UK Withdrawal from the EU — Impact on UK and EU Private Equity Firms

15 July 2020

There is less than six months until the end of the transition period provided for in the Withdrawal Agreement between the European Union (the "EU") and United Kingdom (the "UK"), at which point UK-based financial services firms will cease to benefit from the "passporting" rights conferred by EU law. This note follows our update in January 2020 on the UK's withdrawal from the EU and the regulatory consequences for UK and European Economic Area ("EEA") based private equity and venture capital firms.

End of Transition Period

The eleven month transition (or "implementation") period will end at 11pm UK time on 31 December 2020. Despite disruption caused by the COVID-19 pandemic, the UK government announced in June that it will not seek, or agree to, an extension to the transition period, underlining its commitment to cease to be subject to EU law from 1 January 2021.

However, although EU law will cease to apply in the UK from 1 January, there will be limited immediate impact on UK law. UK legislation that is derived from the EU (including FCA rules and secondary legislation that implements EU Directives) remains in force. In addition, directly effective EU legislation that is both in force and applicable as at 31 December 2020 will be largely "onshored" with effect from that date, taking effect in the UK with changes to reflect that it only applies in a UK context, including, for example, the transfer of functions from EU agencies to UK authorities. The UK Financial Conduct Authority ("FCA") will also expect firms to follow non-legislative materials produced by EU agencies, such as formal and informal guidance published by the European Supervisory Authorities, interpreting them in light of the UK's withdrawal from the EU. The FCA will also have a special power to waive or modify obligations imposed on UK firms where the firms' obligations have changed as a result of the "onshoring" exercise, to prevent or mitigate disruptions for firms. The FCA has confirmed that it will not exercise this power in relation to "incoming" EEA firms (i.e., firms that are EEA-based and wish to conduct business in the UK), but it may be of some help to UK-regulated firms.

"In-flight" EU legislation, meaning legislation (and specific provisions within legislation) that are in force but do not yet apply, and EU legislative proposals that are not yet in force, will not automatically take effect at the end of the transition period. This includes the package of EU legislation relating to the disclosure of environmental, social and governance (or "sustainability") considerations in investment decision-making (the Sustainable Finance Disclosure Regulation) and the new EU taxonomy (the Taxonomy Regulation). Whether or not the UK government adopts in-flight legislation is a matter of policy, although this may be informed by the UK government's approach to the continuing "equivalence" of UK legislation to EU legislation.

UK Financial Services Legislation — Policy Proposals

The UK government has signaled its intention to diverge from EU financial services legislation and recently announced a number of specific proposals in this respect, including its approach to implementing "in-flight" EU legislation. Of interest to private equity is legislation to improve the functioning of the regime for investor disclosure under the PRIIPs Regulation in the UK. The government announced that it will adopt a new prudential regime for financial services firms (including the majority of private equity "adviser-arrangers") regulated under MiFID that is largely based on the EU's Investment Firms Directive and Regulation, without indication of any separate treatment of private equity adviser-arrangers.

In March 2020, the UK government separately published a consultation on a proposal for an Overseas Fund Regime, which will establish a new process to allow investment funds domiciled overseas to access the UK market. This is designed to replace the passport as the means for marketing overseas retail funds, including EU UCITS and money market funds (which may be structured as UCITS or alternative investment funds), to retail investors in the UK, and is based on the government determining the "equivalence" of the overseas regime to UK standards. The regime is not designed as a means to market alternative investment funds (other than money market funds) to UK retail investors.

UK Temporary Permissions Regime for EEA Firms

At the same time as repealing passport rights for incoming EEA firms at the end of the transition period, the FCA will activate a temporary permissions regime ("TPR") to enable EEA firms to operate in the UK on the basis of their existing passporting rights for a limited period. This is available to EEA firms passporting into the UK on a "freedom of establishment" (the establishment of a UK branch) or "freedom of services"

basis (services provided on a cross-border basis without a permanent establishment in the UK), as well as EEA alternative investment fund managers ("AIFMs") marketing in the UK under the passport. In this regard, the FCA recently announced its intention to re-open the "notification window" for firms to notify the FCA that they want to use the temporary permission regime on 30 September 2020 (and update any previously submitted notifications, if necessary). Firms that step into the regime will largely be subject to the same "home state" and "host state" rules that currently apply to them in the exercise of their passport rights.

