Society of Conservative Lawyers

A Bespoke Arrangement for a European Asset: the Best Post-Brexit Deal for the City and UK Financial Services

A. Introduction, assumptions and executive summary

1. At present, financial services firms authorised in the United Kingdom are firms based in a European Union Member State. For the purposes of accessing the financial services markets of other EU States (and vice-versa), these firms hold single market "passports". These passports enable UK-based firms that have complied with the requirements of the UK regulators to provide financial services in the territory of other Member States (and in some cases of EEA states) without obtaining separate regulatory authorisations from those States.

2. Because different passports are required for different kinds of business, in many cases firms hold more than one passport. As of August 2016, 5,476 UK-authorised firms held 336,421 passports enabling them to conduct business across the EU and EEA. A further 8,008 firms from other EU Member States (or EEA states) held 23,532 passports enabling them to conduct business in the UK.[1] The fact that the number of "outbound" UK passports exceeds the number of "inbound" passports by a factor of almost 15 indicates the overwhelming dominance – as things stand – of UK-authorised firms as providers of cross-border financial services in the EU.

3. For the purposes of this paper, I make the assumptions, first, that the UK will leave the EU and, secondly, that it will not retain access to the Single Market, whether through membership of the EEA or otherwise. In that scenario, the rules governing

[1] See the letter dated 17 August 2016 from the CEO of the Financial Conduct Authority to the Right Honourable Andrew Tyrie MP, Chairman of the House of Commons Treasury Committee.

the UK's financial services sector's access to the EU would, in common with other sectors of the British economy, "default" to the protocols of the World Trade Organisation. Under WTO rules, UK-based firms would automatically lose passporting rights. In order to provide services in each EU (and EEA) Member State, UK firms would therefore have to comply with such conditions and restrictions as each national regulator saw fit.

4. In this paper I consider the options available to UK firms in this scenario. These firms, it should be noted at once, include a very considerable number of firms whose parent company is not based in the UK or another EU Member State, but in a "third country" (in the EU terminology), such as the United States, Japan or China, and which currently uses the UK as a base from which to access the Single Market. On the assumption that Her Majesty's Government regards it as desirable that such firms continue to operate from the UK, it is a matter of great importance that a legal and political mechanism be found that enables them to retain as many as possible of their former passporting rights once Brexit takes place and the UK itself becomes a "third country".

5. In summary, I conclude that:

   (1) the "equivalence" regime, under which UK firms can preserve some passporting rights, is likely to be valuable, but will fall well short of adequately compensating for the loss of full passporting, both in terms of the sectors covered and the clients to whom services can be provided. Moreover, the way in which the EU has so far applied existing equivalence regimes suggests that the UK may not automatically be granted equivalence in all sectors post-Brexit;

   (2) in sectors not covered by equivalence, there is some scope for compensating for lack of passporting by the establishment in an EU Member State of a "branch" of a UK firm, although this is also an incomplete solution, and will inevitably entail the shift of some personnel from the UK to the EU;

(3) the solutions offered by both the equivalence regime and branch establishments entail considerable regulatory and political uncertainty, which will increase the likelihood of UK firms planning to move business to the EU ahead of Brexit;

(4) the optimum solution, if the UK financial services industry is to retain its current pre-eminence, is for a comprehensive settlement to be agreed as part of Brexit negotiations that allows UK firms substantially to retain passporting rights (with continuing reciprocal rights for EU firms). While this settlement could be based on a combination of the existing equivalence and branch regimes, for the reasons discussed below, these regimes are flawed, and seeking to combine them would be undesirably complex. Bespoke, sector-by-sector arrangements are therefore likely to be more advantageous. Such a settlement would prevent the fragmentation of the industry and the decline of the UK – and the EU – as a financial centre in favour of other polities such as New York City, Dubai and Singapore.

B. Equivalence under MiFID II

B.1 Introduction

6. "Equivalence" denotes the regime under which the EU regulator, the European Securities and Markets Authority (**ESMA**), makes an assessment that a third country's domestic financial services regulations achieve an "equivalent" effect to those required by European law, and so allows firms from that third country to provide certain (but not all) financial services throughout the EU.

7. This regime will be enacted under the Markets in Financial Instruments Directive (2014/65/EU) (**MiFID II**) and the Markets in Financial Instruments Regulation (2014/600/EU) (**MiFIR**). MiFID II and MiFIR will replace the present Markets in

Financial Instruments Directive (2004/39/EC) (**MiFID**), which makes no provision for third-country equivalence, and are scheduled to come into force on 3 January 2018. It is therefore highly likely that the equivalence regime will be in place when formal Brexit negotiations begin, although the way in which it will be applied remains uncertain.

