Financial Conduct Authority

Consultation Paper CP16/31**

Investment and corporate banking: prohibition of restrictive contractual clauses

October 2016

Contents

We are asking for comments on this Consultation Paper by 16 December 2016.

You can send them to us using the form on our website at:
www.fca.org.uk/cp16-31-response-form.

Or in writing to:

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We have developed the policy in this consultation paper in the context of the existing UK and EU regulatory framework. We will keep the proposals under review to assess whether any amendments will be required due to changes in the UK regulatory framework, including as a result of any negotiations following the UK's vote to leave the EU.

We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

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Abbreviations used in this paper

AIM	Alternative Investment Market
CBA	Cost benefit analysis
COBS	Conduct of Business Sourcebook
CP	Consultation paper
DCM	Debt capital markets
ECM	Equity capital markets
FCA	Financial Conduct Authority
FSMA	Financial Services and Markets Act 2000 as amended by the Financial Services Act 2012
FTSE	Financial Times Stock Exchange
M&A	Mergers and acquisitions
NOMAD	Nominated adviser
PRA	Prudential Regulatory Authority

1. Overview

Introduction

1.1 In April 2016, we published the interim report of our market study into investment and corporate banking.[1] The market study focused on primary market activities (equity capital market (ECM) services, debt capital market (DCM) services, and merger and acquisition (M&A) services) carried out in the UK by investment and corporate banking service providers.

1.2 The market study covered a wide range of primary market issues and it assessed the effects of cross-selling and cross-subsidisation. We found that primary market providers generally use a 'universal banking' model, which involves the cross-selling and cross-subsidisation of services. While many primary market clients, particularly large corporates, feel this model works well, we found that some practices could hinder competition, especially for smaller clients. In particular, banks use clauses in contracts, mandates or engagement letters that oblige clients to award or offer future services to that bank (which we refer to as 'future service restrictions' or 'restrictive contractual clauses'). We found that these clauses can restrict a client's choice in future transactions. We considered a range of interventions and proposed that these restrictive contractual clauses should be prohibited.

1.3 This Consultation Paper (CP) proposes 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.

1.4 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. In particular, 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 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.

1.5 We consider that softer alternative forms of intervention, such as allowing restrictive contractual 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. This is because clients that tend to accept them are more likely to have less bargaining power with banks in the first place.

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

1.6 This CP is published alongside the final report of the market study and it seeks views on the proposal to prohibit such clauses.

Summary of our proposed prohibition

1.7 We propose to ban the use of restrictive contractual clauses in investment and corporate banking engagement letters and contracts where these clauses cover future corporate finance services (as defined in the Handbook – see Appendix 1) carried out from an establishment in the UK. This prohibition would apply to all agreements entered into after the commencement date. It would not apply to existing agreements.

1.8 The ban would prohibit the use of two commonly used forms of restriction:

- 'Right of first refusal' clauses. These 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. These prevent clients from sourcing future services from third parties, regardless of any potential third party offers.

1.9 We have excluded from the prohibition future service restrictions in bridging loans. This type of loan is provided on the basis that the client will replace it with longer term financing, typically a bond issue, equity issue or term loan. The bank would be unlikely to provide the bridging loan at all or on the same terms if it did not also know that it would be mandated on the subsequent longer term financing.

1.10 We propose that this restriction is included in our Conduct of Business Sourcebook (COBS 18.3), which applies to corporate finance businesses.

Who does this consultation affect?

1.11 The proposal in this CP will affect those firms participating in primary market services, in particular:

- firms providing primary market services
- clients of these firms

Is this of interest to consumers?

1.12 The proposed prohibition does not directly affect retail consumers.

Equality and diversity considerations

1.13 In developing our proposals, we have considered any potential equality and diversity implications. We take the view that they do not adversely impact any of the groups with protected characteristics, i.e. age, disability, gender, pregnancy and maternity, race, religion and belief, sexual orientation and transgender.

1.14 We will continue to consider the equality and diversity implications of the proposals during the consultation period, and will revisit them when publishing the final rules. We welcome any input to this consultation on these matters.

Next steps

1.15 The consultation period for this consultation is two months. This is to ensure the rules are ready for firms to apply from early 2017 and to give firms the most time possible to implement the final rules.

1.16 Please send your response to this CP by 16 December 2016. To submit a response, please use the online response form on our website or write to us at the address on page 2.

