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Brexit Transition Deal Doesn't Remove Legal Risks For City

By **Paige Long**

Law360, London (March 23, 2018, 6:59 PM GMT) -- European Union leaders have signed off on a draft treaty to move forward negotiations with Britain on its exit from the bloc, including a 21-month transition deal, but U.K.-based financial services have been warned against dropping contingency plans for a no-deal Brexit scenario.

Puzzles like resolving the shared Irish border, Gibraltar's status and contested fishing rights will continue to overshadow the London financial center as EU and U.K. negotiators go into deeper detail on the arrangements, aiming for a final withdrawal agreement later this year.

Making lawyers nervous is the EU's assertion, repeated on Friday, that nothing is agreed until everything is agreed, meaning that everything could still be derailed, creating a legal vacuum on cross-border contracts, exclusion from the EU single market and a missed opportunity for a future trade agreement.

"Prudent financial companies should continue to deliver on their plans, mindful of the fact that any further significant delay could prejudice their interests if negotiations turn sour," said Robert Bell, a partner at Bryan Cave LLP.

Here are some of the chief concerns that continue to trouble financial services and their legal advisers as Brexit negotiators dig deeper into vexing details.

An Uncertain Transition

EU negotiators have made clear that the transition will only be finalized once both sides ratify the wider withdrawal agreement that legally seals all terms for Britain's departure. If talks break down, the transition period is at risk of falling away and Britain crashes out of the EU in March 2019 with no deal, leaving financial services companies without legal access to European markets.

Lawyers say that the promise of a transitional deal should not lead firms to shelve their contingency plans for a no-deal scenario on EU market access. Instead, it has simply allowed banks and other financial institutions to breathe a sigh of relief that they have a bit more time for the complicated task of moving some of their operations into Europe.

"We still have to assume the worst: a cliff-edge Brexit with no transitional period," said William Yonge, investment funds partner at Morgan Lewis LLP. "One could take a view that the transitional period will come to pass, in which case one could decide not to implement contingency planning until the start of the transition. But that in itself would be taking a risk."

Businesses have been lobbying for a transition period over the past year, and it is seen by policymakers as a buffer to prepare for and finalize the terms of the future trade relationship. But even with the extended state of play, the timeline remains ambitious, according to many experts.

During the transition, U.K. banks and insurers will retain the benefits of the single market, the customs union and European policies, but they will remain subject to EU law while having little influence over how it develops.

As a matter of international law, EU law will apply "in and to" the U.K. up to and during the transition period, said Bart Van Vooren, a solicitor specializing in EU law at Covington & Burling LLP.

But, he said, "this is not the same as 'equating' the U.K. to a member state," he said.

As a result, the U.K. will have no say on any EU regulations that come into force. Van Vooren points out that there is one exception under the agreement, in that if a draft EU act identifies member states or national authorities, the U.K. will be consulted to make sure it can implement the law properly.

Several London-based banks, insurers and asset managers have already begun shifting staff and operations into the EU to secure their business operations after Brexit. The plans include looking at which key services — such as securities trading, cross-border lending and payment systems — need to be relocated to cities such as Paris, Frankfurt or Dublin.

"Preparations with a hard Brexit in mind are ongoing in a very intensive way, and some contingency plans may still be triggered rather soon," Van Vooren predicted.

Cross-Border Contracts in Question

Legal experts say that among the most daunting prospects is a no-deal Brexit that fails to resolve the legal status of cross-border financial contracts — from securities transactions to insurance policies — once Britain leaves the EU's jurisdiction and legal framework.

The Association for Financial Markets in Europe recently warned that the status of about a quarter of uncleared over-the-counter derivative contracts in the U.K. and the European Union, amounting to around £26 trillion ($36.8 trillion), could be disrupted on the day of Brexit.

The industry group used the stats to urge policymakers and regulators to formally seal a transition agreement to keep a cliff-edge Brexit from casting financial contracts into a legal limbo.

Bryan Cave's Bell said that a wide-ranging solution for contract continuity still needs to be found during the negotiation process.

"If not, financial services companies will need to assess each individual contract to determine if the elements to be performed constitute a regulated activity which is no longer authorized under the EU passporting regime," he said.

Firms may be faced with needing to restructure their contracts so that they comply with the national laws of the member state in which the customer is located, which is seen as a costly exercise, Bell warned.

Alternatively, the EU and the U.K. could put in place pipeline provisions as part of the broader transitional arrangements, ensuring the continuity of contracts within a defined period.

“This will allow financial services companies additional time to transfer or restructure the relevant contracts and/or put in place substitute finance arrangements,” Bell said.

The Association for Financial Markets in Europe is calling for an EU-wide solution where cross-border contracts can be “grandfathered,” allowing them to continue on the same terms until maturity, and avoiding the need for separate solutions in each member state.

Insurers will be renewing annual policies at the end of next month that are going to continue beyond Britain's departure from the EU, the chairman of the Association of British Insurers’ said recently.

