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Brexit and Financial Services: The Final Countdown

Grania Baird and Kya Fear | 05 November 2018

With less than five months before the UK leaves the EU there is no final consensus on a withdrawal agreement, the European Commission has made no equivalence decision vis-à-vis the UK nor have co-operation agreements been signed between the Financial Conduct Authority (FCA) and Member States' supervisory authorities. There are however indications that the two sides are edging closer to a final agreement on the withdrawal agreement and the UK Government has said that firms can continue to plan on the assumption that a deal will be reached. Some recent speculative press reports have also indicated that a deal on financial services is nearly agreed. However, the UK Government is also planning for a no deal scenario recently issuing a large number of statutory instruments to ensure that the UK continues to have a fully functioning financial services regulatory regime when the UK leaves the EU on 29 March 2019. Even if a deal is reached these measures may still be relevant after any transition period. In this article **Grania Baird** and **Kya Fear** consider the current state of the Brexit process in the context of financial services, outline the UK's "onshoring regime" set out in the draft secondary legislation with a particular focus on the investment management sector, and highlight key implications for firms.

1. Brexit overview – where are we now?

Following the triggering of Article 50 of the Treaty of the European Union in March 2017, the UK Government is currently negotiating with the EU on the terms of a UK-EU withdrawal agreement. On 19 March 2018, the UK Government and the EU Commission published a draft withdrawal agreement, which contained certain agreed provisions as well as provisions proposed by the EU but where no agreement had yet been reached. The stated aim of the UK and EU is to have concluded and agreed a draft UK-EU withdrawal agreement by mid-November 2018, giving time for ratification by the EU Parliament, the European Council and the UK before 29 March 2019.

UK and EU negotiators are also aiming to agree the text of a political declaration on the framework for the future relationship between the UK and the EU post Brexit. This high-level declaration would then be referred to in the UK-EU withdrawal agreement with the full agreement on the future relationship to be agreed and finalised once the UK has left the EU. The agreement on the future UK-EU relationship would, if agreed, come into effect at the end of the transition period (referred to below).

At the time of writing although considerable progress has been made on the draft UK-EU withdrawal agreement since March 2018, the final text of the UK-EU withdrawal agreement remains subject to further negotiation. A number of outstanding issues remain, including the Northern Irish border and backstop provisions. We understand that the EU has offered a compromise plan on the Northern Irish border to provide for a bare-bones all-UK customs union in the withdrawal agreement. The timeline for getting the UK-EU withdrawal agreement signed off is however very short.

2. What is the UK Government's approach to the future UK-EU relationship for financial services?

The UK Government's position regarding financial services is set out in its July 2018 white paper: The future relationship between the United Kingdom and the European Union (July 2018 White Paper). The UK Government has accepted that both the UK and EU will wish to maintain autonomy of decision-making and the ability to legislate for their own interests, and that the decision on whether and on what terms the UK should have access to the EU's markets will be a matter for the EU, and vice versa. The result of this conclusion is that the UK Government has said it will be seeking for the future relationship in respect of financial services to use and build on the existing *equivalence regime*, as opposed to one of mutual recognition. The UK Government considers that the existing equivalence frameworks, which have grown up piecemeal, should be expanded to cover a broader range of cross border financial services activities. The July 2018 White Paper acknowledges however that even with an improved equivalence framework any such arrangement would not replicate the EU's passporting regime.

Given that at the point of Brexit the UK will have identical rules to the EU, the UK Government has proposed that there should be reciprocal recognition of equivalence under all existing third country regimes, taking effect at the end of the transition period. Future decisions on equivalence (both granting or withdrawing) would, as set out in the July 2018 White Paper, be autonomous decisions for the UK and EU respectively. That said, the UK Government has indicated that they would look for the arrangement to include; common principles for the governance of the relationship, extensive supervisory cooperation and regulatory dialogue and predictable, transparent and robust processes (which would presumably deal with the process around withdrawal of equivalence). The idea being that the arrangement would be one in which both sides have confidence and which would endure given the ever-evolving nature of the financial services industry.

