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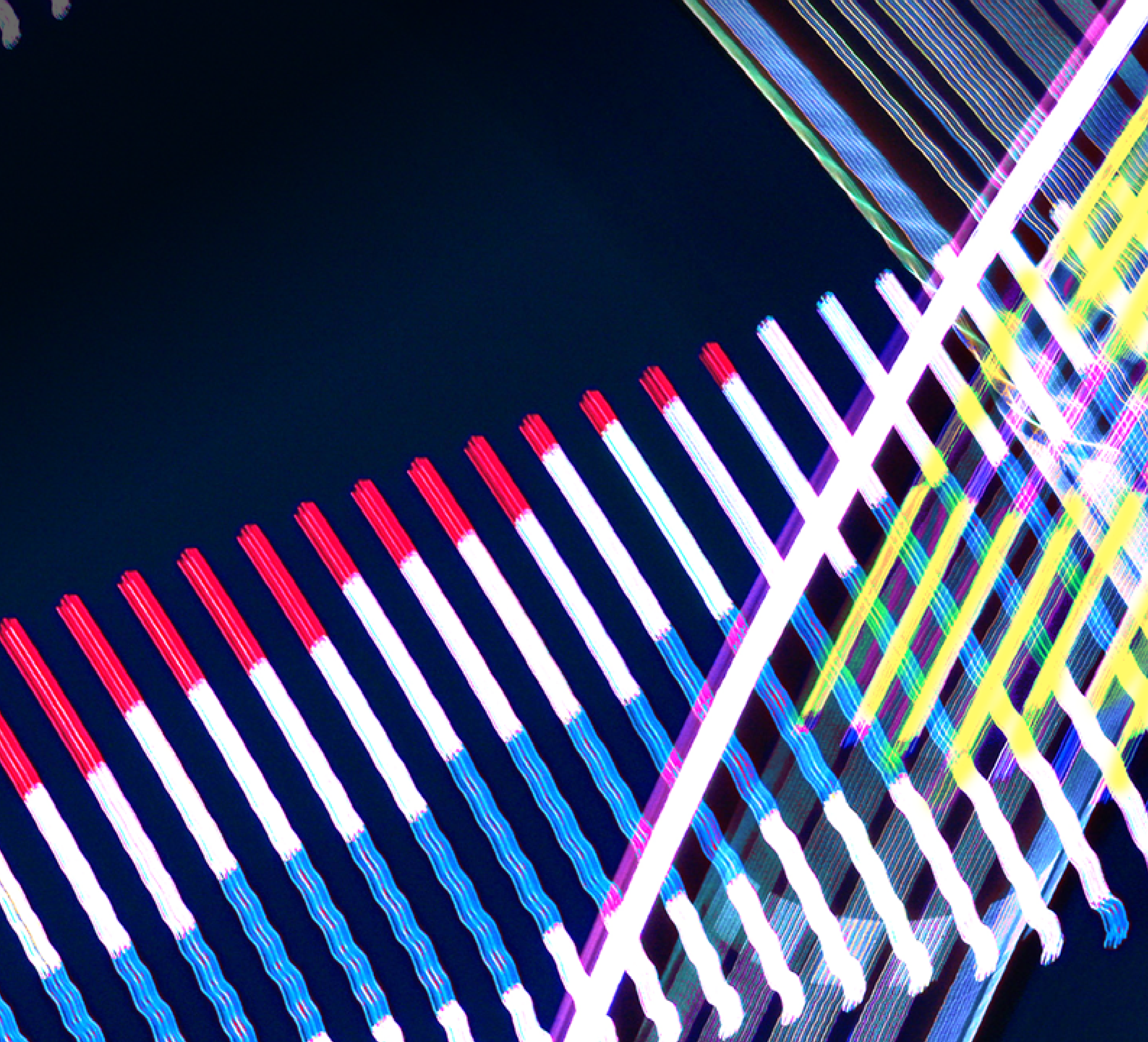
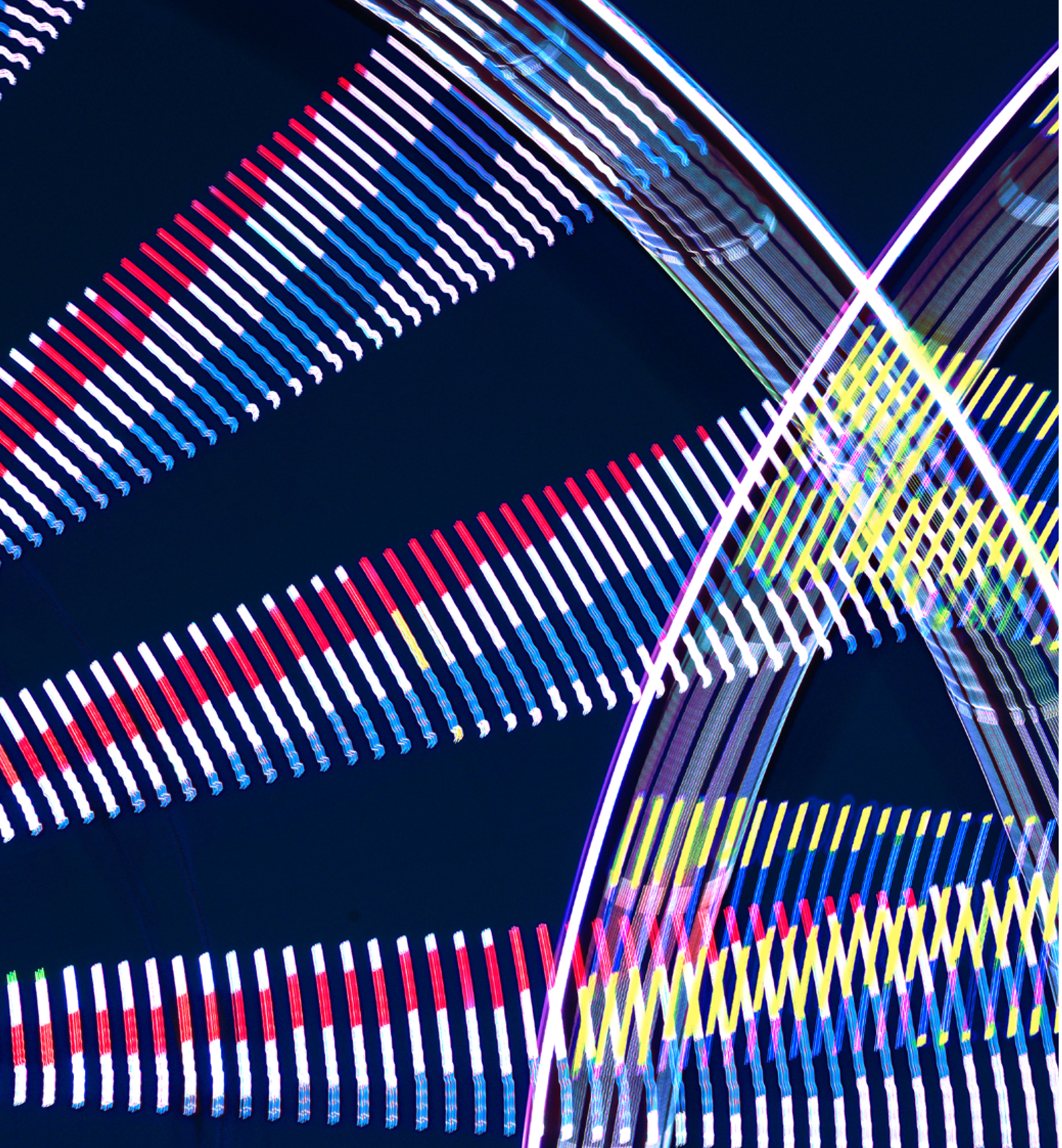
Brexit: Key Implications for the Financial Institutions Sector





