SLAUGHTER AND MAY

Update for Corporate Treasurers

Brexit: managing new challenges

July 2016

The result of the UK's EU referendum and the prospect of Brexit will affect different companies in different ways, both positive and negative. Most groups are currently grappling with the challenge of identifying how, and to what extent their business and financial position might be affected. The new risks and challenges that are starting to emerge must be factored into risk management frameworks. Conversely, as matters unfold, companies will be keen to anticipate their ability to respond to and profit from any investment or other opportunities presented by the post-referendum environment.

Finance and treasury functions will be at the heart of this process. This briefing outlines some of the issues that finance and treasury teams may wish to factor into their impact assessment. Section 1 addresses the risk factors and challenges that might be worth anticipating in the short term. Section 2 considers some additional issues to be taken into account over the longer term, which will evolve as the shape of Britain's future relationship with the EU becomes clearer.

The impact of the referendum vote is expected to vary depending, for example, on the group's international profile, its currency exposures and its reliance (directly or indirectly) on the EU regulatory structure. The timing for Brexit remains uncertain, as is the outcome of the UK's negotiations with its EU partners. In particular, many of the downside risks currently being discussed may or may not materialise or may affect certain sectors or certain companies only. The issues outlined in this briefing are therefore just a starting point.

We are keen to help our clients develop their post-referendum strategy. For assistance, please contact your usual adviser at Slaughter and May.

1. Impact of the "leave vote"

The immediate priority for treasury teams is to assess the impact of the "leave" vote and the uncertainty it has created both in the financial markets and with regard to the trading environment. This will involve an analysis of all financing and treasury arrangements, which will need to be kept under review.

Areas to address in the short term include those outlined below.

Cashflow and liquidity	• Liaise with business to determine the impact on cashflows of a potentially uncertain trading environment (and if adverse, consider whether necessary to restrict spending). • Consider implications of pressure on cashflows under financing terms and assess adequacy of working capital facilities (would it be prudent to extend maturities, negotiate additional headroom, amend existing facilities or put new facilities in place)? • Consider impact of referendum result on going concern assessment.

FX and hedging	• Re-evaluate hedging arrangements and review hedging policies. • Consider effect on cashflows and under debt terms of marking to market/additional collateral requirements. For example: – Restrictions on indebtedness in loan documentation typically capture marked to market hedging obligations: will existing exceptions and baskets accommodate any fluctuations? – Financial covenant calculations may be affected, in particular leverage or other covenants mixing income statement (average rate) and balance sheet (spot rate) measures. Do financial covenant terms provide for exchange rate adjustments?
Contractual arrangements and debt terms	• Consider the implications of the "leave" vote and the trading and financing environment pending Brexit under contractual arrangements: – Assess impact of potential change in trading conditions/financial condition eg on financial covenant tests, under margin ratchets/ coupon step-ups in bond documentation, for cash sweep obligations. – Re-familiarise yourself with your debt covenants: to what extent might they restrict your ability to manage or respond to any change in the business eg by making disposals? – Could prepayment/termination events be triggered? Few contracts negotiated pre-referendum contained specific Brexit related-provisions, but the possibility should be considered. – Potential impact of loss of counterparty authorisation? An issue at the top of the agenda for many financial institutions is the basis on which they will continue to do business in the UK following Brexit. In broad terms, EU-based institutions are automatically entitled to carry on many types of financial services throughout the EU, including in the UK, if they are appropriately authorised to do so in their home country (this is the so-called "passporting" regime). The consequences of this regime being dismantled are difficult to predict. If the activity is regulated in the relevant country, the counterparty may have to apply for new authorisations. Alternatively, it may be able to transfer its obligations to a different branch or facility office to enable a current relationship to continue. An agreement may be reached between the UK and the EU which puts in place transitional arrangements to cater for these sorts of issues. In the worst-case scenario, the counterparty might withdraw from particular activities. From the treasurer's perspective, the action point is to review the current composition of your lending syndicates and other financial counterparties and take the opportunity, where possible, to discuss with them whether they are affected by these concerns, and if so, how they plan to manage them. – Terms of MAC/force majeure provisions – could the "leave" vote or Brexit (of itself) be a trigger? The accepted position under English law is that a MAC cannot be triggered on the basis of an event that the parties were aware of when the contract was entered into (although a significantly more adverse deterioration than anticipated may change that analysis). However, much will depend on the circumstances of the relevant contract and the wording of the clause in question. The possibility might require more detailed consideration in older contracts.

