

UK FCA publishes final report of investment and corporate banking market study

The UK Financial Conduct Authority (FCA) has found that, while many clients feel well served by primary capital market services, a targeted package of remedies is required to encourage competition, particularly for smaller clients. The FCA is also continuing to look at how the IPO process can be improved.

Background

The market study was launched in May 2015 following the FCA's review of competition in the wholesale sector in 2014.

The study covered debt and equity capital markets, mergers and acquisitions, and acquisition financing (primary market) services carried out in the UK. Links with related services such as corporate lending and broking, and ancillary services, were also in scope.

The FCA focused on (i) the choice of banks and advisors faced by clients when selecting services, (ii) transparency, and (iii) cross-selling, bundling and cross-subsidisation.

The FCA's final report, published on 18 October 2016, confirms the findings set out in the FCA's interim report, published in April 2016.

FCA's interim findings confirmed

The FCA does not consider that the feedback it has received or the further work it has carried out since its interim report requires the FCA to change its interim findings or the

Key points

- The FCA has confirmed the findings of its previous interim report.
- The FCA has developed a targeted package of remedies to address its concerns, including:
 - a ban on contractual provisions that restrict competition;
 - ending league table misrepresentation in banks' pitches to clients;
 - removing incentives for loss-making trades to climb league tables.
- The FCA will also carry out a supervisory programme for IPO allocations, and consult further on proposed changes to the IPO process.

proposed remedies in its interim report. It has therefore confirmed the findings from its interim report as final.

Choice and cross-subsidies

The FCA's analysis indicated that most, particularly larger, clients are well served by banks and advisers. However, the FCA considered that under the universal banking model, lending and broking services are usually provided at a low rate of return or below cost in exchange for more lucrative primary market transactional business. The FCA cited concerns that:

- Clients may not always be able to award primary bank mandates to the bank that best suits their needs
- It is difficult for new entrants to break into primary market services without also offering lending and/or broking services
- Banks seek to use contractual provisions, such as right of first refusal and right to act clauses in engagement letters, to restrict a client's choice in future transactions.

Following its interim findings, the FCA gathered further evidence on the

effects and benefits of restrictive contractual provisions, however on balance the FCA has decided that there is no justification for continuing to allow the provisions.

League tables

The FCA considered that certain practices employed by banks can make league tables misleading and reduce a client's ability to compare providers. It noted for example that some banks carry out loss-making transactions purely to generate a higher position in league tables, and many banks routinely present league tables to clients in a way that inflates their own position.

The IPO process

The FCA cited concerns that the 'blackout period' between publication of research by syndicate banks and circulation of the pathfinder prospectus, combined with lack of access to the issuer's management, leaves analysts from independent research providers with little or no information. As such, the diversity of information available to investors during the investor period is limited. The FCA considered these concerns in a separate discussion paper published at the time of its interim report, and plans to publish a further consultation paper with proposals to address its concerns in winter 2016/2017.

Allocation of shares in IPO book-building

The FCA identified the potential for conflicts of interest to arise in the IPO allocation of shares, as banks may seek to reward favoured investor clients where this is not necessarily in the issuing client's interest. The FCA's analysis showed that IPO allocations are skewed towards buy-side investors from whom banks derive

greater revenues from other business lines (for example, trading commission). The FCA also found some allocation policies and practices which are potentially not consistent with its existing guidance or the relevant requirements in the MiFID II delegated regulations.

Remedies

In order to address its concerns, the FCA has developed a targeted package of remedies:

- **Banning banks from using restrictive contractual provisions.** The FCA has published a separate consultation paper alongside its final report setting out its proposals for banning the provisions. Depending on responses to the consultation paper, the FCA expects to publish the final rules in early 2017.
- **Ending league table misrepresentation in banks' pitches to clients.** The FCA is working with the British Banking Association and Association for Financial Markets in Europe so that they can develop and adopt industry guidelines to improve the way in which banks present this information to clients.
- **Removing incentives for loss-making trades to climb league tables.** The FCA has asked league table providers to review their recognition criteria so as to reduce the incentives for banks to undertake these league table trades.
- **Supervisory programme for IPO allocations.** The FCA will carry out supervisory work in the run up to the implementation of MiFID II with firms where it has identified shortcomings in their

allocation policies or a skew in their allocation practices.

- **Revised IPO process.** The FCA is continuing to consult on and develop changes to the IPO process, and as noted above expects to publish a further consultation paper with policy proposals in winter 2016/2017.

Comment

At the time of its interim report, the FCA emphasised the need for any remedies to be proportionate and did not consider that widespread or "highly interventionist" measures, such as separation of lending and transactional services, would be warranted.

The FCA's final report confirms its interim findings as well as the remedies proposals set out in its interim report. The FCA Director of Strategy and Competition has stated that the FCA has developed a package of remedies designed to address the problems it has identified, and this sends a signal that it expects firms to compete on the merits.

While the remedies appear measured, the FCA's final conclusions and remedies are awaited in relation to the ban on restrictive contractual provisions and the IPO process.

Market participants should also bear in mind the potential for individual enforcement action arising from FCA market studies. This recently occurred with the issuance of two "on notice letters" to firms in respect of specific competition law infringement concerns identified during the course of the FCA's retirement income study.

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