Key Implications for Business

Although the UK and EU have now concluded a Trade and Cooperation Agreement (TCA), the impact on financial institutions will be minimal as the agreement makes little provision for financial services. With the post-Brexit transition period having ended on 31 December 2020, financial institutions must now adapt to the new realities over loss of cross-border market access and be prepared for the key challenges ahead.

What should financial institutions be ready for in the post-transition period? To help you get started, we have identified a number of key areas that are affected now that the transition period has ended, and some practical considerations to minimise the impact to your business.

The global nature of our Firm and the clients we represent means that we have a number of experts who can provide advice that is tailored to your organisation and the challenges that you face. If you would like help navigating this complicated, evolving landscape, please contact a member of our dedicated team of specialists (contact details below) or your usual Baker McKenzie contact. Additionally, for further analysis of more general key legal and regulatory issues resulting from Brexit, please see our **Brexit Deal Checklist: Key Implications for Business.**

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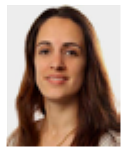

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Market Access & Licensing

- One of the main consequences of Brexit on financial institutions is significantly diminished market access. The precise effects will vary depending on the type of business conducted and whether it is subject to licensing requirements. This is despite agreement having been reached over a TCA. Authorisations that allowed financial institutions to provide services from the UK across the EU ceased to apply on 31 December 2020. The position for EU institutions accessing the UK will be ameliorated initially because of the availability of UK temporary permissions (and marketing) regimes (TPRs).

