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Changes in regulatory landscape for corporate finance service providers

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Investment firms engaged in the provision of corporate finance services to issuer clients are facing some significant changes to their regulatory landscape. With the entry of MiFID II into effect from 3 January 2018, corporate finance service providers will become subject to detailed new requirements on the identification, management and disclosure of specific conflicts of interest arising from the conduct of underwriting and placing activities. The FCA is also increasing its focus on corporate finance service providers and has recently consulted on new rules which, if implemented, would result in a ban on the use of restrictive contractual clauses relating to the provision of future corporate finance services. This article explores these new rules and restrictions and considers what investment firms should be doing now in order to prepare.

MIFID II – Conflicts of Interest rules in relation to underwriting and placing services

MIFID II will introduce a raft of new measures on the management of conflicts of interest by corporate finance services firms. These measures will be set out in a delegated regulation on the organisational requirements and operating conditions for investment firms (the "**Delegated Regulation**"), which is currently only in draft form with the final version expected to be published early this year.

Articles 38 to 43 of the Delegated Regulation set out the substantive new rules applicable to corporate finance firms on the identification and management of corporate finance-specific conflicts of interest. These rules build on the overarching conflicts of interest obligations in Articles 16(3), 23 and 24 of the MiFID II Directive (2014/65/EU). The new rules are more prescriptive and generally add rigour to the existing requirements applied under MiFID I.

The new rules will require corporate finance services firms to implement and operate extensive systems and controls to identify and manage conflicts. These measures include:

1. **Disclosure:** firms must make certain prescribed disclosures to issuer clients before accepting a mandate to manage an offering, including information on:

- 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 on the pricing and placing of the offer;
- details of the targeted investors;

- job titles and departments of the individuals involved in the provision of corporate finance advice on price and allotment; and
- arrangements to prevent or manage conflicts of interest that may arise where the placement is with the firm's investment clients or with its own proprietary book

2. **Identification:** firms must put in place a centralised process to identify all underwriting and placing operations of the firm. Firms must also identify all conflicts of interest between these underwriting and placing activities and any other activities of the firm or group and implement management procedures to address these conflicts.

3. **Execution and research conflicts:** firms must put in place controls to manage conflicts arising between execution and research services and underwriting and placing activities;

4. **Under / over-pricing conflicts:** firms must maintain systems, controls and processes to identify and prevent or manage conflicts of interest that arise in relation to under- or over-pricing of an issue. These arrangements must ensure that the pricing of an offer does not promote the interest of other clients or a firm's own interests in conflict with the issuer's interests.

5. **Stabilisation / hedging:** firms must notify issuer clients about any hedging or stabilisation strategies that it intends to undertake with respect to the offering, including on how these strategies may impact the issuer client's interests.

6. **Placing controls:** firms must establish, implement and maintain effective arrangements to prevent recommendations on placing from being inappropriately influenced.

7. **Issuer / Investment clients conflicts:** firms must maintain effective 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 to the issuer client on allocation. Firms must also have in place systems, controls and procedures to identify and manage conflicts of interest that arise when providing investment services to investment clients to participate in a new issue, where the firm also receives commissions, fees or other benefits in relation to arranging the issuance.

8. **3rd Party payments:** firms must not accept any third party payments or benefits unless such payments or benefits comply with MiFID II Directive Article 24 inducements rules. The following practices are not acceptable:

- allocations made to incentivise the payment of disproportionately high fees for unrelated services provided by the investment firm ('laddering');
- allocations made to a senior executive of an existing or potential issuer client, in consideration for the future or past award of corporate finance business ('spinning');
- allocations that are expressly or implicitly conditional on the receipt of future orders or the purchase of any other service from the investment firm by an investment client.

9. **Allocation policy:** Firms must maintain an allocation policy to set out the process for developing allocation recommendations. A copy of the policy must be provided to an issuer client before agreeing to undertake placing services.

10. **Discuss placing process:** Firms must involve an issuer client in discussions about the placing process in order to understand and take into account the client's interests and objectives. The issuer client's agreement must be obtained to the firm's proposed allocation per type of client.

11. **Investment firm issuers:** Investment firms that place with their clients financial instruments issued by themselves or by entities within the same group, must maintain clear and effective arrangements for the identification, prevention or management of the potential conflicts of interest that arise in relation to this type of activity. Where the issued instruments count towards the investment firm issuer's prudential requirements they must also provide clients with additional information explaining the differences between the instrument and bank deposits in terms of yield, risk, liquidity and any protections provided by deposit guarantee schemes.

12. **Repayment of credit by issuer client:** Where any previous lending or credit to the issuer client by an investment firm (or an entity within the same group) may be repaid with the proceeds of an issue, the investment firm must have arrangements in place to identify and prevent or manage any conflicts of interest that may arise as a result. Where such arrangements are insufficient to prevent risk of damage to the issuer client, the firm must disclose the specific conflicts of interest that have arisen.

13. **Record keeping:** Firms must keep records of the content and timing of instructions received from clients, along with a record of allocation decisions and the final allocation made to each investment client. These records must be made available to competent authorities upon request.

The FCA intends to implement these rules by providing a copy-out of Articles 38-43 in a new chapter 11A of the Conduct of Business sourcebook ("**COBS**") of the FCA Handbook. The existing guidance for firms managing securities offering conflicts of interest in Chapter 10.1 of the Senior Management Arrangements, Systems & Controls sourcebook ("**SYSC**") will be deleted.

