EU-UK Treaty —Crossborder Financial Services: Out with the Passport, in with Uncertainty

12 January 2021

Background. Following the end of the Brexit transition period, the new EU-UK trade and cooperation agreement (the "Treaty") entered into force on 1 January 2021. From that date, directly applicable EU law ceased to apply in the UK and UK firms lost their access to EU clients and markets through their "passports". As expected, the Treaty did not provide any mutual market access for financial services and effectively amounted to a "hard Brexit" in financial services terms—with UK and EU firms putting in place long contemplated plans to address the loss of the EU financial services passports.

Equivalence as Basis for Future Market Access. In the absence of any new framework, the only existing basis on which UK firms can provide services in the EU on a remote or "cross-border" basis is "equivalence". A number of EU Directives (in particular, the Markets in Financial Instruments Directive ("MiFID"), which governs (inter alia) portfolio management, investment advice and fund distribution activities) contain mechanisms allowing firms based in third countries to gain access to EU markets, based on the European Commission deeming a third country's regulatory regime to be of "equivalent" standard to that of the EU. Originally contemplated as a consistent basis for non-EU firms to provide services to professional clients in the EU (over-riding existing member state local rules on access by non-EU firms) on the basis of a determination that a non-EU state had rules of broadly "equivalent" standard to the EU, Brexit prompted EU authorities both to considerably tighten the procedures for entering the regime, as well as adding some uncertainty as to the scope of the "equivalence" assessment required and empowering the EU to withdraw equivalence determinations on 30 days' notice.

Unfortunately, the Treaty does not progress these equivalence decisions in favour of the UK. Instead, as is made clear in the EU's Q&A, the UK and EU agreed on a separate "Declaration" which includes a commitment to discuss "how to move forward on both sides with equivalence determinations between the Union and United Kingdom, without prejudice to the unilateral and autonomous decision-making process of each side". Whilst this leaves some room for co-operation with a view to making these determinations, the EU's Q&A makes clear that they are "unilateral decisions of each party and are not subject to negotiation". The EU has said it will consider equivalence

decisions "when they are in the EU's interest". It has given no indication so far as to whether or not it will make further equivalence decisions in the short term, with the official EU position being that it requires further information, particularly in view of future regulatory divergence by the UK.

That the EU has stated that it will consider equivalence decisions "when they are in the EU's interest" raises many questions. There does not seem to be an immediate need for the EU to grant equivalence, as the EU has already extended access to the UK for financial markets clearing for 18 months until June 2022. From one perspective, equivalence decisions may do nothing to prevent the UK from winning financial services business through perceived "regulatory arbitrage", and they remain a prize that the EU may be less and less inclined to grant to the UK. It is also interesting to note that the UK's "overseas person" exemption has historically allowed access by non-UK firms providing wholesale financial services to UK customers, with few examples of an equivalent exemption in EU states. While the EU may welcome the UK position, it might also look with interest over the next year at the opportunities that the absence of equivalence may generate for EU financial services businesses, in particular whether business will shift from London to the EU financial centres—a trend that it is unlikely to reverse.

Regulatory Divergence in the UK. Whilst the EU's pending work on equivalence may make the UK less inclined to announce changes to domestic financial services law in the short term, regulatory divergence seems inevitable in the longer term. The UK has already announced that it will not implement the EU's Sustainable Finance Disclosure Regulation, which comes into force in March 2021. Instead, the UK will consult on a domestic regime that is focussed on mandatory disclosures by asset managers on the climate related risks (such as greenhouse gas emissions) in their portfolio from 2023. The UK has also announced that, whilst largely adopting the EU's new prudential rules for investment firms, it will delay the application date until January 2022.

The UK Treasury published a consultation on post-Brexit financial services regulation in November 2020, specifically inviting views on the financial services regulatory framework following the UK's departure from the EU. This did not result in concrete legislative proposals but signalled a move from the EU's regulatory approach (detailed and somewhat inflexible regulatory standards set in legislation in order to facilitate a single market in financial services) to an approach for the UK government to set public policy with heavy reliance on the expertise and flexibility for regulators to set regulatory standards—a framework already captured in the UK Financial Services and Markets Act 2000.

UK Firms Performing Services in the EU in the Future. In the absence of the equivalence framework, UK firms will need to examine carefully the type and scale of

activities that they conduct in the EU. The provision of services from a permanent base in the EU will almost always require separate EU-related authorisation (and building of associated "substance" requirements) in that state. Firms are also likely to conclude that the provision of services to retail clients (at least to any scale), or the active marketing of services in an EU member state, will need to be conducted from an authorised EU office. Otherwise, the provision of services by occasional visits or on a remote basis will continue to require case-by-case analysis, with advisors and regulators within the EU taking different views. In that regard, UK firms that conduct marketing or distribution activities will need to consider carefully the risk of those activities being treated as within the scope of licensing requirements in jurisdictions. Although there are arguments that the typical range of private equity "investor relations" activities do not amount to the provision of an investment service to the investor (in a similar manner as corporate finance firms that conduct capital market placings for issuers do not act for the investor participating in the placing), there appears increasingly to be a presumption that marketing activities are within the scope of licensing requirements—and, in light of that, most firms are looking at engaging some regulatory cover for their EU marketing activities. This interpretation is highlighted in the forthcoming EU Directive with regard to cross-border distribution of collective investment undertakings, which reserves pre-marketing undertaken on behalf of an AIFM to EU MiFID investment firms, EU credit institutions and other regulated fund managers.

New UK-EU Memorandum of Understanding for a Framework for Regulatory Cooperation on Financial Services. As well as signalling that equivalence decisions might be made in the future by the EU and UK, the UK and the EU also agreed in the "Declaration" to agree by March 2021 on a new Memorandum of Understanding for a framework for regulatory cooperation on financial services. This is broadly expressed, and includes a commitment to put in place an arrangement for "exchanges of views on regulatory initiatives" and "enhanced co-operation and co-ordination including in international bodies". Whether or not this will translate into any concrete arrangements or even an equivalence determination at least in certain areas is unclear.

Local Equivalence by Member States. In the meantime, until there is certainty about equivalence granted by the EU, some member states offer equivalence status or otherwise accommodate UK and other "third country" firms offering services to professional clients on a cross-border basis in their jurisdiction. For example, UK firms authorised under MiFID may continue their operations in Sweden on the basis of a temporary extension of the passport in relation to existing professional clients (with whom they had a contractual agreement on or prior to 29 March 2019) until 31 December 2021.

Firms providing financial services only to professional investors on a cross-border basis into Germany may apply to BaFin for an exemption from the German licence

requirements. BaFin will grant this dispensation, provided the investment firm is sufficiently supervised in its home state and its home state regulator confirms this to BaFin, confirms that there are no concerns regarding the firm providing services into Germany and undertakes to inform BaFin if such concerns arise in the future. This national regime will be superseded by the MiFID third-country rules once an equivalence decision has been made. After obtaining the dispensation, the investment firm will be partially subject to the German implementation of MiFID. Broadly speaking, the rules on internal organisation and governance will not apply, whilst MiFID "conduct of business" and German anti-money laundering rules will apply. Whilst Swiss firms have to date used this as a means to access German institutional investors, it is a new process for UK firms.

In Luxembourg, the regulator (the *Commission de Surveillance du Secteur Financier*, "CSSF") has introduced a national equivalence regime allowing firms in six third countries to perform investment services in Luxembourg, and the CSSF recently included the United Kingdom in the list of jurisdictions deemed equivalent for the application of the national third-country regime. See our note on this topic.

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Please do not hesitate to contact us with any questions.

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