Although the regime provides helpful continuity of marketing rights for EEA AIFMs marketing in the UK — which can, if necessary, be replaced by a straightforward private placement marketing notification to the UK — EEA firms will need to consider whether to use the regime to continue to exercise the "freedom of services" passport, in light of the type and scale of their activities in the UK. In this regard, firms may conclude it is not necessary to use the regime where they provide services on a purely "remote" basis into the UK, such as portfolio management services rendered to a UK fund or client, although firms will need to consider this on a case-by-case basis. The FCA has stated that it expects the TPR to be in place for up to three years and that it expects firms either to cancel their temporary permission or to obtain permanent authorisation or recognition in the UK by the end of that period. This may take the form either of FCA authorisation of a UK-established branch or subsidiary or prospectively entry into the regime established by the UK's adoption of the "third country" rules in the Markets in Financial Instruments Regulations – see below "Equivalence as basis for future relationship". There will be no change for non-EEA AIFMs marketing AIFs under the UK private placement regime.

Future UK-EU Relationship

Equivalence as Basis for Future Relationship

The Alternative Investment Fund Managers Directive ("AIFMD") and the Markets in Financial Instruments Regulations ("MiFIR") each contain mechanisms allowing firms based in third countries to gain access to professional clients in EEA markets, with MiFIR containing a procedure for the European Commission to deem a third country's regulatory regime to be of "equivalent" standard to that of the EU. "Equivalence" is intended as the basis for mutual market access by UK and EEA financial services firms providing services governed by MiFIR (such as portfolio management, investment advice and brokerage), although it is unclear whether that will be in place by the end of the transition period. The UK is establishing its own equivalence framework that will apply at the end of the Brexit transition period, to allow it to assess the equivalence of the regulatory and supervisory regimes of countries or territories outside the UK, both

in and outside the EEA. To that end, the UK will adopt those equivalence decisions already made by the EEA (in relation to, for instance, the European Regulations governing derivatives trading ("EMIR")) and is ready to make equivalence decisions in relation to the "third country" regime in MiFIR for the provision by EEA (and potentially non-EEA) firms of services in the UK. The UK has indicated that the UK's process will be complete by 1 January 2021, so that EEA firms can register under the UK's third country framework, although there is no assurance that that will be the case in the absence of the equivalent EU regime being in place. The UK's regime will provide a formal framework for EEA firms to provide services on a cross-border basis in the UK (without establishment of a permanent place of business), although it is likely that many firms will be able to continue to provide services on a purely "remote" basis into the UK or on the basis of the UK's "overseas person exemption", which will continue for an interim period (and potentially longer).

In line with the statements in the "political declaration" of October 2019 on the framework for the UK-EU future relationship, the Commission has started work on its equivalence assessment of the UK regime, having submitted detailed requests to the UK for information on UK rules for that purpose. As at early July 2020, the EU confirmed that the UK has made little progress in providing the information requested, with some doubt as to date on which the EU will finalise its assessments. In addition, the European Supervisory and Markets Authority ("ESMA") is developing the rules that provide for the process for registration with ESMA as a "third country" firm and related ongoing reporting – under the auspices of changes to MiFIR that come into effect in June 2021 – shedding considerable doubt as to whether there will be a process for UK firms to register as "third country" firms prior to the end of the year. In the meantime, local Member State rules apply to the provision of services by UK firms – see "Local Member State rules on the provision of services by UK firms" below.

It is not expected that the Commission will activate, for the time being, the separate regime in the AIFMD for the grant of the third country passport to third country alternative investment fund managers. As this entails authorisation and supervision by a regulator in an EU Member State of reference, it is unknown whether any UK firms will ultimately adopt this route even if it becomes available.