1.17 After we have considered the feedback to this CP we plan to publish a Policy Statement in early 2017.

2. Proposed prohibition of restrictive contractual clauses

Introduction

2.1 In this chapter we set out:

- a summary of the relevant findings of the final report of our investment and corporate banking market study that forms the basis for the proposed prohibition of restrictive contractual clauses
- alternative remedies we considered
- the scope and design of the proposed prohibition, including the proposed changes to COBS
- a summary of the cost benefit analysis, which is set out in detail in Annex 2
- the timing of the consultation

A summary of the relevant findings of the final report of our Investment and corporate banking market study

2.2 In April 2016, we published the interim report of our market study into Investment and Corporate Banking.[2] It focused on primary market activities (ECM services, DCM services, and M&A services) carried out in the UK by investment and corporate banking service providers. We have published the final report of the market study at the same time as this CP.

2.3 We found that the relationships between banks or advisers and their clients play an important role in providing investment and corporate banking services. Banks and advisers seek to establish relationships, mainly by providing corporate broking and corporate lending, expecting to sell further services which include ECM services, DCM services and M&A. Our interim report found that lending and corporate broking are typically supplied at a low rate of return or below cost in return for ongoing transactional business, which is usually more profitable. This model seems to work well for large corporate clients who generally have a wide range of lending banks or joint corporate brokers competing against each other for this transactional business. However, medium-sized corporate clients (those of a size equivalent to the UK FTSE 250) and small corporate clients (those of a size equivalent to the UK FTSE Small Cap and AIM) typically have fewer banking relationships. As a result, they may feel the need to 'reward' a lending bank

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

or corporate broker with transactional business even when they would not otherwise have given that bank the business.

2.4 We also found that banks or corporate brokers can increase the pressure on the client to award the transactional business to them by including provisions in their agreements which restrict the client's future choice of supplier. We were concerned about the most restrictive types of clauses, as we found no clear evidence that such future service restrictions were generating better terms for clients for the initial service:

- 'Right of first refusal' clauses. These 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. These prevent clients from sourcing future services from third parties, regardless of any potential third party offers.

2.5 The feedback to the interim report on how future service restrictions are negotiated, their prevalence and enforcement has not given us any reason to change the interim report findings, as set out in Chapter 3 of the final report.

Alternative remedies we considered

2.6 In our interim report, we considered alternative remedies such as:

- measures to separate lending or corporate broking activities from transactional services
- measures to govern how banks make lending decisions (e.g. banning lending committees from including future transactional revenues in their lending assessments)
- measures to introduce more competition for relationship services (e.g. requiring tendering of corporate broking roles every few years)

2.7 For the reasons we gave in the interim report, we rejected these measures. We were not satisfied that the detriment we identified justifies them and they would also create the risk of significant unintended consequences. None of the respondents to the interim report supported any of these measures.

2.8 In response to some consultation responses, we have also considered less interventionist measures like client warnings and only allowing restrictive contractual clauses if clients request them. However, we believe these softer forms of intervention would not 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.

2.9 We also considered taking no action, but believe that inaction might lead to these clauses being used more often than is currently the case.

Q1: Do you agree with our proposal to introduce the rule to ban restrictive contractual clauses? If not, what do you think we should do as an alternative?

The proposed prohibition

2.10 This section sets out considerations for the scope and design of the proposed prohibition and what changes we propose to make to the Handbook.

Feedback to the market study interim report

2.11 Respondents made a number of comments around the scope and design of any prohibition of future service restrictions.

2.12 They also asked us to clarify the scope of the proposed prohibition on the types of clauses or agreements, services and jurisdiction.

2.13 Several respondents said it would be difficult to design such a prohibition in practice. Respondents made several suggestions on the 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 corporate clients, financial institution groups and sovereign, supra-national and agency clients and one adviser suggested permitting these 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, say, more than six months but allowing clauses of shorter duration. Banks and advisers had different views on the time period the clauses needed to cover to achieve any client benefits.

- **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.

2.14 In the interim report, we asked if these clauses should be permitted for any types of services. The respondents suggested the following types of services that should be excluded from any 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 and warehouse facilities)

- **transactions that can go down multiple paths** – it is common for clients to approach banks for 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 the services they will need

- **other types of transactions and advice**, including revolving credit facility (RCF)-to-bond, anti-raid advisory mandates, export credit finance and accordion terms in loans

2.15 Respondents asked us to clarify the scope of the prohibition in a number of other areas, including types of services, types of clauses, types of agreements and jurisdictional scope.

Our views

2.16 The ban will protect those clients that are explicitly constrained by these future service restrictions 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.

2.17 We have considered carefully the consultation responses on the scope and design of the prohibition.

2.18 Dealing first with the clarifications requested (paragraph 2.15):

- The prohibition should apply to those services within the product and geographic scope of the market study. It therefore applies to restrictive contractual clauses that cover future corporate finance services (as defined in the Handbook – see Appendix 1) carried out from an establishment in the UK, regardless of the client's location or the legal entity to which the activity is booked for accounting purposes.[3]

- It does not apply to clauses that do not go so far as to give the firm a right to provide future services. For example, 'right to pitch' and 'right to match' clauses would not be prohibited as these clauses do not restrict client choice to the extent that 'right to act' and 'right of first refusal' clauses do.

