FINANCIAL SERVICES BRIEFING

Cross-border financial services after Brexit: searching for certainty

Brexit, and the loss of the financial services passport, has brought into focus the position of UK, and other non-EU, financial services firms that provide services on a remote or cross-border basis in the EU. The financial services passport allows a firm that is authorised in an EU member state to perform services or activities in another member state without needing further authorisation from another member state to do so.

After Brexit, UK firms that previously relied on a passport under EU single market legislation face acute risks relating to their ability to honour their commitments under cross-border arrangements, and to generate new business, if they no longer have the appropriate authorisation to carry out regulated activities in the relevant jurisdiction.

There are a number of key areas of uncertainty, such as whether the provision of services is considered to be carried on in the firm's or the client's home jurisdiction and why this analysis seems to differ depending on the jurisdiction and the type of financial service. This uncertainty is compounded by a lack of member state guidance or consistent EU practice in this area.

UK approach to overseas firms

In 1997, the European Commission (the Commission) set out a test in the field of banking activity that provided a practical and sensible basis for determining where a service is carried on, by specifying this as the place where the essential elements of the service are performed (*see box "European Commission test"*). In this vein, the UK published guidance in August 2011 to allow Swiss banks to accept deposits from UK clients on the basis that the deposit-taking activity does not take place in the UK as the deposit is "booked" in Switzerland (*https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/356887/memo_by_HMT.pdf*).

Under the Commission's test, activities such as temporary visits to clients in a foreign jurisdiction for marketing purposes, or the remote provision of services in a foreign jurisdiction through the internet, will not amount to the performance of a service in a jurisdiction. However, there is limited evidence that this has formed the basis of an EU-wide test for determining where any other financial service is carried on and there has been little impetus since then to develop a workable EU-wide test.

Although the Financial Conduct Authority (FCA) has published guidance in support of the characteristic performance test, the Financial Services and Markets Act 2000 (FSMA) restricts any person from carrying on a regulated activity by way of business in the UK unless they are authorised or exempt (*www.handbook.fca.org.uk/handbook/SUP/App/3/6.pdf*). The concept of carrying on an activity in the UK is drawn deliberately broadly and, in separate FCA guidance, is stated to be capable of applying to activities that are performed by firms which do not have a UK place of business; for example, firms that reach UK clients through the internet (*Perimeter Guidance manual (PERG) 2.4.6*).

While there is limited UK guidance for overseas firms as to whether a particular activity will be treated as carried on in the UK, overseas firms have the benefit of the legal certainty of the UK overseas person exemption under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (*SI 2001/544*). This broadly exempts firms that do not have a permanent place of business in the UK from any licensing requirement where that firm meets certain conditions for carrying on the activity in the UK, such as limiting its marketing communications to professional clients. This exemption, combined with exemptions from the UK financial promotions restriction in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (*SI 2005/1529*), has long formed a clear basis for non-UK firms to reach professional clients in the UK.

EU approach to overseas firms

Once the government determined that Brexit would signal the loss of the financial services passport, UK firms with significant EU operations spent a substantial amount of time analysing the impact in each jurisdiction. This analysis showed that few EU competent authorities provide much guidance, let alone legislative certainty, on the circumstances in which a foreign firm providing services in their jurisdiction is treated as being within the scope of local licensing requirements. Although there are a number of bases on which non-EU firms have approached the issue to date, a considerable amount of uncertainty remains.

Retail or professional clients. It is clear that competent authorities are more likely to intervene in relation to the provision of services to retail clients. In the UK, for example, there are few instances of the FCA taking steps against unauthorised firms that provide services in the UK unless retail client protection is at stake. Arguably, the provision of financial services to a retail client base on any scale in the EU on a purely remote basis would be unusual, given that serving retail clients usually requires the establishment of a local base from which to process clients' orders and deal with their queries.

