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Avoiding the Cliff Edge - Immediate Steps for Firms and Groups with Financial Services Businesses in Europe Involving the UK

The UK is due to leave the European Union on March 29, 2019 ("Brexit"). Within the EEA, "passport rights" permit financial services institutions and funds authorised in any EEA Member State to conduct business cross border (whether by establishing a branch or on a purely cross border services basis) into any other EEA Member State, which currently includes the UK. Similarly, while still within the EEA, financial services institutions authorised by the UK financial services regulators can exercise these passport rights to conduct business cross border into the other EEA states. These passport rights have been heavily relied upon within the EEA by firms conducting business across the bloc.

The UK and EU have agreed the terms of an implementation period which would apply from the end of March 2019 until the end of December 2020. During this time, EU law would still apply in the UK, so that authorised firms and funds would continue to benefit from passporting between the UK and EEA. However, this implementation period is part of the wider Withdrawal Agreement that has not yet been ratified by the UK Parliament or the EU. Obviously, the time window for ratification of that Agreement, or any revised version of it entered before the end of March 2019, is running out. Financial services businesses in Europe face the real possibility that passporting rights and other EEA wide recognitions that they rely upon to do business may cease to apply on March 29, 2019 if no political solution is reached. Consequently, EEA and UK regulators are urging firms to develop contingency plans to enable them to continue providing services to existing customers and counterparties who may otherwise be disadvantaged. Such firms are expected to find their own solutions, having taken professional advice.

This note highlights some of the key actions affected firms and groups should be taking.

1. UK TEMPORARY PERMISSIONS REGIME

If there is no implementation period, when the UK withdraws from the EU the UK will become a 'third-country' in relation to the EU and EEA firms will no longer be able to "passport" services into the UK. In that event, EEA firms will need to seek full authorisation in the UK to continue to access the UK market. Similarly, EEA investment funds will also need to seek UK recognition to continue to market to customers in the UK.

The UK government and regulators have designed a "temporary permissions regime" ("TPR") under which EEA firms that currently rely upon inwards passports to conduct business in the UK and which give requisite notification to the relevant UK regulator will be deemed to have permission under Part 4A of the Financial Services and Markets Act 2000 ("FSMA") on a temporary basis and thus will be deemed to have the necessary authorisation to conduct business in the UK for a temporary period. The scope of the permission will reflect the scope of a firm's passporting permission pre-Brexit. Similar arrangements are in place to enable EEA investment funds to continue to be marketed in the UK temporarily until UK full UK recognition is obtained. Firms that enter into the TPR are expected to submit applications for full UK authorisation within a specified time window. Once full authorisation has been obtained, the TPR will cease to apply.

If required the TPR will come into force when the UK leaves the EU on March 29, 2019 at 23:00, London time. The regime is expected to be in place for a maximum of three years, within which time firms and investment funds will be required to obtain authorisation or recognition in the UK. The notification window is now open. Details of how to notify are available on the websites of the Financial Conduct Authority ("FCA") and Prudential Regulation Authority.

The following firms can use the TPR, provided the UK regulators have received notification prior to exit day:

- firms which have passports under Schedule 3 to FSMA in place before exit day, including firms with "top-up" permissions;
- Treaty firms under Schedule 4 to FSMA which qualify for authorisation before exit day, including firms with "top-up" permissions;
- electronic money, payment institutions and registered account information service providers who are exercising their passporting rights under the Electronic Money Directive (EMD) or the Payment Services Directive (PSD2) before exit day.

Operators of UCITS schemes and managers of Alternative Investment Funds can use the TPR, provided the FCA has received notification before exit day. The operator of an EEA UCITS which on exit from the EU benefits from the temporary extension to the marketing regime will also be able to market 'new sub-funds' (i.e. those authorised by the relevant home state regulator after exit day) in the United Kingdom, subject to certain conditions.

Firms and funds should consider whether they wish to enter into the TPR (and subsequently obtain full authorisation or, for funds, recognition) in order to continue to service existing customers in the UK and to write new business.

2. UK FINANCIAL SERVICES CONTRACTS REGIME

The UK government and regulators have designed the "financial services contracts regime" ("FSCR") to cover those firms that do not wish to enter into the TPR but instead wish to run off their existing UK business as well as those firms which enter the TPR but are unsuccessful in obtaining full authorisation in due course.

The FSCR is created solely to allow EEA firms to run off existing UK contracts and conduct an orderly exit from the UK market. EEA firms within this regime will not be able to write new UK business. They will be limited to regulated activities

which are necessary for the performance of pre-existing contracts. EEA firms that wish to continue doing new business in the UK after exit and those firms wishing to have more flexibility in the regulated activities they are permitted to carry on will need to enter the TPR. In addition, EEA firms managing UK authorised funds will not be able to rely on the FSCR to continue managing those funds after exit day. To benefit from the transitional period, those firms should enter the TPR by notifying the FCA. The same applies to trustees or depositaries of such funds.

The FSCR will automatically apply to EEA passporting firms that do not notify the FCA that they wish to enter the TPR but have pre-existing contracts in the UK which they would need a UK regulatory permission to service. The FSCR will be time limited depending on the type of contract being performed: it will apply for a maximum of 15 years for insurance contracts and 5 years for all other contracts.

