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Brexit Torpedoes Hopes For UK Capital Markets Turnaround

By **Tom Zanki**

Law360, New York (June 24, 2016, 9:53 PM ET) -- The United Kingdom's shocking vote Thursday to leave the European Union has unleashed panic in capital markets and immeasurable long-term uncertainty that, for the time being, chills any hopes of recovery in Britain's stalled equity-raising environment, experts say.

The British pound tumbled and global stock indexes plunged Friday following the prior day's historic referendum, unsettling U.K. markets that had adopted a "wait-and-see" approach before pursuing new deals. Now that results will usher in unforeseeable change rather than restore the status quo, as a "remain" vote would have done, deal makers are scrambling to make sense of the new landscape.

"We thought the referendum would settle the issue and we can move forward in a more certain environment," Baker & McKenzie LLP partner Edward Bibko said. "Now we have a verdict that exponentially increases uncertainty about the future."

Capital markets activity in the U.K., after a hot start to the year, cooled for months leading up to the "Brexit" vote. Initial public offerings on the London Stock Exchange fell to less than half their year-ago pace, a slowdown that was widely expected given the tendency of deal makers to ice transactions until an election controversy fades.

But few investment banks expected the "leave" camp to prevail, Bibko said, meaning little contingency planning was done. Instead, deal makers hoped activity would restart after a "remain" vote, setting up a second-half recovery.

"The champagne was on ice," Bibko said. "People were waiting to close deals. Now we're in a completely different place."

After weeks of tight polling but widespread predictions that the "remain" camp would thinly prevail, 52 percent of U.K. voters authorized their government to leave the 28-nation bloc on Thursday. The vote stands to make Britain the first member state to leave the EU, severing a decadeslong relationship with its European counterparts.

Following the result, Prime Minister David Cameron, a proponent of remaining in the EU, said he would resign in October, paving the way for fresh leadership amid the changed environment. The announcement added political uncertainty atop market gyrations, leaving capital markets lawyers pessimistic about any uptick in transactions before the dust settles.

“In terms of immediate fallout, investment bank clients of ours have said they will not be going on the road with a new IPO for at least two weeks whilst they assess the impact and effect of the decision,” Dechert LLP partner Sean Geraghty said. “In the medium to long term, the outcome is to be proved.”

The core uncertainty is what kind of agreement the U.K. government will negotiate with the EU regarding terms of its departure, a process that can take two years or longer. Current rules on trade and other EU benefits, which allow member states “passporting” privileges enabling them to sell goods and services across borders without additional national approvals, stay in place until then.

“It's not like a new piece of legislation which has been discussed in advance before coming into force,” White & Case LLP partner Cenzi Gargaro said of the new environment. “This is a potential unraveling of something which will be replaced by something else, but we don't know exactly what that will be."

A key sticking point remains how financial institutions will respond to Britain’s split. London is a financial hub for major investment banks that underwrite stock and bond deals, but those firms currently benefit from passporting privileges that allow them to conduct seamless transactions across nations. Finance groups like CityUK have warned that Britain-based banks could move if the country leaves the EU, fearing they would no longer enjoy current trade advantages.

Britain can negotiate favorable terms of access to the EU single market after Brexit, but it will have to comply with EU regulations with no say in formulating them. Obtaining access to the EU’s single market also requires the free movement of citizens across national borders, a point of objection among "leave" advocates that inspired the Brexit campaign in the first place.

A U.K. departure also runs counter to long-standing EU measures intended to streamline capital markets across countries and ease cross-border investment. The EU’s Prospectus Directive, for instance, sets minimum standards that enable a company to list shares or bonds in any member state once its prospectus is approved by its home state.

Bibko said Britain normally goes beyond the EU’s listing rules, a process known as “gold plating,” in order to enhance its reputation as an elite capital markets destination. But if the U.K. severs itself from following EU norms, Bibko said the country would become “out of sync" with Europe, potentially diminishing its ability to attract cross-border listings from other member states.

Britain is also parting ways with the EU while the bloc is pushing its larger capital markets union project, which seeks to lower investment barriers between member states. The idea is to provide businesses, especially capital-hungry small companies, financing alternatives on a continent that still relies heavily on bank lending, which EU lawmakers say restricts choices for entrepreneurs.

The U.K.’s departure wouldn’t legally complicate the project, which the EU hopes to implement by 2019, but Bibko noted “a union of capital markets that excludes the biggest capital market in all of Europe seems like a less effective project without London.”

For that reason, many attorneys expect Britain will want to negotiate a relationship with the larger capital markets union — assuming it materializes — for its own self-interest.

“London will not want to miss out on the opportunity to participate in such a market,” Gargaro said.

Likewise, attorneys say it’s unclear how the EU itself will respond to Britain’s departure. How leading member states like Germany and France navigate the matter will have to play out, but they added it’s in Europe’s interest to retain strong ties to the continent’s largest market.

"The EU capital markets architecture will certainly suffer in the event access to London is restricted and/or extra regulatory hurdles are put in place,” Geraghty said.

For all the intracontinental uncertainty, experts note that London’s stature as a global financial hub is unlikely to be diminished any time soon. The LSE is home to many strong domestic businesses and serves as a magnet for emerging market companies with no direct ties to the EU.

And amid the Brexit shock waves, the LSE and German exchange Deutsche Börse said Friday they will proceed with their $30 billion merger, noting the tie-up’s “compelling” rationale is not conditioned on the referendum outcome. The combined group will gain deeper access to European, Asian and American capital markets, the exchanges said in a statement.

Gargaro said it’s hard to see another London being replicated in Europe, though the city could see its dominance fragmented somewhat amid increased competition from financial centers in Berlin and Paris. In the meantime, deals watchers say it could be a long time before a “new normal” settles in and restores predictability to the country and continent’s capital markets.

“Markets are always great at adapting fairly quickly, but I think this will take some time to pan out,” Gargaro said. “It's very difficult to make investment decisions when you don't know what the lay of the land will be in two years.”

--Editing by Philip Shea and Aaron Pelc.
