In Practice

Author Tamasin Little

Investment and corporate banking: prohibition of restrictive contractual clauses

The title of the Financial Conduct Authority's Policy Statement 17/13 (PS 17/13) – *Investment and corporate banking: prohibition of restrictive contractual clauses* – might lead one to think that the market study the FCA made into investment and corporate banking[1] had resulted in a massive assault on the terms of business for investment and corporate banking. The actual scope of the paper, and of the new FCA rules made in it, is much more modest. It is nevertheless significant as an indicator of the increasing willingness of the FCA to intervene in the "wholesale" markets and to begin, even if only in a cautious and limited way, to consider competition issues and client service in those markets.

From 3 January 2018, in addition to all the new duties they will have under MiFID II, banks and other corporate finance firms will not be allowed to enter into a written agreement with a client which contains a prohibited form of "future service restriction".

The prohibition applies to any provision which gives the firm or an affiliated company either an absolute right to provide any future primary market and M&A (merger and acquisition) services to the client or a right of first refusal on the provision of such services (ie the right to provide them before the client can accept any offer from a third party to provide the services).

Relevant services are regulated investment business services[2] which are either:

- provided to an issuer comprising structuring, underwriting and/or placing an issue of shares, warrants, depositary receipts or debt securities; or
- relate to mergers and the purchase or disposal of undertakings.

However, the ban applies to all types of agreement entered into by the FCA-regulated firm – not just to investment business agreements but also to loans and other types of service agreement.

The FCA states that the ban is being imposed because such restrictions prevent a client from freely deciding, as and when the need for primary market and M&A services arises, which firm to appoint to provide those services. The FCA regards this as an anti-competitive restriction by firms, which does not give any clear benefit to their clients.

The FCA is applying the new restriction to the full range of those normally caught by COBS (Conduct of Business Sourcebook), ie all business done from UK establishments irrespective of the location of the client. Non-UK subsidiaries and affiliates would not be caught, but overseas branches could be in some circumstances.

The usual argument was put forward in consultation that banning such provisions for UK firms hampers their ability to compete with non-UK firms. The FCA dismissed that argument saying that:

> 'We recognise that these clauses have a role to play in securing future primary markets business (which is why we are seeking to ban them) but we consider that the existence of the clause should not be an essential element of competition for the initial service – claims that non-UK firms will win business primarily on the basis of the clauses (because they are able to price the initial service more cheaply) seem overstated.'

Nevertheless, it is almost as interesting to look at what is *not* caught by the new prohibition as to consider what is prohibited. Setting aside the apparent power still to enter into contractual restrictions of this kind orally (partly on the basis of Sam Goldwyn's sage observation that 'an oral contract ain't worth the paper it's written on', partly because of the obligation of regulated firms to keep records of their client agreements and partly because the FCA makes it clear that it would be concerned if pressure was put on clients by switching to unwritten oral agreements), the new rules do not prevent a number of other provisions commonly used, which can in practice inhibit a client's future choice of service provider.

There is an express exemption for a bridging loan agreement which contains a restriction which only relates to the primary market and M&A services to which the bridging loan relates. The term bridging loan is not tightly defined. It is described as 'a loan provided to a client for the purpose of providing short-term financing, and with the commercial intention that it should be replaced by another form of financing' (such as a share or bond issue).

The new rules say that indicative (but it seems not mandatory) features of such a loan are: (a) its express documentation as a temporary loan intended to be replaced by longer term financing; (b) a short term, typically of less than four years (not the 12 months originally proposed by the FCA), or with interest step up or other provisions designed to discourage longer term use; and (c) a requirement that the proceeds of the future financing must be used to repay the bridging loan.

More generally:

- The ban only applies to wide-ranging provisions which catch any primary markets and M&A services which may be required in future. It does not affect agreements for the future provision of particular specified services;

- It also only applies to future services. It does not prevent "tailgunner clauses" relating to recuperation of fees for work already done by the firm if the client subsequently decides to award the mandate for that transaction or service to another firm;
- It does not apply where the provision does not *bind* the client to use the firm or its affiliate in future but instead gives the firm the right or opportunity to:
  - pitch for future business;
  - be considered in good faith alongside other providers for future business; or
  - match quotations from other providers, as long as the client is not prevented from selecting those other providers if it wishes to do so.

All firms doing corporate finance business[3] will need to review their standard terms across what is potentially a wide range of agreements, put compliance procedures in place to avoid including "right to act" and "right of first refusal" terms and train staff who are negotiating terms to use only the milder permitted provisions.

In PS 17/13 the FCA's actual intervention into freedom of contract in this area is very limited. The modesty of the step taken at this stage should not lead firms to underestimate the importance of the change in regulatory climate which leads the FCA to feel able to intervene at all. It states in PS 17/13 that although it has opted for imposing the ban on a product scope which is clearly aligned with its market study, it remains:

> **'open to extending the ban to other wholesale market services if we see evidence that the clauses are being used to the detriment of clients for such services. Firms should be clear that we will not tolerate restrictive clauses that adversely affect competition and are not clearly beneficial to clients.'** ■

1 The final report on the FCA's Market Study into investment and corporate banking was published in October 2016.

2 "designated investment business" or "MiFID business" as defined under the FCA rules.

3 The FCA found that 86% of the firms in their sample had used restrictions of the kind which will be prohibited in future.

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Tamasin Little is a partner in financial regulation at Reed Smith LLP.
Email: tlittle@reedsmith.com