Source: FCA analysis of Dealogic data

- 6.126** We found that transactions are not highly concentrated among a small number of issuers. In 2015 the transactions conducted by the top 10 issuers accounted for approximately a third of the total value of transactions and the top 20 issuers accounted for approximately half.

**Underwriting banks**

- 6.127** We observed that there are a large number of banks active in the covered bond market in EMEA. As Table 9 illustrates, there were 79 banks underwriting syndicated covered bond transactions in 2015.

**Table 9: Banks underwriting syndicated covered bond transactions 2000-2015**

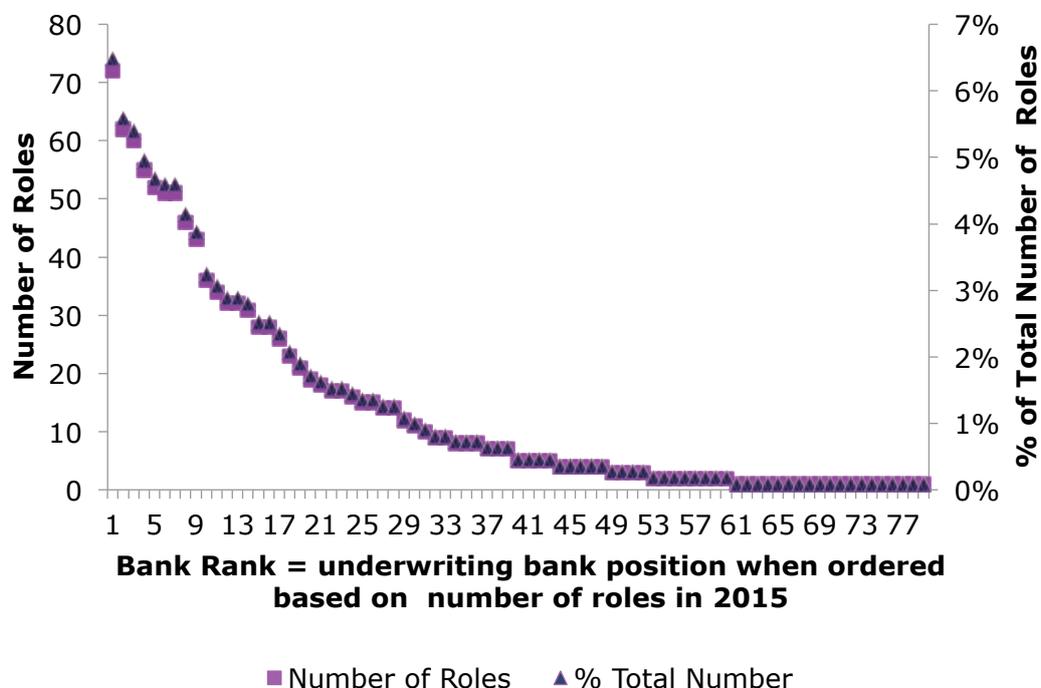
Year	Number of banks underwriting covered bonds	Total value of transactions (\$bn)	Total number of transactions
2000	75	127	254
2001	72	86	173
2002	75	87	144
2003	66	136	176
2004	80	141	157
2005	86	177	194
2006	77	231	237
2007	78	227	214
2008	61	165	133
2009	98	177	166
2010	83	270	286
2011	80	300	284
2012	82	189	221
2013	78	146	205
2014	62	154	186
2015	79	176	253

Source: FCA analysis of Dealogic data

- 6.128** Table 9 shows that the number of banks underwriting covered bonds has varied over time (and was particularly volatile during the financial crisis, falling to 61 banks in 2008 and rising to 98 in 2009). We do not however observe an underlying trend towards entry or exit over the last 15 years with the number of banks and number of transactions remaining at a similar level to that in 2000.
- 6.129** We analysed the distribution of roles among banks underwriting syndicated covered bonds to find out whether a small group of underwriters obtain the majority of roles. As Figure 13 shows, roles are not evenly distributed among all market participants. While a small group of underwriters obtain numerous roles in a year, many of the remaining banks are involved in only one or two transactions per year (which may include self-led transactions).<sup>72</sup> No single bank obtained greater than 7% of the total number of roles and the top ten banks accounted for approximately half of the total roles on transactions and the top 20 for approximately three-quarters.

<sup>72</sup> If roles on self-led transactions are excluded we observe that there were 73 banks obtaining underwriting roles in 2015.

**Figure 13: Banks underwriting syndicated covered bond transactions, 2015**



Source: FCA analysis of Dealogic data

**6.130** Overall, our analysis revealed that covered bond transactions are an important part of FIG issuance and have been issued by an increasing number of banks in recent years. There are a number of banks underwriting these transactions, but a group of 10-20 banks attain the majority of the underwriting roles.<sup>73</sup>

***Prevalence of reciprocal arrangements in covered bonds***

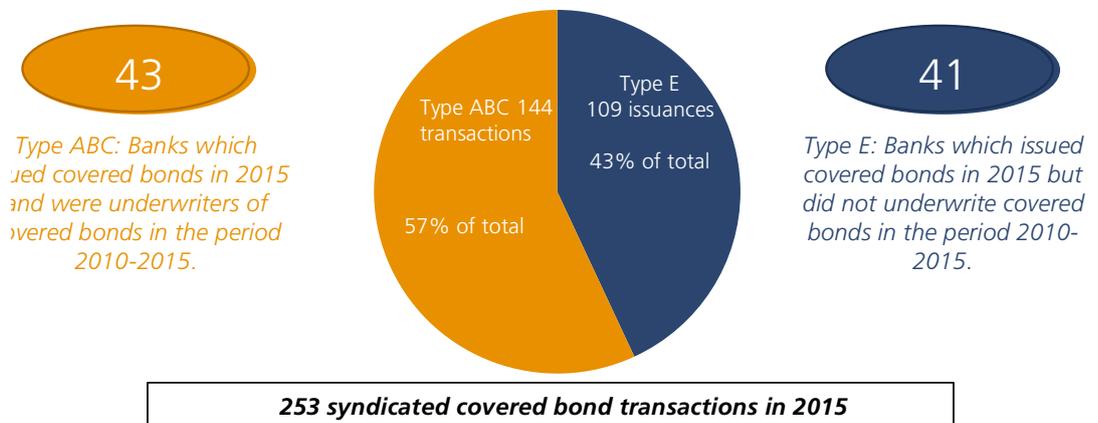
**6.131** In order to determine the potential prevalence of reciprocal arrangements in the covered bonds market we considered:

- How significant is the group of issuers that are also underwriters of covered bonds relative to the total group of issuers of covered bonds (that is, how important is the reciprocal group ABC relative to the group ABC and E combined).
- How sizeable and successful at winning roles on covered bond transactions is the group of underwriting banks that are also issuers of covered bonds compared with the total group of banks that act on covered bond transactions (that is how significant is the reciprocal group ABC relative to group ABC and D combined).

***Issuers of covered bonds***

**6.132** We found that of the 84 banks issuing covered bonds in 2015, 43 also underwrote covered bonds in that year (see Figure 14). These issuers accounted for 57% of the total number of transactions. 41 of the 84 banks that issued covered bonds in 2015 did not also underwrite covered bonds in the same year. These 41 banks issued 109 covered bonds, which accounted for approximately 43% of the total number of transactions.

<sup>73</sup> We consider the types of roles awarded in paragraphs 6.138 to 6.142.

**Figure 14: Banks issuing syndicated covered bonds in 2015**

Source: FCA analysis of Dealogic data

- 6.133** Table 10 shows that since 2000 the number of issuer-underwriters that could potentially be part of reciprocal arrangements (group ABC) has risen from 13 to 43 with a step change in 2009 and 2010. The percentage of covered bond transactions accounted for by issuer-underwriters has increased from 46-62% in 2000-2004 to 52-71% in 2011-2015.

**Table 10: Banks issuing syndicated covered bonds 2000-2015**

Year	Issuers that underwrote covered bonds in the same year (type ABC)	Issuers that did not underwrite covered bonds in the same year (type E)	Number of covered bond transactions by type ABC	Transactions of type ABC as % of total covered bond transactions
2000	13	15	126	50%
2001	11	16	108	62%
2002	13	19	67	47%
2003	12	22	81	46%
2004	18	22	76	48%
2005	17	23	97	50%
2006	25	27	132	56%
2007	23	29	106	50%
2008	23	30	62	47%
2009	34	27	112	67%
2010	45	30	188	66%
2011	42	32	202	71%
2012	37	26	122	55%
2013	38	29	106	52%
2014	35	32	128	69%
2015	43	41	144	57%

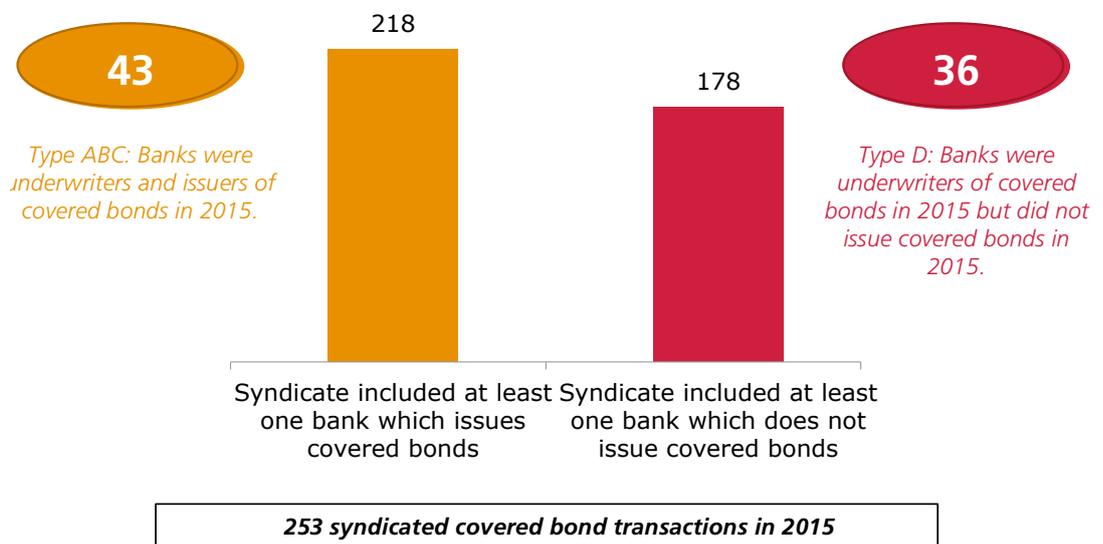
Source: FCA analysis of Dealogic data

**6.134** Equally, however, Table 10 shows the number of issuers which did not underwrite in the same year has increased from 15 in 2000 to 41 in 2015 suggesting that there are still a number of issuers of covered bonds which may not be able to engage in reciprocity.

#### ***Underwriters of covered bonds***

**6.135** We found that of the 79 banks underwriting syndicated covered bonds in 2015, 43 were both underwriters and issuers of covered bonds (i.e. were type ABC) (see Figure 15). At least one of these banks was on the syndicate for 86% of the covered bond transactions in 2015.

**Figure 15: Banks underwriting syndicated covered bonds in 2015**



Source: FCA analysis of Dealogic data

**6.136** As Figure 15 also indicates, 36 of the 79 banks underwriting covered bonds in 2015 were not also issuers of covered bonds (i.e. were of type D). At least one of these banks was on the syndicate for 70% of the covered bond transactions in 2015. These results indicate there are a number of banks underwriting covered bonds which might not engage in reciprocity. However, as Table 11 illustrates, this represents a significant decline since 2000 when there were 62 banks underwriting but not issuing covered bond transactions and at least one of these banks was on the syndicate in 94% of transactions.

**Table 11: Banks underwriting syndicated covered bonds 2000-2015**

Year	No of type ABC	No of type D	Transactions which included at least one bank of type ABC	% of Total	Transactions which included at least one bank of type D	% of Total
2000	13	62	220	87%	239	94%
2001	11	61	146	84%	171	99%
2002	13	62	114	79%	140	97%
2003	12	54	132	75%	172	98%
2004	18	62	134	85%	146	93%
2005	17	69	153	79%	191	98%
2006	25	52	200	84%	206	87%
2007	23	55	183	86%	201	94%
2008	23	38	110	83%	124	93%
2009	34	64	164	99%	130	78%
2010	45	38	285	100%	154	54%
2011	42	38	282	99%	176	62%
2012	37	45	217	98%	172	78%
2013	38	40	196	96%	179	87%
2014	35	27	184	99%	148	80%
2015	43	36	218	86%	178	70%

Source: FCA analysis of Dealogic data

**6.137** The decline in the number of banks of type D, and the corresponding rise in the number of banks of type ABC are likely to be explained in part by a number of banks which were formerly underwriters only beginning to issue covered bonds themselves, particularly since 2009/2010.

#### ***Restrictiveness of reciprocal arrangements in covered bonds***

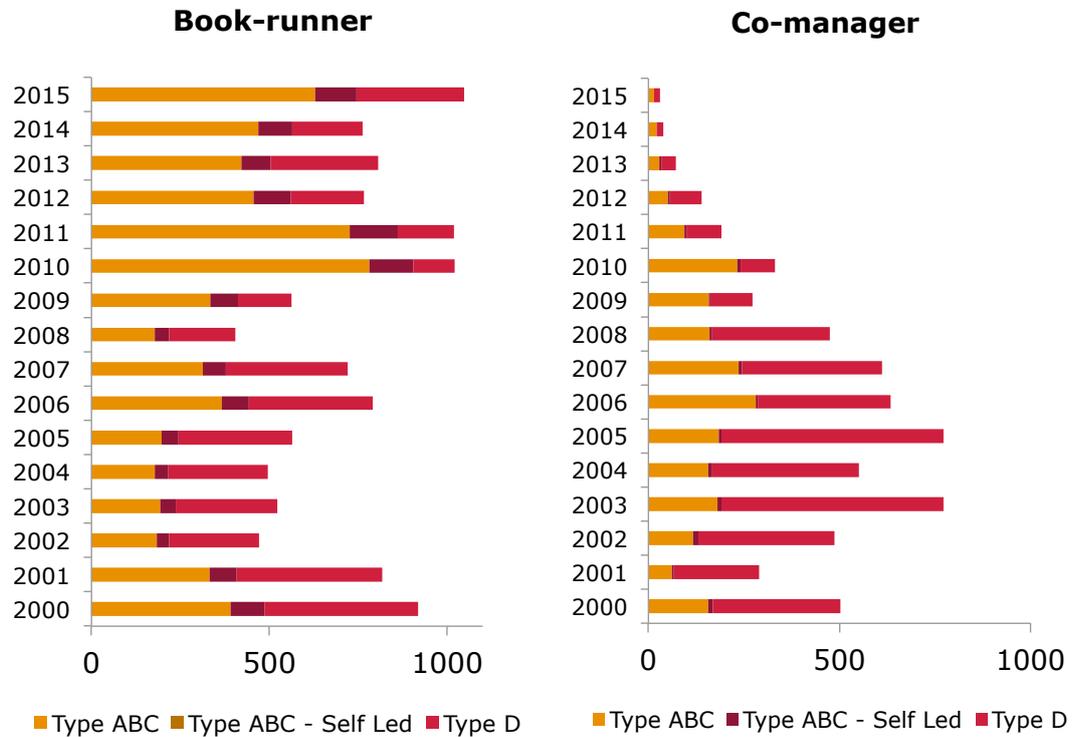
**6.138** To assess whether these changes have affected either the choices available to non-reciprocal issuers or the ability of non-reciprocal underwriting banks to expand we examined the roles that reciprocal and non-reciprocal banks are awarded in covered bond syndicates.

**6.139** Examining the 253 syndicated covered bond transactions conducted in 2015, we found that 1048 book-runner roles, 30 co-manager roles, 29 underwriting roles and 4 non-book manager roles were awarded. Banks which issued covered bonds in 2015 (i.e. type ABC) were awarded 71%, 50%, 38% and 50% of these roles respectively.

**6.140** We looked at whether this pattern had changed over time. Figure 16 shows how book-runner and co-manager roles were split between reciprocal and non-reciprocal banks over the period 2000-2015. It shows that the number of co-manager roles has declined and the number of book-runner roles has increased.<sup>74</sup>

<sup>74</sup> This may be for league table credit reasons, which we discuss elsewhere in Chapter 6.

**Figure 16: Book-runner and co-manager roles awarded to reciprocal and non-reciprocal banks on covered bond transactions 2000-2015**



Source: FCA analysis of Dealogic data. Categories "Type ABC" and "Type ABC – Self Led" combined provide the total roles awarded to banks of Type ABC.

**6.141** As the number of co-manager roles has declined, the number of roles given to banks of type D have declined and the number of book-runner roles awarded to banks' own DCM desks or banks of type ABC have increased. As Table 12 indicates, the proportion of all roles awarded to banks of type D has fallen from 57% in 2000 to 31% in 2015. Banks of type D are still able to attain a number of book-runner roles, but our data does not indicate the seniority of these roles.

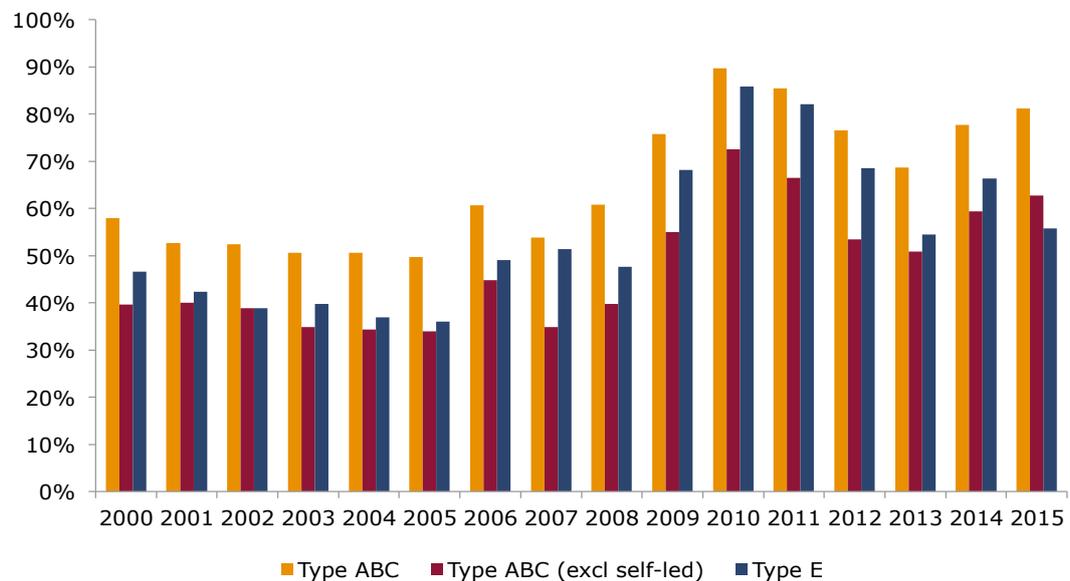
**Table 12 – Proportion of roles awarded to non-reciprocal banks on covered bond transactions 2000-2015**

Year	% of book-runner roles awarded to banks of Type D	% of all roles awarded to banks of Type D
2000	47%	57%
2001	50%	59%
2002	54%	65%
2003	55%	68%
2004	56%	64%
2005	57%	69%
2006	44%	51%
2007	48%	54%
2008	46%	58%
2009	27%	40%
2010	11%	20%
2011	16%	26%
2012	27%	35%
2013	37%	41%
2014	26%	28%
2015	29%	31%

Source: FCA analysis of Dealogic data

**6.142** We also considered whether reciprocal banks are more successful at attaining roles on transactions where reciprocal arrangements could be put in place (i.e. on transactions for other banks of type ABC) than on transactions by non-reciprocal banks (type E). Of the 1048 book-runner roles on syndicated covered bond transactions in 2015, 627 (60%) were awarded by banks that were also underwriters (type ABC) and 421 (40%) were awarded by banks that did not underwrite covered bonds in 2015 (type E). Figure 17 shows that in 2015 banks of type ABC won 81% of the book-runner roles issued by banks of type ABC (19% of which were roles on self-led transactions) and 56% of the roles issued by banks of type E. Figure 17 suggests that reciprocal banks have been able to win an increasing proportion of book-runner roles on type ABC and type E transactions over time. This pattern was at its highest in 2010 and 2011.

**Figure 17: Proportion of book-runner roles attained by reciprocal banks on transactions by reciprocal issuers (type ABC) and non-reciprocal issuers (type E)**



Source: FCA analysis of Dealogic data. Category "Type ABC" represents the total roles awarded to banks of type ABC including those on self-led transactions.

**6.143** Finally, we considered whether the increase in the number of reciprocal banks has led to an increase in fees for syndicated covered bond transactions for either non-reciprocal issuers (type E) or issuers in general (i.e. types ABC and E combined). We found that there is not conclusive evidence supporting an increase in fees for either non-reciprocal issuers or issuers in general (see Annex 7):

- There was considerable variation in covered bond fees prior to 2010, with fees across maturities generally stabilising in the period post-2010.
- There was no noticeable upward trend over the period, and the fees paid by reciprocal banks did not appear to be systematically lower than fees for non-reciprocal banks.

**6.144** We would however welcome views on the factors which have led to the convergence in fee outcomes since 2010. We consider that this may be attributable in part to the use of Dealogic modelled fees for this period as limited information on disclosed covered bond fees is available post-2010.

#### Interim findings

**6.145** By their nature, arrangements between banks whereby they reward one another with roles on transactions have the potential to restrict competition. In particular, we would have concerns that this type of conduct may result in a 'closed shop' to other banks or may otherwise give rise to potential anti-competitive conduct.

**6.146** In 2015 in EMEA, there were 79 banks underwriting syndicated covered bond transactions and 84 active issuers. 43 of these banks were both underwriters and issuers and capable of engaging in reciprocity.

- 6.147** Non-reciprocal underwriting banks seem to be able to compete and non-reciprocal issuers seem to have a choice of non-reciprocal banks: the 41 issuers of covered bonds in 2015 that could not have been part of the reciprocal group had a choice of 36 banks that could not have been part of the reciprocal group.
- 6.148** The main advantage reciprocal banks seem to have is that they are more likely to win senior roles with banks that both issue and underwrite covered bonds, and they have been able to win an increasing proportion of book-runner roles on all types of covered bond transactions over time. However, at present reciprocity does not appear to be excluding non-reciprocal banks from competing because they have been able to win around a third of book-runner roles. We saw no evidence to suggest that reciprocity in covered bonds materially affects the ability of non-reciprocal banks to compete effectively in other types of bonds.
- 6.149** We do not therefore propose to take any further action on reciprocity at this time but we welcome views on this. Should the practice become more widespread or show signs of the potential detrimental effects we have highlighted, we will conduct further work with a view to intervening to prevent this type of behaviour.

### **The role of corporate finance advisers**

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- 6.150** In the Terms of reference, we said that we wanted to understand how corporate finance advisers are used and, in particular, whether clients that use advisers to select a bank benefit from that advice and are able to drive more effective competition between banks than without the advice.
- 6.151** In this section we consider:
- what role corporate finance advisers play in primary market activities
  - the application of the FCA's conduct and organisational provisions to corporate finance advisers
  - the extent to which corporate finance advisers are used on IPOs
  - concerns that have been raised regarding corporate finance advisers

#### **What role corporate finance advisers play in primary market activities**

- 6.152** Corporate finance advisers can provide advice to clients on equity issues, debt issues and M&A activity. Many corporate finance advisers provide advice across all three of these activities. The main focus of our analysis is on IPO transactions, given the prominence of the role that corporate finance advisers play in these transactions.

#### **ECM**

- 6.153** In ECM, corporate finance advisers actively participate in the following aspects of IPOs:
- Providing advice on the timing, structure and terms of the transaction, including the valuation of the issuer.
  - Advising on the choice of book-runner/syndicate banks and managing the RfP process. This includes holding a beauty parade, making recommendations on syndicate banks, vetting meetings with research analysts, making recommendations on syndicate size and structure,

and negotiating the terms of the relevant agreements (e.g. underwriting and placing agreements) between the issuer and the bank(s), including fees. This can also include assistance with other third-party appointments such as lawyers and accountants.

