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Brexit: potential implications for mainstream debt capital markets
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Introduction

On 23 June 2016 the UK voted to leave the European Union. This vote is expected to result in ending the UK's existing relations with the EU and putting in place a new framework for its future relationship with the EU. This note considers some of the potential implications of the vote for mainstream debt capital markets. For a wider discussion of the impact of the vote see also "FAQs on the impact of the UK's vote to leave the EU" and "If the UK votes to leave the EU – assessing the impact".

In light of statements from the UK Financial Conduct Authority and the Governor of the Bank of England on 24 June 2016, there are not expected to be any immediate legal changes as a result of the vote. The UK Financial Conduct Authority statement included the following paragraph:

"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".

As at the date of this note, it is impossible to tell what kind of agreement will be reached between the EU and the UK. Until the terms of the UK's leaving the EU and of its new relationship with the EU are known, the precise effect of the vote on debt capital markets will remain unclear.

Withdrawal – timing and terms

The process for a member state to withdraw is dealt with, in fairly short form, in Article 50 of the Treaty on European Union. To initiate the process of withdrawing from the EU, the UK must give formal notice to the European Council of its wish to withdraw. There is no set deadline by which the UK has to serve this notice, however, David Cameron has stated that any Article 50 withdrawal notice will not be served until after his successor as Prime Minister has been appointed. Under Article 50, a withdrawal agreement between the UK and the EU will need to be approved by the European Council, acting by a qualified majority (i.e. 72%, or 20 out of 27, of the member states representing 65% of the total EU population). The European Parliament, acting by a simple majority, will also need to approve the deal.

The UK will remain a member of the EU, and (existing and new) EU rules will therefore continue to apply to it, until conclusion of the withdrawal agreement. However, if there is no agreement within two years after the formal notification, the Treaty rights and obligations will automatically cease to apply, meaning that the UK could leave the EU without an agreement having been concluded. This two year period can be extended – but only by the unanimous consent of all member states.

The withdrawal agreement will set out the arrangements needed for withdrawal, including the steps needed to undo the many legal, political and other obligations between the EU, its institutions and the UK, and the framework required for the UK's future relationship with the EU. Where rights and obligations are being terminated, transitional arrangements may be required to avoid unnecessary disruption to existing arrangements.

Withdrawal – legal consequences

EU treaties, directives, directly effective decisions and regulations, and rulings of the European Court of Justice would cease to apply to the UK upon its withdrawal from the EU, unless their effect was specifically preserved by UK national law.

EU-derived law applies in the UK through a number of routes and the impact of withdrawal will differ depending on the type of law and, where relevant, how it has been implemented in the UK. There are two broad categories: (1) those which are directly effective such as regulations (such as the Prospectus Regulation, the Capital Requirements Regulation and the (new) Market Abuse Regulation) and (2) those, typically directives (such as the Prospectus Directive, the Capital Requirements Directive, the Directive on the reorganisation and winding-up of credit institutions, the Bank Recovery and Resolution Directive and the Solvency II Directive), which have had to be implemented within the UK by UK legislation.

The former would cease to have effect at the point at which the UK withdraws/the Treaty obligations cease to have effect under Article 50.

In relation to the second category, many of the EU directives have been implemented in the UK by powers conferred on ministers under the European Communities Act 1972 (ECA 1972). In principle, if the ECA 1972 is repealed by the UK Parliament, any legislation made under it would also be deemed to be repealed, unless a specific saving provision is made.

However, not all EU laws have been implemented under the ECA 1972. Some have been implemented by Acts of Parliament or through other measures. The repeal of the ECA 1972 would not of itself affect these provisions and so, absent other steps being taken, they would stay in force.

Given the wide reach of EU-derived legislation and the complexities of unpicking it, it will be very difficult for the UK to determine fully what legislation it wants to keep/repeal/amend by the time it withdraws. In many areas there is no particular reason to suppose that there would be a policy desire to make significant changes to domestic law as a result of Brexit.

Therefore it is likely that the UK government will need to pass some kind of continuity order or savings provision keeping all relevant legislation in place, so far as practicable, until it is specifically repealed or amended. However, this is still likely to raise a large number of technical and interpretive issues, particularly on questions such as transitional arrangements, replacement of references to EU institutions (such as the EBA and ESMA) and the scope of application of EU Court of Justice decisions.