- It only applies to the use of restrictions for the supply of *future* services. An example of clauses that would not be covered by the prohibition are those for recuperating fees for work already undertaken by a financial institution if the client decides to use another financial institution for the same service or transaction ('tailgunner clauses').

- It only applies to contracts or engagement letters entered into after the commencement of the rule. It does not apply to existing contracts or engagement letters.

2.19 Turning to the issues about the scope of the prohibition raised in paragraph 2.13:

- The prohibition will not be restricted to specific clients. This is because it would create significant regulatory uncertainty if we attempted to define which clients should be outside the scope of the prohibition, especially at the margin of any threshold. Moreover, banks did not say that these clauses are more commonly used with a specific group of clients and respondents that suggested different treatment for different clients had conflicting views on whether larger or smaller clients should be exempted.

- We do not propose to allow clients to propose such clauses as this would be relatively ineffective. During negotiations, banks may lean on some clients who may then feel compelled to propose such a clause. Clients with the least bargaining power are likely to feel compulsion the most, when conversely this is where the ban is likely to have greatest positive effect on a client's choice.

3 This means that the prohibition: (i) will not affect services provided to UK-based clients by banks located outside the UK and (ii) will affect services provided from banks' UK establishments to non-UK based clients.

- We propose to ban restrictive contractual clauses of any duration. Some parties argued that a short duration of restrictive contractual clauses may provide some clients with benefits in terms of being offered specific loans or corporate broking services on better terms. Banks and advisers had differing views on the time period the clauses would need to cover to achieve any such benefits, ranging from a very short period to around twelve months. Allowing a long period of time would likely make any ban ineffective and we did not see evidence to suggest that, other than for bridging loans (see below) where the transaction is inherently linked, there was any justification for an allowed duration of clause. Moreover, setting an appropriate time limit might require transaction by transaction considerations and it would be hard to design a fair and effective single or set of time limits.

- We do not propose exempting clauses which only seek to give a bank a role in the group of syndicate banks. Even such clauses may stop a client changing a poorly performing group of banks or keeping them competitive.

- The ban only applies to restrictions in agreements between firms and clients. We envisage this capturing client contracts, engagement letters and other contractual arrangements. We have not also prohibited restrictions which do not form part of an agreement. Such a ban would be difficult to regulate and could create regulatory uncertainty.

2.20 Stakeholders suggested we should exempt some specific types of transactions from the prohibition (see paragraph 2.14). After consideration, we only propose to exempt the use of these clauses in bridging loans, which are typically used to finance acquisition of assets such as a business. Banks and clients have confirmed that bridging loans are given with the expectation of raising future capital – typically in the form of a bond issue. The transactions are inherently linked and the right to act clause is therefore important in allowing the bridging loan to be provided in the first instance.

2.21 We note that warehouse facilities, which are used to finance the origination of new assets (such as mortgages), have similarities to bridging loans as they are designed to provide relatively short financing with both parties assuming that the original facility will be financed by a capital markets transaction. These are effectively therefore part of the same transaction. We therefore intend the definition of bridging loans also to cover warehouse facilities.

2.22 We have not to date found good reasons to exempt any other types of transactions from the prohibition. From the evidence we have seen, removing the clauses in other instances does not appear to threaten the business model being used or the provision of the initial service. In particular, we do not propose to exempt:

- Multiple path transactions. In our view the fact that future transactions are not certain at the outset may actually increase the likelihood that the bank or broker using the clause is not the best firm to provide the future service. Additionally, there are other ways for a bank to get compensation for the work they have already provided if a specific path means that a bank will no longer be involved (for example 'tailgunner' clauses which are used in uncompleted mandates).

- RCF-to-bond. These are two separate financing transactions and not inherently linked in the way that a bridging loan is linked to a subsequent capital raise. In addition, a bond issue is unlikely to replace an RCF, as the RCF would likely continue. We therefore do not see any reason to provide an exemption for the clauses in these circumstances.

- Anti-raid advisory mandates, where a bank agrees to remain available to a client over a longer period of time. In these circumstances, we think there are ways to draft the terms of the engagement without using broad right to act clauses.

- Accordion terms in loans. The subsequent incremental increase in the terms of the loan does not need to be provided on a right to act basis. The client should be free to raise additional finance either inside or outside the facility according to its needs.

