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BBA & AFME Response to the FCA's Investment and Corporate Banking Market Study Interim Report

The British Bankers' Association (BBA) and the Association for Financial Markets in Europe (AFME) welcome the opportunity to comment on the Financial Conduct Authority's (FCA) *Investment and Corporate Banking Market Study* (the study) interim report. As supporters of open and competitive markets that bring substantial benefits to clients, investors and the wider economy, the BBA and AFME support measures that improve competition in the investment and corporate banking space. We welcome the FCA's interim findings that clients benefit from the wide range of service providers regardless of their size or industry and are generally well-served by the UK's investment and corporate banking sector. We look forward to engaging with the FCA as it further develops its conclusions.

The BBA is the leading association for the United Kingdom banking and financial services sector, representing over 200 banks which are headquartered in 50 countries and have operations in 180 countries worldwide. Our members manage more than €10 trillion in banking assets, employ nearly half a million individuals, contribute some €100 billion to the economy each year and lend some €200 billion to businesses.

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

<u>Universal banking and cross-subsidies</u>

Q1: Are there any benefits to contractual clauses that restrict choice that we need to take into consideration? For example, are there any circumstances in which clients have benefitted from reduced fees or better terms when agreeing such clauses? Please provide supporting evidence.

Q2: If restrictive contractual clauses were to be prohibited, what practical issues might arise in doing so? Are there any types of services for which such contractual clauses should be permitted?

Q3: Are there other proportionate ways in which we can reduce barriers to competition for non-universal banks and other service providers? In particular, are there FCA rules and guidance that could be altered to enhance their prospects of competing for transactional business?

Q4: Are there other steps we should taking to allow more innovative approaches to primary market services to emerge?

Contractual Clauses

The BBA and AFME agree with the FCA's findings that primary capital markets are very competitive markets and involve the provision of a wide range of services catering to clients in a diverse range of industries and sectors.

In the view of our members, an important characteristic of these markets is that the clients whom they serve are typically sophisticated, well-advised institutional counterparties with a clear understanding of their legal and commercial interests. It is the experience of our members that where these sophisticated clients enter into contractual negotiations with a counterparty, they and their advisers are able to determine whether any proposed contractual provisions are aligned with those interests, and negotiate accordingly. Taking advantage of the choice available in the market, in those cases where clients and banks cannot agree mutually beneficial

BBA
Pinners Hall
105-108 Old Broad Street
London
EC2N 1EX

T +44 (0)20 7216 8800
F +44 (0)20 7216 8811
E info@bba.org.uk
www.bba.org.uk

terms, clients can (and do) take their business elsewhere. Insofar as the FCA's interim report does not provide detail of the evidence it received leading to its conclusions regarding restrictive contractual clauses, our members would welcome further discussion with the FCA regarding the extent to which its findings are shared by their client base.

We believe that, even if the FCA were to determine that 'restrictive contractual clauses' are not appropriate for inclusion in a bank's general terms and conditions, in order to preserve client choice, the FCA should permit restrictive contractual clauses where clients and banks have expressly negotiated them into bespoke agreements. By prohibiting exclusionary clauses in non-negotiated general terms and conditions, but allowing them to be included where they are expressly negotiated, our members' clients would then retain the freedom to negotiate a contractual and transactional framework that meets their individual needs. We note that such a distinction between standard terms and individually negotiated terms is one that has already been applied in other areas of law (e.g. in unfair terms in consumer contracts legislation) and may be appropriate here.

Furthermore, as is more particularly described below, a variety of clauses have been classified generically in the interim report as being 'restrictive contractual clauses'. As acknowledged by the FCA, there are existing contractual practices that offer tangible benefits to clients such as better pricing terms for individual parts of a 'holistic' transaction. Such clauses vary widely however and grant a variety of contractual rights in relation to future business that relate to a range of investment banking products and services. Defining such practices will be challenging and will require extensive, detailed further engagement with industry bodies and other market participants.

Benefits

There are many circumstances in which clients benefit from contractual clauses of this type. To illustrate this, we have provided below certain examples of these relationships. This is not an exhaustive list and there are many other examples in relation to other investment banking products and services whether M&A, DCM or ECM.