So, it will still be necessary to ensure that these laws function properly in the new situation. For example, the meaning of legislation or rules referring to the EU may need to be clarified and powers given to EU institutions would need to be replaced by alternative arrangements.

Issues of debt securities – certain key areas for focus

Certain key areas for focus in the context of an issue of debt securities are set out below. Each of these will require analysis in light of the terms of the UK's withdrawal.

- ECB Eligibility: when the UK withdraws from the EU, debt securities issued by UK issuers may cease to be eligible as collateral with the ECB unless the UK joins the EEA or the ECB recognises the UK (as a member of the G10) as a jurisdiction in which its rights would be protected in an appropriate manner. Under current ECB eligibility criteria, any debt securities would also need to be listed on a regulated market within the meaning of the Prospectus Directive or another acceptable market (which may not include a listing in London) and satisfy the other eligibility criteria.
- Due Diligence: careful consideration should be given to the level of exposure that an issuer's business has to UK withdrawal from the EU. For example, the level of EU-UK trade or reliance upon mutual recognition of EU regulations such as intellectual property rights. For a fuller list of potential business impacts see "If the UK votes to leave the EU – assessing the impact". This consideration applies both to UK and EU issuers and also non-EU issuers who carry on business in the EU.
- Risk Factors/disclosure: prior to the EU referendum, risk factors relating to Brexit had already become increasingly common. Going forward, the scope and nature of risk factors or other Brexit-related prospectus disclosure may be expected not only to reflect the more generic risks arising from the current uncertainties around the terms of UK withdrawal from the EU but (where appropriate) also should reflect the specific nature of an issuer and its business. Hence the importance of due diligence as discussed above. Consideration may also need to be given to the impact for an issuer of any potential downgrade of the UK sovereign rating.

  Absent particular concerns for an issuer, we do not expect that the result of the vote would, of itself, trigger a requirement for an immediate supplement to a prospectus under Article 16 of the Prospectus Directive as a "significant new factor", in particular where a prospectus already includes risk factors or disclosure on Brexit and in light of the current uncertainty as to the terms of the UK's withdrawal from the EU.
- Passporting of prospectuses: Institutional only and other Prospectus Directive-exempt private placements of securities in the EU should be unaffected. However, with respect to an issue of securities that would constitute a non-exempt public offer pursuant to the Prospectus Directive, a prospectus approved by the UK Listing Authority may, when the UK leaves the EU, cease to be recognised as passportable under the Prospectus Directive and as a result, the offer of any such security in the EU may necessitate either a second prospectus or approval of the offer from a competent authority in the EU.
- Events of Default and Force Majeure: it is unlikely that the UK vote or the UK withdrawal from the EU would of itself trigger a market standard event of default. The position with regards to whether it would trigger a market standard force majeure or material adverse change clause is one which will need to be judged according to the individual circumstances of a debt securities' issuance. For a force majeure to be triggered, in the context of a market standard clause, this requires both a change (or prospective change) in financial, political or economic conditions or currency exchange rates, and for the change to be likely to prejudice materially the success of the offering and distribution of the debt securities or dealings in the debt securities in the secondary market. For any subscription agreements signed after the announcement of the leave vote on 24 June 2016, there will need to be a new event that amounts to such a "change".
- TARGET2: TARGET2 can be connected to by central banks of Eurozone countries and non-Eurozone countries for payments in euro. The UK's position in relation to TARGET2 is therefore unlikely to change, at least initially, when the UK leaves the EU.
- References to "the European Union" or "European Economic Area": each reference to "the European Union" or "European Economic Area" in a debt security or related documentation would require analysis as to how it should be interpreted after a UK withdrawal. The withdrawal arrangements would be likely to address general contractual interpretation of such references.

