

## UKLA Technical Note

### Identifying and managing conflicts

Ref: UKLA / TN / 701.3 – Guidance Consultation

The principle  
(LR 8.3.7AG)

The purpose of the rules and guidance (set out in LR 8.3.7BR to LR 8.3.12AG) that require sponsors to identify and manage conflicts of interest is to ensure that conflicts of interest do not adversely affect:

- 1) the ability of a sponsor to perform its functions properly under LR8; or
- 2) market confidence in sponsors.

We consider that these two limbs of the principle are interconnected because, where a sponsor's ability to perform its functions properly is adversely affected due to a conflict of interest, this may lead to market confidence in sponsors being adversely affected.

Where sponsor firms are authorised by the FCA, they will also need to comply with our overarching conflicts of interest provisions in SYSC 10. To the extent that sponsor firms provide underwriting and placing services, they must also consider a number of conflicts of interest provisions specific to these activities introduced under the Markets in Financial Instruments Directive II (MiFID II).

#### Identifying conflicts

Sponsors are required to take all reasonable steps to identify conflicts of interest that could adversely affect their ability to perform their functions under LR 8 properly (LR 8.3.7BR). In identifying conflicts of interest, LR 8.3.8G requires sponsors to take into account circumstances that could:

- 1) create a perception in the market that a sponsor may not be able to perform its functions properly; or
- 2) compromise the ability of a sponsor to fulfil its obligations to the FCA in relation to the provision of a sponsor service.

#### 'Regulatory' conflicts (LR 8.3.8G(2))

A regulatory conflict may arise where there is a conflict between a sponsor's obligations to the FCA and the terms of engagement with, or express or implied duties to, its client. Sponsors should be alert at all times to the possibility for a conflict to arise between their responsibilities to their client and their duties owed to the FCA.

#### 'Perceived' conflicts (LR 8.3.8G(1))

We believe the 'perception test' set out in LR 8.3.8G(1) is useful as it asks sponsors to consider wider market confidence issues when considering conflicts of interest. In practice, it also

enables us to be brought into the discussion when, despite a sponsor having in place conflict management arrangements, a perception in the market may exist that the sponsor may not be able to perform its functions properly (a 'perceived conflict' or 'perception of conflict'). Set out below are examples of circumstances when we consider a perceived conflict could arise:

- listings, capital raisings or disposals which may be perceived as facilitating an exit or material realisation for the sponsor's group. The context within which such a transaction takes place will be relevant to determining whether a perceived conflict exists; this is more likely to be the case where, as the result of the transaction, the sponsor group's exposure to that company is likely to be extinguished or significantly diminished, and
- unusual, synthetic or high-risk investment fund structures developed and promoted by the sponsor for listing. Considerations relevant to assessing whether a perceived conflict exists may include the extent to which the sponsor's group (a member of which may be acting as investment manager to the fund) is involved in selecting the management of the investment entity and the accumulation of the investment assets to launch the fund.

### **Perceived conflicts – the 'reasonable market user'**

When considering whether a perceived conflict of interest exists, we would encourage sponsors to assess the circumstances from the point of view of a theoretical reasonable market user. Having carried out such an assessment, a sponsor may decide not to act, or to seek guidance from the Sponsor Supervision team at the FCA (see 'When to contact us' below).

The reasonable market user is likely to be a person who has general knowledge of the type of transaction in question, the primary markets, and the operations of integrated investment banks. The reasonable market user would be aware that banks have systems and controls in place to identify and manage conflicts but would not necessarily conclude that conflicts can be managed in all circumstances. The assessment is likely to flex according to the circumstances of the transaction, taking into account its nature, size and context, any existing and proposed lending/financing arrangements that the sponsor has or may enter into with the client or with any related parties or target company in an acquisition, any unusual terms or conditions attached to the sponsor's arrangements or, generally, the nature and extent of its relationships with the issuer. For example, where an issuer is in financial distress and is undertaking a rights issue, the proceeds of which will be used to pay down existing debt owed to the sponsor's group, the reasonable market user may consider that, despite the sponsor firm having arrangements in place to manage its conflicts, a perception of conflict remains. In a similar scenario, but where the issuer is not in financial distress, the reasonable market user may consider that the sponsor's ability to perform its functions properly will not be adversely affected.