- Assisting with the organisation of roadshows. This includes providing advice on marketing materials and drafting of the prospectus.
- Assisting with the due diligence processes.
- Assessing banks' proposals for allocations. This can also include analysis of potential institutional investors and their fit for the issuer.

**6.154** The role that corporate finance advisers play in IPO transactions is distinct from that of banks. Corporate finance advisers do not provide underwriting services and do not have trading, sales or distribution capabilities. Instead, their role is purely advisory, effectively acting as an intermediary between issuers and book-runners. However, there is some overlap in the activities corporate finance advisers and banks undertake. For example, some of the advisory work corporate finance advisers undertake, such as advice on stock valuation, has traditionally been done by banks. Where this is the case, corporate finance advisers may provide a second opinion to the issuer and generally scrutinise the actions of the banks.

**6.155** In addition to providing advice during IPOs, corporate finance advisers also provide advice to issuers in follow-on ECM transactions. The role they play in these transactions is similar to that in IPOs, although typically somewhat less extensive. We were told that for follow-on ECM transactions, corporate finance advisers provide assistance to companies mainly on issue structure (e.g. whether it should be underwritten or on a best efforts basis), timing and fees.

#### ***DCM and M&A***

**6.156** In contrast to IPOs, corporate finance advisers do not have such a defined role in DCM and M&A transactions. They provide advice to the issuer on many facets of the execution of the transaction:

- In DCM, corporate finance advisers often provide advice on the characteristics of the offering, the refinancing of existing debt, negotiating price, covenants, and other terms with lenders, and may also provide credit rating advisory services.
- In M&A, corporate finance advisers provide a similar service to those of investment banks. Therefore, corporate finance advisers compete directly with investment banks and corporate finance teams within accountancy firms for M&A advisory mandates. The main difference between corporate finance advisers and investment banks in this area is that banks may additionally cross-sell ECM or DCM services in order to finance the merger or acquisition

#### **Application of the FCA's conduct and organisational provisions to corporate finance advisers**

**6.157** During our engagement with the industry, a number of stakeholders, notably banks, expressed a lack of understanding of the extent to which corporate finance advisers are covered by the FCA's rules. They sought clarity on this matter. This sub-section summarizes which rules and guidance are likely to be most relevant for corporate finance advisers' activities.

**6.158** Some corporate finance advisers may be MiFID firms, usually where they carry out a wider range of investment activities and/or if they wish to provide investment services on a cross-border basis into other EU member states. These firms will be subject to our MiFID-derived COBS and

SYSC requirements for MiFID business.<sup>75</sup> However, corporate finance advisers can choose to be MiFID exempt if they do not hold client funds or assets, are only authorised to receive and transmit orders, and provide investment advice in relation to transferable securities.<sup>76</sup>

**6.159** Non-MiFID corporate finance advisers that act for an issuer when entering into arrangements with other authorised firms to place and underwrite a new issuance of transferable securities are most likely to be carrying out the regulated activity of arranging (bringing about) deals in investments provided the cumulative effect of their involvement is such that it brings about the transaction.<sup>77</sup>

- In such cases, the firm arranging deals in investments will be conducting corporate finance business and be subject to provisions in COBS 18.3.3R.
- Where carrying out regulated activities, non-MiFID corporate finance advisers will also be subject to a limited application of SYSC.<sup>78</sup> This includes core requirements on conflicts of interest management, competence of employees, and adequate policies and procedures to enable a firm to demonstrate compliance with their regulatory obligations.
- Where firms provide regulated investment services to clients, we expect them to maintain systems and controls at a firm level, which would offer protection to a client if the firm proceeds to providing a regulated activity.

**6.160** Corporate finance advisers who routinely seek to identify investment opportunities that would bring together investors and potential issuers may also be conducting the regulated activity of making arrangements with a view to deals in investments, in which case the same rules as noted above would apply.<sup>79</sup>

**6.161** Corporate finance advisers, as authorised firms, are also subject to the FCA's Principles for Business which set out general obligations of authorised firms under the regulatory system. The Principles require firms to conduct their business with integrity, and with due skill, care and diligence. Firms are also required to pay due regard to the interest of their customers and treat them fairly, as well as manage conflicts of interest fairly, both between themselves and their customers, and between one customer and another.

**6.162** M&A transactions<sup>80</sup> are exempt from being designated investment business under the Regulated Activities Order (RAO) where it is non-MiFID business, so non-MiFID corporate finance firms providing M&A services are not carrying out a regulated activity and are therefore not subject to FCA requirements.

#### **Extent to which corporate finance advisers are used on IPOs**

**6.163** There are a number of corporate finance advisers who offer ECM, DCM, and M&A advisory services. Different corporate finance advisers operate under different business models. For example, some advisers with fewer resources focus on larger issuers, while those with more resources target a range of corporate issuers. In addition, we also heard that some advisers specialise in different areas of the IPO process. For example, some advisers focus more on

<sup>75</sup> Such requirements would also apply to MiFID ancillary services which includes M&A activities (MiFID I Level 1, Annex 1 Section B Paragraph (3))

<sup>76</sup> Under Article 3 MiFID Level 1.

<sup>77</sup> Article 25(1) of the Regulated Activities Order

<sup>78</sup> As determined by SYSC 1 Annex 1

<sup>79</sup> Article 25(2) of the Regulated Activities Order

<sup>80</sup> Defined as where more than 50% of the voting rights of the body corporate are acquired or disposed of.

the final stages of the IPO process around the allocation stage, while others specialise at the beginning of the process on due diligence and book-runner selection.

**6.164** Among corporate financial advisers, Rothschild and Lazard are involved in the most transactions across these three areas while STJ Advisors is also a significant provider of ECM and DCM advice. There are also a large number of other advisory firms such as Gleacher Shacklock, Moelis, Evercore, Perella Weinberg, Ondra and Greenhill. Accountancy firms, who maintain corporate finance teams, also compete for ECM, DCM, and M&A advisory services.

**6.165** Focusing on IPOs, we used our transactional data described in Annex 2 to calculate the number and value of IPO transactions in which advisers have been involved over the period January 2010 to May 2015. Table 13 shows the results:

**Table 13: Transactions involving a corporate finance adviser, January 2010-May 2015**

Adviser	Number of transactions	Value of transactions
Rothschild	37	\$28.0bn
Lazard	11	\$18.1bn
STJ Advisors	27	\$22.6bn
Evercore Partners	8	\$2.7bn
All corporate finance advisers	100	\$71.6bn

Source: FCA analysis of transactional data described in Annex 2. Figures do not sum because some advisers are involved on the same transaction.

Note: The figures shown represent the value and number of times each firm advised on a transaction but there are a number of transactions where more than one adviser had a role. The figure of 100 for All corporate finance advisers means that there are 100 transactions involving at least one corporate finance adviser. The difference between the total value and number of transactions and the sum of those for Rothschild, Lazard, STJ Advisors and Evercore does not therefore give the balance of transactions involving other corporate finance advisers.

**6.166** Table 13 shows that over this five and a half year period:

- 100 IPOs involved the use of at least one corporate finance adviser.
- The most commonly used advisers were Rothschild (37 transactions), STJ Advisors (27 transactions), Lazard (11 transactions) and Evercore Partners (8 transactions). On some transactions, more than one adviser is involved. This is especially likely during disposals by private equity firms where one adviser may advise the private equity firm while another may advise the company being floated.
- Rothschild advised on transactions worth \$28.0bn, Lazard on transactions worth \$18.1bn, and STJ Advisors on transactions worth \$22.6bn. Therefore, while Lazard advised on fewer transactions than Rothschild and STJ Advisors, it tended to advise on larger value transactions.

**6.167** Using our transactional data described in Annex 2, we also sought to understand whether the use of corporate finance advisers on IPOs has increased. Table 14 shows that the proportion of IPOs in our dataset which made use of a corporate finance adviser fell from 21% in 2010 to 11% in 2011 and 2012 before increasing to around 30% between 2013 and 2015. The number of advised transactions is low in 2011 and 2012, which makes the figures in those years less comparable.

**Table 14: The use of corporate finance advisers on IPOs, January 2010 – May 2015.**

Year	Total number of transactions	Number of advised transactions	Proportion of transactions that are advised
2010	62	13	21%
2011	45	5	11%
2012	37	4	11%
2013	83	25	30%
2014	133	38	29%
2015 (first 5 months)	52	15	29%

Source: FCA analysis of transactional data described in Annex 2.

**6.168** There were three main reason that clients, advisers and banks cited for why the use of corporate finance advisers has become more popular in IPOs in recent years:

- **Conflicts of interest within investment banks:** There are potential conflicts of interest in primary market transactions (for example the conflict that banks face in the allocation process between their issuer client and their investor clients) and the issuing process itself can be opaque and confusing for issuers. As a result, issuers have engaged corporate finance advisers to assist in ensuring banks are delivering the best service possible. This possible explanation was highlighted to us by three investment banks. One corporate client, which used a corporate finance adviser on its IPO, felt the adviser's input was valuable during the allocation process to ensure it achieved an optimal investor base. The firm commented that investors to whom the bank proposed to make allocations were known to be likely short term holders of shares after an IPO.
- **Issuer's lack of primary market experience:** An issuer's senior management may not have experience of undertaking capital raising in primary markets. This explanation was cited to us by three investment banks. One issuer commented that in its recent IPO none of the directors had experience of conducting an IPO. The issuer, therefore, engaged a corporate finance adviser. A private equity firm said that given its episodic use of capital markets, it usually seeks additional experience from a corporate finance adviser.
- **To provide reassurance to senior managers:** This reason was cited to us by several frequent issuers and by a housing association. An issuer's senior management team may employ a corporate finance adviser in order to mitigate the risk that the IPO goes badly and thereby protect its own reputation.

#### Concerns raised regarding corporate finance advisers

**6.169** Banks had mixed views about the use of corporate finance advisers in IPO transactions. On the one hand, some banks suggested their contribution to the market is positive. Reasons cited for their positive contribution included their ability to bridge the information gap between banks and issuers, their use of objective selection criteria when advising on book-runner selection, the way they drive greater competition between banks during the beauty parade process, their ability to help manage conflicts of interest, and their ability to help coordinate syndicates. On the other hand, some banks indicated that corporate finance advisers have not made a positive contribution to the IPO market. For example, some banks felt that advisers dis-intermediate the advice between banks and issuers and questioned whether they add value to the IPO process. In addition, some banks questioned the independence of corporate finance advisers.

**6.170** In considering these concerns we are aware that, in part, they may be driven by the corporate finance advisers taking revenue away from the investment banks and also assisting clients in applying greater scrutiny on the banks' service offering. Nevertheless, we consider that we need to examine whether these concerns have any substance.

**6.171** We consider the following issues that were raised:

- certain corporate finance advisers show preference towards certain banks
- advisers choose book-runners based on their analysts' research
- corporate finance advisers' impact on fees paid to book-runners
- the fee structures used by corporate finance advisers misalign incentives with their clients

**Whether certain corporate finance advisers show preference to certain banks**

**6.172** Corporate finance advisers told us that they take into account several factors when advising issuers on which banks to select for their syndicates. In particular, the following were considered important when corporate finance advisers advise issuers on book-runner selection:

- the execution capability of banks
- the sector experience of banks
- the capabilities that banks have in distributing securities to investors
- the credentials of banks' research analysts
- the chemistry between the bank and the issuer

**6.173** However, two banks said that corporate finance advisers show a preference towards certain banks when advising their issuer clients on book-runner selection. There may be a number of reasons why this may occur:

- Advisers may select banks they believe have done a good job on previous transactions. One bank told us that advisers do show preference towards certain banks, but this is because since the recession, some investment banks have proven to be more successful with IPOs than others.
- Certain corporate finance advisers may have a strong track record in certain sectors or countries and their advice on book-runner selection simply reflects this as banks with the relevant sector or geographical specialisms are selected.
- Employees of corporate finance advisers have previously worked for some of the banks they advise issuers to select. This may lead them to have a bias towards their former employers/colleagues with whom they have a good working relationship.

**6.174** The potential concern is that the advice that corporate finance advisers provide issuers is not aligned with the needs of the client. Where a corporate finance adviser shows a preference towards a certain bank (or banks), we would expect the adviser to demonstrate that it is

identifying and managing any conflicts of interest such that it is not putting its own interests ahead of that of its client, and that it is acting in the best interests of its clients.<sup>81</sup>

- 6.175** One universal bank had done some analysis for an internal strategy document looking at its success rate on IPOs when a corporate finance adviser was involved. The success rate referred to the number of times it was selected as a book-runner on an IPO when corporate finance advisers were involved. Overall, it found that, its success rate was below several of its competitors. However, the analysis did not contrast the success rates of banks on IPOs where a corporate finance adviser was not involved compared with when they were.
- 6.176** The analysis also considered what factors may be driving the advice that corporate finance advisers give issuers on book-runner selection. The analysis showed that there was some weak positive correlation between a bank's Extel research ranking and its hit rate on IPOs where a corporate finance adviser is involved. However, the bank also found a strong positive correlation between a bank's ranking in league tables and its hit rate on IPOs with a corporate finance adviser involved. The issue of league tables as a selection criterion for book-runners on an IPO is considered in paragraphs 6.21 to 6.54.
- 6.177** We conducted our own analysis of banks' success rates with different corporate finance advisers to test whether there was any indication of bias towards particular banks. We compared the success rates on 'advised' IPOs (see Table 15) with those where no corporate finance adviser was involved (see Table 16). This data covered IPOs over the period January 2010 to May 2015.

**Table 15: Analysis of bank success rates on IPOs advised by different corporate finance advisers, January 2010 – May 2015**

Rank	Adviser A		Adviser B		Adviser C	
	Bank	Success rate	Bank	Success rate	Bank	Success rate
1	Bank A	51%	Bank D	46%	Bank A	63%
2	Bank B	38%	Bank B	46%	Bank E	33%
3	Bank C	30%	Bank A	46%	Banks F / G/ H	29%

Source: FCA analysis of transactional data described in Annex 2.

Note: Where more than one bank appears in a certain position, those banks hold the joint position. The percentages add up to more than 100% because more than one bank is typically on a transaction.

<sup>81</sup> See SYSC 10 and COBS 2.1.1R.

**Table 16: Analysis of bank success rates on unadvised IPOs, January 2010 – May 2015**

Unadvised transactions (545 IPOs)		
Rank	Bank	Hit rate
1	Bank A	28%
2=	Banks B/E	25%
4	Bank F	23%
5	Bank D	20%

Source: FCA analysis of transactional data described in Annex 2.

**6.178** Table 15 shows that certain banks are strongly associated with transactions that involve certain corporate finance advisers. For example, Bank A featured on 63% of Adviser C's transactions and was selected nearly twice as often as the second most common bank, Bank E. When contrasting the banks that appear in Table 15 and Table 16, they are broadly the same. Further, the banks also appear to be in similar positions. Nevertheless, some banks achieve a much higher success rate with some advisers than they do in unadvised IPOs. Some banks also rank highly with certain corporate finance advisers but do not rank highly on unadvised IPOs. For example, while Bank C is ranked third among banks which are selected on Adviser A-advised IPOs, it is ranked 21st in terms of success rate on unadvised IPOs.

**6.179** Our evidence is inconclusive as to whether corporate finance advisers are providing recommendations to their clients which are not in their best interests. Although certain investment banks appear to have a strong association with certain corporate finance advisers, we have not seen evidence which suggests that these recommendations are not made with the best interests of the client in mind. In addition, we have heard that corporate finance advisers can be beneficial to clients in bridging any information gaps between themselves and banks when choosing book-runners for their transaction. We were also told that issuers ultimately decide which banks they want on their syndicate. Therefore, this is an issue which we believe does not require any further action at this stage. However, we would be interested in hearing any views or evidence in support of or against this finding.

***Whether corporate finance advisers suggest book-runners based on their research***

**6.180** During the book-runner selection process, corporate finance advisers, alongside senior management from the issuer, usually have a separate meeting with the banks' research analysts (these are often referred to as 'vetting meetings'). Some banks expressed concern that these vetting meetings may compromise the independence of the research produced by analysts because the corporate finance adviser may 'lean' on the bank's analyst to produce favourable research.

**6.181** Corporate finance advisers told us that a bank's research capability is a significant consideration when they advise issuers on book-runner selection. They told us that, as their role is to act in the issuer's best interests, the likely favourability of a bank's research is a factor in the advice they give to issuers. However, corporate finance advisers said that the meetings with research analysts were not designed to *influence* research but to discuss the following issues so as to allow them to provide good advice to their clients:

- the analyst's opinion on the issuer's sector
- the research produced on companies similar to the issuer
- how the analyst makes recommendations and valuations

- the analyst's knowledge and understanding of the issuer

**6.182** We note the concerns raised regarding these vetting meetings, but we have to date received no evidence that these have led to any breaches of our rules. Importantly, given that it is the banks, not the corporate finance advisers, who produce research and are bound by our rules on investment research under COBS 12.2, it is for the banks to ensure that the independence of their analysts' research is not compromised. Banks must therefore take the necessary precautions to ensure any meetings with corporate finance advisers are conducted appropriately and in compliance with the FCA's rules. For this reason, corporate finance advisers will also be aware that analysts cannot offer favourable coverage on an issuer during the vetting meetings.

***The impact of corporate finance advisers on book-runners' fees***

**6.183** We were told that some fees paid to corporate finance advisers come from the fee pot assigned to the book-runners on a transaction and some fees come from a separate fee pot. We wanted to understand whether a client that decides to use a corporate finance adviser may pay more in fees overall.

**6.184** We were told by a number of banks and one issuer client that the amount of fees that corporate finance advisers charge is not justified based on the value they add to the IPO process. Specifically, we heard the following concerns:

- One large investment bank believed that corporate finance advisers' fees are too high given the extent of their input to the IPO process.
- A small investment bank said that while corporate finance advisers force book-runners to charge lower fees, they themselves charge high fees.
- Another small investment bank said that when corporate finance advisers are involved in the process, the issuer pays higher fees overall. While the adviser may drive down the fees that book-runners charge, those savings are offset by the corporate finance adviser's fees.
- A housing association told us that corporate finance advisers' fees are surprisingly high to the point where they don't constitute good value.

**6.185** We used our transactional data to assess whether fees charged by syndicate banks are on average lower when a corporate finance adviser is involved in the transaction. The extent of our analysis was limited by the fee information available to us and the ability to control for other factors across relatively small sample sizes.<sup>82</sup> We found that issuers on average pay lower fees to syndicate banks in transactions which involve a corporate finance adviser (see Table 17). However, transactions that involved a corporate finance adviser were on average larger than those that did not. Therefore, it may be the case that the lower fees paid on transactions involving a corporate finance adviser reflect economies of scale in IPO fees rather than any downward pressure that advisers place on them.

**6.186** Table 17 also shows that transactions that involve a corporate finance adviser are more likely to make use of discretionary fees than unadvised transactions. This may present some weak but consistent evidence that advisers try to create more competitive tension in order to drive down fees.

<sup>82</sup> During our information gathering exercise we did not gather data on the fees charged by all corporate finance advisers, as this was not the main focus of our market study.

**Table 17: Fees paid by issuers on advised and non-advised transactions, January 2010 – May 2015**

<b>Advised</b>	<b>Mean transaction value (\$m)</b>	<b>Mean gross fee (% of transaction value)</b>	<b>Mean discretionary fee (% of deal value)</b>	<b>% with discretionary fee</b>	<b>Number of IPOs</b>
Corporate finance adviser	683	2.41	0.71	92%	51
Unadvised or unknown	515	2.90	0.36	64%	137
Total	560	2.77	0.45	71%	188

Source: FCA analysis set out in Occasional Paper 15.

Note: the sample for this analysis was based on that used in the Occasional Paper which includes only those IPOs for which we had order and allocation books. The sample is therefore smaller than that used in the analysis in Table 13 to Table 16.

**6.187** Based on the analysis above, we have not seen compelling evidence that corporate finance advisers are not adding value for their issuer clients. We do not consider the concerns raised warrant further attention at this stage but we would be interested to hear of any further evidence to the contrary.

#### ***Fee structures used by corporate finance advisers***

**6.188** Corporate finance advisers sometimes structure their fees using ratchet fees and completion fees in a way which can misalign their incentives with those of the issuer.

**6.189** **Ratchet fees** are contingent upon the final price of the IPO – the higher the final offer price of the IPO, the more the adviser earns in fees. One corporate finance adviser told us that it encourages clients to use ratchet fees because the ratchet fee aligns its incentives with those of the client. The concern with ratchet fees is that they may incentivise advisers to focus too much on the final offer price of an IPO and ignore other factors which may be important to the issuer, such as secondary market performance or the quality of the investors in the allocation book.

**6.190** **Completion fees** are contingent upon the transaction being completed. The use of completion fees may incentivise corporate finance advisers to push issuers to complete an IPO, even if it is not in the issuer's best interest. For example, if market conditions deteriorate while an issuer is part way through the IPO process, it may be best for the IPO to be postponed, but the completion fee may encourage an adviser to persuade the client not to do so. Most corporate finance advisers charge completion fees on IPOs. However, some corporate finance advisers told us that they also sometimes charge a monthly retainer fee. One of the advisers explained that this guards against pressing for a transaction that is not in the best interests of the client.

**6.191** Whilst it is possible that both ratchet fees and completion fees can misalign incentives between corporate finance advisers and their issuing clients, we consider that it is within the client's means to choose a fee structure that suits its needs.

#### ***Interim findings on corporate finance advisers***

**6.192** We have set out the most relevant FCA's rules that apply to corporate finance advisers' activities in order to address a lack of clarity perceived by some stakeholders on this point.

**6.193** We have considered a number of concerns raised, primarily by banks, regarding the conduct of corporate finance advisers. We have found little cause for concern on the evidence we have

seen to date but we would be interested in receiving further evidence on these points. In particular:

- Although certain investment banks appear to have a strong association with certain corporate finance advisers, we have not seen evidence which suggests that these recommendations are not made with the best interests of the client in mind.
- Although corporate finance advisers are involved in vetting meetings of syndicate banks' analysts, we have seen no evidence that to date this has led to any breach of our rules.
- We have not seen compelling evidence that corporate finance advisers are not adding value for their issuer clients in terms of lower fees with banks. However, clients should consider carefully the incentives they create when agreeing fee structures with corporate finance advisers.

## 7.

# Cross-selling, bundling and cross-subsidisation

### Chapter summary

We analysed how the practice of cross-selling, bundling and/or cross-subsidisation may be impacting the effectiveness of competition for primary market services.

We found that:

- Lending and corporate broking are often supplied below internal hurdle rates or below cost, in exchange for a flow of transactional business, which is typically more lucrative.
- Once a lending and/or corporate broking relationship is established the bank and the client expect that the investment bank will be awarded subsequent transactional services. About three-quarters of DCM primary market roles are awarded to a bank with whom the client holds a corporate banking or lending relationship in the two years before the transaction, though the link is significantly weaker for IPOs.
- This model seems to work well for large corporate clients, who typically have a wide range of lending banks or joint corporate brokers that compete against each other for transactional mandates.
- However, we heard that clients may feel the need to ‘reward’ a lending bank or corporate broker with transactional business even when that bank would not otherwise have won a mandate. This may have a greater effect on medium-sized and small corporate clients, who typically have fewer banking relationships than large corporate clients, and may need to look outside of their relationship banks. Pressure to award transactional business to a lending bank or corporate broker can be exacerbated by contractual clauses in engagement letters that seek to restrict the client’s future choice of supplier.
- The provision of cheap lending and corporate broking makes it harder for those banks providing only transactional services to compete. While boutique advisers have successfully entered into M&A, entry and expansion into ECM and DCM have been mainly by banks that also lend.

- 7.1** As set out in Chapter 3, investment banks, and particularly universal banks, provide a range of services. One area we identified in our Terms of reference where investment and corporate banking may not be working effectively and that would benefit from further investigation was cross-selling, bundling and/or cross-subsidisation of this range of services. We said that we wanted to understand which services are cross-sold, bundled and cross-subsidised.

