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BREXIT HAS HAPPENED - SO WHAT NEXT FOR DEBT CAPITAL MARKETS?

Beyond Borders – Part of the Horizon Scanning series

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One month ago, at 11:00 pm on New Year's Eve, the Brexit implementation period ended and the UK left the EU single market. The Trade and Cooperation Agreement between the UK and the EU that has applied since then does not deal with the regulatory detail of cross-border capital markets transactions. In this briefing we explain how market participants are navigating the different UK and EU regimes for debt capital markets.

The parallel, but distinct, EU and UK regulatory frameworks for DCM

EU single market regulation relevant to the debt capital markets (including the EU Prospectus Regulation, EU MAR and the EU Transparency Directive) lives on, and continues to apply to offers of securities made to EEA investors and admissions of securities to EEA trading venues.

Offers of securities made to UK investors or admitted to UK trading venues are no longer directly subject to EU single market regulation, but are instead subject to the parallel, but distinct, UK Prospectus Regulation, UK MAR and the UK transparency regime. These are 'on-shored' versions of EU laws, a new body of UK domestic law known as 'retained EU law', created under the European Union (Withdrawal) Act 2018 (the 'EUWA').

Key points

- Since the end of the Brexit implementation period, EU regulation impacting DCM and UK regulation impacting DCM are two parallel, but distinct regimes.
- The pan-European wholesale debt capital markets continue, despite Brexit. The impact of Brexit is felt in drafting and disclosure, rather than in market access or transaction structuring.
- The pan-European retail debt market continues to be a niche product, facing considerable regulatory obstacles. The absence of effective equivalence mechanisms is an additional obstacle.
- At present, the substantive content of issuers' continuing obligations has not changed significantly. In the longer term, the potential for regulatory divergence between the UK's and the EU's market abuse and transparency regimes may be a factor in an issuer's choice of trading venue.
- The pace and volume of regulatory change has not slowed down. The EU and the UK are now regulating separately, with a number of initiatives on each of their respective regulatory horizons. This makes the navigation of these regimes a more complex exercise, but if both the EU and the UK regulate in a proportionate manner, the pan-European wholesale debt capital markets need not be affected.

These two systems, EU single market regulation and retained EU law, are parallel, but distinct:

EU regulatory framework for DCM	UK regulatory framework for DCM
EU Prospectus Regulation	UK Prospectus Regulation
Transparency Directive	FCA Disclosure and Transparency Rules
EU Market Abuse Regulation	UK Market Abuse Regulation
EU PRIIPs Regulation	UK PRIIPs Regulation
MiFID II product governance rules	FCA PROD Rules
EU CRA Regulation	UK CRA Regulation
EU Benchmarks Regulation	UK Benchmarks Regulation
EU accounting standards regime	UK accounting standards regime
Bank Recovery and Resolution Directive contractual recognition of bail in	PRA CROB Rules
EU CRR	UK CRR
Solvency II Directive	Solvency rules in PRA rulebook
EU sanctions regime	UK sanctions regime
EU regulations on sustainable finance	UK regulations on sustainable finance

Certain residual elements of UK domestic law relevant to the capital markets that always sat outside the EU single market, for example, the UK financial promotions regime and the UK listings regime, as well as the English common law of trusts, contract, tort and negotiable instruments, have not been impacted by Brexit.

What about EU non-legislative guidance?

EU non-legislative guidance (for example, ESMA's questions and answers on the Prospectus Regulation and ESMA's guidance on risk factors and alternative performance measures) was not on-shored under the EUWA. The FCA has published guidance confirming that:

- market participants should continue to comply with EU non-legislative guidance that was in place before the Brexit implementation period ended, to the extent it remains relevant, taking into consideration the UK leaving the EU single market and associated legislative changes; and
- for EU non-legislative guidance that is produced after the Brexit implementation period ended (including earlier guidance that is modified), the FCA may set out its expectations on an issue by issue basis, where it considers that it is appropriate for market participants to comply.

