

# The legal impact of Brexit on the UK-based financial services sector

A report by Freshfields Bruckhaus Deringer LLP  
commissioned by TheCityUK

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## **1. Introduction to this report**

- 1.1 On 5 October 2016, Oliver Wyman published a report commissioned by TheCityUK that analysed the potential economic impact of Brexit on the UK-based financial services sector (the OW report).<sup>1</sup>
- 1.2 Freshfields Bruckhaus Deringer LLP (Freshfields) has been commissioned by TheCityUK to prepare a legal analysis of the possible impact of Brexit on the UK-based financial services sector and related professional services industry.

### **Scope**

- 1.3 The International Regulatory Strategy Group has published the following two reports:
- (a) a report on the EU's third-country regimes and alternatives to passporting (published in January 2017)<sup>2</sup>; and
  - (b) a report on mutual recognition and market access (published in April 2017)<sup>3</sup>.
- 1.4 This report does not propose to replicate those findings. Instead, the purpose of this report is to assess the extent to which the loss of specific legal rights would prevent the UK-based financial services sector and related professional services industry from continuing to carry on business as it is conducted at present and, in particular, whether changes to access rights to EU markets may lead to:
- (a) the reduction, closure or sale of books of business or businesses based in the UK;
  - (b) the need to seek separate authorisations in the EU;
  - (c) the transfer of people and systems to the EU; or
  - (d) the use of EU-based market infrastructure in place of UK-based infrastructure.
- 1.5 In some cases, the impacts noted above may be mitigated by adopting alternative strategies and forms of business organisation. This report will attempt to identify these alternatives in general terms, but not by reference to the specific contingency plans being considered by individual firms.
- 1.6 This report also seeks to identify issues that may form part of the UK's negotiating strategy, in order to ensure an orderly transition to the new EU-UK relationship as individual rights are lost.

### **Scenarios**

- 1.7 This report draws on the "spectrum of regulatory outcomes" set out in the OW report, and frames the analysis against the following three scenarios ("the scenarios"):
- (a) full equivalence and passporting: the UK would obtain full equivalence and passporting across the full scope of the single market directives where such equivalence and passporting rights are currently available (in this report, "scenario 1");
  - (b) equivalence where the provision already exists but no additional access rights are granted: the UK would become a "third country" and would obtain equivalence across the single

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<sup>1</sup> [http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2016/oct/OW%20report\\_Brexit%20impact%20on%20Uk-based%20FS.pdf](http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2016/oct/OW%20report_Brexit%20impact%20on%20Uk-based%20FS.pdf)

<sup>2</sup> <http://www.irsg.co.uk/assets/IRSG-Full-report-The-EUs-third-country-regimes-and-alternatives-to-passporting.pdf>

<sup>3</sup> <http://www.irsg.co.uk/assets/IRSG-Report-on-Mutual-Recognition-a-Basis-for-Market-Access-after-Brexit.pdf>

market directives and regulations where equivalence is already established. No new access arrangements would be negotiated to compensate for the loss of passporting rights (in this report, “scenario 2”); and

- (c) third-country agreement: the UK would become a “third country” but would not obtain equivalence across the core single market directives. No new access arrangements would be negotiated on a bilateral basis (in this report, “scenario 3”).

- 1.8 Unlike the OW report, this report does not assume that bilateral arrangements between the UK and the EU will be put in place.
- 1.9 The scope of the analysis in this report is limited to scenarios 2 and 3 as scenario 1 is no longer seen as politically feasible. Prime Minister Theresa May’s speech setting out the Plan for Britain, given on 17 January 2017, made it clear that the UK would not remain a member of the single market after Brexit, asserting that “a vote to leave the EU [is] a vote to leave the single market”. Instead, the Prime Minister observed that the UK would “seek the greatest possible access to it through a new, comprehensive, bold and ambitious free trade agreement. That agreement may take in elements of current single market arrangements in certain areas – on the export of cars and lorries for example, or the freedom to provide financial services across national borders – as it makes no sense to start again from scratch when Britain and the remaining member states have adhered to the same rules for so many years.” Further, “because we will no longer be members of the single market, we will not be required to contribute huge sums to the EU budget. There may be some specific European programmes in which we might want to participate. If so, and this will be for us to decide, it is reasonable that we should make an appropriate contribution. But the principle is clear: the days of Britain making vast contributions to the European Union every year will end”. Further, the Government’s Brexit White Paper published in February 2017 referred to “a new strategic partnership agreement” that will aim “for the freest possible trade in financial services between the UK and EU Member States” but will not include membership of the single market.<sup>4</sup>

## Methodology

- 1.10 In preparing this report, meetings were held with representatives of the UK financial services sector (“the bilateral discussions”), and a series of questions were asked covering:
  - (a) the likely impact of scenarios 2 and 3 on the firm’s business, including the extent to which the firm relies on passporting rights in order to access markets in other member states and the extent to which it may be unable to continue its business as it does presently following Brexit; and
  - (b) the likely business response to the two scenarios, including:
    - (i) whether firms would be able to continue to provide services to clients, and whether they would consider seeking additional regulatory authorisations, transferring people or systems, or re-directing activities in order to continue to provide those services;

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<sup>4</sup> <https://www.gov.uk/government/publications/the-united-kingdoms-exit-from-and-new-partnership-with-the-european-union-white-paper>. This position is likely to develop further in light of the upcoming General Election, which will take place on 8 June.

- (ii) whether the firm's response depends on the location or behaviour of others (ie business lines or support functions, a particular client-base or infrastructure provider, or competitors); and
- (iii) the anticipated timing of any decision to restructure or relocate.

1.11 The output of these discussions is described in chapter 6.

## 2. Executive summary

- 2.1 The bilateral discussions revealed a number of themes across the UK-based financial services sector. As an overall theme, firms want to keep as much of their activities in the UK as possible, within the confines of regulatory and operational considerations, and to continue to service their existing EU clients following Brexit with as little disruption as possible. Although it may be possible for some firms to continue to access EU markets under scenario 2, firms are neither relying on equivalence determinations being made nor assuming that equivalence would provide a sufficiently certain basis upon which to build a business plan. Firms are putting in place contingency plans and structuring solutions on the assumption that scenario 3 will apply. In both scenarios, the activities of UK (and possibly EU) firms will be disrupted – the extent of the disruption will depend on the way that individual businesses are structured. Clearly, given the uncertainty around equivalence determinations, firms would prefer arrangements to be negotiated that enable EU and UK firms to access each other's markets on the basis that their respective regimes are broadly consistent.
- 2.2 The individual conclusions are discussed in detail in chapter 6 of this report, but in summary:
- (a) the view of many in the UK-based financial services sector is that the immediate focus for regulators and the Government needs to be on acquiring and transforming the *acquis communautaire*<sup>5</sup> into UK law, and securing an orderly Brexit and an effective transition to a new UK-EU relationship. Brexit may however also provide an opportunity for the UK to re-consider its regulatory approach so that the framework is more tailored to the specifics of the UK market. Whilst the financial services sector is not seeking a “bonfire of regulation”, some feel that this re-framing should be considered in parallel with the exit agreement negotiations. In the past, UK regulators and legislators have responded swiftly to international regulatory developments;
  - (b) firms are seeking to secure an implementation period beyond the initial two-year period for negotiations. The general view across the financial services sector is that the two-year negotiation period will not be a sufficient time to negotiate the UK's exit arrangement, for the UK Government to redefine its ongoing relationship with the EU or for firms satisfactorily to effect any required reorganisation or restructuring. A longer implementation period will be of mutual benefit to both the EU and the UK;
  - (c) there are a number of areas where securing “grandfathering” rights is important for firms, not least so that firms can continue to service existing relationships with EU clients following Brexit;
  - (d) ensuring continuity of existing contractual arrangements is important across the financial services sector;
  - (e) continued access to talent after Brexit is essential to the ongoing success of the UK-based financial services sector and a solution needs to be found to ensure such access can continue in the future; and
  - (f) firms rely on the ability to transfer and use personal data freely. Ensuring that they can receive and transfer personal data is a priority.

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<sup>5</sup> The Governments “Legislating for the United Kingdom's withdrawal from the European Union”, published in March 2017, evidenced that this is a focus - [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/604516/Great\\_repeal\\_bill\\_white\\_paper\\_accessible.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/604516/Great_repeal_bill_white_paper_accessible.pdf)

### **3. Legal framework for the UK financial services sector**

3.1 For the purposes of this report, the UK financial services sector has been divided into the following business lines:

- (a) banking and investment services, comprising:
  - (i) debt and equity capital markets;
  - (ii) sales and trading;
  - (iii) M&A and corporate finance advisory;
  - (iv) research;
  - (v) commercial lending, consumer lending and mortgages;
  - (vi) deposit-taking;
  - (vii) payment services; and
  - (viii) prime brokerage;
- (b) insurance, reinsurance and insurance mediation/distribution;
- (c) asset management, comprising:
  - (i) portfolio management;
  - (ii) private wealth management; and
  - (iii) fund management, ie the management of undertakings for collective investment in transferable securities (UCITS) and alternative investment funds (AIFs);
- (d) custodians and the provision of custody services;
- (e) central counterparties (CCPs);
- (f) central securities depositories (CSDs);
- (g) the provision of credit ratings by credit rating agencies (CRAs);
- (h) the operation of a trading venue;
- (i) the provision of trade repository services;
- (j) the provision of data reporting services; and
- (k) the provision of benchmarks.

3.2 The OW report further sub-divides these business lines into the following activities:

- (a) client-facing and sales;
- (b) execution;
- (c) risk management; and

(d) back office.

- 3.3 These activities are conducted by credit institutions, investment firms, insurers and reinsurers, asset managers, AIF managers, UCITS managers, custodians, trading venues, settlement and clearing systems, and trade repositories based in the UK, ie firms incorporated and headquartered in the UK as well as UK subsidiaries/branches of EU and third-country institutions seeking to provide cross-border services to EU customers (collectively “the UK financial services sector”).
- 3.4 Each activity has been considered in turn and a summary of the analysis is provided in table form in Appendix 1. Whilst this report broadly follows the approach taken in the OW report, in some circumstances business lines have not been broken down into the four activities listed in paragraph 3.2 above.
- 3.5 The analysis of activities and identification of the potential impact of the various scenarios in this report are based on a generic assessment of the activities involved in each business line. In reality, these categories are not precisely defined terms and may cover a variety of specific activities depending on the particular firm. In addition, the extent to which such activities are separable will depend on the organisation and systems of each individual firm. Consequently, the descriptions in this report and the summary in Appendix 1 are only intended to provide a general guide to the potential impact of Brexit. The actual impact on any particular firm may differ as a result of specific circumstances and organisational structures.
- 3.6 This report also considers the impact of Brexit on legal, consulting and accounting professionals (collectively “related professional services”).

### ***Domestic regime***

- 3.7 From a domestic perspective, the legal framework for the UK financial services sector is primarily set out in:
- (a) the Financial Services and Markets Act 2000 (FSMA);
  - (b) secondary legislation made under the FSMA, including the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001;
  - (c) rules made by the Bank of England, the Prudential Regulation Authority and the Financial Conduct Authority under powers conferred by the FSMA;
  - (d) relevant EU regulations, all of which are directly applicable in the UK; and
  - (e) guidance from European supervisory authorities, namely the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority (ESMA).

### ***EU regime***

- 3.8 Currently, the UK financial services sector relies extensively on the ability of firms authorised in one EU member state to carry on permitted activities and provide services to clients located in another EU member state without needing to obtain separate authorisation (termed “passporting”). These passporting rights enable firms to provide services either on a cross-border basis from their home member state or by establishing branches in the member states where clients are located.