**7.2** We identified three potential competition concerns from cross-selling, bundling and cross-subsidisation:

- **Creating barriers to entry and/or expansion:** Competing firms may be less able to enter or expand into primary market services which are bundled with or effectively cross-sold from other services.
- **Restricting switching by clients:** Clients may face additional costs or other disadvantages if they award business to non-relationship banks.
- **Over- and under-consumption of services:** Clients may procure too much of the services that are being cross-subsidised and too little of the services that are the source of that cross-subsidisation.<sup>83</sup>

**7.3** For the purpose of our analysis, we have used the following definitions of cross-selling, bundling and cross-subsidisation:

- **Cross-selling** refers to the practice whereby banks and advisers seek to sell other products or services to an existing client over a period of time.
- **Bundling** refers to the practice whereby two or more services are sold as a package rather than separately on a stand-alone basis. There are two main forms of bundling: 'pure bundling', where it is only possible to purchase the two services together; and 'mixed bundling', where the individual services can also be purchased separately. A practice related to bundling is 'tying', where the supplier of a service, the tying service, requires a client also purchase a second service, the tied service.
- **Cross-subsidisation** is a pricing strategy whereby the profit derived from the sale of one service or group of services is used to offer another service or group of services at a lower return or a loss.<sup>84</sup>

**7.4** In this chapter, we have therefore analysed:

- the nature and prevalence of cross-selling, bundling and cross-subsidisation
- the use of contractual clauses to aid cross-selling
- the potential effects on competition of cross-selling, bundling and cross-subsidisation, specifically whether:
  - cross-selling and cross-subsidisation represents a barrier to entry or expansion into (i) relationship services or (ii) transactional services
  - cross-selling creates barriers to using non-relationship banks such that existing clients are then offered less advantageous terms and conditions by relationship banks compared with new clients

<sup>83</sup> For the purpose of the analysis, this means procuring more lending (or corporate broking) and less primary market transactional services than in the absence of cross-subsidisation.

<sup>84</sup> The term cross-subsidisation is also used to refer to other situations such as cross-subsidies between groups of consumers. These types of cross-subsidy are not relevant for our market study. The terms lower return and loss refer to a situation in which the price is below the economic cost of providing the service in question. Economic cost includes the remuneration of capital employed.

- bundling of transactional services with ancillary services represents a barrier to entry or expansion into ancillary services
- cross-subsidisation leads to reduced consumption of those services used to cross-subsidise and/or greater consumption of those services being cross-subsidised, relative to a situation without the cross-subsidy
- offsetting benefits of cross-selling and cross-subsidisation

**7.5** A summary of our interim findings concludes the chapter.

### **The nature and prevalence of cross-selling, bundling and cross-subsidisation**

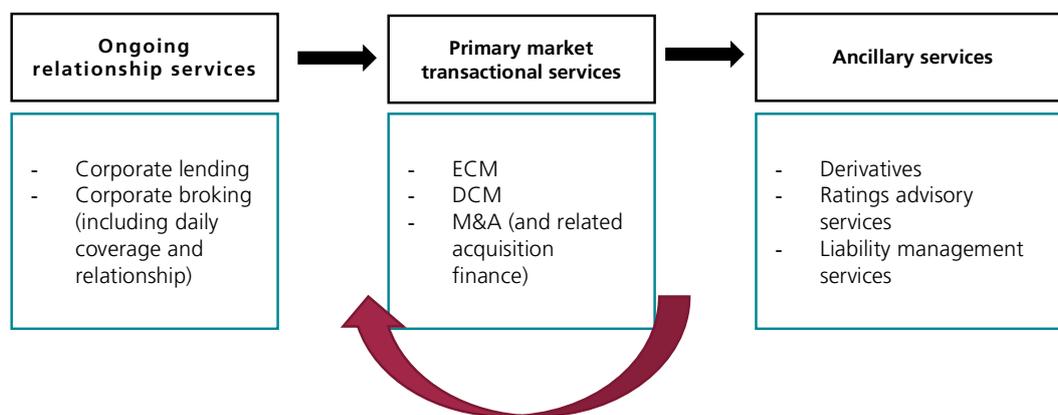
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#### **Relationship, transactional and ancillary services**

- 7.6** The provision of investment and corporate banking services is underpinned by relationship banking. Banks and advisers seek to win and retain clients by becoming a ‘trusted adviser’ to each client. There are two principal means by which they do this: corporate broking and corporate lending. For the purpose of our analysis, we refer to these as ongoing ‘relationship services’. We have used a wide definition of corporate broking in this study so as to reflect the provision of day-to-day coverage which a bank or adviser provides to a client (see also Annex 1).<sup>85</sup>
- 7.7** Banks and advisers providing relationship services are frequently mandated on subsequent primary market transactions in respect of ECM, DCM and M&A. Provision of transactional services can also lead to opportunities for banks and advisers to strengthen their relationships with clients and to be engaged in further primary market transactions. Alongside the provision of primary market transactional services, investment banks may also provide clients with additional ‘ancillary services’, such as derivatives, ratings advisory, agency services and custody services.
- 7.8** This relationship banking model is illustrated in Figure 1, showing example services under each of ongoing relationship services, primary market transactional services and ancillary services.

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<sup>85</sup> Other services might also be considered to form a part of these relationship services, but we have not considered them in detail.

**Figure 1: The relationship banking model**

**7.9** The nature of the relationship between (i) relationship services and subsequent primary market transactional services, and (ii) primary market transactional services and ancillary services, varies depending upon the type and size of the client and their individual needs.

**7.10** Consistent with our analysis in Chapter 5, our focus in this section is primarily on cross-selling, bundling and cross-subsidisation for corporate clients rather than other types of clients such as SSAs for whom corporate lending and corporate broking are not relevant and who tend to have a large panel of banks from which they appoint banks for transactional services (see Annex 3). We focus on the prevalence of:

- Cross-selling and cross-subsidisation between relationship services and transactional services. We analyse this by focusing first on all relationship services, then on lending and corporate broking separately.
- Cross-selling between transactional services.
- Bundling and cross-subsidisation between transactional and ancillary services.

#### **Prevalence of cross-selling and cross-subsidisation between relationship services and transactional services**

**7.11** In order to assess the importance of relationship services in cross-selling primary market transactional services, we consider the extent to which primary market transactional services are provided to clients based on a pre-existing relationship.

**7.12** We used our transactional data described in Annex 2 to conduct our analysis. The data covers the period January 2014 to May 2015. We conducted analysis at a transaction level and a role level. We further split the role-level analysis by client type and size. We explain our approach in the relevant section below, and further details are set out in Annex 6.

**7.13** We conducted our analysis across each of ECM, DCM and M&A and adopted the following definitions:

- 'Lending' relationships include syndicated loans, bilateral loans and other credit facilities (which include overdrafts and revolving lines of credit).<sup>86</sup>

<sup>86</sup> See Annex 1 for a more detailed description of these activities.

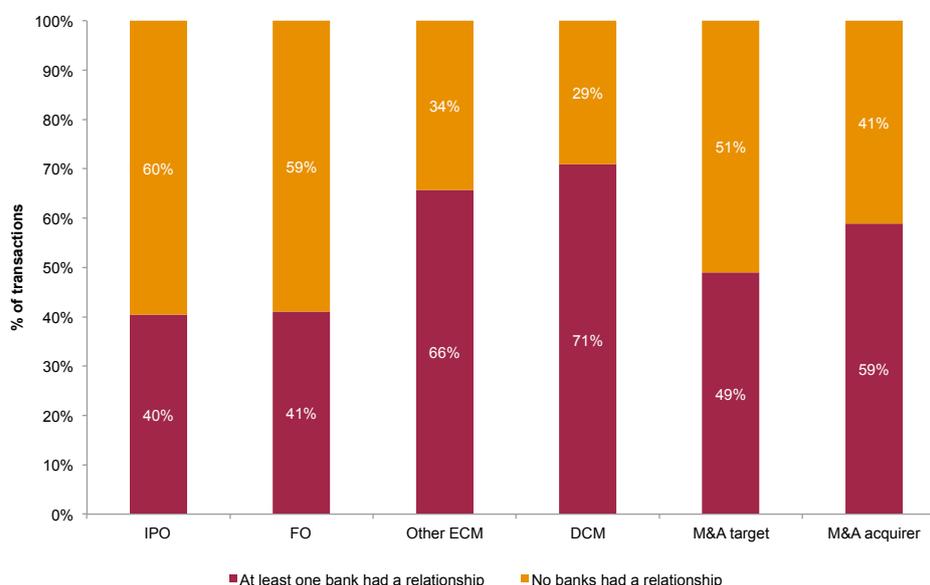
- ‘Other corporate banking’ relationships include corporate broking and other corporate finance activities, but exclude secondary market activities.<sup>87</sup>
- An ‘existing relationship’ is defined as where a bank has provided the relevant services (e.g. lending) in the two-year period prior to a specific primary market transaction. We refer to a bank that has provided services in that timeframe as a ‘relationship bank’.

**7.14** Our analysis is based on those transactions for which we have information. Where a bank or adviser did not provide a response to our request for information, we are not able to determine whether or not there was a previous lending, banking or broking relationship for that bank, so we have excluded those roles and/or transactions from our analysis.<sup>88</sup>

### **Transaction-level analysis**

**7.15** To assess the importance of lending and corporate banking relationships across different types of primary market transactions, we examined the proportion of ECM, DCM and M&A transactions where the syndicate included at least one bank that had provided lending or corporate banking services to the client in the preceding two year period. Figure 2 shows that lending and corporate banking relationships are most important in DCM where 71% of transactions included at least one relationship bank, followed by M&A (49% to 59% of transactions) and ECM (40% to 66% of transactions).<sup>89</sup>

**Figure 2: Corporate client transactions by whether the syndicate included at least one bank that had provided lending or corporate banking services to the client in the preceding two year period, January 2014 – May 2015**



Source: FCA analysis of transactional data described in Annex 2.

Notes: The sample includes 104 IPO, 462 follow-on, 67 other ECM, 1402 DCM, 327 M&A target and 260 M&A acquirer transactions.

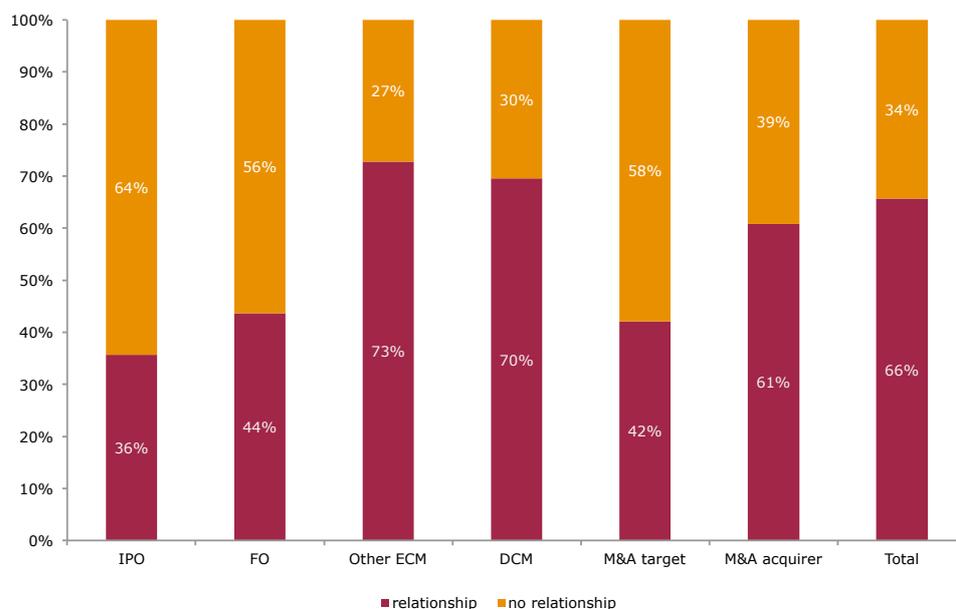
- <sup>87</sup> Our data did not allow us to separate out corporate broking from corporate banking more generally as we did not collect information separately for corporate broking.
- <sup>88</sup> We have no reason to believe that the proportion of existing relationships in our data for which we have such information would be any different from all transactions.
- <sup>89</sup> For DCM, the 71% is a lower bound and the 29% is an upper bound, because it is likely that for some transactions for which we found that no banks had a relationship, there will be banks that did not provide information that did have a pre-existing relationship.

**7.16** We then focused on DCM, where pre-existing lending and corporate banking relationships were most important, and assessed whether banks that had not provided clients with lending or corporate banking services were able to secure mandates on transactions where relationship banks were in the syndicate. We found that, of the 71% of DCM transactions with at least one relationship bank, 43% of these syndicates also included at least one non-relationship bank.<sup>90</sup>

### **Role-level analysis**

**7.17** We then conducted this analysis on a role-level. For the same period, we compared the proportion of roles that had been awarded with or without an existing lending or other corporate banking relationship. We conducted this analysis across each of ECM, DCM and M&A and on the basis of fee revenue and number of roles awarded. This analysis is summarised in Figure 3. Annex 6 includes further details on this analysis and the underlying data.

**Figure 3: Proportion of roles of banks which have or have not provided lending or other corporate banking services in the 2 years prior to the transaction, January 2014 to May 2015**



Source: FCA analysis of transactional data described in Annex 2.

**7.18** Figure 3 shows that only 34% of the roles across ECM, DCM and M&A were awarded to banks which did not provide lending or banking services in the two years prior to the transaction. 66% of the roles (accounting for 71% of the fees – as shown in Table 1 in Annex 6) were awarded to a bank or adviser that also provided a lending or corporate banking service in the two years prior to the transaction. The importance of pre-existing relationships appears strongest in DCM and other ECM (convertible debt) and weakest in IPOs and follow-on ECM.

<sup>90</sup> In the remaining 57% of transactions we did not have information as to whether the other syndicate banks had an existing relationship or not. Due to data limitations, we were not able to carry out a detailed analysis of the proportion of syndicate members that had or had not provided lending or corporate banking services in the previous two years. We did not have information on lending and corporate broking services provided to the client by all syndicate members because some syndicate members were not captured by our information request and not all syndicate members that responded to our information request provided information on their past relationships with clients.

### **Client type and size analysis**

- 7.19** In order to better understand the importance of cross-selling transactional services from relationship services for different types of client, we repeated the role-level analysis on the basis of client types and sizes, respectively. The analysis is set out in more detail in Tables 2 to 4 in Annex 6. The results suggest that the proportion of roles awarded to a relationship bank is less for small corporate clients than for large corporate clients. Small corporate clients mandated 48% of roles to banks with which they had an existing lending or banking relationship, and medium-sized corporate clients and large corporate clients 51% and 75% of roles, respectively.
- 7.20** Given the high proportion of primary market transaction roles awarded by clients to those banks with a pre-existing lending or corporate banking relationship, we wanted to understand whether one type of relationship was more important than another for different types of services or clients. We were told by stakeholders that banks and advisers secure subsequent transactional mandates mainly following the provision of corporate lending and corporate broking. We therefore analysed in more detail the nature of the relationship between each of these services and primary market transactions. We consider each in turn.

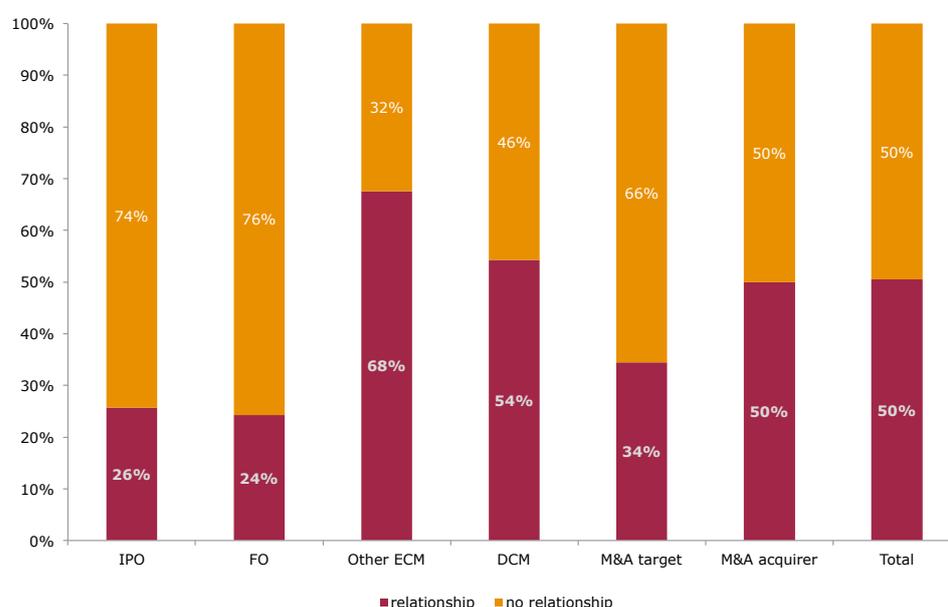
### **Prevalence of cross-selling and cross-subsidisation between corporate lending and transactional services**

- 7.21** Lending facilities, such as RCFs and bilateral loans, are a key part of the ongoing relationship between a bank and its client. The link between lending and subsequent primary market transactional services is based on the nature of the relationship between the bank and its client:
- On the supply-side, banks have an expectation of being rewarded with mandates for future primary market transactions once lending facilities have been established with clients. For the majority of banks, the decision to provide a lending facility to clients is assessed on the expected 'share of wallet' generated on potential future services. Many banks told us that the decision to extend a lending facility and the subsequent monitoring of its performance is undertaken by a lending committee. These lending committees are responsible for overseeing the client relationship and assessing the client's long-term profitability. While banks do not necessarily expect a client to be profitable in the short-term, periodic profitability reviews, which are sometimes communicated to clients, reinforce the expectation that clients need to reward lenders with subsequent transactional business.
  - On the demand-side, we were told (particularly by large corporate clients) that clients seek access to low cost lending. A number of banks stated that a significant proportion of their clients require them to offer lending facilities in order to be considered for future primary market transactions. Several banks also stated that large corporate clients request low cost lending on the basis that they will 'reward' lenders with subsequent transactional services.
- 7.22** Banks stated that lending relationships are most important in securing DCM transaction mandates. One bank commented that it had not been approached to provide DCM services by a client with which it did not already have an existing lending relationship. Several banks stated that they had been unsuccessful in securing mandates and/or securing senior roles on DCM transactions because they were not a lending bank to that client.
- 7.23** A number of banks commented that the existence of a lending relationship was also a factor in cross-selling ECM and M&A services. However, the absence of a lending relationship was perceived to be less important when competing for IPOs or corporate finance advisory services.

### Role-level analysis

**7.24** We next used the transactional data to analyse the importance of an existing lending relationship. For the period January 2014 to May 2015, we compared the proportion of roles that had been awarded with or without an existing lending relationship. We conducted this analysis across each of ECM, DCM and M&A and on the basis of number of roles and fee revenue. The results of this analysis of number of roles are set out in Figure 4 and the analysis on the basis of fee revenues is set out in Table 5 in Annex 6.

**Figure 4: Proportion of roles of banks which have or have not provided lending in the 2 years prior to the transaction, January 2014 to May 2015**



Source: FCA analysis of transactional data described in Annex 2.

**7.25** Figure 4 is consistent with banks' assertions that the existence of a lending relationship is an important factor in whether a bank is subsequently able to sell primary market transaction services. 50% of roles were awarded to a bank which had also provided lending facilities in the previous two years. The strength of this relationship is greater for some services than for others:

- DCM: 54% of roles (63% on the basis of fee revenue) were mandated to banks that had provided a client with a lending facility in the previous two year period.
- ECM: an existing lending relationship was less important for IPOs and follow-on ECM (with only 26% and 24% of roles awarded to banks with a lending relationship in the prior two years). However, a lending relationship was important for other ECM (convertible debt) – 68% of roles were awarded to banks with a lending relationship in the previous two years.
- M&A: 34% of roles on sell-side and 50% on buy-side M&A transactions (38% and 64% by fee revenue) were undertaken where the bank had provided a client with a lending facility in the previous two year period.

**7.26** In order to understand better the importance of cross selling transactional services from an existing lending relationship at a client level, we repeated this analysis for different client types and sizes. Our analysis is set out in more detail in Tables 6 to 8 in Annex 6. The analysis showed

the same pattern to our findings in paragraph 7.19, i.e. that the proportion of roles awarded to a lending relationship bank is less for small corporate clients than for large corporate clients.

**7.27** Given the importance of the lending relationship in awarding primary market roles, we examined the size of lending syndicates in further detail.

#### **Importance of lending syndicates**

**7.28** Several clients told us that they use their group of lending banks to create competitive tension for primary market transaction mandates. Competition between lending syndicate members might help to drive down fees for transactional services and increase service quality.

**7.29** Some clients gave examples of the extent to which they create competitive pressure between lending banks for transactional mandates:

- One large corporate client asked selected syndicate banks to pitch for each DCM transaction it proposes to undertake.
- Several clients stated they have regard to the proportion of their total share of wallet awarded to each of their lending banks. One large corporate client said that banks that have provided funding in the form of an RCF are rewarded with all of its transactional and ancillary business.
- Another large corporate client stated that it reviews its distribution of fees to banks providing it with an RCF on an annual basis. It directs a greater proportion of its share of wallet to those banks that have provided the greatest level of commitment. It said that transactional services are typically only awarded outside of its lending banks where it requires a specific capability (for example, access to a niche market).

**7.30** Banks also commented on how syndicate size affects competition for primary market mandates. They stated that in larger lending syndicates there can be increased competitive pressure when awarding primary market mandates.

#### **Variations in lending syndicate size by client size**

**7.31** To assess the extent to which clients may be able to create competitive pressure between lending syndicate members when awarding mandates for transactional services, we compared lending syndicate sizes for RCFs and term loans that were originated or refinanced in 2014 and 2015.<sup>91</sup> We considered the number of syndicate members as an indicator of the likely intensity of competition for future transactional business.<sup>92</sup> We focused on corporate clients as any concerns are most likely to arise in respect of this category of client (see Chapter 5).<sup>93</sup>

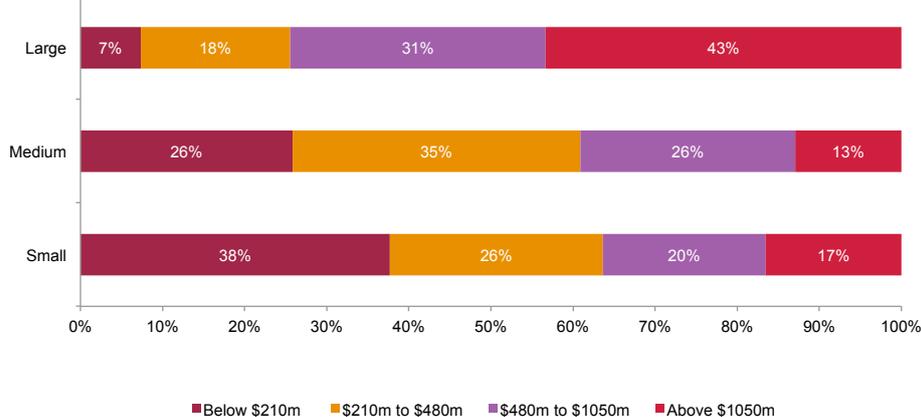
**7.32** We examined how loan sizes and lending syndicate sizes varied for corporate clients of different sizes. Figure 5 shows variation by loan size and Figure 6 shows variation by lending syndicate size.

<sup>91</sup> RCFs and term loans accounted for 94% of loans by number of loans and 87% of loans by loan value. In our analysis, we used the number of syndicate members reported in Dealogic. For more information on sample coverage, see Annex 2.

<sup>92</sup> Syndicate size might understate the extent of competition because there may be other banks with whom the client has a lending relationship or non-relationship banks may be asked to compete for a mandate for a transactional service. Syndicate size might also overstate the extent of competition if some of the banks on a syndicate are not credible competitors for transactional business or only some of the syndicate banks are put into a competitive process for the transactional business.