At the end of January, ESMA published an update to its questions and answers on the EU Prospectus Regulation. In the absence of any statement by the FCA therefore, the ESMA update does not apply to UK prospectuses (although market participants may opt to comply with it, or consider it persuasive, to the extent that it does not contradict FCA guidance).

Has the law changed? Regulatory divergence caused by the on-shoring

The policy intent of the EUWA was to ensure that, as a general rule, the same rules and laws applied on the day after the UK left the single market as on the day before. The EU regulatory framework and the UK regulatory framework therefore closely resemble each other, but they are not exact mirror images. In a few areas, policy-makers had to decide how to fill legislative gaps left by the UK ceasing to be an EU member state, with the result that a degree of substantive regulatory divergence occurred immediately. For example:

	EU regulatory framework for DCM	UK regulatory framework DCM
Moving securities from one regulated market to another	Securities can be moved from an EU regulated market to another EU regulated market on the basis of a summary document rather than a prospectus. To move securities from a UK regulated market to an EU regulated market, a full prospectus is required.	Securities can be moved from either an EU regulated market or another UK regulated market to a UK regulated market on the basis of a summary document rather than a prospectus.
Equivalence of accounting standards	The EU has not made an equivalence determination in relation to UK accounting standards. UK issuers can prepare an EU prospectus using UK IFRS, provided that the notes to the audited financial statements contain a statement that they comply with IFRS in accordance with IAS 1 (presentation on financial statements)	The UK has made an equivalence determination in relation to EU accounting standards. EU issuers can prepare a UK prospectus using EU IFRS.
Prospectus passporting / equivalence	A prospectus approved in one EEA member state can be passported (for regulatory use) into another EEA member state. The EU has not made an equivalence determination in relation to the UK's prospectus regime.	A prospectus approved in the UK cannot be passported into the EEA. The UK has made an equivalence determination in relation to the EU's prospectus regime, but the FCA has confirmed that currently it will not approve an EEA prospectus for regulatory use in the UK.

A somewhat more flexible UK regime?

The common theme that runs through the UK on-shoring changes is that the UK regime is currently relatively more flexible than the EU regime. Whether this initial flexibility is driven primarily by functional necessity (to ease the transition to the new regime) or whether it instead stems from a philosophical approach (a belief in open markets, even on a unilateral basis) is harder to discern.

There are a number of steps that the UK could take on a unilateral basis that may assist participants in the debt capital markets. For example, the UK's equivalence determination in relation to the EU's prospectus regime requires an approval mechanism to be determined by the FCA for it to become operable. Completing this regime could make admissions of securities to a UK regulated market and offers of securities to UK retail investors easier in some respects. The FCA has determined that EEA financial reporting regimes are equivalent to the UK's regime, but this does not extend to other information requirements in DTR6. In the longer term it may also make sense for UK MAR to be amended to include certain equivalence provisions.

Which framework applies? Which transactions are impacted, and how?

Brexit has caused renewed focus on the jurisdictional scope of EU law and UK law, with each piece of the regulatory jigsaw having its own specific rules of application. For example, the EU Prospectus Regulation applies to admissions of securities to trading on an EEA regulated market or non-exempt public offerings of securities in the EEA, whereas the UK Prospectus Regulation applies to admissions of securities to trading on a UK regulated market or non-exempt public offerings of securities in the UK.

Because the exemptions in both regimes are similar, it is easy to structure debt offerings to avoid either the EU Prospectus Regulation or the UK Prospectus Regulation, given that it will almost never be necessary for a Eurobond to be admitted to both an EU and a UK regulated market. It is also easy (and indeed common) to avoid both the EU Prospectus Regulation and the UK Prospectus Regulation by admitting securities to trading on either a UK or an EEA MTF (for example, London's ISM, Ireland's GEM or Luxembourg's EuroMTF) and by using minimum denominations of at least EUR 100,000. These exemptions mean that capital raising in the pan-European **wholesale** debt market continues, on the basis of existing tried and tested structures, without requiring two parallel prospectuses. For wholesale capital raisings therefore, Brexit represents primarily a drafting and disclosure challenge rather than a structuring or market access challenge.

