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COMMENTARY

Brexit: Double, Double Toil and Trouble

"Shakespearean". That, according to the BBC, was the word that British MPs were using over the 4 July weekend to describe the unprecedented political drama that was unfolding in UK parliamentary politics following the result of the UK's Brexit referendum on 23 June. Certainly the shifting alliances, political betrayals and parliamentary mutinies in both the governing Conservative Party and the opposition Labour Party make for fascinating politics. With a policy vacuum and dire economic predictions, what does the UK's vote to leave the EU mean for capital markets activity and, ultimately, its regulation in the UK and Europe?

First, the obvious. There are no prizes for predicting lower levels of activity in the short term. All manner of economists (and others) were falling over themselves before to the referendum to predict short- to medium-term contraction in the UK if the Leave vote triumphed. With the drop in sterling, volatility in equity markets and political uncertainty, both domestically and in terms of the shape or timing of the UK exit, a disappointing year for new equity issuances in the UK and the EU is set to get worse. In other markets, though, there might be increased activity. If traditional bank lending comes under pressure, this should provide an opportunity for credit funds and other alternative capital providers to increase their direct lending. It might also herald an increase in high yield bond issuances as companies' need for finance meets investors' search for yield.

However, looking further ahead, and assuming that the UK is now on an irreversible path to exit, what other issues or trends may be coming down the road? Three themes to monitor as events develop: the prospects of a regulatory and operational turf war in financial regulation, potential paralysis in terms of the planned Capital Markets Union and the likely shape of UK securities law post-exit. These are topics that we will be returning to in more depth in coming weeks.

Rocking the Boat

It is hard to avoid the conclusion that there will be a turf war in relation to the regulation and operation of capital markets' trading activity in the EU. To understand the reasons for this, it is necessary to understand the scale of London's current dominance in EU capital markets and what is at stake. Nearly 80 percent of all capital markets activity of member states of the EU excluding the UK (the "EU27") occurs in the UK. London accounts for almost three-quarters of all over-the-counter trading in derivatives, just under half of all global trading in Euros, and just under 40 percent of all EU IPOs, and it has the greatest share of the investment grade and high yield bond markets. The same is true of European securitisations. It is estimated that the big five US investment banks have 90 percent of their EU staff based in the UK.

The City of London did not want this boat to be rocked and was overwhelmingly in favour of the UK remaining in the EU. For financial institutions headquartered in London and authorised by the UK regulators (the FCA and PRA), having to address the potential loss of EU passporting rights, the rights that enable a bank regulated in any EU country to operate a branch or subsidiary elsewhere in the EU, brings with it operational disruption, additional cost and opportunities for other cities and regulators to encroach upon London's dominance. The red carpet is already being rolled out in Paris, Dublin, Frankfurt and Luxembourg.

Many are predicting that the European Central Bank and other European regulators will assist these efforts, consciously or otherwise, by seeking to (re-)impose certain regulatory restrictions on trading and clearing activities and that the first battleground will be one that has been fought on before. In 2011, the ECB published its Eurosystem Oversight Policy Framework. It declared that securities settlement systems and central counterparty clearinghouses were key components of the financial system, and financial, legal or operational problems affecting them could be a source of systemic financial disturbance. The ECB drew the conclusion that infrastructures that settled euro-denominated transactions should be incorporated in a Eurozone country (which does not include the UK, of course). This was largely seen as an attack on London's domination of a market that has a daily turnover of 927 billion euros. The UK Treasury challenged the ruling in the European General Court and won. However, there have already been noises that the UK's vote to leave will embolden the ECB to impose the location requirement again. With reduced political influence, the UK might face an uphill battle if it does.

CMU: Drifting in the Water?

The prospect of a UK exit may have significant implications for the EU Commission's plans for a Capital Markets Union ("CMU"). The aim of CMU is to provide much deeper and more varied capital markets across Europe and to address a structural overdependence on bank financing—it is estimated that EU SMEs obtain 75 percent of their financing from banks and are four times more reliant on them than are American companies. The project, still in relative infancy, was, until the UK referendum, being led by the UK's only EU Commissioner for financial services, Lord Hill, who advocated a market-led growth of CMU rather than imposing what he described as "a top down grand vision". His resignation in the aftermath of the referendum vote leaves CMU in temporary limbo. New Financial, a capital markets focused think tank, recently commented that a UK Leave vote may lead to "less focus on market-based finance and perhaps a more inward-looking and less liberal CMU that excluded the UK … or the project could grind to an abrupt halt". It may well depend on whether CMU is seen within the EU27 countries as a means to create further barriers to, or competition with, the UK or if it fails to attract sufficient interest and is left in the political doldrums.

A Securities Law Rewrite?

From a transactional regulatory perspective, it is hard to envisage a significant overhaul of UK securities law or corporate governance requirements following an exit from the EU. While there has been much regulatory detail added over the last 10 years or more of harmonisation of EU securities laws, the landscape of UK securities regulation hasn't really changed much from before this time. No-one is seriously contemplating the UK turning itself into some form of low regulation, offshore market. In the absence of any such dramatic shift, the UK's FCA and PRA will be keen to ensure that the UK's financial regulatory system satisfies the EU's "equivalence" test (the thrust of which is that a non-EU financial institution is entitled to access to the EU so long as its own country's rules are broadly in line with those of the EU). So it is much more likely to be a case of "business as usual". As such, we expect that much of the current rulebook created by the EU prospectus directive and transparency directive will be carried over post-exit.

What would be interesting is if the regulators sought in certain areas to pivot towards a more US model. That would be a differentiator for the UK. The most obvious area would be in relation to the marketing of IPOs and the introduction of earlier and more substantive offering disclosure through early filing of the registration statement. That has been advocated by certain institutional investors for some time and is a topic we will explore further shortly.

Conclusion

The Brexit vote means that the UK has lost its voice in shaping the direction of EU capital markets, but it is still, and will be for some time to come, the largest and most important European capital market. It will be interesting to see how the political discussions between EU27 and the UK unfold and how they impact on the three areas discussed here and more generally on the development of European capital markets.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com/contactus/.

Giles P. Elliott
London
+44.20.7039.5229
gpelliott@jonesday.com

Linda A. Hesse
Paris
+33.1.56.59.38.72
lhesse@jonesday.com

John C. Ahern
London
+44.20.7039.5176
jahern@jonesday.com

Alban Caillemer du Ferrage
Paris
+33.1.56.59.38.18
acf@jonesday.com