Firms should consider whether they wish to rely upon the FSCR and take advice upon whether the FSCR will be adequate to ensure the legality of any activities they continue to conduct with UK based customers.

3. OVERSEAS PERSONS/UK REGULATORY PERIMETER

For firms that wish to have continued access to the UK but do not wish to enter the TPR and therefore become authorised and subject to the ongoing requirements of the regulators, there is value in reassessing whether their activities do actually fall within the scope of the UK's regulatory perimeter and, if they do, whether it is possible for the firm to take advantage of existing exclusions within the UK's regulated activities regime.

To be within the regulatory perimeter, firms will need to be carrying out a regulated activity *in* the UK. Certain regulated activities such as arranging deals or managing investments are usually considered to take place where the arrangements or investment decisions are made, regardless whether the customer or counterparty is located in the UK. This is different from the way many other EEA states determine regulatory perimeter, where the focus is often upon whether the customer/counterparty is located within that EEA state. Where a firm has its head office outside the UK, activities it undertakes in the UK will be deemed to take place in the UK if they are carried out from an "establishment" maintained by the firm in the UK - there is complicated guidance to determine what amounts to an establishment for these purposes.

If an activity is being carried out *in* the UK, then it may be possible to rely upon one of the specified legal exclusions from the requirement to be authorized. One example is the "overseas persons exclusion", which applies to activities such as dealing in investments as principal, dealing in investments as agent, arranging deals and advising. The exclusion is not available for all activities and applies differently across activities.

Firms should seek advice as to whether the activities they undertake in relation to the UK and UK clients may fall outside of the UK perimeter or benefit from one or more exclusions.

4. OUTSOURCING/DELEGATION BETWEEN AN EEA ENTITY AND A UK ENTITY

Both the AIFMD and UCITS regimes allow a fund manager to delegate portfolio management services to a third party in a third country. Among the conditions which must be satisfied is the need for cooperation between the supervisory authorities concerned. The FCA recently announced that it has agreed a multilateral Memorandum of Understanding ("MoU") with EU/EEA regulators covering supervisory cooperation, enforcement and information exchange between individual regulators and the FCA, which will take effect in the event of a no-deal Brexit. The MoU will allow the regulators to share information relating to market surveillance, investment services and asset management activities and as a result will allow fund manager outsourcing and delegation to continue to be carried out by UK based entities on behalf of counterparties based in the EEA.

Firms should assess how far they can continue to rely upon existing delegation and outsourcing arrangements cross border between the UK and the EEA.

5. CROSS BORDER BUSINESS FROM THE UK INTO THE EEA

No regime equivalent to the TPR or FSCR has so far been proposed by the EU, so there remains significant uncertainty as to how UK firms will be able to access the EU in the event of a no-deal Brexit. Many firms have already planned for the "worst case" scenario by opening up one or more offices in other EEA states and obtaining direct authorisation there, with a view to passporting services across the wider bloc.

Nevertheless, some positive no-deal contingencies are being taken: the Italian Ministry of Finance has announced that it would introduce a transitional period to allow financial institutions to continue to carry out business in Italy under current rules and there is proposed legislation in Luxembourg to allow the regulator to continue to apply the management passporting regime for UK managers managing funds in Luxembourg for up to 21 months after Brexit.

6. CROSS BORDER DERIVATIVES CONTRACTS AND TRADING

The European Securities and Markets Authority (ESMA) announced on February 18, 2019 that in the event of a no-deal Brexit, three central counterparties (CCPs) established in the UK – LCH Limited, ICE Clear Europe Limited and LME Clear Limited – will be recognised to provide their services in the European Union. ESMA adopted these recognition decisions in order to limit the risk of disruption in central clearing and to avoid any negative impact on the financial stability of the EU. ESMA had previously communicated that its Board of Supervisors supports continued access to UK CCPs. Having assessed the applications and the information submitted by the three CCPs and consulted the relevant authorities in accordance with the European Market Infrastructure Regulation ("EMIR"), ESMA considers that the conditions for recognition under Article 25 of EMIR are met by the three CCPs in case of a no-deal Brexit. Therefore, it has adopted decisions to recognise the three CCPs as third country CCPs under EMIR.

The recognition decisions would take effect on the date following Brexit date, under a no-deal Brexit scenario.

ESMA has previously communicated that its Board of Supervisors also supports continued access to the UK Central Securities Depositary. That recognition process is still on-going, the results of which will be published as soon as the process is finalised.

Steps of this kind are very welcome but are only a partial fix and no general binding comfort has yet been provided by the EU regarding continuity of existing contracts. Many uncertainties remain regarding cross border contracts and trading, where termination events could be triggered as a result of illegality. This is a complex area. The International Swaps and Derivatives Association has published information on its website regarding its analysis of the possible impact upon its standard forms of contract, which includes a discussion on how choice of law and jurisdiction clauses may be affected.

Many dealers providing services cross border between the UK and the remaining EEA Member States have already novated existing contracts to suitably located entities to get around this problem. However, this could impact the availability of some trading lines and have an economic impact.

Firms should urgently assess the legal status of affected contracts that could be outstanding at the end of March 2019 and in consultation with counterparties take steps to mitigate the risks presented by a hard Brexit.

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