Linklaters

Decoding Brexit for the financial services

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1. Passporting: a quick recap

Many global financial services firms have their European headquarters in the UK. Their current European business model, when serving clients across the region, is likely to rely on the right to passport into EEA countries.

This means they can use their UK licence to provide a range of financial services from the UK into the EEA or establish branches in the EEA, instead of having to seek a separate licence for each EEA country in which they want to do business.

2. What will Brexit mean for passporting?

Passporting rights are only available to firms operating within the EEA. Leaving the EU will mean that the UK is a "third country" (EU-speak for a country outside of the EEA) for the purposes of EU law.

Some EEA countries allow certain financial services to be provided from a third country, e.g. where the contact is initiated by the client (known as reverse solicitation). However, depending on their business models, firms may not be able to rely on exemptions for most of their business.

Unless a form of market access is retained by the UK's exit agreement with the EU, for example in a form of mutual recognition / cooperation agreed between the UK and the EU, UK-based firms, which rely on a passport, will need to either:

> establish a subsidiary in the EEA and take advantage of its full passporting rights; or

> establish branches in each country where they wish to do business locally and hope to rely on grandfathering being available for these branches when the UK leaves the EU.

Conversely, those EEA firms that currently passport into the UK may need to obtain fresh authorisations from the FCA and (where appropriate) PRA in order to continue to provide services in the UK.

3. Are there any alternatives to this restructuring? Will "equivalence" help us?

As an alternative to passporting, fifteen EU acts recognise the concept of deeming third country regulatory regimes as "equivalent" to the EU. After Brexit, the UK will be such a third country.

Firms based in equivalent third countries have some rights not granted to firms from non-equivalent third countries. So, the UK being deemed equivalent could theoretically mitigate the loss of passporting rights.

4. What does “equivalence” mean?

Equivalence is assessed by the Commission at its discretion.

The Commission, in assessing the relevant aspect of the regulatory framework in the UK would consider whether the requirements of the regulatory framework are legally binding in the UK, whether they are subject to effective supervision by the FCA and PRA and whether they achieve the same results as EU rules. Given that we are currently complying with the various regimes, as well as getting ready for MiFID II compliance, upon withdrawal it should be straightforward to say that the UK is equivalent. However, this may underestimate the political as well as bureaucratic hurdles that may hold up such a decision.

“Equivalence” is not a blanket concept covering the totality of financial regulation. A third country could be equivalent in respect of MiFID II but not in respect of AIFMD, for example. Even within one regime there may be different equivalence assessments to be made (e.g. MiFID II). Each determination is made separately, according to the processes set out in the particular legislation and subject to its own timescales.

Unhelpfully, although a third country can request to be assessed as to its equivalence, the Commission is under no obligation to act, and if it does act, is under no specific obligations as to deadline. For example, it took nearly four years for the Commission to assess whether the US could be equivalent under EMIR. Recent statements made by ESMA (the European Securities and Markets Authority, the EU regulator focused on the protection of investors, the stability and the orderliness of the financial markets) and the Commission suggest that the mood in the EU may be to further tighten the “equivalence” concept: it has been argued that currently there is no clear incentive for the third country regulator to appropriately address the risks associated with the activities of its supervised entities arising outside of its jurisdiction.

Once a third country is assessed as equivalent, the administrative hurdles are not over: under some regulations the third country firm itself has to apply to ESMA for “recognition”. And it has been suggested that ESMA should be able to charge fees to third country firms requiring recognition to cover some of its administration costs.

5. Do we think “equivalence” is the answer?

In the form currently provided for in EU regulation, it is not; it is uncertain and does not cover all of the financial services.

It may be that a special form of equivalence can be agreed between the EU and the UK. It is doubtful whether this will be ready when the withdrawal comes into force, but it has been suggested that at least the key terms of that arrangement may be drawn up by then, enabling some degree of planning and transitional arrangements to be put in place.

This form of equivalence would not necessarily rely on a unilateral determination by EU institutions that the UK rules meet their standards, but could amount to a form of mutual recognition of standards in the two markets.

