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## **BREXIT IMPACT**

What should GCs be doing to prepare their businesses for Brexit?

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# The edge of the cliff

Eight months after the UK triggered article 50, GCs are still asking what Brexit means for their businesses. We team up with HSF to gauge what actions GCs must take now  
**JAMES WOOD**

**F**or UK business, 2018 will be dominated by one question: when do we push the button on Brexit? Months of scenario planning have given a sense of the possible outcomes, but there is little confidence that a decision will be taken in full possession of the facts.

'We are 500 or so days on from the referendum, and it is still not clear what the arrangements between the UK and the EU will be,' notes Kirsty Cooper, group general counsel (GC) and company secretary at Aviva. 'As GCs we are being asked to give our best guess, but the scale of the conjecture with Brexit is unusual.'

The desire for clarity is widespread. Michael Plumbridge is UK-based head of regulatory change at ICBC Standard Bank. Serving largely Africa and Asia-based clients, the business is far less exposed to Brexit than most tier-one

UK banks. Nonetheless, Plumbridge spent the summer on a road trip of European regulators to address the uncertainties surrounding access to the single market.

'I am still asking the pre-referendum question of what Brexit will look like. The answer seems to be changing on an almost weekly basis.'

Cooper continues: 'Most businesses work on three-to-five-year plans. Whether transitional arrangements are granted will affect decisions they make regarding capital and resources. There is a palpable sense of tension ratcheting up. Given the lack of clarity, almost the only sensible move you can make at this time is working out how high your exposure is in a number of areas and whether responding to exposure warrants the expenditure at this stage.' ▶





**‘A lot of businesses are now engaged in regret spend. There is no real upside.’**  
Kirsty Cooper,  
Aviva

► It is a stance all businesses should adopt, argues Gavin Williams of Herbert Smith Freehills (HSF): ‘For some businesses the cost of taking action is greater than the benefit they can derive at this stage, but an increasing number are waking up to the fact that the consequences of doing nothing might be very significant indeed. If you haven’t done your contingency planning based on a worst-case, hard-Brexit scenario, now is the time to do it. The “wait and see” approach is no longer a reasonable response.’

As the business end of Brexit approaches, what can GCs and legal teams do to guide their companies amid the political uncertainty? We teamed up with HSF to find out.

### THE VIEW FROM THE PRECIPICE

‘Until now Brexit has been something that’s going to happen in the future,’ says Tate & Lyle’s legal head for EMEAA, Ben Woolf. ‘There has been a wake-up call in the last few weeks. There is a possibility that we won’t have a good deal – that will have a major impact on our group.’

However, the scenario planning taking

place at a large number of UK-based plcs continues to be mired in wishful thinking, according to Tom White, head of Europe at Global Counsel, an advisory firm that has been working with EU institutions and governments in the EU27. ‘The simple fact that has escaped an alarming number of otherwise successful companies is that there are two outcomes the EU will allow: you’re in or out. Since we are already in, businesses should plan for the latter outcome now.’

When it comes to Brexit planning, there is a further obvious point frequently overlooked by lawyers, says Nomura’s GC for EMEA, Christopher Barlow: ‘Brexit is a political process. I have attended endless meetings where banks and their lawyers suggest what a good financial services treaty should look like, but none of those people will have the slightest ability to implement that treaty.’

And the politics remains daunting. The UK government, whose negotiating position was badly weakened by the loss of its majority in this year’s general election, has indicated that the UK is set to leave the EU’s single market and customs union, signalling by most views a

‘hard’ Brexit. And while the UK has talked of a transition phase lasting just two years beyond the March 2019 article 50 exit deadline, as *Legal Business* went to press the UK and EU27 were still locked in high-stakes wrangling over the UK’s Brexit liabilities and attempts to head off a hard border with Ireland.

At October’s European Council summit the UK failed to pass a test of ‘sufficient progress’, meaning the outcomes GCs must deal with are being increasingly framed against a worst-case scenario.

Says Rhic Webb, GC for Europe, Asia and Latin America at XL Group: ‘We are dealing with too many uncertain questions to present the business with facts, which means we have to make assumptions. For practical purposes, that means assuming the worst.’