- The TCA, which builds upon on the WTO's General Agreement on Trade in Services (as detailed in each bloc's Schedule of Commitments in Financial Services), only provides limited rights of market access and protections. It commits both sides to keep their markets open on a non-discriminatory basis and to follow internationally agreed standards. This is because the UK has chosen to prioritise regulatory autonomy over alignment in negotiations with the EU, while seeking regulatory and supervisory cooperation arrangements.

- The UK is seeking to rely instead on assessments of equivalence, where available, under EU directives such as MiFID 2 and EMIR. Equivalence regimes, however, do not cover the entirety of the financial services sector. For example, there is no equivalence regime for retail banking, while for wholesale investment it is yet to come into force and, in other cases, only extends to prudential or reporting reliefs. In any event, equivalence decisions may be withdrawn unilaterally, as has happened to Switzerland. The UK has issued a number of decisions granting equivalence to the EU in 22 (out of approximately 40) areas based on a set of technical principles underpinned by internationally agreed standards. By contrast, the EU has yet to finish its assessments, which are forward-looking and take account of likely regulatory divergence. Here, the UK Treasury's recent consultation on the Financial Services Future Regulatory Framework Review and how UK regulation could diverge may further complicate the position.

- For EU businesses that relied on "passports" to access the UK, these rights ceased at the end of the transition period (as they have for UK-based entities accessing the EU). The UK authorities have introduced TPRs that allow financial institutions, which made prior application, to continue operating for up to three years. Alternatively, a financial services contracts regime (FSCR) enables EU passporting entities to continue to service UK contracts entered into before the end of the transition for a limited period, in order to wind down their UK business in an orderly fashion.

- For UK-based businesses accessing the EU, the Commission has put in place limited transitional measures concerning equivalence of central clearing and securities depositories. While the EU has taken a different approach to the UK in terms of managing the transition, its position is made more complex by the split of competences between the EU and Member States and where individual jurisdictions may have their own limited temporary measures (e.g., on contractual continuity).

- The UK regulators have agreed memoranda of understanding (MOUs) with the European supervisory authorities to allow cooperation and exchange of information. Additionally, according to the declarations accompanying the TCA, the EU and UK aim to agree by March 2021 a MOU establishing a framework for regulatory cooperation on financial services, including among other things, transparency and appropriate dialogue in the process of adoption, suspension and withdrawal of equivalence decisions.

Data Protection

- The free flow of data is crucial for financial institutions. The UK is treating the EEA as adequate for the purposes of data transfers **from the UK to the EEA**, at least initially, which allows personal data to continue being transferred from the UK to the EEA without needing to put additional safeguards in place.

- In relation to data transfers **from the EEA to the UK**, the European Commission is currently undertaking an assessment of the UK's data protection regime to determine whether the UK can be granted an 'adequacy decision', which would allow data to continue to flow freely from the EEA to the UK. However, despite the UK's recent membership of the EU and its implementation of the GDPR, the grant of an adequacy decision is not guaranteed. Happily, the TCA provides that data can continue to flow from the EEA to the UK without additional safeguards for the next four months renewable for a further two months in the absence of objection by either party.

Ability to Work

- Brexit gives rise to the question of the immigration status of UK and EU citizens working for financial institutions in each other's territory. Under the Withdrawal Agreement, the rights of UK and EU citizens who are legally resident will be preserved. From 1 January 2021, new UK arrivals are subject to the relevant local requirements applying in the EU and EEA. Similarly, EEA nationals and their family members arriving in the UK who wish to work will need to apply under a new immigration rules system (primarily the points-based system).
- Special arrangements exist between the Republic of Ireland and the UK. Irish citizens do not have to apply for any permission to live and work in the UK, as they continue to have the right to enter and live in the UK under the Common Travel Area.

