UK Withdrawal from the EU—the Changing Landscape for UK Firms

January 31, 2020

Now that the formalities required for the adoption of the withdrawal agreement negotiated between the UK and the EU in October 2019 (the "Withdrawal Agreement") have all been completed, the UK will officially withdraw from the EU at midnight (Central European Time) on 31 January 2020. It goes without saying that this is a very important moment and brings to an end almost 50 years of UK membership of the world's largest trading bloc.[1]

This note considers the immediate regulatory consequences for UK-based private equity and venture capital firms of the UK's withdrawal from the EU, the application of the transition period provided for in the Withdrawal Agreement and the possible shape of the future relationship between the UK and the EU for financial services.

Transition Period

From the moment the UK leaves the EU, a transition period will begin, with the effect that all EU law will continue to apply to and in the UK until (at least) 31 December 2020. Although the UK will no longer be a member of the EU, the application of EU law will be subject to the same principles of interpretation and enforcement, with the same exercise of the powers of the EU institutions, until the end of the transition period. The UK will, therefore, continue to be treated as part of the EEA[2] single market in financial services, giving firms access to the EEA on the basis of passporting rights until at least the end of 2020. The UK government (and, as the relevant regulator for UK-regulated firms, the Financial Conduct Authority (the "FCA")) will implement EU directives where the application date for those directives is during the transition period. Whilst the government is bound to adopt EU legislation which applies during the transition period, there is no certainty about its intentions with "in-flight" EU legislation (that is,

[1] The United Kingdom joined the European Economic Community, as it was then, on 1 January 1973 along with Denmark and Ireland.

[2] The European Economic Area, or EEA, includes Norway, Iceland and Lichtenstein as well as the 27 remaining member states of the European Union.

legislation that does not yet apply or is in process but not yet formally adopted at EU level).

The transition period will end on 31 December 2020, unless agreement is reached to extend it, although the UK government has indicated that it will not seek an extension and has enshrined that position into UK law.[3] Unless the UK and the EU reach agreement on a new free trade agreement covering financial services by 31 December 2020, the practical effect of the end of the transition period for the financial services sector will be similar to that faced earlier by a "no-deal Brexit" (leaving without a ratified withdrawal agreement) with immediate loss of passporting and other market access rights by UK firms operating in the EEA and EEA firms operating in the UK.

In this event, the UK and EU authorities may put in place the same measures developed to address the impact of the loss of passport rights on a no-deal Brexit. The UK will activate the temporary permissions regime to enable EU-headquartered firms to operate in the UK on the basis of their existing passporting rights for a limited period after the end of the transition. The UK will also adapt the statutory instruments already drafted so that they ensure continuity of laws when the transition period ends (the UK's legislative "onshoring" exercise).

Similarly, the EU may also adapt its contemplated no-deal measures, which focus on ensuring the continuity of derivatives trading and clearing activities. Some EU states have to date granted limited extensions to UK firms exercising passport rights under the Markets in Financial Instruments Directive ("MiFID") and the Alternative Investment Fund Managers Directive (the "AIFMD"), and these rights may be similarly rolled over, although this is also not yet certain.

Some EU financial services legislation contains mechanisms allowing financial institutions based in third countries to gain access to EEA markets, based on the European Commission deeming the relevant third country's regulatory regime to be "equivalent" to that of the EU. Unless the Commission has made decisions on "equivalence" before the end of the transition period on the UK regulatory and supervisory frameworks, in particular granting UK firms access to provide services in the EEA, UK firms will not be able to use equivalence as a mechanism to access EEA markets. For that reason, as discussed below, it is anticipated that the UK and the EU will seek to make mutual equivalence determinations in the coming months, although any such determinations would likely be of little value to private equity and venture capital fund managers and advisers.

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[3] Of course, the UK Parliament can change UK law, so it remains possible for the transition period to be extended by mutual agreement.

The EU Withdrawal Treaty and Future UK-EU Relationship

Although the UK government has indicated that the free trade agreement should cover the financial services sector, its current approach to the future UK-EU relationship on financial services is unclear. The "political declaration" of October 2019 on the framework for their future relationship (accompanying the Withdrawal Agreement) states that the UK and the EU intend to develop "agreements" giving effect to the future UK-EU relationship and outlines some broad principles on the basis for that future relationship. These principles are that the UK and the EU are committed to preserve financial stability, market integrity, investor and consumer protection and fair competition; that the UK and the EU will respect each other's regulatory and decision-making autonomy and that the UK and EU will agree on close co-operation on regulatory and supervisory matters.

