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Brexit and financial services – New deal or no deal?

1. Background

On 24 December 2020, the EU and the UK finalised a Trade and Co-operation Agreement (the "**TCA**") setting out the terms of their future relationship[1]. This came just seven days before the end of the transition period for the United Kingdom's exit from the European Union on 31 December 2020, following which:

- the UK ceased to be treated as a member state of the EU for all purposes; and
- EU law ceased to apply in the UK.

The TCA was negotiated in less than one year. Many observers had expressed scepticism over whether an agreement of this kind could be reached in such a short timeframe but the British government insisted from the outset that it was feasible and that it would not seek an extension to the transition period. In this respect at least, the British government has been proved right.

At the time of going to press, the agreed text of the TCA has been approved by the UK parliament (in record time, considering that the document is 1,246 pages long) but remains subject to ratification by the European Parliament, followed by the European Council. Pending ratification, the TCA applies provisionally until 28 February 2021[2] .

The successful outcome of the TCA negotiations has been a cause for satisfaction on both sides of the Channel, as there had been serious concerns over the possible consequences of a so-called "no-deal Brexit" scenario, i.e. the transition period ending without any agreement being reached, with fears of significant business disruption at the start of 2021, particularly in relation to the transport of goods between the EU and the UK. There is, however, some concern that the TCA makes only limited provision for the cross-border supply of services, especially in view of the key role played by the service sector in the British economy. In particular, there has been some suggestion that, as far as the financial services sector is concerned, there was effectively no deal and even the UK Prime Minister, Boris Johnson, has admitted that the TCA "perhaps does not go as far as we would like" over access to EU markets for financial services operators.

1 Available at this link.

2 At the time of going to press, ratification by 28 February is looking increasingly unlikely and it is generally assumed that the deadline for ratification will be extended to April by mutual agreement.

2. TCA and financial services

In relation to financial services, the TCA provides for commitments by the EU and the UK (each, a "**territory**"):

- *International standards*: to use best endeavours to ensure implementation and enforcement of internationally agreed standards for (i) regulation and supervision, (ii) the fight against money laundering and terrorist financing and (iii) the fight against tax evasion and avoidance;
- *New financial services*: to permit a financial service supplier of one territory to supply any "new" financial service[3] in the other territory that local suppliers would be allowed to supply under local law, provided that existing legislation does not prevent it (but excluding, for these purposes, any supply of those services by local branches); and
- *Self-regulatory organisations*: to abide by certain non-discriminatory provisions in the TCA where membership of, participation in, or access to any self-regulatory organisation is required in a territory to supply financial services; and
- *Public payment and clearing systems*: to allow a territory's financial service suppliers established in the other territory access to payment and clearing systems operated by public entities in the other territory, as well as official funding and refinancing facilities available in the normal course of ordinary business, but without conferring access to lender of last resort facilities.

However, the most significant aspects of the TCA in relation to financial services are its carve-outs. In particular:

- *Prudential measures*: nothing in the TCA prevents the EU or the UK from adopting or maintaining prudential measures, such as for the purposes of: (i) protecting investors, depositors, policy-holders or persons to whom a fiduciary duty is owed by a financial service supplier; or (ii) ensuring the integrity and stability of the financial system in their respective territories;
- *Branches*: although, in relation to services generally, the TCA provides for the right of an operator in one territory to establish branches in the other party's territory, this may be subject to specific prudential requirements, such as separate capitalisation and other solvency requirements, as well as reporting and publication of accounts;
- *Most-favoured nation*: there is a specific carve-out for financial services from certain provisions applying to services and investments, in particular "most favoured nation" treatment (i.e. a commitment not to offer more favourable terms to other countries or trading blocs); and
- *Review*: similarly, financial services are excluded from a commitment to endeavour to review certain carve-outs from the TCA with a view to improving the cross-border provision of services further down the line.

3 Presumed to mean a financial service that is not currently being provided.

3. Future framework

Under a separate joint declaration[4], the EU and the UK have agreed to establish a framework for regulatory co-operation, allowing for:

- *Exchange of views*: bilateral exchanges of views and analysis relating to regulatory initiatives and other issues of interest;
- *Dialogue*: transparency and appropriate dialogue in the process of adoption, suspension and withdrawal of equivalence rights; and
- *Co-operation*: enhanced co-operation and coordination, including in international bodies as appropriate.

