Brexit: What are the options for the financial services industry?

On 23 June 2016, UK voters decided to leave the European Union ("EU"). While implementation of this decision will take years, financial institutions doing business in the UK and the rest of the EU, especially those that rely on the EU "passport" for financial services, must begin to assess now the impact of Brexit on their business models. There are a number of issues that financial institutions will face, but amongst the most important are the extent to which firms (i) based in the UK (including the UK subsidiaries of non-UK banks) will be able to access EU markets and (ii) based in the EU (outside the UK) will be able to access UK markets.

After a summary of the steps financial institutions should be taking now, this Brexit report provides an update on the Article 50 Treaty on European Union ("TEU") notification process, the main models that could replace membership of the EU, and the principal options currently available to the financial services industry if, as could well be the case, the EU passport is phased out.

What steps should financial institutions be taking now?

Brexit creates uncertainty concerning how financial institutions may do business in the UK and the EU which is unlikely to be clarified for many years. In the meantime, financial institutions doing business in the UK and the EU, or planning to do so, must consider the potential impact of Brexit on their business models. In this regard, the Financial Conduct Authority ("FCA") has specifically reminded financial institutions of their risk-based obligations to have contingency plans to deal with such a significant change in the financial market place.

Many firms will not be able to wait until the Conservative Party appoints a new Prime Minister, Article 50 is triggered, withdrawal is negotiated and a new relationship between the UK and EU is agreed, before planning, and even implementing, their response to Brexit. Firms faced with the prospect of setting up and authorising a new entity in the EU and then novating contracts and moving staff, a process that could take well over a year for some firms, will need to act more quickly. Accordingly, and depending upon the time their contingency plans will take to implement, some firms may need to act before the outcome of negotiations is known.

In assessing their business goals and meeting their regulatory obligations, financial institutions should consider the following, given the real risk that a full EU passport will not be available in the future (see below – ***What are the principal models of relationships with the EU post-Brexit?***):

- They should identify the activities for which they rely on the passport either to provide services or products from the UK into other European Economic Area ("EEA")[1] jurisdictions, or from other EEA jurisdictions into the UK. Since the passport may be phased out as part of the implementation of Brexit, financial institutions may need to restructure their operations, including obtaining licences in new jurisdictions, to service their customers. In addition, to the extent they are planning to expand their business or attract new customers, they may conclude they need to act quickly to adjust to Brexit.[2]

1 The EEA consists of the EU Member States plus Iceland, Liechtenstein and Norway.

2 Some financial firms, such as insurers and reinsurers, may conclude they are not reliant on the passport to any significant degree for access to the EU market. See our Legal Update dated 7 July 2016 "Brexit: What does it mean for the insurance industry?" on the impact of Brexit on (re)insurers at https://www.mayerbrown.com/Brexit-What-does-it-mean-for-the-insurance-industry-07-07-2016/.

- To the extent that financial institutions already have licensed subsidiaries in other EEA jurisdictions, they may consider whether those subsidiaries could become vehicles for exercising the passport. For example, a US bank that has subsidiaries in the UK and in Germany may want to consider whether "passport" activities throughout the EEA should begin to be conducted from the German subsidiary rather than the UK subsidiary. By the same token, a French bank that has subsidiaries in both France and the UK may want to think about whether certain passporting services conducted from the UK should be transferred to France. Finally, non-EEA banks that have set up branch networks in the EEA based on a subsidiary in the UK should consider the likelihood that the passport may cease to be available for those branch networks and thus may need to consider establishing a presence in another EEA jurisdiction.
- Depending on the nature of their business activities, some institutions may conclude that they will have a reasonable chance to continue to provide services from the UK even if the passport ceases to be available. This is because some EU legislative initiatives, such as Solvency II, Markets in Financial Instruments Directive II ("MiFID II")/Markets in Financial Instruments Regulation ("MiFIR") and the Alternative Investment Fund Managers Directive ("AIFMD"), contemplate permitting third country financial institutions (i.e., institutions that are not located in the EEA) to provide some cross-border services to some customers without local licences if the third country jurisdiction has laws that are "equivalent" to those of the EU. At this time, the UK has fully implemented the required EU legislation, including Solvency II and AIFMD, and is on course to fully implement MiFID II, so the UK's laws will not only be equivalent but identical to those of the EU. It is possible that the EU will recognise that certain activities conducted from the UK pursuant to these legislative frameworks (assuming the UK does not modify them) will continue to have access to EEA markets, even in the absence of the passport. However, as discussed below the EU must decide whether or not to deem a third country's laws equivalent and therefore, in the UK's case, there is a risk that it may choose not to do so or may delay a decision, so this option is subject to uncertainty. In addition, not all EU legislation includes the concept of equivalence and, where it does, equivalence does not give the same access to the single market as the UK currently enjoys.
- Some firms may be able to have a separate legal entity act as a booking centre in an EEA Member State which then enters into back-to-back transactions on a riskless principal basis with a UK entity that has the staff, capitalisation, and systems to hold the risk. It may also be possible for EEA entities to outsource certain activities to UK entities. These operational models, however, may not be welcomed by all EEA regulators.
- Employment issues will also be a concern for firms. A large percentage of the City's approximately three hundred and sixty thousand workers come from other EEA countries, and Ireland, France and Italy between them account for almost half of the City's EEA-originated work force. EEA nationals seeking to live and work in the UK could face new rules incorporating a traditional visa/entry clearance as well as formal requests for work authorisation. UK workers in the EEA would be likely to face reciprocal requirements. The specific terms of any immigration requirements will be subject to the negotiated terms for withdrawal and any domestic arrangements with other EU member states. At a minimum, the current free movement terms are expected to remain in place for the two years the Article 50 process is anticipated to last. Those workers who are legacy beneficiaries of the free movement of workers should consider whether to exercise the right to obtain permanent residency to protect against any future change.
- Firms will need to give consideration to how they handle data within the EEA, and in particular, where customer data is located. Currently firms are free to transfer data within a firm in the EEA with little restriction. Depending upon whether the UK adopts the General Data Protection Regulation (due to come into force in May 2018) and the terms of any exit, firms may face restrictions on the transfer of customer data between the UK and the rest of the EEA and should consider whether steps need to be taken to obtain appropriate consents from customers or relocate the hosting of data.

