Lex et Brexit — The Law and Brexit

November 21, 2018 ISSUE 13

Contents

On November 14, 2018, the UK Government and the European Commission published a draft agreement on the withdrawal of the UK from the European Union (the “**Withdrawal Agreement**”), together with a document entitled “Outline of the Political Declaration setting out the framework for the future relationship between the European Union and the United Kingdom” (the “**Political Declaration**”).

These documents are the result of a lengthy and controversial negotiation process, but at the time of writing it is not clear that the UK Government will succeed in obtaining the necessary parliamentary approval for the deal. Such a failure would make the prospect of a no-deal Brexit, a significant delay to Brexit, or even a cancellation of Brexit much more likely.

In this edition of Lex et Brexit we look at the key implications of the Withdrawal Agreement and the Political Declaration for financial institutions operating in the UK and EU. We then consider the UK Government’s contingency planning for a no-deal Brexit and look at the key areas of financial services that would be affected by such an outcome.

A UK-EU partnership in financial services? Implications of the draft Withdrawal Agreement and Political Declaration

Introduction

On November 14, 2018, the UK Government and the European Commission published a draft agreement on the withdrawal of the UK from the European Union (the "**Withdrawal Agreemen**t"), together with a document entitled "Outline of the Political Declaration setting out the framework for the future relationship between the European Union and the United Kingdom" (the "**Political Declaration**").

At the time of writing, it is far from clear that the UK Government will be able to persuade the UK Parliament to approve the Withdrawal Agreement draft, while the EU will also go through a parallel approval process at the level of the European Council and the European Parliament. In practice, if the UK Parliament fails to approve the Withdrawal Agreement, it is thought that there is insufficient time to substantially renegotiate the terms of the withdrawal prior to the UK's departure on March 29, 2019.

Here we focus on the impact of the Withdrawal Agreement and Political Declaration on financial institutions established in the UK. As previous editions of Lex et Brexit have highlighted, Brexit has generated a number of concerns for financial services firms that wish to carry on UK-EU cross-border business, while the prospect of a "cliff-edge" in March 2019 has led many large financial groups to begin the implementation of their contingency plans even before the terms of the Withdrawal Agreement and the Political Declaration were known.

The Withdrawal Agreement

"During the transition period, the Union law applicable pursuant to paragraph 1 shall produce in respect of and in the United Kingdom the same legal effects as those which it produces within the Union and its Member States, and shall be interpreted and applied in accordance with the same methods and general principles as those applicable within the Union."

Article 127(3), Withdrawal Agreement

The Withdrawal Agreement, if approved by the UK Parliament and the EU institutions, does at least provide a degree of certainty on the transition period that a number of financial institutions have craved over the last two years. In particular, as included in the preliminary terms agreed at the end of 2017, a transition period will run from "Brexit Day", March 29, 2019, until December 31, 2020. During this transition period:

- EU law will apply in and to the UK as though it remained a Member State. This means that financial services firms will be able to rely on passporting rights in the UK and the EU 27 Member States until the end of the transitional period.

- The UK will continue to be bound by EU financial services legislation in the same way as the EU 27 Member States during the transitional period. That means new legislation which becomes effective during the transitional period as well as legislation that is currently being negotiated and finalised, but which will not become effective until the transitional period has commenced (such as important revisions to the EU laws on bank capital, bank recovery and resolution, derivatives trading and clearing supervision), will apply in the UK.

- The UK will not have the right to participate in political, legislative or regulatory processes of the EU in the way that it currently does (although UK experts and representatives may be invited to participate in certain limited circumstances, at the discretion of the EU). In particular, this lack of any influence could lead to the development of EU measures which could harm the interests of the UK and/or UK financial services firms.

- EU authorities such as the European Securities and Markets Authority ("**ESMA**") and the European Banking Authority will continue to exercise the roles and powers given to them in EU legislation in relation to UK financial institutions.

- The UK will continue to be subject to the jurisdiction of the Court of Justice of the European Union.

The Withdrawal Agreement also makes provision for an extension of the transition period where both the UK and EU agree. At the moment, the draft does not set out a final longstop date for this transition, but it is expected that this will be added once the UK and EU political institutions have approved this draft.

The transitional period will allow financial services firms in the UK to extend the deadline for their implementation of contingency plans. These plans include the licensing of new subsidiaries in EU 27 Member States and taking measures to mitigate uncertainty about contractual continuity (broadly, the danger that the performance of contracts made between the UK and EU 27 counterparties pre-Brexit might place the UK counterparty in breach of regulatory rules and/or require a new licence in the period after Brexit) through the novation or court approved transfer of relevant contracts.