Proposed changes to COBS

2.23 Appendix 1 contains a draft of the proposed rule and guidance changes. In summary we are proposing the following:

- We use the existing Handbook definition of 'corporate finance business' to define 'corporate finance services' that are subject to the prohibition. Given our intention to limit the prohibition to future corporate finance services carried out from an establishment in the UK (see paragraph 2.18), we are interested in whether stakeholders consider this definition captures any services that should be outside of the scope.

- We define a 'future service restriction' in order to capture restrictive contractual clauses that are to be prohibited, such as right to act and right of first refusal clauses.

- We amend the existing definition of 'bridging loan' to capture bridging loans (and warehouse facilities) which will be exempted from the prohibition.

- A new rule is added as COBS 18.3. This bans the use of right of first refusal and right to act clauses that apply to future corporate finance services but exempts from the prohibition such clauses in bridging loans.

- We provide guidance that clarifies that the prohibition

  - applies to restrictions for corporate finance services which may take place in the future, but which are not certain or specified at the time of the agreement.

  - only applies to future corporate finance services and does not apply to backward-looking clauses, such as tailgunner clauses relating to work already carried out by the bank

  - does not apply to right to match or right to pitch clauses that do not give firms a right to provide future services

Q2: Do you agree with the proposed scoping, design and drafting of this rule, the guidance provided and the exceptions set out? If not, how should we amend the scoping, design or drafting?

Q3: Is any other guidance or are any caveats required in order to preserve any client benefits or remove any unintended consequences? If so, please specify what these should be and why.

Cost benefit analysis

2.24 In this section we summarise the cost benefit analysis of the proposed prohibition which is set out in more detail in Annex 2.

2.25 These clauses may restrict a client's choice of provider in future transactions. This may reduce competition for these future transactions, as they may not be provided by the firm which can provide the best quality or most competitive terms on the subsequent transaction.

2.26 The direct benefits of the proposed prohibition of restrictive contractual clauses are likely to be modest as such clauses are not universal in client engagement letters. The ban will bring further benefits by sending a clear signal of our unwillingness to tolerate such firm behaviour where it is not clearly beneficial to clients.

2.27 Based on the evidence provided by banks and advisers, we do not expect this proposal to create significant compliance costs for firms or other significant negative unintended consequences. We also 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 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.

2.28 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.

Q4: Do you agree with the cost benefit analysis for these changes as summarised in above and set out in more detail in Annex 2?

Q5: Do you expect the proposal to give rise to any costs that are not of minimal significance that have not already been considered in the CBA?

Timing

2.29 This consultation will close on 16 December 2016. We intend to consider feedback and publish a Policy Statement confirming the final handbook changes in early 2017.

Annex 1
List of questions

Q1: Do you agree with our proposal to introduce the rule to ban restrictive contractual clauses? If not, what do you think we should do as an alternative?

Q2: Do you agree with the proposed scoping, design and drafting of this rule, the guidance provided and the exceptions set out? If not, how should we amend the scoping, design or drafting?

Q3: Is any other guidance or are any caveats required in order to preserve any client benefits or remove any unintended consequences? If so, please specify what these should be and why.

Q4: Do you agree with the cost benefit analysis for these changes as summarised in above and set out in more detail in Annex 2?

Q5: Do you expect the proposal to give rise to any costs that are not of minimal significance that have not already been considered in the CBA?

Annex 2
Market failure and cost benefit analysis

1. The Financial Services and Markets Act 2000, as amended by the Financial Services Act 2012, requires us to publish a cost benefit analysis (CBA) of our proposed rules. Specifically, section 138I requires us to publish 'an analysis of the costs, together with an analysis of the benefits that will arise if the proposed rules are made'. It also requires us to include estimates of those costs and benefits, unless they cannot reasonably be estimated or it is not reasonably practicable to produce an estimate.

2. The proposed interventions we are consulting on are set out in Chapter 2 and Appendix 1. In summary, we are proposing to prohibit 'right to act' and 'right of first refusal' clauses that may restrict clients choice of future corporate finance service providers, apart from those used in bridging loans.

3. This chapter presents the CBA of those proposals. It first sets out the rationale for the intervention (market failure analysis) and then presents our assessment of the benefits and costs that we expect as a result of implementing the rules.

Market failure analysis

4. In this section we present our analysis on the impact of right to act and right of first refusal clauses on certain market practices and on clients' behaviour. We first summarize the relevant findings presented in the interim report and then we analyse the role of the restrictive contractual clauses.

5. In the interim report we found that lending and corporate broking are often supplied at a low rate of return or below cost in expectation that clients will award them with future transactional business, which is usually more lucrative. Clients may feel obliged to reward the supplier of services provided at the low fee or below cost, or may fear losing access to funding if lenders are not rewarded.

