Implications for UK Capital Markets

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On 23 June 2016, a majority of the UK electorate voted to leave the European Union (EU). This decision, referred to as "Brexit", has already caused significant domestic political upheaval, but the ultimate legal implications cannot yet be predicted with certainty or accuracy.

While the terms of the UK's withdrawal from and eventual relationship with the EU are uncertain, on balance, the degree of interconnectivity and London's role in EU capital markets activity should contribute to some degree of consensual cooperation rather than a binary "in" or "out" result, which would be disadvantageous to both the UK and the EU.

In this note, we (1) provide an overview of the existing capital markets regulations, (2) address some of the key short- to medium-term legal implications, and considerations for issuers, and (3) consider the potential future of a recalibrated UK-EU relationship on the capital markets regulatory landscape.

Overview of Existing Capital Markets Regulatory Framework

EU Legislation Has Shaped the Regulation of Capital Markets in the UK

As an EU member state, the UK is required to comply with EU legislation, which will continue to be the case until the formal "exit" procedure under Article 50 of the Lisbon Treaty has been invoked and completed. Once the UK serves notice under Article 50, it will have two years to negotiate and agree the terms of its exit, but will remain bound by EU law until withdrawal. In the area of capital markets, the applicable regulations in the UK are largely set at the EU level and take the form of Level 1 directives (which require national implementation) and regulations (which have direct effect in member states). These include the Markets in Financial Instruments Directive, Prospectus Directive, Prospectus Regulations, Transparency Directive and Market Abuse Regulation. In addition, Level 2 regulatory and implementing technical standards promulgated by the European Commission (EC) and European Securities and Markets Authority (ESMA) have legal effect and impact the interpretation and application of EU securities directives and regulations in the UK.

These directives, regulations, and regulatory and technical standards provide a harmonised regulatory framework for capital markets in the EU — from the rules on the disclosure required for a prospectus to make a public offer of securities in the European Economic Area (EEA) and admission to trading of securities on EEA-regulated markets (including common exemptions), to rules prohibiting market abuse and mandating the continuing disclosure and other obligations for issuers. They also permit the "passporting" of prospectuses approved in one EEA member state into another member state for the offering of securities without further approval in that other member state.

Implications for UK Capital Markets

UK Regulation

Notwithstanding the harmonised regulatory framework for capital markets in the EU, the UK has created two distinct equity listing segments to reinforce the status of the London Stock Exchange as one of the largest and most prestigious international capital markets.

Issuers may seek a Standard listing which requires an issuer to comply with EU-minimum requirements, or a Premium listing which requires issuers to comply with more onerous "super-equivalent" and "gold-plated" requirements imposed by the UK regulator, the Financial Conduct Authority (FCA), that exceed the EU-minimum requirements. These enhanced requirements include rules on corporate governance and investor protection that comply with the highest international standards of regulation, which in turn increase investor confidence, attract one of the widest available pools of investors and provide a lower cost of capital for issuers. A Premium listing is also a prerequisite for inclusion in the prestigious FTSE indices.

Brexit Implications in the Immediate to Short-Term Future

FCA Statement

In a statement issued on 24 June 2016, the FCA confirmed the status quo for the immediate future, which included the following:

> *"Much financial regulation currently applicable in the UK derives from EU legislation. This regulation will remain applicable until any changes are made, which will be a matter for Government and Parliament. Firms must continue to abide by their obligations under UK law, including those derived from EU law and continue with implementation plans for legislation that is still to come into effect. The longer term impacts of the decision to leave the EU on the overall regulatory framework for the UK will depend, in part, on the relationship that the UK seeks with the EU in the future. We will work closely with the Government as it confirms the arrangements for the UK's future relationship with the EU."*

Indeed, the new EU Market Abuse Regulation (MAR) came into effect on 3 July 2016, and the FCA chose to delete the majority of the provisions in its Disclosure Guidance and Transparency Rules in favour of directly sign-posting and applying the relevant articles of the MAR. The UK is also expected to continue with its workplan to implement relevant pending EU legislation such as the new Markets in Financial Instruments Directive and Markets in Financial Instruments Regulation, which are expected to come into effect in 2018.

Capital Markets Union

The proposed EU capital markets union (CMU) that is part of the EC's action plan intended to strengthen EU capital markets was launched in 2014. The proposed CMU aims to encourage deeper and easier access to the EU capital markets and to reduce reliance on bank and institutional lending in favour of unlocking greater access to funding through the capital markets.

The EC intends to deliver the CMU through a package of initiatives such as modernising and replacing the existing prospectus regime with a new directly effective Prospectus Regulation. This would include significant changes such as the introduction of a "universal registration document" intended to replicate the shelf registration document mechanism used in the United States for frequent issuers, and streamlining disclosure requirements to make the capital markets more accessible to small- and medium-sized enterprises. The draft Prospectus Regulation is currently making its way through the EU legislative process and is expected to come into force before 2019.

Until the referendum, the UK was an influential driving force behind the proposed CMU, through Lord Hill's position as EU Commissioner for Financial Stability, Financial Services and Capital Markets Union. However, Lord Hill tendered his resignation following the referendum result in the UK, which has cast doubt on the UK's influence over the formulation of the eventual regulatory framework.

It is understood that European officials, regulators and market participants strongly supported and are, therefore, continuing with the CMU workplan. In particular, the new Prospectus Regulation was not regarded as a controversial element of the CMU, with many jurisdictions supporting the proposed changes to the existing Prospectus Directive. Accordingly, certain elements of the CMU, including the new Prospectus Regulation, may come into effect before the UK's withdrawal from the EU.

