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Client Alert News Flash

Latham & Watkins Financial Regulatory Practice

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The UK Financial Conduct Authority Bans Use of Certain Restrictive Contractual Clauses

The ban extends to foreign branches of UK firms; also where services are provided from a firm's UK establishment.

Key Points:

- Effective 3 January 2018 firms subject to the ban cannot enter into agreements that contain "future services restrictions" with clients.
- However, contracting to provide services that are "specified or certain", even if those services are to be provided in the future, are excluded from the ban.
- Exemptions are also provided for bridge and warehouse arrangements.

Background

During 2014/2015 the FCA conducted a market review on competition in wholesale financial markets as well as a study into investment and corporate banking.

One of the points the FCA focused on in their review is that financial institutions at times use contractual clauses in an engagement letter or other agreement with a client to require the client to offer the financial institution the opportunity to provide certain other future services. The FCA formed the view that these clauses could restrict a client's choice of suppliers and "may as a result hinder effective competition in the interests of those clients". The FCA therefore published a consultation paper in October 2016 (CP16/31), on prohibiting future service restrictions.

The consultation closed on 16 December 2016 and, following a comment period, the FCA has now published a policy statement (PS17/13), introducing modifications to its Handbook of Rules and Guidance to effect a ban of this kind of clause in written agreements — but notably on a basis somewhat narrower than originally proposed.

The ban comes into effect on 3 January 2018 and will only apply to written agreements entered into on or after that date.

Restrictive clauses banned:

The new rules ban the use of future services restrictions, *i.e.* clauses that give a right to act or a right of first refusal:

- A *right to act* clause gives the right to provide future primary market and M&A services to the client
- A *right of first refusal* clause gives the right to provide future primary market and M&A services to the client before the client is able to accept an offer from a third party to provide those services

A right to match — albeit without an obligation on the client's part to accept the matching offer — is not within the scope of the ban.

As noted, agreements for the provision of services that are specified or certain at the date of the agreement (even if the services will take place in the future) are not prohibited, in contrast to agreements for services "as and when the need … arises". While often this distinction will be clear, when read together with the express exception for bridges described below, such a distinction will not always be clear, so the market may seek clarification from the FCA.

Services caught by the ban:

The FCA has introduced a definition to address the scope of primary market and M&A services caught by the ban: these must be both "designated investment or MiFID business" and "…services provided to an issuer comprising structuring, underwriting and/or placing an issue of shares, warrants, certificates representing certain securities or debentures; or advice and services relating to mergers and the purchase or disposal of undertakings".

The Policy Statement helpfully clarifies that the ban does not extend to future corporate lending services at all (in contrast to what was set out in the Consultation Paper), and makes specific reference to accordion clauses that set out a mechanism for subsequent incremental increases in loans.[1]

The ban also does not prevent clients from agreeing so called "*tailgunner clauses"*, designed for recuperating fees for work already undertaken by a financial institution if the client decides to use another firm for the same service or transaction.

The meaning of "advice and services relating to mergers and the purchase or disposal of undertakings" potentially covers a broad spectrum of activities. Clearly due diligence, valuations, ratings agency services, and the like would be captured. While ordinarily future loan and hedging services should not be captured by the ban, it is not clear from the wording whether *e.g.* loans and hedging in connection with an M&A transaction would be captured. The market may seek clarification from the FCA on this point as well.

Services expressly outside the scope of the ban:

Bridge loans: The ban does not extend to "bridge loans", defined as loans with the following "non-exhaustive" characteristics:

1. The terms of the loan expressly document that both parties intend that that the loan offers a temporary solution until the borrower is able to obtain long-term financing from the capital markets or other future financing (*e.g.*, a bond issue).
2. The loan has a short term, typically less than four years from signing, or the client is otherwise discouraged from retaining the loan as longer-term financing, for example by stepping up the interest rates after an initial short period.

3. The loan terms include a provision that proceeds from the take-out financing will be used to mandatorily prepay the loan.

Most bridge facilities meet the criteria in (2) and (3) above. Going forward, financial institutions may want to consider including a recital in bridge documentation to the effect that it is intended to be a temporary solution until the borrower is able to obtain long-term financing, so as also to meet the criteria in (1) above. In any event, these characteristics are non-exhaustive and expressly deal with concerns that industry raised in relation to the originally proposed formulation.