It is a view echoed by HSF’s Brexit director Paul Butcher: ‘GCs need to think what a no-deal situation means to their business and use that to judge Brexit planning. It is relatively easy to predict the consequences of a cliff-edge Brexit and relatively easy to predict what happens if you go into the EEA. All scenarios in between are shades of unknown. Any deal will contain elements of a ‘no deal’ so being prepared for ‘no deal’ broadly means being ready for any deal. You can’t say it’s too early to do things because by March 2018 we will be only 12 months away from a potential cliff edge. What was deemed a proportionate response six months ago has now changed.’

Simon Man, associate GC and head of regulatory advisory at Deutsche Bank in the UK, agrees that hard-Brexit methodology is the only sensible approach to planning: ‘You have to work from an absolutely worst-case, hard-Brexit analysis, otherwise it’s too late. Waiting for transition is not an option.’

The sense of urgency has spread to European businesses, says Ralf Thaeter, head of HSF’s German practice. ‘Because of the lack of progress in talks, businesses in mainland Europe are getting more nervous and looking for alternative markets and suppliers.’ The nerves are starting to show in official forums too. Joachim Lang, director general of the Federation of German Industries, has advised German companies operating in the UK to ‘make provisions for the possibility of a very hard Brexit’.

Purely legal questions quickly get put to one side once businesses look at how existing frameworks will be shaped by politics. Nonetheless, lawyers continue to play a substantive role says Kingfisher’s director of



**‘Unless we get a transition period soon it will not be worth having. That means you stop being a passive legal adviser and start acting as a champion of your industry.’**

Sean McGovern, XL Catlin

legal, Elizabeth Messud. ‘The only thing you can do as GC is to tell the truth but also give advice with very hefty health warnings.’

At the same time, GCs are taking on an increasingly political role, says Lucy Vernall, who has been heavily involved in Funding Circle’s Brexit planning, both as part of the peer-to-peer finance association and in her capacity as GC of the UK’s largest peer-to-peer lender. Funding Circle has played a significant role in extending capital to the UK’s small-to-medium-sized businesses and Vernall has been trying to persuade the UK government of the need to secure continued access to capital from the EU27 following Brexit.

‘Brexit is particularly important for us because it’s a macroeconomic issue that impacts small business customers and our ability to service them. There is a lot of stress-testing scenarios and legal models, and as a lawyer I can give a list of options, but the outcome and future relationship is going to come down to the politics. It is a new type of risk because it is one we cannot control. Making sure you go along to discussions to find out what government is doing both in the UK and the EU is essential.’

In this situation, says Sean McGovern, chief compliance officer and head of government and regulatory affairs at insurance group XL Catlin, and a non-executive director at financial services lobbying body TheCityUK, the lines between legal analysis and advocacy are becoming blurred. ‘We are having to engage with the government to try to create a reasonable degree of legal and political certainty so that business can make informed decisions. Unless we get a transition period soon it will not be worth having. That means you stop being a passive legal adviser and start acting as a champion of your business and industry.’

Henry Gardener, head of legal and regulatory affairs at Markel International, has recently been involved in expanding the New York-listed insurer’s Frankfurt arm in the expectation London will no longer be a suitable place to serve clients inside the EU.

While much of this work has seen him grapple with politics, keeping an eye on legal detail is just as important, he says. ‘The likelihood is a deal is going to be late, fudged and a little crude, which means specific or niche areas of EU law that are nonetheless hugely important to the way businesses operate are less likely to be picked up.’

Once the dust has settled on the negotiations and the UK starts to implement the withdrawal bill, a similar diligence will be required, says Butcher. ‘Transcribing such a large body of laws is a very complex process. GCs must keep an eye on it because various things may inadvertently get changed in a way which damages their business.’

And in the process of monitoring a vast body of EU legislation, a number of hidden complexities start to emerge. ‘Only once the business sits down with their Brexit team and maps their operations do they find which licences they depend on and which authorisations depend on EU law,’ adds Butcher. ‘A lot of this isn’t visible day-to-day ▶



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**Paul Butcher, Brexit Director at Herbert Smith Freehills, sees 2018 witnessing a shift in clients’ focus from Brexit analysis to implementation**

**Brexit is coming. Our clients face urgent implementation decisions in 2018: the lead times to build ‘cliff edge’ resilience dictates this.**

Businesses that have not completed their ‘Brexit audits’ to assess their key risks will now wish to complete regulatory, supply chain and contract reviews. Focus should be on market access rights under threat on day one and on risks of extra cost or delay.