The recent speculative press reports that the EU will accept the UK as having an equivalent regulatory regime as at Brexit is positive, if true, but we wait to see this confirmed by the EU.

3. What is the so-called transition period?

At the time of the joint publication of the draft UK-EU withdrawal agreement earlier this year one of the aspects which was agreed by both sides was the provision for a transition period which would apply from 11pm GMT on 29 March 2019 (Exit Day) until 31 December 2020 (Transition Period).

During the Transition Period, the UK would continue to participate in the customs union and single market. The UK would be treated, for most purposes, as if it were still an EU Member State, with access to EU markets on current terms, and importantly maintaining current passporting rights.

The UK Government has indicated that during the Transition Period the UK would continue to implement new EU law that comes into effect. UK firms would therefore need to comply with any new EU legislation (for example, the proposed Regulation and Directive on cross-border distribution of funds) that became applicable during that period.

However, the Transition Period and related arrangements are conditional on the UK-EU withdrawal agreement being finalised and ratified. If there is no UK-EU withdrawal agreement agreed and signed then there will be no Transition Period. In that scenario the UK will cease to be a member of the EU on 29 March 2019 without a deal and will be in the "hard Brexit" scenario.

4. What is the message from the UK Government and EU respectively on planning for a no deal?

The UK and EU authorities have given somewhat different messages about whether firms can assume that a deal will be agreed and the Transition Period will enter into effect.

HM Treasury announced in June 2018, and repeated in August 2018, that firms should continue to plan on the assumption that a Transition Period would be in place.

The UK Government is however also preparing for a scenario where the UK leaves the EU without a deal and without the Transition Period. Firms will have seen in the last few months that HM Treasury has published numerous draft statutory instruments (Regulations) to ensure that the UK has a fully functioning financial services regulatory regime as at Exit Day, even in a no deal scenario. The Regulations are not intended to make policy changes but to reflect the UK's position outside the EU and to smooth the transition process, including, amongst other things, non-legislative sources of EU law such as Regulatory Technical Standards and temporary permission and recognition regimes. The UK Government refers to these contingency preparations for financial services legislation set out in the Regulations as 'onshoring'.

The UK Government has also set out a proposal for a temporary transitional power to be exercised by UK regulators (the Bank of England, Prudential Regulation Authority, and the FCA). Such powers would allow UK regulators to make transitional provisions by waiving or modifying firms' regulatory obligations where those obligations have changed as a result of onshoring financial services legislation.

The Regulations of particular relevance to the investment management industry are:

- the regulations dealing with the UCITS regime, called The Collective Investment Schemes (Amendment etc.) (EU Exit) Regulations 2018 (UCITS Brexit Regulations)
- the regulations dealing with the AIFMD regime, called The Alternative Investment Fund Managers (Amendment) (EU Exit) Regulations 2018 (AIFMD Brexit Regulations)
- the regulations dealing with the Markets in Financial Instruments Directive (MiFID II) regime, called Markets in Financial Instruments (Amendment) (EU Exit) Regulations 2018 (MiFID II Brexit Regulations), and
- the regulations dealing with passporting rights, called The EEA Passport Rights (Amendment, etc and Transitional Provisions) (EU EXIT) Regulations 2018 (EEA Passport Rights Regulations).

These Regulations will, once finalised, be brought into force on Exit Day in the event of a no deal. They may still be held in reserve in the event of no final agreement being reached on the future relationship at the end of the Transition Period. In addition, even where the UK and EU agree a long-term agreement post the end of the Transition Period the onshoring regime may still be relevant. We consider the onshoring legislation and its impact on the UCITS' regime, Alternative Investment Fund Managers Directive (AIFMD) regime and the impact on MiFID investment firms separately below.

The EU authorities have acknowledged that it is in the interests of both the EU 27 and the UK to have a withdrawal agreement in place by Exit Day but that a no deal scenario cannot be ruled out. The EU has warned firms not to assume that there will be a Transition Period with the European Banking Authority (EBA) urging firms in June 2018 to take the necessary actions to mitigate the effects of a no deal Brexit without delay.

