BANNING RESTRICTIVE CONTRACTUAL CLAUSES IN INVESTMENT AND CORPORATE BANKING: THE FCA'S BID TO PROMOTE COMPETITION

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Robert Finney, regulatory partner in HFW's London office, interviewed by LexisPSL's Kate Beaumont on the Financial Conduct Authority's policy statement on the prohibition of restrictive contractual clauses and what the new rules and guidance mean for regulated firms.

On 27 June 2017 the Financial Conduct Authority (the FCA) published a policy statement setting out the final form of the FCA's new rules prohibiting restrictive right to act and right of first refusal clauses in respect of the supply of certain primary market and M&A services.

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What is the background to this policy statement?

From the inception of the FCA on 1 April 2013, it has had a statutory objective to promote effective competition in the interests of consumers (very broadly defined) in the markets for regulated financial services. Market studies are a major tool of the FCA to examine how competition is working and assess whether intervention is necessary.

In July 2014 the FCA launched a review of competition issues in the wholesale financial markets, focused on wholesale securities and investment markets, and related activities such as corporate banking, in order to identify any areas that might merit further investigation through an in-depth market study. The FCA outlined some such areas, including cross-selling of investment banking services.

In the light of this review, in 2015 the FCA launched market studies into investment and corporate banking (February), and asset management (November). The first of these covered a range of issues in the provision of regulated primary market and related services in equity and debt capital markets, mergers and acquisitions (M&A) and acquisition finance, but with a focus on transparency, cross-selling, cross-subsidisation and bundling.

In its April 2016 interim report on the investment and corporate banking study, the FCA expressed concern about "the practice of banks using contractual clauses to restrict client choice" and proposed prohibiting it. In the FCA's view, such clauses had potentially negative consequences for medium-sized and small corporate clients (respectively companies of a size equivalent to the UK FTSE 250 and the UK FTSE Small Cap and AIM), which typically have fewer banking relationships and may therefore feel pressure to "reward" a lending bank or corporate broker which would not otherwise have won their mandate.

The FCA invited further stakeholder views but in due course affirmed its interim findings in its October 2016 final report on the market study and simultaneously published a consultation paper (CP16/31) with draft rules to ban the use of restrictive contractual clauses, in particular "right to act" and "right of first refusal" clauses. The FCA had found that 43-75% of providers subject to the study had recently used such restrictive clauses, although the industry argued that such clauses were uncommon and rarely enforced.

On 27 June 2017, the FCA published Policy Statement PS 17/13, providing its response to consultation feedback and the text of the new Conduct of Business Sourcebook (COBS) rules (and related glossary definitions) it has now made. The rules prohibiting firms from entering into agreements with a "future service restriction", i.e. a clause that restricts a client's choice of future providers of "primary market and M&A services", will come into effect on 3 January 2018.

What should firms be particularly aware of?

The ban applies to agreements between a firm and a client which grant the firm or an affiliate the right to provide in the future unspecified or uncertain primary market and M&A services to the client. The ban is not intended to prevent clients from agreeing terms with firms for a specific piece of future business that they know they will undertake. Although the FCA's concerns focused on small and medium-sized corporate clients, there are no exemptions based on the size or type of client.

The geographical reach of the ban is wide and, given the definitions on which it relies, somewhat complex. It generally applies to agreements entered into by a firm's UK establishment or its non-UK branches, but not its subsidiaries or affiliates, and irrespective of client location. Non-UK regulated firms that service UK clients are not affected.

Although the effective date of the new rules coincides with that of MiFID II, the rules will apply also to

non-MiFID corporate finance advisory firms.

How has the FCA dealt with clauses relating to cross-selling and cross-subsidisation of services and other industry concerns in the final policy statement?

Like the consultation paper, the policy statement focuses on restrictive clauses, being the only area of intervention the FCA decided upon when it concluded the market study.

In replacing references to "corporate finance services" with the newly defined "primary market services and M&A services", the FCA has helpfully clarified and narrowed the scope of the prohibition. It will not affect restrictions relating to the supply of "future services which are a form of corporate lending", as distinct from restrictions in loan agreements on future primary equity and debt capital market or M&A services (which will be banned).

The prohibition applies to:

- "right to act" clauses: the right to provide any future primary market and M&A services to the client, i.e. preventing a client from sourcing future services from third parties, regardless of terms; and
- "right of first refusal" clauses: the right to provide future services to the client before the client is able to accept any offer from a third party to provide those services, i.e. preventing a client from accepting a third party offer of services unless it has first offered the mandate to the bank or broker on the same terms.

The rules make few changes to the definition of "future service restriction" or to the guidance that the FCA proposed on the scope of that term – e.g. clarifying that it excludes rights to pitch, to be considered for mandates and to match quotations, which entail no obligation on the client to use the firm. However, the FCA made major changes to the definition of "bridging loan" to focus on commercial intent rather than the term of the loan. The FCA provides helpful guidance on the term (e.g. in effect to allow terms of up to four years instead of the one-year maximum originally proposed): if a firm agrees to provide a bridging loan, the agreement can include a restriction whereby the firm will provide the related primary market and M&A services.

What action should regulated firms take in light of this policy statement?

It seems that the ban will not apply to existing agreements, so firms have approximately six months to update their contract and engagement letter templates for relevant services, establish systems and controls to ensure they do not include the prohibited clauses, and provide appropriate training.

How should lawyers advise their clients?

Regulated firms may need help to understand the scope of the rules and guidance and what they must do to comply. However, they should be wary of adopting an overly technical approach. For example, the ban has been limited to written agreements, but the FCA has warned firms against using oral agreements instead and also emphasised that it will not tolerate firms restricting client choice unless it is clearly beneficial to the clients concerned. Indeed, the FCA emphasises that, although the ban is aligned with its market study, it remains open to extending the ban to other wholesale market services if it sees evidence that restrictive clauses are being used to the detriment of clients for such services.

The changes required by the new rules reflect not only competition concerns but should also be seen in the context of the FCA's Principles for Business, particularly those on conflicts of interest and treating customers
fairly, and the work in these areas that firms must do to comply with MiFID II.

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