- Firms should also not forget the practical implications of the options they are considering. The costs involved in shifting significant numbers of employees from the UK to other jurisdictions will be large and many staff may have developed ties to the UK that make them resistant to relocation. Hiring new adequately trained staff in alternative locations may be an issue for a variety of reasons. Tax implications will be a consideration, especially given the UK Chancellor's announcement that he will lower UK corporation tax. The UK's legal system is considered by many to be the most favourable for financial services business in the EEA. Finally, the availability of infrastructure (office buildings, services, and a well-staffed and experienced regulator) in other jurisdictions, will be an additional factor.
- Thus, while all institutions should be planning for Brexit, a decision to take concrete steps now to modify business models should take into account a number of factors since the actual legal framework is not expected to change for at least two years. Some institutions with expansion plans may decide they want to change their structure now to "put Brexit behind them." Others may be able to take a "wait and see" attitude, given the other complexities and factors involved, including uncertainty with regard to developments in the EU.

Background on the single market and the financial services passport

The EU single market in financial services is based on the so-called "four freedoms" of free trade in goods, free movement of workers, rights of establishment and to provide services and free movement of capital.[3] The general rule is that Member States may not discriminate against those who exercise their rights to one of the four freedoms nor impose non-discriminatory obstacles to the exercise of any of the four freedoms unless those obstacles can be justified.

The freedom of establishment and right to provide services means that financial institutions established in an EEA Member State benefit from a "passport" which enables them to access the markets of other EEA Member States without having to set up a subsidiary and obtain a licence to operate as a financial services institution in those Member States. On this basis a financial institution established in the UK may currently:

- establish a branch in another EEA Member State (the "host" state), referred to as an "establishment" passport; or
- carry out its permitted activities cross-border, without establishing a presence in the host Member State, referred to as a "services" passport.

This passport has been used extensively by UK financial services institutions to access other EEA markets, and by other EEA financial services institutions to access the UK markets.

Specific passports are also available for certain products. Undertakings for the Collective Investment in Transferable Securities ("UCITS") funds and alternative investment funds can be managed, marketed and sold on a cross-border basis if they are regulated in one EEA Member State. Prospectuses approved by the regulator in one EEA Member State can be passported into other Member States without further scrutiny.

What is the Article 50 process?

Article 50 TEU provides for a Member State to notify the European Council of its intention to withdraw from the EU and for negotiations concerning its withdrawal to take place. Once the notification has been made, the Article 50 process expires when the negotiations have concluded or after the lapse of two years from the date of notification unless that period is extended by the unanimous consent of the remaining EU Member States. The Article 50 process does not provide for negotiations on the UK's future relationship with the EU. It would make sense (from the UK's perspective at least) for the two sets of negotiations to be handled together or for the UK not to activate Article 50 until there is some clarity as to the UK's future relationship with the EU. The lack of

3 See our Legal Update dated 29 April 2016 "Brexit or Bremain: What does it mean for the financial services industry" for more background on the EU single market and models for Brexit at https://www.mayerbrown.com/Brexit-or-Bremain-What-does-it-mean-for-the-financial-services-industry-04-29-2016/.

a precedent, however, means that it is far from clear whether either option will be feasible[4]. Thus far the desire of the UK government is to put off the Article 50 notice until there is greater clarity on the nature of the UK's relationship with the EU post-Brexit. The EU's position has thus far been to urge the notice to be made as soon as possible.