6. Lending banks and corporate brokers can increase pressure on clients to award transactional business to them by using contractual clauses in engagement letters that seek to restrict the client's future choice of supplier. We observed that restrictive contractual clauses are also used in engagement letters for other services (i.e. ECM, DCM, M&A and NOMAD/Sponsor services).

7. Banks and advisers said that such clauses typically are not enforced but that they can create an obligation for the client to work with them.

8. Such restrictive contractual clauses may harm clients and reduce competition in the following ways:

- clients may not be able to appoint a bank or provider that is better placed to provide the subsequent service and, as a result, receive a lower quality service and/or incur a higher fee

- there may be insufficient competitive pressure on fees and/or quality for these subsequent services

9. Harm from the use of restrictive contractual clauses can be reduced in two main ways:

- Restrictive contractual clauses can include a provision that the subsequent services have to be provided on competitive or 'market terms', which will need to be subsequently agreed upon by the parties. The inclusion of such a provision may mean that the bank will provide the subsequent service on terms prevailing in the market.

- Where a bank or adviser expects profitable subsequent business, it may offer more favourable terms on the initial service, and thus a client may not be worse off overall, even if it receives worse terms on the subsequent service. We summarise the evidence in our analysis of costs and benefits below.

Analysis of costs and benefits

10. In this section we assess the costs and benefits of the proposed prohibition. To do so, we:

- describe the evidence we have based our assessment on

- identify the baseline against which we will assess the incremental benefits and costs

- assess prevalence and enforcement of restrictive clauses

- set out benefits and costs

Evidence base for the CBA

11. To inform our assessment, we collected further information from 29 banks and 6 advisers on the use of restrictive contractual clauses and the potential direct and indirect impacts of a prohibition. The information we requested covered the calendar years 2014 and 2015. Our sample covered the majority of the market and included 10 large banks, 12 medium-sized banks, 7 small banks and 6 advisers. We consider that our sample is representative of the banks and advisers the prohibition will apply to.

12. We considered this information together with that provided by banks and advisers throughout the market study. We also spoke with 16 clients, many of whom either had restrictive contractual clauses or had experience of negotiating over them.

Baseline

13. The relevant baseline against which we assess the incremental costs and benefits of a policy is the situation without any proposed intervention. Without any expected material change to market conditions or the regulatory environment following the introduction of the intervention, the relevant baseline in this case is the status quo.[4]

4 On 23 June the UK voted to leave the European Union (EU). 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.

Prevalence and enforcement of restrictive clauses

14. The scale of benefits and costs of the ban will depend both on how widespread restrictive clauses are and to what extent they are enforced by banks and advisers.

15. On prevalence, we found that 86% of the banks in our sample use or seek to use restrictive clauses across ECM, DCM, M&A, corporate lending, corporate broking and NOMAD/Sponsor services. However, the frequency with which banks and advisers had succeeded in having such clauses in final engagement letters varies across banks and services (see Table 1):

- Restrictive clauses are most commonly used by banks in M&A and corporate broking mandates (72% and 75% of banks had used such clauses) and least commonly used in corporate lending (43% had used such clauses).
- Those banks that said they use such clauses tend to use them rarely in ECM, DCM and M&A engagement letters while some banks said they use such clauses frequently in corporate broking and Sponsor/NOMAD engagement letters. However, many banks did not specify whether they use such clauses rarely or frequently.
- Banks that use restrictive clauses do not necessarily use them across all of the services that they provide. Nine banks said that they use such clauses across all services they provide that were in scope of the market study.

Table 1: Prevalence of restrictive contractual clauses across investment and corporate banking service types (2014-2015)

Banks and advisers in the sample that provided the service and:	ECM	DCM	M&A	Corporate lending	Corporate broking	NOMAD/ Sponsor
Did not use restrictive clauses	**52%**	**33%**	**28%**	**57%**	**25%**	**40%**
Used restrictive clauses	**48%**	**67%**	**72%**	**43%**	**75%**	**60%**
• *used rarely**	*50%*	*79%*	*56%*	*33%*	*20%*	*0%*
• *used frequently**	*0%*	*0%*	*17%*	*0%*	*27%*	*33%*
• *did not specify**	*50%*	*21%*	*28%*	*67%*	*53%*	*67%*
Number of banks and advisers in our sample that provided the type of service:	**25**	**21**	**25**	**14**	**20**	**15**

Source: FCA analysis of information provided by banks and advisers. Percentages have been rounded and may not add up to 100%.

* Expressed as a percentage of those banks in the sample that said that they had used restrictive clauses.

16. Banks also told us that:

- Right of first refusal clauses are more frequent than right to act clauses for all services apart from corporate lending, where usage of the two clauses is similar.
- Large banks use both clauses more frequently than medium-sized and small banks for all services apart from Sponsor and NOMAD services, where usage of the clauses is similar across banks of different sizes.