The European Commission has warned that AIFMs and UCITS management companies about aspects they should consider in a no deal scenario. These include taking steps to inform investors of the consequences of the withdrawal of the UK from the EU and that for UCITS this may also mean updating the key investor information where Brexit affects the investment strategy of the UCITS such that is no longer the same as that communicated earlier to investors. Firms should therefore be considering what notifications they may need to make to investors and what updates may be required to their customer facing documentation.

In a welcome development, the chair of the European Securities and Markets Authority (ESMA) gave a statement in early October 2018 on Brexit, confirming that national competent authorities and ESMA should have in place with the UK regulators the type of memoranda of understanding (MOUs) that they have with a large number of third country regulators, and ESMA plans to start negotiations with the FCA with the objective to have these MOUs in place sufficiently on time before the end of March 2019. These MOUs are discussed below.

5. Why are MOUs or co-operation agreements important?

The subject of MOUs (as referred to by the EU) or co-operation agreements (as referred to in the UK) is frequently mentioned in the context of Brexit and particularly in terms of its importance for the UK investment management industry.

MOUs are important because the UK is a key provider of investment management services, which are often provided on a delegated basis. However, such delegation of investment management services to third country firms is subject to various conditions. In addition to requirements such as the third country firms must be appropriately authorised and supervised in their home state, the UCITS Directive, AIFMD and MiFID II require there to be in place an MOU/co-operation agreement between the competent authority of the UCITS management company/AIFM/MiFID firm and the supervisory authority (in this case the FCA) where the delegate is based, before delegation is permitted. On Exit Day absent a Transition Period the UK will be a third country.

As at Exit Day, in a no deal scenario, unless MOU/co-operation agreements are in place existing delegation arrangements to UK firms would be not permitted under the UCITS directive/AIFMD or MIFID II. With the positive statements from ESMA, and acknowledgements from the UK Government of the importance of this issue there does appear to be a consensus that these agreements are needed by Exit Day. It is likely that a number of such agreements will be in place, in particular with Member States such as Luxembourg, which has a vested interest in maintaining its fund domicile predominance.

6. Impact of a hard Brexit on various regulatory regimes

A. UCITS
What is the impact of the UK's on-shoring regime for UCITS domiciled in the UK? As at Exit Day, UCITS domiciled in the UK will no longer be established and authorised in the EEA, as required under the UCITS Directive, and hence they will lose their legal status as UCITS funds. The UCITS Brexit Regulations introduce a UK UCITS regime for funds established and authorised in the UK, which will have the new label "UK UCITS", and the relevant activity in the regulated activities order (**RAO**) will be "managing a UK UCITS".

On Exit Day, under the UCITS Brexit Regulations, a UCITS based in the UK would become a UK UCITS. A UK UCITS would be able to invest in the same types of eligible assets as it did immediately before Exit Day and would be able to continue to book cash in accounts opened with any EEA credit institution and be able to book cash in third countries, provided that the country has prudential supervisory and regulatory requirements which are considered equivalent to the UK. UK UCITS would be required to have a manager and depositary incorporated in the UK and with places of business in the UK.

What is the impact of the UK's on-shoring regime for UCITS domiciled in the EEA?

For existing UCITS based in the European Economic Area (EEA UCITS) which are marketed to retail investors in the UK under the passporting regime, on Exit Day this passport will cease. To allow UK investors to continue to have access to EEA UCITS that are currently marketed into the UK, the UK Government has provided for a temporary permissions regime (TPR) enabling EEA funds and sub funds which have been notified to the FCA before Exit Day to continue to access the UK market for a limited period after Exit Day. If such an EEA UCITS does not take advantage of the TPR it would be categorised in the UK as a third country AIF (described below).

Subject to making a notification to the FCA prior to Exit Day, a UCITS management company of an EEA UCITS marketed into the UK will be able to rely on a TPR of up to three years (which may be extended by HM Treasury by up to 12 months) which would allow the EEA UCITS to continue to be marketed in the UK to retail investors, and be treated as a recognised UCITS scheme in the UK, falling under the UK's UCITS regime. The TPR is only available to the existing funds and sub funds specified in the notification to the FCA prior to Exit Day. Unfortunately, the TRP is not available for new sub-funds of an umbrella fund created after Exit Day even if the umbrella is notified to the FCA prior to Exit Day.