UK-EU Free Trade Agreement

Alongside the development of the "equivalence" regimes in MiFIR (which the UK regards as "technical matters" which are not subject to negotiation under the free trade agreement), the UK and EU have each put forward draft free trade agreements which contain provisions on financial services. Whilst equivalence provides the basis for mutual market access, the UK's version of the free trade agreement builds in safeguards on the means by which UK firms can offer cross-border financial services into the EEA

by restricting the EU from, for instance, imposing quotas on the services provided by UK firms and allowing for short term fly-in, fly-out business visits. The UK has also suggested a system of regulatory cooperation and consultation for the withdrawal of equivalence decisions – something the EU regards as a power exercisable only by the EU. In a recent speech, Michel Barnier referred to the draft agreement and stated that "There is no way Member States or the European Parliament would accept this!", re-iterating the EU's view that the UK cannot keep the benefits of the single market without being subject to the related obligations. At the moment, the "secure" equivalence proposed by the UK therefore seems unlikely.

Co-operation Arrangements

The third country regime under MiFIR (and the conditions for delegation of functions to third country firms under AIFMD) requires that ESMA has a co-operation arrangement with the relevant competent authorities of the third country, including the FCA. In February 2019, the FCA and ESMA both published press releases[1] announcing that they had agreed on Memoranda of Understanding ("MoU") between the FCA, ESMA and other EEA competent authorities to, inter alia, cover co-operation and the exchange of information in the event of a no-deal Brexit. Although the relevant MoU has been approved by ESMA, it must be signed by the remaining 27 EU Member States and the texts of the MoUs have not yet been published.

Local Member State Rules on the Provision of Services by UK Firms

Until MiFIR's equivalence regime is in effect (and during a three year transitional period provided for in MiFIR), local Member State rules apply to the provision of services by UK firms. The extent to which a UK firm can lawfully provide services to customers in an EEA member state or carry on activities in that state without the benefit of the passport, or entry into MiFIR's equivalence regime, depends on a number of factors. In line with EU Directives, all Member States require firms with a permanent establishment in their state to be authorised by the competent authority in that state (or a competent authority in another Member State if the firm is exercising passport rights). In broad terms, Member States are more likely to intervene and impose licensing requirements on firms accessing retail clients in their state (and potentially clients "opted-up" to professional client status, which are primarily individuals meeting conditions as to their experience and local authority pension funds) or where the key characteristics of the service are regarded as being performed in their jurisdiction. Reverse solicitation – provided it is in accordance with the facts and well documented – remains an option to access investors in many Member States. Otherwise, it is open for

[1] https://www.fca.org.uk/news/press-releases/fca-agrees-mous-esma-and-eu-regulators-allow-cooperation-and-exchange-information%20and%20https:/www.esma.europa.eu/press-news/esma-news/esma-and-eu-securities-regulators-agree-no-deal-brexit-mous-fca.

firms to argue that, whilst the client is resident in an EEA state, the service itself is wholly or substantially provided from outside that state – although many Member States reserve the right to exercise jurisdiction over a non-EEA firm even in these circumstances.

In this regard, Luxembourg's financial regulator recently introduced a transitional regime on the basis of determining that a number of third countries had rules of an "equivalent" standard. This regime covers the United States, Canada, Hong Kong, Singapore, Switzerland and Japan. The regulator separately clarified as to when investment services provided to Luxembourg clients should be considered as taking place "in Luxembourg", thereby providing useful guidance on the territorial scope of the relevant Luxembourg laws—please read here for more information.

By contrast, the German regulator considers services to be provided in Germany if a non-EEA firm targets the German market in order to offer services repeatedly and on a commercial basis to German clients. Whilst Germany has not made any equivalence statements with respect to third country jurisdictions yet, it offers an exemption from the licensing requirements, where BaFin deems that no need for supervision exists in connection with the provision of services, if the non-EEA firm is effectively supervised in its home jurisdiction in accordance with internationally recognized standards and the competent home state regulator cooperates satisfactorily with BaFin. For this purpose, the non-EEA firm must submit a certificate from its home state regulator to BaFin which confirms that (i) the non-EEA firm has a license for services that it intends to provide on a cross-border basis in Germany; (ii) the performance of the cross-border services in Germany raises no supervisory concerns; and (iii) if any such concerns arise, they will be reported to BaFin. In practice, whilst the Swiss regulator FINMA has issued this certificate for Swiss firms, US Securities and Exchange Commission (SEC) has not co-operated in this regard with respect to US investment advisers.

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