Briefing Note

Telephone Taping and M&A Activities

December 2017

1. Introduction

1.1 This note considers the application to M&A advisory and other related activities of investment banks ("***M&A Activities***") of the FCA's telephone taping rules set out in PS17/14, which was published in July 2017 to transpose the MiFID II requirements into UK law.

1.2 The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

1.3 AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is registered on the EU Transparency Register, registration number 65110063986-76.

2. General

2.1 The scope of the telephone taping rules is set out in SYSC10A.1.1, which will come into force on 3rd January 2018. Broadly, the rules apply to UK MiFID investment firms (and other categories of firm) that carry on one of a number of regulated activities in relation to 'financial instruments' (as defined in MiFID II).

2.2 With respect to M&A Activities the relevant regulated activities under MiFID II are:

(a) arranging (bringing about) deals in investments;

(b) dealing in investments as agent; and

(c) dealing in investments as principal.

2.3 The regulated activities in (b) and (c) are not problematic as the circumstances in which an investment bank "deals" in an M&A context are reasonably clear (i.e. when executing transactions as part of stake building or hedging activities for a client).

2.4 There is less clarity regarding the scope of 'arranging (bringing about) deals in investments'. This regulated activity does not cover arrangements unless they bring about, or would bring about, the transaction, i.e. they must be an essential part of the chain of causation which results in the transaction and without which the transaction would not take place[1]. It is questionable whether

[1] See Article 26 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 and the FCA Handbook at PERG 8.32.2

M&A Activities will necessarily involve arranging (bringing about): for example, providing advice to a corporate client on the process, structure or terms of a transaction and thereby assisting the client to negotiate the transaction on a principal to principal basis will not necessarily involve a firm in arranging (bringing about) the transaction. Each situation will, however, be fact specific. Accordingly, this note does not consider this threshold question further, and for the purposes of this note we have assumed that some M&A Activities may involve arranging (bringing about).

2.5 Using this starting point, this note concludes that M&A Activities fall outside the scope of the telephone taping rules, the reasons for which are set out below.

3. Exemptions from the taping rules

3.1 The scope of application of the taping rules is limited by a number of exemptions. These include:

(a) activities which comprise:

(i) underwriting of financial instruments on a firm commitment basis; or

(ii) placing of financial instruments with or without a firm commitment basis; and

(b) ancillary services.

3.2 Accordingly, all underwriting and placing activities are out of scope whether in an M&A context or otherwise.

3.3 In addition, all ancillary services are out of scope. Ancillary services are those listed in Section B of Annex I to MiFID II and include:

"*Advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings.*"

3.4 Any M&A Activity which falls within the scope of this ancillary service will not fall within the requirement to tape telephone conversations. This will be the case even if the activity would also constitute the regulated activity of 'arranging (bringing about) deals in investments'. This is because the FCA has made it clear in its consultation paper that it intends only to implement the MiFID II telephone taping requirement[2]. Pursuant to Article 16 of MiFID II the taping obligation applies to transactions concluded when carrying on the investment services or activities of dealing on own account, execution of client orders and reception and transmission of orders. Where an activity is an ancillary activity it cannot generally also be an investment service or activity (The CSER Guidance, referred to below, does consider it possible to provide the service of investment advice and the ancillary service of corporate finance advice to the same client where the client's investment return objective is equally important to its strategic/entrepreneurial objective. However, we consider the circumstances in which an activity could be both an investment service and an ancillary service at the same time to be very rare (see para 87 of the CESR Guidance)). Consequently, something which is an ancillary activity must also be excluded from the scope of arranging (bringing about) transactions in investments. If it were not, then the FCA would be going beyond the MiFID II taping requirements by requiring

[2] See paragraph 4.1 below.

the taping of ancillary activities if they also involved the UK regulated activity of arranging (bringing about) transactions.

3.5 The CESR Q&A 'Understanding the definition of investment advice' (CESR/10-293) (the ***CESR guidance***) provides useful guidance on when a transaction would fall within the ancillary service rather than being investment advice. The key factor according to CESR is the client's primary purpose in seeking the advice. If the primary purpose is industrial, strategic or entrepreneurial then the advice will fall within the ancillary service.

3.6 Although the CESR guidance looks at the difference between investment advice and corporate finance advice, it is still relevant in determining whether services are within the scope of the ancillary service. If services relating to a merger or purchase of an undertaking are given to a client whose primary purpose is industrial, strategic or entrepreneurial as set out in the guidance then the services will fall within the ancillary service. According to the CESR Guidance private equity and venture capital firms pursue a primarily entrepreneurial objective (in seeking to generate a return) and so such clients would be considered to be acting for an industrial, strategic or entrepreneurial objective (see para 84 of the CESR Guidance).

3.7 The ancillary service covers advice and services relating to mergers and the purchase of undertakings. It is therefore broader than simply advice that is given in an M&A context and will cover other services. To the extent other services involve the UK regulated activity of 'arranging (bringing about) deals in investments' they will fall within the ancillary exemption and not be subject to the taping obligation.

3.8 Consequently, the telephone taping obligation will not apply to M&A Activities which fall within the ancillary exemption. This will cover a broad range of public and private M&A transactions involving the merger, acquisition or disposal of undertakings. We consider that the reference to purchase of undertakings would also cover activities on the sell side, since advice or services provided to the seller are still advice and services relating to the purchase of undertakings. The CESR Guidance also refers to advice on the disposal of a subsidiary falling within the ancillary activity (see para 83 of the CESR Guidance).