Those that have already identified ‘cliff edge’ risks to current operations will begin to action their plans, phased on the basis of proportionality, prioritisation, interdependencies and lead times.

Action to mitigate risks or seize opportunities may include strategic M&A, devising alternative legal structures, uprating customs capabilities, changing geographical footprint, revising compliance frameworks, engaging with regulators, restructuring supply chains and any dispute resolution strategies required for evolving business models.

Our Tier 1 ranking in the new Brexit category reflects that analysing risks and challenges, giving strategic advice and executing complex transactions plays to our strengths, drawing on our leading international trade practice, outstanding regulatory expertise, deep sector understanding and cutting-edge technology and bulk process management capability. Our integrated Alternative Legal Services team provides support for the latter (eg document reviews and repapering) allowing us to provide joined up solutions that control costs while enhancing, not compromising, quality.

This combined capability has led longstanding and new clients to seek our support in developing and implementing their Brexit action plans in this crucial period.

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▶ because it was operating smoothly in the background.’ HSF’s Williams says some clients are looking to unpick the tangle of rules that had previously been taken for granted. ‘EU-derived rules don’t necessarily come with an EU stamp and what many believed to be domestic UK regulation were EU rules which gave them the right to access other European markets. There are a lot of things that might impede market access if regimes are not put in place to smooth things over.’

This has been particularly stark to those in the financial services sector, says Deutsche Bank’s Man. ‘A lot of people had a baseline assumption about how passporting worked, but when you lift up the bonnet you find it’s quite a lot more complicated than that. I don’t think the industry acknowledged how complicated it was until we started looking at it properly.’

### REPAPERING OVER THE CRACKS

If it comes to a cliff edge, GCs in the financial services sector face the most urgent task. Manufacturers may be concerned about the introduction of tariffs, but they can be fairly certain how, in a worst-case scenario, reverting to World Trade Organization provisions would affect their costs. No such comfort is available in a services sector that accounts for around 80% of the UK economy.

This, says Andrew Rogan, executive director for capital markets, infrastructure and Brexit at UK Finance – a trade association representing nearly 300 of the leading finance, banking, markets and payments-related services firms in and from the UK – means services must be at the front of the queue when it comes to the UK’s negotiation strategy.

‘No free-trade agreement that has ever been written even comes close to replicating the arrangements the UK has with the EU with respect to services. We need to have a much more focused dialogue that gives some form of certainty for the near future. We also need to be honest that we will be dealing with this for years.’

According to one senior counsel at a large bank headquartered outside the EU, this plea has so far fallen on deaf ears. ‘Reassurances provided by government have been along the lines of: “You guys in financial services are smart enough to find a way around it all.” Finding a loophole in the rules is not a desirable outcome. It certainly is not desirable from the perspective of our business.’

In this situation, says Cooper, time has already run out. ‘There are a lot of things you



**‘The likelihood is a deal is going to be late, fudged and a little crude, which means specific areas of EU law are less likely to be picked up.’ Henry Gardener, Markel International**

need to do before you can start operating in the EU. You need to set up an entity, get all the risk mitigation and governance structures in place, and the regulator has to be happy. That means a lot of businesses are now engaged in what we call regret spend. There is no real upside because we will either have wasted a lot of money preparing for something which didn’t happen or have to undertake the significant task of moving business. As the clock ticks down we will see a lot of financial services businesses wrestling with the question of when to launch the pretty irreversible process of transforming the way they are structured.’

It is not just UK banks facing difficult choices. The UK-based operations of a large number of European and international banks

will soon become third-country branches serving customers into the EU, meaning regulators in both the EU and UK will have to make a decision on the level of risk such activity carries. As far as the European Central Bank and European Banking Authority are concerned, that dialogue cannot begin until the outcome of political negotiations is clearer.

Says Andrew Procter, a financial services partner at HSF, the experience of regimes in other jurisdictions shows political tolerance for third countries drops off as external parties become more successful in the local market.