	• Does the contract contain provisions referencing the EU? How might these be interpreted in the future? For example, do definitions of "Cash Equivalent Investments" reference EU government securities or is the UK mentioned specifically? • Take note of any contractual provisions referencing EU law or built on an EU foundation to bear in mind going forward, for example, increased costs clauses and choice of law and jurisdiction clauses. It seems unlikely that changes to the EU regulatory/legislative regime will be made in the short to medium term and any new architecture may either be equivalent or incorporate grandfathering arrangements, but that remains to be seen.
Deterioration in funding conditions/ banking sector downgrades	• Consider the effects of any potential contraction in liquidity/availability of finance, for example: - When do current financing arrangements terminate? - Does the group have the benefit of extension options, accordion facilities and other uncommitted lines? - In what circumstances may lenders pass on increased funding costs, for example, funding costs in excess of the agreed benchmark under market disruption provisions in loan documentation? - Assess the consequences of counterparty downgrades eg do account bank, issuing bank or other finance party roles require a minimum rating? If so, what is the process for replacement/substitution? Are there other implications of a downgrade eg requirements to collateralise L/C exposures if a fronting bank drops below an agreed credit rating? Do syndicated lending arrangements include rights to manage defaulting/insolvent lenders? How do downgrades affect cash pooling arrangements?

2. Anticipating Brexit

In the medium to longer term, treasurers will need to assess the implications of any continuing economic and political uncertainty and consider the impact of Brexit itself. Topics to consider might include the following:

- the group's liquidity position and likely refinancing requirements;
- the extent to which Brexit should and can be anticipated in new contractual arrangements;
- staffing and recruitment issues: the allocation of resources to Brexit contingency planning and monitoring, and in the longer term, how treasury operations might be affected by any new rules on migration;
- the impact of ongoing uncertainty and Brexit on reporting obligations; and
- the key EU regulatory regimes that affect finance and treasury operations (to develop a view on the post-referendum landscape).

Some potential action points under these headings are outlined below.

Liquidity/refinancing requirements	• Monitor cashflow and liquidity position on an ongoing basis, including the availability of unused working capital lines. • Review relationships with banks and other finance providers. • Consider how to respond to lenders' questions about the impact of the referendum and Brexit on the business in the context of new fundraising. • Consider, to the extent possible, the impact on the business of tighter lending criteria, increased borrowing costs and credit terms. What sources of liquidity are available? Is there scope to diversify sources of finance? • Consider the timing of refinancing/programme issues. Uncertainty may mean debt capital markets are generally shut for periods or open only to the safest credits or for specific currencies. • Some issuers are including in offering documents risk factors/disclosures relating to Brexit and its impact on their business. If you plan to issue new debt securities, consider with your advisers whether to include such a risk factor/disclosure and the form it might take. • Issuers with public debt programmes should also consider the need to publish a supplement and the impact of any increase in funding costs or interest rate volatility on the terms of new issues.
Impact on new contracts	• Issues include: – Whether to adjust contractual references to the EU and the EEA. Is there a risk that their meaning could be unclear should Brexit occur during the term of the agreement? Clarity may be advisable in certain contexts, although we would anticipate that the legislative arrangements for exit would seek to address how such references should be interpreted going forward. – Whether to adjust provisions that reference EU legislative measures. For example, increased costs clauses may make reference to the EU legislation that implements Basel III in the EU ("CRD IV") and obligors may give representations with regard to their "COMI" status under the EU Insolvency Regulation (1346/2000) and their compliance with EU sanctions legislation. Until the shape of the post-Brexit domestic legislative regime becomes clearer, it is difficult to assess how such references might ultimately be interpreted. For now, we would suggest the action point is simply to be aware of where issues might arise. – Should the contract contemplate Brexit specifically? Perhaps the more likely scenario for treasurers is that lenders or other counterparties could seek to make provision for Brexit, for example, in the form of price adjustments (so-called "Flexit" clauses) or repayment/termination events. We are aware only of

