Financial Conduct Authority

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Market Study MS15/1.3

Investment and corporate banking market study

Final report

October 2016

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Also published alongside this report:

Consultation Paper CP16/31: Investment and corporate banking: prohibition of restrictive contractual clauses

Occasional Paper 15: Quid pro quo? What factors influence IPO allocations to investors? (*Updated version*)

In this final report we set out our final findings of the investment and corporate banking market study.

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Abbreviations used in this document

AFME	Association for Financial Markets in Europe
BBA	British Banking Association
CP	Consultation paper
DCM	Debt capital markets
ECM	Equity capital markets
EU	European Union
FCA	Financial Conduct Authority
IPO	Initial public offering
M&A	Mergers and acquisitions
MiFID	Markets in Financial Instruments Directive
MiFID II	The revised Markets in Financial Instruments Directive (2014/65/EU)
OP	Occasional paper
RfP	Request for proposal
SYSC	Senior management arrangements, Systems and Controls Sourcebook

1.
Executive summary

Chapter summary

In April 2016 we published the interim report of our investment and corporate banking market study, which focused on primary market activities in the UK (equity capital market, debt capital market and merger and acquisition services). These services play a vital role in the economy, matching investors with corporates and public bodies that need to raise finance.

We consulted on the interim findings and proposed remedies with a range of stakeholders including investment banks, clients, corporate finance advisers, innovators, buy-side investors and league table providers.

Having considered the consultation feedback and carried out further work, we are now confirming our interim findings as final.

Our final findings are that there is a wide range of banks and advisers active in primary market activities. While many clients, particularly large corporate clients, feel the universal banking model of cross-selling and cross-subsidisation from lending and corporate broking services to primary market services works well for them, there are some practices that could have a negative impact on competition, particularly for smaller clients.

We have developed a targeted package of remedies to address these concerns and to ensure competition takes place on the merits:

- **A ban on restrictive contractual clauses:** Banks at times use contractual clauses that restrict a client's choice in future transactions. We have published a separate consultation paper alongside this report setting out our proposals for banning such clauses. Depending on the responses to the consultation paper, we expect to publish the final rules in early 2017.
- **Ending league table misrepresentation in banks' pitches to clients:** Banks routinely present league tables to clients in a way that inflates their own position. We are working with the BBA and AFME so that they can develop and adopt industry guidelines to improve the way in which banks present such information to clients.

- **Removing incentives for loss-making trades to climb league tables:** League tables that rank investment banks can be misleading because some banks carry out loss-making transactions purely to generate a higher position in such tables. We have asked league table providers to review their recognition criteria so as to reduce the incentives for banks to undertake such league table trades.

- **Supervisory programme for initial public offering (IPO) allocations:** Allocations of shares in IPOs are at times skewed towards buy-side investors from whom banks derive greater revenues from other business lines (for example, trading commission).[1] In the run up to the implementation of MIFID II, we will carry out supervisory work with those firms where we have identified shortcomings in their allocation policies or a skew in their allocation practices. We have also set out in this report where we have found allocation policies and practices are potentially not consistent with our existing guidance in SYSC 10 or the relevant requirements in the MiFID II delegated regulations.

- **Revised IPO process:** There is a a blackout period in the UK IPO process between publication of 'connected research' by syndicate banks and the circulation of the 'pathfinder' prospectus so both the pathfinder and approved prospectuses are made available late in the process. Together with a lack of access to the issuer's management, this means that non-syndicate banks' analysts and independent research providers lack information from which to produce IPO research. This leaves connected research as the only source of information available to investors during a crucial stage of the process. In a discussion paper published at the same time as the interim report we suggested changes to the IPO process to address these concerns.[2] We are continuing to consult on and develop these changes and expect to publish a separate consultation paper with policy proposals in winter 2016/17.

1.1 In April 2016, we consulted on our interim findings[3] and proposed remedies, and the feedback we received has been largely supportive. This final report summarises the consultation feedback, sets out our response to the feedback, confirms our findings as final and sets out our final remedies.

1.2 This report is published alongside a consultation paper on our proposed prohibition of restrictive contractual clauses (CP16/31: Investment and corporate banking: prohibition of restrictive contractual clauses). Our other remedies are being taken forward as supervisory work, through industry-led solutions or, as is expected in the case of our work on the IPO process, through a subsequent consultation paper.

1 For the detailed analysis, see OP15: *Quid pro quo? What factors influence IPO allocations to investors?* (October 2016): http://www.fca.org.uk/news/occasional-paper-no-15

2 DP16/3, *Availability of information in the UK Equity IPO process* (April 2016): www.fca.org.uk/publication/discussion/dp16-3.pdf

3 MS15/1.2, *Investment and corporate banking market study: Interim report* (April 2016): www.fca.org.uk/news/investment-and-corporate-banking-market-study

Background

1.3 On 22 May 2015, we launched our market study into investment and corporate banking by publishing our terms of reference.[4] This followed from our Wholesale sector competition review feedback statement, published in February 2015, which identified potential competition concerns in investment and corporate banking, and led to the launch of our asset management market study.[5]

1.4 The UK is a global hub for investment and corporate banking, and one of the world leaders in equity initial public offerings (IPOs). We focused on primary market activities (equity capital market (ECM), debt capital market (DCM) and merger and acquisition (M&A) services) carried out in the UK by investment and corporate banking service providers, regardless of the location of the client.[6] Primary capital markets play a crucial role in our economy, helping companies raise capital for investment, expansion and funding ongoing operations. These primary market activities make up around a quarter of revenues earned by universal banks, and in 2014 total gross fees in primary markets generated by investment banks' UK operations amounted to approximately $17bn.

Our interim findings and proposed remedies

1.5 We published our interim findings in April 2016. Our interim findings and proposed remedies were based on a broad range of analysis and evidence, including engagement with a wide range of industry stakeholders and data analysis of over 10,000 ECM, DCM, M&A and corporate loan transactions.

1.6 We found that there is a wide range of banks and advisers active in primary market activities. While many clients, particularly large corporate clients, feel the universal banking model of cross-selling and cross-subsidisation of services works well for them, we identified some practices that could have a negative impact on competition, particularly for smaller clients.

1.7 We proposed a targeted package of remedies to address the concerns we had identified:

- We found that banks at times use contractual clauses that restrict a client's choice in future transactions. We proposed to remove the practice of banks using such clauses and sought views on how best to do so.

- We found that league tables that rank investment banks can be misleading because some banks carry out loss-making transactions purely to generate a higher position in such tables ('league table trades'). Furthermore, banks routinely present league tables to clients in a way that inflates their own position. We said that we would explore how to improve the credibility and usefulness of league tables. We said that these aims were likely to be best achieved through an industry-led solution.

4 MS15/1.1, *Investment and corporate banking market study: Terms of reference* (May 2015): /www.fca.org.uk/static/documents/market-studies/ms15-1-1.pdf

5 FS15/2, *Wholesale sector competition review 2014-15: Feedback statement* (February 2015): www.fca.org.uk/static/documents/feedback-statements/fs15-02.pdf

6 We focused on primary market services because issues in these areas were raised in the Wholesale sector competition review. Concerns in secondary markets were also raised. However, as set out in the Terms of reference, we did not consider now was the right time to pursue these issues due to significant imminent changes in European legislation that may affect competition in secondary markets.

- We found that allocations of shares in IPOs are skewed towards buy-side investors from whom banks derive greater revenues from other business lines (for example, trading commission).[7] We said that we would investigate further with individual banks where our analysis raises questions about conflict management in IPO allocations.

1.8 We also published a Discussion Paper[8] which found that the blackout period between the publication of 'connected research' by syndicate banks and circulation of the 'pathfinder' prospectus means the pathfinder and approved prospectuses are made available to investors late in the process. Together with a lack of access to the issuer's management, this means that non-syndicate banks' analysts and independent research providers lack information from which to produce IPO research. This leaves connected research as the only source of information available to investors during a crucial stage of the process. We suggested changes to the IPO process to address concerns about the way in which information is made available to market participants. We are currently considering feedback received to this Discussion Paper and we expect to publish a Consultation Paper with policy proposals in winter 2016/17.

1.9 We said that we had not identified concerns about the other market practices and issues we investigated and therefore we did not intend to pursue these issues further at this stage. These included choice, reciprocity, syndication, transparency and barriers to entry and expansion. We noted that reciprocity[9] is currently most prevalent in the bank financing market, particularly covered bonds. We found that this practice does not currently appear to be excluding other banks from competing.

Consultation on the interim report

1.10 We consulted widely on our interim findings and proposed remedies. We received 27 written responses and engaged further with a range of stakeholders in around 40 meetings. Stakeholders included investment banks, corporate clients, corporate finance advisers, innovators, buy-side investors and league table providers.

1.11 The consultation responses were generally supportive of our analysis.

Feedback on our interim findings

1.12 Stakeholders broadly supported our interim findings. In summary:

- The main focus of the responses was on our analysis of **cross-selling**, particularly on the impact of **restrictive contractual clauses**. Respondents broadly agreed with our analysis of the relationship banking model and the effect it has on clients and competition. On restrictive contractual clauses, many said that these were not that prevalent and did not materially affect clients' ability to use alternative providers.

- Several respondents provided comments on our analysis of **league table issues**. Although they recognised that presentation of league tables in pitches could be improved, they said that league tables were not taken seriously in pitch presentations so any detriment arising from banks presenting misleading league tables to clients was low. On league table

7 For the detailed analysis, see OP15: *Quid pro quo? What factors influence IPO allocations to investors?* (October 2016): www.fca.org.uk/news/occasional-paper-no-15

8 DP16/3 *Availability of information in the UK Equity IPO process* (April 2016): www.fca.org.uk/news/dp16-03-availability-of-information-in-the-uk-equity-ipo-process

9 Reciprocity is a practice whereby a bank issuing its own financing awards mandates to another bank partly based on how much business it will receive in return.

trades, some observed that loss-making trades may occur purely because of adverse market movements and so it was not possible to distinguish a league table trade. Stakeholders also said that the practice of banks making loss-making trades may be pro-competitive if it helps banks that do not have a presence in a particular sector to compete with those that are already strong there.

- Some respondents questioned our findings on the skew in **IPO allocations**. They stated that we should expect larger investors to get a greater share of the allocations and that this does not reflect a biased skew. Some banks said that they did not have any underlying issues in this area and had sufficient procedures in place to deal with any conflicts of interest.

- Some respondents continued to raise concerns about **corporate finance advisers** that may give rise to potential conduct risks. These included concerns that advisers might lean on syndicate analysts or favour specific banks when advising clients on which banks to appoint. Some respondents also felt that advisers' fees should be more transparent, especially if they are linked to the price of an IPO and this leads to the adviser pushing for a higher price, which might not be in the client's interest.

- Respondents largely agreed with our analysis of market practices and issues where we did not find concerns (**availability of suppliers, reciprocity, syndication, transparency** and **barriers to entry and expansion**).

1.13 Respondents also gave some examples of recent innovation in the market. These included examples of new technologies aimed at improving the efficiency of the book-building process and providing access to retail investors. In the longer term, some of these innovations may improve the transparency of the IPO allocation process and so help mitigate the issues discussed in this report.