- 3.9 A number of European directives and regulations contain “third-country regimes”, which provide rights or advantages to third-country (ie non-EU) firms in certain circumstances. Central to these regimes is a concept of “equivalence”, by which the European Commission (“the Commission”) assesses that the regulatory and supervisory framework of a third country is equivalent to that in the EU from the perspective of having legally binding requirements, effective supervision by authorities and achieving the same results as the corresponding EU provisions and supervisory approach.
- 3.10 There are several identified limitations with equivalence:
- (a) equivalence regimes are not comprehensive;
  - (b) equivalence does not replicate the scope or extent of existing passporting rights and may not cover the full spectrum of a firm’s activities or clients. In some cases, a determination of equivalence enables third-country firms to provide services to EU clients and would adequately replicate lost passporting rights. In other cases, a determination of equivalence serves a different and more limited purpose, for example, in relation to the risk-weightings to be applied by EU financial institutions to exposures to third-country firms for the purpose of calculating prudential ratios;
  - (c) a determination of equivalence is at the Commission’s discretion and is unlikely to be in place across all single market directives where such a determination is available prior to Brexit;
  - (d) a determination of equivalence is inherently uncertain and can be withdrawn; and
  - (e) it is unclear how close the UK regime would need to remain to that in the EU in order to continue to rely on an equivalence determination in future.
- 3.11 The current legal framework for related professional services is set out below:
- (a) legal services: this is a highly regulated sector, which relies on the mutual recognition of professional qualifications, access rights, rights of establishment and automatic legal privilege;
  - (b) consultancy services: as an unregulated business, the provision of consultancy services in member states does not rely on the recognition of professional qualifications. There are structural considerations as well as secondary impacts (ie as a result of clients moving away from the UK) that could have longer term effects. These are explored in more detail in this report; and
  - (c) accountancy services: as a highly regulated sector, the ability to carry on accountancy services on a cross-border basis is dependent, amongst other things, on the mutual recognition of professional qualifications.
- 3.12 Related professional services rely on an immigration system that allows easy access to, and deployment of, the best and brightest talent.
- 3.13 Set out below are the key pieces of EU legislation for the UK financial services sector, as well as a description of the extent to which it would be possible for UK firms to continue to provide services on a cross-border basis following Brexit. For the purpose of this analysis, the question of where an activity is deemed to take place has not been considered in detail. This is a complicated area that, depending on the view taken in a particular member state, may enable activities to continue to be

performed from the UK in relation to EU clients on the basis that they are not considered to have taken place in the EU.

- 3.14 Although not considered in detail for the purposes of this report, Brexit may also have an impact on contractual relationships between UK and EU counterparties. In particular, English law-governed agreements may need to be amended to incorporate the contractual recognition of bail-in where EU firms enter into agreements with UK counterparties, in accordance with the EU Banking Recovery and Resolution Directive.

### **The recast Markets in Financial Instruments Directive and the new Market in Financial Instruments Regulation (together, “MiFID 2”)<sup>6</sup>**

- 3.15 Investment firms that provide investment services or perform investment activities falling within scope of MiFID 2 must be authorised.
- 3.16 Under MiFID 2, third-country firms (which, following Brexit, will include UK firms) will be able to provide investment services or perform investment activities relating to financial instruments<sup>7</sup>, with or without “ancillary services”<sup>8</sup>, to (or with) eligible counterparties and per se professional clients throughout the EU without needing to establish an EU branch (ie on a cross-border basis), provided that the following conditions are satisfied:
- (a) the Commission has adopted a decision that the legal and supervisory arrangements of the third country ensure that authorised firms comply with legally binding prudential and business conduct requirements that have equivalent effect to the applicable EU requirements;
  - (b) the firm is authorised in the jurisdiction where its head office is established to provide the investment services or activities in the EU and is subject to effective supervision and enforcement; and
  - (c) a co-operation arrangement is in place between ESMA and the relevant competent authorities in the third country where the firm is located.
- 3.17 Key considerations are:
- (a) whether the relevant services are “investment services” within scope of MiFID 2 or “ancillary services”. Third-country firms are able to provide investment services or perform investment activities either with or without ancillary services to/with EU eligible counterparties and per se professional clients on a cross-border basis without being separately authorised in the EU provided the UK regime is considered equivalent. The ability of a third-country firm to provide ancillary services on a standalone (ie not alongside investment services) and cross-border basis to EU clients will depend, once MiFID 2 is in force, on the law in the member state where clients are located; and

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<sup>6</sup> MiFID 2 measures will apply from 3 January 2018 and therefore will be relevant when the UK leaves the EU.

<sup>7</sup> This report defines the term “financial instruments” as per MiFID 2.

<sup>8</sup> Ancillary services are defined in MiFID 2 as: (i) safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management and excluding maintaining securities accounts at the top tier level; (ii) granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm granting the credit or loan is involved in the transaction; (iii) advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings; (iv) foreign exchange services where these are connected to the provision of investment services; (v) investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments; (vi) services relating to underwriting; and (vii) investment services and activities as well as ancillary service relating to certain underlying derivatives.

- (b) whether the investment service/activity or ancillary service relates to financial instruments within the scope of MiFID 2. The relevant activities will only be in scope, and firms will only be able to provide services on a cross-border basis in reliance upon the MiFID 2 third-country access regime, if the services or activities involve financial instruments. It would be necessary to consider each product against the MiFID 2 definitions, as the way they are classified internally by an investment firm may not be aligned with the regulatory approach taken under MiFID 2. If the services do not relate to MiFID 2 financial instruments, it will be necessary to consider the position under the law in the relevant member state, as such services could not be provided cross-border to EU clients in accordance with the MiFID 2 third-country access regime. Firms would have to determine whether it would be permissible to provide that service into a particular member state based on local law. One area where this is particularly relevant is with FX trading. As EU jurisdictions approach this differently, jurisdiction-by-jurisdiction analysis is required.

- 3.18 Third-country firms seeking to rely on the MiFID 2 third-country access regime must apply to ESMA to be included in the register of third-country firms and, before providing services or performing activities on a cross-border basis, must offer to submit any disputes relating to services or activities to the jurisdiction of a court or arbitral tribunal in a member state. ESMA may withdraw a third-country firm's registration on 30 days' notice to the relevant competent authority.
- 3.19 An equivalence determination would not however permit a third-country firm to provide services on a cross-border basis to retail clients or elective professional clients based in the EU. Instead, the ability to provide services to these categories of client would depend on member state local law and it is assumed for the purposes of this report that member states will restrict the ability of third-country firms to provide services on a cross-border basis to such clients in their jurisdiction. Member states may require that a third-country firm intending to provide services to a retail client or elective professional client in its territory establish a branch in that member state, which must be authorised in accordance with certain conditions. There may also be other limitations on the ability of UK firms to service certain categories of EU clients under member state local law, eg member states may impose limitations on the ability of third-country firms to provide services to local authorities in their jurisdiction.
- 3.20 MiFID 2 also permits EU investment firms to outsource functions that are critical to the provision of services to clients and the performance of investment activities – provided the firm has taken reasonable steps to avoid undue additional operational risk. This may enable activities to continue to be performed from the UK in relation to services provided to EU customers. Outsourcing of important operational functions may not be undertaken in such a way as to impair materially the quality of the firm's internal controls and the ability of the supervisory authority to monitor the firm's compliance with its regulatory obligations. The extent to which a firm is permitted to outsource will therefore depend to some extent on regulatory discretion.

#### *Trading venues*

- 3.21 Trading venues are multilateral systems on which financial instruments are traded. There are three types of trading venue under MiFID 2: multilateral trading facilities (MTFs), organised trading facilities (OTFs) and regulated markets.
- 3.22 MiFID 2 introduces a trading obligation for shares admitted to trading on a regulated market or traded on an MTF, and derivatives that have been declared subject to the trading obligation. Such instruments must be traded on a regulated market, MTF, OTF (in the case of derivatives) or a third-

country trading venue that has been deemed equivalent in accordance with the procedure set out below.

- 3.23 The Commission may adopt a decision determining that the legal and supervisory framework of a third country ensures that a trading venue authorised in that jurisdiction complies with legally binding requirements that are equivalent to the requirements under MiFID 2 and the Market Abuse Regulation, and that it would be subject to effective supervision and enforcement in that third country. If the Commission makes such an equivalence determination (which may be limited to a category or categories of trading venues) in relation to a particular third country, EU investment firms would be able to satisfy the trading obligation by using a trading venue (eg a regulated market, an MTF or an OTF) in that third country. The consequence would therefore be that where an equivalence determination is made in respect of the UK regime (ie in scenario 2), EU firms would be able to satisfy the trading obligation by trading on a UK trading venue. However, in the absence of such a determination, EU firms would need to use EU venues to satisfy the trading obligation. It is worth noting that an EU investment firm would not be able to satisfy the trading obligation by using a UK systematic internaliser.
- 3.24 MiFID 2 includes a passporting right that enables investment firms and market operators operating MTFs and OTFs to facilitate access to and trading on those markets by remote users, members or participants. The third-country access regime relies upon an equivalence determination being made, and provided this is the case, a third-country (eg UK) firm operating an MTF or an OTF may be able to continue to provide such services to per se professional clients and eligible counterparties in the EU. Even in the absence of an equivalence determination, EU-based members may be able to continue to access UK trading venues directly depending on the UK regime that is put in place, and the rules of the relevant venue.

#### *Data reporting services providers*

- 3.25 In accordance with MiFID 2, investment firms are subject to extensive reporting obligations. Whilst the primary obligation to satisfy these requirements is on the relevant firm, in certain circumstances the obligations can be met using an authorised data reporting service, namely:
- (a) trade reports may be published by an approved publication arrangement on behalf of an investment firm;
  - (b) consolidated tape providers may collect trade reports for financial instruments from regulated markets, MTFs, OTFs and approved publication arrangements, and consolidate them into a live continuous electronic data stream that provides price and volume data for each financial instrument; and
  - (c) approved reporting mechanisms may report details of transactions to competent authorities or to ESMA on behalf of an investment firm.
- 3.26 In any of the cases above, the relevant data reporting service must have its head or registered office in the EU. There is no third-country regime and, following Brexit, firms would no longer be able to use UK data reporting services to fulfil the reporting obligations.

#### *Management of segregated portfolios and fund management*

- 3.27 As described in paragraph 3.20 above, EU firms are able to rely on third parties for the performance of operational functions, including functions that are critical to the provision of services to clients and the performance of investment activities.



- 3.28 Portfolio management is an investment service for the purposes of MiFID 2. Consequently, it can be provided on a cross-border basis to professional clients and eligible counterparties under the third-country regime in MiFID 2 if an equivalence determination has been made.
- 3.29 In accordance with the general outsourcing regime under MiFID 2, as described in paragraph 3.20 above, EU investment firms are permitted to outsource management activities to a third party (including a third-country firm) provided that certain conditions are met, including that the relevant firm has taken reasonable steps to avoid undue additional operational risks and outsourcing of important operational functions is not undertaken in such a way as to materially impair the quality of the firm's internal controls or the ability of the relevant supervisor to monitor the firm's compliance with its obligations. Following Brexit, this structure may enable EU investment managers to outsource portfolio management to UK managers.
- 3.30 EU management companies are also able to delegate investment management activities to UK managers in accordance with the AIF Managers Directive (AIFMD) and UCITS Directive, described in further detail below.

