Baker & McKenzie Alert

Client Alert

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Brexit: UK and Third Country Firm Strategies

Now that Brexit is a reality after Thursday's referendum, businesses will need to adapt to a changing legal and regulatory environment. It is, of course, too early to tell what structure will replace the Single Market arrangements that we are all familiar with. As the Financial Conduct Authority (FCA) notes in its statement issued today (24 June) much financial regulation currently applicable in the UK derives from EU legislation. This legislation will remain applicable until changes are made and firms will be expected to continue to comply with it.

Whilst the position is clear with regard to European legislation that is already in force in the UK and that firms are already complying with, the position is less clear with regard to EU level legislation that is still in gestation. MiFID II will require significant changes to firms' processes and procedures, yet firms must now take steps to comply with these changes when it remains unclear what the status of the Directive and Regulation will be when they finally enter into force in 2018. It is imperative that these matters are clarified as soon as possible.

Brexit could, of course, limit the ability of firms to do cross-border business out of the UK. The impact may well depend on the nature of business engaged in. In a 2015 publication on retail financial services (see below), the Commission noted that the EU retail financial services market shows little cross-border activity and that this reflected cultural and national preferences and customers' choice. To the extent that the retail market is fragmented along national lines, Brexit might have a lesser impact as firms will be less reliant on passporting their services across Europe. In contrast, the wholesale markets are more integrated across Europe so that Brexit will have a potentially greater impact.

The impact of Brexit on EEA firms doing cross border business into the UK or with branches in the UK should also not be underestimated. The allocation of responsibilities between Home and Host State regulatory authorities underpins the Single Market Directives. EEA firms may therefore come under closer UK regulatory scrutiny in respect of their cross-border business and branches of EEA firms might need to obtain UK authorisation in their own right if the UK ceases to recognise their passport pursuant to their Home State authorisation.

Although the consequences of Brexit on the financial services industry are likely to be significant, our view is that UK firms should be able to continue cross-border activities into the EU from the UK in certain respects even if Single Market rights are withdrawn.

Key Points
Brexit likely denotes a loss of Single Market passporting rights for UK firms and loss of status as EU "credit institutions", "investment firms" and "insurance undertakings". UK firms will become Third Country Firms (TCFs) - i.e., firms with their head or registered office in a jurisdiction outside the EEA. So far as the EU is concerned the UK may potentially be in no better position to access the EEA market than say a US or Australian firm. Strategies for UK firms to access European markets (if the UK is outside the EEA) include: • Reviewing whether they need a passport at all to service EEA based clients. EU law applies what is known as the "characteristic performance" test in determining whether a firm is regarded as doing business in another jurisdiction. The "characteristic performance" comprises the services that the firm is supplying to clients and for which it is being remunerated. Depending on the facts, firms might take the view that the "characteristic performance" takes place in the UK so that no passport is needed even where clients are located in an EEA country. This is on the basis that the firm is not carrying on any relevant activities in other jurisdictions. If so, no passport would be needed. • Certain EEA countries have a light touch regime for TCFs which permits them to access their markets without having a passport under a Single Market Directive (particularly in the case of wholesale/institutional business). Firms can investigate the options available to them to provide services under such light touch regimes, which can involve no more than a straightforward registration or notification procedure. • Use of reverse solicitation rules (particularly for existing customers and contacts). A firm that does not actively market its services in EEA jurisdictions might fall outside local regulations. Where a client or counterparty approaches the firm for the provision of services or to enter into a transaction, then this would be permissible under the reverse solicitation principle. • Use of the National Private Placement Regime for marketing alternative investment funds. • Using a group company located in an EEA jurisdiction to introduce business to the UK firm. • Setting up delegation and/or outsourcing arrangements between an EEA licensed firm and a UK group company to carry on performing some activities in the UK.

In a worst case scenario, the UK leaving the Single Market will likely mean that UK firms will no longer be able to rely on passporting into Europe on a cross-border or branch basis. Of course, nothing has changed as of today. The UK continues to be a full member of the EU for at least 2 years. Even after the formal departure from the EU, UK regulatory laws are likely to remain "equivalent" to those in the EU, at least in the short term. As explained below, being established in a jurisdiction with "equivalent" laws is now often a gateway to accessing the EU market. That said, the exclusion of the UK from the Single Market will have undeniably serious repercussions for businesses in the UK - with financial services accounting for 8 per cent of GDP according to the Bank of England.

