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Contents

Introduction 1

Walking on the cliff edge 2

Tit for tat: the new proposals for EU intermediate holding companies 6

For additional commentary on politics and finance in Europe, read **Francesco Guerrera**'s Morning Exchange on

POLITICO

"What's the model? Have your cake and eat it."

These were the handwritten notes of a Conservative Party aide captured by a sharp-eyed photographer as the aide left a meeting at the UK Department for Exiting the EU. The note also suggested that the UK will try for a "Canada plus" type arrangement and that getting special treatment for UK financial service providers would be "difficult". As a statement of government policy, this note tells us only a little more than the UK Prime Minister's famous line of "Brexit means Brexit". Conversely, European Union ("**EU**") leaders have begun to warn this week that any special deal to allow the continuation of passporting is unlikely and some may even resist granting a transitional period. In short, then, a relatively rapid move towards a "hard" Brexit seems a reasonably likely outcome of the Brexit negotiations.

In this issue of Lex et Brexit, we examine the potential "cliff edge" effect of Brexit, whereby the UK drops out of the EU without any kind of replacement arrangement. In particular, in the absence of an agreement to make existing rights under EU financial services law permanent for UK firms, we look at the potential implications of a sudden withdrawal of those rights (such as passporting) at the date of Brexit. We then explore why a transitional agreement is needed, before considering what it might look like and highlighting the potential obstacles to such an agreement.

We then examine a European Commission proposal to introduce a new requirement to establish an intermediate EU holding company (an "**EU IHC**") where two or more banking institutions established in the EU have the same ultimate parent in a third country (a "**Foreign Bank**"). The proposal mirrors an existing U.S. requirement for non-U.S. banking organizations to form U.S. IHCs. We outline the specifics of the proposal and the resulting critical structuring and regulatory considerations, before concluding that the proposal has the potential to introduce added complexity to Brexit planning.

Walking on the cliff edge

In her speech to the Confederation of British Industry (the "**CBI**") on November 21, the UK Prime Minister acknowledged that many British companies have concerns about a potential "cliff edge" effect of Brexit, whereby the UK drops out of the EU without any kind of replacement arrangement. This problem arises because of the short two-year negotiating period, which will start when the UK Government triggers Article 50 of the Treaty on EU; many consider that the two-year period will not be long enough to enable the negotiation of a comprehensive agreement to cover EU-UK relations in the future.

Why is a transitional agreement needed?

If the UK Government triggers Article 50 by the end of March 2017, as planned (which is based on the presumption that the UK Government's timetable is not disrupted by the need to gain parliamentary approval if last month's UK High Court decision is upheld (on which, please see our **Client Newsflash of November 4**)), the UK will likely leave the EU by Spring 2019. Article 50 envisages a negotiation to determine the terms of a member state's exit, such as outstanding budget contributions, pension contributions for EU employees and institutional issues. While this narrow set of issues could well be resolved within the two-year period, we believe that the negotiation of a bespoke, comprehensive agreement on free-trade and market access may take substantially longer (in the region of five to ten years based on previous EU trade negotiations).

What is the "cliff edge"?

The "cliff edge" refers to the prospect of the UK leaving the EU without any agreement for continued access to the single market or customs union in some form. In other words, going over the cliff would involve a disorderly Brexit without a UK-specific deal. Cross-border business would then be done, at best, on the basis of World Trade Organization trading rules alone.

"People don't want a cliff edge, they want to know with some certainty how things are going to go forward. That will be part of the work that we do in terms of the negotiation that we are undertaking with the European Union ." – UK Prime Minister, November 21, 2016, CBI conference

For financial services firms, potential "cliff edge" effects include:

- ***The loss of passporting rights:*** UK financial services institutions, including subsidiaries of U.S. and other non-EU parent companies, would no longer benefit from the EU financial services passport after this type of 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. As discussed in the **first issue of Lex et Brexit**, it would be time-consuming and costly for many financial institutions to obtain separate authorization in a remaining EU member state, or to amend or upgrade an existing license in such a member state. Relying on third-country passporting provisions available under some EU laws alone may work for some smaller institutions, but such reliance is fraught with timing and political obstacles, and may not prove a panacea for larger financial institutions in any case. Future EU-UK negotiations to extend the passporting concept more widely (e.g., to deposit-taking and commercial lending) could be politically contentious and would be subject to the EU legislative process to amend the relevant parts of EU law; these arrangements would likely not be in place at the date of Brexit.