#### **The Capital Requirements Directive and the Capital Requirements Regulation (together, “the CRD”)**

- 3.31 Under the CRD, credit institutions (ie firms that are in the business of taking deposits or other repayable funds from the public and granting credits for their own account) must be authorised in the EU before commencing their activities. Credit institutions that have been authorised are able to provide services, either on a cross-border basis or by establishing a branch, to clients in another member state, provided that such activities are within the scope of their regulatory permissions.
- 3.32 However, the CRD does not enable third-country banks to provide services on a cross-border basis to EU clients. Whilst it does provide for equivalence determinations to be made in limited circumstances (namely in relation to: (i) the prudential treatment of certain types of exposures to entities located in third countries; and (ii) for the purposes of third-country consolidated supervision), an equivalence determination for the purpose of the CRD does not give third-country banks access to EU markets.
- 3.33 Once the UK ceases to be a member of the EU, a finding of equivalence would therefore not adequately compensate for the loss of passporting rights under the CRD. Instead, the ability of UK banks to continue to provide services to EU clients on a cross-border basis will depend on member states' local law. The default position under the CRD is that UK banks will need to establish separately authorised branches or subsidiaries in the EU in order to continue to service EU clients following Brexit. If a UK bank established an authorised EU branch, this would not enable it to provide banking services on a cross-border basis into other member states.

#### **The Mortgage Credit Directive (“the MCD”)**

- 3.34 The MCD introduces a supervisory regime for credit intermediaries and appointed representatives. In addition, it provides an EU framework of conduct rules for mortgage firms.
- 3.35 It does not, however, contain a general passporting right or third-country access regime, other than in relation to credit intermediaries, which are able to provide services throughout the EU either on a cross-border basis or by establishing branches. On that basis, firms that are not exempt from the MCD and lend in a way that would constitute a regulated mortgage contract in a member state would need to obtain a licence in order to provide such services on a cross-border basis.

- 3.36 The MCD authorisation regime does not cover credit institutions, and UK banks are currently able to provide mortgages within the scope of their CRD permissions to EU clients in reliance upon the CRD passport (described above). Following Brexit, this right will be lost and it will be necessary to consider the relevant member state's local law in order to determine if firms can continue to service EU clients in this way.

### **The Payment Services Directive (“the PSD”)**

- 3.37 The PSD provides an EU-wide legal framework for the provision of payment services and enables non-bank payment service providers to passport the provision of payment services. There is no existing third-country regime and this position will not change once the Second Payment Services Directive comes into force in 2018.
- 3.38 To provide payment services within the EU, a firm that is not a credit institution must therefore be authorised as a payment services provider and be established in a member state. Whilst there is some uncertainty over how the PSD applies to third-country firms, the general assumption is that once the UK ceases to be a member of the EU, payment services providers established in the UK will no longer be able to provide services on a cross-border basis to EU clients under the PSD. Further, the UK's continued involvement in the single euro payments area (SEPA) post-Brexit would depend on the outcome of the UK-EU negotiations and require the UK to comply with the eligibility criteria for participation. Whilst there may be alternatives to SEPA that could be used to make euro payments to and from the UK, these may have practical (and cost) implications for customers and firms.
- 3.39 Payments UK published a detailed report on the likely impact of Brexit on the payments industry and the provision of payment services in February 2017. This report does not propose to replicate those findings.<sup>9</sup>

### **The Prospectus Directive**

- 3.40 In accordance with the Prospectus Directive, unless an exemption applies, member states cannot allow securities to be admitted to trading on a regulated market or any offer of securities to be made to the public within their territories without prior publication of a prospectus. A prospectus can only be published once it has been approved by the competent authority of the home member state.
- 3.41 In relation to issuers that are incorporated in a third country (eg the UK following Brexit), the competent authority of the firm's designated home member state<sup>10</sup> may approve a prospectus for an offer to the public or for admission to trading on a regulated market. Once the prospectus has been approved, it can be used throughout the EU.

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<sup>9</sup> <https://www.paymentsuk.org.uk/sites/default/files/The%20UK%20e2%80%99s%20exit%20from%20the%20EU%20-%20How%20could%20payments%20be%20affected.pdf>

<sup>10</sup> “Home member state” means:

- (i) for all Community issuers of securities that are not mentioned in (ii), the member state where the issuer has its registered office;
- (ii) for any issues of non-equity securities whose denomination per unit amounts to at least €1 000, and for any issues of non-equity securities giving the right to acquire any transferable securities or to receive a cash amount, as a consequence of their being converted or the rights conferred by them being exercised, provided that the issuer of the non-equity securities is not the issuer of the underlying securities or an entity belonging to the group of the latter issuer, the member state where the issuer has its registered office, or where the securities were or are to be admitted to trading on a regulated market or where the securities are offered to the public, at the choice of the issuer, the offeror or the person asking for admission, as the case may be. The same regime shall be applicable to non-equity securities in a currency other than the euro, provided that the value of such minimum denomination is nearly equivalent to €1 000; or
- (iii) for all issuers of securities incorporated in a third country that are not mentioned in (ii), the member state where the securities are intended to be offered to the public for the first time after the date of entry into force of the Prospectus Directive or where the first application for admission to trading on a regulated market is made, at the choice of the issuer, the offeror or the person asking for admission, as the case may be, subject to a subsequent election by issuers incorporated in a third country if the home member state was not determined by their choice.

- 3.42 Following Brexit, approval by UK authorities will no longer be sufficient to enable a prospectus in respect of a UK issuer to be used throughout the EU. UK firms seeking to offer securities in the EU will need to have their prospectuses approved by an EU competent authority.

### **The Solvency II Directive (“Solvency II”)**

- 3.43 In accordance with Solvency II, the taking-up of the business of direct insurance or reinsurance is subject to prior authorisation.
- 3.44 Solvency II provides for equivalence determinations to be made in relation to: (i) the application of group solvency requirements;<sup>11</sup> (ii) group supervision;<sup>12</sup> and (iii) reinsurance provided by a third-country reinsurer. Solvency II does not establish a general third-country regime otherwise enabling third-country insurers and reinsurers to provide services on a cross-border basis. Instead, third-country insurance undertakings are required to apply to the relevant member state for authorisation and to meet specified requirements, including the requirement to establish a branch in the member state where the authorisation is sought. Member states may allow third-country reinsurers to carry on business in their territory, subject to the provisions on equivalence mentioned below and to the overall requirement that third-country reinsurers cannot be treated more favourably than reinsurers with their head office in the member state.
- 3.45 Solvency II also provides that where the reinsurance regime of a third country is deemed to be equivalent to that laid down in Solvency II, reinsurance contracts concluded with undertakings having their head office in that country shall be treated in the same manner as reinsurance contracts concluded with undertakings authorised in accordance with Solvency II. However, equivalence does not guarantee third-country reinsurers access to EU markets – that would depend on the position taken by each member state.

### **The Insurance Mediation Directive (IMD) and the Insurance Distribution Directive (IDD)**

- 3.46 The IMD currently governs the authorisation and organisation (ie relating to systems and controls, regulatory capital, client assets and approved persons) of firms carrying on insurance mediation as well as regulating the way that such firms communicate with clients, issue financial promotions, handle claims, and advise on, sell and cancel products.
- 3.47 The IMD will be replaced by the IDD with effect from February 2018. The IDD will apply to various persons and institutions that distribute insurance products and will require (amongst other things) insurance, reinsurance, and ancillary insurance intermediaries to be registered with a competent authority in their home member state.
- 3.48 Neither the IMD nor the IDD provides a third-country regime for insurance mediation activities. Instead, the IDD contains an explicit provision stating that it does not affect member states’ law in respect of insurance and reinsurance distribution activities pursued by insurance and reinsurance undertakings or intermediaries established in a third country and operating in the relevant territory under the principle of freedom to provide services, so long as equal treatment is guaranteed to all persons carrying out or authorised to carry out insurance and reinsurance distribution activities in the relevant EU market.

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<sup>11</sup> European Economic Area (EEA) groups with third-country subsidiaries are able to apply local capital requirements for their subsidiaries located in a third country, instead of the Solvency II requirements.

<sup>12</sup> EEA firms with parents situated in a third country may rely on the group supervision conducted by regulators in that jurisdiction.

- 3.49 Therefore, any cross-border marketing activities by third-country firms are currently (and will be in future) subject to member state local law.

### **The UCITS Directive**

- 3.50 The UCITS Directive aims to harmonise rules regulating the authorisation, supervision, structure and activities of funds established or domiciled in member states as well as in relation to the information provided to retail investors. For the purposes of this report, only the position of UK UCITS managers and the impact of Brexit on their activities have been considered:

- (a) fund management is defined as the activity of the overall management of the relevant fund:
  - (i) UK-domiciled former UCITS: in order to be classified as a UCITS, a fund must be established in the EU and managed by an EU management company. There is no third-country regime available. If the UCITS remains UK domiciled following Brexit, the fund would no longer be categorised as a UCITS but instead would be an AIF under the AIFMD (termed a “UK-domiciled former UCITS” for these purposes). A UK manager would be able to continue to manage a UK-domiciled former UCITS following Brexit; and
  - (ii) EU-domiciled UCITS: an EU-domiciled UCITS must be managed by an EU management company so, following Brexit, could not be managed by a UK manager ;
- (b) marketing:
  - (i) UK-domiciled former UCITS: the marketing passport otherwise available in relation to an EU UCITS would cease to be available to a UK-domiciled former UCITS following Brexit. Since a UK-domiciled former UCITS will be categorised as an AIF, marketing will be governed by the rules under the AIFMD. Consequently, such funds could only be marketed into the EU either: (i) in accordance with a third-country passport granted under the AIFMD; or (ii) under national private placement regimes; and
  - (ii) EU-domiciled UCITS: an EU-domiciled UCITS must be marketed by an EU management company so, following Brexit, could not be marketed by a UK manager ; and
- (c) depositary activities:
  - (i) UK-domiciled former UCITS: a UK-domiciled former UCITS should be able to continue to use a UK depositary following Brexit but whether it can use EU depositaries will depend on the UK regime that is put in place; and
  - (ii) EU-domiciled UCITS: a EU-domiciled UCITS depositary must be established within the EU (in the same member state as the relevant fund), and be a central bank, a credit institution or another legal entity authorised by the competent authority of the relevant member state to carry out depositary activities. Accordingly, an EU-domiciled UCITS could not appoint a UK depositary. However, at present, an EU depositary may delegate custody services to a custodian (including one that is based in a third country) provided that certain conditions are met. The third party may in turn sub-delegate those functions subject to the same requirements. The acceptance of delegation structures of this nature is subject to regulatory discretion.



- 3.51 The UCITS Directive contains a delegation regime whereby companies managing an EU-domiciled UCITS are able to delegate certain functions, including the provision of MiFID portfolio management (ie the management of individual portfolios, described in the section on the management of segregated portfolios above) to third parties (including those based in third countries). This should enable EU UCITS management companies to delegate portfolio management of a UCITS to a UK-based portfolio manager, but may be subject to regulatory acceptance of such models in the future.

