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Global Securities/Global - Europe Practice | Alert

July 2016

Brexit: Consequences for Capital Markets

This note addresses the potential impact of Brexit on capital markets regulation and transactions. It is one of a series of *GTM Alerts* designed to assist businesses in identifying the legal issues to consider and address in response to the UK's referendum vote of 23 June 2016 to withdraw from the EU.

This *GTM Alert* outlines the principal laws and regulations currently governing the capital markets in the UK and analyses the potential impact on these rules in the event the UK joins the EEA following its withdrawal from the EU, and in the event it remains outside the EEA. The pending proposals for a European Capital Markets Union are also briefly discussed as well as the potential impact Brexit may have on capital markets documentation and disclosure in prospectuses.

Timing of Brexit

The UK has not left the EU. It will remain a member of the EU, and EU law will continue to apply in its territory for some time.

Before exiting, the UK needs to go through the exit procedure set out in Article 50 of the Treaty on European Union, starting with notification to the European Council of its decision to leave the EU. The new UK Prime Minister, Theresa May, appointed on 13 July 2016, has clearly stated that, while "Brexit means Brexit," there should be no rush to serve the Article 50 notification. She and David Davis, the Secretary of State for the new government department in charge of managing Brexit, have supported the view that notification should not take place before the end of the year. Following their recent discussions with Mrs. May, German Chancellor Angela Merkel and French president François Hollande have both accepted that the UK needs time to prepare for exit negotiations, although they have also stressed that the UK's Article 50 notification should not be unduly delayed as this would not be in the interests of the EU or UK economies.

While the situation remains fluid, it is expected that the next few months will see the UK establishing its preferred negotiating position on the terms of its exit from the EU and its preferred model for its future relationship with the EU, with notification occurring in early 2017. When the notification is made, it will trigger a two-year, extendible period of negotiation with the EU on the UK's terms of exit only. For more information on the timeline for Brexit, please see our previous GTM Alerts, "Brexit: The Timeline" and "Brexit: Progress Report One Month In."

At this time, it is not clear if negotiation of new arrangements with the EU will be conducted in parallel, or at a later stage. It is, however, clear that the UK intends to start negotiating trade terms with non-EU countries as soon as possible.

Overview

Currently, most of the UK's capital markets legislation is derived from EU legislation. As a result, the future of the UK listing, prospectus, and ongoing reporting regime would, to a large extent, be driven by the model chosen for the UK's post-Brexit relationship with the EU. If the UK were to join the European Economic Area (EEA), the current legal framework need not change in principle. If the UK does not join the EEA, the impact on issuers of equity and debt securities would depend on whether UK regulatory and legislative bodies make any changes to applicable laws or choose to keep existing ones, and whether the UK continues to adopt equivalent measures to conform with any new EU rules in the area of capital markets. The main directive introduced in 2003, the EU Prospectus Directive, was heavily influenced by UK rules in place prior to its introduction. Therefore, it is entirely possible that the UK's existing regime will not change radically even if the UK did not join the EEA. However, it becomes less clear with regard to any future EU rules that might depart from the status quo, and whether the UK would have any influence on the formulation of those rules.

Key EU Directives and Regulations

The following are the key directives and regulations affecting capital markets transactions that either apply directly (EU regulations) or have been implemented into UK law (EU directives):

- The Prospectus Directive and Regulation and related EU legislation
- The Transparency Directive and related EU legislation
- The new EU Market Abuse Regulation (most of its provisions came into force on 3 July 2016) and related EU legislation
- The Markets in Financial Instruments Directive (MiFID), which has been overhauled into MiFID II and MiFIR (both adopted in 2014, with the new rules expected to come into effect on 3 January 2018, following a 12-month delay agreed to in June 2016)
- Other related financial services legislation – Credit Ratings Agencies (CRA) Regulation; European Markets and Infrastructure Regulation (EMIR); Alternative Investment Fund Managers Directive (AIFMD).

This *GTM Alert* focuses on the Prospectus and Transparency Directives.

"Passporting" System and Home Member State

The key directives relevant to capital markets transactions (the EU Prospectus and Transparency Directives) operate on the basis of a passporting system between EU Member States, where the supervisory authority in one EU home Member State approves a prospectus, which then can be used simply based on a notification system (passporting), and without further approval required in any other EEA Member States as "host Member States."

The Prospectus Directive provides that for issuers incorporated in an EEA state, the home member state is their member state of incorporation, whereas for non-EU-based issuers, the home member state is the place in which they first make an offer or apply for a listing in the EU. For debt securities with a denomination of EUR 1,000 and more and certain convertibles and GDRs, issuers may, under certain conditions, choose their home Member State.

Ongoing disclosure and reporting in the form of annual, half yearly, and other reports is governed by the EU Transparency Directive, which is also based on the system of passporting. Listed EEA companies provide their ongoing reports, accounts, and significant shareholding notifications to their home Member State regulator. This regime is complemented by the Market Abuse Regulation which requires disclosure of inside information to the market as soon as possible.