Actions for Firms

Whilst the Delegated Regulation has yet to be finalised, no significant changes are expected to the current draft. As such, at this stage most corporate finance service provider firms should already be quite advanced in terms of analysing the impact of MiFID II and the Delegated Regulation on their businesses and in planning for changes to relevant conflicts of interest systems and controls. As many of the new rules reflect existing FCA guidance on the management of conflicts of interest in the provision of underwriting and placement services, such changes may not be substantial and will be primarily for the purposes of demonstrating that existing good practice meets the new prescriptive requirements.

FCA ban on restrictive contractual clauses relating to corporate finance services

The FCA has recently consulted on proposals to introduce restrictions on the ability of corporate finance services providers to include restrictive contractual clauses in customer contracts. In its October 2016 Consultation Paper "*Investment and corporate banking: prohibition of restrictive contractual clauses*" (CP16/31), the FCA proposed the introduction of a ban on the use of restrictive contractual clauses in investment and corporate banking letters and contracts where the clauses cover the provision of future corporate finance services. The ban will apply in relation to all business carried out from an establishment in the UK, regardless of where the client is based or the legal entity to which the activity is booked for accounting purposes.

The Consultation Paper follows an interim report by the FCA in April 2016 concerning investment and corporate banking, in which the FCA found that primary market providers were predominantly utilising a "universal banking" model involving the cross selling and cross-subsidisation of services. Under this model, banks and advisers were establishing relationships by providing corporate broking and corporate lending services at either a low rate of return or below cost in return for securing more profitable ongoing transactional business such as the provision of ECM, DCM and M&A services. The FCA noted that whilst many primary market clients felt that this model worked well, it found that certain practices within the model could hinder competition, especially for smaller clients. In particular, the FCA identified concerns with the use by banks of contractual clauses (in contracts, mandates and engagement letters) that obliged clients to award or offer financial services to that bank.

The FCA has proposed the ban on such "restrictive contractual clauses" as it believes that a ban will protect clients that are explicitly constrained by such clauses and provide them with a greater choice of providers and more competitive terms. The FCA has also noted that the introduction of such a ban sends a clear message of its unwillingness to tolerate such behaviour by firms where it is not clearly beneficial for clients. The FCA considered the use of less interventionist measures such as the use of client warnings or only permitting the use of restrictive contractual clauses where clients expressly request them, but ruled such options out on the grounds that clients are in a weaker bargaining position with banks and therefore might be strong-armed into accepting such obligations.

The ban will be implemented through the introduction of new rules in Chapter 18 of COBS. The new rules will prohibit firms from entering into arrangements with a client which contain a "*future service restriction*" – defined as any provision in an agreement which grants the firm (or an affiliate) the right to:

(i) provide future corporate finance services to the client; or

(ii) provide future corporate finance services to a client before the client is able to accept any offer from a 3rd party to provide those services.

This effectively bans the use of commonly used forms of restriction including "right of first refusal" clauses and "right to act" clauses. However, the rules do not ban clauses that merely give the firm the right or opportunity to pitch for future business, or be considered for future business alongside other providers or match quotations from other providers.

The ban also only applies in relation to the provision of future services. This would not therefore ban clauses that relate to the recuperation of fees for work already undertaken by a firm where the client decides to use another firm for the same service – so-called "tailgunner" clauses. In addition, the prohibition only applies in relation to corporate finance services which may be required in the future but which, at the date of the agreement, are not yet certain. Therefore if an agreement specifies that a corporate finance service *will* be provided in the future then the ban will not apply.

There is also an exclusion from the ban for future service restrictions that relate to the provision of a bridging loan, which for these purposes must be a loan with a term of less than 12 months provided on the condition that it will be replaced with longer-term financing. The FCA included this exclusion as it noted that a bank would be unlikely to provide a bridging loan if it did not also know that it would be mandated on the subsequent longer term financing – and hence the use of restrictive contractual clauses in such cases remains appropriate. Both the Loan Market Association (LMA) and the Association for

Financial Markets in Europe (AFME) jointly together with the British Bankers' Association (BBA)
Have, in their responses to the consultation paper, argued that the 12 month limit on the term of a bridging loan under the exclusion should be removed – as many bridging loans have a maturity of more than 12 months and a key element for the provision of any bridging loan is that it is provided on condition that it will be replaced with longer term financing.

The FCA consultation closed on 16 December 2016, with a Policy Statement expected to follow in early 2017 confirming the final rules. The rules are expected to enter into effect shortly afterwards. The ban will apply to any new contracts or engagement letters entered into after commencement of the rules, but will not apply to contracts or engagement letters that exist before that date.

Actions for firms

The FCA's proposed prohibition on restrictive contractual clauses is expected to enter into force in early 2017 and will have a widespread impact – the FCA noted that 86% of its sample of banks were using or seeking to use restrictive clauses across their ECM, DCM, M&A and corporate lending and broking services. The ban will require such firms to review their business models and contractual arrangements with clients to ensure that they do not contain any restrictive clauses relating to the future provision of corporate finance services. Whilst the ban will not prohibit any agreements in existence before the entry into effect of the ban, the FCA is likely to take a dim view of any firms that seek to "lock-in" clients to such restrictive terms and practices before the official entry into force of the ban.

Firms will therefore need to review their use of restrictive clauses for corporate finance services and determine whether any changes will be required to existing business models. Firms should then consider how best to integrate any required changes into their existing MiFID II action plans. In particular, if new contractual arrangements will be required for new clients from the date of introduction of the ban, firms should consider whether it may be possible to build into these new contracts any specific conflicts of interest disclosures required under the Delegated Regulation.

For more background information on how this impacts finance transactions please see our Prohibition on 'right of first refusal' clauses in financing transactions Client Alert.

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