Banking and investment firms

The UK is now in a transition period following its exit from the EU until the end of 2020. During the transition period, UK authorised firms continue to have free access to EU markets. At the end of the transition period, however, UK firms’ passporting rights will cease (as will EU firms’ rights to passport into UK markets) resulting in restricted EU market access for the UK – unless a new UK-EU agreement is reached that preserves or confers special access rights for the UK, or to the extent this is achieved through mutual declarations of equivalence. It is not currently expected that any new agreement on the future relationship between the EU and the UK will replicate the extensive cross-border freedoms that exist under the current passporting regime. In this section, we look at some of the key regulatory challenges for cross-border financial services, in light of the latest developments for the transition period and beyond.

Deal/transition period

- Following its approval by the UK and EU Parliaments, the Withdrawal Agreement sets out arrangements for the UK’s withdrawal from the EU with effect from 11 pm on 31 January 2020 – when the UK ceased to be an EU Member State.
- The UK is now in a transition period following its exit from the EU until the end of 2020. UK legislation calls this the “implementation period”.
- During transition, EU law continues to apply in and to the UK and the UK continues to trade with the EU as part of the Single Market.
- The non-binding Political Declaration, which accompanies the Withdrawal Agreement, provides a framework for the future.

Leaving the EU

Process and next steps

The European Union (Withdrawal Agreement) Act 2020 (the “Withdrawal Agreement Act”) approving the implementation of the Withdrawal Agreement in the UK became law on 23 January 2020. Subsequent ratification of the Withdrawal Agreement by the EU completed the legal formalities for the UK’s withdrawal from the EU, with the following consequences:

- At 11pm on 31 January 2020, the UK ceased to be a Member State of the EU and is now in a transition period until the end of 2020. UK legislation calls this the “implementation period”.
- During transition, EU law continues to apply in and to the UK and the UK continues to
trade with the EU as part of the Single Market. Immediate changes associated with leaving the EU are therefore likely to be small.

- Rights and obligations derived from EU law continue to apply:
  - In particular, UK banks and investment firms will continue to benefit from the passporting rights that they held before exit day, but in all likelihood stand to lose from the end of the year.
  - Firms must continue to comply with reporting and notification obligations under EU legislation (eg under the Markets in Financial Instruments Regulation ("MiFIR") and Directive ("MiFID II") and the European Market Infrastructure Regulation ("EMIR").
  - Firms must continue implementation plans for EU legislation that will apply before 31 December 2020.
  - As a third country, the UK will no longer participate in the EU’s decision-making processes. The UK will no longer participate in the EU institutions such as the European Parliament, the Council or the European Supervisory Authorities ("ESAs"). However, EU institutions will continue to hold the powers conferred upon them by EU law in relation to the UK and to UK firms throughout the transition period (eg the European Banking Authority ("EBA") and the European Securities and Markets Authority ("ESMA") will continue to have product intervention powers over UK entities under MiFIR; ESMA will continue to directly supervise registered credit rating agencies, trade repositories and securitisation repositories established in the UK during this period).

The Withdrawal Agreement, which sets out the terms for the UK’s departure from the EU, is accompanied by a non-binding Political Declaration on the future relationship between the UK and EEA states. This relationship needs to be negotiated during the transition period. See accompanying section: Leaving the EU - The process and preparations.

- Meanwhile, work is also continuing to fill the gaps that would otherwise appear in the UK’s legislative landscape following Brexit in accordance with the scheme laid down in the European Union (Withdrawal) Act 2018 (the “Withdrawal Act”). See accompanying section: The UK’s new legal order post-Brexit: A new class of UK law.

- No deal - in the sense of a “cliff-edge” end of: (i) the UK’s trading relationship with the EU (and wider EEA); and (ii) the fundamental freedoms (people, establishment, capital and goods) - is still a possibility at 11pm on 31 December 2020 if the transition period is not extended and a new free trade agreement is not ready by that date.