Feedback on our remedies

1.14 We received a range of views on our remedy proposals.

- Regarding **a ban on restrictive contractual clauses**, the main concern raised was that a prohibition may prevent banks from offering some products and services that are beneficial to clients. This concern mainly relates to bridge-to-bond transactions where the bank provides a bridging loan (particularly for an acquisition) which will be replaced by a future bond issue (and the terms of the loan are based on the future bond issue). Some stakeholders also flagged other potential adverse consequences to clients, such as higher fees and reduced choice.

- On **the credibility of league tables**, respondents did not consider this to be a significant issue because many thought league tables were largely discredited in pitch presentations. Most respondents were, however, supportive of the need for best practice guidance for pitch presentations. They felt industry-led guidance was a proportionate approach. Regarding league table trades, respondents recognised that the right incentives should be in place for banks not to use trades to manipulate their position in league tables.

- On **IPO allocations**, respondents were supportive of us not proposing new rules to address the concerns in this area discussed in the interim report, in addition to our existing guidance in SYSC 10 and the requirements being introduced in MiFID II. They favoured targeted supervisory work to address any shortcomings at particular banks. Respondents also agreed that the MiFID II delegated regulation could go some way to addressing our concerns.

Further work we carried out

1.15 To address the feedback we received and to inform our remedy proposals, we carried out further work in several areas:

- **Restrictive contractual clauses**. We gathered further evidence from banks and corporate finance advisers on the prevalence, enforcement and effects of restrictive contractual clauses to assess costs and benefits of the proposal to ban such clauses. We also held further discussions with corporate clients. The evidence and conclusions are set out in CP16/31. The additional evidence did not lead us to change the findings we set out in the interim report. In summary, we found that most banks use or seek to use such clauses but that they are not that common. Some clients are able to negotiate out these clauses and banks told us that they are rarely enforced. Banks did not provide us with evidence of how such clauses benefit clients, for example, by leading to lower fees on the initial service or overall. Therefore, on balance we believe there is no justification for continuing to allow this practice in the market.

- **Corporate finance advisers**. We further considered a number of concerns raised about potential conduct risks related to corporate finance advisers. We assessed the advice provided by corporate finance advisers and we have not found evidence that they provide biased advice on which banks to appoint on particular transactions. We also conducted further analysis of fee structures adopted by corporate finance advisers and concluded that they do not typically charge fees that are linked to the performance of the transaction which may incentivise them to push for higher valuations of transactions. We will incorporate our consideration of whether syndicate analysts are influenced by corporate finance advisers into our work on the IPO process, on which we expect to publish a consultation paper in winter 2016/17.

- **League tables**. We carried out a review of internal policies used by the three main league table data providers to assess what criteria they use for identifying the potential league table trades we considered in our interim findings (medium term notes and equity block trades). We identified some ways in which these recognition criteria may incentivise banks to undertake league table trades.

- **IPO allocations**. We did a further review of the allocation policies of those ten banks which were analysed separately in Occasional Paper 15. We sought to identify good and poor practice and to assess whether those banks we found had a biased skew also have shortcomings in their allocation policies relative to the relevant requirements in the MiFID II delegated regulations and our existing regulatory expectations under SYSC 10. We did not find a clear correlation between the relative shortcomings of a bank's allocation policy and whether the bank was likely to favour clients that generate the biggest revenues for the bank when making IPO allocations. However, we did identify areas that banks would need to improve upon to comply with the MiFID II delegated regulations. An updated version of Occasional Paper 15 has been published with further checks to ensure the robustness of the analysis, the results of which did not require us to update our findings.[10]

1.16 We also did some further work to assess **the level of innovation** in the market. We engaged with a range of innovators and found a number of technological solutions being developed both by technology start-ups and technology providers with established relationships with investment banks. We found that the innovators mostly aim to provide a complementary service

10 See Occasional Paper 15: *Quid pro quo? What factors influence IPO allocations to investors?* (October 2016): www.fca.org.uk/news/occasional-paper-no-15

to that provided by investment banks, rather than competing directly with the incumbent banks. Many innovations are aimed at improving the book-building process in ECM and DCM. These companies did not identify any significant regulatory barriers to entry and expansion, and they did not believe incumbent banks were creating significant barriers to adopting the new technologies.

Developments since our interim report

1.17 On 23 June the UK voted to leave the European Union (EU).[11] This has significant implications for the UK, and may affect the competitive dynamics in the markets investigated by this market study as well as the overall regulatory framework for the UK. While the markets for investment and corporate banking may be materially affected, it is not possible, at this time, to assess any such impacts with a reasonable degree of certainty. The FCA will continue to monitor these markets over the coming years, including in light of any changes to the competitive dynamics that may warrant further investigation. Firms must continue to abide by their relevant obligations and continue with implementation plans for legislation that is still to come into effect, including MiFID II. This has a particular impact on our remedies for IPO allocations, which aim to ensure firms are ready for the relevant provisions being introduced under MiFID II.

Final findings and remedies

1.18 We do not consider that the feedback we received and the further work we did requires us to change our findings or proposed remedies in the interim report. We are confirming the findings from our interim report as final and we are taking forward the following remedies:

- We propose to **ban contractual clauses that restrict competition** without being clearly beneficial to clients. We believe the ban will protect those clients that are explicitly constrained by such contractual clauses and provide them with greater choice of providers for future services, as well as more competitive terms. The ban will also bring further benefits by sending a clear signal of our unwillingness to tolerate such behaviour by firms where it is not clearly beneficial to clients. We want to see firms competing on the merits rather than by restricting clients' choice. Our analysis and the evidence provided by banks suggest that the ban is not likely to result in significant compliance costs or other significant negative unintended consequences. We have published a separate consultation paper CP16/31 alongside this report setting out the scope of the proposed ban. Depending on the responses to the consultation paper, we expect to publish the final rules in a Policy Statement in early 2017.

- We are working with industry to **address our concerns about league tables**. We agree with industry that detriment to clients from the practices we investigated is likely to be low but that there is scope for improvement:

  - We are working with the BBA and AFME so that they can develop and adopt industry guidelines to improve league tables in pitch presentations. We do not intend to publish any guidance or rules.

11 See the FCA's statement on the result of the European Union referendum here: https://www.fca.org.uk/news/european-union-referendum-result-statement

   - We have written to each of the league table providers to identify those aspects of their recognition criteria which may create incentives for league table trades. The league table providers will consider whether the recognition criteria can be improved to reduce such incentives.

- In the run up to implementation of MiFID II, we will conduct **supervisory work on IPO allocations**. Our work reviewing allocation policies suggests that having a comprehensive allocation policy alone is not sufficient to manage conflicts of interest. Banks need to ensure the principles of the allocation policy are embodied in their allocation practices. We will work with those firms that have a significant skew in their allocation practices and whose allocation policies fall short of our existing regulatory expectations under SYSC 10 and of the relevant requirements being introduced under MiFID II.

- Our concern about **corporate finance advisers** influencing syndicate analysts will be incorporated into our work on the IPO process. We expect to publish a Consultation Paper in winter 2016/17. We have not identified any other issues that would require a regulatory intervention at this stage. We will, however, continue to monitor closely the conduct of corporate finance advisers that are authorised firms.

2. Introduction

Chapter summary

We launched our investment and corporate banking market study in May 2015. Our interim findings and proposed remedies were published in April 2016.

We found that while many clients feel well served by primary capital market services, there were also some practices that could have a negative impact on competition. We proposed a targeted package of remedies to address the concerns we had identified.

After we published the interim report, the UK voted to leave the European Union. While the markets for investment and corporate banking may be materially affected, it is not possible, at this time, to assess any such impacts with a reasonable degree of certainty. Firms must continue to abide by their relevant obligations and continue with implementation plans for legislation that is still to come into effect, including MiFID II.

This final report:

- summarises the consultation feedback we received and sets out our response to that feedback
- confirms our interim findings as final and sets out our final remedies, including how these will be taken forward and in what timescale

2.1 In this chapter we introduce our final report. We explain why we decided to do the study, its scope, the issues we investigated and our interim findings. We explain the consultation process, developments since the interim report and the purpose of the final report and structure.

Background

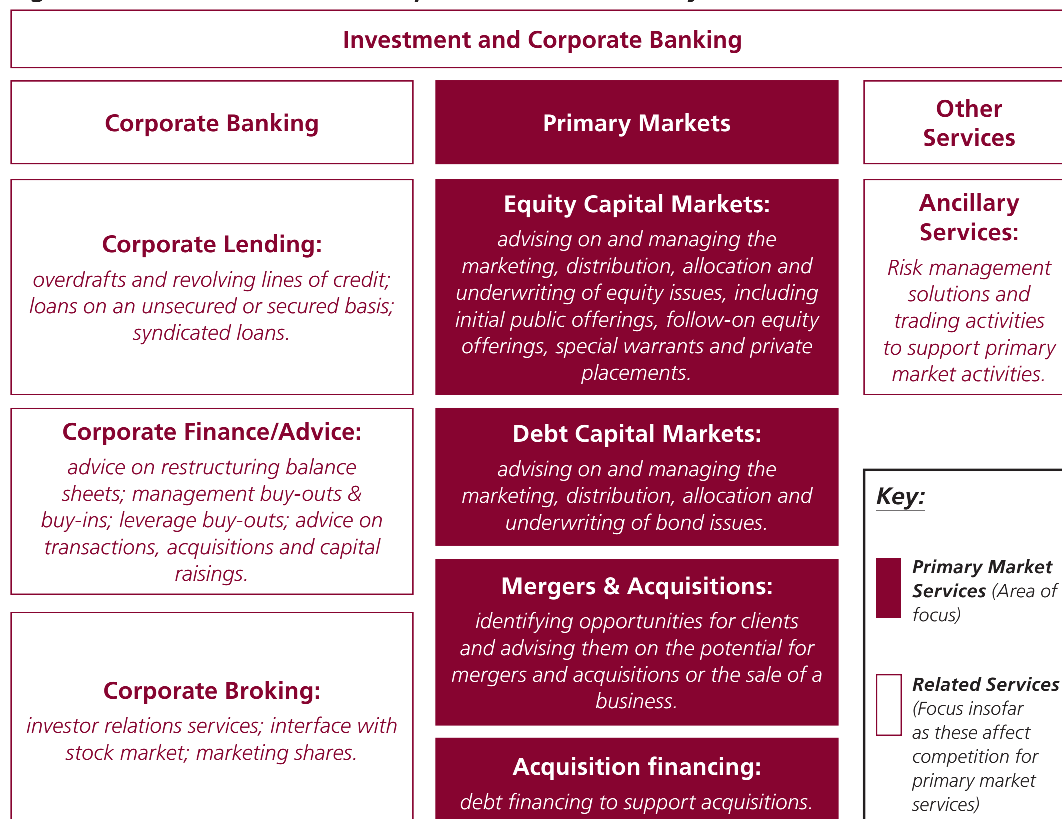
2.2 On 22 May 2015, we launched our market study into investment and corporate banking by publishing our terms of reference. This followed from our Wholesale sector competition review feedback statement, published in February 2015, which identified potential competition concerns in investment and corporate banking.

