OPINION

FINANCIAL SERVICES AFTER BREXIT

Possible cross-border models

Rachel Kent and Dominic Hill of Hogan Lovells discuss whether the UK and the EU might be able to reach a bespoke deal on access to each other's financial markets following Brexit.

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Since the UK's vote to leave the EU, there has been much discussion about how financial services firms in the UK will respond and, in particular, what models will be available for them to have cross-border access to the EU after Brexit.

Currently, UK firms are able to take advantage of the passporting regime under the EU single market directives, which gives them the right either to establish a branch in another EU member state or to provide services directly to customers or deal with counterparties in another member state, in each case without having to obtain a licence from the local regulator in that member state (*see "Brexit sector briefing: financial services and banking", www.practicallaw.com/7-638-0364*).

The government White Paper published on 2 February 2017 makes it clear that the UK will be leaving the single market, and so passporting will cease to be available (*www.gov.uk/government/publications/the-united-kingdoms-exit-from-and-new-partnership-with-the-european-union-white-paper*).

If passporting is not available, what alternatives are there for UK firms to seek cross-border access to the EU?

Third-country regimes

The EU already operates third-country regimes (TCRs), which, like passporting, avoid the need for a licence for firms from countries outside the EU (third-country firms and third countries, respectively). Usually, where a TCR is available, it is on the condition that the EU first makes a determination that the legal and regulatory system in the relevant third country is "equivalent" to that in the EU.

The International Regulatory Strategy Group (IRSG) published a report on 23 January 2017 which considered the usefulness of the TCRs as a means of providing cross-border access for UK firms after Brexit (the IRSG report) (*www.thecityuk.com/assets/2017/Reports-PDF/The-EUs-Third-Country-Regimes-and-Alternatives-to-Passporting.pdf*). The IRSG report concluded that:

- Only a very small proportion of the areas of financial services that are currently covered by the passporting regime are the subject of TCRs. There is a degree of access in relation to market infrastructure (for example, clearing houses and benchmark administrators) and TCRs are due to be introduced shortly under the MiFID II Directive (*2014/65/EU*) for wholesale investment services and under the Alternative Investment Fund Managers Directive (*2011/61/EU*) for certain activities relating to alternative investment funds. However, there is no coverage under the TCRs for deposit taking, lending, payment services, mortgage lending, insurance mediation and distribution, and activities relating to UCITS (undertakings for collective investments in transferable securities) funds. There are also very limited TCRs in relation to the issuing of contracts of insurance.

- Some of the TCRs contain additional restrictions which may prove to be an obstacle to access.

- Where they do exist, TCRs offer rights and protections that are less extensive and less reliable than passporting in particular:

  - they are frequently subject to specific restrictions, for example, regarding the type of customer that can be serviced;

  - for some TCRs, individual member states can opt out of allowing the third-country firm to access their market;

- member states are often able to impose additional restrictions on third-country firms above and beyond the requirements that would apply to a firm from within the EU;

- there are considerable concerns regarding the determination of equivalence of a third country. There is a lack of clarity over what "equivalent" means in practice, and the experience of third countries that have made applications under the existing TCRs shows that the processes followed by the EU authorities are unpredictable and time-consuming; and

- there are structural problems with the processes associated with TCRs. In particular, the EU may withdraw or vary TCRs on either little or no notice and there is no mechanism to appeal a decision not to recognise a third country as equivalent.

Under the TCRs, the requirement to be equivalent is ongoing. In order to maintain equivalence, the UK would be likely to become a rule taker; that is, it would have to follow developments in EU law on an ongoing basis, enact them into UK law and refrain from making changes to the UK's own regulatory framework that would result in it ceasing to be equivalent.

Reliance on local laws

Some commentators have suggested that the absence of passporting or TCRs is of less importance than it seems at first. This could be because passports may have been sought as a protective measure but may, in practice, not be used. Hard evidence is thin on the ground. If firms are using a passport they will need to look at each individual member state and consider whether it would be construed as conducting business there and whether there is an exemption.

Some commentators have argued that in relation to certain regulated activities such as deposit taking, the characteristic place of performance of the activity would be the UK, not the member state, suggesting that the UK firm would not need a licence in the member state in order to undertake the activity. The difficulty with this argument is that, even if the UK courts agreed with it, many member states do not agree with it and would require a UK firm to obtain a licence if it solicited customers in that member state.

Exemptions exist on a state-by-state basis. There is no universal "overseas person" exemption equivalent to that which exists in the UK under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (*SI 2001/544*). There are versions of the "reverse solicitation" exemption, under which firms do not need a local licence if they do not solicit customers, but they are extremely patchy in their scope. For example, in France the relevant exemption applies to investment funds but not to other types of investment and in Italy the relevant exemption applies to investment business but not to banking or insurance.

Under this model, the UK firm would have only a very limited ability to provide cross-border services into the EU. Where these rights did exist, it would be on a patchwork basis and only for certain activities.

Establishing an EU subsidiary

If a UK firm cannot obtain cross-border access to the EU, the alternative would be to establish a subsidiary in the EU and for the subsidiary to apply for authorisation by the local regulator. The subsidiary would be able to passport services from that member state around the rest of the EU.

This model would secure access to the EU for the subsidiary but:

- The UK firm would need to transfer all or part of its business into a regulated EU subsidiary to continue conducting it. A report published by the Association for Financial Markets in Europe and PwC on 2 February 2017 highlighted the serious practical and timing challenges associated with this process (*www.afme.eu/globalassets/downloads/publications/afme-pwc-planning-for-brexit.pdf*).

- It would be significantly less efficient for the corporate group when compared to passporting; for example, from a regulatory capital position, as well as operationally.

Member states sometimes permit third-country firms to obtain authorisation directly from the local regulator, usually to establish a branch of the third-country firm in that member state. This would alleviate some, but not all, of the problems mentioned above, but some member states are unwilling to take this approach and, in some instances, the relevant directives expressly prohibit it. There has been speculation about whether a UK firm could use a so-called "brass plate" approach; that is, an approach under which it puts the minimum resources into the EU subsidiary and outsources functions back to the UK. It would certainly be possible to outsource but the new EU subsidiary would have to be an entity of genuine substance, with real supervision being exercised within that entity.

A bespoke deal?

Having considered the models discussed above, the IRSG report concluded that the UK should instead be looking to enter into a bespoke agreement under which the UK and the EU agree to allow mutual access to each other's markets. This could be on the basis of mutual recognition, or on the basis that the two regimes are broadly consistent, rather than using the equivalence test from the TCRs. If the UK can secure a bespoke agreement of this kind, it may lead to a more favourable outcome than any of the models considered above.

Perhaps the most pressing issue is one of timing. A bespoke deal or any potential extension of the TCRs will take time. It is not clear to what extent a new arrangement can be negotiated in parallel to the withdrawal arrangements. Given the lead-in time for the establishment of a new subsidiary, and in the absence of an early agreement on a transitional period, firms are having to implement their contingency plans in case a deal on financial services is not agreed by the time the UK leaves the EU. A transitional arrangement may still be useful in allowing firms to suspend the implementation of their contingency plans or at least to minimise the extent to which business is transferred out of the UK.

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