Warehouse facilities: The ban does not extend to warehouse facilities, on the basis that they have similar features and principles as bridging loans.

Pitches, future business, and right to match: The ban also does not affect pitches for future business, or a right to be considered in good faith alongside other providers for future business, or a right to match quotes (as distinct from the right to be automatically awarded the business if the relevant terms are matched, as discussed above).

Who exactly is caught by the ban?

The ban clearly applies to agreements entered into by a UK firm and its overseas branches, but not to agreements of its subsidiaries or affiliates, in each case, irrespective of the location of the client. Several issues arise as a result.

Applying FCA conduct rules to non-UK branches of UK firms is unusual, and hopefully this is a limited example of such policymaking.

If a foreign firm has a UK establishment that is FCA authorised, likely the key criteria for the foreign firm in determining whether the ban applies to it is whether the UK establishment enters into the agreement or whether the designated investment business or activities connected with that business "*are carried on from a firm's UK establishment*" (emphasis added). Thus, the ban will not affect services of a foreign firm booked and provided outside the UK to UK-based clients, but will affect services provided from a bank's UK establishment to UK based or non-UK based clients.

For further emphasis, the Policy Statement also notes that the final rules are in line with the FCA's original proposal as set out in the Consultation Paper. The Consultation Paper noted that the ban would apply to future services 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*".[2]

In practice, it may sometimes be difficult to conclude that all of a firm's relevant services are to be provided from outside the UK, requiring either further FCA guidance or difficult judgments if a non-UK firm (outside the UK) or an affiliate or subsidiary of a UK firm seeks to rely on the fact that it is not providing the services from the UK.

Contrast with US position:

While a full description is outside the scope of this client alert, it is interesting to note that US banking regulation has long had an anti-tying rule (Section 106(b)(1) of the Bank Holding Company Act Amendments of 1970), but it takes a very different approach to the one adopted by the FCA.

The focus of the US anti-tying rule is a concern that commercial banks will use their ability to offer bank products (credit in particular) in a coercive manner to gain competitive advantage in markets for other

products and services. Broadly speaking, the US anti-tying rule therefore restricts a bank from conditioning availability or pricing of a relevant product or service (a loan, discount, deposit or trust service) on its client obtaining a non-traditional commercial banking product or service from it or its affiliates, such as securities underwriting or M&A services. The US anti-tying rule also prohibits a bank from conditioning the availability or pricing of a product or service on a customer either (i) providing some additional credit, property or service to the bank or an affiliate of the bank, or (ii) not obtaining some additional product or service from a competitor of the bank or its affiliates. Certain exceptions are provided for restrictions on using third party products or services where reasonably imposed by the bank to ensure credit quality, and most significantly, the US anti-tying rule does not apply extra-territorially, in that it provides a safe harbour for transactions with non-US persons.

Next steps:

Firms have until 2 January 2018 to update their standard forms and templates to remove any relevant right to act and right of first refusal clauses. They also need to check that any right to match clause in their templates do not include an automatic right to provide services if the price is matched.

In order to benefit from the carve out for bridge loans, banks also should consider ensuring that commitment documents and bridge facilities expressly document the characteristics for bridge loans discussed above.

Finally, firms should be mindful of both the booking entity as well as the entity or entities expected to perform any aspect of the services in question. If the entity that will be executing the services, in whole or in part, is a UK entity or establishment, then the contract may be caught by the ban, notwithstanding that the contract may be booked to a non-UK legal entity.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Alan Avery
alan.avery@lw.com
+1.212.906.1301
New York

Nicola Higgs
nicola.higgs@lw.com
+44.20.7710.1154
London

Christopher Kandel
christopher.kandel@lw.com
+44.20.7710.1108
London

Rob Moulton
rob.moulton@lw.com
+44.20.7710.4523
London

Sindhoo Vinod Sabharwal
sindhoo.vinodsabharwal@lw.com
+44.20.7710.1885
London

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Endnotes

1 See footnote 3 of the FCA Policy Statement.

2 See paragraph 2.18 of CP16/31, October 2016 (although the Policy Statement omits any reference to the booking entity).