AFME Equity Capital Markets Working Group on MiFID II: allocation record keeping requirements

*This guidance note has been developed to assist Equity Capital Markets and syndicate business/legal/compliance teams in relation to the **allocation record keeping requirements** under MiFID II Articles 16 and 23, Delegated Regulation (EU) 2017/565 Articles 38-41 and the associated ESMA Q&A (the "**MiFID II record keeping requirements**").[1] The guidance is relevant to both "documented" offerings and "undocumented" offerings, including those conducted on an accelerated basis, but is not intended to be prescriptive and it is recognised that adaptations to the suggested protocols will be appropriate by AFME members to reflect their house policies and in individual deal circumstances, including on "on risk" transactions. On such transactions, firms may wish to consider at which stage and to what extent control of the allocation process may revert to the relevant firm. See Annex 3.[2]*

Under the rules introduced by MiFID II, a firm's records of allocation decisions should, based on the relevant ESMA Q&A, include:

a. A copy of the firm's "overarching allocation policy" in force at the time of the commencement of the service;
b. The firm's initial discussions with its issuer client and the agreed proposed allocation per "type" of investment client;[3]
c. The content and timing of allocation requests received from each investment client with an indication of their type;
d. Where relevant, any further discussion and instructions or preferences provided by the issuer client, other members of the syndicate, or the firm itself, on the allocation process, including any emerging in light of allocation requests received from investment clients;
e. The final allocations communicated to each individual investment client.

In addition, firms must provide a justification for the final allocation made to each investment client. A justification should explicitly provide detailed reasoning unless such detail has been provided through records maintained under (a-e) above.

The "enhanced record keeping" approach proposed in this note sets out steps by which sufficient records (including supporting documentation) are kept at each material stage of the allocation process, enabling firms to cross-refer to these records rather than providing a line-by-line justification for each individual allocation.

For these purposes:

[1] ESMA notes in its Q&A that the purpose of the record keeping requirements is to enable firms to demonstrate to relevant competent authorities how they meet their obligations to the issuer client when providing underwriting and placing services, as well as their obligations to manage conflicts of interest between different clients or groups of clients.

[2] Annex 3 also includes language in relation to certain non-allocation related requirements of MiFID II, namely the requirements to: (a) disclose to a sell-side client costs and charges; (b) disclose to sell-side clients payments or benefits received from third parties in relation to a MiFID II service; and (c) procure the Legal Entity Identifier of counterparties with whom banks trade.

[3] Note: "Types" of investor to be agreed and to reflect the investor's own expressed strategy.

- the term "client" refers to the relevant issuer and/or selling shareholder(s) designated by the relevant firm as their client in relation to the relevant transaction – it does not refer to investors or potential investors; and
- the term "firm(s)" refers to the global coordinators, lead banks or equivalent firms involved in the allocation process on the relevant transaction.[4]

An outline of an enhanced record keeping protocol which may be sufficient to fulfil the above requirements is set out below.

(a) *Allocation policy to client*

Each firm will send (or otherwise make available) a copy or summary of its allocation policy to its client before the firm provides any underwriting or placing services to that client – this could be at the time of responding to an RFP, the onboarding of the client, the signing of an engagement letter, the time of confirmation of appointment or another equivalent time. A copy of the communication should be retained on file.

(b) *Agreeing allocation objectives*[5]

The firms involved in the allocation process will agree with the client the objectives for the allocation of the relevant transaction. Once agreed, the client's objectives will be documented by the firms in writing and notified to the rest of the syndicate (if any).

The agreed client objectives will vary from transaction to transaction and may include some or all of the factors listed in Annex 1.

Any changes to the objectives may be made and agreed over the course of the transaction and should subsequently be recorded.

The firms involved in the allocation process should, where relevant, keep records of any written instruction provided (e.g., as part of the RFP process), any relevant materials provided at different stages throughout the transaction to or by the client and any specific objectives notified by the client during discussions.

(c) *Building the Book of Demand*

Ahead of final allocations, the firms involved in the allocation process will provide to the client details of the book of demand at different price levels, by email or over the phone. If by phone, firms may wish to consider retaining a note on the deal file of the time and date details of the book of demand were discussed with the client.

The information provided may include coverage levels across the book as a whole and price sensitivity across the book as a whole.

[4] I.e. firms who interact with the client with respect to allocations.

[5] On an accelerated deal timetable, it may be appropriate (and sufficient) to establish and evidence agreement through relevant e-mail communications (an example email is set out in Annex 3).