The Political Declaration

The Political Declaration is designed to reflect the intention of the UK and EU to negotiate a trade agreement during the transitional period. Although the seven-page document contains only skeletal proposals for cross-border trade in goods and services, it is intended that some flesh on the bones will be added in the coming weeks. However, the specific legal terms of any free trade agreement will be subject to negotiation during the transitional period proposed in the Withdrawal Agreement.

The Political Declaration has only three paragraphs which address financial services directly. These provisions are set out in the box below. While it is difficult to draw concrete conclusions about the shape of the EU-UK financial services framework after Brexit from such a limited statement, it is clear that both sides have accepted that the fundamental basis of market access in the future will be equivalence under existing EU financial services laws.

- Commitments to preserving financial stability, market integrity, investor protection and fair competition, while respecting the Parties' regulatory and decision-making autonomy, and their ability to take equivalence decisions in their own interest. This is without prejudice to the Parties' ability to adopt or maintain any measure where necessary for prudential reasons.
- Commencement of equivalence assessments by both Parties as soon as possible after the United Kingdom's withdrawal from the Union, endeavouring to conclude these assessments before the end of June 2020.
- Close and structured cooperation on regulatory and supervisory matters, grounded in the economic partnership and based on the principles of regulatory autonomy, transparency and stability, recognising this is in the Parties' mutual interest.

In one sense, these paragraphs reflect in part a model accepted by the UK Goverment in its White Paper on the future UK-EU relationship published in July 2018 (the **"Chequers Proposal**"). In relation to financial services, the Government published later that summer a set of slides entitled "Framework for the EU-EU relationship – Financial Services" (the "**Framework Slides**").

The Chequers Proposal explained the unique degree of interconnectivity of EU and UK financial services markets and highlighted that if new regulatory barriers were imposed in the wake of Brexit causing a fragmentation of firms' balance sheets, the wholesale banking industry in the EU and UK would need to find an additional £23-38 billion of additional capital. The proposal noted that the UK intends to leave the single market, meaning that UK firms would no longer be able to operate under the EEA passporting regime. The Chequers Proposal and the Framework Slides then set out high-level proposals for a regime of "expanded equivalence" based on existing EU concepts that would "encompass a broader range of cross-border activities that reflect global financial business models". The Framework Slides set out the UK's plan for a bilateral agreement for financial services to create a new economic and regulatory relationship to provide certainty and stability under the new expanded equivalence regime. This included plans for formalised UK-EU standards on equivalence and common processes for the granting and withdrawal of equivalence.

Goodbye mutual recognition, hello equivalance?

The Chequers Proposal, the Framework Slides and now the Political Declaration reflect the fact that the UK Government appears to have ignored the pleas of some in the UK financial services industry to demand a bespoke "mutual recognition" regime which would have gone beyond the current EU equivalence regimes to allow access for financial services firms to both jurisidctions on the basis of different regimes achieving similar outcomes. This model was vigorously advocated by a number of major financial institutions in the EU and trade associations during the last two years.

In place of such a model, the Political Declaration confirms that equivalence decisions under existing EU law will be the mechanism to be used by UK financial institutions to gain access to EU customers and markets. In other words, UK financial services firms stand to be treated in the same way as firms from other non-EU "third countries".

As detailed in an **early edition of Lex et Brexit**, rights under a third-country equivalence regimes are not a full substitute for passporting rights and do not cover all areas of business carried on by international banking groups. In particular, financial services firms will have the following concerns about the approach in the Political Declaration:

- Access for third countries based on equivalence will not be extended into areas not currently convered, such as corporate and retail lending, payment services and retail fund management.

- The focus on regulatory autonomy means that each side will be able to make its own equivalence determinations under the existing regimes (a UK version of the EU equivalence regime will be implemented into UK law post-Brexit). In the case of the EU, history has shown that a final decision to grant access under the third-country regimes can be based on political considerations rather than solely on the assessment by the relevant European Supervisory Authority **("ESA")**. In the case of the AIFMD, for example, the Commission has delayed access for firms from equivalent third countries for a number of years since the initial assessment of equivalence by ESMA. Similarly, the process for determining the equivalence of the US regime for the clearing of derivatives was long, painful and politically contentious.

- Under the current framework, equivalence may be withdrawn in a matter of weeks by one side. It is conceivable that any divergence from the EU regulatory rulebook by the UK after the end of the transitional period could lead the European Commission to withdraw access for UK firms under the third-country regimes relatively quickly, causing substantial uncertainty for the European licensing models of global institutions.