‘It is very difficult to reconcile the competing demands of the EU and the US, as the UK will have to shortly. Beyond this, there has been hardening of the European Commission when

## KEEPING THE LIGHTS ON – BREXIT AND THE ENERGY INDUSTRY

The UK's withdrawal from the European Atomic Energy Community (Euratom) is one of the lesser-known aspects of Brexit, but for a nation relying on nuclear power for 20% of its energy, it has far-reaching implications.

'The treaty allows the UK to comply with its international non-proliferation obligations, and without an equivalent safeguards regime the EU and other key suppliers, including the US, Canada, Australia and Japan, will not sanction the movement of nuclear materials to the UK,' notes Silke Goldberg, an energy partner at Herbert Smith Freehills. 'The Office for Nuclear Regulation will set up its own safeguards, but has admitted that it will be a challenge to implement by March 2019. Many

supervisory tasks are currently carried out by Euratom staff and it is unlikely the UK will be able to replace that capacity.'

Angela Hepworth, corporate policy and regulation director at EDF Energy – which owns and operates all 15 nuclear reactors in the UK – says the ability to meet this deadline will be critical for the country's energy security. 'What's at stake is our ability to import nuclear fuel, components, services and information from both the EU and certain third countries. One third of the

supply chain for [EDF-owned] Hinkley Point C will come from outside the UK, mainly from places covered by Euratom. Both existing and new-build reactors will struggle without new co-operation agreements.'

The energy sector is also waiting for clarity on whether the UK will participate in the EU Emissions Trading Scheme (ETS). Says Hepworth: 'What we have been saying to government is, "Whether we are in the ETS or not, we need to maintain the value of carbon pricing".'

The operation of subsea interconnectors, which connect the UK's grid to mainland Europe, is another potential hurdle. Both the UK and the EU remain committed to keeping the system working and ongoing

**'The nuclear power industry will struggle without new agreements.'**  
Angela Hepworth, EDF

private investment in new interconnectors suggests the market believes this will happen, but any regulatory divergence will add costs to operators and consumers.

A final challenge comes at the Irish border. The Republic and Northern Ireland currently operate a single energy market, and there are plans to further integrate physical networks. Maintaining a single energy market with two different sets of regulations will be a challenge, as will applying European energy laws in Northern Ireland post-Brexit.

it comes to equivalence assessments. The EU doesn't want to set a precedent that it's then caught by when the UK leaves.'

The UK's Prudential Regulation Authority is expected to issue guidance by early 2018 informing EU banks whether their UK branches will be expected to become subsidiaries or, if not, on what basis they will be allowed to operate. However, says Procter, the standoff with European regulators makes it difficult for UK agencies to give answers about branch supervision or whether the UK will require branches to 'subsidiarise' or to hold quarantined capital, either of which would hugely increase the cost of doing

business in the UK. 'If all these banks were suddenly required to hold capital against their risks in the UK, it would completely change the balance sheet, which would mean moving a lot of the business into the jurisdiction where the bank is headquartered or into continental Europe.'

With 75 or so European banks operating in London, such a move would impose an enormous capital burden on the European banking industry, which would suddenly have to find the resources to separately capitalise branches. Further, says HSF's Williams, the practicalities are daunting. 'No-one I have spoken to expects London to cease being



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**Libby Jackson, Global Head of Alternative Legal Services (ALT) at Herbert Smith Freehills, explains how ALT can help businesses to navigate the countdown to Brexit**

Our innovative ALT offering provides technologically advanced, cost competitive solutions to the high volume, document intensive aspects of legal work. Clients who have worked with us know the value we bring to large scale transactions or disputes, but how can we help businesses address their Brexit-related challenges?

ALT works on an integrated basis with HSF's core practices – complementing their strategic advice with our streamlined processes, project management and technology driven workflows to provide an end-to-end service for clients. Our extensive experience in undertaking the complex, large scale exercises required to implement change means that we are ideally placed to support clients as they navigate Brexit.

Our highly developed service offering includes contractual reviews and audits, due diligence exercises, repapering projects, restructuring/reorganising exercises, and simple and complex document review.

