

Brexit Update

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Brexit Update: Issues for Structured Finance

On March 29, 2017, the United Kingdom (UK) delivered notice of its withdrawal from the European Union (EU), triggering the most comprehensive legislative review and revision ever to occur in the UK. This update discusses legislative changes that might affect structured finance.

Changes in Law

Upon the UK's withdrawal, EU treaties, directives, directly effective decisions and regulations, and rulings of the European Court of Justice will cease to apply to the UK unless their effect is specifically preserved by English law. Withdrawal from the EU will have an impact on structured finance transactions, including legal and regulatory aspects, which will need to be carefully considered.

Not only is the final outcome of the UK's negotiations with the EU presently unknown, but the process of enacting and repealing legislation will raise an inestimable number of technical, interpretive, political, legal and commercial issues. Subject to that general caveat, the UK government indicated, in its February 2017 white paper (page 10), that it intends that EU laws of direct applicability and UK laws adopted to implement EU membership will remain in place when the UK leaves the EU.

We consider below the impact of the UK's withdrawal from the EU on laws specifically applicable to structured finance.

Insolvency Laws

When the UK leaves the EU, the EU Insolvency Regulation will no longer apply in the UK. As a result, when considering whether or not to commence UK insolvency proceedings in respect of a company incorporated in the EU, the relevance of that company's center of main interests (COMI) would fall away. In contrast, if an insolvent company's COMI were in the UK, main proceedings could not be commenced in an EU member state, where the Insolvency Regulation would still apply.

A UK insolvency process would no longer benefit from automatic recognition in an EU member state, and an EU insolvency process would no longer benefit from automatic recognition in the UK.

Securities Laws

Laws applicable to securities offerings generally (e.g., MAR, MiFID and MiFIR, Capital Markets Union and Prospectus Directive) will continue to apply to securities offers made into the EU and can be presumed to be enacted in some form into UK law for securities offers made within the UK. Regarding the Prospectus Directive in particular, securities offerings solely to institutions, and other Prospectus Directive-exempt private placements of securities in the EU, should be able to continue unaffected.

However, after the UK leaves the EU, non-exempt public offers pursuant to the Prospectus Directive pursuant to a prospectus approved by the UK Listing Authority may cease to be “passportable” and will require either a second EU prospectus or a second approval by an EU listing authority.

Other Laws

Changes to much of the UK substantive law, or to the substantive law of the EU’s remaining member states, are not expected as a result of the UK leaving the EU. Thus, many of the key laws affecting structured finance transactions (e.g., consumer credit, contract, property, trust and tort) are unlikely to be affected significantly by the UK leaving the EU.

Certain matters of substantive UK law have been enacted pursuant to EU directives, and may be affected by the UK leaving the EU. During the exit process, changes in such substantive law might occur which would affect the viability of both existing transactions and structures for use in future transactions.

To the extent that laws relevant to structured finance transactions (e.g., insolvency or taxation) rely in whole or in part on the direct effect of EU regulation, those laws will need to be adopted into UK law. During the process of adoption, changes might occur which would affect the viability of both existing transactions and structures for use in future transactions.

We discuss separately below the impact of the UK leaving the EU on passporting and risk retention, which appear likely to be affected significantly by the UK leaving the EU.

Certain Contract Terms

Certain generally applicable contract terms (e.g., choice of English governing law, submission to jurisdiction of English courts) and the enforceability under English law of specific contractual provisions, are unlikely to change significantly as a result of the UK leaving the EU.

Passporting

When the UK leaves the EU, “passporting” rights (i.e., on the basis of permission granted in one jurisdiction, having a right to act in other jurisdictions) may cease.

Prospectus Recognition and Equivalence

Institutional only and other Prospectus Directive-exempt offerings of securities in the EU should not be affected. For other securities offerings following the UK leaving the EU, EU member states may no longer recognize prospectuses approved by the UK listing authority. Similarly, the UK listing authority may no longer recognize prospectuses approved by EU member states.

Entities

Following the UK leaving the EU, EU member states may no longer permit entities holding UK permissions (including but not limited to banks, investment firms and asset managers) to provide financial services in EU member states. If so, a new process for passporting entities between jurisdictions will need to be developed, or entities with UK permissions seeking to provide financial services in EU member states may need to obtain new permissions within those member states, or new entities may need to be established and authorized within those member states.

STS Securitization

For example, loss of passporting rights might impair the ability of UK entities to participate in the EU’s proposed simple, transparent and standardized (STS) securitization rules. The STS rules have not yet been adopted, but are nearing the completion of the trilogue process prior to final adoption.