8. MiFID II (like MiFID) will deal only with investment services and activities, such as trading in securities and derivatives, executing client orders, giving investment advice and providing portfolio management services. It will not apply to a broad range of other financial activities, such as deposit taking and lending, and these are considered below. In those areas to which MiFID II will apply, however, it will provide some – but not complete – overlap with passporting.

B.2 The MiFID II/MiFIR regime: passporting

9. Article 46 of MiFIR sets out the requirements for a third-country firm to be registered with the European Securities and Markets Authority (ESMA) and allowed to provide services throughout the EU without establishing a branch or satisfying any additional regulatory requirements of individual Member States. The key requirements for a firm to benefit from passporting under Article 46.2 are that:

   (1) the Commission has determined (on the advice of ESMA) that the legal and supervisory arrangements of that third country have equivalent effect to the prudential and business conduct requirements of MiFID II. Under Article 47.1 of MiFIR, this determination will require that the third-country firm is:

      (i) authorised to provide the relevant services in its home country and subject to full supervision and enforcement by the relevant domestic regulator (such as the Financial Conduct Authority in the case of the UK);

(ii) subject to sufficient capital requirements and appropriate requirements applicable to shareholders and members of its managing body;

(iii) subject to adequate organisational requirements in the area of internal control functions;

(iv) subject to appropriate conduct of business rules; and

(v) domiciled in a third-country that ensures market transparency and integrity by preventing market abuse in the form of insider dealing and market manipulation; and

(2) co-operation arrangements have been established between ESMA and the domestic regulator.

10. It is essential to note, however, that the scope of the regime under Article 46.1 is limited. It only allows a third-country firm to provide services to eligible counterparties and *per se* professional clients. It does not permit the firm to provide services to retail clients or to opt-in professional clients.

11. The distinction is an important one. Under Section I of Annex II of MiFID II, professional clients are defined to include only particular entities characterised by size and/or financial sophistication: financial institutions[2], large undertakings that meet specified size requirements[3], national and regional governments, central

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[2] Defined in paragraph (1) of Section 1 as credit institutions, investment firms, other authorised or regulated financial institutions, insurance companies, collective investment schemes and their management companies, pension funds and their management companies, commodity and commodity derivatives dealers, locals and other institutional investors.

[3] Defined in paragraph (2) as large undertakings meeting two out of three requirements of (i) a balance sheet of €20m, (ii) a net turnover of €40m and (iii) own funds of €2m.

banks, international institutions[4] and institutional investors. Any other person or entity is either an elective professional client[5] or a retail client.[6]

12. The effect of the distinction drawn in Article 46 is therefore that – even with passporting rights – a third-country firm could only provide services to large and/or financially sophisticated clients. It could not use the passport to provide services to any other categories of clients, such as private individuals, public sector bodies or local authorities and municipalities, even if those clients were prepared to opt-in to being treated as a professional client (as many at present do). This is likely to impose a considerable handicap on a UK-based firm – even assuming it had passporting rights under MIFIR – seeking to market derivatives in the Single Market post-Brexit.

B.3 The MiFID II/MiFIR regime: branch establishment

13. Third-country firms will therefore wish to overcome this severe limitation in their potential range of clients. The means to do so and to market to elective professional clients or retail clients will be the establishment of a branch under Article 39 of MiFID. Although there is an exemption under Article 42 to the branch-requirement, whereby a third-country firm may deal directly with a retail or opt-in professional client who approaches it, the firm is still not allowed to market new categories of product or services to that client. It is difficult to imagine any sustainable business model that excludes such marketing. The practical reality, therefore, is that third-country firms will need a branch.

[4] Examples given in paragraph (3) include the World Bank and the IMF.

[5] Under Section II of Annex II of MiFID.

[6] Under Article 4.11 of MiFID.

14. It is important to note that certain Member States, most notably Germany, have not agreed to this procedure, and so in those States a third-country firm could only deal with retail and opt-in professional clients if it operated through a subsidiary in full compliance with local regulation.

15. Article 39.2 requires that a branch acquire prior authorisation from the competent authorities of each Member State, subject to certain conditions. These conditions include provisions for domestic authorisation and co-operation similar to those found in the passporting regime, as well as compliance with requirements relating to capital, management, taxation and investor compensation. Article 41.2 also requires that the branch comply with certain provisions of MiFID II and MiFIR. If those requirements are satisfied, then the competent authority of the Member State can authorise a branch to provide services to retail and elective professional clients. This process can take up to 6 months from the application by a third-country firm.