- The procedure for equivalence and the powers and adminstration of the ESAs is currently under review. In particular, the direction of travel in the EU is that an assessment of equivalence will be harder to obtain. In addition, the EU has proposed a number of additional powers for the ESAs in relation to the supervision of certain third-country firms, most notably in the proposal to grant additional supervisory powers to ESMA in respect of certain third country clearinghouses, as discussed in a **previous edition of Lex et Brexit**.

Some crumbs of comfort, however, can be found in the second and third paragraphs of the financial services section of the Political Declaration:

- The European Commission has agreed that it will begin its assessment of equivalence of the UK financial services framework as soon as possible after the beginning of the transitional period (and the UK will assess the EU on the same basis), and both parties will aim to conclude these assessments by June 2020, well before the contemplated end of the transitional period. This is a positive development, as some had feared that the Commission would take many years to reach a finding of equivalence in relation to the UK, owing to political or bureaucratic delays.

- The commitment to "close and structured cooperation on regulatory and supervisory matters" is welcome. Although it falls short of the full integration and co-operation currently enjoyed by UK and EU regulators, or even the formalised mechanisms envisaged in the UK's Framework Slides under the "expanded equivalence" concept, our view is that there will be a least some degree of regulatory co-operation between the relevant regulators. It is possible that the co-operation will take a form similar to that established in the Joint US-EU Financial Regulatory Forum (explained in the box below).

The EU-US Financial Regulatory Forum: A model for "close and structured co-operation" between the EU and UK?

The Financial Markets Regulatory Dialogue was established in 2002 as a forum through which the EU and US could inform each other of regulatory issues of interest and concern. It was renamed the Joint US-EU Financial Regulatory Forum in 2016 (the **"Forum"**). The Forum represents the views of the European Commission and US Treasury staff while also incorporating input from other participants, including regulators as and when necessary.

The Forum is to be used as a platform to enable regulatory cooperation as early as practicable in the law-making and rule-making processes, with the general operational objective to improve transparency, reduce uncertainty, identify potential cross-border implementation issues, work towards avoiding regulatory arbitrage and towards compatibility of standards, as appropriate, and, when relevant, promote domestic implementation consistent with international standards.

Importantly, dialogue does not restrict the ability of either jurisdiction to implement regulatory measures that it considers appropriate.

The Forum is scheduled to meet twice a year, and includes additional technical meetings and calls, as appropriate.

Additional activities which may be undertaken by the Forum include:

- The sharing of information to allow timely identification of potential cross-border implementation issues;
- The sharing of data-driven economic and risk analysis;
- Discussions about potential economic impacts of proposed rules; and
- Exchanges of views on regulatory issues in bilateral contexts and, as appropriate and relevant in specific areas, on issues of cooperation in multilateral contexts.

At least once a year, the Vice-President of the European Commission responsible for Financial Stability, Financial Services and Capital Markets Union and the US Secretary of the Treasury should meet to discuss financial regulatory matters and to review the functioning of the Forum.

Conclusions

When and if the Political Declaration is negotiated and transformed into a binding free trade agreement, we would expect the UK Government and financial services firms to lobby for arrangements which go well beyond the limitations of the EU-US arrangement, particularly in relation to any withdrawal of access under equivalence and ongoing monitoring of each party's regulatory standards. We note, however, that the level of integration and co-operation available under this model will inevitably be limited by the constraints of regulatory autonomy and the ability of the parties to a free trade agreement to take unilateral measures for prudential reasons. Indeed, in any scenario short of remaining in the EEA (either through remaining in the EU or the UK opting for the "Norway model"), UK-based financial institutions will need to study the degree of access currently afforded to third-country based firms and will configure their long-term European business models accordingly.

UK contingency planning for financial services in the event of a no-deal Brexit

On August 23, 2018, the UK Government published a series of papers setting out guidance for individuals and businesses in the event that the UK leaves the EU without an agreement as to the terms of a future UK-EU trading relationship (a so-called "**no-deal Brexit**"). The papers cover a wide range of topics, from farming to product labeling and studying in the UK.[1] This note focuses on the key messages from the paper titled, "Banking, insurance and other financial services if there's no Brexit deal" (the "**Contingency Paper**").

Whilst it has been widely accepted for some time that UK financial services firms will no longer be able to rely on passporting rights to provide regulated services into the EU, some in the City of London held out hope that the UK would be able to negotiate a special access arrangement for the financial services sector. As explored in the article above, it now looks likely that the access arrangements will be covered by the existing EU third-country regimes.

What would "no-deal" mean?

