FCA announces restrictive contractual clause ban, review of league tables and shake up of the IPO process, as banking study is published

The Financial Conduct Authority ("**FCA**") published the final report of its Investment and corporate banking market study (the "**Study**") on 18 October 2016. The FCA concluded that although larger corporate clients found that they were well-served by equity capital market, debt capital market and merger and acquisition services ("**Primary Market Activities**"), banking practices relating to restrictive contractual clauses, league tables and IPO allocations may have a negative impact on competition, particularly for smaller corporate clients. The FCA will therefore take action in these areas. The Study, which confirms the findings of the interim report published by the FCA in April 2016 (the "**Interim Report**"), sets out a package of remedies, designed to address the FCA's main competition concerns.

Background to the Study

The Study was commissioned following the FCA's Wholesale sector competition review which was concluded in February 2015 and raised a number of concerns relating to competition in investment banking and corporate banking. In particular, the FCA was looking at whether the choice of supplier for corporate and investment banking services was more limited for particular types of clients, whether clients are hindered from making effective choices because of lack of transparency in the scope of services provided and fees and whether the cross selling, bundling and/or cross subsidisation of services limits the effectiveness of competition.

The Interim Report's findings and proposed remedies were consulted on with a range of stakeholders from both the buy-side and the sell-side. Following this consultation, the FCA has now confirmed its Interim Report findings as final and has developed its package of remedies which all relevant firms will need to be up to speed on and incorporate into their business strategies.

Main findings and final remedies

The FCA said that the consultation responses supported the view that most clients, particularly larger ones, felt well-served by the universal banking model which allows banks to participate in commercial and investment banking activities, as well as providing other financial services products to clients. However, a number of remedies have been proposed to address the issues identified in relation to restrictive contractual clauses, IPOs, league tables and IPO allocation.

Cross-selling and cross-subsidisation

The FCA said that the Interim Report found that banking relationships were strengthened by cross-subsidised lending and corporate broking, giving larger corporate clients access to a wide range of lending banks and joint corporate brokers that compete against each other for mandates on transactions. Cross-selling for larger corporates has a number of benefits, such as allowing banks to develop in-depth knowledge of a client and expand the range of products for clients.

However, those corporates with fewer banking relationships may feel a pressure to award transactional business to lending banks or corporate brokers because of a threat that lending will be provided on worse terms or not at all and that lending banks appointed on transactions may perform a limited role, that it is not reflected in their title, giving a misleading impression to market participants.

However, the FCA concluded that it does not consider detriment from cross-subsidisation is sufficient to intervene and it did not receive any workable proposals when it asked for views on how to reduce barriers to competition for non-universal banks as part of the Study.

Restrictive contractual clauses

Banks were found to use contractual clauses to restrict a client's choice in future transactions. The main such clauses are the "right of first refusal" clause which prevents clients accepting a third party offer to provide future services unless offered to the bank or broker on the same terms and the "right to act" clause which prevents clients from seeking services from other third parties. However, many respondents said these clauses were not that prevalent and did not materially affect clients' ability to use alternative providers and many could be successfully negotiated away.

Yet the FCA says that there is "no justification" in continuing to allow restrictive contractual clauses, proposing to ban those clauses that restrict competition without benefiting clients. The FCA has said that the ban will protect clients constrained by the clauses and provide them with greater choice of providers for future services and give them access to more competitive terms. The FCA does not think the ban will result in significant compliance costs or other significant negative unintended consequences.

The FCA considered but has decided not to pursue so-called "softer" forms of intervention such as allowing restrictive clauses if they are proposed by a client or expressly negotiated in bespoke agreements as the clients that tend to accept these clauses are more likely to have less bargaining power with banks in the first place. The FCA also said that it wishes to send out a signal to banks that it will not tolerate behaviour that is not clearly beneficial to clients.

The FCA has published CP16/31 which sets out the scope of the proposed ban and expects to publish final rules in a Policy Statement in early 2017. Responses to the consultation should be sent by 16 December 2016.

League tables

League tables ranking investment banks were found to be misleading rather than aiding competition because banks could carry out loss-making transactions to gain a higher position in the league tables and league tables could be used to give a misleading impression of a bank's position from a client perspective.

However, a number of respondents felt that league tables were not taken seriously or ignored in pitch presentations and had a low risk of being misleading and distorting a client's view of a bank. Respondents also said that loss-making transactions were also not always associated with league tables and may be the result of adverse market movements or were carried out to improve a bank's expertise in a particular area.

The FCA agreed with industry concerns that that the detriment to clients from the practices was likely to be low and that league tables can serve a purpose for clients but said that there is scope for improvement in how league tables are used.

