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# Brexit – What You Need to Know

The UK's EU Referendum on membership is looming on the horizon – What are the legal implications of a so-called "Brexit" for banks, funds, insurance and reinsurance companies, payment services providers and other financial services institutions?

The EU Referendum Act 2015 obtained Royal Assent on 17 December 2015 and provides for the following question to be put forward for voting in a referendum in the UK until the end of 2017: "Should the United Kingdom remain a member of the EU or leave the EU?"

During the EU Council Summit of 18-19 February 2016, the Heads of State or Government of the Member States of the European Union (EU) adopted a decision concerning a New Settlement for the UK within the EU and a statement containing a draft Council Decision on specific provisions relating to the effective management of the banking union and of further consequences of further integration of the euro area, as well as an additional Declaration of the European Council and four additional Declarations of the Commission. That decision, the statement and the declarations address the four "baskets" proposed by the British Government for EU reform in its letter of 10 November 2015 to the EU Council. The four baskets deal with economic governance, competitiveness, sovereignty and immigration. The government has determined that the referendum shall take place on 23 June 2016.

What consequences would result from the UK terminating its status as a Member State of the European Union?

## Article 50 of the Treaty on European Union (TEU)

Article 50 (1) TEU provides that each Member State of the EU can decide to cease to be a Member State of the EU. Article 50 (2) TEU provides that the European Council must be notified of a decision to terminate the membership in the EU. Upon receipt of such notification, the EU will negotiate with such Member State "the arrangements for its withdrawal, taking account of the framework for its future relationship". Such agreement on the effects of the withdrawal between the EU and the UK would be adopted with a qualified majority within the Council. Any potential future Association Agreement between the EU and the UK would thereafter need to be adopted with unanimity within the Council, pursuant to Article 218 (8) of the Treaty on the Functioning of the EU (TFEU).

Article 50 (2) TEU does not stipulate the contents of such a withdrawal agreement between the ceasing Member State and the EU. Theoretically, such agreement could provide, for example, for grandfathering rules applying to a specified period of time in relation to previously obtained rights, claims, titles, registrations and licenses of persons and entities domiciled in the UK within the remaining 27 Member States of the EU (and vice versa). It might also provide for the grandfathering of approvals, listings, registrations and licenses and other rights relating to products and services or distribution channels relating to such products and services (e.g. approvals of securities and offering circulars listed at a relevant official market in a Member State) originating in either the UK or the remaining 27 Member States.

Article 50 (3) TEU provides that if no such withdrawal agreement between the ceasing Member State and the EU is entered into, then two years after the receipt by the European Council of the termination declaration, the TEU and the TFEU will no longer apply to the ceasing Member State. Accordingly, in the case of a Brexit, the UK would no longer have the status of a "Member State of the EU" and the persons and companies domiciled in the UK, and the products and services originating from or being distributed through the UK, would no longer have the status of being domiciled in, originating from or being distributed through a Member State of the EU.

Article 50 (3) TEU further provides that the European Council and the ceasing Member State can enter into an agreement which extends such two year period. The two year period would be extended if, as is likely, such extension would be required to base the future UK-EU relationship on a new contractual framework which deals with all the economic and legal consequences of the UK ceasing to be a Member State. There would be various options available for such new framework, which range from a structured and detailed Free Trade Agreement to an Association Agreement (either along the lines of the European Economic Area (EEA) or a more "individualized" version) or a "Swiss Style" bundle of sector-specific arrangements which deal with each sector's specific requirements on a case by case basis.

## Freedom of Movement

Membership in the EU means, in principle, that the persons, entities, companies, products and services which benefit from the membership also benefit from the rights of the free movement of goods, services, capital, establishment and persons.

Such rights of free movement within the EU mean that there is an implied mutual recognition, and that Member States are prohibited from directly or indirectly restricting the sale or distribution of goods and services, the movement of capital or persons, or the establishing of subsidiaries, branches and other establishments by persons and companies domiciled in another Member State.

For example, a financial institution which is established and licensed in the UK cannot be barred from providing its services and products, or from establishing branches or other establishments or subsidiaries, in all the other Member States of the EU. However, if the UK ceased to be a Member State, then each of the remaining 27 Member States could, in principle, prohibit the financial institution established in the UK from doing business within their territories. This would be contrary to the interests of all parties and solutions would have to be found within the context of the Art. 50 TEU negotiations.

## UK Legislation

EU Law primarily exists in the form of the TEU and the TFEU, as well as thousands of Directives and Regulations (so-called secondary EU law). In principle, Regulations are automatically and directly applicable in all Member States of the EU. If the UK ceases to be a Member State, then the existing EU Regulations would no longer be applicable in the UK, unless the UK adopts domestic legislation which provides for a continuation of the application of the relevant Regulations. Directives, however, are not automatically applicable in Member States, but must be implemented by domestic legislation. EU Directives have been implemented in the UK mainly in the form of Statutory Instruments often based on the European Communities Act 1972 or EU secondary legislation. The 1972 Act would have to be amended to ensure that the necessary existing legislation continued to apply.