A UCITS management company of an EEA UCITS would, when relying on the TPR be subject to various ongoing requirements including as regards notifications to the FCA and the provision of information to the FCA. In addition, the UCITS management company would be required to continue to comply with the duties imposed on it by provisions of the UCITS Directive as it applies in the EEA. Under the EEA Passport Regulations, branches of EEA firms will be able to get temporary permissions to continue to operate and carry out regulated activities in the UK. In addition, transitional provisions will apply disapplying the incorporation requirements regarding the depositary and manager after Exit Day for as long as the firm has the temporary permissions needed to undertake the regulated activities in the UK.

An EEA UCITS created after Exit Day or in respect of which its management company does not make a notification in time to rely on the TPR, will be regarded as a third country AIF and the EEA UCITS could be marketed in the UK to professional investors under the UK's national private placement regime (NPPR). However, reliance on NPPR under the UK's on-shored AIFMD regime requires there to be (i) a notification made to the FCA by the management company as well as (ii) a co-operation agreement to be put in place between the supervisory authority of the EEA Member State of the EEA UCITS and the FCA.

It may also be possible to market an EEA UCITS that does not fall under the TPR to UK retail investors if it is given recognised status by the FCA under section 272 of the Financial Services and Markets Act 2000 (FSMA). The Government has committed to review the section 272 regime to ensure that it is fit for purpose post Brexit.

Interestingly, if an umbrella EEA UCITS fund that relies on the TPR after Brexit creates a new sub fund which cannot benefit from TPR and which the UCITS management company seeks to get recognised under section 272 then all of the existing sub funds it wishes to market into the UK (ie including those under the TPR) will need to fall under that application.

How will the EU treat UK UCITS and UK UCITS management companies in a hard Brexit?

On Exit Day a UK UCITS will lose its UCITS status in the EEA and will become a third country AIF. This means that where investors are obliged to invest only in EEA regulated funds or UCITS funds, this might automatically lead to redemption requests. In order for a UK UCITS to continue to be marketed in the EEA to professional investors it would need to rely on the NPPR of each of the Member States that its management company wishes to market within. Under Article 42(1)(b) of AIFMD, in order to use the NPPR a co-operation agreement needs to be put in place between the FCA and the supervisory authority of the relevant EEA Member State.

To continue to market the "AIF" in the EEA to retail investors, the management company of a UK UCITS would need to ensure that the NPPR of the EEA state permits this – some EEA countries do not allow it, and Member States can impose stricter requirements than those set out in the AIFMD so far as marketing to retail investors is concerned.

On Exit Day, a UK management company would no longer be permitted to be a management company of an EEA UCITS. Prior to Exit Day, UK management companies of EEA UCITS need to have either transferred the role of the management company role to an EEA authorised management company (either a third party or group entity) or, if it is able to do so, convert the existing EEA UCITS into a self-managed entity. Portfolio management can be delegated to a UK firm, however, under Article 13(d) of the UCITS Directive, this will require a co-operation agreement to be put in place between the FCA and the relevant Member State's supervisory authority.

In addition, after Exit Day firms providing cross border MiFID investment services to EU customers will need to consider the local licensing requirements applicable to that jurisdiction or whether they can rely on reverse solicitation.

B. AIFMD

What is the impact of the UK's on-shoring regime for AIFs and AIFMs?

Various amendments are needed to the AIFMD regime in the UK to ensure that it continues to operate efficiently once the UK leaves the EU, including a temporary permissions regime for EEA funds and AIFMs, enabling EEA funds and AIFMs that have notified the FCA of their intention to market in the UK via a passport before Exit Day to continue to access the UK market for a limited period after Exit Day.

On Exit Day, under the AIFMD Brexit Regulations all funds based in the EEA, other than those which come under the UK's UCITS regime (described above), will be categorised as third country AIFs and all managers based in the EEA will become third country AIFMs.