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Our international, multilingual team spans eight hubs across Australia, China, South Africa and the UK – providing an agile, around-the-clock service which can accommodate high volumes and tight deadlines. This capability is becoming increasingly important for our clients as March 2019 looms.

We are engaging with longstanding and new clients in developing and implementing their Brexit action plans in this crucial period.

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► the most extensive capital market in Europe and the EU27 will continue to depend on it. There will need to be a solution that allows continued access to capital in those markets.'

The practical difficulties banks will face in setting up a new entity in the EU must not be overlooked, adds Procter. 'Establishing a significant presence in another jurisdiction is an exercise you would normally allow two years for. The queue is going to start to grow and the capacity of regulators in other jurisdictions to process applications will be limited, so as that queue grows the time taken to establish will grow. The regulators are not going to allow banks to set up with a postbox. They want to see real presence on the ground.'

Germany's regulator, BaFin, has already stated that it is not going to relax its application process because of Brexit. But in the scramble to find suitable jurisdictions, EU member states will themselves face difficult questions.

Nomura's Barlow adds: 'The UK has the most experience dealing with complex applications. Approaching regulators with less experience would also lead to delays. There is also a question of ethics. Do these regulators really understand the product and the risk models that a bank is running?'

One GC in the financial services sector argues that the list of problems regulators face in migrating so much business means banks can expect a fudged compromise. There is, he adds, a further challenge that few in the market have picked up on.

'There will need to be a massive repapering exercise once you start to serve clients from another jurisdiction, but clients don't like to sign new contracts and it takes a huge amount of effort. Everyone will draw up lists of their top-priority clients and focus on them first. That's fine, but what about the tail? We are talking about an enormous number of small-to-medium-sized corporates who might have three swaps with one bank and two with another. If we don't have the regulatory licence to perform those contracts, SMEs will find they are under-banked come Brexit. That will damage a lot of European economies.'

For financial services, the linked topics of contractual continuity, repapering and grandfathering are fault lines that meld the theory and practice of Brexit. Contracts predating Brexit will still be valid, but many financial contracts contain life-cycle events that have the potential to trigger a regulatory breach. In the insurance sector, the problem is even more complex, says Markel's Gardener.



**'Once you have identified the risks of Brexit, addressing them is more akin to legal work.'**

Gavin Williams,  
Herbert Smith Freehills

'Policies can stem back 30 to 40 years and to move those books of business you have to find a suitable counterparty or create one yourself. We have a commitment to policyholders and service partners to pay claims, but there is potential for a regulator to bring an investigation or proceedings for acting without a licence in a given territory. That conflict is very hard to resolve and it cuts across the whole industry.'

While it is inevitable that there will be a diminution of services as banks focus on their largest clients, UK Finance's Rogan says there is an imbalance in the level of concern. 'Banks are largely gearing up for a hard Brexit, but their clients, even the very large ones, aren't doing the same. The mass repapering exercise hasn't started yet because people are putting this off as long as they possibly can.'

#### REASONS TO BE CHEERFUL

'In terms of the work being done by legal teams, I'd put Brexit in the same camp as a big-ticket litigation,' says Plumbridge. 'No-one wants to do the work and at the end of the day you'll be in the same place you were before you started. It's not going to improve the bottom line but has negative impact if it goes badly.'

HSF's Thaeter draws a similar analogy. 'Brexit is like a hostile takeover where the management of the target company becomes preoccupied. The whole thinking is around how to survive. But a hostile takeover persists only a few months. Brexit will drag on for a very long time and affect a whole continent.'

The hope that it will be smooth has been largely shelved and GCs must now wait to see how discussions over the structure of the transition unfold, presuming a compromise can be found on the financial settlement.

Likely the best GCs can hope for is vague definition around the nature of the future relationship, ideally one that addresses the red lines of some of the more difficult issues in services agreements. But GCs might also breathe a sigh of relief next year, says HSF's Williams. 'Trying to plan for Brexit has been a peculiar exercise. You need to work out what questions to ask and where to look for the risk without necessarily knowing how to go about it. Fortunately, the next phase is much more familiar. Once you have identified the risks, addressing them is much more akin to standard legal work. That, at least, should make the coming year more tolerable.' **LB**

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