Lex et Brexit — The Law and Brexit

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January 30, 2017 ISSUE 10

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In the last few weeks, some welcome clarity has finally been introduced on the UK side of the Brexit negotiations. In her speech on January 17, 2017, the UK Prime Minister confirmed that the UK will not seek to remain a member of the single market and would not accept any role in the UK for the Court of Justice of the European Union ("**CJEU**") after Brexit. Although her speech was somewhat vague on the specifics of the free trade deal that the UK will seek during the Brexit negotiations, we now know that the UK and the EU will experience a relatively 'hard' Brexit; this could have material implications for those providing financial services in the EU from the UK.

In this issue of Lex et Brexit, we look at another area in UK politics where some clarity has emerged. On January 24, 2017, by a majority of 8 - 3, the UK Supreme Court (the "**Court**") held that UK government ministers (the "**Government**") cannot deliver the notice required to leave the European Union (the "**EU**") without prior authorization through a UK Act of Parliament. The Court also unanimously held that there is no requirement for the consent of the devolved UK legislatures (i.e., the legislatures of Scotland, Northern Ireland and Wales) in order to serve the notice.

This judgment means that all members of Parliament will now have the ability to debate the legislation authorizing the UK's withdrawal from the EU. It also provides the opportunity for Parliament to introduce amendments to the authorizing legislation, which could in theory, but subject to political constraints, impose limitations on the process or even substance of the UK's Brexit negotiations.

We then examine the implications of Brexit for administrators of benchmarks and how Brexit might affect the implementation of the new EU Benchmarks Regulation. We then outline the different approaches available to UK-based providers of benchmarks post-Brexit if they wish to offer their benchmarks to EU financial institutions, before concluding that Brexit may add significant cost and complexity to the task of complying with the new Regulation.

UK Supreme Court Judgment – the *Miller* Case

Introduction

On January 24, 2017, by a majority of 8 - 3, the Court held that the Government cannot deliver the notice required to leave the EU without prior authorization through a UK Act of Parliament (legislation passed in both Houses of Parliament and assented to by the Queen). The Court also unanimously held that there is no requirement for the consent of the devolved UK legislatures (i.e., the legislatures of Scotland, Northern Ireland and Wales) in order to serve the notice.

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The Court's judgment in *R (Miller and Santos) (Respondents) v Secretary of State for Exiting the European Union (Appellant)* (the "***Miller*** **Case**") can be found **here**. The press summary can be found **here**.

Context

On June 23, 2016, the electorate of the UK voted by a majority through referendum in favour of the UK leaving the EU. Article 50 of the Treaty on European Union ("**TEU**") states that an EU member state may withdraw from the EU 'in accordance with its own constitutional requirements' and that a member state which opts to withdraw must notify the European Council of its intention (the "**Notice**"). Under the TEU, service of the Notice triggers a two-year period (unless all member states unanimously decide to extend this period) in which to negotiate a withdrawal agreement, at the end of which the relevant member state will exit the EU, whether or not a negotiated withdrawal agreement is in place.

> ". . . when ministers give Notice they will be 'pulling . . . the trigger which causes the bullet to be fired, with the consequence that the bullet wiill hit the target and the [EU] Treaties will cease to apply'."
>
> *Paragraph 36 of the judgment, quoting Lord Pannick QC in oral argument for Mrs Gina Miller*

There is significant political disagreement in the UK over the substance of any withdrawal agreement. In particular, disagreement exists over the extent to which the UK should be permitted to retain membership of, and access to, the European single market and the extent to which the UK should have to comply with EU laws, regulations and rules, including free movement of EU citizens. These matters were not addressed by the simple in/out referendum question. Accordingly, it is perhaps unsurprising that there is some concern that the withdrawal and negotiation process initiated by the Government serving the Notice should not begin until Parliament has at least been consulted.

On November 3, 2016, the High Court of Justice of England and Wales (the "**High Court**") ruled that the Government could not use its executive powers (the "**Royal prerogative**") to trigger the Notice (Davis Polk's summary of that decision can be found **here**). The Government immediately appealed the decision and, in a 'leapfrog' over the UK Court of Appeal, the case was brought before a full bench of all eleven Justices of the Court in early December 2016.