(d) *Provisional Allocations*

Ahead of final allocations, the firms involved in the allocation process will propose a provisional schedule of allocations which takes into account the agreed client objectives (as set out in (b) above) and the book of demand at different price levels (as set out in (c) above), as well as any other relevant allocation criteria. The provisional schedule of allocations may (but should not be required to) make express reference to the agreed client objectives and/or to other criteria (which may but are not required to be drawn from the list set out in (b) above) used by the firms in the preparation of the provisional schedule of allocations.

(e) *Final Allocations*

Where an allocation meeting or call is held, the firms involved in the allocation process will outline the book of demand (as provided under (c) above) and the provisional schedule of allocations (as provided under (d) above). The client will be given the opportunity to discuss each of these and to raise comments, queries and challenges to the provisional schedule of allocations. Where the client provides further instructions as to its objectives and/or any specific allocations, the firms will record those instructions and make any relevant changes to the provisional schedule of allocations in line with those instructions (which should be reflected and recorded in the final schedule of allocations).

In addition to the final schedule of allocations shared with the client, the firms involved in the allocation process will establish a record:

- highlighting the top twenty per cent. of allocations ranked both: (i) by size of total allocation and (ii) by "fill" (i.e. allocation as a proportion of the bid/order of the investor);
- including a statement of or reference to the agreed client objectives and/or other allocation criteria that have been used in determining allocations to those (top twenty per cent) highlighted investors (taken as a group);
- including specific justification for any allocations to any of those highlighted investors which are inconsistent with, or not clearly justifiable by reference to, those criteria or where the relevant firms believe a specific further explanation would be desirable or appropriate.

Annex 2 sets out an illustrative approach to establishing this record.

Once the final schedule of allocations is agreed with the client,[6] a list of those investors to whom allocations will be made, together with the number of shares to be allocated to each such investor will be provided by email to the client(s).[7] This version of the final schedule of allocations should be deemed to be final unless there are any material subsequent changes, for example as a result of investors withdrawing or scaling back their orders, in which case such amended or updated schedule of allocations will be recorded as the final schedule.

[6] Firms may wish to consider whether to require client's written agreement to the final schedule of allocations.
[7] The firm's internal records regarding allocations are not required to be provided to the client.

Annex 1 – Potential client objectives

1. Client preference for specific investors.
2. Valuation/price – to be considered in conjunction with item 3 below and pricing sensitivities of investors.
3. Extent to which client is focused on the aftermarket.
4. Concentration (i.e. preferences as to size and number of large holdings, medium and/or smaller ones).
5. Any minimum or maximum allocation amounts.
6. Desired investor types (indication of any preference as to approximate balance between identified investor "types" – e.g. long-only and hedge funds, "long-only-like" hedge funds, hedge funds that are like long-only funds, hedge funds that will trade in the stock over the long term, providers of liquidity, geography etc. and categories – e.g. retail fund/tracker fund/pension fund etc) – in each case to the extent known, reasonably assumed or deduced in hindsight from the book of demand.
7. Any "free float" or similar requirements of the relevant listing, trading or indexation regime.
8. Desired geographical locations of investors (including consideration of applicable selling restrictions).
9. Level and timing of engagement in transaction process (pilot fishing/market sounding (on wall-crossed basis or otherwise)/ PDIE/roadshow meetings/other (such as reverse enquiry)/one-on-one/Group.
10. Timing of the request for allocation, relative to final management meeting for that investor (where applicable) and size of the request for allocation.
11. Existing/prior holdings/size of assets under management/interest in issuer/comparable companies or offerings or within the relevant sector (to the extent known or reasonably assumed).
12. Other considerations as appropriate.

Annex 2 – Calculating the top twenty per cent. of allocations

The ESMA Q&A refer to investors that receive a final allocation in the "top 20% of the total allocation." Considering this in descending order by value of allocations would comply with the ESMA guidance, but may result in a sample size representing less than 20% by number of investors to whom allocations are made. Firms may wish to add to the sample, additional allocations (in descending order by value), so as to cover also 20% by number of investors to whom allocations are made.

If, at their discretion, firms wish to apply a more expansive approach, to, for example, verify compliance with the agreed issuer objectives, the calculation of the top 20% could be expanded also to include investors falling within the top 20% of the total initial allocation requests by value, number and/or percentage "fill" (i.e. the amount by which the initial allocation request was "filled").