B.4 The MiFID II/MiFIR regime: drawbacks

16. The equivalence regime, then, has some potential to mitigate the problems that would follow from the loss of single-market access. UK-based firms would likely continue to access *per se* professional clients in the EU using a passport, and other clients through a branch in a Member State. There are, however, significant limitations in the regime, that mean it would be far from providing a complete solution even to those parts of the British financial services industry to which it applies (see paragraph 22 below).

17. First, it is not a given that the Commission would grant equivalence to the UK regulatory regime. This may seem surprising, given that the UK's regime is generally regarded as the most sophisticated of any EU Member State, as is to be expected given London's status as a financial centre. But the decision whether or

not to grant equivalence may become, at least in part, a political one, and dependent on other aspects of the negotiations between the UK and the EU on the terms of Brexit. In order to be granted equivalence, the UK may be expected to conform to the EU's position on contentious points such as remuneration restrictions. Furthermore, under MiFID II/MiFIR no equivalence decisions have yet been made in respect of any third country, and so it cannot be certain how these will be made in practice.

18. Secondly, both an equivalence decision and the establishment of a branch will take time. Such equivalence decisions as have been made in respect of non-MiFID II activities (addressed in section C below) have taken up to a year. After a positive equivalence decision has been made, article 46.4 of MiFIR provides a timetable of a further 6 months for completion of a third country's registration with ESMA, at which point third-country firms could begin to service professional clients. Following this registration, there would then be a further period of 6 months before a branch could be established to service retail and elective professional clients. There could therefore be a significant gap between the UK applying for equivalence and the point at which UK-based firms could begin to offer services to clients. Business and jobs may be lost in the interim.

19. Thirdly, the need to establish a branch in EU Member States to deal with any client other than a large and/or sophisticated institution will lead inevitably to some fragmentation of the financial services industry presently concentrated in London, and the move of some jobs to the EU.

20. Fourthly, not all Member States, most notably Germany, will be willing to allow third-country firms to deal with retail and elective professional clients through a branch.

21. Fifthly, under Article 49.3 of MiFIR, the Commission will keep under review any equivalence decision under Article 47.1. This means that the UK would need to

continue to satisfy the EU that its prudential and business conduct framework fulfilled the Commission's requirements. Any significant divergence in the future between the UK's regulatory regime and that of the EU would therefore put passporting rights at risk. The UK is likely therefore to be in the position of needing to comply with EU financial services regulation over which it has no say.

22. Finally, the MiFID II/MiFIR regime deals only with financial instruments and ancillary services.[7] It does not cover deposit taking, insurance or many other significant areas of the financial services industry. As is explained in Section C below, access to the EU market for UK-based firms will depend on a patchwork of other equivalence regimes, branch establishments and *ad hoc* solutions.

C. Equivalence and branch establishment under other regimes

C.1 Investment management - UCITS

23. At present, the establishment and operation of retail funds is regulated by the Undertakings in Collective Investment Schemes Directive (2009/65/EC) (**UCITS**). Under UCITS Section 16, to enjoy passporting rights, such funds must be based in a Member State and either self-managed or managed by a manger domiciled in a Member State.

24. Once the UK leaves the Single Market, these rights would be lost for UK-based funds and managers. UK-based funds would instead likely be treated as alternative investment funds, which are subject to a different regulatory regime (discussed below). Since the UCITS regime has no equivalence provision, UK funds would need either to obtain passports through the alternative investment fund regime, or be sold into the EU using national private placement provisions.

7 Set out in Annex I of MiFID II.

A further possible option would be for UK-based funds managers to sponsor and act as investment advisers to parallel EU-based funds, with a separate EU-based manager acting as the management entity.

C.2 Investment management - AIFMD

25. A more promising solution may be found in the Alternative Investment Fund Managers Directive (2011/61/EU) (**AIFMD**). AIFMD deals with retail funds based outside the EU (and so excluded from the UCITS regime), as well as other alternative investment funds (**AIFs**) such as hedge funds, private equity funds, retail investment funds, investment companies and real estate funds. There are two potential routes for an AIF based outside the Single Market to operate in the EU/EEA.[8]

26. First, under Article 42 of AIFMD, a UK-based AIF could be marketed to professional investors in the EU through national private placement regimes. Each Member State has its own such regime, and so UK-based AIFs would have to comply with different requirements for each Member State. In addition, article 42 lays down minimum conditions for third-country AIFs to operate in the EU:

(1) the AIF must comply with AIFMD disclosure and reporting requirements;

(2) there must be appropriate co-operation arrangements between the supervisory authorities of the Member States where the AIF is to be marketed and those of the AIF's home state; and

[8] AIMFD has yet to be incorporated into the EEA Agreement but this is anticipated to take place pre-Brexit.