Issuer Considerations

- **Pending/New Transactions.** The short- to medium-term impact on pending and new transactions is limited from a legal perspective given that the status quo of existing rules and regulations will continue to apply. Issuers that have a prospectus approved by the FCA in the UK or a competent authority in an EU member state can continue to passport such approved prospectus into other member states to offer securities into one or more member states without further approval in the other member state. The continuing obligations to publish annual and semi-annual financial reports and the rules on market abuse also remain the same.

  Separately, while market volatility may affect the viability of certain capital market transactions such as equity and debt

offerings, the timing for such transactions will continue to be dictated by the availability of financial statements. Conversely, market conditions as a result of Brexit have also presented issuers with a window of opportunity to launch liability management exercises to tender for and retire existing debt securities at a lower price or exchange them for new debt securities with a lower coupon.

- **Brexit Disclosure.** The Prospectus Regulation requires issuers to provide "a list of risks which are specific to the situation of the issuer and/or the securities and which are material for taking investment decisions". Issuers should therefore consider including Brexit-related risk factors in their disclosure documents, particularly if the issuer's business is likely to be adversely affected by Brexit, the uncertainty of the eventual regulatory environment or market volatility. However, given the inherent uncertainty regarding the Brexit timeline and the future relationship between the UK and the EU, such disclosure will necessarily be high-level only and should contemplate the worst-case scenario while tailored, to the extent possible, to reflect the specific impact on the issuer and its business.
- **Contractual Clauses.** Material adverse change (MAC) clauses are generally interpreted as requiring a high threshold to be met before they can be invoked. Despite the extended period of uncertainty and market volatility following the vote to leave the EU, such uncertainty and volatility is unlikely to be sufficiently severe to constitute a breach of a plain vanilla MAC representation or warranty, or trigger a MAC termination right or a market standard force majeure clause. In addition, the law relating to MAC provisions means that a party is unlikely to be able to rely on a MAC on the basis of circumstances that it knows about when it enters into a transaction.

  Any bespoke Brexit-related contractual clauses would require specific analysis in the context of the issuer and transaction. However, it is unlikely that issuers would accept Brexit-related events of default or mandatory prepayment events in bond terms and conditions, nor would service providers such as trustees and agents accept termination rights as a result of Brexit. Certain administrative and mechanical revisions relating to the right to seek alternative listing venues or to revise cross-currency settlement provisions may be necessary in specific circumstances and should be considered when there is greater clarity on the terms of the UK's withdrawal.

Potential Future

Under the "Norwegian" EEA model, the UK would continue to be part of the harmonised framework of capital markets regulations within a single market. On the other hand, if the UK became a third country outside of the EEA, it would need to consider whether to keep, modify or discard existing EU law, or replace it — and if so, on what basis. For example, how will the UK handle existing EU legislation or the new Markets in Financial Instruments Directive and Markets in Financial Instruments Regulation, which are expected to come into effect in 2018?

It may be the case that the UK will seek to replicate an equivalent regulatory framework by "grandfathering" into UK law existing EU legislation and replicating regulations that no longer have direct effect. This will allow the UK to argue that it should be recognised as a third country with "equivalent" regulations for reciprocal access by issuers to the EU capital markets, since equivalence assessments are undertaken by the EC and ESMA using an outcome-based approach. This would require the UK to show that its rules achieve the same objectives as in the EU; it does not mean that identical rules are required to be in place.

Furthermore, even if EU legislation is not grandfathered or replicated into UK law on an identical basis, there are strong arguments for an equivalence finding, since the overall framework for financial services and capital markets regulation is set at the global level by bodies such as the G-20, International Organization of Securities Commissions (IOSCO) and Financial Stability Board, with the UK playing a leading role. As a result, there should not be any material or major departures from the principles, standards and outcomes under UK law that make them irreconcilable with EU law, particularly given the UK's gold-plated requirements.

However, equivalence alone would not mean business as usual. For example, Article 20 of the Prospectus Directive provides that the competent authority of an EEA member state may approve a prospectus drawn up in accordance with the legislation of a third country, provided it meets international standards set by organisations such as IOSCO for the purposes of public offers or admission to trading of securities on such member state's regulated markets. However, a third-country prospectus is not capable of being passported into other EEA member states without first being approved by the competent authority of an EEA member state under the Prospectus Directive. Therefore, there is a risk that dual or multiple listings and international offerings of securities that involve the UK and other EU member states' regulated markets could potentially be more time-consuming or costly than under the current passporting regime, as a prospectus will need to be approved both in the UK and an EU member state.

Conclusion

Market participants and organisations have now commented extensively on the significant interconnectivity of the UK and EU capital markets. It has been noted that approximately 78% of

all EU capital markets activity and close to 40% of all EU initial public offerings are conducted in the UK, with the UK playing a leading role in formulating market regulations and standards. Given this, it seems sensible that both the UK and the EU would seek to maintain so far as possible the existing regime. Indeed, the Chairman of ESMA, Steven Maijoor, noted the following before the referendum:

"The capital markets union and the single market is all about size... From that perspective, it's extremely important that the UK remains and contributes to the capital markets union and the single market. If the biggest capital market of the EU would not be part any more of that CMU, obviously that would be detrimental and be a negative impact on the CMU, both for the UK as for the remaining financial markets."