17. We found that there had been little enforcement, either because banks had chosen not to enforce such clauses or because clients had not tried to break the clauses. Four banks that responded to our information request said that some of their clients had sought to break these restrictive clauses in 2014 and 2015. One of them said that they enforced the clause.

18. We were told of three instances where clients had paid a fee to break such clauses and to award a mandate to a third party. One firm told us that in two of these cases the clients had not been aware that they had accepted such a clause in the first place. An adviser in a meeting said that a large issuer felt it 'had been bitten in the back' because they had to mandate a bank because of a restrictive clause.

Benefits of the proposed prohibition

19. There may be direct benefits to clients from the proposed prohibition as it may address the potentially harmful outcomes we identified in the market failure analysis. As a result of the prohibition on restrictive clauses, clients may be able to:

- choose from a wider set of providers for the subsequent services and appoint providers that best serve their needs
- negotiate better terms for the subsequent services such as lower fees, particularly if they can attract a larger number of providers willing to provide the service

20. For the benefits to arise following a prohibition, the client does not necessarily have to award subsequent business to a bank other than its relationship bank. The bank which would have used the restrictive clause may still win the mandate for the initial transaction as the client may award it if the bank is best placed to provide the service/provides competitive terms. Should the client wish to work with this bank on future transactions it is still free to do so. However, where the bank previously may not have been subject to competition for providing the subsequent service, it may have to offer it on better terms.

21. The benefits may be reduced if the prohibition results in less competitive pressure on the initial service. This may occur if, without the ability to commit future business, clients' ability to negotiate more favourable terms is reduced (see paragraph 29). However, to the extent to which the prohibition of the restrictive clauses increases competition for the subsequent service(s), fees for those may be lower or the quality of service better.

22. The ban will also bring further benefits by sending a clear signal of our unwillingness to tolerate such firm behaviour where it is not clearly beneficial to clients.

23. We do not consider it reasonably practicable to estimate the direct or indirect benefits as, based on how common these clauses are, the impact of the prohibition is likely to be modest. It would also be disproportionate for us to ask parties to provide such data, given that results would likely be ambiguous.[5]

Costs of the proposed prohibition

24. In this section we consider the costs that may result from implementing the policy intervention. We assess costs to the FCA and direct and indirect costs to firms and clients.

5 To assess the potential effects, we would have to estimate the prices and terms that would prevail without such clauses. The results would be likely to be ambiguous and of limited usefulness and accuracy, for example, because of the complexity of identifying comparable transactions.

Costs to the FCA

25. We expect minimal costs to the FCA as the intervention does not require any material supervisory work or data collection once we have implemented the proposal.

Costs to firms

26. The prohibition will affect all banks and advisers in the market that currently use such clauses in their engagement letters. We expect the prohibition to affect most banks in the market as 86% of them in our sample had used such clauses at least once in 2014 and 2015. This included banks of all sizes.

27. Banks and advisers may incur two main types of costs:

- **Direct incremental compliance costs**. Banks identified one-off staff and legal costs to update their contract templates and develop a compliance programme, and on-going costs from monitoring compliance or reviewing and updating internal guidance. The majority (80%) of banks using the clauses said that they did not expect to incur costs or expected to incur only minimal costs. Four banks said that they could not provide estimates of expected costs or did not comment. One bank provided estimate of costs in the area of up to $70k for on-going costs and $20k-$110k for one-off costs. Based on these responses we expect costs to be of minimal significance but we welcome further evidence from banks and advisers.

- **Indirect costs from having to make changes to business models**. We do not expect the prohibition to fundamentally change the universal banking model as part of which some services, such as corporate lending and corporate broking, are provided below cost or for free in expectation of receiving more lucrative transactional business in the future. Given the low prevalence of restrictive clauses, the use of restrictive clauses is not fundamental for this business model to persist. 56% of the banks in our sample that use such clauses did not expect to have to change their business model as a result of the prohibition or did not comment on this. However, eight banks said that fees on certain services might increase as a result of the prohibition.

28. Some banks also considered that a prohibition may affect their global competitiveness. We do not accept that it is possible to simultaneously argue that clauses are not that prevalent and yet there is also an effect on global competitiveness. Limited evidence was presented to us on the effect of these clauses on the behaviour of clients and banks, therefore in cost benefit analysis terms we do not consider that the proposed prohibition is likely to significantly disadvantage UK-based banks that are competing with non-UK based banks that will not be subject to this prohibition.