<sup>93</sup> The analysis provides for a limited dataset of existing lending relationships between banks and clients. It does not include loans that were originated before 2014 but remained in place in 2014 and 2015. The analysis is also not able to control for clients with multiple syndicate loan relationships and the small proportion of corporates who originated or refinanced more than one syndicated loan.

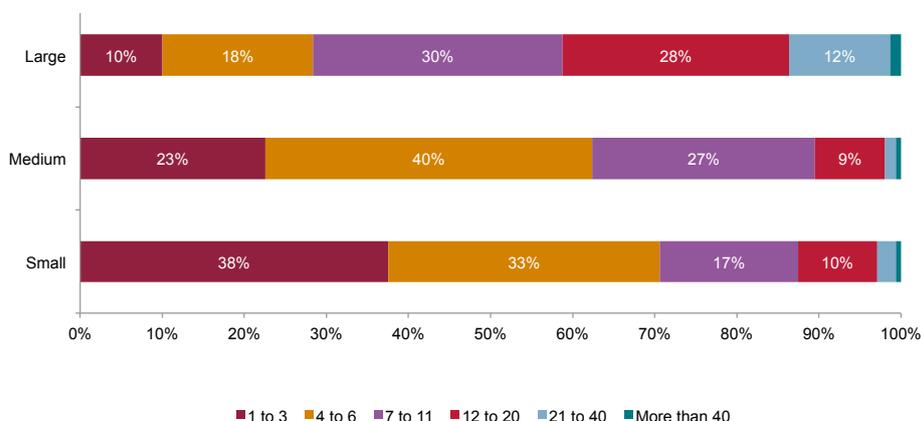
**Figure 5: Proportion of loans of various sizes by client type, January 2014 to May 2015**



Source: FCA analysis of transactional data described in Annex 2.

Note: The sample included 1282 RCF and term loans (533 loans originated or refinanced by small corporates, 271 by medium-sized corporates and 478 by large corporates).

**Figure 6: Proportion of syndicates of various sizes by client type, January 2014 to May 2015**



Source: FCA analysis of transactional data described in Annex 2.

Note: The sample included 1448 RCF and term loan syndicates (613 originated or refinanced by small corporates, 306 by medium-sized corporates and 529 by large corporates)

**7.33** We found that large corporate clients tend to have larger lending syndicates than small and medium-sized corporates. A significant proportion of small and medium-sized corporate clients have relatively small loan syndicates. This is because large corporate clients typically have larger loans (see Figure 5) and therefore banks need to spread the associated greater underwriting risk across a larger syndicate (see Figure 6). For example, 75% of large corporate clients had originated or refinanced a loan above \$480m compared to 39% of medium-sized corporate clients and 36% of small corporate clients.

**7.34** A significant proportion of loans held by small and medium-sized corporate clients had a relatively small syndicate:

- 38% of loans to small corporate clients were provided by a syndicate of one to three banks and 33% of syndicates had four to six members

- similarly, only 40% of loans to medium-sized corporate clients were provided by syndicates with four to six members and 23% had one to three syndicate members

**7.35** In comparison, most loans provided to large corporate clients had a larger number of syndicate banks, with 72% of loans having seven or more members.

**7.36** Although some clients indicated a willingness to engage providers outside of their group of existing relationship banks, the majority of clients stated that they awarded their primary market mandates to their lending banks. Those clients with smaller lending groups that only seek to award within their lending banks may have limited ability to create competitive pressure for primary market mandates.

#### **Cross-subsidised lending**

**7.37** We examined the nature of the relationship between lending and transactional services. In particular, we considered whether lending is sustainable on a stand-alone basis or whether it is cross-subsidised by transactional services.

**7.38** The evidence received to date indicates that facilities such as RCFs are often not profitable on a stand-alone basis. In their written responses and our engagement with stakeholders, many banks stated that the return generated by these facilities and other loans is uneconomic on a single service basis and that they need to generate future transactional business.

- Many banks confirmed that lending services are provided below the internal hurdle rate or even below their cost of capital, and can also make a negative contribution to profitability. One bank said that it sees lending as a cost of doing business and that it typically loses £1m to £2m per annum per client on its lending business. Another bank said that when it enters into a lending relationship, it typically does so at a loss.
- Banks stated that transactional services mandates were needed to support the lending business, such that lending would not be sustainable on a stand-alone basis. One bank also commented that investment grade loans are rarely viable on a stand-alone basis.
- Banks also commented that the decision to provide lending facilities and on what terms is typically taken by a lending committee, which assesses the overall profitability of a client based on the likelihood of future transactional business. One bank said that “on average one loan per week needs to be approved because it is provided below market price levels in anticipation of getting future business from the same client”.

**7.39** Looking at banks’ internal strategy documents, we observed banks considering cross-subsidisation of lending in return for potential future transactional fees. For example:

- When reviewing the relationship with one client, one bank observed that: “[We have] a strong relationship with [this client] dating back [many years]. While returns on the loan have traditionally been below hurdle, overall returns have been supported by the longstanding relationship in [this country] where we have been house bank”.

- One bank stated that: “Lenders continue to justify margins below their cost of funds if the facilities are expected to be undrawn and/or there is a convincing ancillary business opportunity”.
- One bank produced a chart which showed that the return on equity from lending is lower than the return on equity from the overall relationship with clients.
- Similarly, a team within a bank recommended offering an RCF with a negative return on equity to a client. It noted that this was “in line with what we see as European market standard for this risk grade”. It also estimated that the overall relationship return with that client was [a larger percentage] based on existing cross-selling.

**7.40** The evidence received to date indicates that lending is often provided at a low or no return (and below a price that would prevail absent any cross-selling) in order to establish a banking relationship. Having received consistent evidence of lending at cross-subsidised rates, we considered that undertaking a detailed profitability analysis to identify the size of the cross-subsidisation would not be proportionate and would be unlikely to provide further material evidence that would alter our assessment of whether the cross-subsidisation would represent a barrier to entry and whether this has a negative impact on competition in terms of higher prices or limited choice of supplier.

#### **Prevalence of cross-selling and cross-subsidisation between corporate broking and transactional services**

**7.41** Clients value knowledge and sector experience from their banks. They seek advice on managing shareholder and investor relations and require regular (often daily) market soundings in order to inform their business decision-making.

**7.42** Banks and advisers stated that the provision of corporate broking services is a key way to become a ‘trusted adviser’ and is a driver of primary market transactional services, as it enhances the bank’s knowledge of the client and its ability to anticipate the client’s expected future requirements. Banks and advisers who approach clients with good advice and novel ideas are more likely to be awarded future transactional services mandates. A number of banks highlighted the importance of maintaining a strong corporate broking relationship, stating that they would be placed at a material competitive disadvantage if they did not provide such services.

**7.43** Banks and advisers suggested the importance of corporate broking in winning transactional mandates varied according to the primary market service:

- The majority of banks and advisers stated that maintaining a corporate broking relationship with a client was central to their ability to win mandates for subsequent ECM transactions. Several banks noted that the corporate broking relationship was a main driver of the banks’ ability to advise on follow-on ECM deals. This is because it would be very difficult to add value to transactions without in-depth knowledge of the client and its investors. Issuer clients also said that corporate brokers are naturally best placed to lead future ECM transactions (see Annex 3).
- Similarly, in the context of M&A, the existence of a corporate broking relationship is also seen to be an important factor in securing future transactional mandates. This is mainly because of a client’s desire to maintain confidentiality in respect of a future potential transaction. In such situations, clients maintained a ‘close hold’ by limiting the number of participating advisers, often appointing their existing corporate broker who have the requisite knowledge of their business.

- In contrast, a number of banks and advisers stated that a lack of an existing corporate broking relationship is less critical to the ability to secure DCM transaction mandates.

### **Role-level analysis**

- 7.44** We analysed the importance of an existing corporate banking relationship based on the transactional data. As we only collected data for corporate banking services (which included corporate broking relationships) provided in the prior two years, we did not have separate data on corporate broking relationships. We therefore used the data on corporate banking relationships as an indicator for the importance of corporate broking, albeit we recognised that this included other corporate finance activities. Our measure for the proportion of roles awarded to those banks with an existing relationship therefore represents an upper bound of the importance of corporate broking because it may include transactions where the bank had provided services other than corporate broking prior to the transaction and the proportion of roles awarded to banks without such a relationship is a lower bound.
- 7.45** For the period January 2014 to May 2015, we compared the proportion of roles that had been awarded with or without an existing corporate banking relationship. We conducted this analysis across each of ECM, DCM and M&A and on the basis of fee revenue and number of roles.
- 7.46** The analysis is set out in Table 9 of Annex 6. The analysis shows that 49% of roles on primary market transactions are awarded to banks which have provided corporate banking services in the two year period before the transaction (52% on the basis of fee revenue). The importance of a previous corporate banking relationship varies depending on the transactional service:
- With regard to ECM, between 25% (on IPOs) and 42% of roles (on other ECM) (and between 21% (on IPOs) and 55% (on follow-on ECM) by fee revenue) were undertaken by banks or advisers that had a pre-existing corporate banking relationship.
  - In relation to DCM, a pre-existing relationship was more important compared with ECM, with 52% of DCM roles (and 54% by fee revenue) undertaken by banks or advisers that had a pre-existing corporate banking relationship.
  - For M&A, 23% of sell-side and 33% of buy-side roles were undertaken by a bank or adviser which had a pre-existing corporate banking relationship (and on the basis of fee revenue 9% and 27%, respectively).
- 7.47** We also analysed the extent to which a pre-existing corporate banking relationship was important on the basis of client type and size. The analysis is set out in Tables 10 to 12 in Annex 6. It shows that the proportion of transactional services awarded to a bank with an existing corporate banking relationship is again lower for small and medium-sized corporate clients than for large corporate clients.
- ### **Cross-subsidised corporate broking**
- 7.48** The fee paid for corporate broking services varies, and it is often provided for free. Whether a client pays a retainer fee will depend primarily on the size of the client. One bank stated that there is an inverse relationship between the size of the client and the retainer fee paid. The banks said that the inverse relationship reflects, in part, the cost associated with the amount of time and education required to be invested in small corporate clients.
- 7.49** We asked smaller banks and advisers, who we were told are the main providers of corporate broking services to smaller corporate clients, to provide us with an indicative range of the retainer fees they charge to clients. One bank estimated retainer fees for AIM-listed clients

at £70,000-£75,000 per year and others stated that retainer fees for a small company listed on the LSE ranged between £50,000-£75,000 per year. Another investment bank stated that retainer fees might reach £100,000 where a more comprehensive service is provided. In our engagement with stakeholders, banks confirmed that these fees are insufficient to cover the cost of providing the service.

**7.50** Clients above a certain market capitalisation, typically FTSE 250 and FTSE 100 companies, usually receive corporate broking services free of charge. One bank stated that it had considered providing corporate broking services on the basis of a retainer in order to recover part of the cost, but ultimately determined to provide these services free of charge and gain a return through the corporate cycle. Another bank stated that it provides corporate broking free of charge as this coverage of a client materially increases the opportunity to participate in any equity offerings. A number of banks commented that it is market practice to provide such services free of charge and stated that they do not charge retainer fees. This was consistent with views we received from large corporate clients. These clients confirmed they do not pay for corporate broking services (see also Annex 3).

**7.51** A price equal to zero or below cost clearly indicates that the service is cross-subsidised. Given this evidence, and consistent with our view in paragraph 7.40, we did not consider it necessary or proportionate to conduct detailed profitability analysis to assess the extent of the cross-subsidisation further.

#### **Prevalence of cross-selling between transactional services**

**7.52** Where banks provide primary market services to a client, we assessed the extent to which clients mandate the same bank for subsequent primary market transactions. There may be a number of reasons for this, including cost savings, the high quality nature of the prior service provided, because they in some way feel compelled to do so, or because the credentials of the bank continually meet the client's needs.

**7.53** For the period January 2014 to May 2015, we compared the number of roles on each of ECM, DCM and M&A transactions that had been awarded to banks that had or had not provided primary market transaction services in the prior two years. The results of this analysis are set out in Table 13 in Annex 6. The analysis shows that 79% of the roles on primary market transactions were mandated to a bank which had provided other transactional services to the same client in the previous two year period.

**7.54** We then analysed differences by client type and size in the importance of prior provision of transactional services. The analysis is set out in Tables 14 to 16 in Annex 6. It shows that the proportion of transactional services awarded to banks which had provided such services in the previous two year period is slightly lower for medium and small corporates compared with large corporate clients. Approximately 76% of large corporate clients' roles, 56% of medium-sized corporate clients' roles and 60% of small corporate clients' roles, respectively, were mandated to an investment bank that had supplied other primary market services to that client in the previous two years.

#### **Prevalence of bundling and cross-subsidisation between transactional and ancillary services**

**7.55** Banks and advisers offer a wide range of ancillary services alongside primary market activities. We sought to understand which ancillary services are typically sold with which primary market services, how they are sold, and whether there is cross-subsidisation between transactional and ancillary services.

### Which ancillary services are typically sold with which primary market services, and how?

**7.56** Ancillary services offered by banks and advisers vary depending on the primary market activity. For each primary market activity, these services include:

- ECM: advisory services, lending, agency services, foreign exchange derivatives, NOMAD or broking services and research.
- DCM: derivatives (typically interest rate derivatives<sup>94</sup>), agency services, ratings advisory services, liability management and lending.
- M&A: financing (or bridge financing), advisory services, derivatives (more commonly on foreign exchange) and NOMAD or broking services.

**7.57** Some banks and advisers distinguished between ancillary services that are viewed as part of the provision of a given primary market transaction service and other ancillary services which are considered as additional to these services. For example:

- Arrangement of road shows is typically included in an IPO mandate. The scope of and fees for these services are negotiated as part of the IPO mandate and a single fee is usually paid. Similarly, for DCM services, ratings advisory services are often included within the fee for the DCM mandate. As such, road shows and ratings advisory services are less of an 'ancillary' service in our terminology.
- In contrast, foreign exchange hedging and foreign exchange transactions are services that are only required for certain types of IPOs and are negotiated separately. Such ancillary services are typically covered in a separate engagement letter with a separate fee. Providers of such ancillary services are often chosen in a separate process.

**7.58** With the exception of road show arrangement and ratings advisory services, we found little evidence that transactional and ancillary services are sold as a pure bundle. Ancillary services are usually either sold as a mixed bundle or cross-sold from transactional services. As many ancillary services are often priced separately, issuers are able to procure these services from a range of banks, usually within the syndicate. However, evidence from our engagement with banks and clients suggests that ancillary services are often purchased from a bank or adviser that has provided the transactional services.

### Cross-subsidisation between transactional and ancillary services

**7.59** Banks and advisers typically measure clients' profitability through the amount of total business generated (one bank stated that one profitability measure is the amount of ancillary services cross-sold to the client). However, cross-subsidisation from ancillary services to primary market transactional services do not seem as important as for lending and corporate broking:

- For ECM transactions, only one bank stated that it would be unwilling to provide IPO services without a mandate for providing an ancillary service (in that case, research).
- For DCM activities, only one bank stated that it would be unwilling to work on an underwritten transaction where it might incur a potential loss, unless there would be additional revenues from other products.

<sup>94</sup> The responses to our information request do not allow us to distinguish between interest rate and foreign exchange derivatives for each transaction.

- For M&A service, in contrast to other primary market services, some banks and advisers said that they would not provide M&A advisory services without certain ancillary services. For example, some banks and advisers said they would not accept an M&A advisory mandate without also being mandated as a sponsor due to the synergies between provision of sponsor services and advisory services.

### The use of contractual clauses to aid cross-selling

**7.60** We considered the extent to which the inclusion of certain types of clauses in client engagement letters reinforces cross-selling. We asked banks and advisers whether their agreements with clients cover the award of any future mandate and to send us the three most recent engagement letters for any ECM, DCM, M&A, and (active and passive) syndicated loan transactions. 64 Banks and advisers responded to this part of our information request and submitted relevant engagement letters for review. Based on our review of the sample of recent engagement letters, we observed two broad categories of clauses frequently included in engagement letters:

- **Right to pitch or right to provide a quote to act** as well as clauses providing banks with ‘an opportunity to offer [their] services’ or ‘the first option to submit a proposal’. Variations of these types of clauses include the ‘right to match’ the terms of any other bank considered for a mandate, “the first opportunity to offer”, the right to discuss the terms of a future appointment with clients, as well as the right to be “considered in good faith alongside other providers”. The purpose of these clauses is to ensure that clients will at least consider certain banks when procuring future investment banking services.
- **Right of first refusal or right to act** are the most restrictive and frequently included clauses in engagement letters in respect of future mandates. There are a number of different types. A ‘right of first refusal’ precludes clients from accepting a third-party offer to provide future transaction services without first offering a mandate on the terms proposed by the third party to the holder of the right. The engagement letter may also include a ‘right to act’, which is generally not linked to a to-be-matched third parties’ offers. These types of clauses have a similar effect. In practice, they confer the bank the right to act on a subsequent mandate should they wish to do so.

**7.61** The clauses are most often valid for the duration of the engagement letter (i.e. until the relevant transaction has been completed) or until the client or the bank decides to terminate the engagement. In several engagement letters, the clauses cover a period of up to 24 months following the termination of the initial engagement. Moreover, the term of engagement for corporate broking and NOMAD services is often indefinite.

**7.62** Our review of banks’ engagement letters indicated that these are included in corporate broking, NOMAD, ECM, M&A and DCM engagement letters:

- **Corporate broking and NOMAD engagement letters:** In the majority of cases these clauses were used to link corporate broking and NOMAD services to ECM and M&A roles, and on occasion DCM activities. In one example, a bank required the client to offer it a role for any investment banking services the client may require during the term of the engagement (which was indefinite). Right of first refusal or right to act clauses were used in the vast majority of these engagement letters.
- **ECM engagement letters:** These clauses were typically used to link ECM services with follow-on ECM services or corporate broking, and occasionally M&A or DCM activities.

In one example, a bank required a client to offer to appoint it in any M&A, DCM, ECM, foreign exchange and interest rate swap transaction for a period of 18 months following the conclusion of the engagement. In another example, two banks included in an engagement letter relating to an IPO a right of first refusal for future M&A transactions. In approximately half of the ECM engagement letters reviewed, right of first refusal or right to act clauses were used.

- **M&A engagement letters:** The roles and services linked to advisory roles in M&A transactions covered a broad range of investment banking services, including equity and debt issuance, further M&A transactions, lending and interest rate, foreign exchange or any other hedging transactions.
- **DCM engagement letters:** A number of banks linked their engagement in DCM transactions to future investment banking services. For example, one bank linked a number of services to its role as the lead book-runner in a number of DCM transactions. Another bank linked its initial DCM role to a specific related transaction, where it was appointed as debt financing and ratings adviser to the client for a proposed acquisition of a company. It obtained the right to (i) pitch as debt finance provider and (ii) match engagement terms offered by any other adviser for that role and, in that case, be appointed (provided that that was in the best interest of the client).

**7.63** Overall, 27 banks included in their engagement letters contractual clauses aimed at securing future primary market transactional services. On the basis of the sample of reviewed engagement letters, we found that:

- The majority of the larger banks use or seek to use these clauses in engagement letters.
- Six banks submitted template engagement letters for corporate broking and NOMAD roles, ECM and/or M&A services which included right of first refusal, right to act or right to pitch clauses for other investment banking services.
- The remaining 21 banks either submitted engagement letters for ECM, M&A or DCM transactions and for corporate broking and NOMAD services that included clauses that cover the award of future mandates; or they commented that their engagement letters might include clauses covering the award of future mandates, but none of the sample engagement letters they submitted included such clauses.

#### **Benefits and restrictions from such clauses**

**7.64** Banks and advisers using such clauses typically explained that they are not enforced and not enforceable. Even if that is the case, when asked about the benefits for clients, banks and advisers did not put forward any positive justification. We were told by one adviser that some banks have been aggressive in trying to enforce such clauses and that some clients had to pay a fee to walk away from the restriction.

**7.65** Banks and advisers argued that such clauses only create a moral obligation for the client to work with them. Some said that in certain circumstances there were synergies, but that these related to specific situations, such as a bridge to bond. We have not received clear evidence that clients were able to negotiate a benefit (such as lower fees) when committing to such clauses. We would welcome evidence on what benefits clients may receive from such clauses.

**7.66** The effectiveness of cross-selling between primary market transactions and from corporate broking to transactional services may be increased where banks seek to include contractual provisions in engagement letters which have the intention of morally or legally obliging the

client to award future business to the given bank. In such circumstances, right of first refusal or right to act clauses can restrict the client's choice of provider (especially if the client would otherwise have considered other banks for the future business, in particular those which cannot offer the service that is the object of the engagement letter). The impact of these clauses depends on the nature of the services being provided and the duration of the engagement set out in the engagement letter. The longer the time-frame of these clauses and the broader the scope of services they cover, the more they are capable of restricting client choice for a number of future transactions. Less restrictive clauses, such as right to pitch, are unlikely to provide a competitive advantage to the 'incumbent' bank and, therefore, do not raise concerns.

### **The potential adverse competition effects of cross-selling, bundling and cross-subsidisation**

**7.67** In this section we discuss the likelihood of potential adverse effects of cross-selling, bundling and cross-subsidisation, namely whether:

- cross-selling and cross-subsidisation represent a barrier to entry or expansion into (i) relationship services or (ii) transactional services
- cross-selling creates barriers to using non-relationship banks such that existing clients are then offered less advantageous terms and conditions by their relationship banks
- bundling of transactional services with ancillary services represents a barrier to entry or expansion into ancillary services
- cross-subsidisation leads to under- or over-consumption of services relative to a situation without the cross-subsidy

**7.68** Such cross-selling, bundling and cross-subsidisation also has potential benefits for clients which may at least partly offset such adverse effects. We discuss these potential benefits in paragraphs 7.86 to 7.88.

#### **Does cross-selling and cross-subsidisation represent a barrier to entry or expansion into relationship services?**

**7.69** Although the focus of our market study is on primary market services, we considered whether cross-selling of transactional services from cross-subsidised relationship services might act as a barrier to entry or expansion into relationship services. This can occur where rivals that do not provide transactional services cannot subsidise relationship services. This barrier to entry may arise where the relationship service is provided at a price which is below the cost of providing the service, such that a model of stand-alone provision of the relationship services is unlikely to be viable.

**7.70** We found above that fees for corporate broking and lending are lower than they would be absent cross-selling and cross-subsidisation. In the presence of cross-subsidisation many clients requiring lending or corporate broking may be expected to choose a stand-alone provider because they would be likely to face higher fees and/or less favourable terms. As a result a multi-service business model can compete more effectively in the provision of lending and corporate broking than a stand-alone one. The cross-subsidisation of corporate broking and corporate lending therefore appears to create some barriers to entry for those banks that do not wish to provide transactional services.

**7.71** However, as set out in Chapter 4, the observed entry and expansion into lending (for example, by ICBC) and corporate broking (for example, by FinnCap) suggests that the barriers to entry into relationship services are not insurmountable. In addition to cheaper lending and corporate broking, there are also a number of benefits to the cross-subsidised cross-selling model. We consider these benefits in paragraph 7.86 to 7.88.

**Does cross-selling and cross-subsidisation represent a barrier to entry or expansion into transactional services?**

**7.72** Cross-selling of transactional services from relationship services may act as a barrier to entry into transactional services by reducing the business available to rivals who do not offer relationship services (or offer them only to a limited extent). This may arise where rival firms are not able to replicate the same business model based on cross-selling and cross-subsidisation. We considered the extent to which transactions are available to banks and advisers not offering relationship services, and the challenges of competing with a cross-selling and cross-subsidised business model.

**7.73** As set out in Figure 2 and Figure 3 and paragraphs 7.11 to 7.20, the importance of relationship services in securing transactional mandates is reflected in the percentage of primary market transactional services purchased without an existing lending or corporate banking relationship. Our analysis showed that 34% of roles were awarded to banks that had no pre-existing lending or corporate banking relationship. This proportion was lower for large corporate clients compared with medium-sized corporate clients and small corporate clients. The proportion was also typically lower for DCM and other ECM (convertible debt) than for M&A acquisition advice.