As it stands, there are a number of practical and legal limitations on equivalence as a replacement for passporting, including:

- The Commission is under no obligation to grant equivalence and may make its decision on purely political grounds. In the absence of agreement, there will be a period post-Brexit where no equivalence decision has been made. Equivalence, once granted, could be taken away by the European Commission at any time.
- There is no general equivalence regime that covers all of the financial services. Banking activities falling within the scope of CRD IV, including deposit taking and lending, are without such a regime, as are insurance mediation and payment services.
- Where there is the concept of equivalence, it is piecemeal in its application even within a particular regime.
- Under the current provisions, the ability to contract under English law, with recourse to English courts, would be significantly restricted by the requirement for firms operating under several EU equivalence regimes (including that in MiFID II) to offer to submit to EU courts or systems of law.
- Equivalence recognition would not extend, under current rules, to retail financial services.
- The UK would have to maintain an equivalent regulatory regime, limiting its ability to benefit from greater flexibility outside the EU. In any event, such a requirement may be incompatible with taking back control of law-making.

6. A closer look at equivalence under some of the EU regimes

MiFID II
(for banking and investment activities)

"Equivalence" concept? ✓

But…

> Equivalence recognition does not extend to retail financial services – third country firms can provide services to retail clients only through an authorised branch in the EEA and there is no access to a passport.

> Trading in shares must take place on certain types of venues. Investment firms in the UK may currently act as "systematic internalisers", matching orders internally, for the purposes of this requirement. This right will be lost and will not be replaced by the MiFID II equivalence regime.

> EU exchanges and other trading venues are required under MiFID II to open their membership to authorised investment firms but not firms from equivalent third countries.

> EU venues are required to permit only authorised investment firms but not firms from equivalent third countries to provide their clients with direct electronic access, which is a material line of business for UK investment banking.

CRD IV
(for wholesale and retail commercial banking)

"Equivalence" concept? ✗

So…

> Deposit-taking, when authorised under CRD IV (if carried on by an investment firm it is authorised under MiFID) cannot be passported by a third country firm.

> Lending is also a CRD IV activity. In the UK it is not subject to the licensing requirement, but in many other EEA countries it is. A UK based firm with a CRD IV licence to accept deposits and a passport to undertake lending (and deposit taking) in the rest of the EEA will not be able to benefit from its passport post-Brexit. It may need to set up an entity and obtain a CRD IV licence in the EEA in order to benefit from the passport.

AIFMD
(management of alternative investment funds broadly for non-retail)

"Equivalence" concept? ✓

But…

> AIFMD includes a managing and marketing passport which, in theory, can be used by managers in third countries. It is a requirement of using it that the manager must be fully compliant with AIFMD.

> BUT the "third country passport" concept has to be "switched on" by the Commission before it can be used. This has not happened yet at all (n.b. AIFMD has been in force since 2013). It is expected that the "switch on" will be done country by country.

> Absent any special agreement, it seems that the UK's right to use the third country passport cannot begin to be considered by ESMA and the Commission until the UK withdrawal has occurred. There are clearly timing implications to this – first ESMA has to assess the regime in the UK against AIFMD, then the Commission has to take the decision.

> No third country has been recognised by the Commission as yet, although several have been positively assessed by ESMA. We understand that the Commission is waiting for certain tax matters to be agreed first before it can adopt ESMA's assessment, although clearly delays may be political as well.

6. A closer look at equivalence under some of the EU regimes

UCITS
(regulation of (retail) UCITS funds and their managers)

"Equivalence" concept? ✗

So…

> Unless the UK negotiates a settlement to retain its status as being within the jurisdiction of UCITS, all UK UCITS will need to be re-domiciled/re-authorised to remain a UCITS.

> Otherwise, they may be considered a non-UCITS retail fund which would be an AIF under AIFMD, and whose marketing, to the extent in the EEA, would be subject to the AIFMD third country passporting issues identified above, as well as AIFMD restrictions on access to retail investors.

> For a UK manager of an EEA UCITS, remaining in the UK would mean that it would not be permitted to manage the UCITS, although in practical terms it is likely that it could act as a sub-advisor to the EEA manager provided that the requirements of the UCITS country of domicile are met.

> In terms of marketing into the UK, subject to the UK deciding differently at the time, EEA UCITS will only be able to be marketed under the UK national private placement regime, requiring compliance with the UK's financial promotion restrictions and severely impacting upon the UCITS ability to market to retail investors.

EMIR
(regulation of central clearing counterparties)

"Equivalence" concept? ✓

But…

> Should an equivalence decision be made, a UK CCP or UK trade repository would be able to apply to ESMA for recognition under EMIR, which, if granted, would allow EEA counterparties to continue clearing and reporting through UK CCPs and trade repositories.

> Obtaining an equivalence decision from the Commission and CCPs obtaining recognition from ESMA are processes that will take some time – ESMA has 180 days to consider an application for recognition of a third country CCP/trade repository – and it is unclear whether the UK (and UK CCPs) would be permitted to make these applications prior to Brexit taking effect.