EEA AIFs that existed before Exit Day (including those with EuVECA, EuSEF, ELTIF or MMF designations) may continue to be marketed on the same terms and subject to the same conditions under a TPR similar to that applicable under the UCITS Brexit Regulations. To rely on the TPR a relevant notification must be made by the AIFM to the FCA prior to Exit Day.

An EEA AIFM relying on the TPR would be subject to ongoing requirements including notification requirements to the FCA and would need to continue to comply with duties imposed on it by specific provisions of the AIFMD, which were implemented by its home Member State. EEA AIFMs who want to continue to market in the UK after the Transition Period and who are relying on the TPR will be directed by the FCA to make an NPPR notification within two years from Exit Day.

EEA AIFs created after Exit Day and those that have not relied on the TPR must rely on the UK's NPPR to market in the UK. As set out above, reliance on NPPR requires (i) the AIFM to notify the FCA, and (ii) a co-operation agreement to be in place between the supervisory authority of the relevant EEA Member State and the FCA – none of which are yet in place.

Further, with respect to the UK's AIF regime, an EEA AIF could be marketed to retail investors in the UK if:

- it is given recognised status by the FCA under Section 272 of FSMA, or
- the AIFM is relying on the TPR to market on the same terms and conditions that existed before Exit Day, and those terms and conditions allowed for the AIF to be marketed to UK retail investors.

Note that there is a disapplication of the NPPR information and reporting requirements for funds that are recognised under section 272 of FSMA for marketing to retail investors.

How will the EU treat UK-based AIFs and AIFMs in a hard Brexit?

On Exit Day, UK based AIFs will become third country AIFs, and an AIFM based in the UK would become a third country AIFM. Existing passports under AIFMD would cease. Under Article 11(f) of AIFMD, withdrawal would mean that a UK AIFM would lose any authorisation it has under the AIFMD although for UK purposes this is dealt with by the onshoring regime. As the third country passporting regime under AIFMD has not yet been switched on, a UK AIFM previously marketing via a passport in the EEA would need to rely on the NPPR of each Member State that it wishes to market in. As set out above, this will require a co-operation agreement to be put in place between the FCA and the supervisory authority of the relevant EEA State.

Further, as UK AIFs would become third country AIFs, depending on the NPPR in place in a Member State, they may be marketed to a narrower investor base. For example, in some countries, non-EEA AIFs cannot be marketed to retail investors, and where they can be, stricter rules may apply.

C. MiFID II

What is the impact of the UK's on-shoring regime for MiFID II firms?

MiFID II contains, amongst other things, a passport that permits firms to provide investment services cross-border and to establish branches in another EEA state on the basis of their authorisation in their 'home' Member State. On Exit Day the UK will become a third country and as a result the existing passporting rights which UK firms have into other EEA states will cease to apply and any EEA firms currently operating in the UK under a passport will lose their permission to do so.

The EEA Passport Rights Regulations provide for a TPR to allow EEA firms currently operating in the UK via a passport to continue to do so for a limited period after Exit Day. To enter into the TPR, prior to Exit Day firms will either need to submit an application for UK authorisation or a notification of their intent to enter the TPR. Once within the TPR, the relevant regulator (FCA or PRA) can direct the firm to make an application for authorisation if it has not already done so within two years of Exit Day. The scope of activities for which a firm will be covered under the TPR will be limited to the scope of regulated activities the firm was permitted to carry on immediately before Exit Day under their passport.

The UK Government has said that the policy approach set out in MiFID II legislation will not change after the UK has left the EU. However, the MiFID II Brexit Regulations are needed to ensure that the legislation works in the UK following Exit Day, and to ensure that the regime works for firms operating under TPR brought in under the EEA Passport Rights Regulations.

On Exit Day, under the MiFID II Brexit Regulations the functions under MiFID II and the Markets in Financial Instruments Regulation (MiFIR) that are currently carried out by the EU authorities will be transferred to UK authorities, meaning that firms and other regulated entities may have to implement operational changes to be able to send and receive MiFID II transaction and transparency data to and from the FCA. UK branches of EEA firms that currently send transaction reports to their home regulator, will also need to send these to the FCA (including reports on instruments admitted to trading, or traded, on trading venues in the UK as well as the EU).

