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Brexit: Implications for the Financial Services Industry

By David Brennand, Carolyn Jackson, Nathaniel Lalone, Neil Robson and Peter Sugden

Introduction

The UK has voted to cease being an EU member state.

Yesterday, June 23, 2016, the UK held a referendum on its future in the European Union (EU)—the "Brexit". The result this morning shows that 51.9% of voters in the UK want the UK to cease being an EU Member State. Prime Minister David Cameron has since declared that he will be stepping down from his role and that his successor should be in place by autumn. The financial markets have already experienced significant shocks from the Brexit vote; following the vote, the FTSE 100 fell dramatically and Sterling fell significantly against the US dollar[1] and against other major currencies.

Although the Brexit decision will create significant legal uncertainty, it is unlikely that there will be any changes in the short term: a contract that was enforceable yesterday will be enforceable today, and the UK's financial services regime, including EU directives and regulations, remains in place until further notice. Under EU law, the UK has two years from the date of a formal notification of its decision to withdraw from the EU before the UK ceases to be an EU member state, so there will not be any legal changes for some time yet.[2] However, during this period, the UK has to negotiate with the other 27 EU member states as to how the country will leave the EU. For the time being, the UK position remains uncertain. This client advisory summarises key Brexit implications for financial services firms and sets out practical points that firms may wish to consider.

1. **Getting out: What are the implications of the UK voting to a Brexit?**

   i. *Models for the UK post Brexit*

   Subject to what could be difficult negotiations with other EU member states, there are several models of EU interaction that the UK could pursue. These include:

   - become a member of the European Economic Area (EEA), which includes the 28 EU Member States as well as Iceland, Liechtenstein and Norway;
   - join the European Free Trade Association, which currently includes Iceland, Liechtenstein, Norway, and Switzerland;
   - enter into bilateral arrangements (such as Switzerland);
   - strike a free trade agreement (such as Canada); or
   - rely on existing World Trade Organisation membership.

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[1] Its lowest level for more than 30 years.

[2] The UK referendum is advisory and requires an Act of Parliament to begin the process of withdrawal. Therefore there remains a possibility, however remote, that the UK Parliament may refuse to abide by the referendum results.

We will continue to keep clients and friends apprised of developments as they become known to us. However, for more information, please contact any of the attorneys below.

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The most favourable arrangement for the UK would be a free trade agreement that permits the greatest access to the EU with the least sovereign and regulatory interference from Brussels. However, a free trade agreement may reduce firms' access to the EU's single market ("Single Market") and, according to the UK Government, would result in higher costs[3]. The UK would also lose free trade agreements negotiated for the EU and would need to renegotiate those agreements on a bilateral basis. Becoming an EEA Member State, like Norway, would provide some Single Market access benefits; however, it would also result in what the Brexit campaigners may see as an undesirable trade-off in having to abide by Single Market rules without any EU membership vote —while paying a significant tariff to the EU for the right to access the Single Market.

ii. Market access

Market access and passporting arrangements, currently enjoyed by the UK, will be significantly affected by the UK leaving the EU, unless the UK opts for EEA membership. Passporting arrangements allow EEA institutions to access markets in EU Member States, for the most part, without having to establish subsidiaries in each Member State and incur the costs of full authorisation in those jurisdictions (including for example, compliance costs of regulatory capital). Market access will remain a critical issue for non-EEA/non-EU firms, particularly financial services firms, which have established an office in the UK with a view to passporting throughout the EU and providing their services—or accessing European markets—on a cross-border basis. If the UK chooses not to be an EEA Member State, UK firms and those non-EU firms that have an office in London may have to consider establishing an office in an EEA member state to maintain their ability to provide services and to access EU markets. Equally, in reverse, EU institutions wishing to provide services in the UK or access to UK markets may need to establish an office in the UK.

iii. UK regulatory implications

The regulatory framework for financial services in the UK is made of both EU and domestic UK laws, in addition to international policies, codes of conduct and agreements. Depending on the model that the UK chooses for its post-Brexit interactions with the EU, it may be that many EU directives and regulations currently in place as UK law would need to be replaced; it may be that if the UK is not an EEA Member State that all future EU directives and regulations would not become UK law. However, any EU laws currently in force will remain in force in the UK until they are explicitly repealed.

Depending on the model chosen for Brexit, the UK may have greater freedom to enact and repeal laws as it sees fit; however, if the UK wishes to access the Single Market it will likely be the case that the UK has to keep its laws relatively consistent with those in force in the EU in order to benefit from "equivalence determinations" that are mandated by many EU pieces of financial services legislation if a non-EU country is to have access to EU markets.

2. Preparations: What can firms do to mitigate uncertainty?

As outlined above, the terms of the UK's withdrawal and the terms governing its subsequent relationship with the EU are entirely unknown at the current time. Aside from Greenland's exit in 1985[4], there is no precedent for countries wishing to exit the EU. In March 2016, the UK Government predicted that withdrawal and post-exit negotiations with the EU could take a decade or more[5].

The failure of the politicians leading the Brexit campaign to set out what their terms are for a UK exit from the EU and the terms governing its subsequent relationship with the EU will undoubtedly lead to uncertainty and volatility in the near term, as is evidenced by the fall in UK share prices and the value of Sterling, as noted above. Making preparations for the future is extremely challenging. However, firms may wish to consider the following points to assist in their management during this period of uncertainty and any subsequent transitions:

- Confirm current group structures and identify all EU holding companies and subsidiaries;
- Conduct a firm "stock take" of cross-border business;
  - Seek out all current or future interactions, obligations and dependencies on EU firms
  - Identify and analyse key EU clients and jurisdictions

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[3] See the UK Government's Paper titled "Alternatives to Membership: Possible Models for the United Kingdom Outside the European Union", dated March 2016 here.

[4] Greenland, as an overseas territory of Denmark, was previously a member of the European Community (as was) and is the only case to date of an exit from the wider European Union.

[5] See the UK Government's Paper titled "The Process for Withdrawing from the European Union", dated February 2016 here.

- Identify and review key contracts, agreements, policies and arrangements with EU counterparties and service providers

- Identify and review all EU operational dependencies, including outsourcing arrangements
- Consider current and future places of authorisation/ licensing for business activities in the UK and in the EU
- Evaluate the importance of passporting rights particular to the firm (and the importance of maintaining passporting rights throughout any transition phase)
- Review current employment arrangements and identify any EU dependencies or influences
- Assess whether your firm wishes to relocate some staff to another EU Member State so as to maintain its regulatory position vis-à-vis the EU
- Identify and review all funding arrangements with EU influence
- Review current tax dependencies with the EU

3. Looking forward

It is unlikely that there will be any changes in the short term. Under Article 50 of the Treaty of Lisbon, the UK has two years from the date of a formal notification of its decision to withdraw from the EU. The UK government still has to decide when and how to make that formal notification. Even after that notification is made, the process then requires that two years pass before the UK can leave the EU.[6] In the interim, the UK will remain an EU Member State bound by EU laws – so there will not be any legal changes for some time yet. However, during this period, the UK has to negotiate with the other 27 EU Member States as to how the country will leave the EU, meaning that it is virtually impossible at the current time to predict what the true effect of the UK's departure from the EU will be.

[6] However, this two-year timeframe may be extended with the unanimous consent of the other 27 EU Member States.

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