UK - EU relationship

One of the principal uncertainties is how the UK's relationship with the EU will be transformed. A new UK government is expected to be formed this autumn now that David Cameron has announced his resignation. This will have the task of negotiating a preferred approach with the EU and it is likely that formal notice to withdraw from the EU in accordance with Article 50 of the Lisbon Treaty will not be given until then. After a period of up to two years, unless extended by mutual agreement, the UK will then withdraw from the EU. Given the importance of the relationship between the EU and the UK, any UK Government will need to have some formal relationship with the EU-27. What that relationship will be, and how the UK and EU-27 arrive at this is not currently known.

There are various models which at first sight are all problematic from continued membership of the Single Market via EEA membership, to access to the EU customs union (like Turkey, although this does not cover services). Other models include bi-lateral arrangements as between Switzerland and the EU involving separate sector-by-sector agreements, and finally, the use of independent free trade agreements or World Trade Organisation rules.

However, upon closer scrutiny there may be cause for optimism since even now, particularly in the wholesale markets, TCFs are able to carry on a significant amount of business in the EEA. UK firms should not, therefore, find themselves entirely shut out of EEA markets although access will, of course, become more limited. In this alert, we look briefly at the possibilities of doing business in Europe across key sectors in the light of a Brexit.

TCFs - the Member State Patchwork

EU banking and financial services legislation has tended not to address the position of TCFs and their ability or entitlement to access the EEA market. Therefore, laws on market access by TCFs have not been harmonised and the position in each jurisdiction needs to be individually addressed.

In order to do business within the EU, TCFs have to understand the legal and regulatory position on market access for each of the Member States in which they intend to do business. The UK, for example, has traditionally been relatively open to TCFs doing business into the UK on a cross-border basis. The *overseas persons exclusion* permits non-EEA firms outside the UK to access UK markets, provided that contact is made with UK clients or customers in a manner that complies with UK rules on financial promotions or on the initiative of the client.

Potentially UK incorporated firms will become TCFs (i.e., firms established outside the EEA). As such, they will need to clarify whether they can do cross-border business into the EEA according to the law in each Member State. If they have a physical branch in an EEA State, this will need to obtain local authorisation.

Harmonisation of TCF Access

Although currently there is a Member State by Member State patchwork of laws governing access by TCFs to local markets, the recent trend in EU regulation has been to harmonise the position of TCFs. This is evident from the Alternative Investment Fund Managers Directive (AIFMD), and the recast Markets in Financial Instruments Directive, and Markets in Financial Instruments Regulation (MiFIR), together (MiFID II). The AIFMD has introduced restrictions on the marketing of third country alternative investment funds (AIFs) although it also anticipates the introduction of passport rights for non-EEA fund managers that meet certain criteria. In turn, the recast MiFID II and MiFIR seek to introduce pan-European rules for TCFs which are discussed further below

Characteristic Performance and Reverse Solicitation

UK firms wanting to do business in the EEA without a passport may be caught by EU and local Member State laws by virtue of marketing activity which is directed at clients in those states, or because they are otherwise regarded as carrying on business in an EU jurisdiction as their client or counterparty is located there. In relation to the latter, (i.e., the issue of whether the UK firm should be regarded as carrying on activities in another state), many jurisdictions apply the *characteristic performance* test which focuses on the place of provision of the *essential supply* for which payment is due. In other words, the relevant activity is regarded as being carried on from where the services are being provided. For cross-border services, this will typically be where the firm is physically based. However, business models which involve visits to clients or contacts in other jurisdictions may lead to the firm being treated as carrying on services in another state. For example, by advising clients locally or as part of a dealing or management activity. Marketing activities can also result in UK firms being subject to EU or Member State regulation.

It is also worth noting that many European jurisdictions do not regulate activities from offshore providers where there has been a *reverse solicitation* (i.e., the client has approached the firm). This is also reflected in MiFiD II which allows customers in the EU to receive investment services provided by a TCF at their own *exclusive initiative* which is similar to the UK's Overseas Persons Exclusion. Where a TCF provides services at a client's own exclusive initiative, those services are not considered to be provided within EU.

In those circumstances, the requirement to seek authorisation will not apply. As a caveat, individual EU Member States may choose to exclude this option.

More generally, a firm which exclusively carries on business from the UK, and which does not actively market its services in another European jurisdiction may well not be regarded as carrying on business in that jurisdiction. Maintenance of existing customers and servicing new customers who have reverse solicited the firm could therefore fall outside the scope of EU regulation altogether.

Funds: UCITS and AIFs

Funds currently recognised under the regulatory framework of the UCITS Directive may no longer benefit from UCITS status as the UK will not be a Member State. Potential strategies around this issue might see UCITS funds, their manager and depositary transferring from London to (say) Dublin, but delegating portfolio management back to the UK.

