Lex et Brexit — The Law and Brexit

Davis Polk

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Despite the protestations of some, the direction of travel in UK Government thinking seems to be towards the negotiation of a "hard" Brexit, meaning limited market access for services and goods to the EU single market. Attitudes also appear to be hardening in other EU member states: the Italian Prime Minster warned during the past week that it would be impossible for the UK to get special treatment post Brexit as compared with other non-EU states. Some of this may be seen as positioning in advance of the substantive negotiations likely to begin next year, but the hardening of public positions does little to reassure the financial services industry and market participants that a sensible bespoke solution for the UK can be found quickly.

In France, perhaps alone among EU countries, we get a clear sense of one of the French Government's key objectives following the Brexit vote: the supplanting of London's position as Europe's financial center by Paris. In the seventh edition of Lex et Brexit, we look at the recently announced initiative by the French regulators to allow some UK financial services firms to use an accelerated process to obtain French regulatory licences. We conclude that this will be a welcome development for some firms planning their response to Brexit, but that other factors will impact on the ultimate success of this initiative.

We then examine the impact of Brexit on the recently introduced EU Market Abuse Regulation. We conclude that Brexit is unlikely to result in a relaxation of the market abuse regime in the UK in any meaningful way or a substantial mitigation of the Regulation's extra-territorial effects, but there is a possibility that Brexit will allow the UK regulator more freedom to communicate its expectations on market abuse and provide clear guidance to market participants.

French pitch for Paris to become Europe's financial center

Political developments

In the days following the Brexit vote, the Regional Council of the greater Paris region began placing advertisements in the Financial Times and the Wall Street Journal urging businesses to consider investing in the French capital. French efforts to promote its attractiveness to the financial sector have continued since then.

In July, President François Hollande announced that favorable changes to tax regulations applicable to expatriates and French nationals returning from abroad would be forthcoming; these have since been included in the draft 2017 budget. The changes include an extension of income tax relief for repatriation premiums from the current five-year period to an eight-year period and an exemption in respect of these premiums from taxes paid by employers.

In a similar vein, in his speech at the annual conference of France's financial industry lobby Europlace in July, French Prime Minister Manuel Valls confirmed that France "wants to build the financial capital of the future" and stated that the Government would be establishing an administrative contact, in languages other than French, for foreign firms seeking to establish themselves in France. The President of the Regional Council of the greater Paris region has unambiguously stated a desire to "make Paris Europe's top financial center".

French regulators have begun issuing statements in support of this political vision, proposing an accelerated licensing regime for certain UK firms wishing to set up a regulated firm in France.

Passporting – a reminder

Financial institutions established in European Economic Area (the "**EEA**") member states can obtain a "passport" that allows them to access the markets of other EEA member states without being required to set up a subsidiary and obtain a separate license to operate as a financial services institution in those member states.

Unless the UK successfully negotiates a solution during the Brexit negotiations (such as retaining membership of the EEA), UK financial services institutions, including subsidiaries of US and other non-EU parent companies, will no longer benefit from the financial services passport after Brexit. In this scenario, the UK would be a "third country" in EU regulatory parlance, meaning that it would face a different set of rules, requirements and obstacles in accessing the EU market. While the concept of a third country passport exists in some EU financial services legislation (most notably the Markets in Financial Instruments Regulation), we consider that there are considerable practical and timing obstacles to this being a reliable method for providing financial services from the UK into the EU. These obstacles were discussed further in the **first issue of Lex et Brexit**.

If an EU or third country passport is not available or is considered impractical, the process of obtaining separate authorization in a remaining EU member state, or amending or upgrading an existing license in such a member state, has been perceived to be time-consuming and costly. Costs could include moving people and infrastructure to the new site and legal and compliance expenses in setting up or expanding a subsidiary, as well as an increase in the amount of capital needed to support the group's operations within the EU.

In France, the current approval timeline for the authorization of financial institutions and Financial Technology ("**FinTech**") firms typically ranges from three to five months. The application process includes the submission of the firm's by-laws, three years of financial statements and information relating to the firm's managers, management bodies and investors. This information would usually need to be provided in French, in the form required by the French regulators.

A fast lane for some British corporate citizens – action by the French regulators

On September 28th the **ACPR** (*l'Autorité de Contrôle Prudentiel et de Résolution* - the French banking regulatory authority) and the **AMF** (*l'Autorité des Marchés Financiers* - the French securities regulator), issued joint press releases stating that they would be implementing a simplified approval process for certain financial institutions and FinTech firms currently established in the UK that benefit from passporting to provide services to EU member states, if such firms were to submit a request to relocate their activities to France.