The FCA has however witnessed improvements in this practice since the Interim Report was published. Therefore, rather than producing standardised league tables, the FCA has said it will encourage banks and advisers to adopt better practices. It will also work with two industry bodies: the British Bankers' Association and the Association for Financial Markets in Europe to develop and adopt industry-led guidelines to make league tables in pitch presentations more meaningful and reliable to help clients choose service providers, for instance, introducing criteria for league tables that are directly relevant to the transaction that the client wishes to undertake. The FCA will not publish any guidance or rules regarding league tables.

To reduce concerns regarding banks undertaking league table trades, the FCA will work with the industry providers to review the criteria used when recognising transactions for league table credit and to ensure the criteria is robust enough to deter banks from making league table trades. The FCA has also asked that league table providers consider approving the clarity of league tables as well as encouraging market participants to challenge transactions they believe are league table trades.

IPO allocations

The FCA's Occasional Paper 15 found that allocations of shares in IPOs were found to be skewed towards investor clients favoured by banks because they generate greater revenues for them, even if it was not necessarily in the interests of the issuer, despite rules to guard against this in SYSC 10 of the FCA Handbook and to be introduced in MiFID II.

Respondents stated that larger investors should be expected to get a greater share of the allocations and had sufficient procedures in place to deal with conflicts of interest. However the FCA did not agree that the positive relationship between commission payments and allocations could be explained by large funds having high capacities for IPO shares and high trading volumes because of its analysis controls in Occasional Paper 15. Occasional Paper 15 has now been updated following the publication of the Study.

The FCA said it will conduct supervisory work on IPO allocations in the run up to MiFID II implementation and has said that a comprehensive allocation policy alone is not sufficient to manage conflicts of interest, principles of allocation policy must instead be embedded into allocation practices and banks will need to improve existing policies to bring them in line with MiFID II for instance by putting arrangements in place to prevent recommendations on placing being influenced by existing relationships between investors and banks. As a consequence, the FCA said it would "work with" firms that have a significant skew in their allocation practices and those falling short of existing regulatory requirements.

It is not clear what the FCA means by "work with" at this stage. Although it seems unlikely, were the FCA able to identify detriment to clients, for instance where an IPO was priced lower than it should have been, it may potentially lead to claims for redress or claims against former advisers. However, it would be difficult for the FCA to show that skewed allocation caused such detriment.

The FCA Discussion Paper on the IPO process published in April 2016 found that the 'blackout period' between the publication of connected research by syndicate banks and circulation of the 'pathfinder' prospectus means that pathfinder and approved prospectuses are made available to investors late in the process and investors are only able to access connected research at that stage in the IPO process. The FCA is also continuing to consult on and develop changes to the IPO process and expects to publish a consultation paper with policy proposals in winter 2016/7.

Corporate finance advisers

Another issue arising from feedback on the Interim Report was that corporate finance advisers participating in Primary Market Activities may give rise to potential conduct risks as these advisers may favour specific banks, research analysts or book runners when advising on IPOs. Some respondents also felt that fees should be more transparent and did not reflect the value advisers add to the IPO process. There was also concern that fee structures misaligned incentives between the adviser and the client.

The FCA found no evidence that action was required in relation to corporate advisers being bias in advising on appointments during the IPO process or on how fees were structured. The FCA will continue to monitor the conduct of corporate finance advisers and will look at the influence that corporate finance advisers have on research produced by analysts in the FCA's upcoming consultation paper on the IPO process.

Next steps

Investment and corporate banks and their clients will now need to review the findings of the Study and implement the proposed remedies into their business strategies. While these remedies will form part of a number of changes banks will have to make as part of the implementation of MiFID II, the FCA also indicates how it expects banks and advisers to approach clients, particularly those engaged in Primary Market Activities that are considered to be reducing competition.

However, this Study is just the starting point for the FCA. Banks and their clients will need to engage with the current consultation on restrictive contractual clauses and the upcoming consultation on the IPO process to make their views heard regarding the nature and speed of change in this area. Banks will also need to think more broadly about how the products they offer and the practices that they implement impact on clients not just from a conflict of interest or treating customers fairly point of view but also in terms of competition, something that will become pronounced given the FCA's ongoing work in the competition field under its extended remit.

This Study also reflects the FCA's growing concern regarding conflicts of interest in a number of sectors and follows on from the FCA's publication earlier this year of its key findings in its inducements and conflicts of interest thematic review. In light of this, all firms should also consider their supply and distribution chains and identify and manage conflicts of interest that may arise.

If you have any questions or comments in relation to this Update, please contact the authors or your usual Mayer Brown contact.

Guy Wilkes
Partner, London
+44 20 3130 3355
gwilkes@mayerbrown.com

Mark Compton
Partner, London
+44 20 3130 3388
mcompton@mayerbrown.com

Lauren Smith
Associate, London
+44 20 3130 3134
lsmith@mayerbrown.com