> Subject to any special agreement, UK CCPs will not be able to clear contracts subject to the mandatory trading obligation until the UK is deemed equivalent.

PSD / PSD2
(regulation of payment services and providers)

"Equivalence" concept? ✗

So…

> Absent any special arrangement, post Brexit it will not be possible for UK payment services firms to provide payment services in the EEA other than in accordance with local law and the policies of local regulators.

7. What does Brexit mean for access to exchanges and clearing houses?

Subject to special agreement, Brexit signals a loss of automatic access to EEA exchanges, clearing and settlement systems for UK firms.

MiFID II provides that investment firms have a right of direct and indirect access to EEA CCPs, exchanges, clearing and settlement systems. This right is carved out from the "equivalence" concept and does not extend to third country firms. So, post-Brexit, UK firms will not have an automatic right of access and will instead depend upon the rules and membership criteria of the particular CCP.

It may also be that participating in EEA venues is regarded as an authorisable activity by regulators in the relevant member state.

To the extent that the EEA CCP or the regulator in its home state restricts access to non-EEA firms, UK firms would need an affiliate EEA-authorised investment firm or bank to be the clearing member for the group.

Whilst this is relatively straightforward to achieve, it may result in an indirect client clearing arrangement – which may mean firms need to mitigate any increased costs and inefficiencies.

8. We're back to looking at restructuring: what are we talking about and what are the key considerations?

Location of sales hub vs location of booking vehicle

Considerations

> To continue to be able to access clients across the EEA without applying local licensing requirements in each member state, an EEA hub may be required for those aspects of the activities which trigger the licensing requirement (and which can be passported across the EEA).

> The sales arm, which faces clients, is the most likely aspect of the business to be moved into such an EEA affiliate as it is where many of the activities requiring a licence are deemed to be carried out.

> Risk management will be a key consideration in determining the structure of this split, in particular determining what level of oversight and control is required in the EEA hub and what can remain in the UK booking vehicle.

This restructuring can be effected in a number of ways. Two possible arrangements are set out below.

1. Agency intermediation structure

Considerations

> This is where an appropriately licenced EEA affiliate faces clients and trades with them as agent for the UK booking vehicle.

> The viability of this option turns on the risk of the local regulator looking through the structure to the UK vehicle and requiring it to be licensed as well.

> There is a risk that attitudes to intermediation will harden post-Brexit.

8. We're back to looking at restructuring: what are we talking about and what are the key considerations?

2. Back-to-back intermediation structure

Considerations

> As for agency intermediation above, except the EEA affiliate enters into the trades on its own behalf and books the risk that arises from those trades to a separate UK booking vehicle under back-to-back contractual arrangements with that UK booking vehicle.

> This model is more likely to give rise to regulatory capital impacts, including in relation to large exposures, existing netting arrangements and capital leakage.

> But it carries less "look through" risk.

Outsourcing

Considerations

> Any restructuring arrangements will need to be analysed as to whether they constitute a material outsourcing from one group entity to another.

> Outsourcings are subject to regulatory requirements under MiFID I and II, as well as local laws in many EEA countries.

> Group outsourcings have been the subject of significant regulatory scrutiny in recent years to ensure that appropriate levels of oversight and control are exercised, and that risk is properly assessed and managed.

> The EEA entity, as outsourcer, will be required to have sufficient substance in the eyes of the local regulator and it may not be possible to outsource all functions to the UK outsourcee.

> The degree of "substance" required will turn on the attitude of the local regulator; some may be more flexible than others.

> It is possible that over time the EU requirements will tighten in this space, forcing more of the operation and more of the control to move out of the UK booking vehicle.

Delegation of portfolio management

Considerations

> As currently stands, post-Brexit a UK fund manager will not be allowed to manage an EEA UCITS directly. They will be able to manage and market AIFs in the EEA, however the latter will be under the Article 42 regime (and only in countries where this has been implemented), rather than the full passport. Once the third country passport is made available to the UK, UK fund managers managing EEA AIFs, and/or intending to market AIFs under the passport, will need to comply with AIFMD in full and be authorised by a Member State of Reference.

> The delegation model of interposing an EEA AIFM or UCITS manager who delegates portfolio management to a UK-based sub-manager may be an alternative. For this to work there must be sufficient substance in the EEA manager to satisfy regulatory requirements which seek to prevent the manager from being simply a "letter box" entity. Sufficient risk management, governance and compliance must be retained by the EEA entity, meaning that the availability of this option will in part turn on the resources of the fund manager.