  Furthermore, the loss of passporting rights could limit the services and financing available to end-users of financial services in the UK and EU, which could have a material effect on the EU's economy.

  The operations of UK banks operating in the EU by way of a branch, or those EU banks with significant branches in the UK, would also be disrupted if those branches no longer benefited from EU rights of establishment.

- ***Disruption in the derivatives market:*** Significant disruption could occur if UK financial institutions are restricted from providing derivatives-dealing services to EU counterparties. In addition, if the London-based clearing houses are also prevented from providing clearing services to EU counterparties post-Brexit (even if only for a limited time before an equivalence

determination is made and those clearing houses are recognized by the European Securities and Markets Authority (the "**ESMA**")), this could have significant repercussions for financial and non-financial counterparties across the EU.

- ***Disruption to the UK and EU regulatory agenda and regulator workloads:*** As discussed below, the EU legislative agenda for banks and financial markets is still far from complete. The terms of the Directive 2014/65/EU (the Markets in Financial Instruments Directive II, or the "**MiFID II**") / Regulation (EU) No. 600/2014 (the Markets in Financial Instruments Regulation, or the "**MiFIR**") package and the finalized rules for derivatives clearing and margin exchange in Regulation (EU) No. 648/2012 (the European Market Infrastructure Regulation, or the "**EMIR**") have been agreed at the EU level, but will have to be implemented over the next few years. It is not clear whether the European Banking Authority (the "**EBA**", currently based in the UK, but now looking for a new, post-Brexit home) or the ESMA has the time, inclination or workforce to establish and police a bespoke arrangement for UK financial services providers in the next two years, while having to implement radical changes to the regulation of markets in the EU. In addition, the EBA will be faced with an increased workload in drafting EU secondary legislation for the proposals to amend Regulation (EU) No. 575/2013 (the Capital Requirements Regulation, or the "**CRR**") and Directive 2013/36/EU (the Capital Requirements Directive IV, or the "**CRD IV**") (the proposals are known collectively as "**CRD V**"), the Bank Recovery and Resolution Directive (the "**BRRD**"), the minimum requirement for own funds and eligible liabilities (the "**MREL**") and total loss-absorbing capacity ("**TLAC**") which emerged last week.

  At the national level, it is not clear whether the EU national regulators and the European Central Bank (the prudential regulator for banks in the Eurozone) have the ability to process and resolve the myriad license applications and amendments that would have to be made by a number of international banks if they wished to continue to provide significant services in the EU after a "cliff edge" Brexit.

  The UK regulators and the Government will also have the mammoth task of sorting through and amending EU regulations when they are incorporated into UK law under the proposed Great Repeal Bill (on which, see the **eighth issue of Lex et Brexit**), even before they have to face up to their new responsibilities, including the regulation of UK credit rating agencies, assessing and monitoring equivalence of other EU jurisdictions on an ongoing basis and determining license applications for EU financial institutions wishing to continue to provide services in the UK.

- ***Uncertainty for recruitment:*** In the result of a "cliff edge" Brexit, it is possible that EU citizens living in the UK would no longer have the right to live and work in the UK, while UK nationals living in the EU would lose reciprocal rights. While both sides have expressed some willingness to find a suitable compromise on this issue (at least in respect of workers already resident in the UK and the EU), the financial services industry would be particularly badly affected by such an outcome given the large number of non-UK EU citizens employed in the sector.

Timing

Absent the announcement of transitional arrangements, many UK financial institutions are likely to begin the process of trying to mitigate the impacts above as soon as practicable (for example, moving operations to the EU or withdrawing from certain areas of business). Given the size of the task, some larger banking groups may need to begin the execution of their Brexit contingency plans as early as the first half of next year if transitional arrangements appear unlikely to materialize.

What might a transitional agreement look like?

Legal Structure

Although the legal point is not entirely free from doubt, it seems likely that a withdrawal agreement negotiated under Article 50 could provide for transitional arrangements to be put in place, at least in the short to medium term. A longer-term transitional deal might have to go through the trade treaty process at an EU level; the recent travails of the EU-Canada Comprehensive Economic and Trade Agreement have shown that obtaining required approvals from national and regional assemblies can be problematic.

