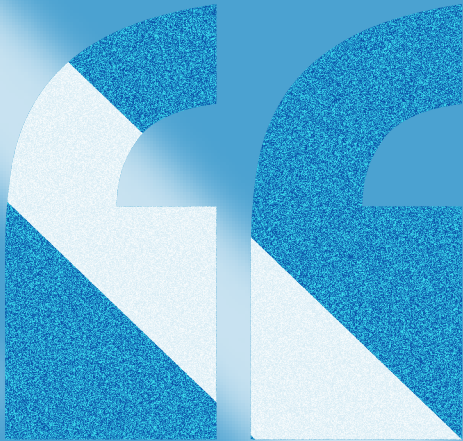


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BREXIT The way forward for multinationals



— THOUGHT LEADERSHIP



BREXIT

The way forward for multinationals

As the dust settles following the UK's decision to leave the EU, Clifford Chance experts explore the impact of Brexit from a business and legal perspective. Here we look at the likely process and timetable for the EU/UK Brexit negotiations and what action multinationals outside the financial services sector should take now to influence the outcome of Brexit. We also discuss how the EU and the UK might agree to facilitate cross-border trade in goods and services short of a single market, including rights to establish businesses, equivalent access, restrictions on protectionism and transparency around regulation.

What is the UK Government doing about Brexit?

The UK government is still in the very earliest stages of its thinking. Government departments have prepared 'opportunities papers', the Department for Exiting the EU – or DEXEU – is still in the process of recruiting staff with relevant experience and the focus is still on consulting businesses. The UK Prime Minister, Theresa May, says that the UK will look for a bespoke deal, and not something off-the-shelf.

Phillip Souta, Head of Public Policy at Clifford Chance, says: "The government hasn't even ruled out continued membership of the EU customs union – which sets a common external tariff for goods. This is noteworthy because membership would make it impossible for the UK to do comprehensive trade deals with third countries, which is frequently stated as a key benefit of Brexit. There is clearly some way to go before some of these pretty basic tensions are resolved." However we are starting to see glimpses of clarity, for example, the PM has ruled out a 'points based system' for immigration, which was one of the key campaign messages of the leave campaign.

What is the UK Government's timeline for withdrawal from the EU?

Article 50 provides for a two-year period to negotiate a 'Withdrawal Agreement'

that removes a member state from the EU "taking account of the framework for its future relationship with the Union." Both the Prime Minister and David Davis, the Secretary of State for Brexit has said that they want "time to get it right."

"We know Article 50 won't be served this year. The UK Government has a small working majority of 17 and they are under political pressure to activate Article 50 as soon as possible," says Souta. "On the other hand, government lawyers and officials have made it clear that the UK is not ready; it is likely to take some months before the UK has a detailed, technical plan for what it wants to achieve in the Withdrawal Agreement and future agreement. Whilst it is possible that Article 50 may be served early next year, it would not be surprising if it happened in the second quarter of 2017."

What are the challenges, trade-offs and risks the UK faces in the negotiations?

The first challenge the UK faces is the continental political landscape and electoral timetable. There are French elections in April/May 2017 and German elections around September 2017. Those countries will be focused on their own elections, and any negotiations that take place during that period may become caught up in attempts by politicians seeking election to seem tough on their opponents such as Marine Le Pen in France, who is also advocating withdrawal from the EU.



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— **PHILLIP SOUTA,**
Head of UK Public Policy,
Clifford Chance

“The key tradeoffs will be between market access and control. There is a range of options between a soft and a hard Brexit,” says Souta. Many businesses, and many of the UK’s international partners, like Japan – which recently called on the UK to retain as much market access as possible – are calling on the UK to go for ‘soft Brexit’. Market access would likely come at the price of having to accept some free movement of people, regulatory equivalence and institutional oversight or cooperation. Many of those who campaigned for the UK to leave the EU are calling for substantive restrictions on EU immigration into the UK and full regulatory autonomy. That, however, is likely to lead to reduced market access and more of a ‘hard Brexit’.

“The most likely scenario in our view is a package deal which would consist of a Free Trade or Association Agreement or Agreements. There is quite a wide range of possible outcomes in terms of market access within that scenario that would look like anything from a soft Brexit or, if it is a pretty standard Free Trade Agreement, quite a hard Brexit,” says Souta.