**7.74** Our assessment of entry and expansion into transactional services is set out in Chapter 4. The interaction between relationship services and transactional services may create barriers to entry into transactional services (in addition to those already identified in Chapter 4). Corporate clients said that they use their lending group as a means to engage their banks in competition for transactional services (and in particular, DCM mandates) and banks said that the provision of corporate broking was a key driver of mandates for ECM transactional services.

**7.75** Assessing the evidence in the round and considering each primary market service separately, it appears that:

- In ECM, there has been little recent entry and expansion, in part due to market conditions. Entry that we have seen has been by banks that also lend or provide corporate broking. This is consistent with barriers to entry and expansion into ECM, including due to cross-selling. Our analysis suggests that the importance of existing relationships seems to be most relevant in other ECM transactions (which is mainly convertible debt) and not IPOs. Any harm from a barrier to entry into the provision of ECM services would need to be weighed against benefits to clients from such cross-selling (see paragraphs 7.86 to 7.88).
- For DCM, existing lending and corporate banking relationships are important and recent entry and expansion tends to have been from those banks with existing lending capabilities. Cross-subsidisation and cross-selling create barriers to entry and expansion for those providers not offering relationship services, in particular lending. New entrants need to be able to provide a range of services to win clients that are to some extent committed to their group of relationship banks. However, cross-subsidisation and cross-selling do not appear to cause such barriers for those banks which already offer lending and have entered recently.
- The number of recent entrants into M&A advisory suggests that cross-selling based on these services does not create a significant barrier to entry into providing such services or lead to reduced competition in the provision of M&A services. In particular, many of the new M&A

advisory firms do not provide ongoing relationship services. However, our analysis of the prevalence of cross-selling suggests that an existing relationship might be important for the provision of M&A acquisition advice (see Figure 3 and Table 1 in Annex 6).

### Does cross-selling create barriers to using non-relationship banks?

**7.76** As set out above clients tend to use banks with whom they have a pre-existing corporate banking or lending relationship or who they have mandated on previous transactional services. Clients might face a barrier to using a non-relationship bank if the cost to the client of establishing a relationship with another bank exceeds the cost of using a bank with which the client has a pre-existing relationship. As a result, banks and advisers might be able to offer less advantageous terms and conditions to their existing clients.

**7.77** We therefore considered whether conditions are present that might lead to existing clients being offered less advantageous terms, in particular:

- **Whether clients incur costs when establishing a new banking relationship, which might deter them from establishing that new relationship.** We found that there are inherent costs to a client associated with establishing a relationship with another bank. This may include procurement costs and time, the cost and time of dealing with a bank which does not know the client, and reputational risk and confidentiality concerns in respect of sharing business sensitive information with a new provider, particularly in the context of M&A transactions.
- **Whether fees are generally negotiated with clients, which would enable banks to charge some clients more than others.** We found that responses to our request for information suggested that fees are usually negotiated with clients on a case-by-case basis. We were told that fee levels and structures are often known to market participants given the presence of data providers and syndicated transactions. Many banks and advisers do not use a standard fee matrix for ECM and DCM deals (although some banks and advisers have a standard fee matrix for M&A services, which specifies fee levels for different value deals). Banks and advisers also stated that there are potential cost savings from serving an existing client on a repeat basis.

**7.78** Given these circumstances, which might allow a bank to charge existing clients higher fees, we considered whether clients with an existing banking relationship pay higher fees than new clients. We analysed to what extent, if any, clients that were provided with services from a bank or adviser in the two year period prior to the transaction paid a higher or lower fee compared with new clients. Our analysis was limited by the data we were able to collect, in particular in some cases we had a small number of transactions of comparable issues and for comparable client types. In such instances, we have only placed limited weight on the results. We focused our analysis on ECM and DCM transactions given our findings on the extent of entry into M&A advisory services. The analysis, set out in Annex 6, does not yield strong evidence that existing clients would face higher fees than new clients, but appears to suggest the opposite applies for some type of issues:

- For ECM transactions, fees paid by clients with a pre-existing relationship were lower for IPOs compared with those fees paid by new clients and very similar for follow on transactions<sup>95</sup> (see Table 17 in Annex 6).

<sup>95</sup> They are lower for clients with a relationship with some banks on the syndicate compared to those without any relationship.

- For DCM transactions, fees paid by clients with a pre-existing banking relationship tended to be lower on high yield corporate bonds compared with fees paid by new clients.<sup>96</sup> Only for investment grade corporate bonds did fees appear to be lower for clients without an existing relationship. For those of short maturity the differences appear small (see Table 19 in Annex 6).

**7.79** Our evidence suggests that, when carrying out primary market transactions, clients tend to use banks and advisers with whom they have an existing relationship. This observation is consistent with some barriers to clients using non-relationship banks caused by the costs to the client involved in establishing a relationship with a new bank. However, our analysis did not yield strong evidence that these barriers lead to higher fees for existing clients. To the contrary, for most types of transactions the fees paid by existing clients appear to be lower.

### **Does bundling of transactional services with ancillary services represent a barrier to entry or expansion into ancillary services?**

**7.80** Whilst banks and advisers seek to cross-sell a number of ancillary services with primary market activities, we identified little evidence that banks supply transactional and ancillary services on the basis of a pure bundle (see paragraphs 7.56 to 7.58). The evidence received to date indicates that investment banks are willing and able to sell transactional services on a stand-alone basis (i.e. without ancillary services). As set out in paragraph 7.57, the provision of many ancillary services is usually negotiated and charged separately.

**7.81** While some clients may 'reward' syndicate banks with subsequent ancillary service business, the provision of ancillary services is not a key criterion for clients in selecting a transactional service provider (see Annex 4, which shows that the provision of ancillary services is not considered among the most important criteria).

**7.82** Certain banks commented that there may be some small off-setting benefits in the form of bundle discounts. Some banks said they might offer a discount on the fee if they knew that they would be providing additional services and others stated fees would be negotiated on a case by case basis. The majority, however, said fees charged would not materially differ.

**7.83** Based on the above, and in the absence of expressions of concern from stakeholders in respect of this issue, we do not consider the bundling of ancillary services with transactional services to be likely to create barriers to entry or expansion into ancillary services.

### **Risk of under- or over-consumption of services**

**7.84** The evidence received to date demonstrates that lending and corporate broking services are often provided at a low return or loss in expectation of revenues from transactional services. Concerns may arise where clients procure too much of those services priced at a loss (in this case lending and corporate broking) and too little of the cross-subsidising services (in this case, the primary market transactional services) compared to a situation in which there is no cross-subsidy. For example, clients may demand too much lending and undertake too little debt or equity issues.

**7.85** We are not aware of any prudential concerns arising from over-consumption of lending by corporate clients, so long as banks are meeting capital adequacy requirements. We have not sought to investigate whether the levels of lending and primary market transactions are at an optimal level given the lack of concerns raised in this area and the difficulties in defining what

<sup>96</sup> An exception is fees paid by clients issuing high-yield debt with short maturity which appears to be very similar to fees paid by clients without a relationship with the banks on the syndicate.

such an optimal level would be. Instead we have focused on the underlying competition for provision of these services.

### Offsetting benefits of cross-selling, bundling and cross-subsidisation

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**7.86** Having assessed potential adverse effects on competition from cross-selling, bundling and cross-subsidisation, we considered whether there are any offsetting benefits.

**7.87** During engagement with banks, advisers and clients we were told of a range of benefits that arise from using a bank or adviser with whom the client has an existing relationship:

- Frequent engagement with a client means banks and advisers to develop **in-depth knowledge** of the client's business, allowing them to provide more tailored services to that client.
- Serving an existing client generates cost savings because it allows banks to **more accurately align their pricing with the risk of the client**. Cost savings may also arise in respect of ECM or DCM services because the work required to distribute and price the issue and assess risk is reduced.
- Bundling and cross-selling may give rise to **economies of scale and scope**. For example, the distribution network of a bank may be used to allocate different issues of a client to the same group of investors.
- Using a bank or adviser with whom a client has an existing relationship may also assist in managing **confidentiality concerns**, particularly in the context of M&A transactions.
- Other costs savings include the time saved in completing due diligence, 'know your client' and other on-boarding procedures.

**7.88** Many clients, particularly large corporate clients, also place value on the ability to access low cost lending and corporate broking. We understood that they prefer certainty of access to cheap lending and corporate broking services over potentially lower fees on transactional services.

### Interim findings

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**7.89** Investment banking is very much a relationship business with relationships strengthened both by cross-subsidised lending and corporate broking (including daily coverage) and by past primary market transactions.

- Many investment banks lend at a low rate of return or below cost on the basis that a sufficient overall return will be made through cross-selling primary market transactional services. Lending committees often consider the share of future transactional business that the bank expects to win over the lifetime of the loan.
- Similarly, corporate broking services are typically provided for low or no fee in the expectation that the bank will be rewarded with future transactional activity.

- 7.90** The concerns raised to us were not about the number of banks per se, but about the impact of this cross-subsidy on competition. In particular concerns were expressed that:
- clients may not always be free to award primary market mandates to the bank that best suits their needs, especially if there are barriers to using non-relationship banks
  - it is difficult for new entrants to break into primary market services without also offering lending and/or corporate broking
- 7.91** We looked at the link between lending/corporate broking and primary market roles awarded to banks, and found it to be strongest in DCM and other ECM (convertible debt) transactions and advice on M&A acquisitions. We found that around two-thirds of roles awarded in these transactions were awarded to those banks with whom the client had an existing relationship, however the link is significantly weaker for IPOs.
- 7.92** To a large extent this 'quid pro quo' is a commercial expectation, but we also found that the majority of the larger banks use or seek to use contractual clauses that restrict a client's choice in future transactions. We found no clear evidence that these contractual clauses were generating better terms on the initial service.
- 7.93** Consistent with the pattern of quid pro quo, we found that entry and expansion in book-running in ECM and DCM tends to be by banks that also lend, whereas a number of boutique advisers successfully provide M&A advice (for example, Moelis & Co. and Perella Weinberg).
- 7.94** Large corporate clients, who want access to cheap lending, establish lending panels with a wide range of participating banks, who then compete against one another on primary market mandates. This enables the client to choose the best bank for a particular mandate provided that over time each bank wins sufficient business to warrant it continuing the lending relationship. We heard that, on occasion, however, clients, particularly medium-sized and small corporate clients, who typically have fewer banking relationships than large corporate clients, feel the need to 'reward' a lending bank or corporate broker with transactional business even when that bank would not otherwise have won a mandate.
- 7.95** Based on these findings, we do not see grounds for widespread intervention at this time, but we are concerned about the practice of banks using contractual clauses to restrict client choice and propose to address this.
- 7.96** We found that there are unlikely to be significant concerns in the following areas:
- The cross-subsidisation of corporate broking and corporate lending appears to create some barriers to entry for banks that do not wish to provide transactional services. However, there has been some entry and expansion into lending and corporate broking, which suggests that the barriers are not insurmountable. For these reasons we do not consider that any barriers to entry and expansion in relationship services generated by cross-subsidisation are likely to cause harm to clients procuring such services.
  - There is little evidence that banks supply transactional and ancillary services on the basis of a pure bundle and so harm from such bundling appears unlikely. Although some clients may 'reward' syndicate banks with subsequent ancillary service business, the provision of ancillary services appears not to be an important criterion for clients in selecting a transactional service provider. Bundling of ancillary services with transactional services is therefore unlikely to create barriers to entry or expansion into ancillary services.

- We are not aware of any prudential concerns arising from a possible higher use of lending by corporate clients than in absence of cross-subsidisation, so long as banks are meeting capital adequacy requirements. We have not sought to investigate whether cross-subsidisation leads to a situation where the levels of lending and primary market transactions are not at an optimal level given the lack of concerns raised in this area.

## 8.

# Fee outcomes and service quality

### Chapter summary

We considered fee outcomes and service quality on primary market transactions.

Fees are typically negotiated on a transaction by transaction basis, as a percentage of the transaction value. They comprise a base fee and, sometimes, a discretionary fee, paid at the client's full discretion.

Discretionary fees allow clients to vary the fee the bank receives after the transaction based on their assessment of the quality of service received, acting as an incentive for banks to provide better quality service. Discretionary fees are most popular in IPO transactions, but less so in DCM and M&A. For IPOs, the prevalence of fee structures with a discretionary fee element increases as transaction size increases.

For most types of services, fees for transactions with similar characteristics vary because fees are negotiated on a transaction by transaction basis.

Comparing EMEA average fees with average fees elsewhere in the world we find that in the US fees for IPOs, follow-on ECM transactions, corporate investment grade bonds and high yield bonds are higher than in EMEA and South East Asia. Fees in Asia are in some cases lower than in EMEA and are diverse across countries.

Some clients noted that they were happy with the quality of service provided. Quality of service is, however, very difficult to measure and we have not attempted to measure how it differs across the market and whether 'lower quality' providers charge lower fees.

Much of the evidence presented in this chapter is necessarily high level. We invite comments on this evidence, including observations on service quality and any explanations for the fee outcomes we observe.

- 8.1** The amount clients pay in fees, the quality of service they receive and the choices available to them are all key outcomes of the competitive process and thus an important way to assess if a market is working well for clients. These outcomes should, however, be considered together with our assessment of underlying market features and the behaviour of clients and banks.

- 8.2** In this chapter, we assess the overall level of fees paid for primary market services and how much they vary.<sup>97</sup> We also consider the quality of service provided. Our analysis of clients' choice of suppliers is set out in Chapter 5.

### Fee outcomes

- 8.3** In this section we examine the setting of fees and fee levels for the main types of ECM, DCM and M&A services<sup>98</sup> as follows:

- **Fee setting:** We consider whether the way in which fees are determined and structured encourages effective competition. In particular, we focus on the use of discretionary fees and the extent to which discretionary fees are used on transactions of different sizes.
- **Fee levels and variability:** We consider the overall level and variability of fees for different types of primary market services. We assess whether fees vary for ECM services with the size of the transaction, and for DCM services with the size, maturity and rating of the transaction. We then provide a high level comparison of fee levels in EMEA, the US and South East Asia.

- 8.4** We have not assessed in any detail the extent to which fees reflect costs and quality of service.

- For costs, we consider that determining appropriate cost allocations, particularly in the context of cross-subsidisation, would require too many assumptions and be unlikely to produce meaningful results.
- In relation to service quality, we have not assessed differences in quality of service across the market due to difficulties with measuring quality of service based on transaction outcomes. This is because transaction outcomes are influenced by factors other than quality of service. We have considered the views of clients in paragraphs 8.48 to 8.56.

### How are fees determined?

- 8.5** Fees tend to be negotiated on a transaction by transaction basis. Banks and advisers do not typically maintain matrices of set fees for specific types of services. However, exceptions include:

- DCM transactions carried out by large corporates and SSAs, such as benchmark transactions in major currencies, where fees are usually determined by the client and sometimes proposed to banks on a 'take it or leave it basis' (see the SSA and large corporate client case studies in Annex 3).
- Some banks stated they use fee matrices for specific types of DCM and M&A transactions. However, these are primarily used as guidance and as a starting point when negotiating fees.

- 8.6** We were told that fees broadly depend on the characteristics of the transaction, past and future business from the client and the bank's broader strategic considerations. Factors affecting fees are summarised in Table 1.

<sup>97</sup> We assess other fee-related issues in the following Chapters: Chapter 6 assesses whether banks provide clients with all the necessary information on fees to make informed decisions, the extent to which clients focus on and negotiate fees when selecting banks and advisers, and how fees are set and allocated among syndicate members; and Chapter 7 looks at the effects of cross-subsidisation and relationship-based pricing.

<sup>98</sup> For an overview of services covered, see Annex 7.

**Table 1: Determinants of fee levels across ECM, DCM and M&A services**

<b>Transaction characteristics</b>	<ul style="list-style-type: none"> <li>• transaction type, value and complexity</li> <li>• transaction risk profile, including rating and maturity</li> <li>• whether the transaction is traditionally underwritten or back-stopped at a pre-determined price</li> <li>• timing and market conditions</li> <li>• currency of the transaction (for example, US dollars, euros, sterling)</li> <li>• geographic factors (for example, jurisdictions in which the issue will be distributed)</li> </ul>
<b>Client-related factors</b>	<ul style="list-style-type: none"> <li>• overall relationship with the client, including past lending and/or corporate broking relationship, and future potential revenue from transactional business from the client ('share of wallet')</li> </ul>
<b>Bank's strategic considerations</b>	<ul style="list-style-type: none"> <li>• credentials that could be gained from the transaction and desire to build a track record in a particular sector or country (for example, £1 Royal Mail IPO)</li> <li>• broader market conditions (e.g. macroeconomic conditions, volume of transactions in the market)</li> </ul>

Source: FCA analysis of submissions from banks and clients.

**8.7** Banks and advisers told us that when they set fees for new transactions they take into account fees on past transactions with similar characteristics. To negotiate fees effectively, clients need to be aware of fees paid on comparable transactions in the market. Clients, including corporate finance advisers (see Chapter 6), who are frequent market participants said they have a good understanding of market rates for different types of transactions and sometimes have fee information for more transactions than banks do. However, clients who are infrequent market participants and do not use corporate finance advisers, may not have access to reliable information about fee levels across the market.

**8.8** Use of fee precedents, combined with a lack of clients' willingness to negotiate fees, may lead to fees that tend to 'stick' at a particular level. We assess if, and how, fees vary across transactions of different types and sizes in paragraphs 8.28 to 8.41.

#### **How are fees structured?**

**8.9** The main component of the fee (i.e. the base fee) for most primary market services is usually set as a percentage of transaction value, rather than as a fixed fee or an hourly or daily rate as in many other service sectors. As well as the base fee, some ECM, DCM and M&A fees also include a discretionary element. There are usually no set criteria for the award of discretionary fees. Clients typically have full discretion to decide how much, if any, to award (see paragraphs 8.12 to 8.27 where we discuss the use of discretionary fees).

**8.10** The total amount of the fee is linked to the transaction value, and it is our understanding that it will generally only be paid where the transaction takes place, though clients and banks may at times agree on a fee that is paid if the transaction does not go ahead. One housing association stated that the fact that banks and advisers are paid a success fee meant that clients may be put under pressure to complete DCM transactions irrespective of whether it was in their interests.

**8.11** Setting fees as percentage of transaction value may be in the client's interest if this fee structure incentivises banks and advisers to maximise the value of the transaction. However, as transaction size increases we would expect fees to reflect any gains in economies of scale. For example, one client questioned whether a £2bn IPO should cost twice as much as a £1bn IPO. We consider the extent to which fees expressed as a percentage of the transaction decrease with transaction sizes in paragraphs 8.28 to 8.41.

### **Use of discretionary fees**

**8.12** As long as discretionary fees are awarded based on a client's perception of the quality of service rather than other criteria, they are likely to have pro-competitive effects:

- They allow clients to vary the fee the bank receives after the transaction based on their assessment of the quality of service received. This may lead to a wider distribution of fees than if all banks were just paid a similar base fee regardless of the quality of service provided.
- They create stronger incentives for banks to provide a good quality service, as opposed to a situation where the fee has already been agreed.

**8.13** Effective use of discretionary fees is one potential indicator of the extent to which clients are able to negotiate a 'better deal' with their bank or adviser. We have, therefore, considered the following questions:

- what criteria clients adopt when deciding whether and at what level to award discretionary fees, particularly based on the quality of service provided
- how prevalent discretionary fees are across different services and client types
- how frequently discretionary fees are paid in full and whether clients withhold discretionary fees if they believe the quality of service did not meet their expectations
- how much discretionary fees affect the level of base fees

### **Criteria used to award discretionary fees**

**8.14** Before a transaction, banks and their clients agree a split between a base fee and a discretionary fee. The discretionary fee is specified as a potential maximum fee. Clients have full discretion as to whether to pay all, some or none of the fee. We were told that while engagement letters and underwriting agreements may record the issuer's discretion to decide if this fee is payable, there are typically no formal criteria determining when and at what level discretionary fees will be paid. We were told that on some occasions, high level criteria may be included in engagement letters, although we did not observe such criteria in the sample of engagement letters that we reviewed (see the transparency section in Chapter 6).

**8.15** Many banks stated that they were not involved in their client's decision-making process to decide the level, if any, of a discretionary fee. They believed that being paid a discretionary fee tended to reflect the client's overall satisfaction with the service provided. The specific criteria for deciding the level of any discretionary fee inevitably varies across different types of transactions and clients. However, banks that responded to our request for information said that that relevant criteria might include one or more of the following and were directly related to the quality of service provided:

- the bank's overall commitment to the transaction (e.g. seniority and experience of people involved, allocated resources, proactivity and diligence of the team)
- quality of advice provided about structuring the transaction (e.g. transaction size, timing, syndicate composition, strategic M&A advice)
- quality and quantity of marketing and other materials produced, road show meetings and market feedback gathered
- quality and breadth of investors targeted and final investor demand/order book generated

- short-term after-market performance of the instrument issued
- quality of the bank's project management, including maintaining good relationships with relevant regulatory authorities
- constructive behaviour and engagement among syndicate members, counsels, accountants and other experts and advisers

**8.16** A number of clients told us that they had used discretionary fee structures and confirmed that discretionary fees reflect issuer's subjective assessment of the quality of service it had received. Some of the clients had chosen not to pay out the fee in full, or at all, because the quality of service and outcome of the transaction did not meet their expectations.

#### *Prevalence of discretionary fees*

**8.17** We wanted to understand which services most commonly include discretionary fees. Banks said that discretionary fees are more common in ECM than in DCM and M&A:

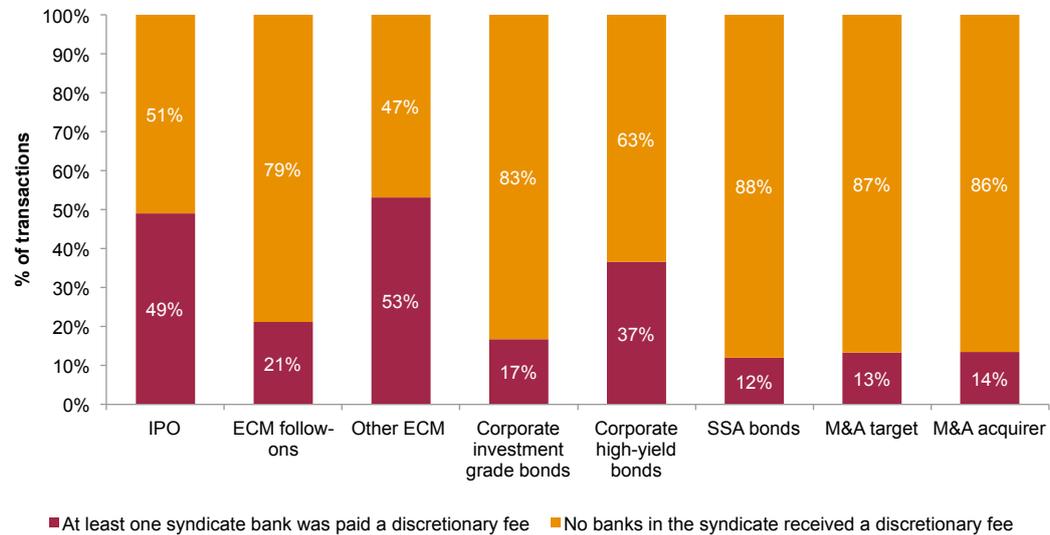
- **ECM:** the extent to which banks stated that fees include a discretionary element varied. A number of large and medium-sized banks, said that most IPOs and a significant proportion of follow-on transactions include a discretionary fee element. Small and medium-sized banks stated that discretionary fees were rare and some noted that they had never undertaken a transaction with a discretionary fee.
- **DCM:** banks stated that, overall, discretionary fees are less common in DCM than in ECM. Discretionary fees are most likely for the more complex and lower rated non-investment grade/high yield and emerging markets transactions; they may be a feature in investment grade transactions and are rare in ABS transactions. Some banks added that discretionary fees are more common in corporate bond issues (particularly for infrequent issuers), while SSAs and financial institutions rarely include a discretionary element.
- **M&A:** banks and advisers said that discretionary fees are only occasionally used in M&A.

