MiFID II

Underwriting and placing

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Hogan Lovells

Key Points

- Firms must identify and prevent or manage conflicts of interest that may arise due to underwriting and placing activities, and provide information to clients.
- ESMA has proposed arrangements in relation to advising, pricing, placing, providing retail advice or distribution, and lending to an issuer client.

Background

Underwriting and placing, which are categorised as investment services/activities for the purposes of MiFID, give rise to potential conflicts of interest, particularly between an investment firm and its client that is issuing securities (the "**issuer client**"). Further conflicts may arise between the firm and its issuer client and any other clients of the firm that are also issuing their own securities or are investing in the issuer client's securities.

The MiFID I Directive already contains general provisions relating to conflicts of interest:

- Article 13(3) requires firms to have in place effective organisational and administrative arrangements to avoid conflicts.
- Article 18 requires firms to identify and prevent or manage conflicts of interest; if a firm is unable to prevent or manage such a conflict, it must disclose that conflict to the affected client.

The provisions in the MiFID I Directive will be carried forward into Articles 16(3) and 23 respectively of the MiFID II Directive.

However, because of the particular risks posed by underwriting and placing, MiFID II will also introduce rules requiring more rigorous arrangements and greater disclosure in relation to conflicts of interest arising in these scenarios.

Conflicts of interest in underwriting and placing

The MiFID II Delegated Regulation[1] will impose a number of organisational requirements on firms undertaking underwriting and placing business, to avoid conflict of interests being generated. This follows on from ESMA's May 2014 consultation paper and its Technical Advice of December 2014, which contained various proposals relating to this issue, which have generally been reflected in the rules in the MiFID II Delegated Regulation.[2]

General requirements when a firm is undertaking underwriting and placing business

Article 38 of the MiFID II Delegated Regulation contains a number of general requirements which apply when an investment firm undertakes underwriting and placing business and provides advice on corporate finance strategy.

Conflicts of interest may arise due to an investment firm, such as an integrated investment bank, taking on many different roles in relation to underwriting and placing. For example:

- a firm that recommends a particular means of raising finance (such as a public equity offering) may maximise its own fees, even though its client would have been better served by seeking alternative financing methods;
- a firm may recommend an equity fundraising so that its issuer client repays a loan previously granted by the firm;
- a firm may recommend an equity fundraising to boost its own position in industry league tables;
- the firm may have an existing relationship with the issuer client as its corporate banker;
- an issuer client may be reluctant to change underwriter as this might indicate to the market that it is struggling to raise finance; or

[1] Commission Delegated Regulation of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (the "**MiFID II Delegated Regulation**").

[2] See ESMA, Consultation Paper, 22 May 2014, Chapter 2.10; ESMA, Final Report: Technical Advice to the Commission on MiFID II and MiFIR, 19 December 2014 (ESMA/2014/1569) (the "**Technical Advice**"), Chapter 2.10.

- there may be an information asymmetry between a firm with experience of underwriting and placing and an issuer client that has not previously engaged in this activity.[3]

Article 38(1) requires that where a firm is providing advice on corporate finance strategy and providing underwriting and placing services, such a firm must make arrangements to disclose certain information to the client. In particular:

- the various financing alternatives available with the firm, and an indication of the amount of transaction fees associated with each alternative;
- the timing and the process with regard to the corporate finance advice on placing and/or pricing of the offer;
- details of the investors to be targeted;
- the job titles and departments of the relevant persons individuals involved in the provision of corporate finance advice on the price and allotment; and
- firm's arrangements to prevent or manage conflicts of interest that may arise where the firm places the relevant financial instruments with its investment clients or with its own proprietary book.

Disclosure of this information must be made prior to the firm accepting a mandate to manage an offering for that client.

