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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

7 Key Takeaways As UK Pulls Brexit Trigger

By **Mark Taylor**

Law360, London (March 29, 2017, 11:25 PM BST) -- In handing over a six-page letter Wednesday to European Council President Donald Tusk confirming Britain's exit from the European Union, U.K. Prime Minister Theresa May set in motion a process that will redraw Britain's entire financial services sector.

Like many who spoke with Law360, DLA Piper Brexit Committee Chair Richard Bonnar commented on the symbolism of the day and expressed hope that more detail would soon emerge to calm firms' fears, going beyond the political rhetoric that has driven proceedings thus far.

"Ultimately, financial institutions have been waiting for this to happen," Bonnar said. "They held off contingency plans until it was triggered. From talking to financial services and business clients, everyone accepts this is the reality, and we are trying to get on and make the best of it and work around it."

Law360 looks at the main takeaways from the letter and what this historic day means for firms based in London and those in the U.S. that use the British capital as their regulatory springboard into Europe.

May Hints a Transition Deal Is Possible

To avoid a "cliff-edge scenario" of no deal after the two-year negotiation period expires, both the U.K. and EU would benefit from a transition period to help businesses adjust, May said.

Clearinghouses especially have been fearful of the cliff edge as the hardest-possible Brexit; they would be inside London but at the same time outside the EU, with no legal certainty of how they could continue trading or clearing euro transactions.

Banks and financial services firms are still preparing for that worst-case scenario, despite the hints of compromise.

"There will undoubtedly be a crisis of legal certainty if the U.K. leaves the EU after two years without a provisional agreement for ongoing commercial relations with EU states," said Hazel Moffat, a litigation and regulatory partner at DLA Piper. "If they have not already begun contingency planning, the starting gun has now been fired and businesses must now get serious about their Brexit strategy."

Technical Talks About Financial Services Will Be Crucial

The only mention of "financial services" in May's letter Wednesday was a short point referencing how

U.K. policy needs immediate attention and will likely present the biggest challenge. May hinted at preserving existing rules, highlighting the strength of the U.K.’s regulatory framework.

Britain has been at the heart of much of Europe’s financial reform, and its standards are considered of a higher level than anywhere else in Europe.

While it's accepted the U.K. will lose control over the EU rule-making, the country is crucially, for now, considered to be of equivalent status. Arguments of equivalency between regulatory regimes are a thread that experts predict will run for many years and to be lobbied hard by financial services firms.

Difficult decisions lie ahead.

“Obtaining 'equivalence' might satisfy specific sectors with the financial industry — for example buy-side firms only dealing with professional clients — but it will not be good enough for the financial industry as a whole,” said Leonard Ng, financial regulation partner at Sidley Austin LLP.

The “equivalence” concept covers only certain EU directives and is subject to being revoked at the EU’s discretion. It is not something financial institutions can sensibly rely upon for long-term planning.

“The result is that firms are left with no choice but to make decisions now to relocate some staff and operations,” Ng said. “The danger is that this leads, over time, to a slow bleeding of talent and business to other European financial centers.”

The U.K.’s financial and professional services contributed more than £128.2 billion ($159.2 billion) to the national economy last year, accounted for more than 2.2 million jobs across the country, and in 2015 the sector paid £71.4 billion in tax, according to the City of London Corporation, the capital’s governing body.

Several countries have been courting bankers and eyeing this lucrative sector since the June 23 vote, but legal experts say nothing can replace London overnight, and there is more likely to be a fragmentation over time.

“People come to London not just for the single-market access — there is the language issue, most of the talent is in London, the support services and legal firms here, and they won’t disappear overnight,” said Glynn Barwick, financial services counsel at Goodwin Procter LLP.

Single-Market Access Is a Pipe Dream

May said the U.K. cannot abide by the four principles of the EU that are required to retain single-market access, and there will be no “cherry-picking” of rules to allow financial services firms to continue serving investors and clients in the bloc without a tariff.

“This is the most formal statement on the issue of the single market: We will not be a member of the European Economic Area,” Barwick said. “Until now the discussion has been a bit like the hokey cokey: Are we in or out?”

The issue of preserving full access has been the main demand for many in the sector, but May has shot this down with the message that the U.K. accepts it will lose influence over the rules that affect the European economy, including the swaths of banking reforms that have and continue to be put in place since the 2008 financial crisis.