Again following Britain's withdrawal, a UK alternative investment fund manager (AIFM) would become a non-EEA AIFM under the AIFMD. For UK AIFMs managing EEA AIFs, one possible option to counter the loss of AIFMD passport rights is to establish a new firm in the EU to act as manager, but (again) delegate its functions to a UK portfolio manager.

The European Securities and Markets Authority (ESMA) is in the process of evaluating the extension of the passport to non-EU jurisdictions where equivalence can be established (it has recently confirmed that the passport could be extended to Jersey, Guernsey and Switzerland). If the UK continued to implement the AIFMD in national law, it would qualify as an equivalent jurisdiction. It is highly likely then, that the UK would be among the first jurisdictions to be deemed equivalent and therefore able to benefit from a passport.

In the meantime, UK AIFMs might use NPPRs to offer non-EEA AIFs to EU investors, although the position may change over the next few years

The National Private Placement Regime (NPPR) is a mechanism under the AIFMD allowing AIFMs to register in each Member State prior to marketing a fund to local investors. It is implemented in different ways throughout Europe and the registration criteria set out by each national regulator varies from country to country. The similarity between the regimes is that all regulators require a notification or registration setting out the basic details of the AIF and the AIFM, although some regulators require more information than others (e.g., Germany). Additionally, once registered under the NPPR, AIFMs must comply with ongoing reporting obligations which can cause an administrative burdens.

The challenge facing non-EU AIFMs with non-EU AIFs is that the requirements to register under the NPPR are not streamlined across the Member States. For example, a depositary is required in Germany, Denmark and France whereas this is not a requirement in Sweden, Finland (or the UK). Furthermore, not all jurisdictions have implemented the NPPR. For example, Spain and Italy do not have a local registration process and this often deters fund managers from marketing their non-EEA funds in those countries.

Investment Services

A number of European jurisdictions allow access by TCFs to their markets, particularly with regard to professional business. TCFs may, therefore, be able to provide services from the UK into EU jurisdictions relying on local exemptions and registration processes that fall outside the scope of MiFID, but grant similar market access rights. Jurisdictions such as Belgium and the Netherlands are generally more open to TCFs doing business with clients in their jurisdictions and for many firms this might be a realistic alternative to a MiFID passport, but this will need to be examined on a country by country basis.

The recast MiFID specifically addresses the position of TCFs, distinguishing between retail and professional business. For retail business the Directive allows Member States to continue with their own national regimes for TCFs dealing with retail or elective professional customers, or to require TCFs to establish a branch in their jurisdictions if they wish to deal with such clients. Firms in the UK may therefore be required to establish local branches to service retail clients.

For wholesale business (with per se professionals and eligible counterparties), under MiFIR, national regimes will continue to be replaced eventually by a registration requirement with ESMA. Therefore, no branch requirement will apply but firms will need to consider whether there are any restrictions on doing cross-border business from the UK into the jurisdiction concerned.

What will be the impact on EU retail financial services? In December 2015, the European Commission consulted on why retail financial services markets were not yet as integrated in the EU as they could be. It observed that services and structures were still operated mainly on a national basis and that it was impossible for consumers to access or transfer many financial products cross-border (e.g., the majority of insurance or mortgage credit). Despite a range of proposals to improve the functioning of the cross-border passport, the elephant in the room is undoubtedly the lack of a common language and the trust that goes with it. Brexit is unlikely then, to lock out the UK from valuable opportunities in this regard.

As for *per se* professional clients and eligible counterparties, TCFs may continue to provide wholesale services under MiFIR until such time as the European Commission chooses to impose the equivalence requirements on third countries with respect to EU prudential and business conduct standards. Implementation of MiFID II is not due until January 2018 and there will be a three year transitional period from when the Commission acts. Time for businesses to plan.

Capital markets

Markets are global and the London market for many reasons ranging from its time zone, language and infrastructure is pre-eminent. Even outside the EU these realities are unlikely to change. Moreover, many of the measures in MiFIR and EMIR over the trading of securities and derivatives have arisen through initiatives of the G20 and the Financial Stability Board in the wake of the last financial crisis. Indeed, London may benefit from having increased flexibility to implement these international standards in comparison to an EU which is perceived to be more hostile to such markets; its support of a financial transaction tax and restricting high frequency trading being examples.