(3) the home state of the AIF must co-operate in combatting anti-money laundering and counter-terrorism.

27. Although the common core Article 42 conditions do not appear especially stringent, the requirement to comply with a range of different national private placement schemes is likely to make the Article 42 route an unattractive one for UK-based AIFs. In some cases, these additional national requirements are strict and effective in discouraging third-country AIFs from operating in that Member State.

28. More attractive is likely to be a second option: the apparently comprehensive passporting regime for third-country AIFs under Articles 35 and 37-41 of AIFMD. Even this route has potential drawbacks, however, as the treatment of the 12 non-Member States that have so far applied for an equivalence decision under AIFMD shows.

29. First, the length of time these applications has taken has not been encouraging, with almost a year elapsing between application and decision. The slow pace of decision-making is not a hopeful sign for similar decisions under MiFID II/MiFIR.

30. Secondly, the results of these eventual determinations proved decidedly mixed. In 5 cases, unqualified approval was given that the regulatory regime of the third country had equivalent effect to the EU's regime.[9] In 4 cases, only qualified approval was given, with definitive advice awaited on the remaining 3.[10] The third countries receiving qualified approval were the US, Australia, Hong Kong and Singapore. All of these are states with highly developed financial services industries and sophisticated regulatory systems, but which were judged not fully compatible with the EU for passporting purposes. This should give pause for

[9] Canada, Guernsey, Japan, Jersey and Switzerland.

[10] Bermuda, the Cayman Islands and the Isle of Man.

thought to those who assume that the UK will automatically be granted equivalence post-Brexit, whether under the AIFMD regime or elsewhere.

C.3 Prospectus Directives and Capital Markets

31. The requirements for circulating a share prospectus among EU Member States is dealt with by the Prospectus Directive (2003/71/EC). Article 20 of the Prospectus Directive provides for an equivalence regime that allows an issuer based in a third-country to offer shares to the public or trade on a regulated market in the EU, subject to having satisfied the requirements of the issuer's domestic regulator and of an equivalent regulatory regime in a Member State.

32. The UK could take advantage of this regime post-Brexit, albeit that UK-based issuers would still be exposed to the potential downsides of passporting outlined above in the context of MiFID II/MiFIR and AIFMD. However, in 2019 the EU plans to introduce the Capital Markets Union regime, under which the rights of third-country firms are presently unclear.

C.4 Derivatives

33. Passporting is also possible for the sale of over-the-counter derivatives (**OTCs**) and derivatives sold through central counterparties (**CCPs**), by virtue of the European Market Infrastructure Regulation (2012/648/EU) (**EMIR**), which imposes requirements for authorisation and conduct of business regulations for CCPs and on counterparties to derivatives contracts and trade repositories.[11]

[11] The EMIR regime derives from commitments made by the G20 in 2009 and so will likely be grandfathered into UK law or otherwise replaced.

34. Article 14 of EMIR allows passporting for clearing services provided by an EU-based CCP authorised by the domestic regulator of its Member State. Articles 13 and 25 provide for third-country CCPs to apply to ESMA for recognition to provide clearing services to persons established in the EU, so long as that third country has been granted equivalency. As with the MiFID regime, this process may take up to 6 months (Article 25.4).

35. To date, equivalence has been granted to CCPs from 19 non-EU Member States, including Australia, Canada, Hong Kong, Japan, Singapore, South Korea and the United States. So far as the respective regulatory regimes are concerned, there is no reason to think it would not also be granted to the UK. There will be, however, a degree of political risk to this process, as the European Central Bank might take the opportunity to insist that a CCP that does clearing business in Euros must be based inside the EU. The UK was successful in challenging the ECB on this point in 2015 through the ECJ but, post-Brexit, such a challenge would no longer be available.

<u>C.5 Insurance</u>

36. Insurance and reinsurance business is dealt with by the Solvency II Directive (2009/138/EC). The Solvency II regime does not offer comprehensive passporting rights to third-country insurance companies, and any useful instances of equivalence are limited to:

(1) an equivalence/passporting regime for third-country reinsurers under Article 172; and

(2) the provision in Article 260 that allows EU supervisors to rely (under certain conditions) on the group supervision exercised by a third country with equivalent status, thereby obviating the necessity of dual group-supervision.