**8.18** Using the transactional data submitted by banks (see Annex 2), we compared the proportion of transactions in which at least one bank on the transaction was paid a discretionary fee with the proportion of transactions in which no banks received a discretionary fee.<sup>99</sup> Consistent with what banks told us, Figure 1 indicates that the use of discretionary fees varies across services. Discretionary fees are most common in IPOs and other ECM (convertible debt) transactions – being paid out to at least one bank on 49% and 53% of transactions, respectively.<sup>100</sup> In DCM, discretionary fees are more common in corporate high yield bond transactions (37%) than in corporate investment grade and SSA bond transactions (at 17% and 12%, respectively). In M&A, at least one bank received a discretionary fee in 13%-14% of transactions.

<sup>99</sup> This data provides a lower bound estimate for the proportion of deals that include a discretionary element as it does not capture cases where a discretionary fee was included in the fee structure but no bank on the deal received it.

<sup>100</sup> Note that the estimates reported in the Occasional Paper "What determines IPO allocations" published alongside this report differ as they are based on discretionary fees paid on IPOs that took place between January 2010 and May 2015, whereas here we assess discretionary fees paid on the most recent IPOs (January 2014 to May 2015).

**Figure 1: Proportion of transactions where at least one syndicate bank was paid a discretionary fee, January 2014 to May 2015**



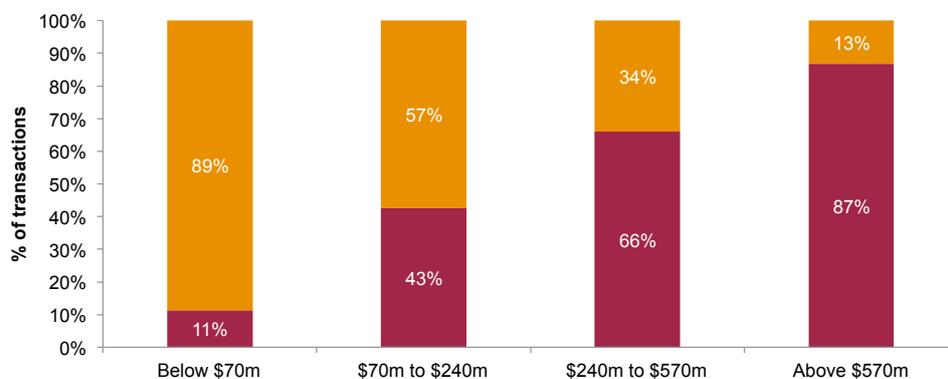
Source: FCA analysis based on transactional data described in Annex 2.

Note: The sample included 3746 transactions (224 IPO, 752 follow-on, 113 other ECM, 857 corporate investment grade bond, 315 corporate high-yield bond, 450 SSA bond, 591 M&A target and 444 M&A acquirer transactions). Where the bank did not specify that a discretionary fee was paid, we assumed that no discretionary fee was paid.

**8.19** We focused our analysis on IPOs because overall, only a small proportion of DCM and M&A deals involved a discretionary fee.<sup>101</sup> We assessed the use of discretionary fees across transactions of different sizes. We found that discretionary fees become more prevalent as the value of the transaction increases (see Figure 2). On 87% of IPOs above \$570m and 66% of IPOs with transaction value between \$240m to \$570m a discretionary fee was paid out to at least one bank in the syndicate. In comparison, a discretionary fee was paid out to at least one bank in only 11% of transactions below \$70m and 43% of transactions between \$70m and \$250m.

<sup>101</sup> We also examined other ECM transactions but do not report results here. As for IPOs, we found that discretionary fees become more prevalent as the value of the transaction increases.

**Figure 2: Proportion of IPOs where at least one bank was paid a discretionary fee by transaction size, January 2014 to May 2015**



■ No banks in the syndicate received a discretionary fee ■ At least one syndicate bank was paid a discretionary fee

Source: FCA analysis based on transactional data described in Annex 2.

Note: We split the sample into four equal groups, each containing approximately 25% of observations. Transaction value thresholds reflect 25th, 50th and 75th percentiles rounded up to the nearest \$10m. The sample included 213 IPO transactions.

**8.20** Some banks observed that the use of discretionary fees on IPOs had increased over time, particularly as corporate finance advisers had become more prevalent (see the assessment of the role of corporate finance advisers in Chapter 6). We examined our data to see whether it supported this observation. We found that over the time period considered (January 2010 to May 2015), the proportion of IPOs where at least one bank was paid a discretionary fee ranged between 30% and 50% but we did not observe any clear time trends, most likely due to small sample sizes.<sup>102</sup>

#### ***Extent to which discretionary fees are paid out***

**8.21** We next examined the extent to which discretionary fees are paid out in full, in part or not at all.

**8.22** Banks' and advisers' estimates of how frequently discretionary fees are paid varied greatly. For example, four large banks said that, across all ECM services, they were paid the full discretionary fee in 33%-64% of transactions, and across IPOs, they were paid discretionary fees in full in 25%-85% of transactions. This suggests that clients are willing to pay a discretionary fee in full, if they decide it is appropriate to do so, and withhold some or all of the discretionary fee where service quality does not meet their expectations.

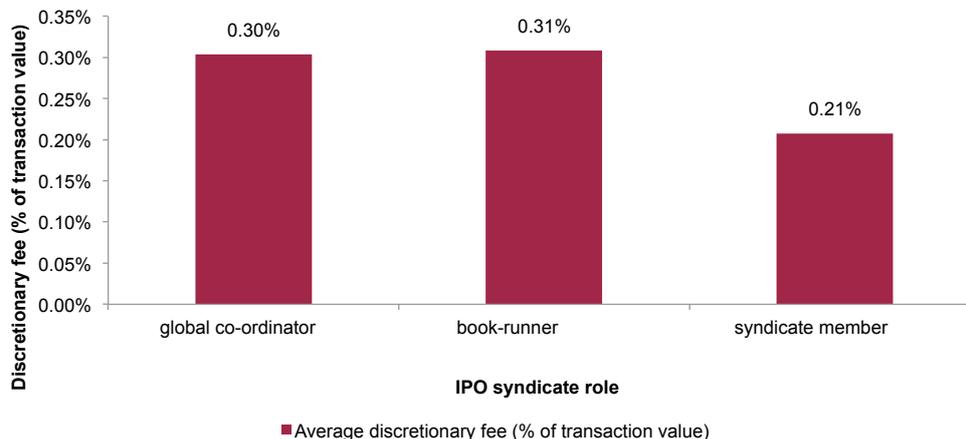
**8.23** If a transaction involves a syndicate of banks, clients allocate any discretionary fee they pay to syndicate members according to the perceived contribution of the individual banks. A number of banks said they had been part of transactions where issuers had paid different discretionary fees in order to differentiate between the contribution of each respective bank. Others stated that some clients choose to pay pro-rated discretionary fees to all banks (or just the lead active banks).

**8.24** We analysed the extent to which average discretionary fees varied across different syndicate roles in IPOs. Figure 3 shows that the more senior global co-ordinator and book-runner roles

<sup>102</sup> Our sample covered 79 IPO transactions undertaken in 2010, 67 in 2011, 50 in 2012, 109 in 2013, 163 in 2014 and 61 between January and May 2015. Not all transactions had information on discretionary fees paid out.

receive higher discretionary fees as a percentage of transaction value than the more junior syndicate member roles.

**Figure 3: IPOs – average discretionary fee paid for each role (% of deal value)**



Source: FCA analysis based on transactional data described in Annex 2.

Note: The sample included 231 roles (110 global co-ordinator roles, 76 book-runner roles and 45 syndicate member roles). Note that the 'book-runner' role includes both active and passive roles, as well as book-runner roles where the bank had not specified whether the role was active or passive.

### **The effect of discretionary fees on base fees**

**8.25** Stakeholders provided several comments on the effect discretionary fees have had on base fees paid:

- One large universal bank thought that discretionary fees had been adopted in an attempt to drive down base fees (for example, instead of an IPO base fee of 3%, a client may require a base fee of 2% with a discretionary fee at 1%). It had observed that in IPOs discretionary fees were making up an increasing proportion of the overall fee. It said that in some recent transactions clients had even insisted on only having a discretionary fee, with no base fee.
- Another bank believed that discretionary fees in DCM had developed due to banks offering to underwrite a transaction where the issuer has the option to pay lower than standard fees if the deal does not meet their expectations. The bank also believed that the discretionary element is a means of reducing fees for under-performance rather than an additional fee for rewarding over-performance.
- Another large universal bank thought that gross fees had decreased as a result of clients using discretionary fees, particularly in IPOs. It referred to fees declining from 2.25% several years ago to 1.35-1.75% currently.

**8.26** Due to data limitations we have not been able to assess the extent to which the use of discretionary fees has been driving down base fees and total fees, and whether discretionary fees constitute a significant proportion of the overall fee.<sup>103</sup>

<sup>103</sup> We have not examined the effect of discretionary fees on base fees due to two main data limitations. First, we did not have data for the total discretionary fee pot agreed prior to a transaction. Second, we were not able to reliably estimate total discretionary fees paid on each transaction across the whole syndicate because our sample does not cover all syndicate banks and not all banks in our sample provided discretionary fee information.

### ***Interim findings on the use of discretionary fees***

**8.27** Overall, we found that discretionary fees are being adopted by clients, particularly by corporate clients on high value IPOs and in other ECM (convertible debt) transactions. Discretionary fees allow clients to vary the fee paid after they have had an opportunity to assess the quality of the service they receive after the transaction, acting as an incentive for banks to provide a better quality of service. However, our analysis suggests that discretionary fees are less likely to be used on lower value IPOs than on higher value IPOs. We welcome additional views and evidence on why clients that undertake smaller value transactions do not appear to be using discretionary fees as frequently as those undertaking larger transactions.

### **Fee levels and variability**

**8.28** We analysed gross fee levels and variability across the main types of ECM, DCM and M&A services using the transactional data submitted by banks and advisers (see Annex 2).<sup>104</sup>

**8.29** For each type of transaction, we considered the following:

- **How gross fees vary depending on the transaction's main characteristics – transaction size for ECM and M&A and transaction size, maturity and rating for DCM.**<sup>105</sup> We assessed whether fees, given as a percentage of the transaction, decrease with transaction size. We would expect this to be the case because a bank's absolute level of costs for providing advice on larger transactions are unlikely to increase in proportion to increases in transaction size (i.e. economies of scale). For example, providing advice on a \$2bn IPO is not likely to be twice as costly as providing advice on a \$1bn IPO. In DCM transactions, we also assessed differences in fees paid for transactions with different maturity and rating to ensure that we were comparing fees for transactions with similar main characteristics.
- **Average fee levels and variability for transactions with similar main characteristics.** We assessed whether there appears to be a 'market price' for different types of services and how much fees vary for transactions with similar main characteristics. In a market with different transaction characteristics and fees determined on a transaction by transaction basis, clustering of fees at similar levels may indicate a lack of fee negotiation.

**8.30** We examined fees paid on transactions carried out between January 2014 and May 2015. For IPOs, we also considered changes in fees over time (January 2010 to May 2015). For other services, we only collected fee data over a 17-month consecutive period between January 2014 and May 2015<sup>106</sup>, so we have not assessed fee trends.

**8.31** This section summarises our main findings for each type of service. The supporting analysis is set out in Annex 7.

### ***ECM fees***

**8.32** We analysed gross fees paid on IPOs, two main types of follow-on transactions (accelerated book-builds and cash placings) and convertible debt ECM transactions.

**8.33** The detailed results of our analysis are summarised in Annex 7. In summary, we found that:

<sup>104</sup> For an overview of the main types of ECM and DCM services considered, see Annex 7.

<sup>105</sup> Differences in fees paid on different transactions may be driven by further transaction specific characteristics that were not captured by our analysis, including complexity and timing of the transaction. However, we consider that our analysis captures the main transaction characteristics that are relevant for a high level analysis of fee levels and variability.

<sup>106</sup> See Annex 2 for further details.

- For all types of ECM services, average gross fees in dollar terms increase with transaction size and average fees expressed as percentage of transaction size decrease with transaction size to reflect economies of scale.
- For most ECM services, we did not find that fees clustered around specific values and fees for transactions of different sizes tended to vary. The only exception was cash placings where we found that for 64% of the smaller transactions (those below \$32m) the fee was set at 3.5%<sup>107</sup> and for 61% of larger transactions (those above \$32m) the fee was set at 2%<sup>108</sup>. We invite views on what may explain this pattern in cash placings.

**8.34** Table 2 summarises the results for IPOs.<sup>109</sup> We found that while average fees in dollar terms increase with transaction size, average fees expressed in percentage terms decrease to reflect economies of scale. For example, an IPO below \$70m costs, on average, \$1.43m (4.61%) in fees while an IPO above \$570m costs, on average, \$25.61m (2.29%) in fees. We did not find that fees clustered around specific values and fees for transactions of different sizes tended to vary.<sup>110</sup> For example, for transactions below \$70m, fees for the middle 50% of transactions ranged between 3.50% and 5.00% (a 1.50 percentage point difference) and fees for the middle 80% of transactions ranged between 2.85% and 7.00% (a 4.15 percentage point difference).

**Table 2: Average IPO fee levels and variation by transaction size, January 2014 to May 2015**

Transaction value	Average fee		Fee variation for 50% of transactions, excluding top and bottom 25%		Fee variation for 80% of transactions, excluding top and bottom 10%	
	% of deal value	\$m	Range	Diff.	Range	Diff.
<b>Below \$70m</b>	4.61%	\$1.43m	3.50% – 5.00%	1.50ppt	2.85% – 7.00%	4.15ppt
<b>\$70m to \$240m</b>	3.18%	\$4.28m	2.25% – 3.50%	1.25ppt	2.00% – 5.00%	3.00ppt
<b>\$240m to \$570m</b>	2.51%	\$9.56m	1.98% – 3.00%	1.02ppt	1.65% – 3.50%	1.85ppt
<b>Above \$570m</b>	2.29%	\$25.61m	1.70% – 2.85%	1.15ppt	1.45% – 3.44%	1.99ppt
<b>Total</b>	<b>3.13%</b>	<b>\$10.32m</b>	<b>2.00% – 3.75%</b>	<b>1.75ppt</b>	<b>1.68% – 5.00%</b>	<b>3.33ppt</b>

Source: FCA analysis based on transactional data described in Annex 2.

Note: We split the sample into four groups, each containing approximately 25% of observations. Transaction value thresholds reflect 25th, 50th and 75th percentiles rounded up to the nearest \$10m. The sample included 210 IPOs undertaken between January 2014 and May 2015.

**8.35** We also considered whether average IPO fees had changed over the last five years. Annex 7 shows that average gross fees have remained relatively stable at around 3% to 4%. We did not assess differences in IPO fees paid by small, medium-sized and large corporate clients as IPO transaction size already reflects differences in client size.

<sup>107</sup> For 18% of transactions fee was below 3.5% and for 17% of transactions above 3.5%. The sample included 156 cash placing transactions with transaction size below \$32m.

<sup>108</sup> For 22% of transactions fee was below 2% and for 17% of transactions above 2%. The sample included 69 cash placing transactions with transaction size above \$32m.

<sup>109</sup> For results for other types of ECM services, see Annex 7.

<sup>110</sup> For a chart showing the spread of transactions by gross fees and transaction value, see Annex 7.

**DCM fees**

**8.36** In DCM, we examined fees paid in respect of three types of bonds:

- corporate investment grade bonds
- corporate high yield bonds
- SSA investment grade bonds<sup>111</sup>

**8.37** The detailed results of our analysis are summarised in Annex 7. In summary, we found that fees were the highest on corporate high yield bonds, followed by corporate investment grade bonds and lowest on investment grade SSA bonds. Across the whole sample, the average fee for high yield bonds was 1.26%, for corporate investment grade bonds 0.38% and for investment grade SSA bonds 0.15%. This reflects a perceived reduction in credit risk.

**8.38** We assessed the extent to which fee differences were driven by transaction size, bond maturity and rating. We found that:

- for all three types of bonds, fees expressed as a percentage of transaction size did not tend to decrease with transaction size
- for corporate investment grade bonds, fees increased as maturity of the bond increased and rating decreased
- for corporate high-yield bonds, fees increased as bond rating decreased but did not tend to vary with maturity of the bond<sup>112</sup>
- for SSA bonds, fees varied only by maturity, but not by transaction size or rating

**8.39** When examining variation in fee levels for bonds with similar maturity and rating (as applicable), we found that fees on corporate investment grade bonds and high-yield bonds tended to vary, while fees on SSA bonds were clustered at specific values. Where large SSA clients tend to set their own fees which they offer to banks on a 'take it or leave it' basis, this would explain the lack of fee variation.

**M&A fees**

**8.40** In M&A, we would expect the nature of the advice clients receive to differ as between the buy-side and sell-side of a transaction. As such, we assessed separately fees paid when advising the target and acquirer. We found that gross average fees paid to acquirer and target advisers were very similar and therefore below we have only presented results for advice given to a target. The results for advice provided to an acquirer are set out in Annex 7.

**8.41** Table 3 summarises results for M&A target adviser fees. We found that average fees in dollar terms increase with transaction size, but average fees expressed in percentage terms decrease to reflect economies of scale. For example, a transaction below \$150m costs, on average, \$1.02m (1.59%) in fees while an M&A transaction above \$1,270m costs, on average, \$14.98m (0.49%) in fees. We did not find that fees clustered around specific values and fees for transactions of different sizes tend not to vary significantly.<sup>113</sup> For example, for transactions below \$150m, fees for the middle 50% of transactions ranged between 1.18% and 1.88% (a 0.70 percentage

<sup>111</sup> We restricted our analysis of SSA issues to investment grade issuers as they accounted for most transactions.

<sup>112</sup> Lack of variation in fees by maturity can be explained by most bonds having similar maturity as 67% of corporate high-yield bonds in our sample had maturity of five to eight years.

<sup>113</sup> For a chart showing the spread of transactions by gross fees and transaction value, see Annex 7.

point difference) and for the middle 80% of transactions ranged between 0.97% and 2.43% (a 1.45 percentage point difference).

**Table 3: M&A target adviser average fee levels and variation by transaction size, January 2014 to May 2015**

Transaction value	Average fee		Fee variation for 50% of transactions, excluding top and bottom 25%		Fee variation for 80% of transactions, excluding top and bottom 10%	
	% of deal value	\$m	Range	Diff.	Range	Diff.
<b>Below \$150m</b>	1.59%	\$1.02m	1.18% – 1.88%	0.70ppt	0.97% – 2.43%	1.45ppt
<b>\$150m – \$450m</b>	0.97%	\$2.71m	0.80% – 1.12%	0.31ppt	0.57% -1.30%	0.73ppt
<b>\$450m – \$1270m</b>	0.73%	\$5.25m	0.53% – 0.89%	0.36ppt	0.35% – 1.12%	0.77ppt
<b>Above \$1,270m</b>	0.49%	\$14.98m	0.33% – 0.64%	0.31ppt	0.18% – 0.83%	0.65ppt
<b>Total</b>	<b>0.90%</b>	<b>\$6.32m</b>	<b>0.52% – 1.13%</b>	<b>0.61ppt</b>	<b>0.32% -1.44%</b>	<b>1.13ppt</b>

Source: FCA analysis based on transactional data described in Annex 2.

Note: We split the sample into four groups, each containing approximately 25% of observations. Transaction value thresholds reflect 25th, 50th and 75th percentiles rounded up to the nearest \$10m. The sample included 402 M&A transactions undertaken between January 2014 and May 2015.

### Comparison with fee levels in other countries and regions

- 8.42** In this section, we compare average gross fees in EMEA with fees in other countries and regions to assess whether average fees charged by banks in EMEA are higher, lower or similar to fees charged in other regions.<sup>114</sup>
- 8.43** In our discussions with stakeholders, several banks and clients commented on the difference between fees in the US, Asia and the UK/EMEA. Many investment banks and two private equity firms noted that ECM and DCM fees are generally higher in the US than in the UK and Europe. Investment banks suggested that fees in Asia were similar to or lower than those in Europe, with diversity in fees in Asia across the different countries.
- 8.44** Investment banks gave two reasons for these differences in fees. First, they said that the markets in Europe and Asia are more competitive than in the US, thus leading to greater pressure on fees. Second, some banks thought that issuers in the US are more willing than those in Asia to pay a higher fee if they feel they receive a good quality service. We also understand that fee levels in the US may be higher in part to reflect the way in which legal liability rests with the underwriting bank, whereas elsewhere the liability for the issue falls upon the issuer.
- 8.45** We compared fee levels between EMEA, the US and Asia<sup>115</sup> across IPOs, follow-on ECM transactions, investment grade corporate bonds, high yield corporate bonds and government and local authority bonds. Our analysis largely corroborated the views we received from

<sup>114</sup> We focused on EMEA given banks confirmed that fees in this region are comparable to those in the UK. The analysis is based on Dealogic data and not the transactional data described in Annex 2 because it allowed us to take all the data from one source and cover a time period longer than that covered by our transactional data. We note the Dealogic data for EMEA is likely to include some transactions falling outside the scope of our market study and exclude some transactions falling inside the scope of our market study (see Annex 7).

<sup>115</sup> Our analysis focused on South East Asia to follow Dealogic's classification. We set out which countries are covered by Dealogic's definition of South East Asia in Annex 7.

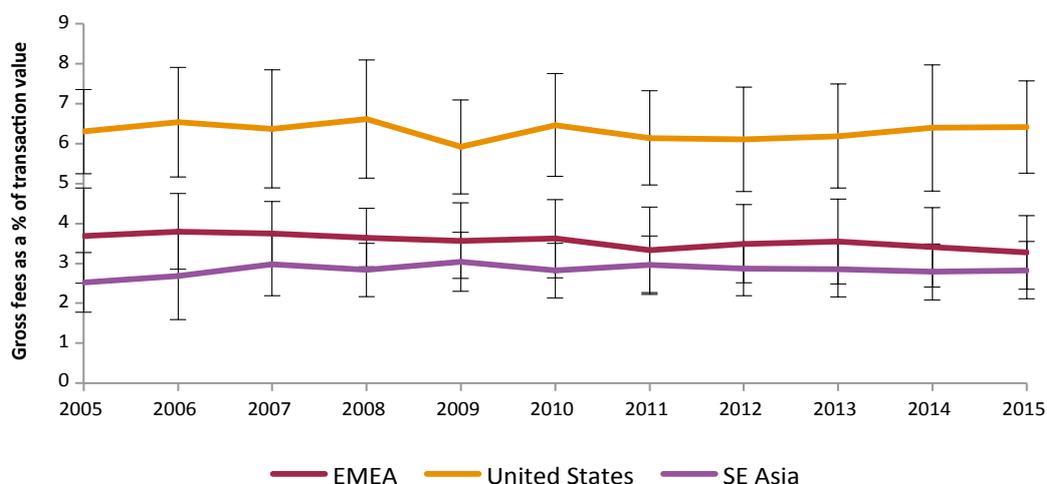
investment banks and clients. The results of this analysis are set out in further detail in Annex 7. Below we summarise our findings.

**8.46** Figure 4 compares average fees for IPOs in EMEA, the US and South East Asia. Figure 5 sets out the distribution in fees. We found that:

- Fees in the US are in general higher than in EMEA and South East Asia. This is particularly true for IPOs, follow-on ECM transactions, investment grade bonds and high yield bonds.
- Fees in South East Asia are on average comparable to or lower than in EMEA and are diverse across countries. This is apart from Japan where fees are at comparable levels to the US.