He adds that a major risk in that scenario is that the package is not ratified. That could happen if the agreement is a ‘mixed agreement’, which would mean that both the EU and individual members of the EU have to ratify elements of the deal – that happened to the Ukrainian Association Agreement which was vetoed by the Dutch Parliament. In those circumstances the UK would have a ‘hard, disorderly’ Brexit, and have to fall back on its basic rights as a member of the World Trade Organisation/GATS (General Agreement on Trade in Services). This provides for reduced tariffs on goods, but minimal preferential access on services, and minimal regulatory coordination. That would represent a significant shock to the UK economy.

Another challenge is ensuring that the UK does not have to fall back to WTO/GATS status in between the conclusion of the Withdrawal Agreement and the entry into force of the future agreement. It would be in both the UK’s and the EU-27’s interests to avoid the economic dislocation that would be caused, by agreeing to a transitional period. That would make sure

that the current rules on market access would apply until the new arrangements came into force.

What preparations are being made by the 27 other EU countries and by European Institutions, to prepare for Brexit?

Clifford Chance Counsel, Michel Petite, a former head of the EU Commission Legal Service, who negotiated the Amsterdam, Maastricht and Lisbon Treaties and who is now advising Monaco on its negotiations for a free trade arrangement with Europe, says: “The official EU position is clear cut – there is no negotiation and no formal or informal meetings before Article 50 is triggered. But internally the European Commission is advancing its preparation and already has a team set up.”

“It is important to bear in mind that there will be two distinct negotiations, there will be one on Brexit and there will be one on the future relationship between the EU and the UK.”

— **MICHEL PETITE,**
Counsel, Clifford Chance

How are the negotiations going to work?

There will be the usual interplay between the EU institutions – the European Council will focus on political discussions and the highly complex technical aspects will be the remit of the European Commission. However, these two institutions inter-relate so the political elements will, to an extent, be driven by work coming out of the Commission. After the Article 50 letter is sent the European Council will give some political orientations on the next steps to be taken, which will be taken into account in the written mandate recommended by the Commission and adopted by the Council.

Who does the UK need to reach agreement with?

Petite says: “It is important to bear in mind that there will be two distinct negotiations, there will be one on Brexit and there will be one on the future relationship between the EU and the UK.” The adoption process for the Withdrawal Agreement is





The UK hopes to be able to negotiate something different from and better than the existing models.



— **JESSICA GLADSTONE,**
International Law Partner,
Clifford Chance

relatively easy and requires a qualified majority vote by the European Council, with the consent of the European Parliament. “The problem could come from the European Parliament which no doubt will wish to have its own say,” Petite adds. “The agreement on the future relationship between the UK and the EU is more complicated. In addition to the European Council and European Parliament, this agreement, because it almost certainly will be a so-called ‘mixed agreement’, will have to be ratified by each of the 27 member states, each following their constitutional arrangements, which could be problematic.”

Technically the UK will have to negotiate Brexit and then the EU/UK future agreement, but in practice the two negotiations will overlap. “Managing this will not be easy and there would be the need for a transitional arrangement between the UK’s withdrawal becoming effective, and the UK/EU future agreement coming into force,” Petite says.

When will the written mandate be made public?

There is a trend to publish mandates rather than keep them confidential as happened in the past, says Petite. However, this mandate will probably take some time to be adopted by the Council. “It could be very controversial and may be adopted in practice by some sort of a consensus rather than a qualified majority, so it could be a very difficult negotiation on this mandate. Businesses should not wait for the mandate to be published but should make their views known to governments in terms of their own priorities.”

What are likely to be the red lines from the perspective of the 27 EU member states?

The first is likely to be around the movement of EU citizens. “This is a highly charged issue in the UK, but also in France and Germany and especially in Eastern Europe, where it is viewed as an essential element of the European Union,” says Petite. “However my feeling is that there will be some flexibility on the movement of people because it is also at the heart of the concerns of many member states.”

The second red line will be the conditions of full access to the internal market.

“This includes two elements which do not seem to be on the cards at the moment – the first is that the internal market implies that participants accept in advance any future EU legislation on the subject and it normally requires uniform interpretation of this EU legislation. Both are very difficult politically for the UK, and so full access to the internal market is probably difficult to conceive,” says Petite.

What are the precedents for a future agreement between the EU and the UK?

In reality, there is no real precedent for the UK’s relationship with the EU. “The UK hopes to be able to negotiate something different from, and better than, the existing models,” says Jessica Gladstone, an International Law Partner at Clifford Chance, and formerly a legal adviser at the UK Foreign and Commonwealth Office.