Any transitional arrangements would also have to be given effect in the EU and the UK through new legislation – in the EU this could be in the form of a directly effective regulation, while in the UK the Great Repeal Bill could incorporate this concept.

Duration

Most models envisage the transitional arrangements as a “bridge” or “runway” to an eventual permanent agreement on the EU-UK trading relationship. Ideally, this would mean a transitional arrangement that would run for a period long enough to allow for the negotiation, ratification and bedding-in of a permanent settlement. The period would also allow time for financial institutions to implement their plans to adapt to that settlement and for any necessary equivalence assessments to be completed. This points towards a longer transitional period of perhaps seven to ten years.

It may be more practical, however, to agree a shorter post-exit transitional period of perhaps two to three years, given the legal and political obstacles that a longer-term transitional deal might face.

Terms

In financial services, the preferred approach would involve the maintenance of the status quo in respect of passporting, regulatory policy development, market regulation and employment for as long as possible. In other words, the relevant EU financial services legislation should continue to apply to UK firms and other UK market participants for the duration of the transitional period after Brexit.

In terms of content, the following issues will be carefully negotiated in any transitional agreement:

- The right of UK financial services firms to use branch and services passports, while separate licensing applications might be ongoing in EU member states;
- A commitment by the UK to maintain equivalent financial services legislation for the duration of the transitional period, including a commitment to implement new EU primary and secondary legislation such as CRD V and BRRD amendments;
- A commitment by the European Supervisory Authorities (the “**ESAs**”) and the European Commission to complete equivalence assessments for the UK, so that such market access available under some EU financial services legislation could be continued at the end of the transitional period;
- A proposal for the ESMA recognition of UK-based clearing houses and trading venues for the purpose of EU markets regulation;
- UK involvement in the development of new EU financial services legislation during the transitional period, possibly at the ESA level;
- Continued UK adherence during the transitional period to the four freedoms of the single market: free movement of people, goods, services and capital;
- Continued payments by the UK into the EU budget for the transitional period, possibly over and above any budget settlements required as part of any withdrawal agreement;
- A decision as to whether the UK would continue to be bound by the rulings of the Court of Justice of the EU (the “**CJEU**”) during the transitional period; and
- A decision as to whether an “emergency brake” termination or suspension mechanism should be available to either side.

As can be seen from the preliminary list of issues above, the term "transitional agreement" contemplates a range of different models, dependent on the rights to be maintained and the timing of the process itself. The shape of the final EU-UK partnership to be agreed will also have a material impact on the issues above.

One straightforward transitional model might involve maintaining full single market access and the customs union across all parts of the UK's economy for the duration of the transitional period. Alternatively, other models might envisage a "multi-speed" or "pick 'n' mix" approach, where different parts of the UK economy disengage from the EU system at different times and in different ways. This approach would be time-consuming to negotiate in itself, but might be easier to achieve politically than full market access during the transitional period.

Potential obstacles

For the reasons described above, many UK-based financial institutions would like the UK and the EU to declare their intention to put in place a transitional agreement to take effect at the time of Brexit. There are, however, a number of political and legal obstacles to overcome in relation to a transitional deal.

Political

If the EU offers the UK and the financial markets an assurance that market access will be retained post-Brexit for a limited period, the EU may lose one of its key cards in the Brexit negotiation: the ability to force the UK over the "cliff edge" in 2019. There may also be reluctance among some EU member states to make the terms of any transitional arrangements too generous in favour of the UK, preferring instead to make the UK pay a heavy price for its decision to leave in order to discourage other EU member states from following the UK's path.

Furthermore, a long transitional period where EU immigration and budget contributions remain at a pre-Brexit level, and where CJEU decisions are still binding on the UK, would be politically unpalatable to the UK Government, especially in the run-up to a general election anticipated in May 2020. Many proponents of Brexit in the UK will likely resist any attempt to implement transitional measures, arguing that transitional measures are an attempt to reverse or dilute the exit demanded by the British people in the Brexit referendum. Many Brexiteers will be wary of a "temporary" transitional deal, pointing out that the trading arrangements in place between Norway, Switzerland, Turkey and the EU were all originally designed to be temporary waypoints towards further integration with the single market; those arrangements have now been in place for decades.