The Decision

Legislative authority required for the Notice

Unlike the United States, the UK does not have a written constitution, but rather the UK's constitutional arrangements have developed over centuries through statute, events, conventions, academic writings and judicial decisions. The *Miller* Case centered on the interplay between two features of the UK's constitution: (i) the Government generally enjoys a power under the "Royal prerogative" to enter into and to terminate international treaties without recourse to Parliament; but (ii) Parliamentary sovereignty, the bedrock of the UK constitution, means that the Government is not normally entitled to exercise any power it might otherwise have under the Royal prerogative if it results in a change in UK domestic law (unless Parliament specifically provides that power).

The majority of the Justices (with three Justices dissenting) decided that the Government could not issue the Notice using the Royal prerogative without prior authorisation from Parliament. The Notice (as was accepted by all parties) is the stage at which the 'trigger will be pulled' for withdrawal from all EU treaties, and as the European Communities Act 1972 made EU law a direct and overriding source of UK law, withdrawing from those treaties will constitute a fundamental change to the UK's constitutional arrangements and a curtailment of domestic legal rights of UK residents. As such, the Court found that it is Parliament, and not the Government, that must initiate that change.

However, the Court was careful to stress that the only legal question the Court was considering was whether the Government has the constitutional authority to cause this change in law without Parliamentary approval. It did not opine on the wisdom or terms of withdrawal, timetable or the necessary content of the Act of Parliament authorizing that withdrawal.

No consent rights of devolved legislatures

Devolved powers in the UK were afforded to the governments of Scotland and Northern Ireland in 1998 and Wales in 2006. The devolution settlements authorise the legislatures of Scotland, Northern Ireland and Wales to legislate on issues of local significance such as agriculture, education and local government, but reserve certain powers, such as foreign policy and defence, for the UK Parliament. The devolution settlements were conducted on the basis that the UK would be a member of the EU, but the Court unanimously held that the settlements did not require the UK to continue as an EU member state, and there is no parallel competence of the devolved legislatures in respect of withdrawal. The Court also noted a political convention of seeking consent of the devolved legislatures before legislating at a UK level on matters within devolved competences, but determined that the courts are 'merely observers' to such political conventions, which are not justiciable by the courts.

Consequences

On January 26, 2016, the Government published the European Union (Notification of Withdrawal) Bill (the "**Bill**"). In a statement to Parliament, Secretary of State for Exiting the European Union, David Davis, noted that Parliament should 'rightly scrutinise and debate' the Bill, but cautioned against making the Bill a 'vehicle for attempts to thwart the will of the people'.

His warning stems from two concerns: (i) a number of MPs have indicated that they will vote against the Bill entirely (although it is unlikely that the Bill will not be passed given a Government majority in the House of Commons and an indication by the Opposition leadership that it will not oppose its passage); and (ii) the ability of Parliament to legislate has provided Parliament with the opportunity to require greater Parliamentary scrutiny in respect of the negotiations for withdrawal. However, the Bill published on January 26, 2016 contains just two clauses and less than 140 words (see inset), and the House of Commons has only been granted five days to debate the Bill. It therefore remains to be seen what conditions Parliament can pratically impose. In particular, it is not clear that the Government will publish a proposed policy paper building on the Prime Minister's recent speech (in which she confirmed that the Government will not seek continued membership of the European single market) before the Parliamentary debates on the Bill occur.

A BILL TO

Confer power on the Prime Minister to notify, under Article 50(2) of the Treaty on European Union, the United Kingdom's intention to withdraw from the EU.

Be it enacted by the Queen's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows:—

1 Power to notify withdrawal from the EU

(1) The Prime Minister may notify, under Article 50(2) of the Treaty on European Union, the United Kingdom's intention to withdraw from the EU.

(2) This section has effect despite any provision made by or under the European Communities Act 1972 or any other enactment.

2 Short title

This Act may be cited as the European Union (Notification of Withdrawal) Act 2017.