All this is all pretty vague and it is worth noting that the declaration is less than half a page long. Nevertheless, the parties have committed to entering into a memorandum of understanding by March 2021.

4. Passporting and equivalence

The EU regulatory framework has two quite different regimes for market access to the European Economic Area by financial institutions inside and outside the EEA:

- *Passporting*: under passporting, a firm that is authorised to carry on certain activities in one EEA member state (the "**Home Member State**") is entitled to carry on those same activities in another EEA Member State (the "**Host Member State**") on the basis of a notification to the Host Member State by the Home Member State's competent authority; and
- *Equivalence*: financial institutions in countries outside the EEA (so-called "**third countries**", now including the UK) may provide a more limited range of financial services in the EEA under the equivalence mechanism, by which the EU issues a decision to the effect that the regulatory package in the third country in a particular area of activity is equivalent to the EU regulatory regime.

Since the 2016 referendum, there has been speculation over the extent to which mutual access between the UK and EEA markets under passporting rights might be replaced by a regime of equivalence. In reality, equivalence is no real substitute for passporting for three reasons (sometimes referred to as the "**three P's**"):

- *Patchy*: the range of financial services that may be provided in the EU is incomplete, covering a total of 59 possible areas but not including key activities such as deposit taking and investment services for retail clients;
- *Precarious*: the EU may revoke equivalence decisions on 30 days' notice or, where they are granted for a fixed period, choose not to renew them; and

4 Joint Declaration on Financial Services Regulatory Cooperation between the European Union and the United Kingdom (25 December 2020), available at this link (page 2).

- *Political*: in practice, a decision to grant or withdraw an equivalence decision may be linked to political considerations, as witnessed by the move by the EU in 2019 not to renew its recognition of equivalence of Swiss trading venues for the purposes of Regulation (EU) No. 600/2014 on markets in financial instruments ("**MiFIR**"), which was generally supposed to be linked to the reluctance of the Swiss government to sign up to a comprehensive agreement with the EU on market access in a whole range of areas that were by no means limited to financial services.

5. Current status of equivalence regime

During the original negotiations that ultimately led to the TCA, the EU and the UK agreed to endeavour to conclude assessments of equivalence by 30 June 2020. However, this deadline was not met and the process remains ongoing, and falls outside the scope of the TCA. The current position of the EU, as set out in its Q&A's on the TCA[5], is that equivalence decisions are unilateral and not subject to negotiation. To date, the EU has granted equivalence in relation to certain UK central counterparties and central securities depositaries but only for a temporary period. In other areas, the European Commission has assessed the UK's replies to equivalence questionnaires in 28 areas but the EU states that a series of further clarifications will be needed, in particular regarding:

- *Divergence*: how the UK intends to diverge from the EU regulatory framework going forward;
- *Supervisory discretion*: how the UK will use its supervisory discretion regarding EU firms; and
- *Temporary regimes*: how the UK's temporary permissions regimes will affect EU firms.

For these reasons, says the EU, the European Commission cannot finalise its assessment of the UK's equivalence in those 28 areas and, although the assessments are ongoing, they will not take decisions for the time being and will ultimately consider equivalence when it is in the EU's interest. It is therefore reasonable to conclude that, notwithstanding the intentions set out in the above-mentioned joint declaration, equivalence decisions are unlikely to be taken by the EU any time soon.

In the meantime, the UK has set up a new framework for equivalence of other countries' regulatory or supervisory regimes, including retention of equivalence decisions taken by the European Union in favour of third countries prior to the end of the transition period and the making of equivalence decisions on EEA member states. Interestingly, the UK has also granted an equivalence decision[6] to Swiss trading venues (namely, SIX Swiss Exchange and BX Swiss) for the purposes of MiFIR with effect from 3 February 2021, marking one of the first examples of regulatory divergence from the EU (which, as mentioned above, effectively suspended its equivalence decisions in favour of Swiss trading venues in 2019).

5 Questions & Answers: EU-UK Trade and Cooperation Agreement (24 December 2020) available at this link .

6 The Markets in Financial Instruments (Switzerland Equivalence) Regulations 2021.

6. Temporary permissions

In the absence of satisfactory arrangements under the TCA and in order to allow for a smoother transition following the UK's exit from the EU regulatory framework on 31 December 2020, the UK has established a temporary permission regime, aimed at allowing EU financial services firms that intend to continue carrying on business in certain areas to do so for a provisional period while they seek authorisation or recognition from UK regulators.