What are the principal models of relationships with the EU post-Brexit?

Maintaining full access to the single market is a crucial goal of the financial services industry. However, that goal may conflict with other Brexit goals including limiting the free movement of workers and ending contributions to the EU budget. Subject to the likelihood that the UK relationship will ultimately by necessity be of a bespoke nature, there are three main models for the relationship that the UK could have with the EU post-withdrawal. These are all based on existing relationships between the EU and other states and give differing rights of access to the internal market. They are as follows:

(A) European Economic Area e.g. Iceland, Liechtenstein and Norway

Iceland, Liechtenstein and Norway have access to the internal market as members of the EEA. The EEA Agreement (the "Agreement") includes EU legislation covering the four freedoms throughout all EEA States and cooperation in various other areas, including research and development, education and social policy. The Agreement guarantees equal rights and obligations within the internal market for citizens and economic operators in the EEA.

Iceland, Liechtenstein and Norway are obliged to implement all internal market rules in exchange for access to the internal market but they do not take part in the negotiation of those rules. They also contribute towards the EU budget: in Norway's case, around 90% of Britain's net payment per head. Further, they are obliged to accept persons migrating from EU Member States in exercise of EU free movement rights. This option is the only option that would give the financial services sector similar access to the internal market as it enjoys under EU membership, i.e., the financial services passport.

In order to join the EEA, the UK would need to negotiate access to the European Free Trade Area ("EFTA")[5] and then EEA membership with EEA and EFTA members. Given the obligations of EEA membership, there seems little likelihood that Brexit supporters would accept this option. As Nikolai Astrup, a Norwegian Conservative MP stated in 2013, "*If you want to run Europe, you must be in Europe. If you want to be run by Europe, feel free to join Norway in the European Economic Area.*"

(B) Bilateral agreements (under EFTA membership) e.g. Switzerland

Switzerland is an EFTA State but is not part of the EEA Agreement. Instead it currently has around one hundred bilateral agreements with the EU that give access to the internal market for goods but not most services. Switzerland also contributes to the EU budget. In 1999 the EU and Switzerland signed an agreement on freedom of movement which gives the other's citizens the right to enter, live and work in its territory. Switzerland is an associate member of Europe's border-free Schengen area and a full participant in the Dublin system for dealing with asylum claims[6].

The EU has closer ties with Switzerland than any other non-EEA State but bilateral relations have been severely strained since the February 2014 Swiss anti-immigration initiative, the outcome of which called into question the principles of free movement of persons and the internal market that underpin those relations.

4 Greenland (a Danish dependency) withdrew from the European Economic Community (a precursor to the EU) in 1985 and Algeria left upon its independence from France in 1962. Greenland's exit was the product of three years of negotiations. It predated Article 50 TEU.

5 EFTA consists of the EEA Member States plus Switzerland. The EFTA Convention Agreement establishes the intergovernmental institutions of EFTA and the EEA.

6 The Dublin Regulation (604/2014) determines the EU Member State responsible for examining an application for asylum seekers seeking international protection under the Geneva Convention and the EU Qualification Directive.

The network of agreements is complex and sometimes incoherent: they are currently managed through a structure of more than 15 joint committees. There are, however, neither proper mechanisms to adapt the agreements to evolving EU legislation nor surveillance nor efficient dispute settlement mechanisms. The EU has determined not to give Switzerland further access to the internal market until a framework agreement is established but negotiations have stagnated.

It therefore seems unlikely the EU would establish a similar relationship with another non-EEA State but, if this were possible in principle, it is likely it would operate on a similar basis. The UK would have to negotiate a large range of bilateral agreements with the EU. The UK would not automatically have to implement new EU legislation and agreements would be negotiated on a case-by-case basis.

Swiss financial institutions cannot benefit from the passport but the close relationship between Swiss and EU legislation on financial services, developed as a result of the bilateral agreements, has, in a number of instances, given Swiss financial institutions an advantage over institutions from other non-EEA countries as Swiss legislation is often regarded as "equivalent" to that of the EU.

