FCA ban of "restrictive contractual clauses" in financing transactions

Summary
The Financial Conduct Authority (FCA) has recently confirmed that it will ban certain restrictive contractual clauses in agreements between regulated firms and their clients from 3 January 2018[1]. The FCA believes the ban will protect those clients that are explicitly constrained by such clauses and provide clients with greater choice of providers for future services, as well as more competitive terms. The ban is of particular interest to those involved in financing transactions – in connection with which various restrictions or mandates relating to future business have become commonplace. It will, however, not reach as widely in this area as the FCA's original proposals suggested it might.

The ban

What will the ban cover?

The use of "future services restrictions" in contracts, mandates and engagement letters which force clients to award future services to existing service providers will be prohibited.

In particular, the FCA will ban:

- "Right to act" clauses. These prevent clients from sourcing future services from third parties, regardless of any potential third party offers.
- "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. Any clauses that simply give the bank or broker the opportunity to match the quote from the third party, but do not prevent the bank or broker from selecting the other providers, will not be caught.

What is the scope?

In its original proposals the FCA intended to apply the ban to a number of restrictive clauses in investment and corporate banking engagement letters and contracts that cover the provision of corporate finance services carried out from an establishment in the UK. In response to feedback, the FCA has now decided to align the ban more closely to the services covered in its original market study that prompted this initiative. The ban will therefore apply to "primary market and M&A services" which (mirroring MiFID II) are defined as:

- *"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 ban applies when firms' UK establishments and overseas branches (but not subsidiaries or affiliates) provide services to UK and non-UK based clients, but does not apply to any non-UK regulated firms – regardless of whether they are providing services to UK or non-UK based clients.

Are there any exemptions?

Future service restrictions that are included in an agreement for a firm to provide a bridging loan will not be caught by the ban. This is the only explicit exemption, as the FCA recognises that a bridging loan is provided on the basis that a mandate on the "take-out" longer-term financing will be secured from the client.

In light of industry feedback, the FCA has amended its proposed definition of "bridging loan" to remove the requirement that they should have a term of 12 months or less. The new definition provides only that it be a means of providing short-term financing, and with the commercial intention that it be replaced with another form of financing. The FCA goes on to specify characteristics of a loan that could be considered a bridging loan for these purposes. These are when:

- the loan document expressly provides that the facility is temporary and is intended to be replaced with longer term financing;
- it has a short term (typically less than four years) or may contain incentives to discourage the client to retain for a long period (e.g. stepped interest rates); and
- the terms provide that the proceeds from the future financing are used as mandatory pre-payment on the loan.

Whilst this less prescriptive approach will be welcomed by those structuring and/or underwriting short-term debt for specific purposes, it does inevitably leave a measure of uncertainty as to whether a particular arrangement is exempt. It is worth noting that warehouse facilities – classically used to finance the origination of assets for securitisation, and structured for repayment from the proceeds of the resultant issuance of debt securities – are intended to be characterised as "bridging loans" for these purposes, and future service restrictions included in an agreement for a firm to provide a warehouse facility are exempt as a result.

[1] FCA Policy Statement 17/13 – Investment and corporate banking: prohibition of restrictive contractual clauses

Also leaving a measure of uncertainty is the FCA's allowance of in-scope clauses where they relate to the provision of a "specified or certain" future service by the firm to the client. There is room for debate as to how specific or certain the service need be. The FCA has declined to provide any further guidance on this, stating that further guidance on these terms would not "add value".

Where is the impact most likely to be felt?

Capital markets

Following the above, some tight calls can be envisaged as to whether a mandate to underwrite or otherwise act in relation to a capital markets issuance constitutes a prohibited future service restriction. Where such a mandate is contained in loan documentation it will be necessary to determine whether that loan is a bridging loan of the sort described above and, if it is not, whether the mandate nevertheless constitutes an agreement in relation to a specific piece of future business that the client knows it will undertake (which will mean it is exempt from the ban). The specificity with which the capital markets issuance is described could have a significant bearing on the analysis. For example, a mandate to act "in relation to a debt capital markets issuance if completed within the next 24 months" is probably not specific enough.

Incremental facilities

There was concern that the terms regulating a borrower's incurrence of incremental facilities (an "accordion" provision, as it is often known) in loan facilities agreements might fall foul of the ban. However, the FCA has confirmed that the introduction of the new defined term "primary market and M&A services" (as detailed above) means that such terms will fall outside the scope of the ban, presumably on the basis that they concern future leveraged or corporate lending and these are not in-scope services. In practice, such terms are found in facilities agreements and, though market dependent, regularly do give existing lenders a right of first refusal in relation to the incremental facilities that the borrower is seeking.

Hedging

Similarly, there was concern that the FCA's original proposals for the ban would touch so-called ancillary services, such as hedging. Fortunately, this has been largely clarified and it appears clear that hedging (and other ancillary services, for that matter) are not intended to be caught – regardless of whether, in the case of hedging, it is provided as an adjunct to a loan (which will likely not involve a "primary market and M&A service") or a capital markets issuance (which may well involve a "primary market and M&A service").

This said, firms should take note that the FCA remains open to extending the ban to other wholesale market services (which could include hedging and, potentially, lending) if they see evidence that restrictive contractual clauses are being used to the detriment of clients for such services.

What should firms do next?

Only new agreements will be affected – the ban will not catch in-scope clauses in agreements entered into prior to 3 January 2018.

Firms should put procedures in place to ensure that they do not enter into agreements with clients containing prohibited clauses after that date. In practical terms, this might involve amending templates for contracts and engagement letters, and updating guidelines and training for staff to ensure that they are aware of the new restrictions.

But before taking these steps there will likely be a need to reflect and give careful thought to marketing and cross-selling strategies, particularly within banks. Decisions will need to be taken as to whether any contractual requirements made of clients will be permitted or prohibited; and, most crucially from a commercial perspective, how best to promote services will require fresh thinking where restrictive contractual clauses can no longer be relied upon in expectation of future business.

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