2.3 This section explains the scope of the market study, the issues we investigated and the evidence we gathered.

Scope of the market study

2.4 The market study focused on the provision of regulated primary market and relevant related services (insofar as they may affect competition for primary market services). Figure 1 below summarises the types of services which were the focus of the market study.[12] We covered investment and corporate banking services carried out in the UK.[13]

Figure 1: Services within the scope of the market study



Issues we investigated in the market study

2.5 The market study focused on three principal areas:

- whether the choice of supplier for corporate and investment banking services is more limited for particular types of clients
- whether clients are hindered from making effective choices because of a lack of transparency in the scope of services provided and fees
- whether the cross-selling, bundling and/or cross-subsidisation of services limits the effectiveness of competition

12 For more information on the scope of the market study, see Chapter 2 of the interim report.

13 When identifying services carried out in the UK we focused on the location of the activity, and had within our geographic scope all services undertaken in the UK, regardless of the location of the client or the legal entity into which the activity is booked for accounting purposes. This means we included within scope all services carried out in the UK and provided to either a UK or non-UK client or for a UK or non-UK transaction. We did not include within the scope those services carried out from outside of the UK to either UK or non-UK clients or for UK or non-UK transactions.

2.6 It was also suggested that a range of market practices could distort competition or impede effective client choice. We looked at the following:

- syndication
- reciprocity
- league tables
- corporate finance advisers
- the IPO process
- allocation of shares in IPO book-building

Evidence we gathered and our interim findings

2.7 We gathered evidence and data from a wide range of parties, including investment banks, corporate finance advisers, investors, issuing clients, trade associations and other interested parties such as researchers and corporate brokers. We analysed over 10,000 ECM, DCM, M&A and corporate loan transactions spanning a period of up to five years. Before the interim report, we met with over 100 stakeholders in a series of roundtable and one-to-one meetings.

2.8 In April 2016 we published our interim findings. We have summarised their contents in the following two chapters of this report.

Consultation on our interim findings and proposed remedies

2.9 We invited stakeholders to set out their views on the interim findings and each of our proposed remedies.

2.10 We received 27 written responses to our consultation from a cross-section of stakeholders including investment banks, corporate finance advisers, investors and several trade associations. As part of the consultation process, we also held around 40 one-to-one meetings with investment banks, corporate finance advisers, innovators, data providers and clients to discuss their views on the interim findings and proposed remedies.

2.11 We also requested further information from banks on the potential impact of a ban on restrictive contractual clauses and on how corporate finance advisers manage conflicts of interest.

2.12 There was broad support for both our provisional findings and proposed remedies. Most respondents agreed with our finding that clients have a sufficient choice of providers. Respondents provided a range of helpful views on practical issues on the detailed design and implementation of our remedies. We set out the feedback and our response in detail in Chapters 3 and 4 of this report.

Developments since the interim report

2.13 On 23 June the UK voted to leave the European Union (EU).[14] This has significant implications for the UK, and may affect the competitive dynamics in the markets investigated by this market study. The markets for investment and corporate banking may be materially affected by the UK's exit from the EU. It is not possible, at this time, to assess any such impacts with a reasonable degree of certainty. The FCA will continue to monitor these markets over the coming years, including in light of any changes to the competitive dynamics that may warrant further investigation.

2.14 The decision to leave the EU may also have an impact on the overall regulatory framework for the UK. The impact will depend, in part, on the relationship that the UK seeks with the EU in the future. Existing financial regulation, much of which derives from EU legislation, will remain in place until the Government and Parliament make any changes to the applicable legislation. Firms must continue to abide by their relevant obligations and continue with implementation plans for legislation that is still to come into effect, including MiFID II. This has a particular impact on our remedies for IPO allocations, which in part aim to ensure firms are ready for MiFID II.

Purpose of the final report and its structure

2.15 This final report summarises and responds to the feedback we received to our interim report and finalises both the findings and the remedies.

2.16 This final report is structured as follows:

- Chapter 3 sets out a summary of our interim findings for each issue, the key messages from consultation feedback, our response to the feedback and our final findings.
- Chapter 4 sets out a summary of each of our proposed remedies, the key themes from consultation feedback, our response to the feedback and our final remedies.

14 See the FCA's statement on the result of the European Union referendum here: www.fca.org.uk/news/european-union-referendum-result-statement

3. Our findings

Chapter summary
In our interim report we asked if respondents agreed with the conclusions of our analysis and whether there were any reasons we should not make our interim findings final. This chapter summarises the key themes from the responses we received to those questions and our conclusions.

Overall, the consultation responses on our interim findings supported the view that most clients – particularly larger ones – feel well served by the universal banking model and that most are in a strong position to secure good outcomes across these services as a whole.

The key themes of the consultation responses to our findings were:

- The main focus was on our analysis of **cross-selling** and the impact of **restrictive contractual clauses**.
- Several respondents also provided comments on our analysis of **league table issues**.
- Some respondents raised concerns about **corporate finance advisers** that may lead to potential conduct risks.
- Some respondents questioned our findings on the skew in **IPO allocations**.
- Respondents largely agreed with our analysis on issues where we did not find concerns (**choice, reciprocity, syndication, transparency, barriers to entry**).
- Respondents gave some examples of recent **innovation and entrants** that aim to bring innovation into this market. We also did some further work to assess the extent to which innovators are entering the market. This chapter summarises the results.

Some responses challenged our findings. We have considered those responses in this chapter but we consider that they do not materially change our conclusions.

In light of these responses, we consider that, overall, the consultation feedback supports our conclusions on competition in this market. We confirm our interim findings as final.

3.1 In this chapter we summarise and respond to feedback received on our market study interim findings.

Consultation feedback on overall market study findings

3.2 A large majority of responses supported the findings in our interim report. The feedback we received broadly agreed that there was sufficient choice available and that most clients – particularly larger ones – feel well served by the universal banking model.

3.3 We received more detailed feedback on some findings in the interim report which we discuss in the sections below:

- cross-selling, cross-subsidisation and the use of contractual clauses that restrict clients' choice
- league tables
- IPO allocations
- corporate finance advisers
- barriers to entry and expansion, and innovation

3.4 A few respondents also commented on some of the other issues considered in the interim report. These are also discussed below.

3.5 This report does not summarise nor respond to the feedback received to Discussion Paper 16/3 on the IPO process. We expect to publish a Consultation Paper on this issue in winter 2016/17.

Cross-selling, cross-subsidisation and use of restrictive contractual clauses

Overview of findings from our interim report

3.6 The interim report found that investment banking is very much a relationship business. Relationships are strengthened both by cross-subsidised lending and corporate broking and by past primary market transactions. We found that lending and corporate broking are typically supplied at a low rate of return or below cost in exchange for a flow of transactional business, which is typically more lucrative.

3.7 From a client perspective, this model seems to work well for large corporate clients. These clients typically have a wide range of lending banks or joint corporate brokers that compete against each other for transactional mandates. However, medium-sized and small corporate clients, who typically have fewer banking relationships, may feel the need to 'reward' a lending bank or corporate broker with transactional business, even when that bank would not otherwise have won a mandate.

3.8 We also found that the pressure to award the transactional business to a lending bank or corporate broker can be exacerbated by the widespread use of contractual clauses in client engagement letters which restrict future choice of supplier. We were concerned about the

most restrictive types of clauses as we found no clear evidence that such contractual restrictions were generating better terms on the initial service for clients:

- '**Right of first refusal**' clauses that prevent clients from accepting a third party offer to provide future services unless they have first offered the mandate to the bank or broker on the terms proposed by the third party.
- '**Right to act**' clauses that prevent clients from sourcing future services from third parties, regardless of any potential third party offers.

3.9 In the interim report, we asked stakeholders whether there are any benefits to contractual clauses that restrict choice which we need to take into consideration. For example, whether there are any circumstances in which clients have benefitted from reduced fees or better terms when agreeing to such clauses.

Consultation feedback

3.10 We received feedback to our interim report from twelve banks and advisers, including seven large banks, three medium-sized banks and one small bank and one adviser, and a joint submission from two trade associations and a small provider of other services. We did not receive any written submissions from clients but we discussed our analysis with 16 clients of various sizes in one-to-one meetings.

3.11 Below, we discuss separately the feedback we received on:

- our analysis of cross-selling and cross-subsidies (the relationship banking model)
- the use of restrictive contractual clauses

The relationship banking model: cross-selling and cross-subsidies

3.12 Overall, respondents broadly agreed with our analysis of the relationship banking model and the effect it has on clients and competition.

3.13 Respondents, particularly large banks, broadly agreed with our analysis of the range of benefits to clients from the relationship banking model and suggested further benefits that may arise. Benefits noted by the respondents included the following:

- cross-selling allows banks to develop in-depth knowledge of a client and provide a better service as a result, and the trust between the client and the adviser can simplify transactions
- cross-selling can lead to an expanded range of products for clients and reduce the overall costs to clients seeking multiple services
- for clients running complex, multi-stage strategies, it would not be efficient to sign contracts for all primary market services at the outset as it may not be clear what services will be needed – cross-selling makes it easier for clients to run such strategies

3.14 One small provider of other services, however, questioned whether cross-subsidisation of services is necessary to deliver these benefits. The respondent thought that these benefits from cross-selling would still exist if banks did not cross-subsidise some of their services. It argued that the cross-subsidisation shuts out other competitors.

3.15 One small and one medium-sized bank gave examples of how cross-subsidisation and cross-selling may harm clients and competition more broadly:

- Clients may feel pressured to appoint the lending firm on transactional mandates. This pressure can be due to a perceived or real threat that lending will either be provided on worse terms or not at all, when the client would have preferred to appoint other advisers on the transaction (e.g. due to better credentials or capabilities).

- Offering lending at cross-subsidised rates may press lenders to recover their costs of debt financing. As a result, they may push clients to carry out a transaction even when it is not in the best interests of the client, particularly in relation to the transaction's timing and pricing.

- Lending banks that are appointed on transactional mandates alongside other advisers may sometimes play a very limited role on the transaction. However, this may not be reflected in the title of the role and may give a misleading impression to market participants of the role of the bank on the transaction.

3.16 On the impact of the relationship banking model on barriers to entry and expansion, one small bank and one medium-sized bank and a small provider of other services disagreed with our overall assessment. They considered that barriers to entry for smaller firms that cannot provide relationship services at cross-subsidised rates are significant. They said that this is because large banks can easily absorb the lost income from cross-subsidisation or recoup the lost income through cross-sale of products that small firms cannot offer.

Use of restrictive contractual clauses

3.17 Feedback on restrictive contractual clauses focused on four main areas[15]:

- prevalence of such clauses
- how such clauses are negotiated
- enforcement of such clauses
- benefits to clients

3.18 **Prevalence:** Some banks and a corporate finance adviser commented on the prevalence of restrictive contractual clauses. Respondents generally said that these clauses are rare and are an exception rather than the rule, though one corporate finance adviser said that contractual clauses such as right of first refusal do come up 'quite frequently'. One large bank said that these clauses are more likely to be used with small clients because of the smaller amount of business they offer.

3.19 **Negotiation:** Several large and medium-sized banks and two trade associations emphasised that most clients are sophisticated counterparties who are often advised by external counsel and enter knowingly into agreements containing restrictive contractual clauses. As a result, they can decide whether contractual clauses are in their interests and if not, either negotiate the clauses or choose another provider. Such clauses are typically discussed and negotiated with the client. Further, future mandates are subject to agreement on price and terms to ensure clients get competitive terms. One large bank added that, in relationship lending, often the request for future commitment comes directly from clients.