## The AIFMD

- 3.52 The AIFMD provides a framework that enables EU AIF managers (AIFMs) to market UK and EU AIFs in the EU. For the purposes of this report, only the role of UK AIFMs and the impact of Brexit on their activities have been considered:

- (a) fund management is defined as the activity of the overall management of the relevant fund:
  - (i) AIFs may be internally or externally managed depending on their legal form. In accordance with AIFMD, all AIFMs are required to be authorised to manage AIFs;
  - (ii) UK AIFs: UK AIFMs would be able to continue to manage UK AIFs following Brexit;
  - (iii) EU AIFs: UK AIFMs would only be able to manage EU AIFs following Brexit if they were authorised by the competent authority of their member state of reference<sup>13</sup> or otherwise in accordance with member state local law;
- (b) marketing and distribution:
  - (i) UK AIFs: the AIFMD marketing passport would cease to be available to UK AIFs following Brexit and these funds could only be marketed into the EU either: (i) in accordance with a third-country passport granted under the AIFMD; or (ii) under national private placement regimes. Despite ESMA being able to bring the AIFMD third-country passport into effect for a number of years, it has not yet done so. In addition, some member states have not implemented national private placement regimes, and the approach taken by others is very restrictive. In circumstances where a

<sup>13</sup> The member state of reference for a non-EU AIFM is determined in accordance with Article 37(4) of the AIFMD as follows:

- (a) if the non-EU AIFM intends to manage only one EU AIF, or several EU AIFs established in the same member state, and does not intend to market any AIF in the EU, the home member state of that or those AIFs is deemed to be the member state of reference and the competent authorities of this member state will be competent for the authorisation procedure and or the supervision of the AIFM;
- (b) if the non-EU AIFM intends to manage several EU AIFs established in different member states and does not intend to market any AIF in the EU, the member state of reference is either: (i) the member state where most of the AIFs are established; or (ii) the member state where the largest amount of assets is being managed;
- (c) if the non-EU AIFM intends to market only one EU AIF in only one member state, the member state of reference is determined as follows: (i) if the AIF is authorised or registered in a member state, the home member state of the AIF or the member state where the AIFM intends to market the AIF; (ii) if the AIF is not authorised or registered in a member state, the member state where the AIFM intends to market the AIF;
- (d) if the non-EU AIFM intends to market only one non-EU AIF in only one member state, the member state of reference is that member state;
- (e) if the non-EU AIFM intends to market only one EU AIF, but in different Member States, the Member State of reference is determined as follows: (i) if the AIF is authorised or registered in a Member State, the home Member State of the AIF or one of the Member States where the AIFM intends to develop effective marketing; or (ii) if the AIF is not authorised or registered in a Member State, one of the Member States where the AIFM intends to develop effective marketing;
- (f) if the non-EU AIFM intends to market only one non-EU AIF, but in different Member States, the Member State of reference is one of those Member States;
- (g) if the non-EU AIFM intends to market several EU AIFs in the EU, the Member State of reference is determined as follows: (i) in so far as those AIFs are all registered or authorised in the same Member State, the home Member State of those AIFs or the Member State where the AIFM intends to develop effective marketing for most of those AIFs; (ii) in so far as those AIFs are not all registered or authorised in the same Member State, the Member State where the AIFM intends to develop effective marketing for most of those AIFs; and
- (h) if the non-EU AIFM intends to market several EU and non-EU AIFs, or several non-EU AIFs in the EU, the Member State of reference is the Member State where it intends to develop effective marketing for most of those AIFs.

non-EU (ie a UK) AIFM seeks to market a UK AIF in a member state without a passport, appropriate co-operation agreements must be in place between the competent authority of the member state where the AIF is to be marketed and the relevant UK competent authority. However, the UK must not be listed as a non-co-operative country and territory by the Financial Action Task Force;

- (ii) EU AIFs: assuming that no third-country passport is available and that a UK manager would not seek to be authorised in the EU, the extent to which it would be possible for a UK manager to market an EU AIF that it manages in the EU following Brexit will be subject to the same conditions as in (i) above, save that the competent authority of the member state where the EU AIF is located must also have entered into a co-operation agreement with the UK; and

(c) depositary activities:

- (i) UK AIFs: the depositary of a non-EU AIF must be established: (i) in the third country where the AIF is established; (ii) in the home member state of the AIFM managing the AIF; or (iii) in the member state of reference (ie the EU member state which is treated as the AIFM's home member state)<sup>14</sup> of the AIFM managing the AIF. For a UK manager managing a UK AIF, the depositary must either be established in the AIFM's member state of reference or in the UK (being the third country in which the AIF is established) and certain conditions must be satisfied; and
- (ii) EU AIFs: the depositary of an EU AIF must have its registered office or a branch in the AIF's home member state (being the member state where the AIF was first authorised or registered or, if it is not authorised or registered, where it has its registered office or head office). It would not be possible for a UK depositary to provide services in relation to an EU AIF following Brexit. However, at present, it is possible for an EU depositary to delegate its safekeeping functions to a third-party custodian, provided that the tasks are not delegated with the intention of avoiding the requirements of the AIFMD, it can demonstrate that there is an objective reason for the delegation and it has exercised all due skill, care and diligence in the selection, appointment and ongoing monitoring of any third party to whom it has delegated parts of its tasks and of the arrangements of the third party in respect of the matters delegated to it, and it ensures that the third party meets the specified conditions at all times. The acceptance of delegation structures of this nature relies upon regulatory discretion.

3.53 The AIFMD contains a delegation regime whereby an EU AIFM would be able to delegate certain functions, including the provision of MiFID portfolio management (ie the management of individual portfolios, described in the section on the management of segregated portfolios above) to third parties (including those based in third countries). This should enable EU AIFs to delegate portfolio management of EU AIFs to a UK manager, but may be subject to regulatory acceptance of such models in the future.

3.54 The analysis of the impact of Brexit on fund management activities in this report has been limited to AIFs and UCITS. Other types of funds, such as European long-term investment funds (which are

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<sup>14</sup> See preceding footnote.

required to be authorised as AIFs in the EU and managed by EU AIFMs) and European venture capital funds, have not been considered.

### **The European Market Infrastructure Regulation (EMIR)**

- 3.55 EMIR imposes a clearing obligation for “eligible” OTC derivatives (ie contracts that fall within the scope of pre-defined eligibility criteria, such as certain levels of standardisation and liquidity) to be cleared through CCPs. This obligation can be satisfied by using an authorised EU CCP or a third-country CCP that has been recognised by ESMA.
- 3.56 Recognition of a third-country CCP requires: (i) the Commission to adopt an implementing act determining that the legal and supervisory arrangements of a third country ensure that CCPs authorised in that jurisdiction comply with legally binding requirements equivalent to the requirements laid down in EMIR, and that those CCPs are subject to effective supervision and enforcement in that third country on an ongoing basis; (ii) the CCP to be authorised in the relevant third country and be subject to effective supervision and enforcement ensuring full compliance with applicable prudential requirements in that third country; (iii) ESMA to establish co-operation arrangements with the relevant competent authorities of the third country; and (iv) the third country to be considered to have systems for combatting money laundering and the financing of terrorism that are equivalent to those in the EU.
- 3.57 A determination that the UK regime is equivalent and the consequent recognition of a UK CCP also has the following effects:
- (a) a UK or EU firm will be able to satisfy the relevant EMIR clearing obligation by clearing through a recognised UK CCP; and
  - (b) the capital requirements for derivative trades cleared through a qualifying CCP (ie a CCP that has been recognised by ESMA) are significantly less onerous than for trades cleared through non-qualifying CCPs.
- 3.58 UK firms also rely on the ability to access EU CCPs. Access to EU CCPs for third-country firms is not guaranteed and is subject to the membership requirements of the individual EU CCP, as well as regulatory approach.

#### *Trade repositories*

- 3.59 In accordance with EMIR, counterparties to derivative contracts and CCPs are required to report details of relevant arrangements to a trade repository. The general requirement is that trade repositories must be registered by ESMA.
- 3.60 A third-country trade repository can provide services in the EU provided it has been recognised by ESMA, the conditions being: (i) the Commission has adopted an implementing act determining that the legal and supervisory arrangements of a third country ensures that trade repositories authorised in that third country comply with legally binding requirements, which are equivalent to those laid down in EMIR; (ii) effective supervision and enforcement of trade repositories takes place in that third country on an ongoing basis; and (iii) guarantees of professional secrecy exist, including the protection of business secrets shared with third parties by the authorities, and they are at least equivalent to those set out in EMIR.

## **The CSD Regulation**

- 3.61 Third-country CSDs may provide services within the EU either on a cross-border basis (if they have been recognised by ESMA) or by setting up a local branch. In order to be recognised, a number of conditions must be satisfied, including that the Commission has made a determination that the third-country CSD is subject to effective authorisation, supervision and oversight.
- 3.62 In the absence of an equivalence determination, UK CSDs may be able to establish links with EU CSDs as account holders in each other's systems. This would enable clients of the UK CSD to access securities maintained in the EU CSD without requiring those clients to be direct participants. The use of such arrangements would depend on the way that the EU CSD currently settles securities and may not provide a business-as-usual solution.

## **The CRA Regulation**

- 3.63 The starting point under the CRA Regulation is that EU financial institutions may only use credit ratings for regulatory purposes if they are issued by CRAs established in the EU and registered with ESMA.
- 3.64 The CRA Regulation permits ratings from third-country CRAs to be used if either:
- (a) the issuing CRA is certified by ESMA; or
  - (b) the third-country rating has been endorsed by a CRA established in the EU.
- 3.65 Certification by ESMA enables credit ratings issued by a third-country CRA, and which relate to entities established or financial instruments issued in third countries, to be used for regulatory purposes in the EU, provided that the credit ratings are not systemically important for the financial stability or integrity of the financial markets of one or more member states.
- 3.66 In order for a certification based on equivalence to be granted, a number of conditions must be satisfied, including that: (i) the CRA is authorised or registered, and is subject to supervision, in a third country; (ii) the Commission has adopted an equivalence decision in relation to that third country recognising its legal and supervisory framework to be equivalent to the requirements of the CRA Regulation; (iii) a co-operation agreement is in place between ESMA and the relevant third-country authority; and (iv) the credit ratings issued by the third-country CRA and its credit rating activities are not of "systemic importance" to the financial stability or integrity of the financial markets of one or more member states.
- 3.67 As an alternative, ratings produced by third-country CRAs may be used if they have been endorsed by an EU CRA. In order for a third-country rating to be endorsed, a number of conditions must be satisfied including that: (i) the credit rating activities resulting in the issuing of the credit rating to be endorsed are undertaken in whole or in part by the endorsing CRA or by CRAs belonging to the same group; (ii) the third-country CRA complies with third-country requirements that are "at least as stringent" as the requirements under the CRA Regulation (a determination that will be made by ESMA); and (iii) there is an "objective reason" for the credit rating to be "elaborated" in a third country. Once a credit rating has been endorsed, it is considered to be a credit rating issued by a CRA established in the EU and registered in accordance with the CRA Regulation. The EU CRA that has endorsed the third-country CRA will be fully responsible for it as well as for the fulfilment of relevant conditions. Given the conditions that need to be satisfied in order for a third-country rating to be



endorsed, equivalence alone would not enable all ratings produced in third countries to be used in the EU following Brexit.

- 3.68 As the UK does not currently have its own authorisation or supervision regime for CRAs, it would need to put in place a suitable framework in order to be deemed equivalent or “at least as stringent”.

### **The Benchmarks Regulation**

- 3.69 The Benchmarks Regulation establishes that a benchmark or a combination of benchmarks provided by an administrator located in a third country may be used in the EU if:
- (a) the benchmark and the administrator are included in ESMA’s register, which requires that the administrator be authorised or registered under an equivalent third-country regime (as determined by the Commission);
  - (b) the administrator is recognised by member state authorities pending an equivalence decision; or
  - (c) the benchmark is endorsed by an EU administrator.
- 3.70 In order to endorse a benchmark or a family of benchmarks for use in the EU, the EU administrator (or any other supervised EU entity that monitors the provision of a benchmark) must apply to the relevant competent authority and certain conditions must be satisfied, including that the firm has the necessary expertise to monitor effectively the activity of the provision of a benchmark in a third country, can manage the associated risks and there is an objective reason both for providing the benchmark in a third country and for its use in the EU.
- 3.71 An endorsed benchmark or an endorsed family of benchmarks will be considered to be a benchmark or family of benchmarks provided by the endorsing administrator or other supervised entity, and the EU entity will be fully responsible for it as well as for the third-country firm’s compliance with relevant obligations.