> What is sufficient substance will depend to an extent on the approach of the particular member state regulator, and some, notably the Luxembourg and Irish regulators, are thought to be receptive to a "lighter touch" regime in respect of delegation to a non-EEA portfolio manager.

> That said, it is still uncertain the extent to which the delegation model could be eroded post-Brexit. There are some signs that Brexit may be a catalyst for the EU to rethink its approach to delegation, for example by tightening the obligations on AIFMs to supervise third party service providers, which would include sub-managers. Post Brexit, this would impact not only UK managers of EEA funds, but also US managers who currently manage EEA funds on a delegated basis. ESMA has indicated that it intends to look at delegation models with the aim of stopping "a race to the bottom", i.e. chains of sham entities cascading down to a non-EEA portfolio manager.

> The delegation model relies on cooperation agreements between countries. There are currently none between the EU and the UK, but post-Brexit these will be required although in what form and when they will be agreed is unknown as yet.

8. We're back to looking at restructuring: what are we talking about and what are the key considerations?

Access to financial markets infrastructure (CCPs, regulated markets, trading venues)

Considerations

> Firms will need to assess the terms of all memberships that they hold. Do they still permit access once the firm is a third country institution?

> If not, does the firm need to join through an affiliate in the EEA?

> What are the consequences of new clearing arrangements on the client clearing model: can clients continue to contract with the UK firm or do they need to be taken on by the EEA affiliate directly? What is the impact of this on the UK and EEA entity?

Non-financial considerations

Whilst this guide clearly focuses on regulatory issues, it is the case that decisions about structure and location need to factor in a range of considerations including:

> Current presence in any other juristiction

> Language and experience of the regulator

> Employment law, HR, pensions and remuneration

> Presence of competitors

> Education system and availability of financial services workforce

> Data protection

> Tax

> Hardware locations and impacts of latency

> Cost of living

9. Implementation: the bigger picture

In the absence of a "day 1" deal on equivalence or some other form of mutual recognition, firms based in the UK need to prepare for a regulatory environment in which there are no special access arrangements into the EEA, for a period of time at least.

New EEA affiliates may need to be set up, or existing ones transformed, with the appropriate licences. From a regulatory perspective, this may involve extensions to current permissions, changes in control (requiring regulatory approvals), new authorisations or notifications of the exercise of passporting rights, all likely accompanied by an in-depth dialogue with regulators.

Clearly there are timing issues associated with this. Regulators have three months to consider a change of control application and six months to grant a new licence, although in reality by "stopping the clock" to ask further questions, and by firms engaging with regulators in advance of the formal application, we can expect this to take much longer in some cases.

The regulatory processes will run in tandem with corporate mechanisms to relocate operations.

Depending on the mechanisms envisaged, these may need to commence far in advance of the exit date, unless transitional arrangements are agreed between the EU and the UK allowing firms extra time to get ready.

EU institutions, including the ECB, have indicated that they would be willing to expedite processes and grant firms transitional periods if they move to the EEA. However a reliable commitment to this remains to be seen.

By way of indication, business transfers of banking or insurance business under Part VII of the UK's Financial Services and Markets Act typically require between nine and fifteen months to complete as there are lengthy, fixed court timetables involved. Mechanisms under the EU Cross Border Merger regime are also lengthy – typically taking around one year to complete – due to potential delays for negotiation of employee participation. Conversion to a "Societas Europaea" (a form of pan-EU public company) takes three to four months at a minimum, although again, employee negotiations may significantly extend the period. Given the timescales involved, and in the absence of clarity around any transitional arrangements, many UK firms find themselves in the position of having to plan for these re-organisations now.

Key contacts

Peter Bevan
Partner, London
Tel: +44 20 7456 3776
peter.bevan@linklaters.com

Michael Kent
Partner, London
Tel: +44 20 7456 3772
michael.kent@linklaters.com

Harry Eddis
Partner, London
Tel: +44 20 7456 3724
harry.eddis@linklaters.com

Nikunj Kiri
Partner, London
Tel: +44 20 7456 3256
nikunj.kiri@linklaters.com

Carl Fernandes
Partner, London
Tel: +44 20 7456 3002
carl.fernandes@linklaters.com

Sarah Parkhouse
Partner, London
Tel: +44 20 7456 2674
sarah.parkhouse@linklaters.com

Martyn Hopper
Partner, London
Tel: +44 20 7456 5126
martyn.hopper@linklaters.com

Nadia Swann
Partner, London
Tel: +44 20 7456 5232
nadia.swann@linklaters.com

linklaters.com

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