### **Identifying conflicts: factors to take into account when a transaction involves the provision of finance**

a) Proposed new loan – application of metric

When a sponsor or sponsor's group proposes to make a loan to an issuer in connection with a sponsor service (for example in relation to a merger or acquisition), which is of strategic importance to the sponsor group due to its size, we consider that a conflict or perceived conflict of interest may arise. Therefore, where the amount (prior to syndication) of the proposed loan is equal to or in excess of 0.5% of the sponsor group's total assets by reference to its last published consolidated accounts, the sponsor should contact us to discuss the relevant transaction prior to accepting the sponsor appointment.

The existence of a proposed loan which meets this size threshold does not automatically mean that a sponsor's ability to perform its functions properly will necessarily be (or be perceived to be) adversely affected. Similarly, the existence of a proposed loan which does not meet this size threshold does not rule out the possibility that there may be potential conflicts to be considered. The size of the financing is only one of the factors to be considered.

b) Existing or proposed financial exposure

When a sponsor or sponsor's group has an existing or proposed lending or other financial relationship with an issuer (typically because of an existing loan facility or a loan facility proposed to be entered into in connection with a sponsor service) the following factors may be relevant in considering the application of the rules and guidance in LR 8.3.7AG to LR 8.3.12AG:

- in relation to a loan which is proposed in connection with a sponsor service (in addition to the application of the metric as referred to in a) above):
  - whether the terms of the loan are normal commercial terms for that type of loan; and
  - any proposed syndication of the loan, including the sponsor's pre and post syndication exposure, whether the sponsor is lead arranger, is participating on equal terms, and its priority within the syndicate;
- in relation to an existing loan or financial exposure, the significance or materiality of the existing loan or financial exposure to the issuer and whether the loan is performing in line with expectations or is impaired;
- whether the transaction has a rescue element and, if so, the impact on the profit and loss account of the business area accountable for the loan within the sponsor's group should the loan be written off; and
- the prevailing circumstances of the issuer and details of the relevant sponsor service, including, in the case of a transaction that will lead to an injection of funds to the issuer (for example, by way of a rights issue or re-financing):
  - the primary motivation for the transaction;
  - the credit-worthiness of the relevant issuer;
  - the effect of the use of proceeds of the transaction (and, in particular, whether the sponsor's group exposure to the issuer will be extinguished or will materially diminish, or the sponsor's group will otherwise materially benefit, as a consequence of the transaction);
  - the nature and significance of the finance being provided to the issuer including whether the issuer is at serious or imminent risk of breaching the terms of the loan including any of its existing banking covenants; and
  - whether the sponsor's group is the only provider of finance to the issuer.

### **Identifying conflicts: factors to take into account generally**

Sponsors considering the application of the guidance and rules in LR 8.3.7AG to LR 8.3.12AG generally may wish to take the following into account:

- whether the amount and terms of the remuneration (i.e. fees and commissions) payable to the firm for the provision of sponsor and non-sponsor services are such that the sponsor's ability to perform its sponsor functions may be, or perceived to be, adversely affected (for

example, where the sponsor fee is unusually high or structured in a way which is unusual for that sponsor for the type of sponsor service being provided);

- whether there are any unusual or onerous contractual terms in documentation being entered into by the sponsor and the issuer or any other party in relation to the transaction; and
- other exposures the sponsor or sponsor group has to the issuer (e.g. equity interests or board representation).

The above factors are not intended to be exhaustive, nor does the presence of any one factor automatically mean that a sponsor's ability to perform its functions properly will necessarily be (or be perceived to be) adversely affected. We expect sponsors to carry out a full assessment of all the circumstances and to apply their judgement before reaching a view as to whether or not a conflict exists that could adversely affect their ability to perform its functions properly, or market confidence in sponsors, such that the sponsor should not act.

Depending on the outcome of its assessment, a sponsor may consider that it can manage the conflict appropriately, may decline to act or it may wish to contact us to discuss the issues arising and obtain our guidance (see 'When to contact us' below for when this may be the case).