Legal

As noted above, even if a relatively short-term transitional arrangement can be agreed, the terms of that deal would have to be reflected in EU law generally, and in financial services directives and regulations in particular. EU financial services legislation does not envisage any transitional status for a former member state; the cleanest approach for full transitional access would be to have an EU regulation that provides that the UK is to be treated as an EU member state for the purposes of the relevant law across all EU legislation.

In the event of a multi-speed Brexit where certain industries do not benefit from transitional treatment, or where certain elements of market access are retained and others discarded, the legislative implementation of a transitional agreement would be far more complex.

Dealing with changes to EU law during the transitional process may also be a challenge. Although the UK may well seek continued influence at the ESA level, this is unlikely to be granted in respect of forward-looking legislation. The UK Government would also have to determine how to deal with the implementation of new EU legislation into UK law during the transitional period.

Conclusion

In the past few months, there has been an understandable reluctance on the part of the UK Prime Minister to "show her hand" before the Brexit negotiations begin. The European Commission and national leaders in the EU have also presented a remarkably unified position in refusing to negotiate

with the UK before triggering Article 50. Hopes are not high, then, for a joint announcement early in the New Year that a transitional arrangement will be put in place.

Nonetheless, it is clearly recognized that even with all the challenges described above, an early commitment to a robust and well-defined transitional arrangement would clearly help to mitigate some of the business continuity issues for cross-border international banks operating in the EU. The disruption to markets and financial stability that could result from the UK falling over the "cliff edge" means that it is imperative for the UK government to announce that it is committed to obtaining transitional arrangements for financial services. Ideally, this would grant full passporting and recognition rights for institutions based in the UK for at least three years after the Brexit date, providing the time and space necessary for the form of the EU-UK relationship to be established and for financial firms to adapt their business and licensing models to reflect that final settlement.

If a commitment to a transitional arrangement cannot be made at the outset of negotiations, the UK and the EU should recognize at an early stage the need to prioritize transitional arrangements as part of the negotiation of the withdrawal agreement.

Tit for tat: the new proposals for EU intermediate holding companies

New package of banking reforms

Over the last four years, the EU has undertaken a substantial reform of the financial services regulatory framework. Largely based on global standards, the reform package has included (i) CRR and CRD IV on prudential requirements for and supervision of credit institutions and investment firms, (ii) the BRRD on recovery and resolution of credit institutions and investment firms, and (iii) Regulation (EU) No. 806/2014 on the Single Resolution Mechanism (the "**SRM Regulation**").

While the European Commission believes that these reforms have rendered the financial system more stable and resilient against future financial crises, it warned earlier this year that the above measures do not comprehensively tackle all of the problems that were identified in the wake of the 2007-2008 financial crisis.

To that end, on November 23, the European Commission proposed a number of further reforms:

- a CRD V proposal for a Directive of the European Parliament and of the Council amending the CRD IV as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures;
- a CRD V proposal for a Regulation of the European Parliament and of the Council amending the CRR as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and amending the EMIR and Annex;
- a proposal for a Regulation of the European Parliament and of the Council amending the SRM Regulation as regards loss-absorbing and recapitalization capacity for credit institutions and investment firms;
- a proposal for a Directive of the European Parliament and of the Council amending the BRRD on loss-absorbing and recapitalization capacity of credit institutions and investment firms and amending a number of other directives; and
- a proposal for a Directive of the European Parliament and of the Council on amending the BRRD as regards the ranking of unsecured debt instruments in insolvency hierarchy.

The content of many of these legislative proposals has been extensively flagged (and leaked) in the past few months. This issue will focus on a particular aspect of CRD V that threatens to add further complexity to planning for an already complex post-Brexit world.

Article 21b of CRD V

Article 21b of the CRD V proposal introduces a new requirement to establish an EU IHC where two or more banking institutions established in the EU have the same ultimate parent in a third country. Previous regulatory rules did provide powers to EU national regulators to impose sub-consolidation at the EU level, but this power was rarely exercised. The new proposal is, in contrast, mandatory in the circumstances described below.

