Client Alert | Banking

Prohibition on ‘right of first refusal’ clauses in financing transactions

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Authors: **Stuart Willey**, **Malcolm Mclean**

In May 2015 the Financial Conduct Authority (**FCA**) launched a market study to assess, among other matters, the effects of cross-selling and cross-subsidising of investment and corporate banking services in the UK by investment and corporate banking service providers (‘**service providers**’) to its clients.

The FCA considered whether such practices inhibit a client’s choice of service provider thereby restricting competition and creating a barrier to entry for small to medium service providers. Following on from this survey, in its interim report published in April 2016[1], the FCA proposed certain measures, including the banning of a number of restrictive contract clauses in investment and corporate banking letters and contracts where the clauses cover the provision of future primary corporate finance services, in order to lower barriers to entry and expansion for non-universal banks and other service providers and expand the choice of service providers for clients with less bargaining power.

In its interim report, the FCA considered that the ban should apply to the certain restrictive contract clauses including the following

- ‘Right of first refusal’ clauses, which prevent the client from accepting a third party offer of future services unless such mandate was first offered to the existing bank or broker on the terms proposed by the third party; and
- ‘Right to act’ clauses, which prevent clients from sourcing future services from third parties, regardless of what terms the third party has offered.

On 18 October 2016, the FCA published its final report[2] and a consultation paper[3] on the matter. The FCA concluded that the use of ‘future service restrictions’ and ‘restrictive contractual clauses’, of the type identified above, in contracts, mandates and engagement letters that compel clients to award future services to service providers acting for them on other or related transactions restricts clients’ choice in future transactions and should be banned. This being the most appropriate measure to promote wider access for clients to future service providers and more competitive terms being offered as banks are encouraged to compete for repeat business based on the merits of their offering.

For the avoidance of regulatory uncertainty, the FCA ruled out the scope of the prohibition being restricted to specific clients. Furthermore, the FCA considered but ultimately decided against the use of 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 (rather than in standard terms and conditions).

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1 *Market Study 15/1.2: Investment and corporate banking market study interim report*

2 *Market Study 15/1.3: Investment and corporate banking market study final report*

3 *Consultation Paper 16/31: Investment and corporate banking: prohibition of restrictive contractual clauses*

The FCA will allow for grandfathering with the prohibition only applying to the supply of future services and not existing agreements. 'Tailgunner clauses' for recovering fees for work already undertaken by the bank where the client eventually elects to mandate a competitor will not fall within the prohibition. Further, 'right to pitch' and 'right to match' clauses which do not go so far as to give the bank a right to provide future services will not be prohibited, as they do not restrict clients' choice.

The FCA has proposed changes to the Code of Business Sourcebook (**COBS**) to implement the ban and these are set out in the consultation paper. The Loan Market Association (**LMA**) and the Association for Financial Markets in Europe (**AFME**) jointly together with the British Bankers' Association (**BBA**) have provided responses to the consultation paper some of which are considered in more detail below.

Impact of proposals – RCF / bonds and incremental facilities

The FCA proposes to prohibit the use of restrictive contractual clauses of any duration. In the context of RCF / bond transactions, a 'right to act' on a revolving facility agreement being entered into in connection with a bond offering may fall foul of the prohibition. The consultation paper also specifically singled out restrictive contractual clauses in respect of accordion terms in loans, noting that "[t]he 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". However, there is a tension between this statement and the proposed amendments to COBS as the term "corporate finance services" is defined by reference to the "corporate finance business" definition in the FCA handbook – which itself is limited to the conduct of "designated investment business" which in turn is limited to the conduct of certain regulated activities relating to "specified investments". Wholesale (i.e. non-consumer) lending is not regarded as a regulated activity and such loans are generally regarded as not being "specified investments". On that basis, the wording of the proposed rules implementing the ban would not appear to cover restrictive contractual clauses in accordion or incremental facilities. Irrespective of where the final changes end up on this, it will have little impact on financings in the leveraged market as currently service providers rarely require (or sponsors rarely agree to) right of first refusal clauses in incremental facilities . We anticipate it will be of greater impact on SME borrowers and service providers operating in the corporate lending market.