(C) Free Trade Area e.g. Canada, South Korea

This option contemplates a single bilateral free trade arrangement. The EU is a party to trade agreements and other agreements with a trade component both in the World Trade Organisation ("WTO") context and bilaterally with certain countries and regions. Countries, including Canada and South Korea, have free-trade deals with the EU that do not require observance of all its rules, paying into the budget or accepting persons exercising free movement rights. The EU has fifty three such deals. The EU also has, or is negotiating, free-trade deals with the US (the controversial Trans-Atlantic Trade and Investment Partnership ("TTIP")), China and India, which would not include a post-Brexit UK. Such deals do not, however, cover all services.

In withdrawing from the EU, the UK would seek a free-trade deal to gain access to the EEA. The process would be lengthy and its precise outcome uncertain. In addition, the UK would wish to agree free-trade deals with other non-EU countries to replicate the free-trade deals from which it benefits as a member of the EU. This would be challenging because the UK no longer has an extensive body of its own trade negotiators and the UK alone may not be able to command terms as favourable as those secured by the EU acting as a bloc. As Sir Nicholas Macpherson, previous Permanent Secretary to HM Treasury commented, "*... you're going to be negotiating with a whole lot of battle-hardened trade negotiators and Britain does not have a department of trade full of equivalent experts.*"

Although not necessarily attractive, this outcome currently seems to be the model that best fits with the objectives of those who promoted and voted for Brexit. This would not, however, give financial services firms the same access to the internal market they currently enjoy: they could not use the passport. A bespoke arrangement for the UK should not be ruled out at this stage as, given that the UK is the EU and Germany's biggest export market, there are incentives for both the UK and the EU to adopt a mutually beneficial arrangement. A bespoke arrangement would not, however, be adopted quickly nor easily.

How can the financial services industry preserve the passport?

Given that the only existing model that will preserve the passport is the EEA option, which appears unlikely to be adopted, there is a distinct possibility that financial institutions may have to restructure their operations to rely on a subsidiary in another EU Member State for EU passport purposes.[7]

The loss of the passport means that financial institutions established in the UK (UK headquartered groups, branches of other EEA-headquartered groups and subsidiaries of non-UK headquartered groups) could not provide services to customers in the EEA from the UK. Equally, financial institutions established in the EEA could not provide services to UK customers from the EEA. UCITS and AIFs could not be managed, marketed and sold in cross-border scenarios involving the UK. Prospectuses could not be passported from nor into the UK.

If existing passports were revoked and new/extended passports were not available, financial institutions would be required to seek a new or additional EEA or UK base for operations if they wished to provide cross-border services. Thus, a financial institution established in the UK would require an establishment in an EEA country if it wished to service clients in a number of EEA Member States, as that establishment would enable it to obtain another passport. Equally, EEA financial institutions which wished to service UK clients would need a UK establishment.

A financial services institution which establishes itself in a jurisdiction has to apply for a licence to operate as a provider of financial services and subject itself to the regulation of and supervision by the competent authority in the State in which it establishes itself. Accordingly, establishment in a jurisdiction is a costly and time-consuming exercise with far-ranging consequences: hence the value of a passport.

Can the financial services industry rely on "equivalence" in lieu of the passport?

Given the likely loss of the passport, the UK financial services sector is likely to be best served by the UK mirroring EU law as closely as possible.[8] There is a mechanism for recognition of non-EEA Member States in some pieces of EU legislation which gives financial services institutions established in their jurisdictions certain rights within the EEA as long as the legislation in that non-EEA state is deemed equivalent to the EU's. These rights vary and are unique to each piece of legislation. For example, equivalence under the European Market Infrastructure Regulation ("EMIR") allows avoidance of conflicting obligations in cross border transactions while equivalence under the AIFMD and MiFID II/ MiFIR allows a quasi-passport specific to the activities regulated by those laws. These rights are not equivalent to the current passport, but are still highly advantageous. There is not a prescribed process but it typically involves an assessment of whether the third country legal regime is equivalent to that in the EEA.

7 Greenland's negotiations for withdrawal involved the agreement of transitional provisions during which Greenlanders, non-national residents and businesses with rights acquired under EU law retained such rights. The Greenland experience arguably provides a precedent for preserving the passport, at least for a transitional period. There is also an argument that international law protects rights acquired or obligations exercised under treaties prior to withdrawal from them. Article 70(1)(b) of the Vienna Convention on the Law of Treaties provides that, unless the treaty provides, or parties to the treaty agree, otherwise, the termination of a treaty "does not affect any right, obligation or legal situation of the parties created through the execution of the treaty prior to its termination". Whether and how much such acquired rights would be protected cannot be predicted. Further, such arguments could not be used going forward. They would not permit the extension of existing passports to new jurisdictions or new services nor the acquisition of new passports to permit the outward provision of financial service from the UK nor the inward provision of financial services to the UK.