37. Otherwise, UK-authorised insurance companies that wish to operate in an EU Member State post-Brexit will need to do so through a branch established in a Member State, using the provisions of Article 162.2 of Solvency II.

38. Providers of insurance and reinsurance distribution services (e.g., brokers or agents) will from 23 February 2018 be dealt with under the Insurance Distribution Directive (2016/97/EU).[12] This makes no provision for any equivalence regime, and so, post-Brexit, UK-based insurance intermediaries will need to ensure they are authorised under the national regulations of each individual EU Member State.

C.6 Lending

39. Deposit-taking and lending by credit institutions in the EU/EEA are regulated under the Capital Requirements Directive IV (2013/36/EU) (**CRD IV**). This does not at present provide passporting rights to third-country firms, which must operate in compliance with the specific regulations applicable in each individual Member State in which they do business. Recital 23 of the Directive does, however, envisage that an equivalence regime may be established in the future, although (by contrast with the MiFID II/MiFIR regime), there is no detailed guidance on how this regime might operate. After Brexit, such UK-based lenders as engage in cross-border lending will therefore hope that an agreement can be negotiated with the EU/EEA, whereby some sort of passporting is permitted, although these negotiations will doubtless be vulnerable to the concerns discussed above in respect of MiFID II/MiFIR passporting.

40. The regime which deals with secured property lending – the Mortgage Credit Directive (2014/17/EU) – makes no provision at all for passporting for third-

[12] The present regime is the Insurance Mediation Directive (2002/92/EC), but Brexit is likely to occur before or very shortly after this becomes obsolete.

country firms, and so UK-based firms that wish to provide these services in the EU/EEA post-Brexit will need to comply with the particular requirements of each Member State.

C.7 Money transfers

41. From 13 January 2018, payment services across the EU/EEA will be dealt with by the Payment Service Directive II (2015/2366/EU).[13] This makes no provision for passporting rights for firms based in third countries, and so in order to operate within the EU post-Brexit, UK-based firms will need to comply with individual local requirements.

42. The post-Brexit position will be similar for UK-based firms who wish to provide e-money services to EU Member States. The applicable regulation – the Second E-Money Directive (2009/110/EC) – makes no provision for passporting rights for third-country firms, although, like CRD IV, it does envisage in very general terms that an equivalence regime may be established in the future (see Recital 15).

D. Conclusions

43. None of the new and proposed third-country rights for UK-based firms will fully mitigate the loss of EU passporting rights after Brexit. Without a comprehensive solution, business and jobs are therefore likely to be lost in London, Edinburgh and across the UK. Some of these will doubtless go to financial centres in EU Member States, as firms headquartered in the UK are forced to establish subsidiaries or branches. But, should the attraction of London as the gateway to the Single Market wane, there is also a significant risk that non-European financial firms will prefer

[13] Replacing the present Payment Services Directive (2007/64/EC).

to shift resources to more comparable centres such as New York or Singapore, rather than to comparatively minor players such as Frankfurt, Paris or Dublin. No other EU financial centre comes close to matching the depth and breadth of London's expertise, or will do so post-Brexit.

44. The negotiation of a comprehensive settlement to preserve the ability of firms based in the UK to operate seamlessly in the EU is therefore imperative. Such a settlement is likely also to be to the advantage of the remaining Member States. Absent such settlement, no one European city or polity is likely to attract more than a very small fraction of the business currently concentrated in the UK; and the result will be the dispersal of this business across a number of locations. This may provide some short-term attraction to other Member States, but any long-term gain is likely to be illusory.

45. Financial services is an industry that benefits from a concentration of expertise, deep and liquid capital markets and a sophisticated and predictable regulatory, political and legal infrastructure. London is uniquely well-placed to provide these benefits to the EU as a whole. If the European financial services industry fragments, London will not lose its European pre-eminence, but it will suffer by comparison with its rivals outside Europe. The only winners from a diminishment of London's status will be its global competitors, rather than the European economies on its doorstep, which presently benefit from ready access to the world's leading financial marketplace. The preservation of the status quo in financial services regulation is therefore something that both the UK and the EU should strive to achieve, no matter how difficult other aspects of the Brexit negotiations may prove.

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5 February 2017

Endnote: The author would like to thank Michael Poole-Wilson for his valuable assistance in commenting on an earlier draft of this paper. The Society of Conservative Lawyers is an association of lawyers who support or are sympathetic to the aims of the Conservative Party. Members hold a range of different views within those parameters and the views expressed in this paper are not necessarily held by all members of the Society or by the Conservative Party.

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