### **Data transfer**

- 3.72 By the time that the UK exits the EU, the General Data Protection Regulation (GDPR), which applies from May 2018, will need to be considered. The GDPR will impose similar restrictions on the ability of firms to transfer personal data outside the EU to those contained in the current Data Protection Directive. Personal data may only be transferred to a third country if:
- (a) the Commission has issued an adequacy decision stating that the third country ensures a level of protection for personal data essentially equivalent to that within the EU;
  - (b) appropriate safeguards are in place, for example binding corporate rules or model clauses; or
  - (c) one of the derogations has been met (for example, the customer has explicitly consented to their data being transferred having been informed of the risks of the transfer, the transfer is necessary to perform a contract with the individual, there are important public interest grounds or the transfer is needed for the establishment, exercise or defence of legal claims).
- 3.73 There will be significant penalties under the GDPR for firms that fail to comply with relevant requirements or conditions for international data transfers. The most serious breaches could attract fines of up to €20m or 4 per cent of a firm’s total worldwide turnover, whichever is greater.

**Regulatory co-operation**

- 3.74 In addition to the legal rights described above, the ability of UK firms to continue to access EU markets also relies upon regulatory will and co-operation between regulators in the EU and the UK. Whilst outside the scope of this report, this is an area that will need to be considered and assessed.

## 4. Analysis of the Brexit scenarios

### *Scenario 1: Full equivalence and passporting*

- 4.1 Although securing an outcome based on scenario 1 (ie full equivalence and the continuation of passporting) would minimise the negative impact of Brexit on the UK financial services sector, for the reasons explained in paragraph 1.9 above, it is not considered further in this report. Additionally, the option for full equivalence and passporting would likely require acceptance of other aspects of the single market framework that, based on various statements made by the Prime Minister and other members of the UK Government prior to the publication of this report, would be politically unacceptable in the UK, such as the free movement of people and the continued jurisdiction of the Court of Justice of the European Union (CJEU).

### *Scenario 2: Equivalence where the provision already exists but no additional access rights granted*

- 4.2 Once the UK ceases to be a member of the EU, it would become a third country for the purposes of EU legislation.
- 4.3 Under this scenario, where a third-country regime is available, it is assumed that the Commission would make a determination, in anticipation of Brexit, that the relevant UK regime is equivalent to the corresponding EU regime so that UK firms will benefit from rights conferred on third-country firms.
- 4.4 In reality, it is considered unlikely that equivalence determinations across all single market directives will all be made before March 2019 (ie two years after Article 50 was triggered). On that basis, firms are considering structuring solutions to enable them to mitigate the loss of access rights.

### **Impact of the UK becoming a third country**

- 4.5 The extent to which firms may be able to continue to access EU markets following Brexit depends on the activities being performed and the legislative framework that governs those activities. As described in chapter 2, some pieces of EU legislation provide a framework for third-country firms to access EU markets without needing to be separately authorised, an essential element of which is an assessment of equivalence. Others have a regime that has a more limited scope and does not establish access rights for third-country firms.
- 4.6 Full third-country access regimes are limited in scope and only cover:
- (a) investment services, trade repository services and operating a trading venue under MiFID 2;
  - (b) clearing services performed by CCPs under EMIR;
  - (c) services provided by CSDs under the CSD Regulation;
  - (d) ratings issued by non-EU CRAs certified under the CRA Regulation or endorsed by an EU CRA in the same group; and
  - (e) benchmarks provided under the Benchmarks Regulation.
- 4.7 An assessment of equivalence could also confer benefits in areas other than access rights, for example:
- (a) EU firms and counterparties would be able to meet their obligation to trade shares and derivatives on a trading venue by trading on a UK trading venue;

- (b) EU firms would be able to meet their obligation to clear certain derivatives through a CCP by clearing through a UK CCP;
  - (c) EU firms would be able to use ratings that were either issued by a certified UK CRA or endorsed by an EU CRA; and
  - (d) EU insurers could continue to treat reinsurance purchased from a UK reinsurer in the same way as reinsurance purchased from an EU reinsurer.
- 4.8 In practice, even where full third-country access is available, the extent to which firms feel able to place reliance on such regimes in structuring and organising their business in response to Brexit may be limited for the reasons described in paragraph 3.10 above.
- 4.9 Limited third-country access regimes are available for:
  - (a) managing and marketing UCITS under the UCITS Directive; and
  - (b) managing and marketing UK and EU AIFs under AIFMD (although the third-country passporting regime has not yet been “switched on”).
- 4.10 No third-country access regimes are available for:
  - (a) prospectuses under the Prospectus Directive;
  - (b) deposit-taking or lending under the CRD;
  - (c) mortgage-lending under the MCD;
  - (d) payment services under PSD;
  - (e) insurance under Solvency II; and
  - (f) insurance mediation under the IMD.
- 4.11 Third-country reinsurers have access to most EU member states on a cross-border basis and whilst some member states do have regulatory restrictions, these do not apply where the reinsurer is located in a jurisdiction with an equivalent regime. This will require a case-by-case analysis of the law in each member state into which services are to be provided. In addition, third-country insurers may be able to write some classes of insurance business on a cross-border basis depending on local law.

### ***Scenario 3: Third-country agreement***

- 4.12 Scenario 3 assumes that no equivalence determination is made, that the UK would become a third country and that no new access arrangements would be negotiated.
- 4.13 When considering the continued ability of UK firms to provide services on a cross-border basis, the activities and law in each member state where they wish to provide services will need to be considered on a case-by-case basis, primarily to determine if the relevant activity is regulated and requires a licence or other permission. The question of where a service is deemed to be provided is a complicated area and varies between member states. This question has not been considered in this report.
- 4.14 If performance of the activity does not require a licence, it may be possible for a UK firm to continue to provide services on a cross-border basis following Brexit. However, where a licence is required, alternative steps may need to be taken to ensure continuity of service. These may include establishing



EU subsidiaries or branches that are authorised or otherwise permitted to service EU clients and reorganising businesses to ensure that no regulated activities are provided on a cross-border basis from the UK.

## **5. Business line analysis**

- 5.1 This chapter assesses the impact of Brexit across the identified business lines in scenarios 2 and 3.
- 5.2 In scenario 2, it is assumed that an equivalence determination is made and that all relevant conditions required for equivalence are satisfied.
- 5.3 In scenario 3, absent an equivalence determination, member states may still be able to provide some access to third-country firms under local law. However, this report does not assume that member states will permit third-country firms to carry on activities or provide services on a cross-border basis other than in accordance with existing or prospective regimes under the single market directives. Whether firms are permitted to provide services on a cross-border basis will depend on the individual regimes in member states so will need to be considered on a case-by-case basis, an issue that is outside the scope of this report.
- 5.4 Further, whilst it may be possible for firms to rely on reverse solicitation exemptions under local law in order to perform activities, the assumption is that this would not enable services to be provided on a business-as-usual basis given that the approach varies between member states. It is not considered further in this report.
- 5.5 In most cases (except where an alternative description is provided for a particular business line), the term “back office” is used to describe activities that are not considered to be client-facing, primarily consisting of support functions, for example, record-keeping, IT, operations, HR, internal audit and accounting, and compliance. Although it is generally anticipated that some back-office services will follow the flow of business (ie if front-office activities move to the EU, so will back office ), this may not always be the case and will depend on individual firm structures. Whilst in certain circumstances back-office activities are colour coded green, indicating that it would be technically possible to perform such activities from the UK in relation to EU business after Brexit, it may not be practically or operationally viable to do so and so the actual impact may be “red”.
- 5.6 Appendix 1 summarises the impact of scenarios 2 and 3 on the business lines considered in paragraphs 5.8 to 5.74 below using a traffic light signalling (ie red, amber and green) to indicate a high, medium and low impact respectively. Both scenarios 2 and 3 have the potential for causing dislocation and therefore, whilst amber may be used, the actual impact will depend on the individual firm and the way that its business is organised. In addition, whilst the use of “amber” may suggest that it may be possible for UK firms to continue to service EU clients on a cross-border basis following Brexit (on the basis of local member state licensing or exemption regimes), this will need to be considered on a jurisdiction-by-jurisdiction basis. In jurisdictions where this is not the case, it would no longer be possible for UK firms to provide services on a cross-border basis and therefore “amber” may instead be “red”.
- 5.7 It is also necessary to consider this analysis against the backdrop of regulatory appetite. Although there have been recent indications from EU regulators that they will not accept empty “shell” companies in the EU, and that all entities in the euro area must have adequate local risk management, sufficient local staff and operational independence, this will need to be considered over the course of the negotiations and tested against individual firm structures and contingency plans.<sup>15</sup>

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<sup>15</sup> Introductory statement by Sabine Lautenschläger, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB, at the AFME Board Meeting in Frankfurt, 22 March 2017

### ***Debt capital markets (including marketing new issues and block trades)***

- 5.8 For this purpose, only the ability of UK firms to continue to service EU institutional clients has been considered. The analysis for retail clients is set out in the section on private wealth management below.
- 5.9 Debt capital markets activities primarily involve underwriting and placing, but may also include the reception and transmission of orders. There are a number of pieces of EU legislation governing different activities that are likely to be relevant, including MiFID 2, the Prospectus Directive and the CRD.
- 5.10 For the purpose of this analysis, debt capital markets activities have been sub-divided as follows:
- (a) client-facing and sales consisting of origination (ie the part of the business with the issuer relationship) and the marketing of underwriting and distribution services;
  - (b) execution consisting of:
    - (i) syndication;
    - (ii) underwriting and placing; and
    - (iii) distribution (ie the sale of debt to the market); and
  - (c) back office consisting of:
    - (i) administration; and
    - (ii) documentation.
- 5.11 For all activities, a finding of equivalence may enable UK firms to continue to service EU per se professional clients and eligible counterparties on a cross-border basis (shown in green for scenario 2).
- 5.12 In scenario 3, where no equivalence determination is made, client-facing and execution services could no longer be provided from the UK in accordance with the EU third-country access regime under MiFID 2 and it would be necessary to consider local law in the relevant member state (shown in amber).
- 5.13 It may be possible to continue to carry on back office activities from the UK after Brexit and for that reason green has been used in both scenarios 2 and 3.

### ***Equity capital markets (including marketing new issues and block trades)***

- 5.14 See the analysis provided in relation to debt capital markets activities above, which also applies to equity capital market activities.

### ***Sales and trading (including secondary market loan trading) in relation to MiFID 2 financial instruments***

- 5.15 For this purpose, only the ability of UK firms to continue to service EU institutional clients has been considered.

- 5.16 “Sales and trading” refers to the various activities relating to buying and selling securities or other financial instruments, both in a firm’s proprietary capacity and on behalf of its clients. For the purpose of this analysis, sales and trading activities have been sub-divided as follows:
- (a) client-facing and sales activities;
  - (b) execution consisting of:
    - (i) execution of transactions; and
    - (ii) acting as a clearing member;
  - (c) risk management (ie the way that the firm manages its own risk exposure) consisting of pricing/hedging; and
  - (d) back-office activities.
- 5.17 In scenario 2, assuming that the relevant financial instruments fall within scope of MiFID 2, it will be possible for UK firms to continue to provide such services to per se professional clients and eligible counterparties in the EU, and so all activities are colour coded green.
- 5.18 In scenario 3, client-facing sales activities and the activity of executing transactions is colour coded amber on the basis that it would no longer be possible to provide such services in accordance with the MiFID 2 third-country access regime, and it would be necessary to consider local law in the relevant member state. Acting as a clearing member has also been colour coded amber on the basis that UK firms’ access to EU CCPs is not guaranteed and is subject to the membership rules of the relevant CCP.
- 5.19 In scenario 3, it may be possible to conduct some risk mitigation activities in the UK and as such they have also been colour coded amber.
- 5.20 Whilst back-office activities may not be impacted by Brexit (and are colour coded green in scenarios 2 and 3), as noted above it may no longer be viable from a practical perspective for such activities to be performed in the UK if a decision is made to move the rest of the business to Europe.