Despite the fact that the UK ceased to be a Member State of the EU on 31 January 2020, there is as yet no clarity what the future trading relationship between the UK and the EU will involve. As the UK Government has stated its intention not to extend the transition period beyond the end of 2020 and reinforced this in s 33 of the Withdrawal Agreement Act, there is also a question whether a trade deal can be agreed in the remaining 11 months to a point where it could be implemented at the beginning of 2021. The risk of the UK ending transition without a new trade deal with the EU and reverting to trade on WTO terms remains a real one, although this is not what either the UK or the EU is seeking to achieve.

On 25 February, following a proposal for negotiating directives from the European Commission of 3 February 2020, the EU Council decided to authorise the Commission to begin negotiations for a new partnership with the UK and issued specific negotiating directives for that purpose. On the UK side, also on 3 February 2020, the UK published its proposed approach to the negotiations with the EU on the future relationship. On 27 February 2020, this was followed by more detailed position paper: The future relationship with the EU: the UK’s approach to negotiations. It is clear, however, that the UK and the EU starting positions are a long way apart. See accompanying section: Trade - the future relationship between the UK and the EU.

Even if negotiations do result in agreement by the end of the year, the Political Declaration contains little of substance about the future conduct of cross-border financial services beyond the parties aspiring to complete equivalence assessments with respect to the other jurisdiction before the end of June 2020. To be effective to enable cross-border financial services, this is likely to require a series of assessments in relation to different components of the UK and EU financial services regimes. Whilst findings of equivalence would have some value, it only offers, at best, a limited solution to EEA market access for certain UK authorised firms. See “Equivalence – a solution?” below.

The EU and the UK – there will now be an intense period of negotiations to seek to finalise the details of the future relationship. The effect of these arrangements is that:

- Passporting rights between the UK and the EEA for banking and investment firms and financial products will continue during the transition period.
- Directly applicable EU legislation, such as the Capital Requirements Regulation (EU 2013/575), Markets in Financial Instruments Regulation (EU 2014/600) and European Market Infrastructure Regulation (EU 2012/648), will continue to apply in the UK until the end of that period.
- There will not be any immediate Brexit-driven changes to financial services laws (eg the Financial Services and Markets Act 2000) or the FCA and PRA rules.
- The UK and EU have stated their commitment to finalise equivalence assessments by June 2020.
- No-deal contingency measures implemented by the UK Government and regulators (including the TPR and the FSCR) are not expected to be activated until the end of the transition period.

At the end of transition – will there be elements of no deal?

- At the end of the transition period, if the new trading relationship is not in place, there could be a situation similar to no deal. It is more likely that this will be modified by the introduction of agreed elements of the future relationship or some other temporary set of rules, even though the UK Government has ruled out extending the transition period. The UK and the EU have now set out their respective
Access to European markets after the transition period

During the transition period, UK authorised firms will continue to have free access to EU markets, to the same extent as before 31 January 2020. At the end of the transition period, however, UK firms’ passporting rights will cease (as will EU firms’ rights to passport into UK markets), resulting in restricted EU market access for the UK, which will have no more than “third country” status – unless a new UK-EU agreement is reached that preserves or confers special access rights for the UK. It is not currently expected that any new agreement on the future relationship between the EU and the UK will replicate the extensive cross-border freedoms that exist under the current passporting regime.

What “third country” status means in practice will differ depending on the EU legislation. As an example, the MiFID II enables EU Member States to require third country firms to establish a branch in that State before being permitted to provide services to retail clients and certain professional clients. This means that UK firms wishing to provide services to these clients across the EU may be required to set up branches in different Member States to be able to provide services. Access to EU eligible counterparties and certain professional clients may be possible without establishing a branch under MiFID II’s third country equivalence regime, but this will be subject to uncertainty as it will depend on a European Commission decision on equivalence of the relevant UK legislation. See “Equivalence – a solution?”

Transitional regimes

Some individual EU Member States have brought forward legislation to deliver national temporary permission regimes or similar grandfathering treatment for UK firms currently operating under passporting arrangements. However, the existence, scope and timing of these regimes and the conditions for access vary substantially across individual Member States. Firms will therefore need to assess their position under each of these regimes as necessary and engage with EEA regulators where appropriate.

Equivalence – a solution?

