FCA prohibits banks locking in future ECM, DCM and M&A business

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On 27 June 2017 the FCA published policy statement PS17/13, containing final versions of the rules proposed in consultation paper CP16/31. The new rules will ban the use of certain clauses in investment and corporate banking engagement letters and other contracts which restrict a client's choice of future providers of equity or debt capital markets services, or merger and acquisition services.

The new rules will come into force on 3 January 2018.

Scope of the ban

From 3 January 2018, the FCA's Conduct of Business (COBS) sourcebook will prohibit firms that are regulated in the UK from entering into written agreements containing clauses giving them (or an affiliated company):

- the right to provide any future primary market and M&A services to the client ("**right to act**" clauses); or
- the right (to be given the opportunity) to provide future primary market and M&A services to the client before the client is able to accept any third party offer to provide those services ("**right of first refusal**" clauses).

"Primary market and M&A services" essentially comprise:

- structuring, underwriting and/or placing an issue of shares, warrants, depositary receipts (or other certificates representing certain securities) or bonds (or other debentures) for an issuer; or
- advice and services relating to mergers and the purchase or disposal of undertakings.

The ban will only apply to written agreements containing the prohibited clauses. However, PS17/13 states that the FCA does not expect firms to replace written clauses with unwritten oral agreements.

General exceptions

The ban is only intended to cover clauses restricting the provision of primary market and M&A services which may be required in the future, but which are not specified or certain at the time the clause is agreed. The ban is also intended to only prohibit clauses which oblige the client to use the existing bank or broker (or an affiliated company).

Accordingly, FCA guidance states that the ban does not apply to:

- agreements to provide specified or certain services in the future;
- restrictive clauses relating to the recuperation of fees for work already undertaken by the existing bank or broker, where the client decides to use another firm for the same service or transaction (so-called "tailgunner" clauses);
- rights to pitch for future business;
- rights to be considered in good faith alongside other providers for future business; or
- rights to match quotes from other providers, provided the client is not obliged to award the mandate to the existing bank or broker (or an affiliated company) if the relevant terms are matched.

Corporate lending exceptions

Bridge and warehouse facilities

Event-driven bridge facilities are often provided on the basis that the borrower is obliged to give the underwriters a role in the take-out refinancing (e.g. a bond issue or term loan). The ban does not extend to this practice.

The ban will not apply to a restrictive clause in an agreement to provide a bridging loan, provided the restriction only covers primary market and M&A services to which the bridging loan relates. A "bridging loan" is defined as a loan for the purpose of providing short-term financing, with the commercial intention that it be refinanced. The FCA gives a (non-exhaustive) example of a bridging loan as one where:

- the expressly documented intention of the parties is that the loan offers a temporary solution until the client is able to obtain longer-term financing from the capital markets or elsewhere;
- it has a short term (typically less than four years from signing) or the client is otherwise discouraged from retaining the loan as longer term finance (e.g. the interest rates "step up" after an initial short period); and
- the terms require the proceeds from the future financing to be used to pre-pay the loan.

PS17/13 confirms that the definition of a bridging loan also covers warehouse facilities. These are used to finance the origination of new mortgages (or other loan assets) and are designed to provide relatively short-term financing until the mortgages can be sold into the secondary market or securitised.

Accordion facilities

PS17/13 confirms the ban will not prohibit accordion facilities within loan facility agreements on the basis that they relate to future corporate lending services, not primary market and M&A services. Accordion facilities will often give lenders a right of first refusal should the borrower wish to increase the amount of the loan facility.

Geographic limitations

The ban applies where relevant services are carried on from the UK establishment of a regulated firm. Those services could form part of the services covered by the original engagement letter or other contract. Alternatively, those services might form part of the future primary market and M&A services affected by the restrictive clause.

UK regulated firms are prohibited from entering into agreements with clients containing the banned clauses, irrespective of where those clients are located. This includes agreements entered into by the firm's UK establishment or its overseas branches but does not cover agreements entered into by non-UK group affiliates of a UK bank if the relevant services would be carried on outside of the UK.

In their joint response to CP16/31, AFME and the BBA pointed out some of difficulties that may arise in practice:

- A bank or broker may provide services for its clients from multiple locations. For example, a small number of individuals on a firm's wider deal team may be located in the UK.

- The location from which the bank or broker will provide future services may be unclear or may change after the agreement is entered into. For example, the location of personnel providing future services for an IPO may depend on which listing venue is chosen, and that choice might only be made after the original agreement is entered into.

For example, consider a hypothetical UK investment bank. Its French branch signs an engagement letter with a French client to provide services in France. The engagement letter gives the investment bank a right of first refusal to act as lead manager on any IPO which the client undertakes in the next 2 years. A year later the client decides to undertake an IPO involving a London listing. The IPO will involve the investment bank providing primary market services from its UK establishment. It seems this will infringe the ban. To avoid this risk, banks and brokers should ensure that they and their overseas branches do not enter into any agreements with clients containing the banned clauses, where any element of the original or future services could be provided from the firm's UK establishment.

On the other hand, the US affiliate of a global investment bank could agree such a right of first refusal with a client as long as the relevant services, when provided in the future, were carried out from outside the UK. The FCA appears to accept this oddity but does not think that it will competitively disadvantage UK establishments of investment banks. In practice, of course, it would be very difficult to provide such services (say, a London IPO) entirely from outside the UK and it would be very risky for an investment bank that has sponsor authorisations with the FCA to seek to do so.

Practical implications

PS17/13 confirms that the ban will not apply to existing agreements (i.e. those entered into before 3 January 2018) with clients which contain the banned clauses.

Banks and brokers should review their template engagement letters and other contracts to ensure that any banned clauses will be removed by 3 January 2018. Internal guidance, policies and training on the terms which may be agreed with clients should also be reviewed and, if necessary, updated.

In practice, our experience suggests that large corporate clients have typically successfully resisted the inclusion of such clauses in their template engagement letters and other contracts (albeit that, as a relationship matter, there may be an expectation that providing corporate broking and corporate lending services will give rise to opportunities for ancillary business). As such, it is likely that the ban will have relatively little impact on current market practices. In relation to bridging facilities, we may see some change in provisions included in documentation in circumstances where it is intended that the bridging facility exception should apply.

Issuers and borrowers should now avoid agreeing to this kind of restrictive clause even prior to 3 January 2018, now that the FCA has finalised its position. Banks using such clauses may also wish to consider whether it is appropriate for them to continue doing so in the run-up to 3 January 2018.

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