### ***M&A and corporate finance advisory***

- 5.21 M&A advisory business primarily involves advising on public and private M&A transactions (buy and sell side) as follows:
- (a) evaluating potential targets or merger partners;
  - (b) providing valuation analyses;
  - (c) advising on strategy, timing, structure, financing and pricing; and
  - (d) assisting in negotiating and closing transactions.
- 5.22 Corporate finance advisory deals with the sources of funding and capital structure of firms, and involves risk management, capitalisation and budgeting. It may involve the following activities:
- (a) structuring of management buy-outs/buy-ins;
  - (b) project-managing disposals;
  - (c) advising businesses on their fundraising requirements;

- (d) succession planning;
- (e) development capital; and
- (f) refinancing.

- 5.23 The impact of Brexit on M&A and corporate finance advisory activities will depend on whether or not they are provided on a standalone basis or are ancillary to MiFID 2 investment services/activities (ie within scope of the ancillary activity of “advising undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings”). It is assumed for the purposes of this report that such activities would not constitute the “core” activity of investment advice under MiFID 2. However, if activities did involve the reception and transmission of orders, as a core investment service/activity under MiFID 2 it would only be possible to provide these services to EU clients in scenario 2 in accordance with the MiFID 2 third-country access regime.
- 5.24 If such advisory activities instead constituted an ancillary service for the purpose of MiFID 2, it would be necessary to consider the local law across different member states as the MiFID 2 third-country access regime would not be available. There is an inconsistent approach in this regard and, whilst in some jurisdictions these activities are not regulated and therefore could be provided freely (including on a cross-border basis), in others they may be subject to authorisation requirements and/or other restrictions.
- 5.25 Given the above and the need to consider member states’ local law, client-facing, sales and advisory activities are colour coded amber in both scenarios 2 and 3. As described above, it may be possible to continue to provide back-office services from the UK following Brexit, shown in green.

### **Research**

- 5.26 The provision of investment research is an ancillary service under MiFID 2. Assuming that it is provided alongside a MiFID 2 investment service/activity, a UK firm would be able to provide research to eligible counterparties and per se professional clients in the EU following Brexit provided the UK is deemed equivalent, shown in green in scenario 2 for all activities. Although not considered in the summary table, it would not be possible to provide investment research to retail clients in accordance with the MiFID 2 third-country access regime, and it would instead be necessary to consider member states’ local law. If a colour had been used for this scenario, it would have been amber.
- 5.27 As described above, if investment research is not provided on an ancillary basis to MiFID 2 investment services/activities or alternatively where the UK regime is not deemed to be equivalent, it would be necessary to consider local law in relevant member states as firms would not be able to rely on the MiFID 2 third-country access regime. For these reasons, client-facing and sales activities are colour coded amber in scenario 3.
- 5.28 Similar to the analysis set out above in relation to other services, it may be possible to continue to perform back-office activities from the UK even where no equivalence determination is made, shown in green for both scenarios 2 and 3.

### **Pure commercial (non-consumer) lending (trade finance, finance lending and receivables financing) and pure consumer (ie retail) lending (including credit cards)**

- 5.29 For the purpose of this analysis, lending activities have been sub-divided as follows:



- (a) client-facing and sales consisting of:
  - (i) origination; and
  - (ii) marketing;
- (b) execution consisting of:
  - (i) evaluation;
  - (ii) approval; and
  - (iii) closing;
- (c) risk management consisting of credit assessment; and
- (d) back-office activities consisting of loan and asset servicing.

5.30 Lending may be carried out either as an ancillary activity under MiFID 2 (namely “granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm granting the credit or loan is involved in the transaction”) or, more commonly, on a standalone (ie “pure”) basis under the CRD.

5.31 As described in paragraph 3.32, the CRD does not establish an equivalence regime for third-country firms providing banking services. It would therefore be necessary to consider member state local law in both scenarios 2 and 3, shown in amber, to determine if it would be possible to lend to EU clients on a cross-border basis after Brexit. The approach may vary across member states and, for example, pure commercial lending is not currently regulated in the UK (unlike in some other member states).

5.32 If, instead, lending was carried out on an ancillary basis to MiFID 2 investment activities, it may be possible to continue to provide cross-border services to per se professional clients and eligible counterparties following Brexit, provided that the UK regime is deemed to be equivalent (ie in scenario 2). That would not, however, enable UK firms to lend to EU consumers (ie retail clients) on a cross-border basis, and such activities would require an assessment of member state local law.

### ***Mortgages***

5.33 For the purpose of this analysis, the activity of entering into regulated mortgage contracts has been sub-divided as follows:

- (a) client-facing and sales activities consisting of:
  - (i) origination; and
  - (ii) underwriting;
- (b) execution consisting of advancing loans;
- (c) risk management consisting of credit risk assessment; and
- (d) back-office activities consisting of processing.

5.34 Mortgage lending is governed either by the MCD (for non-banks) or the CRD (for credit institutions). As described in paragraphs 3.34 to 3.36 above, the MCD does not provide an access regime to EU markets for third-country firms other than in relation to credit intermediation activities (which are

not considered in detail for the purposes of this report). Lending by credit institutions is governed by the CRD (although the conduct provisions under the MCD also apply) and following Brexit, assuming that no new arrangements are negotiated, UK credit institutions will no longer be able to lend to EU clients on a cross-border basis in reliance upon the CRD passport. It will therefore be necessary to consider the local law in member states where borrowers are located in order to determine if mortgages can be provided on a cross-border basis. For this reason, activities in both scenarios 2 and 3 have been colour coded amber.

- 5.35 The bilateral discussions revealed that, as a result of the restrictions imposed by MCD on the ability of firms to lend cross-border to customers in one currency where that individual's earnings are in a different currency, there are in any event currently a low number of cross-border mortgages being provided in the EU. Consequently, the perception is that Brexit is likely to have less of an impact on such retail lending activities than on other parts of the UK financial services sector.

### ***Pure deposit-taking***

- 5.36 Deposit-taking (ie the activity of accepting and managing deposits from customers, in exchange for the payment of interest) is governed by the CRD.
- 5.37 As the CRD does not establish an equivalence or access regime for third-country firms providing banking services, the ability to provide such services on a cross-border basis from the UK after Brexit will depend on member state local law.
- 5.38 Given that, all activities are colour coded amber in both scenarios 2 and 3.

### ***Payment services***

- 5.39 As described in paragraphs 3.37 and 3.38 above, the PSD does not provide a framework for third-country firms to access EU markets. The assumption is that once the UK ceases to be a member of the EU, UK payment services providers will be unable to provide payment services on a cross-border basis.
- 5.40 Given that, the provision of payment services is colour coded red in both scenarios 2 and 3.

### ***Prime brokerage***

- 5.41 The provision of prime brokerage activities is governed by MiFID 2, AIFMD and EMIR. In relation to activities within scope of MiFID 2, the provision of such services on a cross-border basis from the UK following Brexit depends, at least in the first instance, on whether an equivalence determination is made. However, the precise impact of Brexit will depend on the nature of the prime broker's clients. There is no requirement under AIFMD for prime brokers, as delegates of depositaries, to be based in the EU.
- 5.42 As shown in Appendix 1, prime brokerage business can be broken down into the following activities:
- (a) client-facing and sales activities: scenario 2 has been colour coded green as, if an equivalence determination is made, it would be possible for client-facing and sales activities to be conducted from the UK in relation to EU per se professional clients and eligible counterparties. Scenario 3 has been colour coded amber because, if no equivalence determination is made, the MiFID 2 third-country access regime would no longer be available and it would be necessary to consider the local law in the relevant member state;

- (b) margin lending: in a prime brokerage context, margin lending would be considered an ancillary service for the purpose of MiFID 2. As such, it may be provided on a cross-border basis to eligible counterparties and per se professional clients in the EU after Brexit if an equivalence determination is made. Given this, scenario 2 has been colour coded green. If no equivalence determination is made, the ability to continue to provide such services on a cross-border basis would depend on member state local law, shown in amber for scenario 3. It would also be necessary to consider local law requirements in the relevant member states in both scenarios 2 and 3 if the activities are provided on a standalone basis and are not ancillary to MiFID 2 investment services/activities;
- (c) securities financing: this activity is governed by MiFID 2 and the provision of securities financing services on a cross-border basis by UK firms relies on the UK regime being equivalent (shown in green for scenario 2). If this is not the case (ie in scenario 3), the ability to provide services from the UK on a cross-border basis will depend on local law, shown in amber;
- (d) custody: safekeeping is an ancillary service under MiFID 2 and the impact of Brexit would therefore depend on whether services are provided on a standalone basis. Assuming in a prime brokerage context that activities are ancillary to a MiFID 2 investment service/activity, custody and safekeeping services could continue to be provided if the UK regime is deemed equivalent (shown in green for scenario 2). In the absence of an equivalence determination, it may be possible to continue to provide these services on a cross-border basis depending on member state local law (shown in amber for scenario 3);
- (e) acting as clearing member: UK prime brokers could be subject to the clearing obligation under EMIR if their activities have a “direct, substantial and foreseeable” effect in the EU. This requirement would need to be satisfied either by using an EU CCP or alternatively a UK CCP deemed equivalent for the purposes of EMIR. Whilst reliance on UK CCPs will be possible if an equivalence determination is made (shown in green for scenario 2), if there is no equivalence determination (ie in scenario 3), UK prime brokers would be required to fulfil the clearing obligation using EU CCPs. Individual CCPs are able to set their own membership criteria and, whilst it is anticipated that UK firms will continue to be members of EU CCPs, there is some uncertainty in this regard, shown in amber for scenario 3;
- (f) settlement: where an equivalence determination is made, UK prime brokers would be able to use UK CSDs (shown in green for scenario 2). If no equivalence determination is made, EU CSDs would need to be used. Whilst it may be possible for UK CSDs to mitigate the impact of Brexit by linking to EU CSDs to provide UK clients with indirect access to those CSDs, this is likely to require new arrangements to be put in place (shown in amber for scenario 3); and
- (g) risk management and back-office services can continue to be provided cross-border following Brexit and as such are colour coded green for both scenarios 2 and 3.

### ***Insurance: effecting and carrying out contracts of direct insurance***

5.43 For the purpose of this analysis, the activity of effecting and carrying out contracts of direct insurance has been sub-divided as follows:

- (a) client-facing and sales activities consisting of broking, intermediation and distribution activities carried out by intermediaries or by insurers directly;

- (b) execution consisting of:
  - (i) underwriting; and
  - (ii) contact between brokers and underwriters (in subscription markets); and
- (c) back-office activities, which may consist of claims-processing and policy-servicing activities.

- 5.44 As described in paragraph 3.44 above, Solvency II does not establish a general third-country regime for insurers to provide cross-border services and a determination of equivalence for the purposes of Solvency II would not give UK insurance firms access to EU markets. Consequently, all client-facing and execution activities are colour coded red in scenarios 2 and 3.
- 5.45 In relation to back-office activities, there are certain activities (eg data processing and storage) that are important to the provision of services to clients and may need to be moved to the EU in order that they sit in the same jurisdiction as the relevant customer. In relation to others (eg claims handling), the local regulatory approach will be important as some regulators may also require these activities to be conducted locally. Both claims processing and policy servicing may be delegated by an underwriter to an intermediary in the same jurisdiction as the customer.
- 5.46 In addition, where such back-office services continue to be provided from the UK to EU-based insurers, it will be important to ensure that the UK regime does not require such EU insurers to be authorised in the UK in order to use the services of a UK-based agent or service provider. Given these uncertainties, back-office activities have been colour coded amber in both scenarios 2 and 3.