Costs to clients

29. Based on our analysis and the feedback we received, clients may incur two main direct and indirect costs from the prohibition but we have not been provided with robust evidence suggesting that they are likely to arise (see Table 2 for a summary of evidence we received):

- **Fees on the initial service, such as corporate broking, may increase**. The removal of the clause may limit banks and brokers ability to offer the initial service at low or no cost because they have less expectation of more lucrative business in the future. This effect on fees may partially or fully offset the benefits from better terms that clients may get on the subsequent service as a result of our intervention. We do not consider it likely that fees will increase given the low prevalence of the clauses and given that banks could not provide evidence of benefits to clients beyond qualitative comments.

- **Reduced choice for some clients**. Some clients, particularly smaller clients, may face reduced choice where agreeing to restrictive clauses currently allows them to attract larger banks and advisers that would not have been interested in serving them if they were not able to commit a larger volume of business. We do not consider it likely there will be fewer firms competing for business for some clients given the limited number of banks and advisers that said that this would be a relevant consideration and were able to provide supporting evidence.

Table 2: Views and evidence received from banks and advisers on the potential direct and indirect costs to clients

Direct or indirect effect on clients	Evidence provided banks, advisers and clients
1. Potential fee increase	**Views from banks and advisers:** • Eight banks said that the inclusion of restrictive clauses may allow them to offer lower fees in the expectation that the bank will be engaged for more profitable work in the future. Some banks told us that if the prohibition of these clauses lowers the likelihood of getting future business, fees on the initial service may increase. Five banks said that they would consider increasing fees (e.g. introducing a retainer fee for corporate broking services). • None of the banks and advisers were able to provide evidence that removing restrictive clauses from engagement letters had led to a worsening of terms or that their inclusion had led to improved terms. **Views from clients:** • Five clients said that fees might increase, particularly for corporate broking services that are currently provided for free, though only two of them have restrictive clauses in their engagement letters. • Without the ability to commit future business, clients may be less able to negotiate more favourable terms. One client that did not have restrictive clauses in its engagement letters stated more generally that clauses are a bargaining tool for clients and the prohibition would mean clients lose this tool. • None of the clients we spoke to said that fees had increased as a result of negotiating these clauses out of their engagement letters.
2. Reduced choice for some clients	**Views from banks and advisers:** • Two medium-sized banks said that the prohibition may result in banks focusing only on those clients that are likely to appoint them to perform more profitable subsequent services. Two other medium-sized banks said that the prohibition may impact on their appetite to take on certain higher risk or lower valued transactions. **Views from clients:** • One small client said that the ability to commit to future services had helped it attract a large investment bank that otherwise would not have been interested in serving them otherwise. • Three other clients said that these clauses might help them to get access to lending.

Overall view on costs and benefits

30. 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 direct benefits of the proposed prohibition of restrictive contractual clauses are likely to be modest as such clauses are not universal in client engagement letters. 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.

31. We do not expect this proposal to create significant compliance costs for firms or other significant negative unintended consequences. We also 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 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. 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.

Annex 3
Compatibility statement

Compatibility with the FCA's general duties

Introduction

1. This Annex sets out our view on how the consultation proposals and draft rules in this CP are compatible with our general duties under section 1B of the Financial Services and Markets Act 2000 (FSMA) and our regulatory objectives set out in this section, and sections 1C, 1D and 1E of FSMA.[6]

2. We have had regard to the regulatory principles set out in Section 3B of FSMA and consider these proposals to be the most appropriate way of meeting our statutory objectives. This meets the requirements on consultation by the FCA set out in section 138I(2)(d) of FSMA.

Compatibility with our statutory objectives

3. In discharging our general functions, our duty is, as far as is reasonably possible, to act in a way that is compatible with our strategic objective, to ensure that the relevant markets function well and to advance one or more of our operational objectives.

4. Our proposed prohibition in this CP will help advance our strategic objective and two of our operational objectives. Our proposed prohibition will principally enhance competition. It will also protect corporate clients that have previously felt compelled to accept contractual clauses that limit their future choice of investment bank.

Compatibility with the duty to promote effective competition in the interests of consumers

5. We have had regard to the requirement under Section 1B(4) of FMSA, to ensure that in so far as it is compatible with acting in a way that advances our operational objectives of consumer protection and enhancing market integrity, we also seek to promote effective competition in the interests of consumers.

6. The primary aim of the proposed prohibition is to promote competition.

Compatibility with the regulatory principles

7. Section 1B(5) of FSMA requires that, in carrying out our general functions, we have regard to the principles of good regulation. In formulating these proposals we have had regard to the following relevant principles set out in Section 3B of FSMA.