Conversely, in the case of a true **retail** debt offering made in both the EEA and the UK, both the EU Prospectus Regulation and the UK Prospectus Regulation apply, raising the question of two different prospectuses. As we have discussed previously, true retail debt offerings face considerable regulatory obstacles and are therefore rare. This is still the case even for true retail debt offerings that are restricted just to UK retail investors or just to EEA retail investors.

How to draft and disclose for Brexit

Because of the current regulatory proximity between the EU and the UK, and because any given wholesale Eurobond issuance will typically be made both to EU and UK regulated investors, a practice has arisen for parallel regulatory disclosure in many instances. For example, it is typical for prospectuses and other offering documents to show the regulatory status of benchmarks and credit rating agencies both for EU and UK purposes and to include offer restrictions and related disclaimers in compliance with both the EU and UK product governance regimes and to ensure that both the EU and UK PRIIPs regimes are avoided. Wording recommended by ICMA is widely used for these purposes.

In the immediate aftermath of the Brexit implementation period ending, the question over how to refer to 'retained EU law' (the distinct body of on-shored law that now applies in the UK and forms part of UK domestic law by virtue of the EUWA) and to ensure that it is clearly distinguished from 'EU law' itself, represents a challenge on all cross-border transactions rather than being a specific DCM challenge. This challenge may be felt acutely when it comes to updating legacy documentation, but will continue to become easier as a body of precedent and market practice builds up.

Given that the UK leaving the EU single market is no longer a theoretical event that may occur in future, but a real event that has already occurred in the past, practice with Brexit-related risk factors has now changed. In many circumstances it is not appropriate to try to update language from previous deals without considerable thought. Given that the legal and regulatory framework for cross-border transactions is now certain and the trading relationship between the UK and the EU has been agreed, the volume of Brexit risk factors (many of which tended to deal with uncertainty) can be expected to diminish. In areas where there continues to be a specific Brexit regulatory risk or a specific risk relating to a particular issuer's business, a risk factor may still need to be disclosed.

Implications for ECB eligibility

The large amount of liquidity injected into the corporate bond market by the ECB, partly as a response to the COVID-19 pandemic, continues to incentivise bond issuance. As we have discussed previously, the rules for eligibility for the ECB's Pandemic Emergency Purchase Programme, as well as the ECB's general rules on eligible collateral, contain jurisdictional limitations. These mean that GBP, USD and JPY denominated instruments issued by UK issuers are no longer eligible for ECB collateral.

We continue to see non-Eurozone issuers establishing Eurozone special purpose vehicles to access the ECB's PEPP and it continues to be the case that securities admitted to trading on the London Stock Exchange's Main Market are eligible for ECB collateral (due to the London Stock Exchange ensuring that such securities are automatically admitted to trading on BondVision, an ECB acceptable market).

What about continuing obligations? Should issuers reconsider trading venues?

An issuer's continuing obligations derive primarily from where its securities are admitted to trading:

	Market Abuse?	Transparency?	Other
London Stock Exchange (Main Market)	UK MAR	FCA Disclosure and Transparency Rules	FCA Listing Rules London Stock Exchange Admission and Disclosure Standards
London Stock Exchange (International Securities Market)	UK MAR	ISM Rulebook	London Stock Exchange Admission and Disclosure Standards
Euronext Dublin (Main Securities Market)	EU MAR	Rules of the issuer's home Member State (under the Transparency Directive)	Euronext Dublin Listing Rules
Euronext Dublin (Global Exchange Market)	EU MAR	GEM Rulebook	
Luxembourg Stock Exchange (Regulated Market)	EU MAR	Rules of the issuer's home Member State (under the Transparency Directive)	Luxembourg Stock Exchange rules and regulations
Luxembourg Stock Exchange (EuroMTF)	EU MAR	Luxembourg Stock Exchange rules and regulations	

Because of the way that the "home Member State" concept in Transparency Directive works, certain legacy debt securities are now subject to a different set of transparency rules as a result of the Brexit implementation period ending:

- Debt securities admitted to trading on the London Stock Exchange Main Market are subject to the FCA DTRs (even if they were previously subject to another EEA Member State's rules, for example, because the issuer was established in another EEA Member State).
- Debt securities admitted to trading on an EEA Regulated Market (for example, Euronext Dublin Main Securities Market or Luxembourg Stock Exchange Regulated Market) are subject to the rules of their EEA home Member State (which will be a new home Member State if their previous home Member State was the UK).