3.20 Most of the clients we engaged with following the interim report agreed that banks may at times try to include restrictive contractual clauses in draft engagement letters and that such

15 We gathered further evidence from banks to assess prevalence of such clauses. Our analysis of this evidence is set out in the 'Our response' section in the below.

clauses are usually subject to negotiation. The clients we spoke with had either negotiated a less restrictive wording of the clause or had asked for the clause to be deleted. A few clients said that they would not accept such clauses.

3.21 **Enforcement:** Five banks of various sizes agreed that such clauses are rarely enforced and are not usually binding. One large bank noted that in many cases such clauses are 'morally enforceable' at best, because of competition between banks and the importance of maintaining client relationships. Two large banks said that they had such clauses in engagement letters but clients still chose to award the mandate to different advisers, or only awarded a minor role on the transaction. In those cases, banks did not seek to enforce the clauses. However, banks agreed that such clauses do act as a reminder to clients that they are receiving services, such as corporate broking or lending, for free or significantly below cost. One corporate finance adviser noted, however, that it had observed a case where a large issuer had had to award a mandate to a bank because of the restrictive clause.

3.22 Only a couple of clients we spoke to commented on the enforcement of restrictive clauses. One client said that it had not tried to get out of such clauses, but, if it decided to 'walk away', it would expect the bank to request a penalty fee to make up for the lost fees. Another client thought that the clause it was subject to was not enforceable because of the way it was worded. It considered that such clauses are there as a reminder to give business to corporate brokers rather than to be enforced.

3.23 **Benefits to clients:** In the interim report, we asked whether there are any benefits to contractual clauses for clients. Many banks, mainly medium-sized and large banks, argued that restrictive clauses are mutually beneficial to both clients and banks. However, one small adviser thought it is not possible to evidence benefits to either side. The benefits mentioned by banks included the following:

- **Lower fees and better execution.** Two industry associations and seven, mainly large, banks said that where clients can commit to take related services from the same provider, the provider may be able to price those services more cheaply and the client may, more generally, attract greater competition. One large bank described such clauses as 'a tool in clients' negotiating armoury' that allows clients to leverage competitive tension between banks in a way that is not possible with only a verbal indication of commitment. This can be particularly important for smaller and riskier clients that may otherwise struggle to attract banks.

- **Allows firms to provide corporate broking services for free.** Several respondents thought that cross-subsidisation allows banks to provide corporate broking services for no fee. A bank can only adopt such a business model if it can reasonably expect that it will earn a return later on.

- **Incentivises banks to invest resources into the initial phases of projects.** Clients may sometimes hire advisers to give strategic advice on a project with no automatic link to the execution and implementation phases. Banks may be reluctant to dedicate resources to the assessment phase if they do not have certainty around execution. Some banks also noted that it protects the 'intellectual property' invested in the strategic advice. More broadly, without such clauses a newly appointed bank would not be incentivised to invest resources into developing the relationship if there is a higher degree of uncertainty over whether it will win further work.

- **May allow banks to account for opportunity costs due to conflicts of interest/ exclusivity.** Respondents, mainly several large banks, said that clients may expect them to

be available for advice, for example, in a defence situation, and not to act for other parties in the interim where it may create a conflict of interest. Further, some banks said that, by taking on a relationship role (e.g. corporate broking) and receiving confidential information, they would inevitably find themselves conflicted from taking other competing mandates. So contractual clauses can reassure the client and cover banks' opportunity costs. Without such reassurance, banks would be incentivised to accept work from other clients that could cause them conflict in accepting the subsequent mandates from the first client.

- **For some services, the linking is fundamental for the economic viability of the transaction.** Banks and trade associations gave several examples of such transactions including bridge-to-bond transactions.

- **Clients have more flexibility regarding when to pay.** Some banks thought that some clients are keen to have flexibility to choose if, when and how fees are paid. Contractual cross-selling can help with this, particularly where the initial service is provided at a lower cross-subsidised rate. Smaller clients in particular may seek to minimise the annual fees they pay to their retained advisers through the fees paid on fund raising.

- **Allows banks to recover costs for uncompleted mandates.** For example, if an IPO is not completed, there are no fees payable to the banks so it is typical for parties to agree that if the issuer decides to execute the same transaction at another time, the original banks will be offered the right of first refusal.

3.24 One large bank made the caveat that restrictive contractual clauses would not benefit clients if they are included in standard letters without being specifically negotiated by clients or where they are included in general financing documents, such as revolving credit facilities.

3.25 Some of the clients we spoke to commented on the potential benefits of agreeing to restrictive clauses. Some clients considered that they may be beneficial. For example, one small client thought that including restrictive clauses may convince a large bank to serve a client it would not have served otherwise. Some clients also thought that committing future business may help negotiate better fees. Clients also recognised the benefits of free corporate broking services. One large private equity firm, however, could not think of any circumstances where such clauses were necessary, except for 'bridge to bond' transactions.

Our response

Relationship banking, cross-selling and cross-subsidies

3.26 Respondents broadly agreed with our analysis of benefits and costs of the relationship banking model. We therefore do not consider that we need to update our interim findings in this regard.

3.27 One respondent noted that cross-subsidisation is not necessary for the benefits of cross-selling to arise. While we agree with this assessment, we do not consider that the detriment from cross-subsidisation is sufficient to require us to intervene to change that model by introducing highly interventionist measures (e.g. measures which seek to separate lending or corporate broking activities from primary market transactional services, or measures which seek to govern how lending decisions are made). As noted in the interim report, such measures are likely to have significant unintended consequences for clients.

3.28 On barriers to entry and expansion, we consider that there is sufficient evidence of entry to show that such barriers are not insurmountable. However, we noted in the interim report that entry and expansion in ECM and DCM has largely been by lending banks. In the interim report, we asked for views on whether there are any other proportionate ways in which we can reduce

barriers to competition for non-universal banks and other service providers. However, we did not receive any workable proposals on this.

Use of restrictive contractual clauses

3.29 We consider that the feedback we received agrees with the findings about the role of restrictive contractual clauses we set out in the interim report. However, to further inform the cost benefit analysis of our proposal to ban restrictive contractual clauses, we gathered further evidence from banks and advisers on the prevalence, negotiation, enforcement and benefits of restrictive contractual clauses. The full analysis of that evidence is set out in the consultation paper on the proposed prohibition of restrictive contractual clauses (CP16/31) but, where relevant, we summarise the findings in the below.

3.30 **Prevalence.** Our further analysis set out in CP16/31 found that restrictive clauses are not that common, particularly in engagement letters for ECM, DCM and M&A services, though we found that most banks had sought to use such clauses.

3.31 **Negotiation.** We acknowledge that such clauses are successfully negotiated away by some clients. However, our concern is that some clients may not feel able to negotiate for them to be removed or negotiate a less restrictive version of the clause.

3.32 **Enforcement.** The feedback we received and the further work we did supported the view that such clauses are rarely enforced but that they can create an obligation for the client to work with the banks. The lack of enforcement may be either because banks had chosen not to enforce the clause or because clients had not tried to break the clauses. As set out in CP16/31, most of the banks that provided evidence in response to our follow-up information request did not provide examples of situations where they had enforced such clauses during 2014 and 2015.

3.33 **Benefits to clients.** Most of the potential benefits of restrictive contractual clauses mentioned by banks and clients in paragraphs 3.23 to 3.25 correspond to those we identified in our interim report. However, we are not convinced that restrictive contractual clauses are always necessary for many of these purported benefits to occur:

- **On lower fees and better execution:** We acknowledge that the ability to commit future services could allow some clients to negotiate better fees on the initial service, and some clients have noted this as a potential benefit. However, banks have not been able to provide us with evidence to demonstrate such fee reductions and/or better execution. Further, in our response to the follow-up information request, some banks explicitly said that they do not offer any fee reductions when such clauses are included nor increase fees when such clauses are negotiated out of engagement letters.

- **On incentivising banks to invest resources into the initial phases of projects:** Banks should not need certainty of execution to build relationships, but should be incentivised to do so in expectation of future business driven by clients' satisfaction with the service offered to date.

- **On allowing banks to account for opportunity costs due to conflicts of interest/exclusivity:** Banks should be able to provide assurance to clients over their own conflicts of interest without having to require the client to use that bank in future transactions. Such commitments are not required in other service markets, as clients noted that, for example, auditors and legal advisers do not attempt to use such clauses.

- **On allowing firms to provide cross-subsidised services, including corporate broking services, at low rates or for free:** We do not consider it likely that banks would only be willing to provide services at cross-subsidised rates where they have restrictive contractual clauses. While banning such clauses may reduce the certainty that banks will be awarded future mandates, banks will still be incentivised to forge strong relationships with clients by offering services at low fees and/or high quality service. For example, corporate broking provides a bank with frequent direct access to senior management which enables it to build the relationship and put it in a favourable position when competing for mandates for subsequent services. We also note that we do not consider that the 'free corporate broking' model is the only model that may be beneficial to clients.

- **On enabling clients to defer payments for services due to banks or advisers offering to work for a discounted or no fee:** The clients we spoke to that had such a clause did not raise this as a relevant consideration, though we acknowledge that this may be important to some clients. However, banks could offer the same flexibility by offering to work for a discounted fee if they are mandated on future transactions without obliging the client to mandate them through a restrictive clause.

- **On allowing banks to recover costs for uncompleted mandates ('tailgunner' clauses).** These are backward-looking clauses and do not relate to future transactional services. Clauses that relate to work already done where the bank wants to ensure it gets paid can be covered by alternative mechanisms to recover such costs, for example a conditional fee should the transaction not go ahead. They do not need to relate to other primary market services.

3.34 We consider the benefits to clients of such clauses for inherently linked transactions (see paragraph 3.23) in Chapter 4 of this report and the consultation paper on the proposed prohibition of restrictive contractual clauses. On balance, we believe there is no justification for continuing to allow the practice of using restrictive contractual clauses in the market.

League tables

Overview of findings from our interim report

3.35 In our interim report we said that banks focus on league table positions when assessing staff performance and pitching to clients, and, to differing degrees, clients consider these league tables when choosing which bank to use.

3.36 League tables can promote competition if they help clients compare banks and if this drives banks to compete on the areas that matter to clients. However, we had concerns that certain practices distort league table rankings and reduce comparability:

- Some banks undertake transactions with the main aim of gaining league table credit, even if they lead to a significant loss to the bank.

- Many banks routinely present league tables to clients in a way that inflates their own position and with a lack of transparency on the criteria used to create league tables.

3.37 As a result, unreliable league tables are, at best, ignored by clients and, at worst, distort clients' choices because they do not accurately signal banks' capabilities to undertake a comparable transaction.

Consultation feedback

3.38 We received written feedback from thirteen parties including nine banks of various sizes, three industry bodies, and one market data provider. We also discussed our concerns in meetings with banks and league table data providers.