In the same spirit, individual EU Member States have also taken the initiative, including Italy, where new legislation[7] provides for a six-month grace period for certain financial services providers wishing to continue to operate in Italy. In particular, until 30 June 2021 or, if earlier, the date on which the competent authority grants the relevant authorisation the legislation provides as follows:

- *Banks*, etc: Banks, investment firms and electronic money institutions regulated in the United Kingdom and operating in Italy through a branch or on a cross-border basis that have applied prior to 31 December 2020 for a third party authorisation to carry on business in Italy, or for the establishment of an Italian intermediary to which that business is to be assigned, may carry on business or provide services in Italy that they carried on or provided prior to that date and so will be entitled to operate in Italy, but solely in relation to management of existing contractual relationships. The creation of new contractual relationships or amending existing relationships is, however, not permitted.
- *OTC derivatives*: With regard to over the counter derivatives, business related to life-cycle events for which no payment is due from the central counterparty is permitted, which could include entering into new transactions, subject to certain limitations.

As regards UK insurance firms (which, from 1 January 2021, have been removed from the Italian register of insurance firms), they may continue business on a temporary basis, limited to the management of existing contracts and insurance cover until their expiry or termination, but without being allowed to enter into new contracts or renewing existing contracts.

7 Article 22 of Law Decree No. 183 of 31 December 2020.

7. Alternative measures

For UK financial services firms that have not obtained local authorisations in the EU, the limited range of options include the following:

- *Relocation*: One response may to establish a subsidiary in an EU member state (or use an existing subsidiary), obtain a local authorisation and then have that authorisation passported to cover other member states. A key question is how substantial the presence of the local subsidiary would need to be and, in this connection, EU regulators have made it clear that they will not look favourably on the use of "brass-plate" offices, i.e. maintaining a minimal presence, with all significant operations carried out in the UK under outsourcing arrangements[8]. In practice, a number of UK-based financial institutions have already been moving some of their operations to EU member states since 2016, with an estimated 7,500 City employees relocated to the EU by the end of last year.

- *Authorisation by individual member state*: A more limited option available in individual EEA member states, including Italy, may be to obtain a local authorisation to operate in that member state through a branch or on a cross-border basis as a third country regulated firm. This, however, may be subject (as in Italy) to a number of specific, and often very stringent, limits under the local regulatory framework and another drawback is that the authorisation is nationwide only and cannot at present be passported to other EEA member states.

- *Reverse solicitation*: Following the end of the transition period, some firms in the UK have allegedly sought to circumvent requirements under Directive 2014/65/EU on markets in financial instruments (MiFID II) by including clauses in their terms of business in which the client states that transactions are executed solely at its initiative. The European Securities and Markets Authority has recently issued a communiqué[9], warning third country firms that, where they solicit business in the EU, the corresponding service should not be regarded as having been provided at the client's initiative, regardless of any contractual clause or disclaimer purporting otherwise.

8 See Guidance by the EU supervisory and resolution authorities on Brexit (October 2020) at ths link.

9 See Reminder to firms on reverse solicitation (13 January 2021) at this link.

8. Conclusion

Although many breathed a sigh of relief on Christmas Eve, when it became apparent that the UK's exit from the EU regulatory framework would not take place on a no-deal basis, the TCA makes few concrete provisions for the cross-border provision of financial services between the UK and the EU. The next step is expected to be the memorandum of understanding that the UK and the EU plan to enter into by March 2021, although the extent to which it will provide clarity on future arrangements is not known at present. As in other areas not adequately covered by the TCA, the EU and UK are likely to be engaged in ongoing negotiations on a long-term basis, in which they will seek to improve market access on a reciprocal and incremental basis: not at all unlike the current (and, at times, uneasy) relationship between the EU and Switzerland. The upbeat assessment of the British Government in relation to financial services is that Brexit is, in the words of Chancellor of the Exchequer, Rishi Sunak, an opportunity "to do things differently". What that will mean in practice is unclear at present but it is unlikely to help speed up the granting of equivalence decisions by the EU. More generally, in any future negotiations between the EU and the UK on financial services, the key question is whether regulatory convergence, rather than divergence, will be a prerequisite for improved market access.

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