The EU IHC must obtain authorization either as an EU bank or as an EU financial holding company or mixed financial holding company.[1] The requirement to establish an EU IHC would apply only to third-country groups (i) that are identified as non-EU global systemically important institutions ("**G-SIIs**") or (ii) that have entities in the EU with total assets of at least EUR 30 billion. In calculating total assets, the assets of both subsidiaries and branches of those third-country groups would be taken into account. As a result, regulators in EU member states would be under an obligation to notify the EBA of the total assets and liabilities of third-country group authorized branches in their territory. The EBA would, in turn, publish on its website the list of all third-country group branches authorized to operate in the EU member states, indicating the member state and the total assets of each branch. Such requirements would likely necessitate improved collaborative arrangements between competent authorities of EU member states and the EBA. In addition, multiple EU IHCs would not be permitted: Article 21b provides that there must be a single EU IHC for all EU banking institutions that are part of the same third-country group.

According to the European Commission, the purpose of this new requirement is (i) to facilitate the implementation of internal loss-absorbing capacity for non-EU G-SIIs and third-country groups with a significant EU footprint in EU law and (ii) to simplify and strengthen the resolution processes of third-country groups. No mention is made of the roughly analogous U.S. requirements for IHCs (described below) that were strongly resisted by EU banking groups and condemned as damaging by the previous European Commission for creating an unlevel playing field.

Establishing an EU IHC

Establishing an EU IHC would likely involve complex structuring and legal analysis. The EU IHC would have to be structured in an efficient and optimal manner from a business, operations, capital, funding, liquidity, tax, risk management, resolution planning and corporate governance perspective. Critical structuring and regulatory questions would include, among other things:

- Whether to designate an existing EU entity as the EU IHC or establish a new EU IHC?
- Which ownership structures will be the most tax efficient?
- How will the EU IHC's structure affect its ability to repatriate profits to the Foreign Bank parent?
- How should the EU IHC hold certain subsidiaries so as to minimize the adverse impact of minority interest treatment under CRDIV / CRR and home country Basel III rules?
- Should the EU IHC issue CRD IV / CRR-compliant capital instruments to third-party investors or receive funding from the Foreign Bank parent?
- Will the Foreign Bank be able to recognize EU capital and liquidity resources trapped in the EU IHC for purposes of calculating its own capital and liquidity ratios under home country standards?
- How should the EU IHC balance the different asset composition incentives created by risk-based capital, leverage capital and liquidity requirements under CRD IV / CRR and home country Basel III rules?
- What is the optimal risk management and corporate governance structure for the EU IHC and the Foreign Bank's EU operations?

[1] "Financial holding companies" and "mixed financial holding companies" are defined in the CRR / CRD IV framework.

- How should the Foreign Bank reconcile EU and home country risk governance requirements and expectations?

A comparison with the U.S. rules

The analogous U.S. requirements for foreign banking organizations ("**FBOs**") to form U.S. IHCs were finalized in a final rule (the "**Final FBO Rule**") issued by the Board of Governors of the Federal Reserve System (the "**Federal Reserve**") in February 2014. The Final FBO Rule is considerably more detailed than Article 21b and differs from it in a number of respects.

To begin with, the thresholds for establishing a U.S. IHC are different from those required for an EU IHC. An FBO must satisfy three different asset thresholds to become subject to the U.S. IHC requirement:

- total consolidated assets of $50 billion or more;
- "combined U.S. assets" (the sum of the consolidated assets of each top-tier U.S. subsidiary - subject to certain exclusions – and the total assets of each U.S. branch or agency) of $50 billion or more; and
- "U.S. non-branch assets" (the sum of the consolidated assets of each top-tier U.S. subsidiary, subject to certain exclusions) of $50 billion or more.

Unlike Article 21b, the Final FBO Rule does not automatically require an FBO that is a G-SII to form a U.S. IHC, but does so only if the G-SII (or any other FBO) meets each of the three asset thresholds above. Moreover, whereas Article 21b would require a non-EU bank with, for example, an EU branch with total assets of EUR 29 billion and an EU investment firm subsidiary with total assets of EUR 2 billion to form an EU IHC, the Final FBO Rule does not require an FBO with, for example, a U.S. branch with total assets of $50 billion and a U.S. broker-dealer with total assets of $10 billion to form a U.S. IHC because the FBO would not satisfy the third asset threshold of at least $50 billion of U.S. non-branch assets.