3.39 Some banks disagreed that conducting league table trades softens competition in the market. Four large banks said that they offer low fees and risk making a loss on a transaction in order to generate a flow of business in a specific industry sector or country/region which they can then use to attract future clients. They said that this can be particularly helpful in a sector where they do not have expertise as it can help them to challenge incumbent banks. One medium-sized bank said this is no different to supermarkets which offer products as loss-leaders. Similarly, another medium-sized bank said that while it does not support loss-making transactions in order to improve league table position, banks should be allowed to lower their fees in order to gain business. Another large bank said there is unlikely to be detriment to a client where a bank undertakes its transaction at a loss as the client is potentially getting better value for money.

3.40 One large bank said there is a distinction to be made between loss-making transactions which are carried out to improve a bank's expertise or experience in an area and those where the bank has a largely passive role and yet still gets league table credit. The bank considered that the latter is a more pressing issue than the former.

3.41 Many banks suggested that clients pay little attention to league tables in client pitches as clients are aware that league tables are often manipulated. However, they agreed that the quality of pitch presentations could be improved and that they are at times misleading.

Our response

3.42 We do not consider that the feedback received requires us to update our interim findings.

3.43 On league table trades, we recognise that losses on transactions can arise from misjudgements or unexpected market movements. We agree that defining league table trades is difficult and that banks offering lower fees on transactions can sometimes be beneficial to competition.

3.44 Our high-level analysis of medium term note trades over the past two and a half years suggests that since we published our interim report there have been fewer trades that we consider exhibit characteristics of potential league table trades.[16] It is too early to say whether this is a trend that is attributable to our report or wider economic factors. We want to ensure that firms are not incentivised to carry out league table trades so that league tables represent banks' capabilities.

3.45 On presenting misleading league tables in client pitches, we do not accept that league tables can serve no purpose to clients. For example, our analysis of the screening criteria used by corporate finance advisers (see paragraph 3.69) suggests that league tables are given significant prominence. We consider that there is scope to make league tables more reliable so that they can help clients in their choice of service providers.

16 In paragraph 6.38 of the interim report, we note that corporate bonds that are league table trades typically have the following characteristics: (i) a short-dated maturity between one and three years, potentially produced as part of a medium term note programme; (ii) a floating rate note; (iii) a sole book-runner and no syndicate; (iv) the issuer is a financial institution.

IPO allocations

Overview of findings from our interim report

3.46 There is potential for conflicts of interest when allocating shares on IPOs as banks may seek to reward favoured investor clients, where this is not necessarily in the issuing client's interest. Our overarching conflicts of interest provisions in SYSC 10 require firms to identify and manage conflicts of interest between the firm and a client, or between one client of the firm and another client, including through implementing a conflicts of interest policy.

3.47 In addition to these provisions in SYSC 10, we currently provide some guidance for firms on managing securities offerings:

- SYSC 10.1.14G reminds a firm that, during a securities offerings, its duty is to its corporate finance client but that its responsibilities to provide services to its investment clients are unchanged.
- SYSC 10.1.15G contains guidance on measures a firm can include in its conflicts of interest policy for managing a securities offering.

3.48 Further, MIFID II introduces specific requirements for firms to manage conflicts of interest and to disclose information relevant to underwriting and placing activities.

3.49 However, Occasional Paper 15 found that some banks' IPO allocations are skewed towards buy-side investors who provide greater revenues for banks through other business lines (for example, trading commission). Since we cannot measure issuer specific preferences some of these investors may be of benefit to issuing clients. However, there is also a risk that allocations are not in the issuing clients' best interests.

Consultation feedback

3.50 We received comments on the IPO allocation findings from four industry organisations, six banks, three buy-side firms, one technology provider and two individuals.

3.51 Some respondents challenged our findings and said that the positive relationship between commission payments and allocations can be explained by large funds having both high capacities for IPO shares and high trading volumes.

3.52 Most banks said that they did not think our analysis identified a bias in their practices because their procedures and allocation policies mitigate the potential conflicts of interest in the allocation process.

Our response

3.53 We do not agree that the positive relationship between commission payments and allocations can be explained by large funds having both high capacities for IPO shares and high trading volumes. This is because the analysis in Occasional Paper 15 controls for size of investor in a way that excludes the possibility that investor size is the sole reason for banks' skew towards their best clients.[17]

3.54 We have published an updated version of Occasional Paper 15 alongside this report. It includes further analysis to ensure the robustness of the findings. The additional analysis does not

17 To account for size, OP15 looked at percentage allocation of individual investors relative to the percentage allocation of all investors. This approach identified investors that receive large allocations in comparison to the order they submitted and in comparison to the allocation that other investors received. OP15 also controls for order and investor size directly in the regression setup using investor fixed effects and order size controls.

change the findings but adds further insights on how the practice of banks favouring their best investor clients affects investor revenues.

3.55 To assess whether biased skews in allocations may be explained by banks not having robust procedures and allocation policies in place to mitigate the potential conflicts of interest, we reviewed ten banks' allocation policies (those banks which were analysed individually in Occasional Paper 15). In particular, we sought to understand whether there is a correlation between the quality of banks' allocation policies and the extent to which banks favour their most important investor clients.

3.56 We saw varying degrees of detail in the allocation policies and some clear areas for improvement if banks are to ensure their practices are in line with our regulatory expectations under SYSC 10:

- Most of the policies referred to conflicts of interests and acknowledged that the policy was designed to help manage such conflicts. However, only two of the ten policies provided detail on the types of conflicts of interest that should be considered. SYSC 10.1.11 requires firms to identify the types of conflicts that arise and include this in their conflicts policy.

- In most cases quid pro quo arrangements were explicitly prohibited. However, we found that some banks' business relationship with an investor was considered a permissible factor when allocating shares. We note that when MiFID II is implemented, allocation policies will need to ensure there are effective arrangements to prevent recommendations on placing being inappropriately influenced by any existing or future relationships (see Article 40(1) of the MiFID II delegated regulation).

- In most cases (seven out of ten) policies were clear about the need to get an issuer's agreement of the proposed allocations, in line with SYSC 10 and Article 40(5) of the MiFID II delegated regulation.

- 90% of the policies specified the need to record details of final allocations but very few referred to recording the justifications for the allocations. Some referred to the need to record any instances of material departure from the allocation proposal agreed with the issuer. Only one stated that the bank should be in a position to discuss the basis for its decisions, and three specifically stated that the bank does not need to document the basis for each allocation decision.

3.57 We did not find a clear relationship between how much allocation policies address conflicts of interest and the skew in the allocations to investors that generate more revenues. For example, quid-pro-quo arrangements were prohibited in about 90% of allocation policies of banks for which the empirical evidence in Occasional Paper 15 shows a clear relationship between investor revenues and allocations. This suggests to us that the existence of a clear allocation policy is not itself sufficient to ensure that conflicts of interest are adequately addressed. Our findings cast doubt on how well these allocation policies are followed in practice.

Corporate finance advisers

Overview of findings from our interim report

3.58 In our interim report, we considered the role that corporate finance advisers play in primary markets. We showed that these advisers have taken a prominent role in many IPOs in recent years and many clients have valued their input. They advise clients on selecting syndicate

banks, assist with running the IPO process and advise on the allocations of equity the syndicate banks propose. When we explored the reasons for the increased use of these advisers, clients suggested that they can be beneficial by counteracting an issuer's lack of experience in capital markets. They do this either by providing some scrutiny of conflicts of interest within investment banks or by providing reassurance to the issuer's senior managers.

3.59 However, the banks suggested that the role of corporate finance advisers can create conduct risks and that there is a lack of clarity over how the FCA's rules and guidance apply to them.

3.60 We investigated four potential concerns raised with us about corporate finance advisers:

- Whether certain corporate finance advisers show preference to certain banks. In particular, whether the advice that corporate finance advisers provide to issuers is not aligned with the needs of the client.

- Whether corporate finance advisers recommend book-runners to the issuer client based on the likely favourability of their research. This can impair the objectivity of the research which connected analysts produce.

- Whether the level of fees that corporate finance advisers charge is not justified based on the value they add to the IPO process.

- Whether the fee structures used by corporate finance advisers misaligns the incentives between the adviser and the client.

3.61 In the interim report, we found no evidence of corporate finance advisers giving advice which would be against a client's best interests. We also found no clear evidence these advisers try to unfairly influence the research on IPOs, although a positive research message from analysts is one of the main factors considered when advising the issuer on which banks are appointed to a syndicate. We invited further evidence from industry stakeholders on all of these issues.

Consultation feedback

3.62 We received feedback on corporate finance advisers from two medium-sized banks and one small bank. We also held meetings with two of the three banks who responded on this topic, as well as two corporate finance advisers.

3.63 One medium-sized bank was concerned about the role that corporate finance advisers play in producing IPO-related research. It wanted us to further consider the advisers' involvement in verifying IPO valuations with individual analysts, or in any way interfering with how valuations are presented or how investment banks select analysts to write pre-deal research. The bank had observed a trend where corporate finance advisers play an increasingly active role in the production of deal-related research.

3.64 Another medium-sized bank reiterated many of the issues which we discussed in our interim report. Specifically, it told us that:

- Corporate finance advisers create barriers to entry for smaller investment banks by showing preferences towards larger investment banks and even blocking certain banks from approaching the issuer.

- It believed the fee structures used by corporate finance advisers are often linked to the IPO issue price or valuation. It suggested that this leads to detriment for the issuer as aftermarket performance tends to be poorer when a corporate finance adviser is involved in

the deal. The bank gave us evidence which it said showed that IPOs which use a corporate finance adviser are overpriced and so perform worse in the aftermarket than those with no adviser.[18]

- Corporate finance advisers' fees can be significant in the context of a transaction and may warrant transparency for the benefit of investors and existing shareholders, in the same way as banks' fees are made transparent.

- Corporate finance advisers often advise the issuer on information flow between the issuer and the firm acting as sponsor which prevents or limits access to the issuer. This may weaken the regulatory protection investors have.

- A corporate finance adviser has recently acquired an 'independent specialist investor relations' firm which undertakes equity distribution services on IPOs and seasoned equity offerings. The bank believed that this creates a conflict of interest as it creates incentives to price IPOs more aggressively.

3.65 One small bank said it believed there are benefits in appointing corporate finance advisers on a transaction, particularly for those companies which are unfamiliar with the corporate finance process.

Our response

3.66 In response to the consultation feedback, we sent information requests to six corporate finance advisers in order to get a better understanding of three issues:

- how they advise clients on book-runner selection

- what protocols they have in place for interacting with syndicate analysts

- how their fees are structured and whether those fees are made transparent

3.67 We consider these points in this section as well as some of the other issues raised in the consultation feedback.

Syndicate selection

3.68 To further assess the claims of corporate finance advisers being biased towards selecting certain banks on syndicates, we asked them to send recent advice given to clients and to explain their screening process when advising which banks to invite to pitch.

3.69 Although there are inevitably variations between corporate finance advisers, in general, this advice involves the following steps:

- Advisers do an initial cut (or desktop analysis) of investment banks' credentials. This analysis is heavily based on advisers' knowledge of the relevant expertise of banks, banks' positions in IPO league tables, Extel research rankings and trading activity rankings. These league tables will be relevant to the sector and geography in which the client operates. Advisers may also find a group of similar companies to the client and look at which investment banks cover these companies in terms of research.

18 More specifically, the analysis compared the share price of the floated company 90 days after flotation with the share price at the close of the flotation date. This was to factor out any initial IPO underpricing. The analysis covered all IPOs between January 2014 and 25 May 2016. The results were that the 90-day price on UK IPOs with an adviser was on average 5% lower compared with the closing price on the flotation date. This compared to 4.6% higher when an adviser was not involved.