While clear exemptions for providing services to professional clients do not always exist, there has long been a perception that competent authorities allow, as an accepted practice, limited access to professional or wholesale clients in their member states, particularly where the foreign firm does not conduct any marketing activity in the member state. The Luxembourg financial regulator, the Commission de Surveillance du Secteur Financier, confirmed in July 2020 that one of the bases on which services are always treated as provided in Luxembourg is where the service is provided to a retail client in Luxembourg, except where the service is provided at the request of the retail client (*www.cssf.lu/wp-content/uploads/cssf19_716eng_01072020.pdf*).

The same is true for the German regulator, known as BaFin, which indicated in 2005 that while a cross-border service to institutional investors can be based on the provision of services on a passive basis without active marketing in Germany, this does not appear to be possible for retail clients (*www.bafin.de/SharedDocs/Veroeffentlichungen/EN/*

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Merkblatt/mb_050401_grenzueberschreitend_en.html). This perhaps reflects the presumption that the provision of services to retail clients usually involves an element of marketing.

Reverse solicitation or passive freedom to provide services. Reverse solicitation, or the provision of a service in a jurisdiction at the exclusive initiative of the client, has been used as a basis for non-EU firms to provide services in the EU. In Germany, for instance, BaFin applies its financial services licensing requirement in a cross-border scenario when a firm is targeting the German market, as opposed to providing services passively at the initiative of a client that is resident in Germany. However, in other member states, it is open to debate whether that principle is enshrined in domestic law or is simply a basis on which non-EU firms can conclude that there is low risk of regulatory intervention.

European Commission test

In a communication published on 20 June 1997, the European Commission (the Commission) attempted to define the circumstances in which firms, at least in the field of banking activity, carry on activities for the purpose of exercising their passport on a cross-border basis within the territory of another EU member state (*https://op.europa.eu/en/publication-detail/-/publication/4a6f984b-dabb-4ea2-96f5-8dc61379a883*).

While acknowledging that banking services are difficult to pin down to a specific location and are increasingly provided in an intangible form, the Commission proposed that, in determining where an activity is carried on, it is necessary to determine the place where "the essential supply for which payment is due" or the place of "characteristic performance" of the service. Therefore, it concluded that a bank may have non-resident clients without necessarily pursuing the relevant activities in the territory of the clients' member state.

In proposing this test, the Commission stated that, as the Court of Justice of the European Union had not ruled on the issue, any bank in the EU is free to choose, for reasons of legal certainty, to make passporting notifications. It therefore effectively conceded that consistency of approach among member states on the issue is unlikely, and arguably unnecessary, as long as the financial services passport is available.

On a cross-EU basis, the concept of the passive freedom to provide services confers a right on the recipient to request a service, although there is limited authority for the application of this concept in the field of financial services. The concept allows, for example, expatriates, having moved from their home state, to continue to access financial services from another member state, in particular by using internet-based services. The reverse solicitation basis of providing services will also generally not infringe any local restriction on marketing or advertising the service in a member state.

No active marketing in the EU. While the jurisdictional scope of a member state's licensing requirements for activities carried out in that member state may be unclear, there are generally clear rules in member states to restrict the promotion by non-licensed firms of financial services and products. For example, the UK restricts an unauthorised person from making a financial promotion in relation to a financial service or product in the UK, other than to limited classes of institutional clients (*section 21, FSMA*). Restrictions on promotions will generally cover promotion through the internet, particularly where a firm allows clients in a member state to access its website. In practical terms, regulators may find it easier to take recourse against a non-EU firm on the basis of local offering or marketing rules rather than licensing rules.

Arguably, leaving a degree of vagueness in the law on licensing requirements actually addresses investor protection concerns. Strictly defining when a foreign firm is treated as performing a service in or outside of a member state may allow the firm to perform some services in, and some services outside of, that member state, thereby accessing clients in the member state in a way that raises investor protection concerns. In addition, a lack of distinction in the law between services provided on a remote basis into the member state and services provided on the ground in the member state generally has the effect of forcing non-EU firms to meet licensing requirements in that member state when providing services of any scale to clients. There is little incentive for an EU competent authority to allow a foreign firm to access a large client base in its jurisdiction without the benefit of supervising a locally established office.