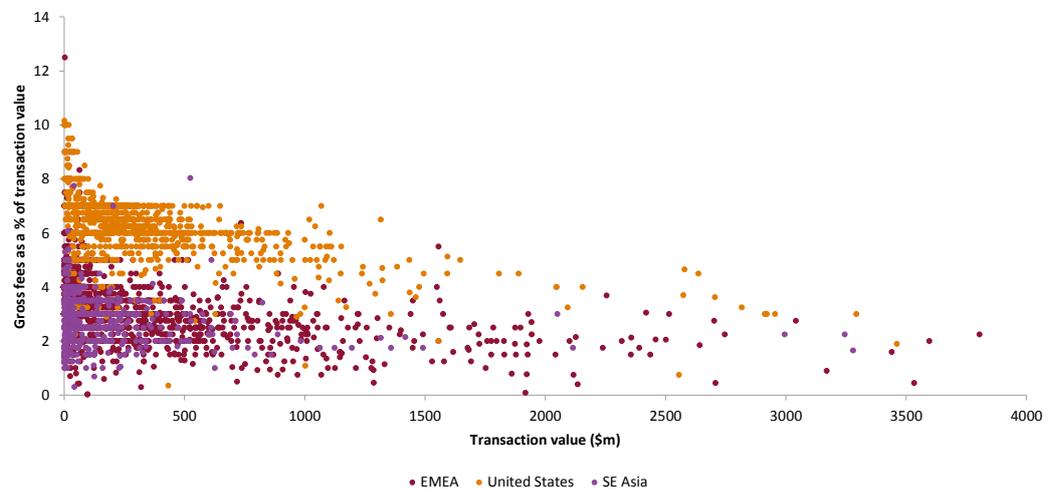
**8.47** We do not know of any significant cost reasons for these differences and no stakeholders gave such reasons in our discussions. However, we welcome views on the reasons for these differences in fee levels, such as differences in legal costs. We also welcome views on whether the fact that fees are in some cases lower in Asia than in EMEA (and the UK) suggests there is scope for fees to be driven down further in the UK.

**Figure 4: Comparison of average IPO fees in EMEA, the US and South East Asia, 2005-2015**



Source: FCA analysis of Dealogic data.

Note: The years are based on the transaction pricing date of the IPOs. The regions are defined by the region or nationality of the exchange in which the IPO took place. The bars show one standard deviation in the fees paid in that year in that region.

**Figure 5: Distribution of IPO fees in EMEA, the US and South East Asia, 2005-2015**

Source: FCA analysis of Dealogic data.

Note: The chart includes all transactions between 2005 and 2015. We have excluded transactions where data on transaction size or fees are not available. For presentational purposes, we have also excluded transactions with a value above US\$4 billion.

### Quality of service provided

- 8.48** Fee levels are typically more easily observed and assessed than quality of service provided. Nevertheless, quality of service can be as important, or even more important, than fees paid. We therefore considered clients' views on the quality of primary market services provided by banks and advisers.
- 8.49** The quality of investment banking services provided is made up of several factors, including:
- quality of advice provided on pricing, timing and structure of the transaction
  - seniority, experience and commitment of bank representatives working on the transaction
  - quality and breadth of investors targeted and included in the final order book
  - quality of research analysts and market-making
  - quality of project delivery
- 8.50** Banks and clients emphasised that quality of service provided is often much more important than fees paid (see the section on selection processes and criteria in Chapter 6 and the client case studies in Annex 3). This is because low quality execution can result in significant long-term costs to clients in terms of, for example, higher than necessary spreads on bonds or a significantly under-priced IPO.

- 8.51** In paragraphs 8.12 to 8.27, we noted that the extent of discretionary fees paid may be one indicator of whether the quality of service received matches clients' expectations. We heard evidence of some clients not paying discretionary fees because they were not happy with the quality of service (see paragraph 8.16).
- 8.52** Several clients stated that they were happy with the quality of service provided and some believed that the quality of service provided was high. On value for money, one private equity firm thought that it was receiving value for money service but that fees were generally high. Another private equity firm said that while the absolute level of fees earned by banks appeared high, fees were relatively low, given the volume of equity and debt capital raised for clients. One large frequent issuer thought that in the case of debut bond issuances, banks put in a lot of work for comparatively little revenue, given the work involved.
- 8.53** However, one private equity firm complained that, in the last few years, the large investment banks had dropped their coverage of companies with market capitalisation below £1bn and that large banks often overlooked small investors. They noted that the smaller investment banks may be at times better placed to provide the appropriate research and access to mid-market investors.
- 8.54** Banks should be incentivised to provide good quality service in order to maintain a relationship with a client and secure further mandates. One private equity firm stated that banks know they would not be invited into future transactions if they provided poor service and poor value for money.
- 8.55** Difficulties with measuring quality of service may give existing banks and advisers an advantage, as clients may prefer large established banks or suppliers they have worked with before, and it takes time for smaller banks to build credibility.
- 8.56** In the absence of significant concerns about service quality from clients, we have not attempted to measure how service quality differs across the market, whether 'lower quality' providers charge lower fees and how service quality affects outcomes. Moreover, it is difficult to measure quality of service and to assess how service quality has affected transaction outcomes, except in cases where the quality of advice provided has been particularly poor. We invite comments on the quality of service provided in the market, particularly where clients have concerns that they wish to raise with us.

## 9. IPO processes and allocations

### **Chapter summary**

An efficient IPO process and an effective book-build and allocation process are essential to the successful execution of an IPO. We assessed the UK IPO process and the way in which banks allocate shares in IPOs.

### ***IPO process***

There is a blackout period in the UK IPO process between publication of research by syndicate banks and circulation of the pathfinder prospectus. This means the pathfinder and approved prospectuses, both key sources of information, are made available to buy-side investors late in the process. The late availability of the approved prospectus, combined with a lack of access to the issuer's management, also means that non-syndicate banks' analysts and independent research providers have little or no information from which to produce IPO research. This means that the only source of information available to investors at a crucial stage of the process is research by syndicate analysts, reducing the diversity and independence of information available to investors, which ultimately may lead to poorer investment decisions being made. Our analysis is set out in a separate discussion paper.

### ***Allocations***

There is potential for conflicts of interest to arise in the allocation of shares in IPOs as banks may seek to reward favoured investor clients, where this is not necessarily in the issuing client's interest. We expect banks to manage these potential conflicts of interest appropriately, including through the implementation of allocation policies. With one exception (which we are pursuing), all of the banks in our sample have allocation policies in place.

Our analysis of IPO allocations is set out in a separate occasional paper. We found that the way in which allocations are scaled back shows some patterns consistent with issuers' interests. In particular, allocations tend to favour investors who assist with the price discovery process, and long-only investors tend to receive more favourable allocations than other investors, including hedge funds. However, we also found that allocations are skewed towards investors who account for significant broking revenues to the bank, suggesting that the allocation decision reflects the interest of the bank. The strength of the skew towards the bank's favoured investors varied significantly by institution. We do not find evidence that banks make less favourable allocations to investors who go on to flip those shares after the IPO, nor that they favour investors who provide aftermarket liquidity.

We are interested in views on whether there are any reasons that the observations we have made in IPOs would not also apply to DCM.

- 9.1** IPOs play a vital role in the UK economy, enabling companies to raise finance for investment, expansion and on-going operations. They provide investment opportunities for pension funds, insurance companies, other institutional investors and individuals. Two key aspects in executing a successful IPO with high demand at the best price are an efficient IPO process and an effective book-build and allocation process.
- 9.2** In this chapter we therefore set out our interim findings on:
- the UK IPO process, particularly with regard to the availability of information
  - allocations, with a specific focus on IPO allocations

### The UK IPO process

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- 9.3** In the Terms of reference, we said we would examine whether existing rules and practices for disclosing information in an IPO allow information, such as prospectuses and unconnected research, to be released at the appropriate junctures.
- 9.4** We have examined whether the prospectus is available early enough in the UK IPO process to serve as a meaningful source of information to potential subscribers. Also, we have considered whether during the process there is an over-reliance on the research published by the banks connected to the transaction. Our assessment of the evidence we have gathered on the availability of information during the IPO process is set out in a separate discussion paper published alongside this interim report (Discussion Paper [DP16/3]: Availability of information in the UK equity IPO process).
- 9.5** In summary, the findings set out in that discussion paper are that:
- Current market practice for UK IPOs includes a ‘blackout’ period typically lasting 14 days between publication of research by syndicate banks, (‘connected’ research) and circulation of the pathfinder prospectus. Banks told us that they impose this ‘blackout’ period to manage potential legal liability and perceived regulatory risks.
  - This blackout period means the pathfinder prospectus and final approved prospectus are often made available to investors late in the IPO process. The late availability of the prospectus, combined with lack of access to the issuer’s management, means that independent research providers and analysts within non-syndicate banks (‘unconnected’ analysts) have little or no information on which to produce research. Of the 169 IPO transactions we examined, only one transaction featured unconnected research published during the IPO process. This means the only source of information during the investor education period is connected research. Such connected research is itself at heightened risk of bias due to potential pressure on connected analysts – during meetings with the issuer’s management or its corporate finance advisers before a mandate is awarded – to produce favourable research. We are concerned that this lack of information during the investor education period reduces the diversity and independence of information available to investors, and ultimately leads to inefficient investment decisions and price formation.

## Allocations

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- 9.6** In the Terms of reference, we noted that we had heard concerns from issuing clients and investors that banks acting as book-runner may favour certain investors when allocating debt or equity transactions.
- 9.7** Our concern is that potential conflicts of interest could arise when allocating debt or equity if banks show a preference to their favoured investor clients when determining allocations. This might not be in the interest of the issuer client if, for example, such investors are not long-term investors. Where the allocation process is not transparent, the issuing client may find it difficult to monitor whether its requirements are being taken into consideration.
- 9.8** As part of our analysis of this issue, we have considered:
- the obligations on banks under the FCA's rules and guidance on conflicts of interest
  - whether and how issuers are given the ability to influence allocations
  - whether investors inflate their orders and whether this causes difficulties in the allocation process
  - whether there is a skew in IPO allocations towards favoured investors
  - whether there are any potential detrimental effects from any lack of transparency and/or from reduced long-term participation in new issuances if certain investor clients are favoured
- 9.9** We have also considered whether the issues we have identified in IPOs have any read across into DCM.

### Regulatory framework on conflicts of interest

- 9.10** The FCA's rules and guidance on conflicts of interest (SYSC 10) require banks and advisers to take all reasonable steps to identify and manage conflicts of interest between themselves and their client, or between one of their clients and another. Principle 8 also requires firms to manage conflicts of interests fairly.
- 9.11** Potential for conflicts of interest is more likely to arise where the bank offers a range of products and services to a number of clients. For example, in capital raising, potential conflicts which may arise are conflicts between the investment bank acting for the issuer client and its own interest in:
- favouring those investor clients who generate more revenues with the bank when determining allocations
  - receiving an allocation of securities (for example, for its own asset management division)
  - securing future investment banking mandates from clients
- 9.12** A conflict of interest may also arise between a bank and its investor clients, where more than one investor client is equally preferable to the issuer and the bank favours the investor that generates more revenues when determining allocations.

**9.13** We expect banks to manage potential conflicts of interest by operating effective organisational and administrative arrangements, including implementing and maintaining appropriate internal allocation policies.<sup>116</sup> Where there is potential for conflicts of interest to arise, the duty falls upon the bank to demonstrate that the conflicts do not cause detriment to a client; or that the bank's interest has not been placed ahead of its client. We consider the importance of allocation policies in further detail below.

#### **Issuers' role in allocations**

**9.14** We sought to understand the process and policies by which banks take allocation decisions and how they reflect the issuing clients' preferences, particularly with regard to the volume of subscriptions, price levels and type of investors.

#### **Allocation processes and policies**

**9.15** With one exception, all of the banks who responded to our request for information submitted an internal allocation policy, setting out their approach for the allocation process, addressing the potential conflicts of interest and emphasising the importance of an issuer's preferences in determining allocations. One bank explicitly stated in their response that they did not have an internal allocations policy. We will be following up with supervisory work with the bank to understand why this is the case.

**9.16** Based on these policies (and banks' submissions in response to our request for information), a typical allocations process may be described as follows:

- the issuer expresses its view on the allocation criteria and which investors they would like to include or exclude (this step is taken by some issuers; others are more likely to review and comment on an allocation proposal prepared by the bank)
- the bank prepares an allocation proposal/recommendation
- the bank sends the issuer the allocation proposal
- the issuer reviews the proposed allocation book and may seek amendments to the proposal
- the proposal is discussed between the issuer and the bank, and any changes required are subsequently made
- the issuer signs off the allocation
- the bank communicates the allocation to the market

**9.17** The majority of banks stated that during book-building, they maintain a continuous dialogue with the issuer, who ultimately decides and provides sign-off of the final allocation. This ongoing engagement is the key mechanism for issuers to state their preferences in the allocation process. This is typically undertaken over telephone calls, emails, meetings and by sharing the order book with the issuer during the book-building period. Banks stated that typically issuers comment on orders and state preferences at all times during the book-building process.

**9.18** We heard of some good practices:

<sup>116</sup> The provisions in SYSC 10.1.14G and SYSC 10.1.15G are of particular relevance to firms managing a securities offering.

- One bank said that it sends its issuing clients a notice ahead of the allocation of the offering. The notice summarises its allocation policy, lists the allocation factors commonly used by the bank and invites the issuing client to state its objectives and preferences in the process.
- Other banks stated that they make their issuing clients aware of their allocation policy. Issuing clients are then free to express their preference over allocations and certain investors being included/excluded at any time.

**9.19** While issuers' engagement in the process depends on the client in question, banks said that issuers generally take an active interest in the process and discuss at least the largest allocations line by line. Where engaged, corporate finance advisers may also take an active role in reviewing the proposed allocation.

**9.20** With regard to final sign-off of the allocation, one bank stated that while it endeavours to obtain written confirmation from the issuer, a verbal approval from the issuer is also accepted as a confirmation. Another bank noted that while in the majority of the cases allocations are discussed with the issuer on a line by line basis, there is less opportunity for this in accelerated transactions or where the time between the book closing and the stock trading is short. Transactions where the banks themselves are at risk (i.e. transactions that are underwritten by the bank) are exceptions to the process. In these transactions banks said that they ultimately decide the allocation and sign off from the issuer is not required.<sup>117</sup>

#### **Managing issuers' preferences**

**9.21** With regard to managing issuers' preferences, banks stated that in theory there is a trade-off between the price of an issue and the desired investor allocation. However, banks said that issuers rarely move the price significantly to accommodate specific allocation preferences.

**9.22** Banks highlighted that it is ultimately the issuer that decides whether it wishes to set a low issue price in order to achieve specific allocation preferences. Banks noted that this trade-off is always discussed with the issuer. Banks said that they often demonstrate to the issuer how the quality of the order book changes at different price levels. In addition, the book-runner(s) present the issuer with alternative choices for the allocation.

**9.23** Banks noted that given that the ultimate choice on price and allocation is made by the issuer, there is typically little need for the banks to balance the issuer's preference for investors against the need to attract sufficient volume of subscriptions at an appropriate price level.

#### **Order inflation**

**9.24** In the context of allocations we heard concerns from some banks and buy-side investors in relation to order inflation. A number of stakeholders suggested that order inflation was prevalent, particularly in the context of DCM. Other stakeholders stated that, whilst order inflation has historically been an issue, it was now less frequent and could be effectively managed. Stakeholders identified a number of drivers for this. The main driver identified was improved compliance procedures for buy-side investors, where systems and controls for managing 'internal sign-off' for investments had been enhanced in recent years. The role of corporate finance advisers, particularly in IPOs, can also act as an additional means to access and challenge orders and proposed allocations. Investment banks also stated that the ability to identify and effectively manage potential order inflation is an inherent part of the service they provide to issuer clients.

<sup>117</sup> Such a process was explicitly mentioned by two banks. Both stated that in these instances, they seek to accommodate client preferences, but that they have the ultimate decision on allocation.

### Analysis of skew in IPO allocations

- 9.25** Banks' allocation policies varied in their wording but those of the most active book-runners were largely similar in content. One bank's allocation policy, for example, notes that: 'The amount of trading commission or other income received or expected to be received by the Firm from a particular investor client should not be a relevant factor in the decision to allocate securities to that client. [...] Prohibited allocation practices: [...] Any other type of "quid pro quo" arrangement under which an allocation is made conditional on or linked with a compensating benefit such as the investor's participation in a "cold" deal or payment of excessive commissions on trading in the aftermarket or in other securities.'
- 9.26** We sought to analyse the extent to which the banks' management of the allocation process may give rise to a skew in IPO allocations towards their investor clients which generate the most broking or other revenue.
- 9.27** In analysing the factors that influence the allocation of shares by banks, we decided to focus on data from IPO allocations for the period January 2010 to May 2015. We did this because the relevant IPO allocation books were readily available and it was in the context of IPOs where stakeholders raised the greatest concern regarding allocations.
- 9.28** The data analysed included allocation books for IPOs conducted from the UK. We excluded from our analysis fixed price IPOs, allocation books containing limited information in relation to bid history and those transactions where a bank undertook a passive rather than active role. We analysed 372 allocation books for 19 banks encompassing 220 IPOs. Together, these IPOs account for approximately three quarters of IPOs by value conducted in EMEA for the period January 2010 to May 2015.
- 9.29** Our analysis of allocations in relation to IPOs is set out in a separate occasional paper published at the same time as this interim report (Occasional Paper 15: Quid pro quo? What factors influence IPO allocations to investors?). In summary, the findings from this analysis are:
- Banks make favourable allocations to investors from whom they generate greatest revenue elsewhere in their business, most notably brokerage commission. Investors in the top quartile of the book-runners' clients by revenue receive allocations, relative to the amount they bid, approximately 60% higher than those received by investors who are not clients of the book-runner. This result is driven primarily by allocations in 'hot' IPOs, i.e. those IPOs which are the quickest to be fully subscribed. This effect is stronger for some banks than for others.
  - Banks make favourable allocations to investors who assist in the price discovery process. In particular, investors who submit price-sensitive bids and those who attend meetings with the issuer are favoured in allocations.
  - Long-only investors seem to receive more favourable allocations than other investors, including hedge funds.
  - We do not find evidence that banks make less favourable allocations to investors who go on to flip those shares after the IPO, nor that they favour investors who provide aftermarket liquidity. The average flipping rate is however low.

### Findings on detrimental effects

- 9.30** Our analysis to date does not allow us to reach a definitive conclusion on whether a skew in allocations causes detriment to issuing clients. This is because we have not carried out an assessment of each IPO's allocation against each issuer's preferences and each bank's allocation

policies. In any event, there is no unique optimal allocation or pricing policy for each IPO, and so it is difficult to quantify the extent, if any, to which allocating shares to banks' preferred clients leads to a less favourable outcome for issuers. It is, for example, possible that banks only allocate shares more generously to their favoured clients once the optimal shareholder base has been achieved.

**9.31** However, our finding that there is a skew in allocations towards investors who generate significant revenues with the banks leaves us with cause for concern because the majority of banks explicitly state in their allocation policies that revenues received from individual investors should not influence the determination of allocations by the bank. Banks have a duty to demonstrate that they are effectively managing any potential conflicts of interest. They need to be able to show that favouring one client (i.e. a specific investor) does not cause detriment to another client (i.e. the issuer) and that the bank's own interest is not being placed ahead of its client (i.e. the issuer) when determining the allocation.

**9.32** The strength of the skew towards the bank's favoured investors varied significantly by institution, and, as part of our supervisory work, we will investigate those banks where the skew appears strongest to assess whether these outcomes align to issuing clients' best interests (see Chapter 11).

#### **Read across to DCM allocations**

**9.33** Although our analysis of allocations has focused on IPOs we have considered whether there is any read across to DCM allocations.

**9.34** We did not observe any material difference in approach to allocation practices in the context of DCM and for many banks their allocation policies are designed to cover both ECM and DCM issuance under the brand of 'securities allocations'. Allocations in DCM transactions are described in a broadly similar manner to ECM transactions, with one or two exceptions:

- The allocation process is broadly the same. The mechanisms available for issuers to indicate their preferences and to influence and monitor the allocation process mainly consist of ongoing interaction between the bank and the issuer and reviews of the order book. Banks stated that issuers are often given access to the electronic order book. This allows them to comment and monitor the development of the book in real time.
- With regard to final sign-off of the proposed allocation book, a number of banks noted that they do not require a formal sign-off for allocations from the issuer. However, issuers are free to express their preferences on allocations throughout the process. The banks also noted that, although a formal sign-off is not required, they typically present the allocation proposal to the issuer for transparency. One large bank stated that its clients typically take around 30-60 minutes reviewing the recommended allocations, reverting back to the syndicate members where appropriate.

**9.35** We note that in October 2015, the Investment Association issued Guidelines for New Issue Transactions in Fixed Income which included guidelines on disclosure of post-allocation statistics.<sup>118</sup>

**9.36** We are interested in views on whether there are any reasons that the observations we have made in IPOs would not also apply to DCM.

<sup>118</sup> <https://www.ivis.co.uk/media/111120/Investment-Association-Guidelines-for-New-Issue-Transactions-in-Fixed-Income-Oct-2015-.pdf>

# 10.

## Interim findings

**10.1** In this chapter we summarise our interim findings. These assess how effectively competition works in delivering good outcomes for issuers and investor clients by reference to:

- choice, universal banking and cross-subsidies
- other market practices
  - syndication
  - reciprocity
  - league tables
  - corporate finance advisers
  - transparency of scope of services and fees
  - the IPO process
  - allocation of shares in IPO book-building

### Choice, universal banking and cross-subsidies

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**10.2** We did not identify compelling evidence that any particular sector or category of clients faces a lack of available suppliers for corporate and investment banking services. Our analysis indicates that large and frequent issuers such as financial institutions, SSAs and large corporate clients are all well served by banks and advisers. There are often between 20 and 40 banks active in any particular sector and for different types of client – SSA, financial institutions and corporate clients. The largest four firms in the market account for 39%, 35% and 50% of the value of transactions in ECM, DCM and M&A, respectively.

**10.3** Medium-sized corporate clients and small corporate clients also have a reasonable choice of banks at present. However, we have seen evidence that larger banks opt to reduce their engagement with smaller, newer and/or riskier clients in response to market conditions and regulatory change. Future regulatory developments or an economic downturn could therefore cause some banks to withdraw from these types of clients to focus on larger, more attractive clients.

**10.4** Investment banking is very much a relationship business with relationships strengthened both by cross-subsidised lending and corporate broking (including daily coverage) and by past primary market transactions.

- Many investment banks lend at a low rate of return or below cost on the basis that a sufficient overall return will be made through cross-selling primary market transactional services. Lending committees often consider the share of future transactional business that the bank expects to win over the lifetime of the loan.
- Similarly, corporate broking services are typically provided for low or no fee in the expectation that the bank will be rewarded with future transactional activity.

**10.5** The concerns raised to us were not about the number of banks per se, but about the impact of this cross-subsidy on competition. In particular concerns were expressed that:

- clients may not always be free to award primary market mandates to the bank that best suits their needs, especially if there are barriers to using non-relationship banks
- it is difficult for new entrants to break into primary market services without also offering lending and/or corporate broking

**10.6** We looked at the link between lending/corporate broking and primary market roles awarded to banks, and found it to be strongest in DCM and other ECM (convertible debt) transactions and advice on M&A acquisitions. We found that around two-thirds of roles awarded in these transactions were awarded to those banks with whom the client had an existing relationship, however the link is significantly weaker for IPOs.

**10.7** To a large extent this 'quid pro quo' is a commercial expectation, but we also found that the majority of the larger banks use or seek to use contractual clauses that restrict a client's choice in future transactions. We found no clear evidence that these contractual clauses were generating better terms on the initial service. Consistent with the pattern of quid pro quo, we found that entry and expansion in book-running in ECM and DCM tends to be by banks that also lend, whereas a number of boutique advisers successfully provide M&A advice (for example, Moelis & Co. and Perella Weinberg).

**10.8** Large corporate clients, who want access to cheap lending, establish lending panels with a wide range of participating banks, who then compete against one another on primary market mandates. This enables the client to choose the best bank for a particular mandate provided that over time each bank wins sufficient business to warrant it continuing the lending relationship. On occasion, however, clients, particularly medium-sized and small corporate clients, who typically have fewer banking relationships than large corporate clients, may feel the need to "reward" a lending bank or corporate broker with transactional business even when that bank would not otherwise have won a mandate. Overall, although many clients are in a strong position to secure good outcomes across services as a whole, the bargaining position of many medium-sized and small corporate clients is likely to be less strong than that of large corporate clients.