Looking Forward

The Government has indicated that they intend to give Notice in March 2017, though the nature of the Parliamentary process may delay the timeline, especially if heavy amendments are made to the Bill.

Outside England, the battle over Brexit will continue in various forms. The Scottish First Minister, Nicola Sturgeon, has suggested that a second Scottish referendum on independence is 'undoubtedly' closer following the devolution decision by the Court. A legal challenge emanating from Dublin has also been initiated, which is designed to force the CJEU to rule on whether the Notice is irrevocable (a position that both parties accepted in the *Miller* Case). If the Notice is deemed revocable by the CJEU then it would potentially enable the UK to reject the outcome of Brexit negotiations, should they not prove acceptable to Parliament or voters, and remain in the EU.

The Court judgment in the *Miller* Case has provided greater clarity on the involvement of Parliament and the devolved legislatures in the first stage of the Brexit process. As noted above, greater clarity on the Government's negotiating position is also expected as, following demands from the major political parties, the Government has agreed to publish an official policy document outlining its formal plan for Brexit (although commentators suggest that it is likely simply to reiterate the UK Prime Minister's desire for a 'hard Brexit' – that is, a complete break with the EU and the single market). However, the road to withdrawal continues to be unclear, with competing views on the appropriate style of exit in the UK and across Europe, meaning that the negotiation of the withdrawal agreement is likely to be fraught with political and (potentially) legal difficulties.

What will Brexit mean for benchmark administrators in the UK?

The EU Benchmarks Regulation (the "**BMR**") will establish a new European regulatory regime for benchmark administrators. The European Commission published its original proposal for the BMR in 2013 following the settlements reached by regulators with a number of banks concerning the manipulation of the LIBOR and EURIBOR interest rate benchmarks. The European Commission's stated aim was to limit the risks of future manipulation by improving the way in which benchmarks are produced and used, and to consequently protect investors and consumers (it has been estimated that contracts with an outstanding value of at least $300 trillion reference LIBOR alone). Benchmarks affected by the BMR play a fundamental role in the operation of global financial markets, and the European Commission has cited estimates "that the value of financial instruments and contracts referenced by benchmarks exceeds 1,000 trillion euro".

A benchmark for the purposes of the BMR is consequently defined widely, and encompasses a broad range of indices including (amongst others) interest rate benchmarks, commodity benchmarks and more bespoke strategy indices. Administrators will be caught by the BMR where indices they produce are referenced in EU-traded instruments or EU regulated consumer loans/mortgages, as well as where they are used by EU investment funds to measure performance.

The BMR imposes an authorisation requirement for EU benchmark administrators, in addition to conduct and governance requirements. The majority of its provisions will apply from 2018 and administrators currently providing benchmarks in the EU are required to apply for authorisation under the BMR by 1 January 2020.

Whilst this means that UK benchmark administrators should not, on the current Brexit timetable, need to apply for regulatory permissions under the BMR (although they may well need to do so under equivalent UK measures), they will not wholly dodge the BMR bullet as the conduct and governance requirements in the BMR will apply from next January. Moreover, for administrators wanting to provide their benchmarks for use in the EU post-Brexit, the position is by no means straightforward. Here, we consider the options that will be available to UK-based benchmark administrators post-Brexit.

Restrictions on use of benchmarks in the EU

If, as seems increasingly probable, the UK does not maintain EEA membership following Brexit, the UK would become a "third country" for the purposes of the BMR.

The BMR provides that, from January 2020, EU financial institutions will only be able to use a benchmark produced by a third country administrator in the European Union if: (i) the benchmark administrator is included in the register of third country administrators maintained by the European Securities and Markets Authority ("**ESMA**") (based on equivalence); (ii) where no equivalence decision has been made, the third country administrator is "recognised" under the BMR; or (iii) the benchmark has been endorsed by an EU financial institution (which could be an EU benchmark administrator).

Use for these purposes includes issuing a financial instrument or being party to a financial contract that references the benchmark (and calculating amounts payable under any such instruments/contracts), as well as using a benchmark to measure the performance of an investment fund.