The political declaration points to the "equivalence" frameworks currently in place as the apparent basis for the future UK-EU relationship, for both UK firms providing services into the EU and EU firms providing services into the UK, with a commitment to seek to conclude assessments of these frameworks before the end of June 2020. It is not clear how far these commitments go and, in particular, whether they extend to the provision of market access on a passported basis under the framework envisaged in MiFID, although the UK government recently signaled its commitment to seek equivalence across all the equivalence regimes in EU legislation.[4]

The European Commission recently published further preparatory work[5] on the negotiation of the future UK-EU relationship, underlining the fundamental differences between the freedoms conferred by the single market in financial services (the "single market eco-system") compared to a model of access based on a free trade agreement and generally repeating the position in the political declaration that the future framework will rely on equivalence assessments, with the UK treated, in terms of access to the EEA for financial services, in the same manner as other third countries. It is also clear that the Commission regards equivalence assessments as made unilaterally by the EU, with an assessment of equivalence for the UK based on a "risk-based and proportional approach as for other third countries, [meaning that] the higher the possible impact on EU markets and interests, the more granular the assessment".

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[4] See letter from John Glen, Economic Secretary to the Treasury, to Lord Kinnoull, European Union Committee Chair dated 27 January 2020.

[5] The Commission recently published slides "Internal EU27 preparatory discussions on the future relationship: free trade agreement" and "Internal EU27 preparatory discussions on the future relationship: "Personal data protection (adequacy decisions); Cooperation and equivalence in financial services".

Earlier objectives suggested by Theresa May's government suggested a system of "enhanced equivalence" under which the UK would maintain autonomy of decision making whilst retaining access to EEA markets, proposing immediate reciprocal recognition of equivalence, wider application of third country rules and some safeguards to preserve equivalence decisions in the future, such as ongoing supervisory co-operation and more structure around the equivalence decision making process, particularly in relation to withdrawal of equivalence (which is done unilaterally by the EU). Although such an approach could be revived, it currently seems unlikely, and the existing equivalence frameworks seem the likely basis for UK firms' immediate rights of access.

AIFMD Third Country Regime

The AIFMD envisages the grant of the third country passport to third country alternative investment fund managers ("AIFMs") if the European Securities and Markets Authority ("ESMA") issues positive advice that, in the case of the relevant country, there are no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risk. Although the AIFMD third country passport is in principle available to third countries that meet the criteria, it has never been activated for any jurisdiction.

The most important consequence of relying on the third country passport is the obligation to identify (and thereafter to be supervised by) the regulator in the relevant EU Member State of reference and to comply fully with the AIFMD. This is determined according to certain criteria and would entail dual supervision by the FCA and an EEA Member State regulator, with a legal representative established in that Member State.

Given the issues associated with the AIFMD third country passport and the fact that it has never been activated, it seems unlikely that the EU and the UK will seek to accelerate its application as part of the equivalence assessments foreseen in the political declaration.

National Private Placement Regimes and Future Supervision

Regardless of the position in relation to the third country passport under the AIFMD, it is assumed that UK firms will be able to market their funds in EU states on the basis of state-by-state national private placement regimes that already exist. If the AIFMD third country passport were to be activated, that could put these regimes at risk: the AIFMD foresees that they could end three years after the introduction of the passport.

The MiFIR Third Country Regime—a Possible Means of Access for UK Firms?

MiFID and the Markets in Financial Instruments Regulation ("MiFIR") introduced a new regime for "third country" firms, which are firms whose head office or registered office is outside the EEA and that provide various types of "investment services" to clients in EEA member states.[6]

Investment services in MiFID terms include a range of discretionary investment management, non-discretionary investment advisory, broker-dealer (such as dealing as agent or dealing as principal) and corporate finance activities (such as underwriting). The regime in MiFID is prospectively available to UK firms that provide discretionary or non-discretionary investment management services to an EEA client[7] (other than services provided as an alternative investment fund manager directly to EEA funds) and those performing the service of "reception and transmission of orders" for a European client.[8]

The Commission took the opportunity this year to consider the application of the rules in light of firms based in the UK becoming "third country" firms following Brexit.