Article 38 of the MiFID II Delegated Regulation also contains a number of other requirements applicable to firms undertaking underwriting and placing business:

- Firms must have in place a centralised process to identify all underwriting and placing operations of the firm and record such information, including the date on which the firm was informed of such operations.
- Firms must identify all potential conflicts of interest arising from other activities of the investment firm, or group, and implement appropriate management procedures. Where a firm cannot manage a conflict of interest by way of implementing appropriate procedures, the firm must not engage in the operation.
- Firms providing execution and research services as well as carrying out underwriting and placing activities must ensure adequate controls are in place to manage any potential conflicts of interest between these activities and between their different clients receiving those services.

Pricing of an offering

Article 39 of the MiFID II Delegated Regulation contains additional requirements in relation to the pricing of an offering.

ESMA noted, in its consultation paper on this issue,[4] that potential conflicts may arise as part of the pricing process. These conflicts may encourage an investment firm to under-price or over-price an offering, depending on the circumstances. For example, a firm may have an interest in securing a low purchase price for its investment clients or for its own proprietary trading desk. Alternatively, the firm could inflate demand for an issue to reward favoured clients who are early participants in that issue and can sell at a higher price later.

Article 39(1) of the MiFID II Delegated Regulation requires firms to have systems, controls and procedures to identify and prevent or manage conflicts of interest that arise in relation to possible under-pricing or over-pricing of an issue or involvement of relevant parties in the process. In particular, firms must establish internal arrangements ensuring:

- that the pricing of the offer does not promote the interests of other clients or the firm, in a way that may conflict with the issuer client's interests;
- the prevention or management of a situation where persons responsible for providing services to the firm's investment clients are directly involved in decisions about corporate finance advice on pricing to the issuer client.

Firms must provide clients with information about how the recommendation as to the price of the offering and the timings involved is

3 ESMA, Consultation Paper, 22 May 2014, p. 79.

4 ESMA, Consultation Paper, 22 May 2014, pp. 79-80.

determined. In particular, the firm must inform and engage with the issuer client about any hedging or stabilisation strategies it intends to undertake in relation to the offering, including how these strategies may impact the issuer clients' interests. During the offering process, firms must also take all reasonable steps to keep the issuer client informed about developments with respect to the pricing of the issue.[5]

Placing

Article 40 of the MiFID II Delegated Regulation contains additional requirements in relation to placing.

Firms must have arrangements to prevent placing recommendations from being inappropriately influenced by other existing or future relationships.[6]

Firms must also have effective internal arrangements to prevent or manage conflicts of interests that arise where persons responsible for providing services to the firm's investment clients are directly involved in decisions about recommendations on allocation.[7]

Firms must also not accept third party payments that conflict with the inducements rules in MiFID II (see our separate briefing note on Inducements). The MiFID II Delegated Regulation provides the following non-exhaustive examples of practices that would be considered not compliant with those requirements:

- an allocation made to incentivise the payment of a large amount of fees for unrelated services provided by the firm ("laddering") (including disproportionately high volumes of business at normal commission levels provided by the investment client as compensation for the allocation);
- an allocation made to a client's company executive in return for corporate finance business awarded to the firm ("spinning"); and
- an allocation that is conditional on future business.[8]

Firms must have an allocation policy that sets out the process for developing allocation recommendations. The policy must be provided to the issuer before agreeing to undertake a placing. The policy must set out relevant information that is available at that stage, about the proposed allocation methodology for the issue.[9]

Firms must involve the issuer client in discussions about the placing process to enable firms to take account of the client's interests and objectives. Firms must also obtain the client's agreement about the proposed allocation per client type.[10]

Retail advice / distribution

Article 41 of the MiFID II Delegated Regulation contains requirements on advice, distribution and self-placement.