As mentioned above, the EU and UK have both stated their intention to complete equivalence assessments with respect to each other before the end of June 2020 – although these reciprocal statements oversimplify what will in practice need to encompass a number of different equivalence assessments for different but connected purposes (taking into account, among others, cross-border investment services, fund management and marketing, central counterparty clearing and prudential regulation) reflecting the fragmented nature of the equivalence construct under current EU financial services law. The premise of equivalence regimes is that they allow third country firms access to EU markets, once the European Commission assesses and determines that the third country’s regulatory, supervisory and enforcement regime is equivalent to the corresponding EU framework. That recognition makes it possible for the competent authorities in the EU to rely on third country entities’ compliance with the third country framework which has been deemed “equivalent” by the Commission.

Importantly, equivalence-based access is available only under some, but not all, EU financial services legislation: including regulations made, including regulations to create “onshored” versions of Markets in Financial Instruments Directive (EU 2014/65), Capital Requirements Directive (EU 2013/36/EU) and Payment Services Directive (EU 2015/2366). Further adjustments are likely to be required, however, including to take account of the transition period.

• The body of EU law in force at the end of 2020 will be imported into UK law (with necessary amendments) under the European Union (Withdrawal) Act 2018 and the UK legislation made to implement EU law will be retained, with suitable amendments – this will be called “retained EU law”.

• A lot of the secondary legislation has already been made, including regulations to create “onshored” versions of Markets in Financial Instruments Directive (EU 2014/65), Capital Requirements Directive (EU 2013/36/EU) and Payment Services Directive (EU 2015/2366). Further adjustments are likely to be required, however, including to take account of the transition period.

• The onshoring legislation includes various consequential amendments to financial services legislation, including the Financial Services and Markets Act 2000 and related secondary legislation.

• The PRA and FCA have already consulted on changes to their rules that would have been necessary as a result of any no-deal exit. Both are expected to confirm their position, including the need for further adjustments to reflect the transition period, before the end of 2021.
jurisdictions. See “List of equivalence decisions taken by the European Commission” here. On the other hand, at the time of the risk of a no-deal Brexit during 2019, the EU had no difficulty in issuing short term equivalence decisions at short notice. For example, on equivalence of UK CCPs (see paragraph on “Clearing” below) and could do so again, if in its interests so to do.

Practically, the outcome of any equivalence assessments will depend on the extent to which the UK chooses to replicate provisions in EU legislation and on the Commission’s general policy aims, taking into account the empowering legislation and the EU treaties. In theory, the closer the UK stays to EU requirements, the more likely it is to be assessed as equivalent; the approach that the UK Government adopted in its financial services onshoring legislation indicated that a close correspondence of UK and EU financial services regulation would be maintained, although current UK Government policy may make some divergence more likely. However, it is broadly acknowledged that the equivalence process is not fully predictable in terms of outcomes. The Commission retains an element of discretion in awarding equivalence to jurisdictions and may rescind equivalence decisions at short notice. The Commission repealed equivalence decisions relating to the legal and supervisory framework for credit rating agencies in Brazil, Canada, Argentina, Singapore and Australia in July 2019, for example, to take effect twenty days after publication of the decision in the Official Journal of the EU. UK policy on equivalence remains largely untested, although the indications are that it would adopt EU decisions on third countries where in force at the end of the transition. Application of UK equivalence decisions to EU Member States may depend upon the level of reciprocity the EU is offering; it could become a political football in negotiations on the future relationship.

It is important to highlight that increased global market access is not regarded by the Commission as the primary purpose of equivalence. In a communication from July 2019, the Commission acknowledges that “in a few cases, equivalence decisions may also increase market-access possibilities”, but that “[At] the same time, the equivalence process is primarily a risk management exercise. It invariably involves managing any risks associated with the cross-border activity of market participants (ie impacts on EU financial stability, market integrity, investor protection and the level-playing field in the EU internal market), while exploiting the benefits of an open and globally integrated EU financial market.”