The rules distinguish between services provided to "eligible counterparties", "per se professional clients", "elective professional clients" and "retail clients". Broadly speaking, most types of institutional or wholesale client will either be "eligible counterparties" or

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6 The definition in MiFID is "a firm that would be a credit institution providing investment services or performing investment activities or an investment firm if its head office or registered office were located within the Union" (article 4(1)(57) of MiFID). A third country firm will generally be treated as providing investment services in the EU when it provides this service to any type of client (retail or institutional) in the EU, regardless of whether the firm provides the service from outside or within (on a temporary basis) the EU, – although there may be differences of interpretation and approach across the EU.

7 The extent to which sub-advisory or sub-management services provided to the manager of an EU UCITS fund or EU alternative investment fund qualify as MiFID investment services may be a matter for local state interpretation.

8 A manager or dealer which is receiving a client order and then passing it for execution by a separate entity will generally perform "reception and transmission of orders". Active promotion of a financial product or service in the EU on behalf of a fund manager (including an affiliate) may also be treated as the investment service of "reception and transmission of orders"—although in the absence of a consistent interpretation of this term, this may depend on local state interpretation and the view of the non-EU firm as to the scale of its activities in the EU. It is also currently unclear whether a non-EU firm providing services to an EU affiliate (such as delegated portfolio management) will fall in scope of this term—such a firm may need to avail itself of the group exemption in MiFID as a person providing investment services "exclusively for its parent undertakings, for their subsidiaries or for other subsidiaries of their parent undertakings".

"per se professional clients", whilst other clients (including all individuals) will either be "elective professional clients" or "retail clients".[9]

Once the MiFIR third country regime is operative and available, UK firms will be able to provide services to per se professional clients and eligible counterparties on the basis of a registration with ESMA, subject to fulfilling certain conditions, notably the adoption of an "equivalence" decision in relation to that firm's country.

Equivalence Decision under MiFID

The European Commission will make an equivalence decision on the basis that the third country has prudential, organisational and business conduct requirements which have equivalent effect to the EU Directives and Regulations that apply to MiFID investment firms (comprising the Capital Requirements Directive, the Capital Requirements Regulation, MiFID, MiFIR and the new Directive and Regulation on investment firms' prudential and regulatory capital requirements); that firms in the third country are authorised and subject to effective supervision and enforcement on an ongoing basis; and that the third country prevents insider dealing and market manipulation.

There is uncertainty on the precise scope of an equivalence determination. MiFIR originally suggested that the assessment is based on ensuring that non-EU regulation achieves sufficiently equivalent "outcomes" as EU regulation, not requiring a line-by-line assessment. However, recent changes made to MiFIR require the Commission to make a "detailed and granular" assessment where the scale and scope of the services provided and activities performed by third country firms are likely to be of systemic importance for the EU. It is likely that the regulatory framework in countries with firms that will rely heavily on the third country regime—notably the UK after Brexit—will be more heavily scrutinised under the equivalence procedure, potentially providing a means for the EU to restrict the degree to which UK legislation can diverge from EU legislation without losing its equivalent status.

As mentioned above, given that the MiFIR third country passport is not yet operative and requires various steps to be taken by the Commission and ESMA as well as an equivalence determination, it does not seem likely that the passport will be available to UK firms at the end of 2020 when the transition period is scheduled to end. However, at the moment, that position remains unclear.

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[9] As a result of separate rules in MiFID, it is no longer possible to treat EU local public authorities (and, depending on their structure, their pension schemes) as per se professional clients - such entities are by default "retail clients" and could be treated as "elective professional clients" if they meet the conditions for that status.

Registration Requirement

Once the third country regime is in place, a third country firm wishing to provide services to EU clients will need to register with ESMA. This will be an application for registration, so it will require a form of approval from ESMA. ESMA reserves 180 working days (from receipt of a complete application) to grant or refuse registration. Once registered, under recent changes to MiFIR, the third country firm will also need to inform ESMA annually of information relating to the scale and scope of services it carries out in the EEA, including the geographical distribution across Member States and a description of the firm's investor protection arrangements and its governance arrangements, including the names of the key individuals responsible for the firm's activities in the EEA. ESMA will communicate this information to the Member States where the third country firm provides services.

Under the revised version of the legislation, ESMA has been given new powers to monitor regulatory and supervisory developments, enforcement practices and other relevant market developments in third countries for which equivalence decisions have been adopted to verify whether the conditions are still fulfilled and submit an annual report relating to those developments to the Commission. In addition, there is a new power for ESMA to restrict a third country firm from providing investment services in the EEA where the firm has, among other things, failed to comply with any prohibition or restriction imposed by ESMA or a competent authority, does not cooperate with an investigation or on-site inspection or has acted in a manner clearly prejudicial to interests of investors or orderly functioning of the markets.