Under the EUWA, the UK's transparency regime is a close reflection of the EU Transparency Directive, so most issuers' transparency obligations have not become more onerous (or even changed in a material way).

Issuer obligations under EU MAR apply primarily to financial instruments admitted to trading on an EU trading venue. Since the end of the Brexit implementation period, issuer obligations under UK MAR apply to financial instruments admitted to trading on a UK trading venue. Again, the substantive content of UK MAR obligations (for example, the obligations to maintain insider lists and disclose inside information) are close reflections of EU MAR obligations, so most issuers have not noticed a material difference.

Unlike prospectus and other public offer rules, which are simply a 'day one' obligation, the rules for continuing obligations apply for as long as a security is admitted to trading, and these may change over time. The possibility of future regulatory divergence between the EU's and the UK's respective market abuse and transparency frameworks, may therefore cause some issuers with securities admitted to both EEA and UK trading venues to consider consolidating their securities admissions within either the EU or the UK, so as to avoid a potential dual compliance burden that may increase in the future. This remains a somewhat open question.

Choice of law, choice of jurisdiction clauses and contractual recognition of bail-in

Despite EU regulations related to choice of law, choice of jurisdiction and enforcement of judgments no longer applying to the UK, we have not observed a change in practice related to Brexit, other than in the specific context of EEA banks subject to contractual recognition of bail-in. In most scenarios we are advising that a change in practice would not be appropriate.

The underlying rationale for asymmetric jurisdiction provisions (under which an issuer may only sue in one jurisdiction, for example, England, but the noteholders may sue in a range of jurisdictions) is that noteholders want to be able to sue wherever a defaulting issuer's assets may be located. This rationale has not changed as a result of Brexit. There has long been an open question over the extent to which different courts within the EU consider that asymmetric jurisdiction clauses fall within the 'exclusive jurisdiction' concept in the Brussels Regulation and this debate lives on. There is now a similar open question in relation to the Hague Convention. Because this area of law is highly specialised, a case by case analysis will be necessary for certain fact patterns. However, for a majority of transactions the balance of risk will not have sufficiently shifted so as to trigger a change in practice.

Prior to the end of the Brexit implementation period, it was already standard practice for EEA financial institutions to include contractual recognition of EU bail-in provisions both in their English law governed debt issuances and in other English law governed capital markets documentation to which they are party, such as subscription agreements, as these will contain 'other liabilities' for EU BRRD purposes. Since the end of the Brexit implementation period, this is now a clear obligation. There is now a parallel regime for contractual recognition of UK bail-in relevant to UK financial institutions, for their debt issuances and other documentation containing 'other liabilities' governed by the law of an overseas jurisdiction. The approach suggested by ICMA in a note they circulated in November has been widely adopted.

Looking to the future: reforms and regulatory divergence

The EU's regulatory system for financial services is dynamic rather than static, with the detail of regulations changing and new guidance from regulators emerging regularly. This fact, coupled with the nature of the Trade and Cooperation Agreement which gives both the EU and the UK broad regulatory freedom in relation to their respective financial services frameworks, means that the EU and UK capital markets frameworks (arguably) most closely resemble each other now, in the immediate aftermath of the end of the Brexit implementation period.

Given the clear statements from both the EU and the UK relating to their desire for regulatory autonomy, it seems that further divergence, going beyond that caused by the UK leaving the single market and the on-shoring process, is likely in the future. This divergence will come from two directions: actions taken by the EU and actions taken by the UK.

EU reforms

There are a number of EU reforms on the regulatory horizon.