Annex 3 – Sample email to be sent to the issuer/selling shareholder(s) (as appropriate) on accelerated undocumented offerings

MiFID II record keeping requirements apply to accelerated undocumented transactions other than pure secondary "bought deals," in which a firm purchases securities from a selling shareholder or subscribes for shares in an issuer for its own account, at an agreed fixed price, with no additional financial[8] or other obligation to its counterparty. Whereas "back-stop" arrangements will typically be in scope, onward sales of shares purchased as part of a "back-stop" arrangement with no additional financial or other obligation to the counterparty are out of scope. In addition, at the moment when in the execution of an "on risk" or "backstopped" transaction progress with the placing is such that the issuer/selling shareholders has no further interest in the outcome, a risk of conflict no longer exists, there is accordingly no longer any obligation to manage any conflict between such a client interest and the interests of the firm in managing the risk it has assumed.[9]

The sample e-mail below is intended for use in accelerated undocumented transactions other than pure bought deals. A further simplified approach may be appropriate if a counterparty which will retain no residual stake in the relevant entity indicates that its sole objective is to achieve the best price. In these circumstances this may be agreed by email with the counterparty as an alternative to the below.

The sample e-mail also includes, language relating to: (a) the requirement in Article 50 of Delegated Regulation EU 2017/565 to disclose to sell-side clients costs and charges; and (b) the requirement in Article 11(5) of Delegated Directive EU 2017/593 to disclose to sell-side clients payments or benefits received from third parties in relation to a MiFID II service.[10]

To be sent at the outset of the process, for example once appointment has been confirmed/in response to an RFP/once bid is accepted and before [or at time] of launch of bookbuild.

Dear [ ]

[Offer of [*number*] new shares of X] [Sale of [*number*] of shares in Y][11] (the "***Offering***")

[Introductory language re appointment etc.]

Allocation of the Offering

I have attached to this email [a copy of our allocation policy and][12] a list of the objectives/criteria that we propose to consider when allocating the Offering (the "**Objectives**") *[provide list from Annex 1 [with appropriate amendment, if applicable][13]]*.

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[8] Such as "upside-sharing."

[9] This will usually be the moment in a bookbuilding where there is no longer a reasonable prospect that the book will be covered at all or at a level at which the issuer/selling shareholder will benefit from upside sharing.

[10] Banks should consider whether additional disclosure obligations apply.

[11] Amend as appropriate to reflect the circumstances of the transaction - whether a new issue of shares or a sale of existing shares through e.g. a block trade.

[12] Amend as appropriate e.g. if a link is to be provided in lieu of a copy.

[13] Depending on the circumstances, for example where, as a matter of practice, there is not time to extract and agree with the client specific objectives prior to the launch of the transaction a firm may wish to send the full list set out in Annex 1.

If you wish to: (a) include further Objectives; (b) modify any of the specified Objectives; or (c) highlight Objectives that you would like us to focus on, or to distinguish the relative importance of the Objectives, please provide us with your comments as soon as possible. [N*ame*] on [*contact details*] is available to discuss with you the Objectives and any modifications or additions that you may wish to make.

To the extent that we do not receive comments from you, we will proceed on the basis of the Objectives, subject to any amendments you or we deem necessary to reflect the specific context and circumstances of the bookbuild. In any case, we look forward to discussing allocations with you, including any changes you or we require to the Objectives and/or to the preliminary allocation proposal we will provide to you before your approval of the final allocations for the Offering.

To the extent we agree to provide a backstop or otherwise transact with you "on risk", you agree that we can take steps in the allocation process as we consider necessary or appropriate to manage our risk.

[Disclosure of costs and charges

Prior to [Bank] carrying out the services you have engaged it to undertake, it is obliged under regulation to inform you about costs and charges to be incurred by you in connection with such services. We believe these are understood by you, having been separately discussed. If you require further details regarding such costs and charges, please let us know. Details will also be set out in the agreement to be executed between us relating to the services.]

[Disclosure of potential brokerage commissions

[Bank] is also obliged under regulation to inform its clients that, in common with market practice, [Bank] may charge "buyside" investors commission when executing secondary market transactions and that such commission levels may vary depending on the relevant investor. Such commissions may be charged to buy-side investors in connection with the placing services you have engaged [Bank] to undertake on your behalf. Following [execution/settlement] of the transaction, [Bank] will inform you of the aggregate amount of commission that it has been paid by investors under such arrangements.] [14]

[Legal Entity Identifier

We are required by regulation to confirm the Legal Entity Identifier of counterparties with whom we trade. Please would you provide details of your Legal Entity Identifier to [*insert details of responsible individual*].]

[Sign off]

[14] [Where a syndicate of banks is appointed, such commissions may in some cases be "pooled" and split among the syndicate banks. It is anticipated that, in such circumstances, each bank would disclose to the client the portion retained by it.]