A third country firm will be able to provide services to eligible counterparties and per se professional counterparties under existing member state rules for three years beyond the date on which the Commission makes a decision as to the "equivalence" of the regulation in the third country firm's state. It is assumed that the opportunity to register will exist during this transitional period.

There is a "reverse solicitation" exemption from the requirement to register. This is available if the eligible counterparty or per se professional client initiates the provision of the relevant investment service or activity at its own exclusive initiative. Prior solicitation or promotion by the third country firm in the EEA in relation to the client will generally preclude reliance on reverse solicitation, and an initiative by a client will only allow the firm to market the "category" of product or services solicited by the client. Recent ESMA guidance suggests that advertising on a website which is accessible in the EEA may prevent a firm from claiming that the business was done at the "own exclusive initiative" of the client.

The Position for Retail Clients and Elective Professional Clients

Under MiFID, a Member State may require a third country firm which is providing services (with or without any ancillary services) to retail clients and elective professional clients to establish a branch in that state, other than where the client initiates at its "own exclusive initiative" the provision of an investment service. A branch is not a separate legal entity; it is the local office of a third country firm. A third country firm which is required to establish a branch will have to comply with the rules of that state which implement specific provisions of MiFID relating to, for instance, conflicts of interest, client disclosure, client reporting and order execution. The branch must also have "sufficient initial capital" at its disposal. One or more people must be appointed to be responsible for the branch's management. MiFID contains other conditions relating to the existence of regulator to regulator co-operation agreements and requiring that the firm belongs to an EEA investor compensation scheme. All business conducted with retail clients will need to be done through the branch.

If a third country firm establishes a branch, that branch will not be able to provide investment services to elective professional clients and retail clients in other member states (via the "passport"). However, a branch which is authorised in one state may provide investment services to per se professional clients or eligible counterparties in other member states if the third country firm is in a country which has been recognised as equivalent in accordance with MiFIR (see above). As a result, firms which intend to actively solicit business from retail clients in more than one or two member states will want to establish a separate entity in one state, obtain authorisation for that entity and use the MiFID passport to provide services in all other states.

If a Member State does not require a third country firm to establish a branch to provide services to retail clients and elective professional clients, it can continue to allow third country firms to provide services on the basis of existing local law. Few Member States have implemented the option under MiFID to require a third country firm to establish a branch to service retail clients. As a result, existing local requirements continue to apply—which often require the establishment by the third country firm of a locally authorised entity, at least when providing services to retail clients at the firm's initiative or to a certain scale.

World Trade Organisation and Impact on Existing EU Free Trade Agreements

Any future relationship agreement agreed between the UK and the EU will need to satisfy the requirements of the exemption in the rules of the World Trade Organisation ("WTO") concerning free trade agreements. In particular, the General Agreement on Trade in Services ("GATS") includes a general exemption from GATS for agreements

"liberalising trade in services" between WTO members provided, among other things, that the agreement has a substantial sectoral coverage (that is, it must not be limited to just one sector).

When negotiating the future relationship agreement, the EU will also need to have regard to free trade agreements agreed with the rest of the world that contain "most favoured nation" provisions relating to financial services. If it negotiates financial services provisions with the UK in the future relationship agreement that are more favourable than those in other free trade agreements, the EU may need to "upgrade" its existing free trade agreements with other jurisdictions to include equivalent provisions.

Summary

For firms managing private funds, the immediate next steps are now reasonably clear, with preparing for the loss of passporting rights at the end of this year being a priority. Given that this outcome has been a distinct possibility since 2016, many firms already have parallel structures or well developed contingency plans. Certainly, any UK firms that expect to be fundraising in 2021 and have previously relied upon the passport will need to activate that plan.

For the most part, rules will not change overnight. But, in the longer term, the position is less clear. The UK may amend its rulebook, and the EU may tighten its rules on market access and delegation if it perceives that the current situation leaves it vulnerable to unfair competition or risks to financial stability. Firms will have to keep a close eye on the developing landscape.

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Please do not hesitate to contact us with any questions.

LONDON

Katherine Ashton
kashton@debevoise.com

Patricia Volhard
pvolhard@debevoise.com

Simon Witney
switney@debevoise.com

John Young
jyoung@debevoise.com

Jin-Hyuk Jang
jhjang@debevoise.com