EEA Option
If Brexit were structured such that the UK were to become a member of the EEA, very few changes are likely to be made to existing UK rules, as the EU financial services legislation extends across the whole of the EEA, not just the EU. However, in recent years, as a result of new powers granted to the European Supervisory Authorities (ESAs) under many of the financial services directives and regulations, including powers granted to the European Securities and Markets Authority (ESMA), financial services legislation has in some cases been applied with certain delays in EEA States, as those states do not participate in the ESAs. Hence, even in the case of the UK becoming a member of the EEA, the application of the capital markets regulatory framework may not ensure application of new EU legislation on the same timetable as for member states of the EU. In addition, it has to be noted that currently, EEA members and European Free Trade Association (EFTA) States have limited direct influence on the EU legislative process and therefore any changes to existing rules are likely to be made by EU Member States without significant input of UK stakeholders.

Bilateral Agreements and Impact on Passporting/Home Member State
If the UK were to negotiate bilateral arrangements instead of becoming a member of the EEA, the passporting system would only be available post-Brexit if specifically negotiated and agreed upon with the EU for the remaining 27 EU Member States on a bilateral basis. In this scenario, the UK could voluntarily apply EU capital markets rules to UK firms, but would also need to adopt UK specific rules and market architecture for those firms not operating in the EU (or legislate to apply the EU rules generally). This could result in overlapping of UK and EU requirements, which would increase UK companies' regulatory burden. In this scenario, EU companies and companies from other third countries wishing to list in the UK would have to obtain a separate approval from the UK regulator. Conversely, UK companies seeking to make an offer to the public in an EU Member State, or list on an EU-regulated exchange in an EU Member State, would be required to choose a new EU home Member State and to obtain approval from the competent authority in that home Member State. Likewise, a third country issuer that has previously chosen the UK as its EU home Member State would have to choose a new EU home Member State if it wanted to make an offer to the public in one or more EU Member States or list on an EU-regulated exchange. These issuers would make a new first time decision on their EU home Member State. While the Brexit arrangements are being clarified, new issuers may wish to delay making a binding home Member State selection.

Equivalence for Third Country Regimes
Apart from the question of home Member State, it would have to be determined if prospectuses made in accordance with UK rules could be approved for use by the EU home Member State for use throughout the EU based on the passporting system. The EU Prospectus Directive includes provisions allowing the European Commission (Commission) to decide whether a third country's laws are equivalent to the EU regime. Under the Directive, an EU home Member State can approve a non-EU prospectus drawn up in accordance with international standards if they are deemed equivalent to the requirements of the EU Prospectus Directive. ESMA has developed a framework, adopted by the Commission, under which a third country issuer can meet the equivalence requirements. Under this regime, following application by the UK regulator (the Financial Conduct Authority) ESMA would assess the UK's prospectus rules and issue an opinion detailing any additional items which would have to be included in a wrap to a UK prospectus to meet the requirements of the Prospectus Directive. If the UK were to keep the existing EU-derived prospectus rules largely intact, no additional information is expected to be required. Following ESMA's opinion, UK issuers could then apply to the competent authority in their home Member State to make use of the equivalence regime. The application would need to include a written confirmation from the issuer that the prospectus has been drawn up in accordance with UK law. The home Member State competent authority would then examine the prospectus and wrap, and approve it under the Prospectus Directive once satisfied that the requirements were met. Following approval, the prospectus could then be passported into other EEA Member States. Accordingly, if an issuer based outside the EU (as a UK issuer would be post-Brexit) wanted to use a prospectus it had prepared in accordance with then applicable UK rules for use in the EU, that issuer would have to rely on an equivalence decision as to UK laws made by the Commission in due course, and a positive decision of the applicable

EU home Member State. In order to achieve equivalence, the UK may have to broadly apply EU rules, which would appear easy to achieve if the UK decides to largely retain the capital markets legislation currently in place.

If there was no equivalence decision and no approval by the EU home Member State, in order to make a public offer throughout the EEA in the absence of an available exemption under the Prospectus Directive, a UK company would have to draw up a new prospectus in accordance with the EU legislation in place in that company's home Member State. The need to comply with separate UK legislation and separate approvals both in the UK and in EU Member States would likely increase administrative burdens and the cost of raising capital, and could entail lengthier timelines for multinational capital raises of both equity and debt.

Exempt Offers

The exemptions under the Prospectus Directive for offers to qualified investors may continue to be available to UK companies if addressed in the arrangements for Brexit. In that case, offers and sales to institutional investors and other offers made under the existing exemptions to the Prospectus Directive (or offers that fall outside of its scope) would be unaffected. Currently, a large number of capital markets transactions make use of the exemptions from Prospectus Directive requirements.

Employee Share Offerings

The Prospectus Directive contains an exemption from the requirement to publish a full prospectus for offers to employees of all EU-incorporated companies as well as companies with securities admitted to trading on an "equivalent" third-country market (which requires an equivalence decision by the Commission in respect of specific third countries to be made on application by the competent authority of a Member State). In the scenario that the UK was not an EEA member state, employee share offers by UK companies to employees in EU Member States could be made without approval of a prospectus following an application to the EU Commission and positive decision by the Commission as to UK rules being equivalent.