Some six million British insurance policyholders could be at risk if the U.K. and Brussels fail to legislate to preserve cross-border insurance contracts after Brexit, according to Bank of England estimates.

Limited Market Access

In addition to a transition period, the heads of the European Union's governments on Friday agreed on a joint negotiating position for establishing a trading relationship with Britain after Brexit, listing a series of restrictions to EU market access for British financial services.

The EU has officially dashed Prime Minister Theresa May’s early hopes for a new trade deal that constitutes a "deep and comprehensive partnership" with the EU, allowing financial firms to continue to operate on an EU-wide basis.

British government officials had suggested that U.K. financial services could continue to have broad access to the EU's single market on the basis of mutual recognition and reciprocal regulatory equivalence.

But the European Council of EU government leaders confirmed on Friday they will offer U.K.-based service providers, including banks and other financial services, only limited market access because Britain will be leaving the EU's regulatory and judicial regimes.

The U.K. will become a “third country” in EU legal terms when it leaves the bloc's legal framework, subject to the same market access rules and restrictions as the U.S. and other trading partners outside the EU.

Lawyers have known for a while that British financial services will not have the same access rights to the EU single market after giving up their so-called passporting after Brexit, and having guided their plans to relocate key operations to new homes inside the EU gain access.

“The Brexit deal does not contain any satisfactory solution for continuing market access U.K.-EU27 direction and EU27-U.K. direction. These two risks are risks for the EU27 as well as the U.K.,” said Morgan Lewis’s Yonge.

Even moving operations isn't an automatic cure. Banks will shift to the EU with only home-state rights to do business in the country they are licensed in, not through the full EU single market as is currently the case with the U.K., still a member of the EU.

Lawyers also counsel banks to tread carefully around EU regulators who remain watchful for banks setting up only "letterbox" firms while leaving the bulk of their operations back in London. The European Securities and Markets authority has ordered national regulators to strictly supervise any outsourcing or delegation arrangements, under which certain activities or functions of an institution are conferred back to a U.K. affiliate.

John Young, counsel at Ropes & Gray LLP, said that most of his clients are in the institutional investor group and so will be affected by the loss of passporting. Their options for keeping access to EU customers boil down to accepting third-country status or to restructuring their business by setting up a subsidiary in the EU, he said.

The U.K. government has called for a system of mutual recognition of financial regulation, or equivalence, to maintain London's access to continental markets. But financial services firms have learned that their government has limited room for maneuvering because of EU rules on maintaining the integrity of the single market by not cutting special deals for nonmembers.

"It's widely known that the U.K. wants a much better deal for financial services, because it regards the equivalence test that the EU offers the rest of the world as not fit for purpose for the U.K., given the scale of the financial services industry in London and its links to the EU," Young said.

"The government essentially wants preferential rights for the U.K.," he said. "But the EU is minded only to offer access based on the equivalence of the U.K. regime to the EU's regime, making the U.K. a rule-taker."

EU rules forcing firms to transfer operations to the EU could have longer term implications for London's status a world-leading financial center.

"In the medium-term, once people are established in Europe and the final trade deal is done, then people will have another think about where their European business is best located," said Rob Moulton, financial regulatory partner at Latham & Watkins LLP. "London will have to win that battle on its own."

Risky Legislative Roadmap

U.K. and EU negotiators aim to settle terms of the Britain's exit from the bloc, the transition period and broad terms of a future trade deal in time for the council to approve the package in October. The details would then be taken to the European Parliament and national legislatures for ratification ahead of the March 2019 Brexit deadline — leaving potential for protracted debate on parliamentary floors across 28 countries.

Legal experts question just how much detail financial services firms can expect to see at the end of that process. Some expect only a broad political agreement on future trade relations, leaving the detail to be worked out during the transition period.

"Twenty-one months is considered too short a time to negotiate a very complex and deep future relationship," Covington's Van Vooren said.

Lawyers also warn of regulatory uncertainty inside the U.K. itself as it readjusts its laws after leaving EU jurisdiction.

Britain has drawn up the European Union (Withdrawal) Bill, to smooth its departure from the currently 28-member bloc and end the jurisdiction of the European Court of Justice. Its purpose is to transpose all EU law on to U.K. books, with the intention to amend or drop some laws and regulations further down the road.

The process is expected to hand the government power to make delegated or secondary legislation through the use of statutory instruments.

Lawyers warn that firms may also need to keep an eye on the government and their regulators for sudden changes to regulatory rulebooks.

Michael Dean, partner at Dentons, said that U.K. financial services firms will have to watch the activity of the Financial Conduct Authority in particular, as it is expected to increase the number and range of inquiries into competition infringements.

“All in the sector should review examples of information exchanges in various contexts, platforms, vertical integration, IPOs, syndicated lending; all of these require vigilance," he said.

--Editing by Rebecca Flanagan and Kelly Duncan.