## **Managing conflicts**

It will be possible in many cases for a sponsor, having identified a conflict of interest arising from it having more than one interest in a transaction, to manage the conflict in such a way that the sponsor can continue to perform its functions properly.

## **Systems and controls**

A sponsor is required to have appropriate systems and controls in place to carry out its role as sponsor (LR 8.6.5R(3)). This will include having effective systems and controls to identify and manage conflicts of interest (LR 8.6.12R(8)) and LR8.6.13AG provides guidance in this respect.

## **Operational and administrative arrangements**

LR 8.3.9R requires a sponsor to take all reasonable steps to put in place and maintain effective organisational and administrative arrangements that ensure conflicts of interest do not adversely affect its ability to perform its sponsor functions properly under LR 8. Sponsors should create a comprehensive conflicts policy that reflects the unique role of a sponsor, including the fact that it is a quasi-regulatory role, and the nature and diversity of their firms' operations. Sponsors which are authorised by the FCA will also need to comply with our overarching conflicts of interest provisions in SYSC 10. Sponsors' conflicts procedures should take into account that the purpose of LR 8.3.9R is also to ensure that conflicts of interest do not adversely affect market confidence in sponsors.

The operational and administrative arrangements that might be effective to manage conflicts of interest will vary according to the circumstances and we cannot prescribe how sponsors should approach specific conflicts of interest. However, we have set out below some common examples of potential conflicts scenarios and a non-exhaustive set of associated operational or administrative arrangements that sponsors should consider which may assist the sponsor to manage the conflict.

Circumstance	Conflict	Example conflict management steps
A member of the sponsor team has a material equity or other interest in a client or in a target company of the client.	The individual's interests may not be aligned with those of the sponsor or the FCA due to self-interest.	<ul style="list-style-type: none"> <li>• Individual is not included in the sponsor team on the transaction.</li> <li>• Key sponsor decisions on the transaction are made by a committee that excludes the individual (where the individual is included on the team).</li> <li>• Individual must not deal in the relevant shares or financial instruments (in accordance with their obligations under MAR).</li> <li>• Compliance oversight and approval of the conflict and the arrangements to manage the conflict.</li> </ul>
A member of the sponsor team has a current or past employment relationship or directorship with the client or target company.	<p>The individual may be overly familiar with the client, therefore impacting objectivity.</p> <p>The individual's interests may not be aligned with those of the sponsor or the FCA due to self-interest.</p>	<ul style="list-style-type: none"> <li>• Individual is not included in the sponsor team on the transaction.</li> <li>• Key sponsor decisions on the transaction are made by a committee that excludes the individual (where the individual is included on the team).</li> <li>• Compliance oversight and approval of the conflict and the arrangements to manage the conflict.</li> </ul>
A member of the sponsor's group has made or is proposing to make available loan finance to the client.	The financial interests of the sponsor's group in relation to the lending arrangements may be in conflict with their role as sponsor and their obligations to the FCA, impacting objectivity.	<ul style="list-style-type: none"> <li>• Arrangements in place to manage information flows between the lending team and the sponsor team.</li> <li>• No inter – conditionality of fees between the provision of the sponsor service and the proposed financing.</li> <li>• Arrangements in place to ensure decisions made in relation to the sponsor service are free from inappropriate influence by the lending interests of the sponsor firm.</li> <li>• Compliance oversight and approval of the conflict and the arrangements to manage the conflict.</li> </ul>

Where a sponsor is not reasonably satisfied that its organisational and administrative arrangements will ensure that a conflict of interest will not adversely affect its ability to perform its functions properly, it must decline or cease to provide the sponsor service (LR 8.3.11R).

## **Information controls**

Common organisational and administrative arrangements to manage conflicts of interest are likely to include establishing 'information controls' between the sponsor team and other areas of the business with an interest in the transaction, such as the areas of the sponsor group responsible for lending and for credit risk. We understand that, in certain circumstances, the sponsor team will need information about the existence and type of finance facility provided by its group to an issuer for whom the firm is providing sponsor services. This type of information may be needed to ensure that there is appropriate disclosure in the relevant shareholder circular, prospectus or listing particulars and to ensure the sponsor properly discharges its working capital obligations.

