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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Brexit Vote Casts UK Into Regulatory Wilderness

By **Mark Taylor**

Law360, London (June 24, 2016, 2:05 AM ET) -- Lawyers and lawmakers are braced on Friday for uncertainty following the U.K.'s vote to exit the European Union, leaving London to redefine and rewrite its trade and legal ties with the EU, the U.S. and the rest of the world.

The 52 percent to 48 percent vote compels the U.K. to begin a two-year period of complex negotiations with the EU to unravel 43 years of legal, financial and social integration. Its leaders will face other EU leaders who for months have angrily warned against leaving and promised no special treatment once Britain was outside the single market.

The British government has stressed it intends to keep U.K. laws in sync with EU legislation to avoid immediate compliance conflicts. With matters out of its hands, London's financial services industry risks losing its place as the heart of global finance, and U.S. firms reliant on London face regulatory uncertainty and reorganization, as well as staffing and contract issues.

"There will be a lot of folks running around trying to work out the strategy," said Sue McLean, of counsel at the London office of Morrison & Foerster LLP in the technology transactions the global sourcing group. "I was fielding questions from U.S. clients about this and it seemed less likely to happen at one point, but it did start going up the agenda in the U.S. as the vote neared, more people contacting us to ask how it would impact them."

In voting for a "Brexit," Britain has pulled out of the 28-member bloc, the largest free-trade zone in the world, and has put a huge question mark over how global financial companies use the U.K. to access the EU single market. London is the central hub for U.S. and other multinational firms to easily passport services to the bloc's 500 million inhabitants without having to gain complex and costly regulatory approval on a state by state basis.

The passporting regime allows firms to locate and be licensed in London before serving the EU. Those active in financial services and insurance face relocating their London headquarters and applying elsewhere for regulatory approval to serve the bloc.

"Clients have been saying, 'OK we need to be established, we need a presence in Europe, and we want to be able to use the passport. But we'll wait until after the referendum'," said Chris Finney, partner in Cooley LLP's London office and leader of the firm's London financial services and financial technology regulatory practices. "There are too many unknowns for it to make sense to do anything more than that until the beginning of next week. But things will have to change quickly."

U.S. and other foreign banks have warned they will transfer some operations to other EU financial centers to maintain a presence inside the single market. Other countries now face reordering their trade relations with the U.K., which currently is covered by EU trade agreements.

“The fifth-largest economy in the world voting out will cause not only a major shock through the U.K. market but through the world market,” said Jane Jee, of counsel at the London office of Bryan Cave LLP.

The Financial Conduct Authority, Britain’s finance watchdog, and the British Bankers' Association both declined to comment when approached by Law360 on guidance given to firms concerned about the loss of passporting in the event of a Brexit.

Financial services accounts for 7 percent of the U.K. workforce, producing nearly 12 percent of total economic output, adding £66 billion ($96 billion) in taxes and generating a trade surplus of £72 billion ($105 billion), according to a study commissioned by leading think tank TheCityUK. Foreign companies have invested about £100 billion ($145 billion) into the U.K. financial services sector since 2007, with about half of that total coming from the U.S.

Under single-market rules, firms authorized in the U.K. under FSMA can apply to operate in other states located in the European Economic Area, without necessarily having to obtain the necessary regulatory permissions in each of those states.

Without the Financial Services and Markets Act 2000, U.S. multinationals, investment and insurance companies, cross-border payments companies, challenger banks, data and analytics and platforms will no longer be able to rely on London and all its advantages as their steppingstone to the trillion dollar EU market.

Outside the EU, with no guarantee of access to the single market, the FCA would be stranded as a regulator with the highest standards to satisfy but offering little in the way of reward.

“The passporting of banks from U.K. is possible only if we are part of the European Economic Area, and the problem with that is we'd have to adopt all the standards and regulations, but with little input, and it doesn’t really address the problems,” Jee added.

Whether the EU allows Britain-based businesses to continue accessing its single-market from outside the bloc is also now an issue for debate. Senior EU leaders like German Finance Minister Wolfgang Schaeuble have firmly ruled out that possibility. “That won’t work,” he told Der Spiegel magazine earlier in June. “In is in. Out is out.”

Bilateral preferential access to the single market could trigger challenges from world trade partners of the EU, who would protest this preferential treatment under the most-favored-nation principle set by the World Trade Organization.

Should the U.K. not be able to secure preferential access to the EU single market, its commercial relations with the EU will be governed by the WTO rules, which are definitely not as wide in scope as the freedoms within the single market, trade experts warned.

A report by researchers from PricewaterhouseCoopers in April said the gradual erosion of the U.K.’s status as a regional financial center in the event of a Brexit would irrevocably damage the U.K. economy.

JPMorgan Chase & Co chief executive Jamie Dimon warned of job losses in London in the weeks leading up to the vote, as business chiefs repeatedly stressed the importance of the U.K. remaining part of the single market.

“As a business, it will be very challenging for so many,” McLean said. “All the digital single-market initiatives are around harmonization, and it is much easier for a company coming into Europe from the U.S. or Asia knowing that they don’t have to work out 28 different laws.”

While it's almost impossible to predict what would come next, it is likely that the government would do all it could to protect financial services and minimize disruption, she said.

“As we are the financial capital of Europe, we have been so influential and so involved with the regulations that we don't really want to completely rewrite the book,” McLean added.

However some legal experts believe the U.K. can absorb the short term shocks and look to minimize damage. “A vote to leave could have major implications, but I don't think the impact will be as bad as some have made out,” said head of financial services at Baker & McKenzie LLP, Arun Srivastava.

Brexit should not affect business done directly with London from non-EU jurisdictions, such as Asia and the U.S., said Srivastava. “What will be affected is the ability of U.K. firms to do business across Europe on a passporting basis. That is at risk, significant risk.”

U.S and Japanese organizations that have headquarters in London may look to relocate, but right now Paris and Frankfurt, Germany, the likely destinations, would not have the scale to take up London’s mantle.

“That is one of the advantages London has, we have the physical infrastructure, professional services firms, the staff with expert skills, and you cannot re-create that overnight, London will not go away as a global financial center,” he said.

Given more than 80 percent of the firms attending a recent FCA Project Innovate event in London were licensed by the U.K but came from outside its borders, it appears a second Brexit, of financial service firms, may be in the cards.

While today’s vote has triggered major uncertainty, attention now turns to easing the markets and restoring stability. For some, such as Bryan Cave’s Jee, the vote may further spur London to separate from the herd and solidify its place as the world’s financial capital.

“There are so many initiatives going on, the U.S. is so far behind us in terms of government support, establishment support for things like fintech,” she said. “Better to go gung ho than be negative. We live in such an interesting time in the market, it is brilliant.”

--Editing by Patricia K. Cole.