***Reinsurance: effecting and carrying out contracts of reinsurance, but not direct insurance (ie “pure” reinsurance)***

- 5.47 For the purpose of this analysis, the activity of effecting and carrying out contracts of reinsurance has been sub-divided as follows:
- (a) client-facing and sales activities consisting of broking, intermediation and distribution activities carried out by intermediaries or by reinsurers directly;
  - (b) execution consisting of:
    - (i) underwriting; and
    - (ii) contact between broker and underwriter (in subscription markets); and
  - (c) back-office activities, which may consist of claims-processing and policy-servicing activities.
- 5.48 As described in paragraph 3.45 above, Solvency II does not establish a general third-country regime for reinsurance companies to provide cross-border services. However, where the reinsurance regime of a third country is deemed to be equivalent, reinsurance contracts entered into with reinsurers from that country are treated in the same manner as contracts entered into with reinsurers operating under Solvency II from the EU. In addition, third-country reinsurers are able to underwrite certain classes of insurance business in reliance upon local law, but this may not be available for all classes of business or on an unrestricted basis. For this reason, all client-facing and execution activities are colour coded amber for scenario 2 and red for scenario 3.
- 5.49 Again, the ability to perform claims-handling and policy-servicing activities from the UK will depend on the local regulatory approach, shown in amber for both scenarios 2 and 3.

### ***Insurance and reinsurance: insurance mediation and distribution***

5.50 For the purpose of this analysis, insurance mediation and distribution activities have been sub-divided as follows:

- (a) client-facing and sales activities consisting of broking;
- (b) execution consisting of distribution;
- (c) risk management; and
- (d) back office.

5.51 As described in paragraph 3.48 above, there is no third-country regime for insurance mediation under the IMD or the IDD, and any cross-border activities would be subject to member state local law. For this reason, all activities are colour coded amber for both scenarios 2 and 3.

### ***Asset management***

#### **Portfolio management – the management of discretionary portfolios**

5.52 Portfolio management is defined in MiFID 2 as “managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments” and involves the following activities:

- (a) client-facing and sales activities: scenario 2 has been colour coded green as, if an equivalence determination is made, it would be possible for client-facing and sales activities to be conducted from the UK in relation to EU per se professional clients and eligible counterparties. Scenario 3 has been colour coded amber because, if no equivalence determination is made, the MiFID 2 third-country access regime would no longer be available and it would be necessary to consider the local law in relevant member states;
- (b) distribution of funds: the distribution of funds from the UK into the EU may involve the MiFID activities of the reception and transmission of orders and investment advice. In scenario 2, UK firms would be able to provide such services to per se professional clients and eligible counterparties in the EU in reliance upon the MiFID 2 third-country access regime. However, in scenario 3 third-country access rights would not be available and it would be necessary to consider the local law in the relevant member state to determine the extent to which such activities could continue to be provided on a cross-border basis. For that reason, scenario 2 is colour coded green and scenario 3 amber; and
- (c) portfolio management: in scenario 2, UK portfolio managers would be entitled to provide portfolio management on a cross-border basis to eligible counterparties and per se professional clients in reliance upon the MiFID 2 third-country access regime, colour coded green. In scenario 3, such access rights would not be available and it would be necessary to consider the local law in the relevant member state in order to determine if cross-border portfolio management activities can continue to be provided, shown in amber. In part, this will necessitate a consideration of where portfolio management activities are considered to take place (ie whether the key determining factor is where the relevant decision is made or the location of the client). UK managers may be able to continue to provide portfolio management services to EU managers on an outsourced basis, but this would depend upon the approach taken by member state regulators.



## **Private wealth management**

- 5.53 In this context, “private wealth management” refers to the provision of investment advice, portfolio management, and lending and dealing services to EU retail clients. As described in paragraph 3.17 above, it is assumed for the purposes of this report that member states will restrict the provision of services by third-country firms to retail clients in their jurisdiction on a cross-border basis, and further that they may require such firms to establish branches to service retail clients in accordance with MiFID 2.
- 5.54 For both scenarios 2 and 3, investment advice, portfolio management and dealing activities have been colour coded red as it is assumed that member states would restrict the provision of services by third-country firms on a cross-border basis to retail and elective professional clients in their jurisdiction once the UK is a third country.
- 5.55 In relation to lending activities, in both scenarios 2 and 3 the impact of Brexit would depend on whether the activities fall within the scope of MiFID 2 (and constitute an ancillary activity) or the CRD/consumer lending legislation (and are provided on a standalone basis). If lending is ancillary to MiFID 2 investment services, once the ability to perform the associated investment activity is lost, it would not be possible to provide such services to retail clients on a cross-border basis (shown in red for scenarios 2 and 3). For standalone lending activities provided in accordance with CRD, scenarios 2 and 3 have been colour coded amber as it will be necessary to consider member state local law for the reasons described in paragraphs 5.29 to 5.32 above.

## **Fund management**

### *Managing a UCITS*

- 5.56 The provision of fund management services relating to a UCITS is governed by the UCITS Directive. As described in paragraph 3.50, the ability of a UK manager to continue to perform activities following Brexit depends on whether the relevant funds are UK-domiciled former UCITS or EU-domiciled UCITS. For these purposes, the ability of a UK manager or depositary to perform activities in relation to UK funds has not generally been considered (other than in relation to the ability of a UK manager to market such funds to EU investors), although it is expected that such activities could continue following Brexit:
- (a) fund management: a UK management company would no longer be able to manage EU-domiciled UCITS (shown in red for both scenarios 2 and 3);
  - (b) investment advice and portfolio management: whilst a UK manager would not be able to provide investment advice or portfolio management services directly to EU funds, an EU management company is entitled, in accordance with the UCITS Directive, to delegate certain functions to third parties. Accordingly, a UK investment manager would be able to provide investment advice and portfolio management services in relation to EU funds on a delegated basis (shown in amber for both scenarios 2 and 3);
  - (c) client-facing and sales activities: whilst the ability of a UK manager to market UK-domiciled former UCITS in the EU would depend on the private placement regimes in the relevant member state prior to the AIFMD passport being “switched on” (shown in amber for both scenarios 2 and 3), a UK manager would not be able to market EU-domiciled UCITS in the EU (shown in red for both scenarios 2 and 3). Of course, this would not prevent an EU manager from marketing (or distributing) EU UCITS to EU clients; and

- (d) depositary activities: in the first instance, it is necessary to use EU depositaries in relation to EU-domiciled UCITS. However, such entities may delegate the provision of services to a third-party custodian (including one that is based in a third country). This is not dependent on an equivalence determination being made, but would require an arrangement to be put in place allowing UK depositaries to continue to perform activities on a delegated basis. For this reason, whilst red has been used in relation to the activity of acting as a depositary for both scenarios 2 and 3 (as UK depositaries would be restricted from directly performing services in relation to EU UCITS), acting as a sub-custodian (on the basis of delegation) is colour coded amber in both scenarios 2 and 3. As noted in paragraph 3.50(c) above, under current rules, there are limitations on which entities are able to act as depositaries, so the impact on individual firms may not be as significant as the colour coding of red would suggest.

### *Managing an AIF*

5.57 The provision of fund management services in relation to AIFs is governed by the AIFMD. As described in paragraph 3.52, the ability of a UK manager to perform activities following Brexit depends on whether the relevant funds are UK or EU AIFs. For these purposes, the ability of a UK manager or depositary to perform activities in relation to UK funds in the UK has not generally been considered (other than in relation to the ability of a UK manager to market such funds to EU investors), although it is expected that such activities could continue following Brexit:

- (a) fund management: a UK management company would not be able to manage EU AIFs unless it was authorised by the competent authority of its member state of reference (shown in red for both scenarios 2 and 3);
- (b) investment advice and portfolio management: assuming that a UK manager would not seek to be authorised by the competent authority of the member state of reference, it should be able to provide investment advice and portfolio management services to EU AIFs on a delegated basis. This is shown in amber for both scenarios 2 and 3;
- (c) client-facing, sales, marketing and distribution activities in the EU: the ability of a UK manager to market UK and EU AIFs in the EU would depend on the private placement regimes of the relevant member states, prior to the AIFMD marketing passport being “switched on”, shown in amber for both scenarios 2 and 3; and
- (d) depositary activities: in the first instance, it is necessary to use EU depositaries in relation to EU AIFs. However, it is possible for these entities to delegate services to a third-party custodian (including one that is based in a third country). This is not dependent on an equivalence determination being made, but would require an arrangement to be put in place allowing UK depositaries to continue to perform activities on a delegated basis. For this reason, whilst red has been used in relation to the activity of acting as a depositary for both scenarios 2 and 3 (as UK depositaries would be restricted from directly performing services in relation to EU AIFs), acting as a sub-custodian (on the basis of delegation) is colour coded amber in both scenarios 2 and 3. As noted in paragraph 3.52(c) above, under current rules, there are limitations on which entities are able to act as depositaries, so the impact on individual firms may not be as significant as the colour coding of red would suggest.

### ***Custody and custodians***

- 5.58 The activity of the “safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management and excluding maintaining securities accounts at the top tier level” (ie custody) is an ancillary service under MiFID 2.
- 5.59 In relation to standalone custody services (ie those that are not ancillary to MiFID 2 investment services) provided from the UK, the extent to which it may be possible to continue to provide such services to EU clients following Brexit will depend on member state local law. Given this, both scenarios 2 and 3 are colour coded amber.

### ***CCPs***

- 5.60 The activities of CCPs are governed by EMIR.
- 5.61 As described in paragraphs 3.55 to 3.57 above, third-country CCPs must apply for recognition from ESMA in order to be able to offer services to clearing members and trading venues established in the EU. Central to this is an assessment of equivalence.
- 5.62 In scenario 2, UK CCPs would continue to be able to provide clearing services to EU clients (shown in green) but in scenario 3, this would no longer be possible (shown in red).
- 5.63 In relation to access to CCPs, in scenario 2, where an equivalence determination is made, UK and EU firms would be able to use UK CCPs to fulfil the clearing obligation (shown in green). However, in scenario 3, where there is no equivalence determination, it would be necessary for UK and EU firms to use EU CCPs in order to fulfil the clearing obligation. Access to EU CCPs is not guaranteed and UK firms will be subject to the membership requirements of the individual EU CCP as well as the regulatory approach in the future (shown in amber).

### ***CSDs***

- 5.64 If an equivalence determination is made, UK CSDs should be able to provide settlement services on a cross-border basis to EU clients (shown in green for scenario 2). If no equivalence determination is made, UK CSDs may be able to link to EU CSDs, thereby enabling clients to indirectly access those CSDs. However, this may not provide a business-as-usual solution (shown in amber for scenario 3).

### ***CRAs***

- 5.65 The core piece of EU legislation governing the regulation of CRAs is the CRA Regulation.
- 5.66 For the purpose of this analysis, the activities of CRAs have been broken down as follows:
- (a) client-facing and sales activities;
  - (b) execution consisting of the production and dissemination of ratings;
  - (c) risk management consisting of the control infrastructure; and
  - (d) back-office activities consisting of other non-control support functions.
- 5.67 As described in paragraphs 3.64 to 3.67 above, the CRA Regulation permits ratings issued by third-country CRAs to be used for EU regulatory purposes if the issuing CRA is certified by ESMA or the third-country rating has been endorsed by a CRA established in the EU.