However, it is important that employees providing or responsible for sponsor services are not subject to influence from other areas of the sponsor group (and vice versa). In particular, employees providing or responsible for a sponsor service should not be in a position to be influenced by, or to influence, decisions relating to the provision of loan finance to the issuer or decisions relating to the credit worthiness of the issuer. To this extent, the sponsor team's knowledge should be limited to factual information about the loan. We would normally expect the sponsor to obtain information about the loan directly from the issuer or, where relevant, reporting accountants or other advisers. Where employees working on the sponsor service need to obtain information held by another part of the sponsor group (e.g. colleagues working in the area of the bank responsible for a loan), contact between the two areas should be carefully managed.

Sponsors should have appropriate arrangements in place to ensure that direct access to employees working on the non-sponsor service aspects of a transaction is appropriately supervised and that the passing of information between areas is controlled. A sponsor should maintain appropriate records where information passes between the two areas, including what and to whom information has been provided. Having these arrangements in place will assist a sponsor to comply with its obligation to have effective administrative arrangements in place that ensure conflicts do not adversely affect its ability to perform its sponsor functions properly (LR 8.3.9R).

## **When to contact the FCA**

If, after considering all the relevant circumstances and carrying out a reasonable market user assessment where appropriate, a sponsor is reasonably satisfied either that no conflict exists or that it can effectively manage the conflict, we do not usually expect the sponsor to contact us prior to it acting. Where a sponsor is in any doubt about whether a conflict can be effectively managed it should contact the Sponsor Supervision team at the FCA before it decides if it can provide any sponsor services (LR 8.3.12G). We expect to hold discussions about sponsor conflicts with a sponsor's legal or compliance team.

In exceptional circumstances, we would ask that a sponsor always contacts us in advance of deciding if it can provide sponsor services and, where this is the case, sponsors should make such contact at the earliest opportunity. These circumstances are where:

- 1) in connection with a transaction a sponsor proposes to provide loan finance which (prior to syndication) is of an amount equal to or in excess of 0.5% of the sponsor group's total assets (by reference to its last published consolidated accounts);
- 2) the issuer is in financial distress or is at imminent risk of being in such distress and the transaction provides the sponsor or sponsor's group with an exit or its exposure to the issuer is materially diminished as a result of the transaction;
- 3) where the transaction involves a related party and, specifically, where the sponsor proposes to provide confirmation that the terms of the transaction or arrangements with the related party are fair and reasonable in accordance with LR 11.1.10R(2)(b) or LR 13.6.1R(6) and is also acting in another capacity, such as providing acquisition finance, for the related party or other party to the transaction;
- 4) as an outcome of carrying out the reasonable market user assessment or otherwise, a perception exists that the sponsor may be unable to perform its functions properly;
- 5) there are any unusual, novel or complex features to the transaction or the sponsor's involvement in it; and
- 6) the amount and terms of the sponsor's remuneration (i.e. fees and commissions) for the provision of sponsor and non-sponsor services are such that the sponsor's ability to perform its sponsor functions may be, or perceived to be, adversely affected (for example, where the sponsor fee is unusually high or structured in a way which is unusual for that sponsor for the type of sponsor service being provided).

In the above situations, we consider that a perception that the sponsor is unable to perform its functions properly may exist and that, as such, market confidence in sponsors may be adversely affected. We consider this particularly likely to be the case in the situation where a sponsor is providing a fair and reasonable opinion pursuant to LR 11.1.10R(2)(b) or LR 13.6.1R(5) as well as acting in another capacity on the transaction for the related or other party. In circumstances such as those outlined above, we will wish to gain a fuller understanding of the conflict position and a sponsor should contact us for this purpose. Where, after consideration, we have residual concerns that the conflict cannot be effectively managed or that a perceived conflict exists, we may query how the sponsor has reasonably satisfied itself and ultimately may indicate that we are not comfortable with the firm's assessment.