Finally, should STS securitization rules be adopted within the EU but not in the UK, investor appetite for “non-compliant” UK asset-backed securities might diminish.

Mitigation?

The loss of passporting rights could be mitigated in certain circumstances. For example, Ireland already permits managers located outside Ireland to manage Irish funds or special purpose vehicles, without requiring the manager to be authorized by the Irish regulator or otherwise be regulated in Ireland, if the manager has no head or registered office or branch in Ireland.

Risk Retention

The EU risk retention rules currently require that the risk retainer be a “sponsor,” an “originator” or an “original lender.” The EU is currently considering changes to the risk retention rules.

If the risk retainer qualifies on the basis of being a sponsor, that definition requires that a sponsor either be a credit institution or an investment firm subject to MiFID. After the UK has left the EU:

- If the risk retainer is a credit institution (essentially, an EU-regulated bank) or an investment firm regulated in an EU member state, it may continue to qualify as a sponsor; but
- If the risk retainer is a credit institution or an investment firm regulated in the UK, it will no longer qualify as a sponsor.

After the UK has left the EU, UK securitizations sold to EU investors will continue to need to comply with the EU risk retention regime, which should in most cases be relatively straightforward. After the UK has left the EU, whether the UK will adopt a risk retention regime applicable to UK investors, sponsors and arrangers similar to that currently in place within the EU remains unclear.

Other Issues

Risk Factors

Generic risk factors relating to Brexit had become common even prior to the EU referendum. Going forward, the scope and nature of risk factors or other Brexit-related prospectus disclosure should become more precise as Brexit details are resolved. Risk factors should reflect the specific nature of an issuer and its business and/or (as applicable) the underlying assets.

In drafting a relevant risk factor, parties should consider the impact of any downgrade of the UK sovereign rating.

Consideration should also be given to what sort of development will give rise to an immediate obligation to supplement a prospectus under Article 16 of the Prospectus Directive as a “significant new factor.”

Ratings

The UK sovereign debt rating may be downgraded further when the UK leaves the EU. Ratings, including those of structured finance securities, are often capped at the sovereign rating ceiling. Thus, a UK sovereign ratings downgrading will give rise to rating agency review of existing ratings.

Subject to the terms of each transaction (such as the location of the underlying assets, the account bank, the cash manager, the hedge counterparty, each guarantor, and each other provider of credit and liquidity

support), a UK sovereign ratings downgrade may result in a downgrade of an issue of asset-backed securities.

ECB Eligibility

When the UK withdraws from the EU, debt securities issued by UK issuers may cease to be eligible as collateral with the European Central Bank. A number of the eligibility requirements for asset-backed securities require an EEA connection. For example, asset-backed securities must be denominated in euro (or in the former currency of an EU member state whose currency is euro) in order to be eligible as collateral with the European Central Bank.

In addition, an ABS issuer's acquisition of the underlying assets must be governed by the law of an EU member state.

Material Adverse Change or *Force Majeure*

Whether the UK vote or the UK withdrawal from the EU would of itself trigger a material adverse change clause or a *force majeure* clause will depend on the language of the clause itself and the individual circumstances of an issuer and its debt securities.

Material adverse change clauses are triggered, for example, by an event, occurrence or change which has resulted or could reasonably be expected to be materially adverse to the issuer or its business, prospects, operations or results of operations, or the condition (financial or otherwise) of the issuer or any of its material assets. *Force majeure* clauses are triggered, for example, by an event or occurrence or change in general political, financial or economic conditions which is likely to prejudice materially the success of the offering and distribution of the debt securities or dealings in the debt securities in the secondary market.

Similar, although not identical, considerations would apply to clauses covering market disruption and illegality.

Currency

Central banks of both EU member states and non-EU countries may connect to TARGET2 for payments in euro. Thus, the UK's position in relation to TARGET2 is therefore unlikely to change as a result of the UK leaving the EU. Even so, clearing euro-denominated amounts in London will require additional analysis.

Conclusion

In conclusion, the UK withdrawal from the EU will impact structured finance transactions, and that impact may be material. The scope and nature of the changes to laws affecting structured finance are only now starting to take shape. A careful watching brief is strongly advised.

If you have any questions about this *Brexit Update* or assistance that Latham can provide in contingency planning for Brexit, please contact the Latham lawyer with whom you normally consult or any of the following members of our European Structured Finance practice:

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