



MS15/1.2: Annex 5

Market Study

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# Investment and corporate banking market study

Interim Report: Annex 5 – Transparency of scope of  
services and fees

April 2016

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## Annex 5: Transparency of scope of services and fees

1. This Annex summarises our assessment of the transparency of scope of services and fees.

### Our approach to reviewing transparency

2. We have reviewed responses to our request for information and a considerable number of tender requests (or equivalent client communications), engagement letters and underwriting and placing agreements to understand the level of information being provided to new clients on the scope of services and fees. We have also discussed the level of transparency with issuing clients.
3. We have considered information provided both prior to the engagement letter and in the engagement letter. The former is important because clients will make a decision on which banks to select before they sign the engagement letter.

### Transparency of scope of services

#### Prior to the engagement letter

4. In equity capital markets (ECM), debt capital markets (DCM) and mergers and acquisitions (M&A) transactions, the services to be provided are not generally spelled out in any detail prior to the engagement letter, with practices varying according to the different types of transactions.

#### **ECM**

5. For some ECM transactions it is impracticable to provide a detailed description of the activities that the bank will carry out in advance of the mandate being awarded. For example, for some ECM follow-on deals for which speed of execution is essential, or where the client wishes to commence work while negotiations in respect of the terms of the mandate are on-going, pre-mandate communication on the scope of services is often only verbal. There are no formal disclosures on services offered other than those contained in the signed underwriting or placing agreement, which will be entered into after the bank has been selected.
6. For other ECM transactions or roles, where the speed of execution may be less of a concern, a detailed description of the activities included within the mandate is possible before instructing banks. For example, an initial public offering (IPO) where formal or informal requests for proposals (RfPs) are standard. However, even for these transactions RfPs do not focus on the scope of services and banks typically do not include such information in “pitch books” or presentations. For example, in a recent detailed and lengthy IPO proposal of a major investment bank to its clients the scope of services to be provided was not described.

7. Conversely, we observed occasional instances of disclosures prior to the engagement letter on the scope of services provided to clients. For example, one bank, in an email to a prospective client, set out in detail the key areas of work and responsibilities it proposed to undertake as part of acting as the client's nominated adviser (eight activities) and broker (five activities) in respect of an IPO on AIM.

#### **DCM**

8. The provision of information on the scope of services for DCM transactions largely depends on the characteristics of the client. Where the client is sophisticated, the mandate is more likely to be awarded verbally and with no engagement letter. For example, certain DCM deals involving sovereign and supranational agencies (SSAs), as frequent issuers, may require banks to quote at short notice for transactions to be executed within 24 hours from the award of the mandate. These clients are not only aware of what services banks are expected to provide but will also set the fee they consider reasonable under the circumstances.
9. DCM transactions involving infrequent or debut issuers may involve at least informal RfPs. Banks are required to outline the issuing process and, occasionally, the activities banks offer as part of their services. For example, rating advisory services, which are important as these clients are typically unrated, are often included as part of the service offering. Where ratings advisory services are included this is made clear to clients pre-mandate. Other ancillary services, such as risk management solutions (required to protect clients from interest rate or currency fluctuations) are generally not included in the scope of services provided in the core engagement. Banks may recommend these services, consistent with their advisory role, but do not generally seek to include them within the relevant DCM transaction.

#### **M&A**

10. We were told by banks that, except for some governmental agencies and private companies, formal RfPs are rarely used for M&A transactions due to confidentiality concerns. Clients are unlikely to invite a large number of banks to pitch for an M&A transaction and mandates are typically awarded based on an existing relationship or on-going dialogue between a bank and a client. Accordingly, we have not seen significant examples of disclosure on the scope of services for M&A transactions prior to the engagement letter.

#### **In the engagement letter**

11. Engagement letters include information on the services banks will offer to their clients. Some engagement letters are more detailed than others as a reflection of either the specific transaction, the role of the bank/adviser, or the client's appetite to have all services clearly set out at an early stage. In some engagement letters banks comprehensively set out the services that are within and outside of scope (for example, the provision of general financial advice). In others, they merely refer to the 'usual procedures' connected with the specific role performed by the banks in the transaction.
12. One universal bank noted that corporate finance advisers may assist issuers negotiating the terms of the engagement letters including the scope of services. In particular, they may require banks to be more granular in their description of what services will be provided and how (for example, clarifying the format and timing of feedback relating to marketing activities).