## **What to expect from us**

Where, in the circumstances set out above or otherwise, a sponsor contacts the Sponsor Supervision team to discuss a potential conflict of interest on a proposed transaction (or, alternatively, where we contact the sponsor), simple queries may often be dealt with over the telephone or in person. Queries of this nature are dealt with in accordance with SUP 9. If oral queries from sponsors raise complex or significant issues, we are likely to request that the sponsor provides a written submission and may request specific information to be included in it. We will need sufficient information and sufficient time before we can properly evaluate the situation and respond to a request for guidance. Where appropriate, we may request further information either in writing or in a follow up telephone call with the sponsor. We will aim to respond quickly and fully to reasonable requests and will expect a sponsor to have taken reasonable steps to research and analyse a topic before contacting us. Sponsors should provide the name of the issuer and:

- a description of the circumstances relating to the request for guidance including the factors taken into account in identifying the conflict or potential conflict and, where relevant, the sponsor's reasonable market user assessment;

- an explanation of how the sponsor proposes to manage the conflict by reference to its systems and controls and operational and administrative arrangements; and
- the firm's analysis of whether the conflict (actual or perceived) can be appropriately managed or whether there are concerns that a perception of conflict remains.

If a query is time-critical, the sponsor should make this clear to us from the outset. The more notice a firm can provide, the more likely we will be able to meet the sponsor's desired timescale, although it is important to note that the time taken to respond will necessarily depend upon the issues involved and where an issue is novel or complex we may wish to escalate the matter for decision within the FCA.

Sponsors should be aware that there may be a delay in us providing comments on a prospectus, circular or other document which has been submitted to the FCA for review until any conflict queries have been resolved. **Accordingly sponsors should consider whether there are any legal, regulatory or commercial risks should they decide to provide a sponsor service or to continue working on a sponsor service while we are considering the conflict query.**

Sponsors should keep their conflicts assessment under review throughout the course of the sponsor service and reconsider their obligations if any of the circumstances change.

## Approach to conflicts in early or urgent provision of sponsor services

A sponsor may be asked to provide advice which comprises a sponsor service prior to or in the absence of any formal appointment as sponsor. We expect a sponsor to consider the application of LR 8.3.7AG to LR 8.3.12AG in these circumstances and, accordingly, to take reasonable steps to identify conflicts of interest that could adversely affect its ability to perform its functions properly under LR 8, though we appreciate that there can be practical challenges in doing so. Examples of situations which may be problematic include where a sponsor has been asked to provide:

- early stage guidance to an issuer (for instance, initial class test advice or advice on IPO structuring) which falls within the Listing Rule definition of 'sponsor service', bearing in mind that the definition includes 'preparatory work' that a sponsor may undertake before a decision is taken about whether or not it will act as sponsor for a listed company or applicant or in relation to a particular transaction; or
- sponsor services outside normal office hours or as a matter of urgency (for example, in a situation such as a rescue or when an issuer is in severe financial difficulty).

In exceptional circumstances it might be appropriate for sponsors to modify their approach to conflicts checks on a temporary basis. In this event, matters which a sponsor might take into account include:

- currently held information on its clients, including any work-in-progress relating to them;
- results of conflict checks carried out by virtue of other pre-existing relationships it has with the issuer (for example, as a corporate broker, financial advisor or from involvement in a recent transaction); and
- negative assurances, given to the best of their knowledge, by those involved in the matter on which advice is being sought (for example, the deal team, direct management, client contacts).



We would expect sponsors to record any steps taken, as envisaged by LR 8.6.16AR(4). In addition, in exceptional circumstances where modified conflicts checks have been performed, we would expect full conflicts checks to be performed as soon as practicable, in accordance with the sponsor's usual procedures.

### **Record Keeping**

Sponsors are reminded of their record management obligations set out in LR 8.6.16AR to LR 8.6.16CG. LR 8.6.16AR(4) specifically requires a sponsor's records to be sufficient to be capable of demonstrating the steps the firm has taken to comply with its obligations in relation to conflicts under LR 8.3.7BR, LR 8.3.9R and LR 8.3.11R.