1. <u>Transactions which take place in steps or stages</u>. Certain transactions consist of a series of individual steps that represent, in effect, a single transaction. In such cases it may be more appropriate to divide those transactions into separate engagements that appropriately reflect the nature of the relationship between bank and client at the relevant time (e.g., advisory, credit counterparty, underwriter). Notwithstanding these differing roles and responsibilities, by looking at the transactions together a bank is better able to assess and manage (and therefore more precisely price) the risks it faces. It is also the case that the underlying work undertaken and, in some cases, the corresponding risk analysis by the bank is utilized across all stages of the transaction. For example, in acquisition financing, a bank's assessment of the risks it faces in one step (for example a bridge loan) may depend heavily on the certainty that it will be responsible for the capital markets product that will be issued in order to repay that loan (e.g. bond or equity issuance). Not only would a bank be expected to be able to provide better pricing in the later transaction(s) due to its familiarity with the issuer, the certainty of a future role is also likely to positively affect its risk analysis in the initial stage.

2. <u>Mandates in relation to general financial advisory services</u>. There are types of financial advisory mandates in which a bank agrees to remain available to a client over what can be a long period of time with no guarantee of a transaction (e.g., an anti-raid advisory assignment for a client who is not approached by an unsolicited bidder or general financial advisory work in exploring strategic options for the business, none of which are carried out). In these cases, a bank may enter into an engagement letter with modest fees to assist the company and its board to prepare for a bid that may not come. By doing so, the bank in question will have incurred opportunity costs by undertaking the defence preparations (i.e. from a conflict point of view, it is committing itself not to act against the client and potentially from not acting on other situations in the same sector) and may have foregone other fee-paying business from other companies with overlapping interests to its client in order to remain unencumbered. Without certainty of a mandate at the time an approach is made – in the form of an active defence mandate or a sellside mandate – fewer banks may be willing to provide these services to corporates or may require higher fees to do so, reflecting the opportunity cost of the mandate.

3. <u>Corporate broking mandates.</u> A significant number of investment banks, in seeking to build a closer client relationship with corporate clients, may act as a corporate broker for no fee. A bank will only be able to follow such a business model if it has the reasonable expectation that it will earn a return on its considerable investment of time and resources. As well as a pricing advantage for the client, the bank is also investing in a client by agreeing to act as its corporate broker. The client knows it can develop

and enjoy a trusted advisor relationship with the bank. Similar to the example above, in addition to providing its services for no fee, the bank is, typically, excluding itself from a certain pool of potential future fee earning work for other clients. An additional benefit for the client is that a corporate broker typically manages its conflicts to remain free to act as sponsor for the client if they are required to appoint a sponsor pursuant to Listing Rule 8.

4. Uncompleted IPO mandates. A further example is where a bank works on an IPO or other capital raising for a significant period of time only to see the transaction fail to complete. In such cases, no fees are payable to the bank, so it is entirely typical for the parties to agree that, if the issuer or seller decides to execute the same transaction at a later time when markets or circumstances are improved (or chooses to pursue a variation such as a DCM or M&A transaction), the original banks are offered the right of first refusal to work on such transaction on commercial terms to be agreed at the relevant time.

Practical Issues

In the event that the FCA were to propose to prohibit certain 'restrictive contractual clauses', a number of practical issues would arise.

As it is difficult to arrive at a precise, clear and workable definition of a clause that could act as a barrier to competition without negatively affecting the positive outcomes and client benefits such as those listed above, it is helpful to consider the general categories of clauses that exist. Our members have advised that contractual clauses contained in engagement letters broadly grant three different types of rights: (i) to act or a right of first refusal to act in a specified type of transaction; (ii) to match terms offered by an alternative provider; or (iii) to submit a proposal.

We do not believe it would be appropriate to attempt to define prohibited clauses through a granular prohibition of specific language, nor do we recommend that the FCA attempt to develop an exhaustive list of the types of permissible clauses and investment banking services and products to which they apply. Instead, we would suggest that the FCA focus on restrictive contractual clauses based on a principle of exclusivity, i.e. a clause in relation to subsequent or future business that compels a client to engage only with the bank or banks entering into the engagement letter to the exclusion of all other potential competitor banks. We would note that certain such clauses may be appropriate, depending on the circumstances, and therefore this issue will require careful consideration. Equally, our members believe that those contractual provisions based on the principle of inclusion should be expressly permitted (i.e. clauses that require the client to consult a specific firm when seeking a service partner, but that leave the client free to approach other firms concurrently). Consistent with this, we also suggest the FCA includes within this category "last look" or "right to match" clauses that allow a company to seek out better pricing from competitors, but would require the inclusion of the relevant bank or banks benefitting from the clause on the same terms. Our members would welcome the opportunity to discuss these issues with the FCA in further detail going forward.