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## ECM

13. In ECM transactions, we found that the scope of services is wider and better defined in engagement letters for IPOs compared with follow-on transactions. However, if banks assume a co-manager role in an IPO, an engagement letter can reflect its passive role in the transaction in very broad terms by referring to the performance of “such general financial advisory and investment banking services that are customary and appropriate in an engagement of this type”.
14. This is in contrast with a number of good examples we observed for lead roles in ECM transactions. In particular:
  - a universal bank clearly set out a number of services provided in relation to a joint global co-ordinator and joint book-runner role for a proposed ECM and convertible bond placing. The description of the services was clearly set out, including what services were included and excluded.
  - an engagement letter for a joint global coordinator and joint book runner role in an IPO which set out in detail not only the scope of services provided by the banks, but also the objectives of the client in relation to the transaction, which the bank would have regard to when providing the services.
15. Engagement letters that do not clearly describe the scope of services typically only include a statement providing that the engagement relating to the transaction comprises of the appointment of the bank to act in the relevant role. Other engagement letters simply “confirm the engagement”, without an explanation of what the role or engagement entails. For example, an engagement letter from a large bank for a book runner role in an ECM transaction only stated that the letter confirms the appointment of the bank by the client to act as the sole book-runner in the proposed follow-on offering. The letter did not make any further reference to the specific activities the bank may undertake as part of their role.
16. In ECM transactions, underwriting and placing agreements typically also include a section on the services provided. However, while the agreements usually describe the underwriting or placing commitment of the bank(s), they do not set out the scope of services covered by the mandate in the same detail as an engagement letter.

## DCM

17. For those DCM transactions for which engagement letters are signed, they clearly set out the activities included within the scope of the engagement: from preparing the required documentation to assisting with marketing activities and liaising with the relevant bodies.

## M&A

18. Although RfPs are not frequently used for M&A transactions in order to maintain confidentiality, we generally found that the scope of services is reasonably well described in the engagement letters. Good examples included letters setting out a comprehensive description of the different duties and responsibilities the bank or adviser proposed to undertake. For example, an adviser gave a clear itemisation of its duties and responsibilities in an engagement letter to include aspects such as advising and assisting the client on structure, process and timing of the transaction, as well as on the offer tactics and negotiations with the acquirer.
19. We also identified poor examples of banks only very briefly, if at all, setting out their responsibilities in engagement letters. For example, in an engagement letter for a

financial adviser role for an M&A transaction, a bank explained that it would perform such activities “that are customary and appropriate in engagements of this type” with little further detail of what services it would provide. In another example, an adviser in an M&A engagement just stated it would support the client in analysing, structuring, planning, negotiating and effecting a transaction.

## Transparency of fees

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### Prior to the engagement letter

20. Clients need to be provided with information on fees before selecting their banks/advisers. Fees are in the overwhelming majority of cases communicated ahead of the relevant transaction, often verbally (unless a formal competitive process is adopted). In most cases fees are also agreed prior to the commencement of activity, unless the nature/structure of the potential transaction is unclear at the outset.
21. We were told that large clients and frequent users are generally aware of ‘market standards’ relating to comparable transactions and/or issuers may sometimes propose (to the banks, prior to the engagement letter) what fees they expect to pay for the transaction. Smaller clients are not equally aware of fee levels in the market. They are provided with information on fees by prospective service providers, generally by the bank they have an established relationship with (e.g. their corporate broker), and occasionally other banks, when clients seek to at least benchmark the fees levels offered by their relationship bank.

### ECM

22. Fee disclosure is mostly in writing for those ECM transactions, particularly IPOs, for which corporate finance advisers are appointed and where formal competitive processes are adopted. This is because information on fees is often one of the criteria for awarding the mandate. Where formal competitive processes are not used, clients tend to ask verbally, pre-appointment, what the likely fee level would be.
23. ECM follow-on transactions present similar dynamics on fee disclosure to IPOs, although it is more common for fee negotiations in follow-on transactions to continue after the selection of the banks. At least five banks acknowledged that fee negotiation in follow-on ECMs may last until the early stages of execution. This is because the structure of the transaction is often unclear at the earlier stages (for example, the level of required underwriting is yet to be finalised).

### DCM

24. Clients are aware of fees for DCM transactions either because they propose them (in case of sophisticated/frequent issuers) or because they will be provided with the required information (with or without a competitive process) ahead of appointing the relevant banks.

### M&A

25. With regard to M&A, practices are not that dissimilar from DCM transactions, although clients do not tend to propose fee levels to banks.

### In the engagement letter

26. Fees are in the overwhelming majority of cases included in engagement letters (to the extent they are entered into – the exception being where important transaction details are not yet finalised) and are always included in the relevant underwriting/placing agreements.
27. Sometimes we observed that fees are not disclosed in the context of an engagement letter. For example, an adviser and its corporate client agreed in the context of an M&A transaction that they “will agree an appropriate fee in good faith as soon as possible, the details of which will be set out in a separate letter between the parties”.

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