VAT & Tax

- UK businesses that supply financial and insurance services (specified supplies) to EU customers may be able to recover VAT incurred on costs where previously the VAT was restricted from recovery. This will bring the rules for supplies made by financial and insurance businesses to EU customers in line with the current rules as they apply to non-EU business.
- VAT may apply differently to cross-border supplies of advertising and broadcasting service, transfers and assignments of copyright, patents, licences, trademarks and similar rights, legal advice, banking services, supplies of staff and hire goods amongst other things, where one counterparty is in the EU and one in the UK, particularly where the services are supplied to non-taxable persons. This is because the place of supply rules may be impacted for such services. Financial institutions are recommended to review contracting arrangements to ensure they are optimal from a VAT perspective and mitigate VAT cost for them and their clients.
- Financial and insurance institutions should monitor changes to the existing VAT rules, and in particular the scope of VAT exemption for the services they supply and the purchase of outsourced services; once the UK is no longer bound by decisions of the CJEU, the approach of the UK government and tax authorities may begin to diverge.
- As for direct taxes, much of tax law falls outside EU competence. There will nonetheless be an impact, for example, the UK's status as a holding company location may be affected by the UK losing the benefit of the EU Parent-Subsidiary and Interest and Royalties Directives.

Sanctions

- With respect to sanctions screening and compliance, at the end of the transition period, the EU sanctions regimes ceased to apply in the UK. The UK has implemented legislation providing for an autonomous sanctions regime, and has made statutory instruments to continue existing EU sanctions after the end of 2020. While the new UK legislation follows the principles of the EU regime, it is lengthier and there are some nuanced differences in interpretation and definitions of particular concepts and restrictions. The UK has also unilaterally introduced a "Global Human Rights" sanctions regime, a "Magnitsky"-style regime that designates various individuals and entities from Russia, Saudi Arabia, Myanmar and North Korea accused of involvement in severe human rights violations. In future, the UK may diverge further from the EU, for example, in its approach to licensing or to pursue specific foreign policy objectives (e.g., in respect of Russia and China).
- However, no firm proposals have been made on the future UK sanctions landscape (other than the new Global Human Rights Regime), and there is no indication that the UK intends to adopt a more aggressive, US-style approach to sanctions. To date the UK has remained broadly aligned with the EU on many areas of sanctions policy, for example, by continuing to support the Joint Comprehensive Plan of Action (also known as the Iran deal) through upholding the EU "Blocking Regulation," which the UK has retained in amended form after the end of the transition period. Further background on the UK's post-Brexit sanctions framework can be found in OFSI's financial sanctions guidance, an updated version of which has been made available in advance of the new framework becoming fully operational.

Competition Law

- The substantive application of competition law remains essentially the same and there are no fundamental changes to the previous UK competition law regime. Previously, UK regulators and English courts had an obligation to interpret UK competition law consistently with EU law. This changes to an obligation to ensure that there is no inconsistency with pre-Brexit EU case law, unless there is an appropriate reason in light of specified circumstances to depart from that position. These specified circumstances are very broad, including where there are differences between markets in the UK and markets in the EU, and where there have been developments in forms of economic activity. This means that from 1 January 2021, the UK Competition & Markets Authority (CMA), sectoral regulators (including the FCA) and English courts have flexibility to depart from pre-Brexit EU case law. However, the TCA wording relating to competition law tightly mirrors that of the EU legislation, such that our view is that a material departure is unlikely. The CMA and the sectoral regulators are now responsible for competition law investigations and merger control reviews that affect the UK market, whereas previously many cross border investigations or mergers would have fallen under the one-stop-shop jurisdiction of the European Commission. The CMA in particular intends to scale up significantly its operations to take on these new responsibilities.

Recommendations

- **Now that UK-based organisations have lost ready market access**, they should consider how this may affect their operations and take all necessary steps to comply with the new regulatory landscape and protect their customers' interests. Strategies must address issues around contractual continuity if the organisation has carried on regulated activities in the EU and, specifically, where appropriate, to review and re-paper stationery and key contractual documentation, if there are particular concerns or risks associated with that contract.

- The ability of UK financial institutions to continue providing services to retail customers resident in the EU is dependent on national regimes. UK businesses with EU retail customers must decide on their approach to servicing existing contracts with those customers. They should take what steps are available to continue to service customers in accordance with local law and national regulators' expectations. The FCA expects that they will have communicated with their customers in a timely and supportive manner, and treat them fairly.

- UK-based organisations wishing to carry on licensed activities in the EU will likely have already sought authorisation for branches or subsidiaries, given the considerable lead time involved. Otherwise contingency measures (or "alternative actions" as referred to by the European Banking Authority), pending authorisation will need to be adopted.

