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Topical issues

FCA ban on restrictive contractual clauses

On 27 June 2017, the Financial Conduct Authority (the '**FCA**') published new rules banning clauses which restrict an entity's choice of provider for future primary market and M&A services. The rules are set out in the Future Services Restrictions Instrument 2017 (the '**Instrument**').

The new rules follow the FCA's market study of investment and corporate banking. The final report of this study, published in October 2016, concluded that the use of contractual clauses to restrict a client's future choice of service provider could inhibit effective competition. This would be against the interests of those service providers' clients, and the FCA proposed to address this by banning such clauses.

The new rules follow a period of consultation on the FCA's proposals. In their final form, the rules include changes welcome to the loan markets. In particular, the application of the new rules to future primary market and M&A services, as opposed to 'corporate finance services' as previously proposed by the FCA, makes clear that restrictive contractual clauses related to, for example, the provision of future corporate lending or hedging arrangements fall outside the ban. Making this key change from the previous proposal, the FCA has responded to consultation feedback and acknowledged that the term 'corporate finance services' encompassed services beyond its intended scope.

This, and other, clarifications to the scope of the new rules since the FCA's earlier consultation should be helpful for loan market participants making preparations to ensure compliance.

In this article we examine the rules and their application in relation to loan transactions.

Scope of the ban

Application of the rules

The ban applies to regulated firms that provide primary market services, irrespective of the location of the firm's client and its size or type.

Prohibition

The core prohibition in the new rules is that '…a firm must not enter into an agreement in writing with a client that contains a future service restriction'.

'Future service restriction'

The term 'future service restriction' refers to a contractual provision which grants a firm (or an affiliated company of the firm):

> the right to provide any future primary market and M&A services to the client (known as '**right to act clauses**'); or

> the right to provide future primary market and M&A services to the client before the client is able to accept any offer from a third party to provide those services (known as '**right of first refusal**' clauses).

'Primary market and M&A services'

The term 'primary market and M&A services' refers to services that constitute designated investment business or MiFID business and that are either (a) services provided to an issuer comprising structuring, underwriting and/or placing an issue of shares, warrants, certificates representing certain securities or debentures, or (b) advice and services relating to mergers and the purchase or disposal of undertakings. This covers debt capital market services, equity capital market services and merger and acquisition services.

Exceptions to the ban

Bridging loans

The new rules exclude from the ban arrangements that are included in an agreement in writing to provide a bridging loan and only involve the firm providing primary market and M&A services related to the bridging loan.

The FCA has defined a bridging loan as a loan for the purpose of providing short-term financing, and with the commercial intention that it be replaced with another form of financing such as an equity or debt capital markets issue.

It has stated that a loan with the following characteristics could be considered a bridging loan:

> it is expressly documented that the 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 other future financing;

> the loan has a short term, typically of less than four years from signing, or where the client is otherwise discouraged from retaining the loan longer term, for example by providing for interest rates to increase after an initial short period; and

> the loan provides for the proceeds of future financing to be applied in mandatory prepayment of the loan.

In practice, the term and mandatory prepayment provisions in many bridging loans will be consistent with the second and third of these characteristics. It will, however, be advisable to ensure that the documentation expressly confirms the intention of the parties in order to meet the first characteristic.

The FCA's list of characteristics is non-exhaustive. In its Policy Statement PS17/13 which accompanies the new rules, it notes that warehouse facilities which are used to finance the origination of new assets such as mortgages are intended to fall within the definition of bridging loans, on the basis that these have similar principles to a bridging loan, and are therefore outside the scope of the ban.

Arrangements relating to specific services

Arrangements for the provision of a 'specified or certain primary market and M&A service' are not prohibited, even where that service will take place in the future. The prohibition concerns services which may be required in the future, but which are not specified or certain at the time of entering into the agreement. This has been done to avoid preventing clients from agreeing terms for specific identifiable future business which they know they will undertake. The FCA specifically refers to allowing the continued use of 'tailgunner clauses' that allow for the recuperation of fees for work undertaken by a firm if the client decides to use another firm for the relevant service or transaction.

Other exceptions

Provisions in an agreement that only give 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, but which do not prevent the client from selecting the other providers,

are not 'future service restrictions' and so are outside the scope of the ban. The FCA has drawn a distinction between a 'right to match' clause where the client ultimately decides which firm will provide the relevant services, which is not banned, and a right to match clause which requires the client to engage a particular firm, which is banned.

Implementation

The new rules come into effect for agreements which are entered into from 3 January 2018.

The FCA has noted that it will monitor the implementation of the ban and that it remains open to extending the ban to other wholesale market services if there is evidence that restrictive clauses are being used to the detriment of clients using those other services. This is consistent with an increased focus by regulators on competition issues in the loan markets generally. For example, the FCA noted in its regulation round up for February 2017 the need for all regulated firms to understand and ensure compliance with competition law, and the European Commission's Management Plan for 2017 suggested that it may be considering the area. Competition issues will be of continued interest for market participants, and an area to be closely monitored.

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