Registration based on equivalence

A third country administrator is permitted to provide benchmarks in the EU if it is included in the register of third country administrators maintained by ESMA. In order to be included in the register: (i) the European Commission must have adopted an equivalence decision recognising the regulatory framework in the third country as equivalent to the requirements of the BMR; (ii) the administrator must be authorised or registered and subject to supervision in that third country; and (iii) co-operation arrangements must be in place between ESMA and the third country regulatory authority. European Commission equivalence decisions may apply generally in respect of benchmark administrators in a third country, or to specific administrators and benchmarks.

Whilst obtaining an equivalence determination from the European Commission may seem straightforward given the UK's involvement in the development of the EU regulatory regime, the uncertainty of the timing and scope of any such determination is likely to give benchmark administrators some concerns around relying solely on these provisions for their post-Brexit plans (please see the **first issue of Lex et Brexit** for our thoughts on the potential pitfalls of relying solely on equivalence mechanisms in EU financial services legislation). In the case of the BMR, any concerns around the timing of an equivalence decision are less acute than might otherwise be the case as the unfettered use of third country benchmarks in the EU is permitted in the absence of an equivalence decision (and in the absence of recognition/endorsement) until January 2020.

That said, there does remain some uncertainty around whether the UK's regulatory regime will be deemed equivalent to the BMR following the UK's withdrawal from the EU. The announced intention of the UK Government is to preserve all pre-Brexit day EU law in force in the UK and carry over into UK law the full body of EU law not already implemented in UK domestic law. The intention is then for the UK to change these laws as necessary over time. Given that Brexit day will likely take place after the go-live date for the BMR, one could reasonably expect UK law to be equivalent to the BMR.

Recognition

Until an equivalence decision has been made, the BMR allows third country administrators to obtain "recognition" in their "Member State of reference" and, on the basis of that recognition, provide benchmarks in the EU. Recognition applies to the administrator meaning that, once recognised, an administrator will be permitted to provide all of its benchmarks in the EU. This is in contrast to the endorsement approach which, as explained below, applies on a benchmark-by-benchmark basis.

A first step for third country benchmark administrators looking to rely on the recognition regime is to determine their member state of reference. Where an administrator is part of a group containing one or more EU financial institutions, the member state of reference is the country where the highest number of EU financial institutions are located, with ties being resolved by reference to the value of contracts and funds using the third country administrator's benchmarks. For these purposes, a financial institution includes an EU authorised benchmark administrator meaning that, for some UK groups post-Brexit, it may be possible to select the member state of reference by incorporating one or more benchmark administrators in that jurisdiction and transferring part of the benchmark business to those entities. A key consideration if adopting this approach would be the need for sufficient business to be transferred to the newly-incorporated EU entity to justify its authorisation as a benchmark administrator – there will be a balance to be struck between the expectations of EU national regulators and the desire to minimise the amount of business transferred. If the administrator is not part of a group containing EU financial institutions, the member state of reference is determined by reference to the value of contracts and funds referencing the benchmark and the location of benchmark users.

Once the member state of reference is determined, the third country administrator must apply for recognition from the relevant regulatory authority in that member state. In order to obtain recognition, the following conditions must be met: (i) the administrator must comply with the majority of the conduct and governance requirements established in the BMR; (ii) if the third country administrator is subject to supervision in its home jurisdiction, there must be a cooperation agreement in place between the regulator in the member state of reference and the regulator in the administrator's home jurisdiction; and (iii) the administrator must appoint a financial institution established in its member state of reference (which could include an EU authorised benchmark administrator) as its legal representative to act on its behalf vis-à-vis EU regulatory authorities and other EU persons. That legal representative must, together with the third country administrator, perform the oversight function relating to the benchmark administration process. This latter requirement could present a barrier to the use of the recognition by UK groups post-Brexit. In particular, UK groups will need to find (or establish) an authorised person in their member state of reference that is willing and has the expertise to oversee the benchmark determination process. UK administrators may not be willing to cede part of the control over the benchmark determination process to another EU entity, particularly if the administrator is subject to a separate UK regulatory regime that may gradually diverge from the BMR.