8 It is unlikely that the UK legal framework for regulating financial services will significantly change post Brexit. First, it is entwined with EU regulation both because it has implemented directives and because it relies on regulations. Second, a large proportion of EU law implements international obligations or guidelines (ie those agreed at global level with countries other than just the EU), albeit the EU may "gold-plate" those obligations or guidelines for the purpose of its internal market. The UK might revoke or repeal certain discrete EU-specific obligations with which it does not agree, such as the cap on bankers' bonuses, but the vast majority of its financial services regulation would be likely to remain post-withdrawal, at least for the near future. A further reason why UK financial services legislation is likely to mirror EU legislation, at least immediately post any Brexit, is that UK existing financial services legislation has been a principal source of EU legislation in recognition of the pre-eminence of the UK as a global financial centre.

Given the close relationship between Switzerland and the EU, Switzerland is often one of the first non-EEA jurisdictions to be granted equivalence. Other jurisdictions, including the US, which might be assumed to have similar legislation to the EU as they have implemented the same international obligations, can struggle to obtain equivalence, perhaps because the process is often politically influenced.

Presumably the UK can qualify for such treatment. At the moment, the UK is not just equivalent, it is identical and it is very well placed to gain favourable assessments from the EU and to have access to regulatory concessions and quasi passports. However, in the current circumstances it is not possible to assert with absolute certainty that favourable equivalence assessments will be granted. If issues arose, this would be highly contentious. In addition, the process for evaluating equivalence is often lengthy and is done separately for each piece of legislation. This means that it is highly unlikely that the UK will have been deemed equivalent at the point it leaves the EU. In this regard it is to be hoped that the Article 50 negotiations (discussed above) would arrange transitional provisions that would allow continued operation of passports in the meantime, but this is also uncertain at this time.

For example, AIFMD incorporates the option of a non-EEA passport, subject to an European Securities and Markets Authority ("ESMA") recommendation that it be adopted and a favourable equivalency assessment by the European Commission. In its advice on extending the AIFMD passport to non-EEA managers and funds, ESMA conducted a country-by-country assessment for six jurisdictions – Guernsey, Hong Kong, Jersey, Singapore, Switzerland and the United States and concluded that no obstacles existed to the extension of the passport to Guernsey and Jersey, with Switzerland expected to remove any remaining obstacles soon. ESMA made no conclusion on Singapore, Hong Kong or the United States, but expressed concerns over competition, regulatory issues and a lack of sufficient evidence to assess properly the relevant criteria. Although ESMA gave positive advice in relation to three countries, it nevertheless suggests that the European Commission not extend the passport to any non-EEA mangers yet and wait for more assessments, but the option is there.

If the Commission extends the AIFMD passport, non-EEA mangers looking to benefit from the passport would become subject to substantially all the obligations of AIFMD, including those relating to capital requirements, depositaries and remuneration, on a global basis.   In return, the firm gets easier access across the EEA.

Another example is MiFIR which also contains third country quasi passport options. With regard to retail clients and opted-up professional clients, Member States are free to continue to apply national rules on cross border activity. However, third country firms dealing with per se professional clients or eligible counterparties will be permitted to operate on a cross border basis either from outside the EEA or from a branch in a Member State where the firm is registered with ESMA.

ESMA will only register a third country firm if, amongst other matters:

- the Commission has adopted a decision that the prudential and conduct requirements in the firm's home country are equivalent to MiFID II/MiFIR and the Capital Requirements Directive IV ("CRD IV");
- the firm is authorised and effectively supervised in its home third country in respect of the provision of the relevant services; and
- co-operation arrangements exist between ESMA and the firm's third country national regulator.

So, the possible loss of the passport may not be the end of cross border financial services from the UK, but this raises the issue of whether future UK financial services legislation will also meet the equivalency test.

It also ought to be noted that Brexit does not affect relations between the UK and the rest of the world so that London can remain a global financial centre, albeit one without a gateway to EEA markets.

Finally, until the UK actually leaves the EU under Article 50, the legal situation is unchanged in terms of complying with EU directives and regulations. The FCA has put out a statement reminding financial institutions that EU regulation "will remain applicable until any changes are made, which will be a matter for government and parliament. Firms must continue to abide by their obligations under UK law, including those derived from EU law and continue with implementation plans for legislation that is still to come into effect." This means that firms must still carry on with plans to implement, for example, the Packaged Retail and Insurance-based Investment Products Regulation ("PRIIPs") in December 2016, MiFID II/MiFiR in January 2018 and the Insurance Distribution Directive ("IDD") in February 2018.

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