**Relocation of operations**

Whilst equivalence will be of value to some firms, it can only provide a limited solution to certain areas of financial services. As such, many businesses have already put in place, or are in the process of finalising, plans to ensure they continue to be able to carry on investment activities and service clients in the EEA after the transition period. Some firms will need to set up subsidiaries in the EU in order to maintain full access to EU markets.

EU subsidiaries will be able to benefit from the EU passport. However, establishing a subsidiary typically takes 6-12 months and comes with capital implications which are particularly burdensome for deposit-taking and proprietary trading activities. For other firms, it could be necessary to move parts of the firms’ operations out of the UK into the EU. Some firms will be able to use existing subsidiaries, but again there may be capital implications associated with a rebalancing of assets or activities from the UK to the EU.

Employment, immigration, tax and contractual continuity considerations (among others) will also be relevant.

Over the past few years, the ESAs and the European Central Bank (“ECB”) have issued materials on entity, activity and function relocations from the UK. See guidance from ECB, EBA and ESMA. These materials typically speak both to firms in the UK which are considering relocations and to supervisors in the remaining EU27. Seeking to stave off a race to the bottom to attract lucrative business into their territories, the materials tend to emphasise the need to ensure that so-called “letterbox” entities are not tolerated. On the release of ESMA’s principles on its supervisory approach to relocations from the UK in July 2017, Steven Maijoor, ESMA Chair, said: “[Relocating] firms need to be subject to the same standards of authorisation and ongoing supervision across the EU27 in order to avoid competition on regulatory and supervisory practices between Member States. See ESMA press release here.

**Other considerations**

In addition to potential structural considerations discussed above, firms should consider other practical issues which might affect their ability to service EEA clients after the transition period. For example, firms should assess their outsourcing arrangements, in particular their dependency on EEA third party providers. The FCA has also recently reminded banks and payment service providers (“PSPs”) that they will need to take steps now to ensure they have relevant customer information when making payments to and from the EEA after the transition period.
Currently, banks and PSPs do not need to provide the name and address of the payer when making intra-EEA payments (including direct debit transactions where a firm is instigating a transaction on behalf of the recipient and yet will still need to have the relevant details of the payer). They will need to be able to do so after the transition period.

**EEA firms operating in the UK**

**Transitioning to post-exit rules and standards**

The future regulatory approach of the UK will generally be to treat EEA Member States and EEA firms consistently with other third countries and firms. However, some temporary divergence from this guiding principle will apply after the transition period in order to minimise disruption and avoid material unintended consequences for the continuity of financial services provision, to protect the existing rights of UK consumers or to ensure financial stability. The most prominent practical example of this is the Temporary Permissions Regime (“TPR”) - see below.

In the longer term, the UK has traditionally accepted branches of banks from third countries and is expected to continue to host EEA branches, consistent with this approach. The current view of the PRA is that new third country branches of banks within the UK (which will include existing passported EEA branches upon expiry of the TPR) should focus on wholesale banking and at a level that is not critical to the UK economy (EEA and other third country groups with a significant retail or other systemic UK presence would be expected to establish subsidiaries). The PRA is in the process of working with existing EEA branches to enable these branches to become directly authorised by the PRA and has not indicated that subsidiarisation will be required for any such branches. However, the transition from passported EEA branch to third country branch will present some compliance challenges, due to the increase in applicable PRA and FCA rules and the need for EEA firms that maintain UK branches to continue to comply with existing home state requirements in parallel with the (similar but not identical) requirements under the post-Brexit UK financial services regime.

**Temporary Permissions Regime**

The TPR will allow EEA banks and investment firms currently passporting into the UK to continue operating in the UK for up to three years after the transition period, pending full authorisation from UK regulators. Similar arrangements will apply to EEA insurers, financial market infrastructure providers, electronic money and payment institutions, registered account information service providers and EEA securities and funds that are offered or marketed into the UK.

**FCA**: The window for firms and fund managers to notify the FCA that they wish to use the TPR closed before the end of January 2020. The FCA has said that it will confirm its plans for reopening the notification window later this year to allow additional notifications to be made by firms and fund managers before the end of the transition period. Fund managers should also have the opportunity to update their previously submitted notifications.