The most likely basis for the relationship would look something like a Free Trade Agreement or Agreements. The best examples for the UK’s purposes would be the more recent, more complex FTAs that the EU has negotiated with Korea, Singapore and Canada. However, even with these examples, FTAs are not all-encompassing; and so any agreement that meets the UK’s needs and expectations would push the boundaries of a normal FTA. “That is not altogether surprising. After all, FTAs were designed to bring separate states closer together. Here, the UK is separating out from the EU, which I think requires a fresh look at what the relationship should look like,” says Gladstone.

What is on the menu for a UK/EU Free Trade Agreement?

FTAs are more comprehensive than they have been in the past and their annexes take a sector-by-sector approach, building up from the WTO rules. Key areas include: trade in goods; trade in services; technical barriers to trade (e.g. regulations); health measures; customs and trade facilitation;

government procurement; intellectual property; competition; sustainable development; investor protection; and dispute settlement.

How would an FTA compare with the single market from the perspective of multinational businesses?

“It will depend on your business, as to how dramatically you will feel the differences under an FTA,” says Gladstone. “But the reality is there are very few sectors for which any FTA would enable the UK to maintain current conditions of trade with the EU, or vice versa.”

“For example, there will be additional hidden costs in doing cross border business from, or into, the UK without the EU single market. Reducing tariffs is the easy bit”, says Gladstone. Under an FTA the countries can agree to eliminate all tariffs other than those which are listed in a schedule, and for those, the agreement would normally provide a timeline for staged reduction in future. So if it is in the UK’s interests to reduce tariffs to zero on, say, the import of cars and components, the UK can do that. And it can negotiate with the EU to reciprocate on imports into the EU.

But just as costly, if not more so, than tariffs, are non-tariff barriers. These are less-easily identified or quantified, because they can take many different forms – but they include the additional time and costs of customs procedures, and the costs of adhering to different sets of regulations. These are things a multinational company may be used to dealing with operationally in other parts of the world, but which it has not had to think about before in relation to trade between the EU and the UK.

To deal with non-tariff barriers, recent FTAs have typically attempted to reduce customs procedures and to harmonise regulations (through commitments to cooperate and consult when introducing new standards to try to maintain compatibility). But for the UK maintaining harmonisation from outside the EU is more complicated than from within, where the regulatory standards set by the EU are directly incorporated into domestic law.

In addition, an FTA is unlikely to cover everything. If multinationals hope to retain some of the trading benefits of the single market, a EU/UK agreement will have to go well beyond what is usually agreed in an FTA. Taking trade in services as an example, the most ambitious FTA in terms of services currently concluded by the EU is the EU-Korea FTA, which liberalises market access in more than 100 sectors. But the trading environment that an FTA creates is materially different from a single market:

- An FTA ‘liberalising market access’ in a certain sector does not give the same rights as EU membership.
- FTAs exempt certain services. For example, typically there are exclusions for audio-visual services, freight shipping and air freight.
- The EU has no single external services policy, so commitments in FTAs can vary by Member State. Typical areas where limited commitments are given in EU FTAs include cross-border sales of pharmaceuticals, distribution of tobacco and alcoholic beverages, manufacture of gas, and transportation and storage of fuels.

“In order to retain the current level of access between the UK and the EU-27, the UK and the EU Member States would need to agree to a much greater degree of liberalisation than they have previously agreed to in FTAs, and for a wider range of sectors,” says Gladstone.

How would an FTA work for services and how does this compare with the single market?

There are a broad range of services which are ‘exported’ from the UK to the EU-27, and from the EU-27 to the UK – ranging from construction, IT, professional services, media and retail – and a broad range of business models. The rights of establishment and to supply services on a cross-border basis under the EU treaties apply to all services. That isn’t the case under a typical trade agreement.

Firstly, ‘right of establishment’. Currently one way of accessing a market is to acquire a local subsidiary or supplier. The EU has over many years taken steps to ensure that governments do not



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— **JENINE HULSMANN,**
Partner, Clifford Chance

discriminate against bidders from other EU countries in an M&A context. *Endesa* was probably the most high profile case where the European Commission took action to stop the Spanish government from preferring a bid by another Spanish energy company over bids from French and Italian competitors.

Trade agreements do not typically provide the same level of protection. Under the EU–Canada FTA for example, national treatment for investors is limited and the Canadian Government has reserved the right to apply Canadian foreign investment rules to EU investors, albeit with more relaxed thresholds.

