MiFID II

Underwriting and placing

2016

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 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.

ESMA proposals on conflicts of interest in underwriting and placing

ESMA has identified a number of scenarios in the underwriting and placing process when a conflict of interest may arise. Consequently, ESMA proposes that additional requirements for organisational arrangements and information disclosure should be put in place as a result.

In its May 2014 consultation paper, followed by its Technical Advice of December 2014, ESMA proposed the following rules in relation to the scenarios listed below.[1]

Advising on an offering

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
- 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.[2]

ESMA proposes in its Technical Advice that, before an investment firm accepts a mandate to manage an offering, it should disclose to the client:

- the various financing alternatives available from the firm, and an indication of the level of fees for each;
- the timing and process for the corporate finance advice given by the firm for pricing and for placing the offer;

[1] 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.

[2] ESMA, Consultation Paper, 22 May 2014, p. 79.

- details of investors to be targeted;
- job titles and departments of individuals providing the corporate finance advice; and
- how it will manage any conflicts arising if it places securities with its other clients or on its proprietary book.[3]

Pricing of an offering

ESMA has noted 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.[4]

ESMA's Technical Advice proposes that firms should have arrangements to identify and manage conflicts of interest to ensure that pricing does not promote the firms' and other clients' interests over those of the issuer client. Firms should also provide clients with information on how the firm determines its recommendation for the price and timing of the offering.[5]

Placing

ESMA has proposed in its Technical Advice that firms should have arrangements to prevent placing recommendations from being inappropriately influenced by other relationships. In particular, firms should not accept third party payments that conflict with the inducements rules in MiFID II (see our separate briefing note on Inducements). ESMA has given the following non-exhaustive examples of practices that would be considered abusive:

- an allocation made to incentivise the payment of a large amount of fees for unrelated services provided by the firm ("laddering");
- 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.

Firms should have an allocation policy that sets out the process for developing allocation recommendations. The policy should be provided to the issuer before agreeing to undertake a placing.[6]

Retail advice / distribution

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.[7]

ESMA's Technical Advice proposes that firms must 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 investor in relation to an issuance where it has also received commissions or fees for that issuance. ESMA has confirmed that any such commissions or fees must comply with Article 24(9) of the MiFID II Directive, which sets out the rules on inducements (for further detail on these rules, please see our separate briefing note on Inducements).

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.[8]

Lending / provision of credit

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:

[3] ESMA, Technical Advice, 19 December 2014, pp. 91-92.

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

[5] ESMA, Technical Advice, 19 December 2014, p. 92.

[6] ESMA, Technical Advice, 19 December 2014, p. 93.

[7] ESMA, Consultation Paper, 22 May 2014, pp. 82-83.

[8] ESMA, Technical Advice, 19 December 2014, pp. 93-94.

- 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.[9]

ESMA's Technical Advice states that firms should 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.[10]

Recordkeeping and oversight

According to ESMA's Technical Advice, firms will be required to keep records of client instructions. They must also keep records of all allocation decisions in order to provide a complete audit trail showing the correlation between client instructions and the allocations made to investors.

Firms should have a centralised process to identify and record all underwriting and placing operations. Firms should also identify al potential conflicts and implement appropriate management procedures, where possible.[11]

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 2017. Member states have until July 2016 to transpose the MiFID II Directive into national law.

However, following discussions between ESMA and the European Commission, it is now expected that the implementation of MiFID II will be delayed until January 2018. The European Commission is also drafting delegated acts on the basis of the Technical Advice received from ESMA in December 2014.

[9] ESMA, Consultation Paper, 22 May 2014, p. 83.

[10] ESMA, Technical Advice, 19 December 2014, p. 94.

[11] ESMA, Technical Advice, 19 December 2014, p. 95.

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