EEA firms subject to the TPR will be subject to a "substituted compliance" regime where they will not be in breach of the UK's on-shored MiFID II regime if they can demonstrate that they comply with corresponding provisions in the EU's MiFID II rules provided that the EU MiFID II requirement has an equivalent effect to a requirement in the UK MiFID II regime in respect of the service the firm is providing in the UK.

The equivalence decisions taken by the European Commission before Exit will be incorporated into UK law and will continue to apply to the UK's regulatory and supervisory relationship with those third countries.

How will the EU treat UK-based MiFID II investment firms in a hard Brexit?

On Exit Day UK firms will no longer be able to rely on the existing passport under MiFID II to provide investment services cross-border and to establish branches in another EEA state on the basis of their authorisation in the UK.

The MiFID II regime does include a passport regime for third country firms (although this is considerably more limited than that which currently applies to UK firms). Under Article 46 of MiFIR a third country firm is permitted to provide cross border services to professional clients and eligible counterparties in the EEA subject to various conditions. These conditions include the requirement for the European Commission to have made an equivalence decision vis-à-vis the UK's regime and that co-operation agreements have been established. Neither of these conditions are yet met. Alternatively, UK firms could establish EU-based branches under Article 39 of MiFID II subject to local law requirements, which would allow them to provide services to retail clients. Again, requirements apply including the need for a co-operation agreement to be in place.

7. What contingency planning is the EU proposing on a hard Brexit?

The EU is not planning on introducing a TPR similar to that set out in the UK Regulations. This means that the proposed Regulations issued by the UK Government providing for a TPR do not cover UK firms which have exercised passport rights into the EEA under European legislation such as the UCITS Directive, AIFMD or MiFID II. Nor do they cover the position of European investors in UK domiciled funds. In a no deal scenario the existing passport rights which UK firms have relied upon to access the EEA will cease to apply.

The EU Commission has however announced that European companies will still be permitted to use derivative clearing services in the UK even in the event of a no deal Brexit. We would hope that there will be further accommodations announced as Exit Day nears.

In addition, the EU does appear to be preparing to put in place MOUs with the FCA and to encourage other national regulators to do the same (see comments above).

8. How might existing contracts be affected on a hard Brexit?

The European Commission observed that there does not appear to be a "general concern" related to contractual continuity but that this should be considered on a case-by-case basis. In our view firms should be checking the contracts which they currently have in place with key service providers and clients to check the implications of Brexit on these. For example, Brexit may be a termination event or a force majeure event in some contracts which may trigger early termination, automatic redemption, and / or the application of other remedies, the governing law of the contract should also be considered.

9. What next?

The UK Government is planning that the UK-EU withdrawal agreement, including the Transition Period, will be in place for Brexit. The industry is waiting and hoping that this will be confirmed soon but even with agreement in principle key approvals need to be obtained including from the UK parliament. It is also worth remembering that the detailed terms of any agreement as to the future relationship between the UK and EU will only be finalised after the UK has left the EU.

Hoping for the best but preparing for the worst is perhaps the best motto for Brexit preparations. Even if the UK is granted equivalence status across existing third country regimes, as some recent press speculation has indicated may be the case, that will not replicate the existing passporting regime. In addition any enhancements to the equivalence framework and process is likely only to be agreed once the UK has left the EU.

If you require further information on anything covered in this briefing please contact Grania Baird grania.baird@farrer.co.uk (+44 (0)20 3375 7443), or your usual contact at the firm on 020 3375 7000. Further information can also be found on the Finance Department page on our website.

In our view, it is likely that the UK onshoring legislation, even if not needed as at March 2019 is likely (in amended form) to be relevant to the post Brexit regulatory environment. As a result, we hope this briefing has provided a helpful summary of some of these draft measures. We will be providing a Brexit update to our clients in our forthcoming Financial Services Seminar on 27th November.