- > Governing law clause: the English courts are obliged by two EU Regulations (Rome 1 and Rome 2, in relation to contractual and non-contractual obligations respectively) to give effect to the parties' choice of law (subject to limited exceptions). If this legislation (or any equivalent) did not continue under English law after UK withdrawal from the EU, the efficacy of the parties' choice of law would largely remain. The English courts would, under English common law, uphold the parties' choice in relation to contractual matters. Although the position in relation to non-contractual matters is largely untested, the English courts would also be likely to uphold the parties' choice. EU courts would continue to apply Rome 1 and Rome 2, and so would continue to recognise the parties' choice of English law.
- > Jurisdiction clause: subject to limited exceptions, EU legislation gives effect to a clause in favour of the English courts by conferring jurisdiction on those courts and requiring any non-chosen EU court to decline jurisdiction (if the clause is exclusive). This legislation is principally set out in EU Regulation No. 1215/2012, known as the Brussels 1 Recast. When the UK leaves the EU, if the withdrawal negotiations resulted in none of this legislation continuing to apply to the UK, the English courts would, under English common law, accept jurisdiction on the basis of the parties' choice. However, the treatment of the clause in relation to any non-chosen EU court declining jurisdiction in favour of the English courts, as a third-party non-EU state, would be more complex, potentially depending on the application of the Brussels 1 Recast, the Lugano Convention 2007 or national law and so resulting in greater inconsistency. This may be off-set by more freedom for the English courts to protect their jurisdiction, principally by way of anti-suit injunction.
- > Judgments: within the EU, enforcement of court judgments is facilitated by the Brussels 1 Recast. This will cease to apply as regards the UK, when the UK leaves the EU. Whether anything will remain in place between the UK and EU would be a matter for the UK's withdrawal negotiations. Assuming, however, a "worst-case" scenario where nothing is left to fill the gap, then the enforcement of an English court judgment by courts in the EU would become a matter for national law, which will vary and local law advice would therefore be required. Foreign judgments from EU member states would be enforceable in England pursuant to English common law. This would be more cumbersome procedurally than under the current EU regime, but otherwise there would be little practical impact.
- > Arbitration clause: the parties' choice of London seated arbitration and related matters under any such arbitration clause is likely to be unaffected by the UK leaving the EU as arbitration law is regulated by national law (the UK's Arbitration Act 1996) and non-EU international instruments (the New York Convention). An arbitral award made in the UK should be recognised and enforceable in EU member states, and vice versa, on this basis.
- > Bail-in and contractual stay clauses: Article 55 of the EU Bank Recovery and Resolution Directive (BRRD) requires EU member states to ensure that EEA financial institutions incorporate contractual recognition of write-down and conversion language into most agreements creating (and in some cases modifying) non-EEA law governed liabilities. If the UK leaves the EU, the BRRD would be likely to continue to apply in the UK, at least initially, given how embedded it is in English law. However, as the UK would likely no longer be part of the EEA, an English law governed bond would constitute a non-EEA law governed liability for (non-UK) EU issuers. Such bail-in language may therefore need to be included in bank instruments and agreements with EU banks as a party thereto which are governed by English law.

  Similar considerations will apply in relation to contractual stay requirements. These are rules which require BRRD undertakings to include provisions limiting counterparty termination rights in certain non-EEA law contracts, including contracts for the purchase and sale of securities (such as subscription agreements).
- > Other Issues: Other issues may also impact an issue of debt securities and require consideration. For example, and crucially, UK banks and branches may no longer benefit from EU passporting rights to do business throughout the EU. Clearing euro-denominated amounts in London may require analysis. Pan-European initiatives, for example in relation to developing a private placement market, may face more challenges.

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Key contacts

Neil Dixon
Partner, London
Tel: +44 20 7456 2691
neil.dixon@linklaters.com

Ben Dulieu
Partner, London
Tel: +44 20 7456 3353
ben.dulieu@linklaters.com

Jasper Evans
Partner, London
Tel: +44 20 7456 4571
jasper.evans@linklaters.com

Elaine Keats
Partner, London
Tel: +44 20 7456 4441
elaine.keats@linklaters.com

Richard Levy
Partner, London
Tel: +44 20 7456 5594
richard.levy@linklaters.com

Catriona Lloyd
Counsel, London
Tel: +44 20 7456 4591
catriona.lloyd@linklaters.com

Paulette Mastin
Counsel, London
Tel: +44 20 7456 4503
paulette.mastin@linklaters.com

Arjun Muddu
Counsel, London
Tel: +44 20 7456 5548
arjun.muddu@linklaters.com

Richard O'Callaghan
Partner, London
Tel: +44 20 7456 4783
richard.ocallaghan@linklaters.com

Keith Thomson
Partner, London
Tel: +44 20 7456 4584
keith.thomson@linklaters.com

Carson Welsh
Partner, London
Tel: +44 20 7456 4602
carson.welsh@linklaters.com

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