- Those investment banks which make the initial cut will be sent 'request for proposal' (RfP) letters. These letters generally request information on: the bank's credentials (i.e. experience in terms of research, IPOs and sales and trading), the bank's positioning of the equity story (i.e. the key messages they would want to get across to investors about the client), a valuation of the client's company including the methodology they have used to value the company, how the bank proposes structuring the IPO and the syndicate, the bank's fee proposal and any conflicts of interest that the bank faces.

- Following the RfP process, the adviser will provide the client with a summary of the banks' RfP submissions. Advisers may either provide a raw comparison of the information or apply their own evaluation framework where they score the banks in different areas (for example, the sales and distribution capability of the bank) with different weights for different factors depending on the importance of the factor to the deal.

- Advisers will then provide recommendations and supporting analysis to the client. Advisers may provide syndicate structure options, including which banks should be on the syndicate.

3.70 In our assessment of the examples of recent advice given to clients, we did not identify any advice from corporate finance advisers which caused us concern about bias towards particular banks. Corporate finance advisers appear to have a process that aims to select banks based on their relative merits and appropriateness for the deal. We saw examples of deals where small and medium-sized banks were recommended for a transaction because they had some of the best research analysts for the sector in which the client operates. This evidence demonstrated how corporate finance advisers can help bridge the gap in experience and knowledge between an issuer and an investment bank.

3.71 Therefore, coupled with our analysis in paragraphs 6.172 to 6.179 of the interim report, we do not consider there is any need for further action in this area.

Leaning on research analysts

3.72 During the market study, we heard from several stakeholders who have concerns about the influence that corporate finance advisers have on research produced by analysts who are connected to the deal.

3.73 We asked several corporate finance advisers to provide us with their protocols on interaction with research analysts at investment banks. These policies were broadly similar. In particular, they all had the following procedures:

- The investment bank's compliance department or Head of Research must approve all contact between the adviser and the research analyst.

- The interactions between the bank's research analysts and the advisers are strictly governed by the rules set out by the investment bank's compliance unit or general counsel.

- The meetings are usually held separately from the beauty parade meetings or any other meetings held with the bank's ECM team or any other investment bankers involved in the IPO.

- No non-public financial or material information about the issuer should be disclosed to the analyst. In particular, the analyst should not have access to the issuer's forecasts. Analysts should only be asked to provide feedback on the issuer based on what they know about the business today.

- Advisers can ask analysts for their views on the issuer's sector, the company itself, and investor appetite for the sector and the company. All this must be based on publicly available information.

- Advisers can ask about the methodologies that analysts use to value companies and the key primary valuation drivers and key performance indicators that investors look for.

3.74 As noted in the interim report, we emphasise that, consistent with our COBS 12 requirements, it is the responsibility of the investment banks producing the research to manage conflicts of interest in relation to analysts involved in its production and dissemination. Our concern about whether syndicate analysts are influenced by corporate finance advisers will be incorporated into our work on the IPO process. We expect to publish a Consultation Paper in winter 2016/17.

Fee structures and transparency

3.75 We wanted to understand further the structure and transparency of corporate finance advisers' fees. In particular, whether these fees depend on the final IPO price or valuation and, if so, whether these fees are made transparent to the market ahead of the IPO.

3.76 We collected information from three corporate finance advisers to get a better understanding of their fee structures. The feedback we received does not suggest that corporate finance advisers' fee structures are misaligning the incentives between themselves and their clients. Corporate finance advisers told us that they almost always use a flat fee or monthly retainer structure and a discretionary fee which depends on the client's satisfaction with the service they have received. They do not generally link their fees to the price or valuation of the IPO (although one adviser gave an example of a recent dual-track M&A/IPO exit transaction where a proportion of its fees were linked to the final valuation achieved at IPO).

3.77 We will, nevertheless, continue to monitor changes in the fee structures of authorised corporate finance advisers. In addition, on transparency of their fees, we note that the EU Prospectus Directive is designed to harmonise the requirements for the prospectus, which is required when securities are offered to the public or admitted to trading on a regulated market. We would remind industry stakeholders that it has an overarching requirement for the disclosure of all information that is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer, and of any guarantor, and of the rights attached to its securities. The directive's specific disclosure requirements include:

- a summary of each material contract to which the issuer or any member of the group is a party, for the two years immediately preceding publication of the registration document

- an estimate of the total expenses of the issue/offer

Other issues raised in consultation feedback

3.78 The feedback we received does not suggest that corporate finance advisers attempt to control the flow of information between an issuer and the bank acting as sponsor in a way that adversely affects the issuer. The flow of information between the bank acting as sponsor and the issuer is a matter for the bank to ensure through its own relationship with the issuer. If the issuer wants to use a corporate finance adviser to control the information flow, that is a matter for the issuer.

3.79 With regards to the potential conduct risks of a corporate finance adviser owning an investor relations firm, we have commented on issues of conflict of interest in general in the above. We

expect corporate finance advisers that are authorised firms to manage any conflicts of interest that arise from their corporate structures.

Overall response

3.80 While we have found no evidence that the concerns raised about selection bias and fee structures require action at this stage, we will continue to closely monitor the conduct of corporate finance advisers that are authorised to ensure they comply with our rules.

3.81 Given the importance of research analysts in the IPO process, we will incorporate the influence that corporate finance advisers have on research produced by connected analysts into our work on the IPO process.

Barriers to entry, expansion and innovation

Overview of findings from our interim report

3.82 In the interim report, we found that entry and expansion in ECM and DCM has been primarily by those banks that already provide lending, though there had been entry by smaller/niche providers in M&A.

3.83 We also identified several barriers to entry and expansion:

- Sales, trading and research capabilities: banks seeking to enter ECM and/or DCM require, as a minimum, origination, sales, trading and research capabilities. In contrast, M&A capability requirements are lower because firms can enter with experienced professionals but minimal infrastructure.
- Reputation is a crucial factor in selecting a bank.
- Cross-selling from lending and corporate broking: firms without these capabilities can find it harder to compete, particularly in ECM and DCM.
- Capital adequacy requirements mean more capital is required than in the past, but regulation in general was not seen as a major barrier to entry and expansion.

3.84 We invited further feedback on barriers created by regulation, particularly on capital requirements, authorisation rules and remuneration.

3.85 In the interim report, we also said we had seen limited innovation in primary markets, particularly in book-building. The technological aspects of the book-building process in particular are still relatively unsophisticated. We invited views on why technological innovation has not yet been as successful in primary market activities as in other aspects of banking and if there are regulatory barriers that prevent technological solutions being adopted.

Consultation feedback

3.86 Overall, responses did not highlight additional barriers to entry and expansion other than the ones discussed in our interim report. However, two small and medium-sized banks and a small provider of investor relationship services disagreed with our findings. They argued that the barriers created by the cross-subsidisation of lending and corporate broking are significant. We discussed these points in the section on cross-selling above.

3.87 On innovation, respondents highlighted industry initiatives to digitalise and automate the book-building process, led by FIX Trading Community – a non-profit, industry-driven standards body, as well as a technological solution developed by a start-up (see Table 1 below).

Our response

3.88 Based on the feedback we received, we did not consider that we needed to update our analysis of barriers to entry and expansion, as respondents did not raise new barriers or provide further evidence on the barriers discussed in the interim report. We did, however, carry out further work on innovation.

Further work on innovation

3.89 Following the publication of the interim report, we held discussions with a number of innovators in the market. We found that there are a number of solutions being developed both by technology start-ups and by technology providers with established relationships with investment banks, see Table 1 below. Overall, innovation is occurring in primary market services, but no business model that fundamentally challenges the role of banks in primary market services is currently taking hold.

3.90 The innovators we engaged with did not highlight any significant regulatory barriers to innovation. Many start-ups were aware of or already in touch with our Innovation Hub.

Table 1: Examples of recent innovators in primary market services

Type of innovation	Examples
Online platforms that facilitate private placements. These platforms allow issuers to post desired sizes, terms and maturities of private placements directly to investors. Such platforms do not aim to replace banks but are open for banks to join.	• **Origin:** a UK start-up developing an online platform for issuers to post new private placement offerings to their dealers, streamlining the process for bond issuance. • **CMDportal:** a large collaborative market data network for bonds and money market professionals. In April 2016 CMDportal announced that it is creating a global platform that provides pre-trade access to private placement bond and money market financing opportunities for issuers and dealers. • In July 2016, **LSE** announced a new platform for private placements that matches members of LSE's ELITE network of private companies with investors.
Innovations that allow retail investors to access IPOs. Retail clients traditionally have not been able to invest in UK IPOs. Some technology companies have developed tools to facilitate such access.	• **SyndicateRoom:** a UK based online investment platform for sophisticated and high-net worth investors that allows investors to access IPOs. The company is not involved in the allocation process which is still managed by the IPO syndicate. • **OnMarket BookBuilds:** an Australian firm that has a joint venture with the Australian Securities Exchange and has also developed an app allowing retail investors to directly place bids for shares and be allocated shares on a pro-rata basis.

Type of innovation	Examples
Technological solutions aiming to improve the IPO distribution process, including book-building. Currently placing orders for new issuances is a manual and time consuming process with scope for error, as multiple banks and advisors populate the order book. Various providers are developing solutions that address these inefficiencies.	• There is an industry-wide initiative led by the **FIX Trading Community** and implemented by technology vendors **Ipreo** and **Dealogic**. Dealogic is developing capital markets solutions to allow investors in new issues to submit orders electronically directly to an order book shared by syndicate members. Ipreo is developing solutions in fixed income and equities to allow investors to receive deal-related information directly from the syndicate members and to directly place orders electronically. • **Issufy:** a UK start-up that is developing a platform to facilitate and enhance the IPO distribution process for institutional investors, advisory firms and corporates that are issuing stock.
Technological solutions based on blockchain technology. Blockchain has the potential to simplify the new issuance process, especially clearing and settlement, where highly secure and possibly low cost 'distributed ledger' solutions could replace central clearing providers. Solutions that use distributed ledger technology are still in their infancy.	• **Finclusion Systems:** the firm is delivering a Blockchain Service Platform (BSP) provider service to raise funds for HIV Cure and Cancer Immunotherapy Research and Development (R&D) and will use Distributed Ledger Technology (blockchain) to manage the issuance's clearing and settlement, with subsequent transparent and efficient distribution of R&D funding. Among other benefits, blockchain would allow retail subscribers to invest with small amounts in the impact bond. • **Nivaura:** a start-up using workflow automation and distributed ledger technology to streamline the primary issuance and administration processes, from term coordination, document structuring, and custody services.

Feedback on other market practices

3.91 We received a small number of responses on the other issues assessed in the interim report. We summarise these below:

- availability of suppliers (choice)
- syndication
- reciprocity
- transparency
- fees and quality

3.92 Some respondents also raised some other issues which were not within the scope of the market study or related to other ongoing FCA work. We have addressed those comments directly or they will be considered in other FCA work.

Availability of suppliers (choice)

3.93 In the interim report we concluded that we had not identified compelling evidence that any particular sector or category of clients faces a lack of available suppliers for corporate and investment banking services.