A number of EU countries have foreign investment rules – these include France, Germany, Italy and Austria. The new UK Prime Minister has suggested that this is something that the UK may also consider.

“This is an area where the future EU agreement with the UK will need to go beyond what we traditionally see in trade agreements. Ensuring that cross-border M&A continues to function smoothly is one area where there is likely to be a mutual benefit. We are, therefore, hopeful that expanded rights of establishment can be achieved”, says Jenine Hulsmann, a Clifford Chance Partner who specialises in antitrust and EU regulation.

Second, a more complex and potentially contentious area is the provision of services through cross-border supply. The EU has taken a number of steps – both through legislation and court cases to promote cross-border supply of services across the EU. Importantly companies can challenge national laws which prevent them supplying a service on a cross-border basis – and there are many cases where companies have done this.

Under a typical trade agreement, the commitments in this area are usually very limited. A typical trade agreement would not preserve the ‘country of origin’ principle we see in areas such as the digital single market. This could mean that broadcasters and providers of e-commerce services need to comply with additional rules in the countries

where their service is received, as well as the country of origin. A typical trade agreement will provide for a degree of regulatory harmonisation in some areas, such as telecoms, e-commerce, shipping and IP – but significantly less than what we see under EU directives – and over time these rules can diverge.

In some unregulated sectors, this is causing less concern – because governments simply do not have effective means to prevent supply on a cross-border basis. Even in regulated sectors, there may be other international agreements which provide a degree of protection – for example, European television channels need to show a minimum amount of European programming, but this is defined in an agreement which the UK will remain party to. It is, therefore, very important that business continues to help their governments to understand the potential barriers to cross border trade in each sector – and what needs to be preserved.

Presumably the EU-27 will continue to be heavily constrained by EU state aid rules. How might a EU/UK FTA affect the situation for the UK, and what would be the position under the WTO rules?

Many sectors of the UK economy receive some type of government support – whether that be a guarantee, levy payment, special tax arrangement or grant. Currently these are subject to EU State aid rules, supervised by the Commission. “There is a misconception that if the UK leaves the EU, there will be no legal restrictions on the UK Government's ability to provide subsidies. That isn't correct, as there are WTO rules which relate to subsidies for goods,” says Hulsmann. “It is, however, true that the WTO subsidy rules are much narrower than the EU rules – WTO rules do not apply to services and enforcement is weaker.”

The EU is therefore likely to press for the UK to agree to broader obligations regarding subsidies as a condition for removing trade barriers to UK businesses

in any given sector. The EU-Vietnam trade agreement and the current draft TTIP, for example, extend the WTO rules to the service sector. A key question is whether the rules will be supervised by the Commission or a new UK authority. “Investors looking at long term projects in the UK energy and infrastructure sectors, for example, which require significant government support will want to make sure they are talking to the right authority from an early stage”, says Hulsmann.

What can businesses do to help themselves?

Companies should broadly be considering three scenarios, says Souta. “First, a soft Brexit, or business as usual. Second, a package deal which could be anything between a soft or relatively hard Brexit. That in a way is the hardest to plan for, given the possible variations of outcome. Third, and this is the worst case scenario, how to deal with the possibility of a hard disorderly Brexit where the UK falls back on its WTO and GATS membership.”

Clifford Chance is working with companies to help evaluate the impact of these scenarios on their businesses, and the potential commercial exposure – which will vary of course depending on the nature of a particular business and its operations. Jessica Gladstone says that it is crucial that businesses undertake a high level analysis of their trade flows and

supply chains. “Key to this initial assessment will be identifying what you rely on the EU’s single market for; and internationally, what you rely on the EU’s FTAs with other third countries for, and that will inform your representations to Government as to what you need from the UK’s negotiations.”

Jenine Hulsmann adds : “We are working with industry groups to help businesses understand what a typical FTA will and will not do. These discussions are valuable in terms of identifying the real risks for each sector and ensuring that the key messages are communicated to government in a way that has impact. Government continues to need business input – but doing this on an industry basis is key.”

Mark Poulton, Head of Corporate, London says that the UK Government wants to achieve a consensus with industry and business about the way forward. “EU governments also need to know what this means for businesses which are important for their countries too. I think the message for multinational businesses remains clear: wherever you are, now is the time to gain a full understanding of what Brexit might mean for you and what outcome you should reasonably push for, and to make your voice heard with Governments and the EU Commission,” he says.



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