Currently, UK approved prospectuses offering securities may be passported to other EU Member States. A UK prospectus would therefore need to be approved in at least one EU Member State and be subject to the time and cost involved. However, current EU rules allow an EU market authority to approve a prospectus that has been drawn up in accordance with international standards that are equivalent to requirements under the Prospectus Directive. Such a prospectus might then be passported to other Member States. Similarly, an EU market authority might exempt non-EEA issuers from certain continuing obligations on the basis of domestic equivalence.

Banking

There are a diverse range of banks in London ranging from significant UK domiciled entities, the large international banks and investment banks as well as a variety of foreign bank branches. Banks that are TCFs might similarly be able to rely on local exemptions or registration requirements, or by taking the approach that these activities are carried on in the UK and not the EU jurisdiction in which the client is located. In relation to the latter, this may be a fact dependent analysis, but deposits are typically regarded as being accepted where accounts are held and loans granted in the jurisdiction where the funds are credited.

Some cross-border activities could therefore continue, particularly where other jurisdictions were not being targeted through active marketing. On the other hand, the loss of status of being an EU "credit institution" might deprive UK authorised banks of their ability, for example, to act as a depositary of an AIF where this status might be a condition of providing those services.

Potentially, there will be significant changes in the authorisation and supervision of branches of EU banks established in London if the UK is outside the EEA (as opposed to the EU). Currently, the Prudential Regulation Authority (PRA) has only a residual role as regards their prudential supervision relying on the EU Home State supervisor. In future, the PRA might seek to supervise the branch on a whole bank basis as it does existing non-EEA third country branches. Moreover, it would be reluctant to allow significant retail deposit taking business to be undertaken unless a UK subsidiary was incorporated. Conduct regulation by the FCA would be less affected. Depositor protection insurance and provisions regarding recovery and resolution are both governed by EU Directives implemented into UK law. Again, if the UK was outside the EEA, and therefore outside the scope of this legislation, EEA banks would have to satisfy the PRA over depositor protection and insert clauses into relevant UK contracts recognising the Bank of England's bail-in powers.

EU directives and regulations establish the prudential requirements to be met by most of the financial institutions in the UK. Consequently, the basis on which UK regulators determine what financial resources UK financial institutions must maintain is the same as that applied by other EU regulators for equivalent types of institution. UK regulators will therefore need to decide to what extent UK financial institutions should continue to be subject to common prudential requirements as are other EU entities. As these rules are themselves based on wider international standards, such as Basel III, the degree of convergence should be limited.

Conversely, UK incorporated banks will potentially lose their passports under the Capital Requirements Directive, MiFID and the Payment Services Directive. Instead, they will need to seek authorisation (or licences) for their branches located in the EU and to continue offering cross-border services.

Payment Services

What will be the impact on payment services? The UK belongs to the Single Euro Payments Area (SEPA) which provides a framework for the making of electronic payments within Europe. As well as all EU Member States, SEPA also includes the members of the European Free Trade Association or EFTA, so arguably, the UK might remain part of SEPA post-Brexit although query whether EFTA membership would be necessary? Other key payments legislation includes the Payment Services Directive (PSD) and the Interchange Fee Regulation (IFR).

Many businesses such as money services businesses, outsourcing suppliers and mobile network operators already benefit from exemptions to the current Payment Services Directive although the recast Directive (PSD2) will narrower their scope.

The PSD permits passporting of payment services across Europe. An authorised payment institution (API) established in the UK would continue to be able to carry on activities across the EU/EEA where it relied on a licencee model. For example, if the API licenced local issuers or acquirers. Proprietary activities currently carried on cross-border or through a branch may be affected, as these are more dependent on the passport, however, simple brand promotion and liaison on the other hand, fall outside the scope of the PSD and should be unaffected.

The IFR would apply to transactions within the more limited EU and organisational requirements relating to separation of scheme and processing would likely still need to be complied with.

Insurers

Directive as insurance undertakings. With Brexit, these will be lost. The approach taken across Europe to TCFs varies. Generally, a locally admitted or FCA insurer will be needed to insure risks located in EEA States. Reinsurance, in contrast, is likely to continue. In addition to this, some jurisdictions permit business to be written where there is reverse solicitation or in respect of certain specified categories of insurance business.

The Challenge

The legal and regulatory position will undoubtedly be more complex as careful analysis of each jurisdiction will be required if the UK is outside the EEA and Single Market, in the absence of new treaty access rights. With the formation of a new UK Government in the autumn, and the emergence of its preferred policy options, the position should become clearer. In any event, in the context of an evolving EU approach to market access, there are strategies that TCFs can potentially adopt to mitigate some of the impact of Brexit on their business.

Contacts

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