3.94 Several banks commented on our analysis and agreed that clients do not face a lack of choice in the market. In light of the limited responses in this area, we have not undertaken further analysis of choice.

Syndication

3.95 Syndicates on ECM and DCM transactions involve banks taking on different roles to execute the transaction. In the interim report, we found that clients control the size and composition of syndicates. Larger syndicates are not associated with higher fees, and they can broaden clients' relationship options and provide a route for smaller banks to enter and expand. We said that for these reasons we did not propose to pursue issues around syndication any further at this stage.

3.96 Six respondents, including banks, trade associations and data providers, commented on our findings on syndication. Four respondents agreed with our analysis and that no further action is required on syndication. One respondent, a data provider, observed that there is a trend towards larger syndicates in corporate bonds following the financial crisis.

3.97 One large bank raised concerns about the syndicate composition in the European high-yield corporate bond market. It noted that most syndicates in this market only have a single lead-left bank which is typically one of the few large banks. It also noted that the lead-left banks typically take sole control of the execution of the transaction which means that other syndicate banks may struggle to get key information. In the view of this bank, such syndicate structure and behaviour of lead-left banks results in a lack of transparency and may restrict competition.

3.98 We do not consider that the feedback received requires us to update our overall interim findings. For the issues raised about syndicate structures in European high-yield debt markets, our overall analysis in the interim report indicated that the issuers make the decisions about the syndicate structure and there may be valid reasons, such as efficiency, for choosing to appoint only one lead bank on the syndicate. In our analysis, we did not identify that the lead banks have a significant influence on the syndicate composition.

Reciprocity

3.99 Reciprocity is a practice where a bank that issues its own financing awards mandates to another bank partly based on how much business it will receive in return. In the interim report, we found this practice is currently most common in the bank financing market, particularly covered bonds. We concluded that reciprocity does not currently appear to be excluding non-reciprocal banks from competing because they can win mandates. We did not propose to take any further action at this time but said that we may revisit reciprocity if it becomes more common or has a significantly greater impact.

3.100 Six respondents, including banks, trade associations and a data provider, commented on our findings on reciprocity. Five of these respondents supported our findings and agreed that no further regulatory intervention is required. One medium-sized bank welcomed our approach of keeping reciprocity under review but considered that the subject could justify further analysis. In particular, this bank suggested that we carry out further analysis by fees earned rather than roles taken on a transaction as different roles can have very different levels of associated fees. Role-based analysis may obscure the fact that a small number of players earn most fees.

3.101 We considered carrying out further analysis by fees earned. We agree that such analysis would provide additional evidence but we do not think it would significantly change our overall findings. We consider that our analysis of book-runner and co-manager roles awarded to reciprocal and non-reciprocal banks already provides sufficient evidence at this stage as the most senior roles tend to receive the highest fee allocations.

Transparency

3.102 In the interim report, we assessed whether banks disclose adequate information about services and fees to their clients. Our review of engagement letters found that transparency is not a

material area of concern. In the interim report, we asked whether there are any reasons why we should take any action on transparency.

3.103 All respondents who commented on transparency agreed with our findings that the obligations in our existing rules, together with the forthcoming MiFID II implementation, ensure sufficient transparency for clients. No respondent expressed any concerns about our view that we should not intervene further in this area.

3.104 One buy-side investor, whilst generally agreeing with the analysis in the interim report, noted that disclosure of fees in the prospectus, including the basis of how any incentive fee awarded after completion is decided, may be helpful.

3.105 Our transparency assessment focused on whether investment banks provide prospective clients with enough information on fees and scope of services before their appointment. We continue to hold the view that the obligations in our existing rules, together with the forthcoming MiFID II implementation, ensure sufficient transparency for clients.

Fees and quality

3.106 In the interim report, we found that, for most types of services, fees for transactions with similar characteristics vary because fees are negotiated on a transaction by transaction basis. Fees are typically made up of a base fee and sometimes a discretionary fee which is paid at the client's full discretion. On quality, some clients noted that they were happy with the quality of service provided.

3.107 One small bank commented on our analysis of discretionary fees. It said that it generally welcomes the practice of issuers using discretionary fees as such fee structures incentivise brokers to provide high quality service to the issuer. It also agreed that discretionary fees are typically used on larger value IPOs rather than lower value IPOs.

Overall conclusions on our findings

3.108 Having considered the consultation feedback we have received, we have not changed our conclusions on competition in this market. For the reasons we have explained above, we consider that overall the feedback supports the findings in our interim report. We have therefore decided to confirm our interim findings as final. We consider comments from consultation respondents on how we propose to address our findings through our proposed remedies in the next chapter.

4.
Our remedies

Chapter summary
Overall, the consultation feedback we have received on our proposed remedies in the interim report has been supportive and we have decided to confirm our proposed remedies, which are:

- a ban on contractual clauses which restrict a client's ability to use an alternative bank or adviser on a subsequent transaction; we have published a separate consultation paper alongside this report setting out the proposals
- bringing an end to poor league table practices by working with BBA/AFME on industry guidance for presenting league tables in pitch presentations and working with league table data providers to revise their recognition criteria for certain types of transactions to reduce the incentive for league table trades
- supervisory work with banks we have identified as having shortcomings in their allocations policies and/or strong skews in their IPO allocations towards their most important investors

We are continuing to consult on and develop proposals to make changes to the IPO process and expect to publish a separate consultation paper with policy proposals in winter 2016/17.

Overall consultation feedback on remedies

4.1 The majority of respondents supported the proposed remedies. We received most comments and divergent views on the proposal to prohibit restrictive contractual clauses. We discuss the following remedies below:

- banning restrictive contractual clauses
- improving the credibility of league tables
- addressing the skew towards larger investors in IPO allocations

Remedy 1 – banning restrictive contractual clauses

Overview of remedy proposal from our interim report

4.2 In the interim report, we said that we do not currently consider that the detriment from universal banking and cross-subsidisation is sufficient to require highly interventionist measures such as those which seek to:

- separate lending or corporate broking activities from primary market transactional services
- govern how banks make lending decisions

4.3 We also considered measures such as requiring tendering of corporate broking roles every few years, or limiting lending terms to a set period of time, but considered that these are unlikely to be effective.

4.4 We said that we would focus on lowering barriers to entry and expansion for non-universal banks by removing the practice of banks using restrictive contractual clauses.

4.5 In the interim report, we asked:

- what practical issues might arise if restrictive contractual clauses were to be prohibited
- whether there are any types of services for which such contractual clauses should be permitted

Consultation feedback

4.6 We received feedback from eleven banks, including seven large banks, three medium-sized banks and one small bank, one adviser, a joint submission from two trade associations and a response from a small provider of other services. We did not receive any written submissions from clients but we discussed our analysis with 16 clients of various sizes in one-to-one meetings.

4.7 The feedback we received covered three main issues:

- whether we should ban restrictive clauses
- costs and benefits that may arise if restrictive clauses are prohibited
- the design of the prohibition

Whether the FCA should ban restrictive clauses

4.8 We received a range of views on whether we should ban restrictive clauses.

- A few small banks supported a ban. One medium-sized bank said that it would not object to us prohibiting such clauses if they are to the detriment to clients. Another medium-sized bank said that any activity which restricted clients' ability to mandate their preferred providers should be restricted or prohibited. One small provider of other services supported removing contractual 'right to act clauses' from broking agreements.
- Several large banks and two trade associations were against a ban. They argued that the interim report did not show that such clauses create significant risks to effective competition. As a result, a ban is likely to lead to very small benefits to clients and competition while the potential costs and unintended consequences would be significant. One large bank also

noted that clients had not expressed concerns about these clauses. One small bank said that it would not support an outright ban as it thought that such clauses can sometimes help small firms who take a new client and undertake a significant amount of initial work for the client.

- Some banks said that they would only support a narrow ban, and made suggestions on the scope of such a ban.

4.9 Below, we discuss in more detail respondents' views on the costs and benefits that may arise and suggestions on how such a ban should be designed.

Benefits and costs if clauses were prohibited

4.10 Most banks held the view that such a ban would bring very limited benefits. They added that restrictive clauses are not very common, and, where present, they are not enforced. Furthermore, respondents, particularly smaller respondents, emphasised that a ban is unlikely to change the prevailing practice of cross-selling and cross-subsidisation. One medium-sized bank said that lenders would still be able to apply commercial pressure on clients even if these clauses are banned. One small provider of other services thought that, to 'level the playing field', we would have to stop the cross-subsidy, for example, by allowing universal banks to bundle their services but insisting on them not selling services below costs.

4.11 Most respondents, particularly large banks, said a ban would result in costs to clients and banks, as well as creating unintended consequences, though one medium-sized bank did not expect to see any issues if truly restrictive clauses are banned. The costs and unintended consequences included the following:

- an increase in the aggregated fees paid by clients, as banks will have to reassess the cost base for corporate broking and lending services
- restriction on client choice because the transaction that results in the engagement letter attracts less competition and hence fewer banks compete to provide the service
- small or riskier clients may struggle to obtain the service and banks may focus on larger and more sophisticated companies
- banks will incur compliance costs and there may be a 'chilling effect' if banks rule out a much wider range of potentially pro-competitive conduct to ensure that they comply with the rule
- the universal banks may withdraw completely from providing the relationship service to concentrate on the more lucrative M&A or capital markets activities
- some services or transactions, such as bridge-to-bond, may no longer be commercially viable and may no longer be offered (or fewer firms may compete for such business)
- clients may seek to use banks not subject to the FCA's rules (i.e. those based in other jurisdictions) which may weaken the ability of UK-based banks to compete for these transactions if the providing bank is domiciled in the UK

4.12 Several banks considered that, on balance, the small benefits that may arise if restrictive clauses are banned do not justify the costs and potential unintended consequences.

Design of the prohibition

4.13 Overall, several respondents said it would be difficult to design such a prohibition in practice.

4.14 Respondents made several suggestions on the potential scope of the prohibition which included the following:

- Restricting the prohibition to certain groups of clients. One large bank suggested excluding sophisticated clients (or at least applying a different standard to them), one medium-sized bank suggested excluding large corporates clients, financial institution groups and sovereign, supra-national and agency clients and one adviser suggested permitting such clauses for services to AIM/smaller companies as they may particularly value the flexibility.

- Allowing such clauses if they are proposed by a client or expressly negotiated with a client into bespoke agreements.

- Banning open-ended restrictive clauses that cover a period of more than six months.

- Banning 'exclusionary clauses' that exclude other banks from the tender process but allowing 'inclusionary' clauses that only seek to have the relationship bank in the pool of advisers on a particular transaction.

- Banning or restricting any activity which restricts a customer's ability to instruct their preferred choice of advisers, not just the inclusion of restrictive clauses in legal documents.