**PRA**: On 31 January 2020, the PRA confirmed that no further action is required if a firm has already:

- made (and not withdrawn) a valid notification to the PRA that it wishes to enter the TPR; or
- submitted (and not withdrawn) an application for permission under Part 4A of the Financial Services and Markets Act 2000 ("FSMA") (or for variation of an existing “top-up” permission).

The validity of existing TPR notifications is not affected by the change to the start date of the TPR to after the implementation date. The PRA has said a firm that has not taken the necessary steps to enter the TPR may still do so by submitting an application for permission under Part 4A of FSMA (or for variation of an existing “top-up” permission) before the end of the transition period. Although it is no longer possible to make a TPR notification in accordance with the PRA’s Direction (see 12 April 2019 update).

**Financial Services Contracts Regime**

The Government has also published draft legislation for the Financial Services Contracts Regime (“FSCR”). The FSCR will enable firms which do not enter the TPR to wind down their UK business in an orderly fashion after the transition period. The FSCR will automatically apply to EEA passporting firms that do not notify the regulators that they wish to enter the TPR, but have pre-existing contracts in the UK which a firm would need a PRA or FCA permission to continue to service. HM Treasury has legislated such that the FSCR will now take effect from the end of the transition period at 11pm on 31 December 2020.

**Other contingency measures**

Before the UK-EU transition period was agreed, draft legislation had been developed to provide for temporary transitional powers that could be exercised by the FCA, PRA and the Bank of England ("BoE") to mitigate adverse impact in a hard-Brexit scenario. The regulators had intended to use their
transitional power to provide a general “standstill” and ensure that firms and other regulated entities would not have needed to prepare (subject to certain exceptions) to meet the changes to their UK regulator obligations connected to Brexit. In most cases, firms would generally have been able to continue to comply with the requirements as they were before exit day until the end of a 15-month UK-only transitional period. The FCA, PRA and BoE have confirmed that as the transitional directions are not required during the agreed UK-EU transition period, they have not come into effect. They will communicate on the status of the directions before the end of the transition period.

The FCA, PRA and BoE previously published policy materials including EU Exit Instruments, Supervisory Statements and Statement of Policy which generally had the effective date of “exit day” or “immediately before exit day”. The commencement of these instruments has been delayed until the end of the transition period.

**Longer-term impact on UK rules and legislation**

The starting point of the Withdrawal Act is the transposition of existing EU law, with adaption or amendment only insofar as necessary to ensure a workable regime post-exit. The question of whether deliberate policy changes may be implemented in the longer-term remains unclear at this stage, even more so since Boris Johnson’s written statement on 3 February which proposed generally that any agreement between the UK/EU “cannot […] include any regulatory alignment”.

The public statements from the UK regulators to date do not indicate there will be any reduction in the level of regulation post-Brexit (for example, the evidence of Mark Carney, Governor of the BoE, at a Treasury Committee meeting on 17 July 2017 where it was noted that the UK needed the flexibility to implement stricter regulation than the EU if necessary). It is also unclear whether even limited divergences from current EU-derived requirements (such as repeal of the bonus cap) would be compatible with the strong incentives to secure equivalence decisions from the European Commission, which could limit scope for anything other than continued strict alignment.

The nature of any future equivalence arrangement remains to be seen. Andrew Bailey and Mark Carney have in the past raised concerns with accepting an equivalence-based relationship which forces the UK regulatory authorities to become mere “rule takers”. Mark Carney, when giving evidence to the Treasury Committee in January 2017, preferred equivalence as a means of achieving “equivalent outcomes”, which would permit different approaches and recognise different institutional structures. See House of Commons Briefing Paper Number 07628 Brexit and financial services, 23 August 2018. The BoE repeated the potential risks of the UK becoming a “rule taker” in its paper on EU withdrawal scenarios and monetary and financial stability in November 2018. Andrew Bailey has also discussed his views on “outcomes-based equivalence”. For example, in a speech he gave in April 2019.