A no-deal Brexit would involve the UK leaving the EU, and the EEA, on March 29, 2019, without any special arrangements or transitional arrangements being in place. Where no transitional period comes into force, and where no equivalence decisions in relation to the UK have been reached, access to EU markets by UK firms will be determined by a combination of EU legislation and the domestic rules in each EU member state.

The loss of passporting rights is seen by many as a significant blow to financial services firms authorized in the UK. The advantage of passporting rights, in respect of most types of services, such as banking, brokerage, insurance and fund management, is that there is no need for a firm to be separately authorised in each member state in which it conducts business.

The sudden loss of passporting rights for UK firms providing services in the EU as well as for EU firms servicing clients in the UK has the potential to cause significant market disruption. The Contingency Paper is intended to provide guidance to UK and EU firms by setting out the steps that have been or are proposed to be taken by the UK government to minimise the potentially disruptive impact of a no deal Brexit.

Temporary fixes for no-deal

One such step is the introduction of the temporary permissions regime ("**TPR**") which will allow firms based in the EU that currently access UK clients and markets via passporting rights to continue operating in the UK for three years after the UK exits the EU.[2] During a three-year transitional period, firms relying on the TPR can apply to become fully authorized in the UK or wind down their activities in an orderly manner. The TPR is available to banks, insurers, investment firms, electronic money and payment institutions, UCITS schemes and alternative investment funds.

Alongside the TPR is the temporary recognition regime ("**TRR**"), which applies to central counterparties ("**CCPs**"). Under the TRR, non-UK CCPs may continue to provide clearing services to UK clients for up to three years following the UK's withdrawal from the EU whilst those CCPs apply for recognition from the Bank of England ("**BoE**").[3] The BoE anticipates that the UK will apply the regime currently in place at the EU level for the recognition of non-EU CCPs under the European Market Infrastructure Regulation ("**EMIR**"), which means that those third-country CCPs that have already

---

[1] The papers are available at: https://www.gov.uk/government/collections/how-to-prepare-if-the-uk-leaves-the-eu-with-no-deal.

[2] For more information on the TPR, see: https://www.fca.org.uk/markets/eu-withdrawal/temporary-permissions-regime.

[3] For more information on the TRR, see: https://www.bankofengland.co.uk/news/2018/july/temporary-permissions-and-recognition-regimes.

been recognised under EMIR should quickly receive recognition from the BoE.[4] We examined the potential impact of Brexit on the OTC derivative market in an **earlier edition of Lex et Brexit**.

Although the TRR provides relief for non-UK CCPs, clearing members and trading venues based in the EEA will not be able to use UK CCPs unless parallel legislative measures are adopted by EU authorities. As a consequence, EU customers might be unable to satisfy the EMIR clearing obligation by clearing their OTC derivatives on UK CCPs. The impact of this on the market could be significant, as 98% of all Euro-denominated interest rate swaps are cleared on LCH Limited which is a UK CCP.[5] However, until such time as the UK CCPs are recognised pursuant to Article 25 EMIR, they will not be available to clients in the EU. In late October, the European Commission Vice-President in charge of Financial Stability, Financial Services and Capital Markets Union announced that EU authorities would take action to enable EU clients to continue to access UK CCPs on a temporary basis in the event of a no deal Brexit. The full legal basis and text for these measures, however, has not yet been made clear.

In addition to the TPR and TRR, another unilateral measure described in the Contingency Paper relates to the validity of prospectuses. Currently, prospectuses benefit from passporting rights such that a prospectus approved by the competent authority in one EU member state is valid in another member state. We considered how Brexit might impact UK and EEA isuers under the EU Prospectus Directive in a **previous edition of Lex et Brexit**. In the Contingency Paper, the UK has committed to treat as valid prospectuses approved pre-Brexit, including those approved in other EU member states, for the remainder of the 12-month period from the date of approval. Issuers will therefore benefit by not being required to seek approval from the UK Financial Conduct Authority for prospectuses that have already been approved as of the date of the UK's withdrawal from the EU.

Trading venues based in the UK are likely to be negatively impacted by a no-deal Brexit because they will cease to be "trading venues" within the meaning of the recast Directive on Markets in Financial Instruments ("**MiFID II**"). The effect of no longer being classified as MiFID II trading venues is that EEA firms may not be able to be direct members of UK trading venues and will be prohibited from entering into certain equity and derivative contracts on UK trading venues, at least until such time as UK trading venues are assessed as equivalent by EU authorities.