“As of legal rights, we will have no access to passporting, except to the extent we can negotiate a special financial services access that other countries don’t currently get,” Barwick said. “We may end up paying to get passported access to the European markets, perhaps granting concessions in other areas.”

Just as U.S. firms are not excluded from the European market, U.K. businesses will face additional red tape and checking of legal positions before they can offer services.

Asset Managers Are Keeping Calm

For the U.K.’s enormous asset management sector, lawyers believe there will be little movement beyond that which was already moving to Dublin and Luxembourg pre-Brexit.

“Apart from the fact the notice has been served, nothing is different, nothing has changed in terms of what the picture is and will look like,” said Peter Astleford, financial services partner at Dechert LLP. “You should not expect too much change for the investment management industry.”

Investment managers have income from three primary sources.

The first is Undertakings for Collective Investment in Transferable Securities, which have a passport to sell around Europe and will in two years. Typically Lux and Irish funds are used for cross border sales. Nothing material changes in terms of that plan for accessing the bloc, Astleford said.

The second source is income from non-UCITS funds; however, for multiple reasons related to tax haven status, old methods are being wound down irrespective of Brexit. Instead, those targeting the EU27 are increasingly setting up their specialist funds in Lux and Ireland which will retain a passport post Brexit.

The third source is from segregated accounts, which Astleford said could also be secure either via registration under the revised Markets in Financial Instruments Directive or use of a new EU27 based affiliate.

“Broadly, the shape and nature of the U.K. (or U.S.) investment management industry will not need to change,” Astleford said. “There will be papering at the edges to do, there may be instances where a passported right for an investment manager to undertake business in the EU27 or the U.K. (as relevant) will need to be replaced with a new stand-alone license application, but we are not talking about fundamental change to the business.”

May Is Confident the Two-Year Deadline Will Be Met

May has acknowledged the challenge of meeting the two-year limit to negotiate the terms of the exit under Article 50 of the Treaty of the European Union, but said she believes it can be done, again referencing how aligned Britain’s regulatory framework is with the bloc's.

Financial services lawyers are less optimistic.

“We now know that the U.K. is firmly on the path to Brexit in March 2019, but the service of the Article 50 notice today does not give businesses any level of real comfort on what that path will look like or how they can plan for a post-Brexit future,” said Nick Brittain, banking and finance partner at Sidley Austin.

As lawyers were quick to point out, the timing clarity aside, the serving of the notice has not clarified or fundamentally changed the U.K.'s ability to predict how Brexit will evolve.

"Whilst some clients have taken precautionary steps to give them flexibility in their reaction to changing trade environment, regulation and U.K. legislation, there is insufficient certainty at this stage to react one way or another," Brittain said. "Most of our clients, like us, continue a watching brief on Brexit, and we continue to engage actively with them on any developments."

Until Brexit is Final, EU Law Reigns Supreme

Britain's government will need to change U.K. laws to include, replace or alter EU laws the country currently has, and is planning to include EU law in British law through a bill called the Great Repeal Bill. Both May and Tusk have made clear in their communications that this needs to happen to ensure as little disruption as possible.

For financial firms, this adds little clarity and may simply accelerate contingency plans to move jobs and functions away from the U.K. to minimize disruption.

The triggering came in the same week Britain's Prudential Regulation Authority and the Financial Policy Committee inside the Bank of England issued statements setting out expectations on stress tests, noted Jake Green, financial regulation partner at Ashurst LLP.

"The regulatory authorities are at pains to emphasize that plans should include consideration of disruptive events leading up to Brexit," Green said. "Some may say the central authorities are simply doing their job and planning for all eventualities. Others may imply that the level of confidence of a smooth exit may not be the highest."

EU Promises Tough Love

It took just a matter of hours for Tusk to respond in a tone that suggested the niceties are over.

"Our goal is clear: to minimize the costs for the EU citizens, businesses and member states," Tusk said. "We will do everything in our power — and we have all the tools — to achieve this goal."

Despite their proximity to Westminster and advantage of being able to lobby ministers on their home turf, London's financial services firms may be better off looking to Europe for clues on where their fate lies.

"The transparency issue has been a common thread," Bonnar said. "There has been an interesting asynchronicity with Europe; there will be a good deal of transparency from Europe in how it conducts talks, but the U.K. government has said it won't show it cards. It will be interesting to see how that plays out."

--Additional reporting by William Shaw and Richard Crump. Editing by Rebecca Flanagan and Edrienne Su.