Accordingly, the relevant legislative bodies of the UK would need to decide, on a case by case basis, how to deal with the relevant legislation following the Brexit, taking into account the negotiation with the EU in respect of the future UK-EU relationship. Some UK legislation provides for the current role of the EU institutions, and decisions would have to be made whether such a role should be maintained or other measures put in place. In this context it should be noted that Schedule 5, Section A3 of the Scotland Act 1998 provides that "Financial Services, including investment business, banking and deposit taking, collective investment and insurance" are a so-called "reserved matter" and can only be legislated on by the UK Parliament in London, not by the Scottish Parliament. Negotiations related to financial services would not, therefore, be complicated by regional interests in the UK.

## Domestic Legislation of the Remaining 27 Member States and the European Central Bank (ECB)

Existing domestic legislation in the remaining 27 Member States of the EU would not be automatically and directly modified following a Brexit. Domestic legislation implementing EU law in the area of banks, funds, insurances, reinsurances, payment services providers and other financial services institutions regularly refers to such institutions and their products being granted mutual recognition and so-called EU Passports, provided that such institutions are situated in a Member State of the EU or the EEA. Once the UK is no longer a Member State of the EU (and thus also no longer a Member State of the EEA), any such reference in the domestic legislation of the remaining 27 Member States of the EU would, subject to any grandfathering rules agreed upon and agreements in respect of the future relationship between the EU and the UK to be negotiated and entered into, no longer be applicable to institutions situated in the UK. In the unlikely event of satisfactory arrangements not being agreed to in the Art. 50 TEU negotiations, the domestic legislators of each of the remaining 27 Member States of the EU would be free to decide how to treat institutions from the UK, and the UK would be equally free to decide how to deal with institutions from the EU.

There would also be a number of more indirect consequences. For example, Section 13 of the German Mortgage Bond Act (*Pfandbriefgesetz*) provides that mortgages are eligible for cover purposes of a German Mortgage Bank if the relevant real estate is situated in the EU, the EEA, Switzerland, the US, Canada, Japan, Australia, New Zealand or Singapore. If, or as long as, the UK is not added to that list by the German legislator after the UK ceases to be a Member State (and one might assume that such adding of the UK by the German legislator would be quite likely in order to protect German *Pfandbriefbanken*), any loans secured by real estate situated in the UK would no longer be eligible for Covered Bond purposes of German Mortgage Banks and would need to be removed from the cover-pool and be replaced by alternative cover assets. Similar rules may apply under the domestic covered bond legislation of other Member States.

Further, Article 55 of Directive 2014/59/EU of the European Parliament, and the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, provides that Member States shall require banking institutions to include in contracts which are governed by a law of a "third country" contractual terms by which the parties to the agreement creating the liability recognise that the liability may be subject to the relevant write-down and conversion powers ("bail-in"), unless the relevant resolution authority of the relevant Member State of the EU has determined that the law of such third country gives otherwise effect to the bail-in. If a Brexit occurred, English law would become the law of a third country (like New York law which currently already is the trigger for bail-in clauses) and all relevant banking contracts governed by English law would need to be amended to include bail-in clauses, unless it is determined by the relevant competent resolution authorities of the remaining 27 Member States that English law recognises bail-in.

The Guidelines of the European Central Bank on the implementation of the Eurosystem monetary policy framework contain extensive requirements for the so-called eligibility of assets for monetary policy operations of the Eurosystem relating to, for example (pursuant to Articles 74 and 75 of such Guidelines), the place of issuance, place of issuer, originator, obligors and guarantors, intermediaries, the governing law of assets and asset transfer agreements, security and underlying instruments being situated in or being governed by the law of a Member State of the EU or EEA. Such requirements would need to be reconsidered by ECB and market participants, if the UK were no longer a Member State and if English law were to be no longer the law of a Member State of the EU or EEA.

## Contractual References to EU Persons, Companies, Products and Services

Facility Agreements and other banking, insurance, reinsurance and financial services contracts may contain references to certain reference entities, counterparties, debtors, obligors, guarantors or other entities, assets, products or services being domiciled in or originating from a Member State of the EU. If the UK ceased to be a Member State such existing contractual arrangements would need to be revisited. Further, other contractual provisions, like termination clauses, increased cost clauses or material adverse change clauses, may be triggered by a Brexit.

If the referendum votes in favour of a Brexit, as explained above, under Article 50 TEU there is no automatic cut-off – i.e. the UK is not immediately outside the EU. Banks, funds, insurance and reinsurance companies, payment services providers and other financial services institutions would need to consider their existing contracts in respect of EU relevant trigger points and keep a close watch on how the UK's relationship with the EU develops through the negotiations and lobby, where necessary.

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