In the asset management industry, UCITS management companies and alternative investment fund managers are currently permitted to delegate investment/portfolio management functions to non-EU firms, subject to satisfaction of certain conditions. One such condition is that there are cooperation agreements in place between supervisory authorities in the EU member state and the relevant non-EU jurisdiction. The UK government has indicated in the Contingency Paper that it is prepared to agree to cooperation arrangements with EU authorities as soon as possible. Provided the authorities in the EU member states agree to put such arrangements in place, the Contingency Paper predicts minimal disruption to UK asset management firms.

A no-deal Brexit poses particular problems for central securities depositaries ("**CSDs**") in that the securities of EU issuers may not be able to directly settle in the UK. The UK's CSD, Euroclear UK and Ireland Limited ("**EUIL**"), services both the UK and Ireland. There should be no disruption to customers settling UK securities at EUIL as a result of a no-deal Brexit, but customers settling EU securities may be unable to do so in the UK unless action is taken at the EU level. Specifically, EUIL would require recognition from ESMA as a third-country CSD and the European Commission would have to recognise that EUIL was subject to domestic regulations that are equivalent to those in the Central Securities Depositaries Regulation. For its part, EUIL has announced that it intends to seek authorization for a separate CSD in Ireland to address these issues.

---

[4] The list of third country CCPs that have been recognised to offer services and activities in the EU is available at: **https://www.esma.europa.eu/press-news/esma-news/esma-updates-list-recognised-third-country-ccps.**

[5] Amir Khawaja, Swaps data: the monopoly effect in clearing, Risk.net (15 February 2018), available at: **https://www.risk.net/comment/5416976/swaps-data-the-monopoly-effect-in-clearing**.

To mitigate the impact on UK customers that use non-UK CSDs, the UK government announced that it was bringing forward legislation permitting these CSDs to benefit from transitional provisions. These transitional provisions will allow non-UK CSDs to continue to provide services to customers in the UK until both equivalence and recognition decisions are made.

The operation of settlement finality is likely to be significantly impacted by a no-deal Brexit. The EU Settlement Finality Directive provides for the protection of payments and transfers of securities made by participants of systems which have been designated and that are governed by the law of an EU Member State from claims in the event of the insolvency of one of these participants. It has been implemented in the UK through the Settlement Finality Regulations ("**SFRs**"). Firms operating systems that have already been designed under the SFRs will continue to be designated after the UK leaves the EU. Moreover, the Contingency Paper explains that the UK plans to enact legislation enabling the BoE to designate systems from outside the UK, so they may benefit from the SFRs. However, if the EU does not provide for the designation of UK systems, the Contingency Paper points out that UK-designated system providers may cease to grant access to EU clients, as they will pose higher risks to the stability of the designated system.

Conclusion

This article has provided a brief summary of the some of the areas identified in the Contingency Paper within the financial services sector that are likely to be impacted by a no-deal Brexit and the steps being taken by the UK government to minimise disruption to clients and service providers.

Since publication of the Contingency Paper, the UK government has issued a number of draft statutory instruments designed to give legislative effect to many of the contingency measures described above. While it is clear that unilateral action by the UK government is prudent in the circumstances, it is ultimately an imperfect solution when compared to co-ordinated action by UK and EU authorities. It remains to be seen whether a no deal Brexit can be averted, but if it cannot, the Contingency Paper at least provides a basis for firms and customers to prepare for such an eventuality (to the extent they have not already done so).

In addition to the formal legal measures envisaged by the UK and, to a lesser extent, the European Commission, we expect that national regulators in the UK and EU would also have to exercise a significant degree of regulatory forbearance in the event of a no-deal Brexit, given the lack of clarity about how thousands of EU-derived rules would apply. It is also predicted by many economists that a no-deal Brexit would have significant negative economic effects on the wider UK economy; conceivably this could pose a financial stability threat to the UK banking system requiring swift intervention by regulators.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Thomas J. Reid	**+1 212 450 4233**	tom.reid@davispolk.com
John D. Amorosi	**+1 212 450 4010**	john.amorosi@davispolk.com
John Banes	**+44 20 7418 1317**	john.banes@davispolk.com
Leo Borchardt	**+44 20 7418 1334**	leo.borchardt@davispolk.com
Will Pearce	**+44 20 7418 1448**	will.pearce@davispolk.com
Simon Witty	**+44 20 7418 1015**	simon.witty@davispolk.com
Michael Sholem	**+44 20 7418 1027**	michael.sholem@davispolk.com
Mark Chalmers	**+44 20 7418 1324**	mark.chalmers@davispolk.com

About Lex et Brexit — The Law and Brexit

Lex et Brexit is our publication on Brexit developments. In each issue, we select and discuss emerging legal issues from the maze of Brexit-related debates and developments.

Read previous issues at **www.davispolk.com/brexit >**

Sign up to receive Lex et Brexit >