3.9 Given the reference to 'mergers' and the 'purchase of undertakings' it is less clear whether the acquisition or sale of a minority stake in an undertaking ("minority transactions") would fall within the ancillary exemption. However, it would be reasonable and logical for the ancillary activity to be construed so as to cover the purchase or sale of a strategic minority stake, even if this does not give the acquirer control over the company or undertaking. In particular, it seems difficult to identify a regulatory or policy rationale for treating services relating to the acquisition of a 51% stake in a company as falling within the ancillary activity, but not services relating to the acquisition of a 49% stake.

3.10 However, even if minority transactions are not considered to fall within the ancillary activity, we consider that such minority transactions will, for the reasons given in section 4 below, also fall outside the scope of the taping obligation where the client is pursuing an industrial, strategic or entrepreneurial objective.

4. Are M&A clients "investors" under MiFID II?

4.1 It is clear from the FCA's commentary in PS17/14 that it intends only to capture those activities to which the MiFID II telephone taping requirements apply:

"*Communications occurring during corporate finance business* ***would*** *be in-scope of the taping requirement insofar as they are automatically captured by MiFID II as set out in the above paragraph* [i.e. the reception, transmission or execution of client orders or when dealing on own account]."[3]

"*For corporate finance business, we have only implemented the minimum scope of the telephone recording requirement as required by MiFID II.*"[4]

4.2 The MiFID II requirements set out in Article 16 apply to "*transactions concluded when dealing on own account and the provision of client order services that relate to the reception, transmission and execution of client orders*".

4.3 The FCA's view is that the regulated activity of 'arranging (bringing about) deals in investments' is the same as the MiFID II investment service of reception and transmission of orders as extended by recital 44 of MiFID II, which states that:

"*the business of reception and transmission of orders should also include bringing together two or more investors, thereby bringing about a transaction between those investors*".

4.4 The FCA refers in PS17/14 to PERG 13 Q13D and states that reception and transmission of orders could include "*negotiating terms for the acquisition or disposal of investments on behalf of a corporate client, with a potential buyer or seller, for example as part of a merger or acquisition.*"[5]. This is on the basis that the negotiation involves bringing together two or more investors.

4.5 As noted above, if the negotiation for a corporate client is a service relating to a merger or the purchase of an undertaking it would fall within the ancillary service exemption and so not be subject to the telephone taping obligation.

4.6 However, where the M&A Activity relates to a transaction which is not considered to be within the scope of the ancillary services exemption it would still need to amount to 'reception and transmission of orders' as extended by recital 44 in order to fall within the taping obligation. Consequently, it would have to bring together two or more 'investors' thereby bringing about a transaction between those investors.

4.7 The CESR guidance referred to above considers the question of when advice is given to a person in his capacity as an investor. Where the primary objective of the recipient of the advice is to receive a financial return or to hedge a risk then the recipient will be an investor and the advice will be investment advice. Where the primary purpose of the advice is strategic, industrial or entrepreneurial then the recipient will not be acting as an investor and the advice will be corporate finance advice.

4.8 We consider that the same approach should apply to the reference to 'investor' in recital 44. In which case, where the client's objective is strategic, industrial or entrepreneurial it would not be acting in the capacity of an investor and so negotiating a transaction (or conducting any other

[3] p.76 PS17/14

[4] p.137 PS17/14

[5] p.138 PS17/14

activity which brought that client together with another person) would not amount to the reception and transmission of orders.

4.9 Consequently, if it is considered that the ancillary activity does not cover certain types of transaction (which may include the acquisition or sale of a minority stake) then such transactions will still fall outside the scope of the telephone taping obligation if the client's objectives in pursuing the transaction are strategic, industrial or entrepreneurial since, in this case, the client is not an investor.

5. Timing of the taping obligation in the event that the obligation applies?

5.1 For the reasons given above, we consider that M&A Activities are not within the scope of the taping rules. Notwithstanding this conclusion, it is worth noting the approach taken by the FCA to the stage at which the recording obligation would apply in relation to a transaction which takes place over a protracted period of time.

5.2 The FCA states that in-scope conversations are those that are either directly related to the conclusion of a transaction or intended to result in the conclusion of a transaction[6]. Early stage discussions about a potential transaction would not therefore fall within the scope of the recording obligation. According to the FCA, where the taping obligation does apply, it would expect a firm to record "*telephone conversations in relation to key elements of the final intended transaction, notably price*"[7].

5.3 The reference to "key elements of the final intended transaction" implies that the recording obligation would only arise where the conversation was about the key elements of the transaction terms (and not, for example, in relation to process matters or negotiating strategy) and only in relation to the 'final intended terms' (which would arguably require taping only once the parties had reached a point in time where they are discussing the 'final' terms of the transaction and not early stage bids, proposals or positions in relation to the transaction).

6. Conclusion

6.1 M&A Activities which fall within the scope of the ancillary services exemption fall outside the obligation to tape telephone conversations. This will cover M&A Activities which relate to mergers and the purchase of undertakings.

6.2 For those types of transaction which are not mergers or the purchase of undertakings, and which may potentially be considered to fall outside the scope of the ancillary activity (which may include the acquisition or sale of a minority stake), it will be necessary to consider whether the firm's client is pursuing a strategic, industrial or entrepreneurial objective. If they are, then the client will not be an investor and the telephone taping obligation will not apply.

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[6] p.137 PS 17/14

[7] p.138 PS 17/14

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