An additional feature that the FCA would need to consider regarding the use of these clauses is the operation of a time limit on their use. The FCA's own findings reflect that these contracts generally apply for a period of 24 months' time from the date of initial contractual engagement. However, it is important to consider that some exceptions would likely be necessary – for example, in the case of the corporate broking example listed above it is market practice for these relationships to be on an evergreen basis – but this approach would nevertheless require both client and bank to regularly consider the terms of their relationship.

As noted above, should the FCA conclude that it wishes to develop a framework for the regulation of restrictive contractual clauses, we and our member firms would welcome the opportunity for further engagement with the FCA to explore how this may be achieved in a manner which acknowledges the sophistication of the parties involved, balances the relevant merits to both clients and member firms of the various restrictive clauses currently used in the market, and also preserves client choice.

League tables

Q7: How might an industry-led solution best be achieved to tackle the concerns we have outlined in relation to league tables in Chapter 6?

Q8: What practical issues would need to be considered in determining parameters for presentation of league tables to clients in order to reduce the incentive for league table trades?

Q9: What other solutions could be used (i) to discourage league table trades and (ii) to ensure league tables are presented in a way that is more meaningful for clients?

FCA Interim Findings

The FCA has advised that its concerns with the use of league tables are based on its findings that:

a) Some firms are engaging in transactions at aggressive prices and/or loss-making rates primarily for the purpose of advancing their place on a league table ("buying league table credit"); and
b) When combined with the inconsistent manner in which league tables are often presented to clients, league tables have the potential to be misleading or of limited use to the market.

In its interim report, the FCA advised that it does not propose to create or maintain its own league tables, and neither does it wish to remove firm flexibility when using league tables to engage with their clients. The BBA and AFME support these principles insofar as it is important that banks and advisors retain the flexibility to present league table information to their clients in a manner that can be tailored to the client's needs. Furthermore, banks should be free to present information in a way that they believe to be most illustrative of their relevant competence provided that their methodology is transparent. For example, showing competence in a market, sector and/or region where there are many IPOs per year requires a different presentation than one where one must examine a longer time period in order to find relevant data points.

We do not support the FCA's proposal that league tables must be presented to clients in a manner that is consistent with the way they are used internally by banks. Such narrow parameters would fail to account for the divergent purposes for which banks and clients use league tables, and could in fact reduce their usefulness. For example, a bank may present a league table focusing on share of total street revenue rather than by number of transactions, or a table showing global coordinator roles only but ignoring bookrunner roles. In such cases, the bank may present these tables internally in such a way that would provide little useful information to the client.

In order to address the FCA's concerns, we propose reforms that will improve the transparency and efficacy of league tables and their presentation to clients, and that will also address the FCA's concerns that some firms are undertaking transactions primarily to improve their league table positions.

Improving Transparency

The BBA and AFME believe that the most effective means of improving the efficacy of league tables would be to promote measures that improve transparency for clients. In order to achieve this, both banks and third-party data providers such as Bloomberg, Thomsonreuters and Dealogic must be prepared to introduce transparency and disclosure measures. Although the compilation criteria are available to those banks who pay for the service (and who participate in periodic consultations on appropriate criteria), similar transparency is not available to the market as a whole. Service providers could be required by the FCA to make publicly available:

a) A clear identification of the period of time for which a league table's underlying transactions are based;
b) Clear identification of the eligible transaction types included in a table's compilation criteria (or identifying the *excluded* transaction types, if more practical);
c) The league table criteria, which are determined annually, and details of any adjustment or change to a league table's compilation methodology, and the date from which this was effective; and
d) Any other information relevant to the compilation of the league table.

In order to facilitate easier cross-comparison by clients of league tables submitted in pitches or in response to RfPs, the above reforms would need to be accompanied by similar measures on the part of the banking and advisory sector. Whist BBA and AFME members would support any proposal that requires league tables presented to clients to be accompanied by clearer disclosure requirements, issuers should also be encouraged to determine what additional information they require in order to make more informed decisions and require that information from potential service providers. The banking community is prepared to work with issuers in this regard.