	isolated incidents to date, which largely relate to very specific circumstances (eg in EIB funding terms). - Governing law: EU Regulations known as Rome I and Rome II govern the efficacy of the parties' choice of law to govern contractual and non-contractual obligations respectively. We would anticipate that there is likely to be continuity in the English courts' approach post-Brexit, meaning, broadly speaking, where parties have chosen a governing law for their contract, whether English law or otherwise, that choice will be respected. Accordingly, our key recommendation in this area – to ensure that the choice of governing law is clear – has not changed. - Jurisdiction and enforcement of judgments: The Brussels Regulation contains rules which the courts of the EU (and most EEA and EFTA) states apply to determine whether they can accept jurisdiction over a dispute. It also sets out the rules for the recognition and enforcement of judgments of other member states' courts in each other member state. For the moment, no one knows how these rules will be affected by Brexit. As with choice of law, parties can protect themselves by stating their choice clearly in contracts. This is likely to be an issue that financiers will focus on rather than treasurers in their position as borrowers and issuers, although it may be a concern for treasurers in commercial contracts relating to treasury operations. - Bail-in clauses: Article 55 of the EU Bank Recovery and Resolution Directive requires EEA firms to incorporate in contracts governed by the law of a non-EEA country a clause providing for the contractual recognition of the potential for the bail-in and conversion of certain of their liabilities. Such clauses are not currently required in English law contracts, but EEA counterparties may decide that they should now be included in all English law contracts, in anticipation of Brexit. • Liaise with your advisers to keep up to date with the latest documentation developments put forward by trade associations such as the LMA, ICMA and ISDA, which have all formed working parties to consider the implications of Brexit. Monitor the guidance provided by the ACT.
Staffing and recruitment	• Consider how the treasury team will resource the additional demands from the business and on its own operations arising out of Brexit. Consider responsibility for the initial review, ongoing monitoring and liaison with the board. • Anticipate the impact on treasury staffing/recruitment of potential changes in immigration rules. What steps might be taken to reassure retain/existing EU personnel?

Reporting obligations	• A heightened risk environment may prompt changes to the group's risk management framework and increased focus on financial risks and reporting. Ensure treasury is prepared to explain its approach to Brexit-related risks to management and how those risks are being mitigated.
Key EU regimes affecting finance and treasury	• Over the longer term, take steps to understand, in conjunction with legal, the main EU regulations that affect treasury and finance operations and the products and services used. For example: – Much of the legal and regulatory regime (including the Prospectus Directive and the Prospectus Regulation) which underpins capital markets activity in the UK is derived from EU directives and regulations. – The EMIR framework drives derivatives clearing obligations. – Relationship banks may operate in reliance on EU passporting rights and authorisations. – The UK is currently subject to EU sanctions legislation. – Certain aspects of the tax regime are EU-derived (eg withholding tax, VAT, what is the future of BEPS?). – Certain accounting and reporting obligations (including the implementation of IFRS) emanate from EU obligations. • Develop a view on the post-referendum regulatory landscape. The UK has supported most of the EU regulatory framework, many of its EU commitments are reflected in domestic law and many of the important aspects of EU regulation stem from G20 or other international commitments, which may limit the scope of any changes the Government wishes to make in the longer term. Many EU provisions also apply on an EEA wide basis – and would therefore continue to apply to the UK if its exit arrangements include remaining part of the EEA. In many cases, the current expectation is that the UK, for a transitional period at least, will try to achieve equivalence with the pre-existing regime. Nonetheless, there is potentially the opportunity to re-open certain aspects which should be kept under review. • Consider how to make your views heard (eg via the ACT, legal or accounting advisers, directly to Government).

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