The need to use our resources in the most efficient and economic way

8. We believe that the proposals in this CP will have minimal impact on our resources.

6 These references reflect FSMA 2000, as amended by the Financial Services Act 2012.

The principle that a burden or restriction which is imposed should be proportionate to the benefits

9. We consider that our proposals are proportionate to the benefits we are seeking. As explained in Annex 2, we expect the incremental costs imposed by the proposed prohibition to be minimal.

The desirability of sustainable growth in the UK economy in the medium or long term

10. We do not expect these proposals to have a material effect on sustainable growth in the UK economy in the medium or long term.

The principle that we should exercise our functions as transparently as possible

11. These changes set out our proposed prohibition on restrictive contractual clauses, which we first announced in our Investment and Corporate Banking market study interim report, published in April 2016. We have consulted widely with industry since publication of that interim report, and have, alongside this CP, published a final report.

12. We will continue to engage with stakeholders and welcome comments on these proposals during the two month consultation period, running until 16 December 2016. We will then publish a Policy Statement, which will include feedback on responses, confirming final rules or any alternative approach if relevant.

Appendix 1
Draft Handbook text

FCA 2017/xx

FUTURE SERVICE RESTRICTIONS INSTRUMENT 2017

Powers exercised

A. The Financial Conduct Authority makes this instrument in the exercise of:

(1) the following powers and related provisions in the Financial Services and Markets Act 2000 (the "Act"):

(a) section 137A (The FCA's general rules);
(b) section 137T (General supplementary powers);
(c) section 138D (Action for damages); and
(d) section 139A (Power of the FCA to give guidance); and

(2) in relation to the Glossary of definitions, the other rule and guidance making powers listed in Schedule 4 (Powers exercised) to the General Provisions of the FCA's Handbook.

B. The rule-making powers listed above are specified for the purpose of section 138G(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [*date*].

Amendments to the Handbook

D. The Glossary of definitions is amended in accordance with Annex A to this instrument.

E. The Conduct of Business sourcebook (COBS) is amended in accordance with Annex B to this instrument.

Citation

F. This instrument may be cited as the Future Service Restrictions Instrument 2017.

By order of the Board
[*date*] 2017

Annex

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

corporate finance services	services provided by a *firm* to a *client* which constitute *corporate finance business*.
future service restriction	any provision in an agreement between a *firm* and a *client* which, in addition to the products or services to which the agreement relates, grants the *firm* or an *affiliated company*: (1) the right to provide any future *corporate finance services* to the *client*; or (2) the right to provide future *corporate finance services* to the *client* before the *client* is able to accept any offer from a third party to provide those services.

Amend the following definitions as shown.

bridging loan	(1)	an *MCD exempt bridging loan*; or
	(1A)	(in *COBS* 18.3 (Corporate finance business)) a loan with a term of twelve *months* or less that is provided on the condition that it will be replaced with longer-term financing (such as a *debt security* issue or a *share* issue); or
	(2)	(other than in (1) and (1A)) a *regulated mortgage contract* which has a term of twelve *months* or less.

Annex

Amendments to the Conduct of Business sourcebook (COBS)

After COBS 18.3.4G, insert the following provisions. The text is new and is not underlined.

Prohibition of exclusivity provisions

18.3.5 R Unless exempted in *COBS* 18.3.6R, a *firm* must not enter into arrangements with a *client* that contain a *future service restriction*.

18.3.6 R *COBS* 18.3.5R does not apply to *future service restrictions* that:

(1) are included in arrangements for the *firm* to provide a *bridging loan*; and

(2) only involve the *firm* providing the *corporate finance services* to which the *bridging loan* relates.

18.3.7 G (1) Agreements for the provision of a specified *corporate finance service* by the *firm* to the *client* are not prohibited by *COBS* 18.3.5R, even where that service will take place in the future.

(2) *COBS* 18.3.5R prohibits *future service restrictions* related to *corporate finance services* which may be required in the future but which, at the date of the agreement, are not yet certain. *Future service restrictions* are prohibited because they prevent a *client* from freely deciding, as and when the need for *corporate finance services* arises, which *firm* to appoint to provide those services.

18.3.8 G (1) The *future service restrictions* prohibited by *COBS* 18.3.5R relate to the provision of future services.

(2) An example of restrictions that would therefore not be caught are those which relate to the recuperation of *fees* for work already undertaken by a *firm* in relation to a particular service or transaction when the *client* decides to use another financial institution for the same service or transaction ('tailgunner clauses').

18.3.9 G (1) *Future service restrictions* bind the *client* to use the *firm*.

(2) Provisions in an agreement that only give a *firm* the right or opportunity to:

(a) pitch for future business; or

(b) be considered in good faith alongside other providers for future business; or

(c) match quotations from other financial institutions,

are not *future service restrictions*. In these cases, the *client* is not obliged to use the *firm*.

Financial Conduct Authority

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