The Final FBO Rule is also clear about what the U.S. IHC must hold, namely, any ownership interest of the FBO in a U.S. subsidiary, other than interests in certain U.S. subsidiaries of an FBO's foreign commercial subsidiaries and subsidiaries of any U.S. branch or agency holding any assets acquired in the ordinary course of business and for the sole purpose of securing or collecting debt previously contracted in good faith by the branch or agency. Any U.S. branch or agency of an FBO's non-U.S. bank would not be required to be transferred to the U.S. IHC. In contrast, Article 21b does not contain any details on which entities would have to be transferred to an EU IHC. The Final FBO Rule also provides the Federal Reserve with the authority to allow an FBO to adopt alternative ownership structures if applicable home-country law prohibits the FBO from controlling its U.S. subsidiaries through a single IHC or where the activities, scope of operations or structure of the U.S. subsidiaries would justify such an alternative structure. Article 21b does not currently provide for any such exceptions.

Finally, the Final FBO Rule provides that an FBO's U.S. IHC must separately comply with U.S. Basel III risk-based and leverage capital requirements, capital planning and stress testing requirements, a qualitative liquidity framework (including liquidity risk management standards) and a U.S. liquidity buffer requirement based on the results of internal liquidity stress testing, and a series of risk management requirements (including the requirement to establish a risk committee of the IHC's board of directors). Article 21b does not yet contain any such detailed requirements and thus it remains unclear which requirements would specifically apply to an EU IHC, although we would expect that detailed EU secondary legislation may well deal with this.

Looking ahead

Implementation

The CRD V proposal is only the first step in the EU legislative process. Negotiations will now begin in the European Parliament and the Council of the EU (which comprises government ministers from each EU member state), both of which need to reach an agreement before trilogues[2] can commence. The negotiation process is expected to last approximately one year and, if the CRD V is approved (as it may be rejected or amended), it will have a specific date for entry into force.

Brexit and beyond

Article 21b has the potential to introduce added complexity to Brexit contingency planning. The proposal for an EU IHC could force UK-based credit institutions and investment firms wanting to continue to operate in the EU to establish a substantial separate pool of capital in the EU after Brexit. Arguably, the requirement for a separately capitalized EU IHC in Paris, for example, could make London a less appealing headquarters for third-country groups' EU operations since, post-Brexit, an EU IHC could not be located in the UK in respect of EU banking operations.

Rather than use EU branches of a UK bank to run a European business, these proposals mean that it may be more efficient from a capital perspective for an international bank to establish its main banking presence in the EU and then run the UK business through a UK-authorized branch of that EU institution. The inclusion of branches of the third-country bank in the threshold calculation also raises doubts as to whether the EU intends to eventually require subsidiarization of branch operations in the EU above a certain threshold – this does not appear to be the purpose of this provision but the drafting is unclear.

As these proposals are planned to be finalized in the next 12 to 18 months, it is also unclear whether the UK Government plans to implement them into UK law in advance of Brexit. If it is intended that the UK will introduce identical provisions into its law post-Brexit, this could materially affect EU and U.S. banking groups with significant branch and subsidary networks in the UK (if the UK imposes a mirror UK IHC requirement).

More broadly, Article 21b may cause third-country groups to reconsider the nature and scale of their presence in the EU with potential ramifications for market liquidity. Following the introduction of a requirement to have a U.S. IHC, some third-country groups opted to strip back their balance sheets in the United States. It is certainly conceivable that the introduction of an EU IHC rule could have the same impact in the EU, adding to the growing trend towards fragmentation of liquidity and banking regulation.

[2] This is the EU jargon for the negotiation of a final form legislative text between the Council of the EU, the European Parliament and the European Commission.

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
Luigi L. De Ghenghi	**+1 212 450 4296**	luigi.deghenghi@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
Connie I. Milonakis	**+44 20 7418 1327**	connie.milonakis@davispolk.com
Michael Sholem	**+44 20 7418 1027**	michael.sholem@davispolk.com

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