- Given that licensing barriers will exist after the transition period, UK-based firms accessing the EU should consider "workarounds," such as booking business to certain jurisdictions and using back-to-back transactions, although European supervisors are adopting a restrictive approach to such practices. Where organisations are planning to outsource functions to their head office (in the other bloc) careful consideration will be needed to ensure that sufficient decision-making and resources are situated in the jurisdiction where business is transacted.

- **EU businesses that wish to maintain UK market access** should have already notified UK regulators of their intention to participate in relevant TPRs and should now prepare to apply for UK licences. Where applicable, they should also disclose their TPR status in communications with retail clients. Workarounds for access may also be available (e.g., the UK's relatively generous Overseas Persons Exclusion). EU financial services providers with operations in the UK will need to comply with relevant UK rules, although UK regulators have exercised their Temporary Transition Powers under which financial institutions may continue temporarily to follow certain existing rules, but this does not extend, for example, to reporting obligations and requirements under MAR.

- Organisations should also monitor UK-EU future equivalence decisions. Now that the UK/EU TCA has been concluded, the environment may be more conducive to the grant of further equivalence especially by the European Commission, although given the UK's likely divergence in certain areas, such as on variable and fixed remuneration, and the politicised nature of the process this is by no means certain.

- Aside from the licensing issue, for the **governing law of contracts**, in general terms little should change. The UK has transposed the relevant EU regulations on the rules determining applicable law (for both contractual and non-contractual obligations) into domestic law. English law remains a valid choice of law and its appropriateness for a given contract should be considered in the usual way. For legal proceedings initiated prior to the end of the transition period, the Withdrawal Agreement confirms that the Recast Brussels Regulation continues to apply in the UK and the EU (in situations involving the UK) to the recognition and enforcement of those judgments. However, as regards service of documents, the EU rules will only apply where the relevant document was received by the relevant receiving agency and service took place before the end of the transition period. For legal proceedings begun in 2021, the **enforceability of an English judgment** in the EU will depend on (i) whether the proceedings fall within the scope of the Hague Convention on Choice of Court Agreements (HCCA); (ii) whether the EU consents to the UK acceding to the Lugano Convention (a decision should be made within one year of the UK's request of 8 April 2020); and if not, the national law of the individual state will apply and local law advice should be sought.

- In the case of enforcement of an EU judgment in the UK, absent the application of the HCCA (for instance, due to matters of scope or timing) or of the Lugano Convention, this would turn on English common law rules or statute. As the HCCA only applies to judgments given under an exclusive jurisdiction clause, advisors within the financial services industry (e.g., from a loans perspective) are considering moving away from using non-exclusive jurisdiction clauses, to benefit from HCCA provisions, which are less time-consuming than individual jurisdictions' national laws.

- As for **data flows**, as the TCA only provides an interim solution, businesses will need to monitor the position and be prepared for the expiry of this interim solution for EEA to UK data transfers, and for the possibility of future changes to the UK position on UK to EEA data transfers. If the UK is not conceded adequacy status, it will be treated as a third country for the purposes of the GDPR restrictions on ex-EEA data transfers. Transfers of personal data from the EEA to the UK would need to be legitimised by appropriate safeguards: the most practical option is likely to be the use of standard contractual clauses in contracts with UK data importers, although the adoption of binding corporate rules is an option for intragroup transfers. The CJEU's recent judgment in the Schrems II case (discussed in more detail in a series of posts on our Connect on Tech blog here) adds a further layer of complexity to those safeguards.

- Employers should consider reviewing/amending their HR and **recruitment processes** to ensure these are fully compliant, and in the case of the UK, compliant with the obligations arising under a sponsor licence should the business have to fall back upon the points-based system arrangements when hiring EU nationals who do not have settled (or pre-settled) status.

- Organisations should monitor developments around the introduction of the UK's new **sanctions framework** in order to be aware of any relevant changes, including to the extent that the UK imposes sanctions restrictions diverging from existing EU regimes.

- Organisations should also consider how the transfer of responsibilities for **competition law** from the European Commission to the CMA is likely to impact UK financial institutions. For example, organisations may be anticipating merger activity that may now require an additional UK merger control filing with the CMA (where the UK jurisdictional thresholds are met), which would have previously only required an EU merger filing under the EU Merger Regulation "one-stop shop." The CMA has encouraged businesses in this situation to make early contact with it to discuss notification if the merger raises material issues in the UK. Likewise, financial institutions that are facing allegations of anti-competitive or cartel conduct should consider whether it is necessary to make a leniency application to both the CMA and European Commission in all relevant cases. It may also be worth considering opportunities to build relationships with the CMA or the FCA (for example, by contributing to market studies).

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