Licensing requirements often cannot be fulfilled other than by establishing a permanent office in the jurisdiction, although regimes do exist to grant third-country firms the benefit of a local licence without a local establishment, or even recognise the firm's third-country licence, sometimes based on a system of mutual recognition between the EU and a third-country regulator. While a model based on deference to third-country authorities and regulatory systems seems workable in theory, at least in relation to access to professional clients, there is limited evidence to date of this being applied in practice.

In relation to Brexit, the lack of clear exemptions for the provision of services to professional or wholesale clients in a member state on a remote basis or by occasional visits has raised serious concerns regarding the ability of UK firms to continue to provide services to their EU clients; for example, in matters such as capital raising.

MiFID II third-country regime

The Markets in Financial Instruments Directive (*2004/39/EC*) (MiFID) imposed a common licensing regime on EU investment

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firms but, until its 2018 reiteration as the recast Markets in Financial Instruments Directive (*2014/65/EU*) and the Markets in Financial Instruments Regulation (*600/2014/EU*) (together, MiFID II), it did not cover the position of non-EU firms that provide services in the EU (*see feature article "MiFID II and MiFIR: challenges ahead", www.practicallaw.com/w-010-7941*).

Reflecting a will for consistency of approach across the EU, MiFID II introduced a regime for third-country investment firms (that is, firms with a head office or registered office outside of the EU) that requires them to register with the European Securities and Markets Authority (ESMA) before providing services to professional clients in the EU.

It is significant that, in creating a common licensing regime as a level playing field for non-EU firms, MiFID did not provide any further certainty as to the circumstances in which a non-EU firm is treated as providing a service in the EU, leaving member states to continue to exercise a high degree of discretion.

Once the MiFID II third-country regime comes into effect, which is dependent on ESMA making equivalence determinations for third countries, a process that has been heavily delayed as a result of Brexit, third-country firms that provide services to professional clients in the EU on a cross-border basis will have benefit of an EU-wide passport to access EU professional clients. Providing a degree of new consistency across the EU, the regime in MiFID II specifies the reverse solicitation exemption, which is framed as a service provided by the third-country firm that is initiated by the client "at its own exclusive initiative".

It is interesting to consider whether the MiFID II third-country regime, if it comes into effect, will place firms that provide services to EU professional clients in a better position than previously. While MiFID II provides legal certainty for those firms willing to go through the ESMA registration process, and removes any need for non-EU firms to register with local competent authorities or to establish a firm in the EU, it is arguably unfit for purpose to those providing services at a small scale in the EU. The registration regime that MiFID II foresees has grown, as a consequence of Brexit and its application to UK firms, into a complex and time-consuming process.

Uncertainties remain

The benefit of the EU financial services passport is clear: it acts as a shield to defend firms from any risk of regulatory challenge or client recourse on the basis of a breach of local licensing requirements, while allowing firms to perform a large range of activities associated with the provision of financial services, at any scale, across the EU. The MiFID II third-country passport comes at a price of complex registration requirements and the uncertainty that the equivalence decision of the EU may not last forever. Even if the EU confers the benefit of the MiFID II third-country passport on the UK, it will reserve the right to revisit that decision on a regular basis and acute uncertainty will remain on the position of UK firms that conduct activities in the EU.

While considering the position of UK firms caught by the significant impact of Brexit, it is interesting to reflect on whether the position of other non-EU firms will change. It is clear that EU regulators have, to date, exercised a considerable amount of regulatory forbearance in relation to the access by overseas firms to EU clients. Numerous overseas financial institutions allow EU clients to access their services through the internet: some on a purely passive basis without marketing in the EU while, with others, there is seemingly no prohibition on EU individuals taking steps to be accepted as clients. If the EU signals a lack of tolerance towards UK firms continuing to access EU clients, it is hard to see the current permissive approach to other non-EU firms remaining.

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