**10.9** We also found that clients are less sensitive to fees on primary market mandates and that they are primarily focused on maximising transaction value and minimizing the all-in cost of funds. In our view, therefore, the higher returns on transactional business relative to lending/corporate broking reflect a combination of cross-subsidy (where some of the higher returns are competed away in the lending business) and low fee sensitivity. When compared with transactions executed in other jurisdictions, primary market transaction fees in the UK are lower than in the US, but similar to or slightly higher than in Asia.

**10.10** Overall, our evidence indicates that banks frequently cross-subsidise between lending/corporate broking and primary market services. Cross-selling and cross-subsidisation can bring benefits to

some clients in the form of cost savings from the bank's more detailed knowledge of the client. However, we are concerned to the extent that these practices stifle competition.

- 10.11** We found that cross-subsidies influence the awarding of primary market mandates, particularly in DCM. This cross-subsidy affects both ease of entry and expansion for those providers not offering the cross-subsidised services, in particular lending. The cross-subsidy appears to make it harder – though not impossible – to offer ECM and DCM services on a standalone basis. However, there is sufficient evidence of entry from those already providing corporate lending and broking that we do not attribute the higher returns earned in transactional business to a lack of competition per se.

### Other market practices

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- 10.12** Our interim findings on other market practices cover:

- syndication
- reciprocity
- league tables
- corporate finance advisers
- transparency of scope of services and fees
- the IPO process
- allocation of shares in IPO book-building

### Syndication

- 10.13** Our analysis of the evidence indicates that the size and composition of syndicates is driven by the client and not by banks, although the lead bank(s) may be asked to make recommendations. Syndication has clear benefits for clients when it enables the client to access a greater pool of investors, gain access to a range of research analysts and build relationships with a broader range of banks. Conversely, a less efficient process may be detrimental if, for example, the syndicate becomes too large or roles are not clearly defined. However, we have not identified sufficient evidence of material and direct detriment as a result of syndicate composition. The fees that clients pay on transactions of different sizes do not increase as the size of the syndicate increases.
- 10.14** We observed that large banks are more likely to be chosen for senior syndicate roles, with medium and small banks being awarded more junior roles. Some junior syndicate roles are not expected to contribute significantly to delivering the transaction. Instead, clients sometimes award these roles as a way to 'reward the relationship', but there appears to be little harm from the awarding of these junior roles as the fees involved are low. Junior syndicate roles may also provide a way for a smaller bank to build its credentials without having significant scale or distribution capability.

### Reciprocity

- 10.15** Reciprocity is a practice whereby a bank issuing its own financing awards mandates to another bank partly based on how much business it will receive in return. It generates revenue for banks and may help banks to build their credentials and league table credits.
- 10.16** We found that the practice is currently most prevalent in the bank financing market, particularly covered bonds. We found little evidence that these reciprocal arrangements cause significant detriment to competing banks that do not or cannot reciprocate:
- 10.17** At present reciprocity does not appear to be excluding non-reciprocal banks from competing because they can win mandates. The 41 issuers of covered bonds in 2015 that could not have been part of the reciprocal group had a choice of 36 banks that could not have been part of the reciprocal group.
- 10.18** We do not therefore propose to take any further action on reciprocity at this time. However, should the practice become more widespread or show signs of the potential detrimental effects we have highlighted, we will conduct further work with the intention of intervening to prevent this type of behaviour.

### League tables

- 10.19** Banks focus on league table positions when assessing staff performance and pitching to clients, and, to differing degrees, clients consider these positions when choosing which banks to use. League tables can promote competition when they help a client to compare the services banks offer and where this drives banks to compete on the parameters that matter to clients. However, we have concerns that certain practices distort league table rankings and reduce comparability:
- Some banks engage in transactions which are undertaken with the main aim of gaining league table credit, even if they are executed at a significant loss to the bank.
  - Many banks routinely present league tables to clients in a way that inflates their own position.
- 10.20** As a result, unreliable league tables are, at best, ignored by clients and, at worst, distort clients' choices because they do not accurately signal banks' capabilities to undertake a comparable transaction.

### Corporate finance advisers

- 10.21** Corporate finance advisers have taken a prominent advisory role in many IPOs in recent years and many clients have valued their input. They advise clients on the selection of syndicate banks, assist with the running of the IPO process and advise on the allocations of equity proposed by the syndicate banks. However, it was put to us by the banks that the role of corporate finance advisers can give rise to conflicts of interest and that there is a lack of clarity over how the FCA's rules and guidance apply to them.
- 10.22** We found no evidence of corporate finance advisers giving advice which would be against the client's best interests or trying to unfairly influence the research on IPOs, albeit a positive research message conveyed by analysts is one of the main factors considered when advising the issuer on which banks to appoint to a syndicate. The application of our rules to corporate finance advisers' activities is covered in Chapter 6 of this report.

**Transparency**

- 10.23** Our review of engagement letters found that transparency is not a material area of concern. The need for banks to ensure sufficient transparency of terms for clients is set out in the FCA Handbook and will be enhanced further by MiFID II.

**The IPO Process**

- 10.24** Current market practice for UK IPOs includes a 'blackout' period typically lasting 14 days between connected research and the circulation of the pathfinder prospectus. Banks told us that they impose this 'blackout' period to manage potential legal liability and perceived regulatory risks. This 'blackout' period means the pathfinder and final approved prospectuses are often made available to investors late in the IPO process.

- 10.25** The late availability of the prospectus, combined with a lack of access to the issuer's management, means that unconnected analysts have little or no information on which to produce research. Out of 169 IPOs we examined, only one transaction featured unconnected research published during the IPO process. This means that the only source of information during the investor education period is connected research. Such connected research is at heightened risk of bias due to potential pressure on connected analysts – during meetings with the issuer's management or the issuer's third party corporate finance advisers before a mandate is awarded – to produce favourable research.

- 10.26** We are concerned that this approach reduces the diversity and independence of information available to investors during the investor education period.

**Allocation of shares in IPOs**

- 10.27** There is potential for conflicts of interest to arise in the allocation of shares on IPOs as banks may seek to reward favoured investor clients, where this is not necessarily in the issuing client's interest. We expect banks to manage these potential conflicts of interest appropriately, including through the implementation of allocation policies. With one exception (which will follow up with supervisory work), all of the banks in our sample have allocation policies in place.

- 10.28** We focused our analysis on the factors influencing IPO allocations made by banks to test whether such policies are effective. Our analysis of IPO allocations is described in detail in the accompanying occasional paper. We found that the way in which IPO allocations are scaled back shows some patterns consistent with issuer's interests. In particular, IPO allocations tend to favour investors who assist with the price discovery process, and long-only investors tend to receive more favourable allocations than other investors, including hedge funds. However, we also found that IPO allocations are skewed towards investors who account for significant revenues to the bank from other business lines (e.g. trading commission), suggesting the allocation decision reflects the interest of the bank.

- 10.29** The strength of the skew towards the bank's favoured investors varied significantly by institution, and we will investigate further those banks where the skew appears strongest to assess whether these outcomes align to issuing clients' best interests. The skew may also prevent smaller buy-side investors from gaining access to IPOs in the primary market. We will consider barriers to entry and expansion for smaller buy-side firms more generally as part of our asset management market study. We are interested in whether there is any read across of our findings on IPOs to DCM allocations.

# 11.

## Potential remedies

### Chapter summary

We propose a package of potential measures designed to be effective and proportionate and to ensure that competition takes place on the merits by reducing artificial incumbency advantages, improving clients' ability to appoint banks that best suits their needs and ensuring that conflicts are properly managed. We are also considering possible improvements to the IPO process. Specifically we are aiming to:

- Remove the practice of banks using contractual clauses that restrict client choice.
- Seek views on whether there are ways in which we can reduce barriers to entry and/or expansion for non-universal banks and other service providers without undermining the efficiency benefits of cross-selling.
- Improve the IPO process to ensure more diverse and independent information is available earlier. Our options for reform are set out in Discussion Paper 16/3. We consider three main models incorporating various combinations of the following two measures:
  - **re-sequencing the publication of an approved prospectus and connected research, which is intended to make the approved prospectus the primary source of information available to investors**
  - **providing unconnected analysts with an opportunity to have access to the issuer's management**
- Investigate further with individual banks where our analysis raises questions about conflicts management in IPO allocations. More prescriptive regulatory requirements that will be introduced under MiFID II should also help to reduce the potential impact of conflicts of interest in allocations and of any harm to investors that are less important in revenue terms to a bank.
- Improve the credibility of league tables by exploring ways in which they could be better presented so that they are more meaningful for clients and remove incentives for conducting trades carried out at a loss purely for the purpose of gaining league table credit.

We are keen to hear views from stakeholders on these potential remedies.

- 11.1** As a result of our interim findings in Chapter 10, we are considering remedies in a number of areas in order to improve the process and outcomes of competition in investment and corporate banking services for issuer clients, investor clients and, ultimately, end consumers.
- 11.2** In this chapter, we first set out the principles we use when considering remedies. We then set out our current thinking on remedies to address the concerns we have identified. We consider potential remedies in the following areas:
- cross-selling, bundling and cross-subsidisation
  - IPO process
  - allocations
  - league tables
- 11.3** In addition, we have:
- Taken steps in this report to clarify existing FCA requirements that apply to corporate finance advisers' activities, in order to address a perceived lack of clarity raised by some market participants over their regulatory obligations.
  - Set out at the end of this chapter some questions on those areas in which we are currently minded not to pursue remedies.
- 11.4** At this stage, we are presenting our initial thinking on remedies for discussion. Our final report will set out the final package of proposed remedies with a supporting assessment. We would like stakeholders' views at this stage to assist us in further developing our thinking on appropriate remedies. For each remedy proposal we have set out a list of questions that we would like stakeholders to consider when responding to the interim report.

### Key principles for considering remedies

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- 11.5** We aim to ensure that any intervention is both effective and proportionate to the concerns identified.<sup>119</sup> When assessing remedies we consider:
- how the remedy addresses the interim findings and resulting detriment
  - the tools available to us, including our powers and ability to make further rules, as well as ensuring consistency with relevant EU and domestic legislation
  - how effective and proportionate the remedy (or package of remedies) would be
  - how the different remedies are effective as a package to make the market work better for those clients for whom it is not working well
  - how the remedy (or package of remedies) aligns with the FCA's and other authorities' broader policies and actions relevant to investment and corporate banking

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<sup>119</sup> We must have regard to the regulatory principles in section 3B FSMA when exercising our general functions, including rule-making.

- 11.6** As set out in our market study guidance<sup>120</sup>, we have a range of options which we could explore when developing remedies. These include using rule-making powers and publishing guidance, supervision and enforcement action, and giving an opportunity for the industry to develop measures that ensure compliance and improve client outcomes. Any proposed rule-making remedies would require formal consultation and cost benefit analysis.
- 11.7** The final package of proposed remedies will be assessed for their effectiveness and proportionality against the detriment identified. We will also consider their interaction with other applicable EU and UK domestic legislation.
- 11.8** We set out below the aim of the potential remedies and how they can address the issues we have identified in Chapter 10.

### Potential remedies

- 11.9** Given our interim findings, we propose a package of potential measures designed to be effective and proportionate and to ensure that competition takes place on the merits by reducing artificial incumbency advantages, improving clients' ability to appoint banks that best suits their needs, ensuring that conflicts are properly managed, and improving the IPO process. In this section we set out those measures we are considering on:

- universal banking and cross-subsidies
- the IPO process
- allocations
- league tables

#### Universal banking and cross-subsidies

- 11.10** We have considered what action could be taken to address our concerns regarding universal banking and cross-subsidies, as set out in Chapter 10. The aim of any remedy is to lower barriers to entry to ECM and DCM services and to reduce any potential for clients to feel the need to 'reward' their relationship banks.
- 11.11** At this stage we are not satisfied that the detriment arising from universal banking and cross-subsidisation is sufficient to warrant highly interventionist measures such as:
- Measures which seek to separate lending or corporate broking activities from transactional services. Separating these services would risk losing some of the clear benefits that we have observed from relationship banks providing transactional services to clients (see Chapter 7).
  - Measures which seek to govern the manner in which banks make lending decisions. For example, the role of lending committees could be altered to ensure that future transactional revenues are not taken into account in the lending decision. However, such measures risk increasing the cost of lending to clients in situations where banks are able to use the knowledge of the client's business gained from transactional services to lower the cost of lending.

<sup>120</sup> FG 15/09: 'Market studies and market investigation references – A guide to the FCA's powers and procedures' (July 2015): [www.fca.org.uk/your-fca/documents/finalised-guidance/fg15-09](http://www.fca.org.uk/your-fca/documents/finalised-guidance/fg15-09).

- 11.12** The risk of unintended consequences from such intervention would also be significant. Nevertheless, we remain open to receiving further views and evidence from stakeholders on whether the detriment arising from this issue does warrant significant intervention.
- 11.13** We have also considered whether introducing more competition for relationship services would enhance competition for transactional services<sup>121</sup>. Measures such as requiring tendering of corporate broking roles every few years, or limiting lending terms to a set period of time, would be unlikely to be effective because they would only lower barriers to relationship services.<sup>122</sup> The barriers to entry that we have observed are to those banks that do not or are unable to provide the relationship services. Any restrictions on choice tend to occur once the bank(s) have been selected to a client's panel of relationship banks.
- 11.14** We will therefore focus on lowering barriers to entry and expansion for non-universal banks and other service providers:
- We are aiming to remove the practice of banks using clauses that restrict choice in engagement letters (as described in Chapter 7). However, we are interested in receiving evidence on whether contractual clauses that restrict choice on future transactions lead to more favourable terms to clients.
  - We are seeking views on whether there are proportionate ways in which we can reduce barriers to competition for non-universal banks and other service providers without undermining the efficiency benefits of cross-selling.
- Q1: Are there any benefits to contractual clauses that restrict choice that we need to take into consideration? For example, are there any circumstances in which clients have benefitted from reduced fees or better terms when agreeing such clauses? Please provide supporting evidence.**
- Q2: If restrictive contractual clauses were to be prohibited, what practical issues might arise in doing so? Are there any types of services for which such contractual clauses should be permitted?**
- Q3: Are there other proportionate ways in which we can reduce barriers to competition for non-universal banks and other service providers? In particular, are there FCA rules and guidance that could be altered to enhance their prospects of competing for transactional business?**
- Q4: Are there other steps we should taking to allow more innovative approaches to primary market services to emerge?**

#### **IPO process**

- 11.15** Possible options to address our concerns regarding the availability of information during the IPO process (see Chapter 9) are set out in the discussion paper. This discussion paper includes specific questions for stakeholders to consider.

<sup>121</sup> Relationship services and transactional services are defined in Chapter 7.

<sup>122</sup> Limiting lending terms might not be in clients' interests either.

**11.16** In the discussion paper we set out that:

- We envisage an efficient and well-informed IPO process whereby:
  - **An approved prospectus is the central document in the IPO process such that it is available to investors when they need it.**
  - **High standards of conduct are fostered, in particular there is enhanced management of conflicts of interest inherent during the preparation and dissemination of connected research.**
  - **Conditions exist for unconnected research to be published during the IPO process, where there is demand for it.**
- In contemplating reforms we are alert to the need to avoid unwarranted lengthening of the IPO timetable, or indeed any other unnecessary disruption to the established market practice that has developed around what is a comparatively modest regulatory framework.
- We consider three main models for reform incorporating various combinations of the following two measures:
  - **re-sequencing the publication of an approved prospectus and connected research, which is intended to make the approved prospectus the primary source of information available to investors**
  - **providing unconnected analysts with an opportunity to have access to the issuer's management**
- We are seeking views on the current role of connected analysts in relation to IPOs, specifically asking whether there is any evidence of conduct issues arising when connected analysts meet with issuers and their corporate finance advisers in the process of awarding IPO mandates.

#### **Allocations**

**11.17** We would remind banks that we expect them to manage potential conflicts of interest by operating effective organisational and administrative arrangements, including implementing and maintaining appropriate internal allocation policies.<sup>123</sup> We expect banks to be able to demonstrate that favouring one client (i.e. the investor) does not cause detriment to another (i.e. the issuing client) and that the bank's own interest is not being placed ahead of its client or clients when determining the allocation.

**11.18** Where we found an absence of allocation policies (see Chapter 9), we will be following up with supervisory work to understand why.

**11.19** The aim of any wider remedial action would be to reduce the incentive for banks to reward favoured investor clients, where this is not necessarily in the issuing client's interest, which we found to be of concern in Chapter 9. This would help protect issuing clients and reduce competition concerns for buy-side investors that are less important in revenue terms to the banks.

<sup>123</sup> The provisions in SYSC 10.1.14G and SYSC 10.1.15G are of particular relevance to firms managing a securities offering.

**11.20** Any consideration of remedies in this area needs to be made in the light of the requirements we expect to be introduced under MiFID II, in particular the delegated act to be adopted by the Commission under Article 23(4). ESMA's technical advice to the European Commission on the delegated acts of MiFID II proposes that those acts require banks to maintain an allocation policy setting out the process for developing allocation recommendations. The technical advice notes that:

'this allocation policy shall be provided to the issuer client before agreeing to undertake a placing. The policy shall set out relevant information (to the extent it is known at that stage) about the proposed allocation methodology for the issue...The investment firm shall invite the issuer client to participate in discussions about the placing process so that the investment firm can take the interests of the issuer client into account, for example by obtaining the issuer client's agreement to its proposed allocation per type of client for the transaction in accordance with the allocation policy.'

**11.21** The delegated acts adopted under MiFID II could therefore go some way to addressing the concerns we have identified in Chapter 9.

**11.22** Against the background of the harmonised regime that the delegated acts will bring about, and given the harm arising to issuing clients as a result of the skew in allocation is not unequivocal, at this stage we plan to investigate further with individual banks where our analysis raises questions about conflict management in IPO allocations. We will focus on ensuring compliance with our existing rules and guidance (see paragraph 11.20) and helping banks prepare for the requirements that will be introduced under MiFID II.

**11.23** We are also interested in whether there are other innovative approaches to book-building that may avoid potential conflicts of interest or reduce the impact of potential conflicts in the allocation process. We are keen to understand whether there are actions we may take to assist with the emergence of such approaches.

**Q5: What additional steps should we be taking, consistent with MiFID II, to help address the concerns we have raised?**

**Q6: Are there any barriers to the emergence of other innovative approaches to book-building that we can address?**

#### **League tables**

**11.24** We are interested in whether there are remedies that could help to increase the credibility of league tables by exploring ways in which they could be better presented so that they are more meaningful for clients and remove incentives for conducting trades carried out at a loss purely for the purpose of gaining league table credit (as described in Chapter 6).

**11.25** We have considered several remedy options:

- standardised league tables
- incentivizing different behaviour by setting parameters for presentation of league tables

**11.26** We do not consider that it is appropriate in these circumstances for the FCA to take on production of standardised league tables. The parameters on which league tables are produced need to be varied for clients' different needs. Standard league tables would not allow for the multitude

of different requirements of clients. In addition, standardised league tables would only address one of the aims of the remedies – clearer presentation to clients. We do not consider they would overcome the incentive to undertake league table trades.

**11.27** Both of our aims in paragraph 11.24 could be achieved by improving the way in which league tables are presented to clients in pitches. In particular, we would like to see banks and advisers adopting better practices by presenting league tables in pitches that are more meaningful for clients and in clients' interests. This could, for example, be done by considering criteria for how league tables are presented to clients. Options might include:

- criteria for the presentation of the scope of deals covered by a league table, including:
  - **the period of time to which the transactions relate, where that period of time would be no less than a minimum period, say one year**
  - **the countries and types of transactions covered by the league table**
- league tables presented to clients being based on data that is consistent with the type of transaction the client is undertaking
- league tables presented to clients being the same as the ones used internally by banks
- the proportion (by value and volume) of an individual bank's transactions that exhibit characteristics that are consistent with a league table trade being declared when presenting league tables to clients. Such characteristics might include sole-led loss-making transactions. Whilst one bank would not be able to present data that captures loss-making transactions for all other banks (because the bank would not know which transactions of other banks are loss-making), the incentive of having to illustrate the impact of league table trades on its own position in the league table could reduce the incentive for such trades to be used for league table purposes.

**11.28** This is likely to be best achieved through an industry-led solution.

**Q7: How might an industry-led solution best be achieved to tackle the concerns we have outlined in relation to league tables in Chapter 6?**

**Q8: What practical issues would need to be considered in determining parameters for presentation of league tables to clients in order to reduce the incentive for league table trades?**

**Q9: What other solutions could be used (i) to discourage league table trades and (ii) to ensure league tables are presented in a way that is more meaningful for clients?**

### **Areas in which we are not proposing remedies**

**11.29** We did not identify material concerns that require intervention in respect of the following issues:

- **Availability of suppliers:** in Chapter 5 we did not find compelling evidence that clients that are active in particular regions, countries or sectors face a lack of available suppliers. Nor did we identify substantive concerns in relation to the availability of suppliers for financial institutions, SSAs or large corporate clients. While we have not seen evidence that medium-sized corporate clients are significantly affected by a lack of available suppliers at present we said that we had some concerns that this could become an issue in the future if regulatory developments or an economic downturn were to cause some banks to withdraw from this segment to focus on larger, more profitable clients. We do not see a need for action at this stage but we will monitor the competitive situation for medium-sized corporate clients.
- **Transparency:** in Chapter 6 we found that transparency is not a material area of concern. We expect banks and advisers to be able to demonstrate compliance with our existing rules as well as with the relevant MiFID II provisions, when they enter into force.
- **Syndication:** in Chapter 6 we found that clients have control over syndicate size and composition and that in some cases syndicates may be pro-competitive. Whilst we do not consider intervention is necessary in relation to syndication, clients and corporate finance advisers are reminded to consider the relative advantages and disadvantages of larger syndicates carefully.
- **Reciprocity:** in Chapter 6 we found little evidence that reciprocal arrangements, which are currently largely restricted to the bank financing market, most notably in respect of covered bonds, cause significant detriment to competing banks that do not or cannot reciprocate. We do not see any need for intervention at this stage. However, should the practice become more widespread or show signs of the potential detrimental effects we have highlighted, we will conduct further work with a view to intervening to prevent this type of behaviour.
- **Corporate finance advisers:** in Chapter 6, we noted that there was a perceived lack of clarity amongst some market participants around the extent to which corporate finance advisers are covered by our regulatory regime. We have sought to address this by providing clarity in Chapter 6. We also remind corporate finance advisers and banks of the FCA's rules on investment research under COBS 12.2, although it remains for the banks, not the corporate finance advisers, to ensure that the independence of the research that they produce is not compromised.

**Q10: Is there any reason why we should take any action at this stage in relation to:**

- **availability of suppliers for medium-sized corporate clients (or clients of any other size, type or sector or from any other region)**
- **transparency of scope of services and fees**
- **syndication**
- **reciprocity?**

**If so, what action should we be taking? Please submit evidence to support your claim for the need for action.**

**Q11:** Given the clarity we have provided in relation to the way in which corporate finance advisers are covered by our regulatory regime and lack of concerns we have found in Chapter 6, are there any areas in which we should be considering taking action?

## 12. Next steps

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### Further work planned

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- 12.1** We will continue to develop our thinking on whether we should intervene in this market, and what interventions would be most effective in improving competition to the benefit of issuing and investor clients, and ultimately end consumers. We will have regard to the further evidence we collect and responses of stakeholders.

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### Final report

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- 12.2** We expect to publish our final report in Summer 2016.
- 12.3** The final report will set out our findings and conclusions. If appropriate, we will consult at the same time, or subsequently, on any proposed actions.

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### Stakeholder views

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- 12.4** We would like to hear your views on this report, including on the need for intervention and, if so, your views on what form it should take. Please send us written comments by 25 May 2016.
- 12.5** If you would like to email feedback, please contact us at [icbmarketstudy@fca.org.uk](mailto:icbmarketstudy@fca.org.uk).

Financial Conduct Authority



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