Discouraging the practice of "buying" league table credit

Transactions primarily undertaken to improve a firm's league table position can undermine confidence in league tables and paint an inaccurate picture of a firm's relative success. Whilst it is important that steps are taken to discourage such practices, it is equally important that any proposals be proportionate and measured. This is especially relevant given the FCA's finding that league table positions are rarely the sole determinant when clients are considering their banking or advisory partner. Additionally – and as acknowledged by the FCA – such transactions can still be of benefit to issuers or selling shareholder clients irrespective of any impact league table position, with issuers or sellers potentially benefiting from a higher price than what would otherwise have been achieved without the bid by the relevant underwriting bank(s). As such, we believe that an outright prohibition of specific transactions that are known to be susceptible to the practice of buying league table credit would neither be proportionate nor beneficial to the wider market. Instead, we believe that reforming the manner in which these transactions are represented in league tables would be a more effective response.

Previous attempts to address concerns about league tables have focused on removing a range of specific transaction types from inclusion in league table compilation methodology. These efforts have stalled largely due to the variable use of these transaction types across capital markets which could result in some firms' league table position being disproportionately affected by their removal, whilst leaving others unaffected or even improving. In practice – and as the FCA has identified – buying league table credit is prevalent really only in the capital markets league tables, and in particular the auction block, where the primary, if not only, criterion in underwriter selection is price. In auctions, other factors, such as the bank's ability to distribute the stock without negative market impact or other competencies that league tables would seek to demonstrate are ignored. Therefore, a bank willing to take additional risk in order to improve its league table position need only submit a higher proposed price, whether or not they believe the trade will be profitable or clear the market. Of course, it is extremely difficult to accurately identify motivation in the bidding process and not all trades that do not clear the market will have been bid irresponsibly. However, if the types of trades related to this activity were more readily identifiable in the context of the overall league table, issuers and their advisors could draw their own conclusions.

The BBA and AFME believe that a more viable approach in order to address this issue would be to ensure that the transactions included in the different league tables are as homogenous in their character as possible. This would not involve removing transactions vulnerable to the buying of league table credit completely from consideration in these league tables; instead, we believe that separating components into their own separate table(s) could provide clients and other participants a more accurate and useful picture of their bank's relative position. This would also potentially remove the incentive on the part of participants to engage in these trades solely to climb the overall equity league tables[1]. Any reform in this area would be complex however, and require further consultation between banks, third party data-providers and issuers. The BBA and AFME recommend that the FCA does not make any immediate recommendations for change in this area, but instead works with all stakeholders in a programme to address the FCA's concerns. We stand ready to discuss this further with the FCA.

Establishing a framework around the use of league tables that promotes easier cross-comparison through greater transparency, and separating vulnerable transactions into component league tables should result in a more transparent system that results in better outcomes for clients and participants.

<u>Allocations</u>

Q5: What additional steps should we be taking, consistent with MiFID II, to help address the concerns we have raised?

Q6: Are there any barriers to the emergence of other innovative approaches to book-building that we can address?

[1] Other trade types that could be considered could be self-led or "own issuance" deals and transactions that relate to unpaid mandates, although the latter may be more difficult to identify.

We believe that with appropriate policies and procedures and internal control oversight, the existing regulatory framework, as supplemented by MiFID II, is sufficient to address potential conflicts of interest present in the bookbuilding model. There are, we would submit, alternative explanations for much of the data presented in the interim report, for example that the largest recipients of IPO allocations are in many cases some of the largest global asset managers and by virtue of their size also represent a disproportionate amount of global trading volumes. It is also important to note that not all asset managers purchase IPO stock and would therefore not feature in a bookbuilding process, whether or not they are important trading partners. Recognizing that there are inherent conflicts of interest that must be managed in the bookbuilding process, in the past only very few alternative methods have been attempted (such as the "Dutch auction" method employed by Google) and all have been less successful in providing a balanced shareholder base and an efficient aftermarket in the stock. In our view, the bookbuilding process remains the best available method to demonstrate transparent demand to issuers.

Areas in which we are not proposing remedies

Q10: Is there any reason why we should take any action at this stage in relation to:

- **a) availability of suppliers for medium-sized corporate**
- **b) clients (or clients of any other size, type or sector or**
- **c) from any other region)**
- **d) transparency of scope of services and fees**
- **e) syndication**
- **f) reciprocity?**

If so, what action should we be taking? Please submit evidence to support your claim for the need for action.

Q11: Given the clarity we have provided in relation to the way in which corporate finance advisers are covered by our regulatory regime and lack of concerns we have found in Chapter 6, are there any areas in which we should be considering taking action?

The BBA and AFME support the findings of the FCA with respect to questions 10 and 11 but would welcome the opportunity to assist the FCA further should it require additional information.