Endorsement

The final option for third country administrators under the BMR is endorsement. Endorsement applies to specific benchmarks and not to administrators more generally, meaning that administrators looking to rely on endorsement to provide their benchmarks in the EU would need to apply for endorsement each time a new benchmark is created and marketed in the EU.

The endorsement regime provides that an EU financial institution (including an authorised benchmark administrator) can apply to its regulator to endorse a benchmark provided by a third country administrator for use in the EU. A number of conditions must be fulfilled for the endorsement regime to be available, namely: (i) the EU financial institution must have a clear and well-defined role in the control or accountability framework of the third country administrator; (ii) the endorsing EU institution must have verified and be able to demonstrate on an ongoing basis that the provision of the benchmark complies with standards at least as stringent as those in the BMR (and will be on the hook with EU national regulators for any non-compliance); (iii) the endorsing institution must have the necessary expertise to monitor the provision of the benchmark; and (iv) there must be an objective reason requiring the provision of the benchmark in the third country and its endorsement for use in the EU.

The first three conditions will raise similar concerns to those mentioned in relation to the recognition regime, i.e. it may be problematic for administrators to find EU institutions willing and able to endorse their benchmarks and/or to embed those endorsing institutions into their control frameworks. That said, we expect that the final requirement for an "objective reason" is likely to impose the highest hurdle for some administrators.

The BMR itself does not provide any guidance on what amounts to an objective reason, although the European Commission is empowered to adopt delegated acts expanding on the requirement. In November 2016, ESMA provided technical advice to the European Commission on the content of those delegated acts and, in particular, conditions that regulators may assess when considering if there is an objective reason for the provision of a benchmark in a third country.

ESMA is clear that the assessment of whether there is an objective reason should reflect that the BMR primarily prescribes equivalence and, in the absence of an equivalence decision, recognition for the provision of third country benchmarks in the EU. The criteria set out in ESMA's technical advice reflect this emphasis, and our expectation is that third country administrators will only be able to persuade EU regulators that an objective reason exists in limited circumstances.

The ESMA advice discusses a number of factors that should be considered by regulatory authorities in assessing whether an objective reasons exists including geographic proximity; specific skills and expertise required in the provision of the benchmark; and legal constraints. Avoiding additional costs does not, alone, amount to an objective reason, although in ESMA's opinion cost savings could support an application for endorsement if the cost reducing effects would be "*significantly advantageous to benchmark users*".

Practical implications

It may be the hope of many UK benchmark administrators that, by January 2020, an equivalence determination will have been made by the European Commission. However, such a determination may not be the panacea that it appears – even if an equivalence determination has been made, UK benchmark administrators will only be able to rely on the determination to provide their benchmarks in the EU if they are authorised and subject to supervision in the UK under the UK's incorporation of the BMR post-Brexit. In addition, once an equivalence determination has been made administrators will be unable to rely on the recognition regime.

Neither the recognition regime nor the endorsement regime are without complications. Endorsement relates only to specific benchmarks (creating a compliance and administrative costs for each new benchmark marketed in the EU) and requires an objective reason for the benchmark to be provided by an administrator based outside the EU. A UK benchmark administrator looking to rely on either regime will also be faced with the difficulty of finding an appropriately authorised EU entity with sufficient expertise to be involved in the benchmark determination process, and for certain more specialised indices, such as bespoke strategy indices, that may be easier said than done.

Given the likely reluctance of UK administrators to involve a third party in their oversight and control framework, particularly where they are subject to a domestic UK regulatory regime, we expect that UK administrators looking at the recognition and endorsement regimes will be considering whether they should transfer some of their business to an EU administrator which would be authorised under the BMR. That authorised administrator could act as a legal representative for the purposes of the recognition regime or as an EU-endorser of benchmarks produced by the UK firm. A key consideration will be how much of the administration business needs to be transferred to that new EU entity to justify its authorisation as an administrator and how much of the operations can remain in, and/or be outsourced to, the UK – much may depend on the approach of individual EU regulators to authorisation requirements under the BMR.

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