Exemptions – bridging loans

Again, to avoid uncertainty, the FCA has declined to propose a lengthy list of exemptions from the general prohibition, suggesting only one exemption apply – the use of future service restrictions in bridging loans with a term of less than 12 months and provided on the condition that it will be replaced with longer term financing. The FCA has recognised that such loans are provided on the basis that the client will replace them with longer term financing (usually a term loan, bond issue or equity issue), and that the bank would be unlikely to provide a loan on such terms in the first place if it could not seek further mandate from the client. As warehouse facilities have similar characteristics to bridging loans the FCA proposes to amend the definition of bridging loan to include such facilities. However, the LMA and AFME and the BBA in their joint response identified issues with the proposed definition of bridging loan. In particular, the requirement that the term be of less than 12 months in order to be considered a bridging loan. Many bridging loans exceed a term of 12 months for a variety of reasons such as the regulatory or competition requirements of a transaction. Both the LMA and the joint AFME/BBA response suggest having no maximum maturity term but note that if one is to be included it should (i) be longer (the LMA suggests 36 months), (ii) reflect the ability of the client to extend the bridging loan and (iii) run from the date the bridging loan is advanced rather than signed. The AFME/BBA joint response also suggests several other amendments to the COBS changes in relation to bridging loans.

Hedging

The wording of the proposed ban in the FCA's consultation paper is wide enough to apply to clauses such as a right of first refusal under a hedging letter. However, the FCA's interim report noted that hedging products that may be sold alongside a debt issuance should be regarded as an "ancillary service" rather than a primary market service. The interim report also noted that the bundling of ancillary services with transactional services was unlikely to create barriers to entry or expansion into ancillary services by other service providers and that provision of ancillary services is not a key criterion for clients in selecting a transactional service provider – suggesting that the FCA may have had an intention to distinguish between ancillary and primary market services when introducing remedial measures. However, the distinction between ancillary and primary market services does not appear to have survived into the consultation paper and is not reflected in the wording of the

proposed ban. The AFME/BBA joint response has proposed the FCA reconsider the changes to COBS to make it clear that only primary market services are caught by the ban by replacing the definition of "corporate finance services" (which they suggest is very wide and would leave scope for uncertainty), with the definitions of "primary market services" to cover equity capital market services, debt capital market services and merger and acquisition services and "related services" to cover corporate broking, lending, and NOMAD/Sponsor Services.

Overall, unless the FCA takes on board the changes proposed by AFME and the BBA or seeks to clarify this point in its Policy Statement, it may be prudent for banks to assume that the ban will extend to the use of, for example, right of first refusal clauses in hedging letters. As for incremental facilities, this issue will be less of a concern for sponsors and service providers in the leveraged market as few leveraged financings will include hedging provided on a right to act or right of first refusal basis. However, in the small to mid-cap corporate lending space and some real estate financing transactions where hedging is provided on this basis, borrowers and service providers will need to monitor the final position taken by the FCA.

Geographic impact

The prohibition covers corporate finance services carried out from an establishment in the UK in investment and corporate banking engagement letters and contracts. The client's location or the legal entity to which the activity is booked for accounting purposes is immaterial – this means that the prohibition would not affect services provided to UK-based clients by non-UK regulated overseas banks, but would affect services provided by banks' UK establishments to non-UK based clients

Next steps

The consultation process ended on 16 December 2016, and the FCA intends to publish a Policy Statement implementing final changes to the COBS in early 2017.

For more background information on the proposed changes please see our Changes in regulatory landscape for corporate finance service providers Client Alert.

White & Case LLP
5 Old Broad Street
London EC2N 1DW
United Kingdom

T +44 20 7532 1000

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