The list of financial institutions includes insurance companies, investment firms, payment institutions or electronic money institutions but excludes, at least for the moment, credit institutions supervised by the European Central Bank (presumably because the French regulator would not have the ability under the Single Supervisory Mechanism to speed up ECB prudential assessments in the authorization process). The approval process would be expedited primarily through the use of documents in English previously provided to the UK regulator(s) and through the appointment of a single English-speaking administrative point of contact representing both the ACPR and the AMF, called a “coach”, whose responsibility would include assisting institutions in understanding applicable regulations, guiding firms through the process and answering any questions prior to, during, and for up to six months following, the approval process.

Although the press releases didn’t clarify the timeline of a simplified approval for financial institutions, they stated that FinTech and some management firms (including, for example, robo-advisors and crowdequity funds), authorized by the UK Financial Conduct Authority (the “**FCA**”) would receive a “pre-authorization” in as little as two weeks, allowing such firms to begin preliminary work related to their relocation to France. The authorization allowing access to a complete EU passport would follow two months later, pending satisfaction of the relevant requirements.

The coordination between the ACPR and the AMF in relation to FinTech firms will be overseen by the new FinTech, Innovation and Competitiveness Division created by the AMF, whether coincidentally or not, in June of this year.

An interesting side issue also arises as to whether French regulators might be willing to extend this regime to other non-EU countries which have regulatory regimes which broadly mirror the EU regime (e.g. Switzerland).[1] Furthermore, to the extent this priority treatment is given to UK firms before Brexit, there are questions to be asked as to whether other EU member states would demand a similar treatment for their financial services firms, in line with the general principle in EU law of non-discrimination between member states.

Prospects for success

Clearly, the introduction of a new, accelerated process for the licensing of smaller UK investment firms, insurers, asset managers and FinTech firms is a welcome development for firms planning their response to Brexit. This is a bold move by the French state to try to steal a march on other EU financial centers in attracting UK financial services businesses. It is also well timed, given the current direction of travel in the UK Government seems to be towards a “hard Brexit” with limited market access for UK financial services firms.

That said, the process may not be appropriate for the larger international investment banks based in London, especially those that are credit institutions for the purposes of the Capital Requiements Directive. Furthermore, regulatory authorizations are only one part of the financial services and technology ecosystem which makes London a financial and FinTech hub. Other factors will be in play and, while the initiative is noteworthy, its ultimate success remains to be seen.

[1] It will also be interesting to see if other EU jurisdictions seek to follow the French lead and try to set up similar fast lanes for UK firms wishing to move their operations within the EU.

A regime with sticking power: the EU Market Abuse Regulation

What is the Market Abuse Regulation?

Since July 3, 2016, the Market Abuse Regulation ("**MAR**") has applied across the EU, replacing the previous market abuse regimes that existed in EU Member States and applied only to instruments traded on EU regulated markets.

For the first time, the EU market abuse regime also applies to issuers with financial instruments, such as debt securities, admitted to trading (or for which a request for admission to trading has been made) on a multilateral trading facility ("**MTF**"). Examples of MTFs include Luxembourg's EURO MTF and Ireland's Global Exchange Market, where many US issuers have listed their euro-denominated debt, and which were previously unregulated and not subject to the EU market abuse regime. MAR will also apply to derivatives or other instruments whose price or value depends on or has an effect on the price of a financial instrument referred to above, regardless of where those related instruments are traded. This last category of instruments potentially widens the scope of MAR even further, to include instruments traded outside the EU which could have a price effect on the instruments admitted to trading on an EU exchange.

As a result, the new EU market abuse regime prohibits insider dealing, unlawful disclosure of inside information and market manipulation in respect of a much wider range of securities. The new regime also provides for a range of obligations on issuers and, in certain cases, those institutions who act on their behalf.

In practice, the implementation of MAR has not been without its teething difficulties. In particular, the new regime for "market soundings" appears to have wide extra-territorial effects, requiring non-EU issuers to comply with prescriptive rules on communications to investors in connection with capital markets activity.

Key obligations

Disclosure of inside information

An issuer with securities admitted to trading on an EU regulated market was, under the old regime, under an obligation to disclose inside information to the market as soon as possible, except where it was in the issuer's legitimate interests for disclosure to be delayed. This obligation is retained under MAR but is now extended to a much wider range of trading venues. The legislation also contains a new requirement for an issuer to inform the national regulator of the trading venue of any such delay and issuers must also retain a record of how they determined that the delay in disclosure was in their legitimate interests. In addition, MAR provides that, once disclosed, inside information must be available to the public on the issuer's website for five years.