Offering Documents in Connection with Mergers & Acquisitions (M&A) Transactions Involving Share Consideration

The Prospectus Directive also contains an exemption for securities offerings to the public or listings on an EU-regulated market in connection with a merger, provided that a document is available containing information regarded by the home Member State regulator as being equivalent to that of the prospectus (which includes securities offered or listed in connection with a "division," such as a demerger). If a UK company wanted to offer shares in connection with a M&A transaction to shareholders in any EU Member State, it could avail itself of this exemption to the extent it had a new home Member State whose regulator approved its offering document as equivalent to an EU approved prospectus.

Impact on Non-EU/Non-UK Issuers

Companies from third countries may consider other EU listing venues if they want to have access to European markets in the event the passporting system would not work from the UK. As a result, they may look at different EU venues to choose an EU home Member State, and consider offerings to UK investors on a private placement basis instead of having a primary listing in the UK. However, issuers may also continue to choose the UK as their main European listing and add an EU home Member State for offers into the EU. Others could choose a secondary listing in an EU home Member State, although maintaining a dual listing in the UK and an EU home Member State may be perceived as costly and burdensome as two separate legal regimes would have to be complied with.

Future Legislation: European Capital Markets Union

Currently, the most important EU project affecting capital markets is the package of reform proposals for a Capital Markets Union (CMU), which was agreed upon by the 28 EU Member States in February 2016. The CMU aims to unify European capital markets in order to promote investment and growth, by, among other things, diversifying funding sources for the EU economy and reducing the traditional reliance of companies on bank lending. The UK has played an important part in framing these proposals but, after Brexit, its involvement will be limited or will cease entirely. Equally, unless the EEA route is chosen or EU legislation is applied voluntarily in the UK, the outcome of legislative reform as part of the Capital Markets Union would not apply in the UK. Among other things, the reform package includes a proposal to change the Prospectus Directive into a directly applicable Prospectus Regulation in early 2018. In addition, it includes a new set of more unified rules for securitisation transactions for simple, transparent and standardised securitisations (STS),

which would benefit from harmonised regulatory treatment. It remains to be seen whether UK securitisations could satisfy those new rules, as the current proposed rules include a requirement for the originator, sponsor and securitisation special purpose entity involved in an STS to be established within the European Union.

Impact on Disclosure in Prospectuses and Due Diligence

Public companies may wish to consider adding a risk factor relating to Brexit in their prospectuses and annual and interim reports, which would cover the potential impact on economic conditions and any specific risks tailored to an issuer's business, if relevant. Similarly, underwriters can be expected to add Brexit related questions to their management due diligence questions in order to assess any potential risks that are specific to an issuer of securities and other disclosures warranted in the offering document.

Impact on Capital Markets Documentation and Governing Law

Brexit would not appear to trigger significant changes in documentation relating to equity or debt offerings, such as purchase agreements, fiscal agency agreements, and any securities issuance related documentation. However, it may be necessary to review key definitions in transaction documentation in order to ensure that definitions will still work.

It will be interesting to see whether the choice of English law in underwriting agreements for equity offerings of European, non-English companies may change in the context of offerings extending into the United States under Rule 144A, where, for example, New York law is widely used in the Rule 144A high-yield market.

In debt capital markets transactions involving financial institutions, certain English law-governed contracts will need to include a "contractual recognition of bail-in clause" for the purposes of the EU Bank Recovery and Resolution Directive (BRRD), and may need to include a "contractual recognition of resolution stays clause" if the UK does not become a member of the EEA. The BRRD requires EU Member States to ensure that EEA financial institutions incorporate contractual recognition of write-down and conversion language into most agreements creating non-EEA law governed liabilities. This would be relevant for English law-governed bond issuances of EU financial institutions, as English law would no longer be an EEA governing law (to the extent the UK does not become a member of the EEA). Similarly, the BRRD requires financial institutions to include provisions limiting counterparty termination rights in certain non-EEA law governed contracts, such as contracts for the purchase and sale of securities, which includes subscription agreements.

It also must be considered that debt securities issued by UK issuers may no longer be eligible as ECB collateral, unless the UK joins the EEA, as the current criteria require debt securities to be listed on an EEA-regulated market or another acceptable market.

Conclusion

The full implications of the UK's withdrawal from the EU are still evolving and they will depend to a great extent on the model chosen by the UK for its future relationship with the EU and the EU exit arrangements. Until there is greater clarity and certainty businesses should continue to monitor developments, identify those areas where their businesses are likely to be affected by new or amended legislation and regulation – and, importantly, those areas that are unlikely to be affected – and determine how to mitigate risks in affected areas.

It is, however, important to note that none of the consequences discussed in this *GTM Alert* will apply immediately, but only after the UK withdraws from the EU. Any EU legislation that still requires implementation during the period up until the UK's exit will have to be implemented, and any new EU regulations with direct effect in all Member States will still have to be complied with, such as the new Market Abuse Regulation.

Further information on issues related to Brexit can be found here.

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