As we have previously discussed, the EU's COVID capital markets quick fix package was not finalised before the end of the Brexit implementation period and therefore missed out on being on-shored into UK domestic law. This legislative package is likely to be finalised this month, but it will take another year before EU Member States amend their national measures implementing MiFID II, to exempt bonds with make-whole provisions from product governance obligations.

In connection with the transition from LIBOR to risk-free rates, the EU Benchmarks Regulation is being amended later this month, to create a statutory override for certain 'tough legacy' instruments referencing LIBOR and to extend the transitional provisions allowing EU regulated entities to use third country benchmarks.

In its report on EU MAR in September 2020, ESMA proposed a number of targeted amendments, including clarifying that the market soundings regime is mandatory, even in circumstances where there is no inside information, rather than being a safe-harbour in circumstances where there is inside information. It maybe that the European Commission adopts this proposal in its upcoming consultation on EU MAR, but it will be some time before the law is changed.

In relation to sustainable finance, the European Commission has consulted on a potential legislative solution for an EU Green Bond Standard, that would draw upon market practice led by the ICMA Green Bond Principles, but potentially also create harmonised reporting and a registration and supervision system for second party opinion providers. Measures implementing the EU's Taxonomy Regulation and Sustainable Finance Disclosure Regulation will also be progressed this year.

The European Commission continues to press on with the capital markets union initiative, first launched in 2014, and published an updated action plan in September 2020. In due course it is expected that there will be a range of different targeted proposals, including creating a single European access point in which investors can access regulated information, a review of Solvency II and EU CRR to promote investment in EU capital markets by regulated investors and potentially a recalibration of investor protection measures aimed at retail investors.

Each of the above measures might by itself be better characterised as a small evolutionary step rather than a revolution. However, the cumulative effect of all of these steps may in due course alter the regulatory landscape significantly.

UK reforms

There are also a number of reforms on the UK regulatory horizon and, since the Chancellor's June 2020 speech on his vision for UK financial services, we have a clearer picture of how the UK's regulatory framework might develop.

The Financial Services Bill that is currently going through the UK Parliament will make a number of changes. In connection with the transition from LIBOR to risk-free rates, the UK Benchmarks Regulation will be amended to empower the FCA to create a 'synthetic LIBOR' for certain 'tough legacy' instruments and the transitional arrangements allowing UK regulated entities to use overseas benchmarks will also be extended. These changes have the same objective as the EU's changes, but the method for achieving them is different. The FCA will also be empowered to make changes to the UK PRIIPs regime, and as we have discussed previously this may reduce the circumstances in which a key investor document is required.

The UK Government has not made any announcement in relation to a UK Green Bond Standard (and it may take the view that current market solutions, coupled with the potential for the FCA to take enforcement action against greenwashing, are already sufficiently robust). The Chancellor has however confirmed that the UK will put in place a UK green taxonomy, but the contents and scope of this are still uncertain.

The UK Government is also looking at ways to tailor UK Solvency II and the UK CRR which may result in a recalibration of regulated investor incentives and capital requirements for UK banks and insurers. The UK listings regime is also being reviewed and while this is primarily aimed at equity capital markets, it may end up impacting debt capital markets too. Perhaps more significantly, in the longer term the consequence of the UK's future regulatory review in financial services, under which it is proposed that the current architecture underpinning financial services in the UK is fundamentally altered by moving all technical rules into the FCA and PRA rulebooks (which may then be amended relatively speedily) may result in a framework that starts to look and feel different from the EU regulatory system.

The two regimes: will they stay interoperable?

At present, despite Brexit, the wholesale debt capital markets continue. Transactions are still being executed in much the same way that they always were, with the impact being felt at the margins.

It is impossible at this stage to draw firm conclusions about the longer term consequences of Brexit. It may be that the EU and the UK continue to regulate in relatively similar (and proportionate) ways and that they each use of a variety of deference measures, such as exemptions and equivalence determinations, which will continue to allow for a high degree of interoperability. In this scenario market access difficulties are restricted to the relatively niche retail bond market, where there is arguably a greater case for local tailored consumer protection measures; whereas in the much more widespread wholesale Eurobond market sophisticated investors will continue to be able to invest across borders, as they currently do.

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