Control of inside information and insider lists

MAR also requires an issuer to maintain, in a prescribed format, insider lists detailing those persons working for it (either inside or outside the business) who have access to inside information relating directly or indirectly to it. MAR secondary legislation sets out the precise content of the insider lists which must be kept in electronic form. Detailed templates for the lists are also set out in this secondary legislation. Issuers may keep two separate lists: a list of permanent insiders (typically consisting of senior managers and directors) and a project specific list.

MAR also introduces a new and detailed regime for wall-crossings, now known as "market soundings" (described below).

PDMR dealings

MAR requires persons discharging managerial responsibilities ("**PDMRs**"), as well as persons closely associated with them, to disclose to the issuer and the national regulator certain notifiable transactions in the issuer's financial instruments. The issuer must ensure that any such notification is also disclosed to the EU market. Although the PDMR notification regime was a feature of the former regime applicable to regulated markets, MAR introduces material changes, such as a reduced time limit for notifications of three business days (previously four business days).

In addition, MAR generally prohibits PDMRs from dealing when in possession of inside information or in a "closed period," i.e. thirty days before an announcement of interim or annual results.

While the inside information disclosure regime referred to above applies only in respect of information which is inside information in relation to the securities admitted to trading on an EU trading venue, the European Securities and Markets Authority (the "**ESMA**") and certain member state regulators have expressed the view that the PDMR restrictions apply to all securities of an in-scope issuer, regardless of where, or indeed whether, those securities are listed or traded.

Market soundings

What is a market sounding?

"*A market sounding comprises the communication of information, prior to the announcement of a transaction, in order to gauge the interest of potential investors in a possible transaction and the conditions relating to it such as its potential size or pricing, to one or more potential investors by: (a) an issuer; (b) a secondary offeror of a financial instrument; (c) an emission allowance market participant; or (d) a third party acting on behalf or on the account of a person referred to in point (a), (b) or (c)*" (Article 11(1), MAR).

Where sounding-out investors involves disclosure of inside information, the issuer can benefit from a "safe harbor" in relation to the unlawful disclosure offence where it follows a specific market sounding procedure and maintains certain records.

In particular, a disclosing market participant (i.e., a person who falls into any of the categories set out in points (a) to (d) of the definition above) (a "DMP") must, *inter alia*: (i) determine whether information disclosed is inside information and keep written records of that determination; (ii) keep records in relation to the disclosure of the information; (iii) inform the recipient as soon as possible once the information ceases to be inside information; (iv) keep records of the disclosure process for five years; and (v) inform the market participant that, by agreeing to receive the information, he is obliged to keep the information confidential.

Although the clear policy focus of the market soundings regime is on the selective disclosure of inside information, a market sounding can also encompass situations where no such disclosure occurs prior to the announcement of a transaction (e.g. in a roadshow where only public information is disclosed).

Market impact of the new regime

The new, wider scope of the EU regime means that many non-EU issuers and their financial advisors are struggling to determine when and how they should apply the market sounding provisions in practice. This is particularly the case in the debt capital markets space, where market practice was previously to hold meetings and roadshows with potential investors on a "non-wall crossed basis" (i.e. without the disclosure of any non-public information and without mentioning a potential deal). These meetings, even when outside the EU with non-EU investors in relation to a non-EU company, are potentially in scope of the market sounding regime where the issuer has any securities admitted to trading on an EU trading venue. Until clarification is provided by ESMA or a prominent member state regulator, issuers and syndicate banks will continue to struggle to determine MAR's perimeter and how the market sounding rules should be applied.

The effect of Brexit

In the immediate aftermath of the Brexit vote, the FCA reminded market participants that the UK remained a member of the EU and that MAR would apply from July 3, 2016 as planned. At first glance, if the UK were to leave the EEA, it would appear that there would be a significant opportunity to streamline and clarify the MAR rules in so far as they apply to issuers with securities admitted to trading on UK markets. In the event of a Brexit where the UK does not maintain EEA membership, the UK would have to create new laws to replace MAR – the UK would appear be free to start from scratch when creating a new market abuse regime.