Factors that are likely to be relevant considerations in relation to possible changes to EU-derived rules after incorporation will include whether or not the measures are necessary for the financial stability of firms and the UK financial system, or are necessary to ensure the UK’s competitiveness or to meet an international commitment (eg the EU prudential regime under the Capital Requirements Directive and Regulation partly implements Basel III; EMIR is Europe’s response to the G20 commitment to have standardised OTC derivatives cleared through a central counterparty (“CCP”)). The UK is independently committed to these measures and will remain so after it leaves the EU.

In the longer term, it is expected that the combination of relevant international standards and incentives to secure future equivalence decisions would point towards broad alignment between the UK and EU regimes, although this may be less so for potential future EU reforms on which the UK has had no influence. If UK regulatory policy begins to diverge materially from the EU approach, this will create additional burdens for firms with cross-border interests which would need to comply with yet another set of regulatory requirements. It might also lead the EU to review equivalence in those areas of divergence even if a positive equivalence decision has previously been made, particularly given current proposals at EU level for greater scrutiny of equivalence decisions.

**Issues yet to be resolved**

To ensure smooth running of the markets after the end of the transition period, it is hoped that the EU and UK can resolve outstanding issues – some examples of which below – which will require action and, possibly, compromise from both sides over the coming months.

**Share Trading Obligation**

The application and impact of the MiFID trading obligation for shares (which obliges EU investment firms to trade shares only on
EU trading venues) remains a source of controversy between regulators and uncertainty for UK and EU firms and markets. The EU did not provide for transitional relief on the Share Trading Obligation (“STO”) as part of its no-deal contingency planning, although it partially reconsidered its stance on the EU STO in May 2019 such that its application would be limited to shares with an EU ISIN (reversing the earlier position that shares with a GB ISIN would also be within immediate scope of the STO and would therefore have to be traded on an EU trading venue).

The FCA has publicly expressed concern in response to ESMA’s position, noting that the application of the STO (even if limited to EU ISIN shares) would still cause disruption to market participants, leading to fragmentation of markets and liquidity in both the EU and UK, particularly for EU ISIN shares with a dual listing (and primary liquidity) in London. The FCA has cited reciprocal equivalence as the preferred solution. However, ESMA has meanwhile criticised the absence of a clear plan or policy stance from the UK on the application of the onshored UK version of the STO, which will in principle require UK firms to trade shares meeting the necessary liquidity conditions on UK trading venues.

Derivatives Trading Obligation

The EU’s Derivatives Trading Obligation (“DTO”) requires EU firms to trade some classes of OTC derivatives on EU or equivalent third country trading venues. An identical DTO will be implemented in the UK through onshored legislation. Unless the UK and EU find each other’s regulatory regimes equivalent, EU firms will not be able to meet the EU’s DTO by using UK trading venues to trade in-scope derivatives. Similarly, UK firms will not be able to meet the UK DTO by using EU trading venues.

Clearing

There have been some welcomed developments at the EU level in relation to CCP clearing, although some EU stakeholders have been keen to emphasise the temporary nature of these measures and the continued support for longer-term repatriation of euro-clearing away from London. In November 2018, the EU announced preparations for a Brexit no-deal Contingency Action Plan. This included a limited number of contingency measures that have been deemed necessary on financial stability grounds, following examination of sectoral risks in a no-deal scenario. The measures adopted by the Commission were limited to temporary and conditional equivalence decisions for UK CCPs and central securities depositories, together with two delegated regulations facilitating novation, for a fixed period of 12 months, of certain over-the-counter derivatives contracts, where a contract is transferred from a UK counterparty to an EU27 counterparty (for further details see our blog post on these measures).

One unfortunate feature of these measures was that the legislation in question specified a fixed expiry date of 30 March 2020. In December 2019, following a long period of uncertainty for the market, the EU finally extended its recognition decisions for UK CCPs (applicable only in the event of a no-deal Brexit), for one year after UK’s exit. Unless permanent recognition of UK CCPs is granted before the end of transition, the temporary and ad hoc nature of equivalence measures so far will continue to be a source of uncertainty for the market, in particular for EU members of UK CCPs.

“Almost the entirety of UK financial services legislation over the past 10 years has EU legislation as its source”

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