A conflict of interest may arise if a firm distributes financial instruments to investors, where the firm has been involved in the underwriting and placing of those financial instruments. This might influence the firm to act against the investors' interests, because of its interest in having a successful offering.[11]

Article 41(1) requires that firms have in place systems, controls and procedures to identify and manage the conflicts of interest that may advice where a firm provides investment services to an investment client in relation to an issuance where it has also received commissions or any monetary or non-monetary benefit in relation to arranging that issuance. Any such commissions or benefits must comply with Articles 24(7), 24(8) and 24(9) of the MiFID II Directive, which set out the rules on inducements (for further detail on these rules, please see our separate briefing note on Inducements).Such commissions or benefits must also be documented in the firm's conflicts of interest policies and reflected in the firm's inducements arrangements.

5 Article 39(2), MiFID II Delegated Regulation.
6 Article 40(1), MiFID II Delegated Regulation.
7 Article 40(2), MiFID II Delegated Regulation.
8 Article 40(3), MiFID II Delegated Regulation.
9 Article 40(4), MiFID II Delegated Regulation.
10 Article 40(5), MiFID II Delegated Regulation.
11 ESMA, Consultation Paper, 22 May 2014, pp. 82-83.

Article 41(2) requires firms engaging in the placement of financial instruments issued by themselves or by a group company to their own clients (including depositor clients, or funds managed by entities in their group) to maintain arrangements to identify and prevent conflicts of interest. This may involve a firm refraining from placing financial instruments with such clients if the conflicts cannot be managed.

Firms may also be required to disclose such conflicts to their clients. If this is the case, firms should explain the nature and source of the conflicts inherent to this kind of activity, so that clients may make an informed decision on their investments and comply with the other requirements of Article 34(4) (which are the general requirements regarding disclosure of conflicts of interest— see our note on Conflicts of Interest).[12]

Firms offering financial instruments issued by themselves or other group entities to their clients where those instruments will be counted in capital calculations, shall provide such clients with additional information explaining the differences between the financial instrument and bank deposits including in relation to yield, risk and liquidity.

Lending / provision of credit

Article 42 of the MiFID II Delegated Regulation contains requirements on lending and the provision of credit where this is done in the context of underwriting/placing.

There are potential conflicts of interest where a firm has provided credit to an issuer client for which it is also [providing underwriting and placing services. For example, the firm might:

- fail to provide complete information of the financial situation of the issuer to clients;
- fail to make sufficiently robust enquiries into the financial situation of the issuer; or
- maximise the return on investment from the loan, without any regard to the long-term interests of the issuer client.[13]

Firms must have arrangements to identify and manage any conflicts where they have issued a loan to an issuer client that may be repaid with the proceeds of the issue. If the risk to the client's interest cannot be managed, then the conflict must be disclosed to the client.[14]

Firms must ensure that their conflict of interest policy requires the sharing of information about the issuer's financial situation with group entities acting as credit providers, provided that this would not breach information barriers set up by the firm to protect client interests.[15]

Recordkeeping and oversight

Article 43 of the MiFID II Delegated Regulation contains requirements on recordkeeping and oversight.

Firms must keep records of:

- the content and timing of instructions received from clients;
- all allocation decisions to provide for a complete audit trail between the movements registered in clients' accounts and the instructions received by the investment firm;
- in particular, the final allocation made to each investment client must be justified and recorded.

The complete audit trail maintained of the material steps in the underwriting and placing process must be made available to competent authorities upon request.

Timescales for implementation

The MiFID II Directive and MiFIR came into force on 3 July 2014, and most of their provisions will come into effect in member states from 3 January 2018. Member states have until July 2017 to transpose the MiFID II Directive into national law.[16]

The MiFID II Delegated Regulation will become effective from 3 January 2018. The MiFID II Delegated Regulation will have direct effect and the member states will not need to implement these changes into national law.

12 Article 41(4), MiFID II Delegated Regulation.
13 Articles 41(1) and (2), MiFID II Delegated Regulation.

14 ESMA, Technical Advice, 19 December 2014, p. 94.
15 Article 41(4), MiFID II Delegated Regulation.
16 See Directive (EU) 2016/1034 of the European Parliament and of the Council of 23 June 2016 amending Directive 2014/65/EU on markets in financial instruments.

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