In practice, however, we expect the impact of Brexit to be minimal in the market abuse space, for the following reasons:

- In most Brexit scenarios involving the UK becoming a third country, the UK will wish to maintain a form of equivalency to EU regulation in this area. Although there are no broad third country equivalency measures contained in MAR, in practice, the UK Government and the FCA will wish to maintain a broadly harmonized regime. This is because there may be an overlap with other financial sector EU laws which do contain third country passport or market access equivalency provisions (on which, please see the **first**, **third**, **fourth** and **fifth** issues of Lex et Brexit); in order for ESMA and the European Commission to determine equivalence for the purposes of this other legislation, it is conceivable that they would assess the equivalence of the laws the UK has in place to combat market abuse.
- Furthermore, the FCA will wish to maintain inter-operability, information sharing and other linkages with EU market regulators provided for under MAR in order to be able to continue to effectively police the UK markets. EU regulators will also have a similar desire to maintain the current harmonized framework, e.g. for the reporting of suspicious transaction reports or the maintenance of insider lists.
- Much of MAR builds on the UK experience of tackling market abuse through its implementation of the original Market Abuse Directive. Together with the reforms to the Markets in Financial Instruments Directive, the UK was a driving force in trying to modify market regulation to match recent developments in trading and the proliferation of new trading venues. It is unlikely, therefore, that there would be much political or regulatory will to roll back the more onerous provisions of MAR (e.g. reverting back to a regime that focused on trading on regulated markets only). Indeed, it would appear to be politically risky for the UK Government to be seen to relax a regime which targets, *inter alia*, insider trading and market manipulation. In market terms, a significant divergence from EU norms might also damage investor confidence in the UK markets.
- Even if the UK were to streamline, simplify or strip-down MAR when designing its new UK specific market abuse legislation, we consider that the effects of doing so would be relatively limited for EU and non-EU market participants. In the case of issuers in the US and Asia, the most relevant EU markets triggering the additional requirements of MAR are located outside the UK, in Luxembourg and Ireland. The group of US companies with their only current EU listing in the UK is a very small one. Furthermore, the investment banks offering underwriting services in London will continue to service many issuer clients who are likely to have an EU listing of securities; MAR will remain applicable to these banks when they act on behalf of such issuers.

But…

All of that said, Brexit will provide an opportunity for the FCA to provide detailed guidance on the scope and application of the market abuse regime. The FCA and its predecessor, the FSA, used to provide this in a wide ranging Code of Market Conduct, contained in its Handbook of rules and guidance. This Code provided details of the relevant safe harbors from the market abuse offences and examples of the types of behaviour which constituted market abuse under the implementation of the old Market Abuse Directive in UK law. With the advent of the directly applicable (meaning it did not have to be implemented into national law) MAR, the FCA was required to pare down the Code of Market Conduct considerably. The FCA is not permitted to provide detailed guidance that risks going beyond the EU harmonized rules set out in MAR and associated secondary legislation. In practice, guidance on the scope and application of the MAR rules is now the primary responsibility of ESMA. When the UK exits the EU, it may be possible for the FCA to reinstate a more detailed version of the Code of Market Conduct – this could be particularly helpful in helping to resolve some of the areas of legal uncertainty in the MAR regime, even if the UK legislation and related rules are likely to be similar in function and appearance to MAR.

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A regime that is here to stay

In the three months since it began to apply in the EU member states, MAR has had a material impact on the way that the global capital markets work. The UK government and regulator has, for the most part, bought into the new regime and expects UK market participants to comply with it. We do not expect Brexit to result in a relaxation of the market abuse regime in the UK in any meaningful way or to mitigate MAR's extra-territorial effects, but we can at least hope that Brexit will allow the UK regulator more freedom to communicate its expectations on market abuse and provide clear guidance to firms; to paraphrase the Brexit campaign's most effective slogan, the FCA can "take back control" of the market abuse regime in the UK.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Thomas J. Reid	**+1 212 450 4233**	tom.reid@davispolk.com
John D. Amorosi	**+1 212 450 4010**	john.amorosi@davispolk.com
John Banes	**+44 20 7418 1317**	john.banes@davispolk.com
Leo Borchardt	**+44 20 7418 1334**	leo.borchardt@davispolk.com
Kirtee Kapoor	**+1 650 752 2025**	kirtee.kapoor@davispolk.com
Will Pearce	**+44 20 7418 1448**	will.pearce@davispolk.com
Simon Witty	**+44 20 7418 1015**	simon.witty@davispolk.com
Christophe Perchet	**+33 1 56 59 36 50**	christophe.perchet@davispolk.com
Jacques Naquet-Radiguet	**+33 1 56 59 36 20**	jacques.naquet@davispolk.com
Amy T. Alter	**+33 1 56 59 36 09**	amy.alter@davispolk.com
Juliette Loget	**+33 1 56 59 36 21**	juliette.loget@davispolk.com
Michael Sholem	**+44 20 7418 1027**	michael.sholem@davispolk.com

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