4.15 In the interim report, we asked whether there are any types of services for which such clauses should be permitted. The respondents suggested the following types of services that should be excluded from a ban:

- closely linked transactions that are procured as part of a single tender process and where contractual clauses are used as important risk management tools for banks (e.g. bridge-to-bond)

- transactions that can go down multiple paths – it is common for clients to approach banks to help with a strategic question and it may be hard to predict at the outset what the client will decide they want to do and what services they will need

- other types of transactions and advice, including anti-raid advisory mandates

4.16 Respondents also asked us to clarify our position on several issues:

- confirm that a ban will not apply to services other than those assessed by the market study (e.g. secondary markets)

- confirm that a ban will not apply to non-restrictive types of clauses (i.e. right to pitch and right to match clauses)

- clarify whether the remedy will apply only to contractual agreements, rather than non-binding commercial understandings

- clarify the jurisdictional reach or geographic scope of any prohibition; in particular, how to rules will apply to banks with a global reach and whether the rules will only apply to transactions on behalf of UK clients or more broadly

Our response

4.17 We consider and respond to the arguments in paragraphs 4.10 to 4.16 and the detailed feedback on how to design the proposed ban and set out our cost benefit analysis in CP16/31 published alongside this report.

4.18 In summary, we propose to ban contractual clauses that restrict competition without being clearly beneficial to clients. We consider that softer forms of intervention, such as allowing such clauses if they are proposed by a client or expressly negotiated with a client into bespoke agreements, would be unlikely to reduce the impact of these clauses because clients that tend to accept them are more likely to have less bargaining power with banks in the first place.

4.19 The ban will protect those clients that are explicitly constrained by such contractual clauses and provide them with greater choice of providers for future services, as well as more competitive terms. The ban will also bring further benefits by sending a clear signal of our unwillingness to tolerate such behaviour by firms where it is not clearly beneficial to clients. We want to see firms competing on the merits rather than by restricting clients' choice. As set out in the cost benefit analysis of CP16/31, we do not expect this proposal to result in significant compliance costs or other significant negative unintended consequences. Some banks said that the prohibition may lead to some clients losing some benefits of restrictive clauses. We do not consider such impacts to be likely or significant as any counterbalancing benefits to clients have not been clearly evidenced by banks.

4.20 We do not expect the prohibition to change the current universal banking model in which some services, such as corporate lending and corporate broking, are provided below cost or for free in expectation of receiving other future transactional business from clients. Our analysis and the feedback we received did not indicate that restrictive contractual clauses are essential for this business model to continue. We also note that even in the presence of anti-tying rules in the US banks are able to continue offering services at cross-subsidised rates.

Next steps

4.21 We have published a separate consultation paper alongside this report setting out the scope of the proposed ban on restrictive contractual clauses. Depending on the responses to the consultation paper, we expect to publish the final rules in early 2017.

Remedy 2 – improving the credibility of league tables

Overview of remedy proposal from interim report

4.22 In the interim report, we said that we wanted to find ways to increase the credibility of league tables so that:

- they are more meaningful for clients
- banks do not face incentives to conduct trades at a loss purely for the purpose of gaining league table credit

4.23 We considered several remedy options including standardised league tables and incentivising different behaviour by setting parameters for presenting league tables. We did not consider it appropriate in these circumstances for the FCA to take on production of standardised league tables. Instead, we said that we would like to see banks and advisers adopting better practices by presenting league tables in pitches that are more meaningful for clients. We set out the following options:

- criteria for presenting the scope of deals covered by a league table, including the period of time the transactions cover and the countries and types of transactions included in the league table
- league tables presented to clients being based on data that is consistent with the type of transaction the client is undertaking
- league tables presented to clients being the same as the ones used internally by banks
- the proportion of an individual bank's transactions that show characteristics that are consistent with a league table trade being declared when presenting league tables to clients

4.24 We also said that this is likely to be best achieved through an industry-led solution.

Consultation feedback

4.25 We received feedback from 13 parties including nine banks, three industry bodies, and one market data provider. We also discussed our concerns in meetings with industry stakeholders including banks and market data providers.

League table presentations in client pitches

4.26 Some banks explicitly backed our proposal to work with the industry to develop best practice guidelines. Several respondents believed that the transparency of league tables should be improved by clearly stating the source and criteria used to construct the league table. Further, some respondents stated that league tables should not mislead clients.

4.27 Some banks and trade associations went even further by suggesting some criteria that the industry should adopt when developing best practice guidelines. Some common themes for these suggested guidelines included: clear identification of the time period, industry sector, geography, and data source in the construction of the league table and a note of any changes or adjustments to the league table compilation methodology.

4.28 While respondents generally welcomed the introduction of an industry-led set of best practice guidelines, some also cautioned against the guidelines being over-prescriptive. They also said such guidelines would still need to allow them the flexibility to tailor league tables to ensure they are relevant to the specific client and transaction. One bank also noted that Principle 7 of the FCA's Principles for Business already requires that banks present information which is fair, clear, and not mis-leading, thus suggesting intervention is not required in this area.

League table trades

4.29 A couple of banks suggested it would be difficult to identify league table trades or the parameters which typically define a league table trade. This would make it difficult to enforce any remedy which sought to tackle them.

4.30 One bank suggested we should engage with league table providers and develop the existing league table criteria to discourage league table trades. Another bank suggested that the league table credit that league table providers award to banks should be a reflection of the portion of the deal sold to investors by bookrunners. Finally, two trade bodies suggested that the deals included in league tables are as homogenous as possible. This would involve separating components of league tables into their own standalone league tables, for example block trades should have their own league table separate from an IPO league table.

Our response

4.31 Although some banks have argued that intervention in league tables is unlikely to yield much benefit, we consider that this is an area where practices should be improved. The weight placed on league table data by corporate finance advisers in their screening procedures shows that league tables can matter. If league tables are to be used by advisers and by clients it is important that the data which underpins them truly reflects banks' capabilities and that the way the data is presented tells a fair, clear and not misleading story.

4.32 We have set out our approach to each of the two issues – league table presentation and league table trades – below.

League table presentation in client pitches

4.33 We noted the support for some industry-led guidelines on league tables being used in client pitches. We are working with BBA and AFME so that they can take forward and develop industry guidelines on presenting league tables in pitches. We are keen to encourage the guidelines to be industry-led to ensure the right balance between prescriptiveness and flexibility. We believe that guidelines should build on Principle 7 of the FCA's Principles for Business that requires that banks present information which is fair, clear and not misleading.

4.34 The guidelines need to be sufficiently detailed so that banks understand what is expected of them when they present league tables to clients. At the same time, the guidelines need to be sufficiently high level to ensure that banks can tailor league tables so that they are relevant to the client and the proposed transaction. We have proposed that BBA and AFME consider the following:

- using criteria that are directly relevant to the transaction that the client wishes to undertake
- presenting tables with enough clarity and detail to enable clients to, for example, reproduce the table where they have access to the information from a league table data provider
- including contact details for league table providers so clients can seek relevant information if they wish
- if requested by a client, banks should be prepared to explain what transactions underpin their own data in a league table

League table trades

4.35 To tackle the concerns around banks undertaking league table trades, we conducted further work to review the criteria that each of the three main league table providers use when recognising transactions for league table credit. We identified several criteria for medium term notes and block trades which we believe should be revisited to reduce incentives to carry out league table trades.

4.36 We propose to work with league table providers to ensure their criteria are robust enough to reduce banks' incentives to conduct league table trades. We have already begun this process. We note that the main market data providers hold regular roundtables of industry participants to agree the criteria for which transactions are eligible for league table credit. We have asked league table providers to review their recognition criteria so as to reduce the incentives for banks to undertake such league table trades.

4.37 We also note that the main league table data providers have procedures in place whereby market participants can challenge whether specific transactions are truly eligible for league

table credit. We would encourage market participants to challenge transactions they believe are league table trades in order to further reduce incentives for their occurrence.

4.38 We have also asked league table providers to consider improving the clarity of league tables, consistent with the industry-led guidance above. This could include highlighting which types of transaction are included in the league table and providing enough information to enable an end user to easily replicate the league table.

Next steps

4.39 On improving league tables in pitch presentations, we are working with the BBA and AFME so that they can develop and adopt industry guidelines. We do not intend to publish any guidance or rules.

4.40 On league table trades, we have written to each of the league table providers to identify those aspects of their recognition criteria which may create incentives for league table trades. The league table providers will consider whether the recognition criteria can be improved to reduce incentives for banks to carry out trades purely for league table credit.

Remedy 3 – addressing the skew towards larger investors in IPO allocations

Overview of remedy proposal from our interim report

4.41 Our interim report said that we planned to investigate further with individual banks where our analysis raises questions about conflict management in IPO allocations. We said that we would focus on ensuring that behaviour is consistent with existing regulatory expectations under SYSC 10 and helping banks prepare for the relevant requirements that will be introduced under MiFID II (see paragraphs 3.47 to 3.49).

Consultation feedback

4.42 We received written feedback from four industry organisations, six banks, three buy-side firms, one provider of a book-building platform and two individuals, and we also discussed the issues in meetings with stakeholders.

4.43 Feedback included the following points:

- Respondents believed that the effect of MiFID II on the allocation process should be assessed before any additional steps are taken.
- They highlighted the emergence of various initiatives aimed at automating parts of the book-building process and making it more transparent.
- Buy-side firms generally thought that the allocation process would benefit from greater transparency. One buy-side firm was concerned about the validity of informal communication about the state of the book by the bookrunner during the book-building process.

Our response

4.44 Addressing the consultation feedback above, our aim is twofold:

- To help prepare firms for the relevant requirements being introduced under MiFID II to ensure their allocation policies are compliant. Having reviewed ten banks' allocation policies in further detail, we consider that there are some shortcomings that need to be addressed before MiFID II comes into force.

- Since our analysis has shown that banks have not been following their own allocation policies, we want to ensure that allocation policies are embedded in the conduct of the firm, with genuine transparency for issuers of banks' allocation practices.

4.45 In the run up to the implementation of MiFID II we will conduct supervisory work with those firms whose allocation policies fall short of our existing regulatory expectations under SYSC 10 and our expectations for MiFID II compliance and where they have a significant skew in their allocation practices. Our work reviewing allocation policies suggests that having a comprehensive allocation policy alone is not sufficient to manage the conflict of interest concerns that emerge. Banks also need to ensure the principles of the allocation policy are embodied in their allocation practices. Our supervisory work will seek to ensure that conduct is also changed to align with banks' internal allocation policy requirements. The consultation feedback suggests that our proposed remedies are likely to be both effective and proportionate for the problem we have identified.

4.46 We would also expect those banks with whom we do not conduct direct supervisory work to review their own allocation policies and practices. We will consider whether to conduct further work in this area in the future if we do not see adequate changes in allocation practices. Our work may also extend to those banks that are not the focus of this initial supervisory work.

4.47 We have met with a number of firms that have been looking at innovative book-building solutions. We welcome the emergence of such innovations and we continue to offer our assistance through our Innovation Hub and Sandbox. Some of these solutions are likely to increase transparency and may help address some of the concerns raised in this market study around conflicts of interest in the allocations process.

Next steps

4.48 In the run up to implementation of MIFID II, we will conduct supervisory work with those firms where we have identified shortcomings in their allocation policies or a skew in their allocation practices.

Areas where we did not propose remedies

4.49 In the interim report, we asked whether there is any reason why we should take any action at this stage on the areas where we did not propose any remedies:

- availability of suppliers for medium-sized corporate clients (or clients of any other size, type or sector or from any other region)
- transparency of scope of services and fees
- syndication
- reciprocity

4.50 The respondents that provided answers to this question agreed that we should not pursue remedies in these areas.

Financial Conduct Authority

PUB REF: 005306a

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