- 5.68 In scenario 2, a rating issued by a UK CRA could be used for regulatory purposes in the EU provided that the CRA was certified by ESMA or the rating was endorsed by a CRA established in the EU belonging to the same group (on the basis that the UK regime is considered by ESMA to be “at least as stringent” as that in the EU, which can be expected where an equivalence determination is made by the Commission). Whilst it is possible for both certification and endorsement to be obtained, there is a concern that the endorsement provisions, even if available for the UK, would not cover the majority of ratings of EU issuers with a lead analyst based in the UK, as it is perceived that the objective reason test may not be satisfied. The key consideration from the perspective of determining where the rating is produced is the location of the lead analyst. In scenario 2, execution and risk management activities are colour coded amber on the basis that it may not be possible for all ratings of EU issuers that are produced by UK-based lead analysts to continue to be used in the EU following Brexit, and a finding of equivalence alone would not be sufficient for such ratings to be automatically used on an ongoing basis. Client-facing, sales and back-office activities are colour coded green.
- 5.69 For scenario 3, whilst it may in theory be possible for the rating of a third-country CRA to be endorsed by an EU CRA, this would require the third-country regime to be considered “at least as stringent” as that under the CRA Regulation (which is an onerous assessment, unlikely to be granted where no equivalence determination has been made and generally only considered to be relevant in an intra-group scenario). On that basis, its use may be limited. Alternatively, the CRA could seek to ensure that the rating is deemed to have been produced in the EU. The key consideration for this purpose is where the lead analyst is located – whilst it may not be possible for execution or risk management to be done from the UK (shown in red) if the CRA seeks to preserve the conclusion that the rating is deemed to have been produced in the EU, it may be possible for commercial (ie client-facing) and back-office activities to remain in the UK, shown in amber, as those are not seen as central to the determination of where the rating is produced.

### **Trading venues**

- 5.70 Provided the UK regime has been deemed equivalent, a third-country venue could be used by EU clients in order to satisfy the trading obligation. The activity of operating a trading venue is colour coded green in scenario 2. However, if no equivalence determination is made, although it would not be possible to use a UK venue to satisfy the trading obligation, it may still be possible for a UK trading venue to offer EU-based members direct access to it (shown in amber for scenario 3).

### **Trade repositories**

- 5.71 A third-country trade repository that has been recognised by ESMA (which requires that the relevant third-country regime is equivalent) may provide services in the EU. Therefore, trade repository services are colour coded green for scenario 2 and red for scenario 3.

### **Data reporting services providers**

- 5.72 Approved publication arrangements, consolidated tape providers and approved reporting mechanisms must all be based in the EU. There is no third-country regime and therefore, following Brexit, UK firms will be unable to continue to provide services to EU firms. On that basis, both scenarios 2 and 3 are colour coded red.

### **Benchmarks**

- 5.73 A benchmark provided by a third-country administrator can be used in the EU if: (i) an equivalence determination has been made in relation to the third-country regime and the benchmark and

administrator are included in ESMA's register; (ii) the administrator is recognised pending an equivalence determination; or (iii) the benchmark is endorsed by an EU administrator.

- 5.74 Scenario 2 is colour coded green on the basis that, if an equivalence determination is made, benchmarks provided by third-country administrators may be used in the EU. Scenario 3 is colour coded amber as it may be possible for the benchmark to still be used in the EU if it has been recognised or is endorsed. Even though the Benchmarks Regulation does contain a third-country regime, the relevant provisions are not straightforward to apply and the bilateral discussions revealed that firms may choose not to rely on equivalence, recognition or endorsement.

### ***Related professional services***

- 5.75 The legal and accountancy sectors rely on mutual recognition of professional qualifications and also, for accountancy, on a finding that the Financial Reporting Council (FRC) is treated as either equivalent to or mutually recognised by its EU counterparts. Equivalence generally prevents divergence of regulatory standards between the UK and the EU, and mutual recognition is generally focused on regulatory outcomes so is perceived as being more flexible than equivalence.
- 5.76 The most likely outcome is that Brexit negotiations will ultimately end up with the FRC treated as either equivalent to or mutually recognised by its EU counterparts. However, this is by no means certain.
- 5.77 This is described in more detail in paragraphs 6.46 to 6.64 below.



## **6. Input from the financial services sector**

- 6.1 As described in chapter 1, in preparing this report, bilateral discussions were held with representatives of the UK financial services sector.
- 6.2 The bilateral discussions indicated that firms want to keep as many of their activities in the UK as possible within the confines of regulatory and operational considerations. If firms transfer business out of the UK in order to continue to service EU customers on Day 1 after Brexit, it is unlikely that all business will be moved to a single EU member state. Any such transfer is instead likely to occur on a fragmented basis across multiple jurisdictions as firms seek to be closer to their customers. Individual factors will dictate the location decisions of different firms.
- 6.3 All firms have as their base-case the objective of continuing to service their existing clients with as little disruption as possible following Brexit. Ensuring that clients are provided with continued access to financial services, and are treated fairly and in accordance with regulatory principles is a priority.
- 6.4 Existing market factors, notably technological advancements and the decentralisation of financial services, are already impacting the way that firms do business. Brexit may accelerate these changes.
- 6.5 Although the analysis in chapter 4 shows that an equivalence determination will provide access to EU clients for some sub-sectors of the UK financial services sector, the bilateral discussions revealed that firms are neither relying on equivalence determinations being made nor assuming that equivalence would provide a sufficiently certain basis upon which to build a business plan, not least because such determinations are discretionary, may be withdrawn and may not cover the full spectrum of products or clients. On that basis, firms are putting in place contingency plans on the assumption that scenario 3 will apply.

### ***Impact of a firm's business model on Brexit planning***

- 6.6 The impact of Brexit on individual firms depends, in large part, on the way that their business is currently structured, the nature of services being offered and the location of clients. Certain aspects of a firm's business (notably cross-border client-facing activities) are most likely to be impacted by Brexit whilst others (eg domestic business provided only to UK-based clients or the provision of services to third-country clients from the UK) will largely be unaffected. In all three models described below, there is a risk that it will not be commercially efficient for firms to have "hubs" in both the EU and the UK in the long term, and this may lead to alternative structuring solutions being considered, including moving business from the UK to other financial centres in the EU and elsewhere.

#### **UK firms with a "hub and spoke" model**

- 6.7 In this context, "hub and spoke" refers to a group structure where the main operating entity is based in the UK and services are provided into the EU either on a cross-border basis or through EU branches of the UK firm, in reliance upon access rights provided under the single market directives.
- 6.8 Currently, EU branches of UK firms are able to provide services both to clients located in the relevant member state, as well as on a cross-border basis to clients in (most) other member states. Although there is some uncertainty as to the approach that EU regulators will take following Brexit and what authorisation regime will be applied, under the current regime, where a third-country firm establishes an EU branch, that branch can only be used to provide services to clients in the relevant member state. Firms that provide services to EU clients through branches in the EU are actively planning alternative methods of continuing to service EU customers, including putting in place structural solutions, such

as incorporating and authorising an EU subsidiary or obtaining authorisation for a branch and other mitigating steps to compensate for the loss of passporting rights.

- 6.9 If the UK firm has no EU branches but instead provides services on an outward (and cross-border) basis in reliance upon passporting rights, firms consider that the loss of such rights following Brexit would require them to rely on member state national regimes to continue to provide services in this way. Alternatively they will have to consider structuring solutions (including establishing EU subsidiaries) in order to provide services on an ongoing basis in the EU.

#### **UK firms (including subsidiaries of third-country firms) with EU subsidiaries**

- 6.10 UK and third-country firms that already have EU subsidiaries from which they service EU clients plan to utilise existing passporting rights that would continue to be available to such entities following Brexit, either by providing services on a cross-border basis throughout the EU or alternatively by establishing separate EU branches. This may, in some cases, involve the transfer of persons from the UK to the EU subsidiary and its branches or increasing the hiring of people locally. It may also involve books of the business being transferred from UK to EU entities. The costs of these transfers are high and expose firms to the risk of basic terms being re-negotiated. However, whilst this may be costly in the short term, firms view this as a “Brexit-proof” solution that is not dependent on the outcome of political negotiations.

#### **EU firms with UK branches**

- 6.11 A number of EU firms have branches in the UK that are currently being used (in accordance with existing passporting rights) to service clients in the UK and throughout the EU. The extent to which such activities could continue after Brexit is the subject of extensive discussion. Although the current *acquis* does not contemplate the provision of services back into the EU by third-country branches of EU firms, there is an acknowledgement that the EU internal market is an evolving concept and so that position may change.
- 6.12 Given the additional uncertainty in relation to such branches (ie whether they will need to be separately authorised or benefit from some grandfathering arrangement) and the question of whether EU regulators will allow the cross-border provision of services to clients located in their jurisdiction by such a third-country branch, firms are preparing to obtain authorisation in the UK or are considering structuring solutions to deal with the loss of access to EU markets from the UK branch should that transpire.

#### **Methods of transferring business**

- 6.13 Where firms’ contingency plans involve analysing the ability to transfer business to an existing or newly established entity in the EU, a range of methods of transfer are being considered, including:
- (a) utilising the structure of a *societas europaea*, a European public limited company that can be created and registered in a member state by, amongst other methods: (i) merging two or more existing public limited companies from at least two different member states; or (ii) converting a public limited company that has, for at least two years, had a subsidiary in another member state;
  - (b) a cross-border merger under the EU directive that covers cross-border mergers of limited liability companies;
  - (c) transferring banking or insurance business under Part VII of the FSMA; and

- (d) novating existing contracts.

6.14 In a number of cases, the potential need to transfer existing business to an EU entity provides the biggest legal and organisational challenge as well as the biggest potential impact on those EU customers that are affected.

### ***Key priorities and considerations for the UK financial services sector***

6.15 Set out below are some of the key priorities and considerations for the UK financial services sector that were identified as part of the bilateral discussions.

### **Importance of securing an implementation period**

- 6.16 There is a general view across impacted businesses that the two-year period for negotiating the UK's exit arrangement provided for by Article 50 will not be long enough either for the UK Government to redefine its ongoing relationship with the EU or for firms to satisfactorily effect any required reorganisation and restructuring. Firms are applying a base-case of Brexit in two years from March 2017 (ie the point at which the Article 50 notice was served) with no equivalence and no special passporting or access rights agreed.
- 6.17 If signalled early in the negotiations, a phased implementation period would be of mutual benefit to the EU and the UK. Also, ensuring a smooth transition in respect of the ongoing EU-UK relationship, as individual rights are lost or replaced, is essential.
- 6.18 The bilateral discussions also identified a number of areas where securing "grandfathering" rights are important for firms:
- (a) banks: UK banks that are able to provide banking services on a cross-border basis to EU clients in accordance with the CRD should be able to continue to do so in relation to existing business after Brexit;
  - (b) investment firms: UK investment firms that have exercised freedom of establishment under MiFID or MiFID 2 to set up EU branches prior to Brexit should be able to continue to service existing clients from such branches within the relevant member state after Brexit and should be entitled to continue to service EU clients on their existing books (ie business booked on both an EU branch and the UK firm itself). UK firms also want to ensure they can continue to act as primary dealers, although this is a matter of local member state law;
  - (c) insurers: the ability of UK-based insurers to continue to service policies and pay claims from the UK in relation to contracts of insurance or reinsurance written before Brexit is seen as essential;
  - (d) financial market infrastructure: grandfathering the authorisation of UK CCPs is important:
    - (i) under EMIR, third-country CCPs may only provide clearing services in the EU if they have been recognised by ESMA. As an essential element of this, the Commission must have deemed the legal and supervisory arrangements of the third country to be equivalent to the requirements laid down in EMIR. Whilst the Commission has now issued equivalence decisions for a number of jurisdictions, this occurred a number of years after EMIR entered into force. Despite the fact that the UK regime will be aligned with the EMIR regime at the point the UK leaves the EU, the lack of certainty about whether the UK regime will be deemed equivalent on an ongoing basis and the timing

of any such decision is problematic. It will be important for UK CCPs and their clearing members that recognition is given from the point at which the UK exits the EU so that there is no “gap” or interruption to UK CCPs’ ongoing ability to provide clearing services to EU clearing members. This grandfathering right is particularly important in relation to long-dated contracts. The impact of Brexit on UK market infrastructure is discussed further in paragraphs 6.43 and 6.44 below; and

- (ii) in the absence of an equivalence determination, a grandfathering or transitional period will be essential to avoid a potentially disorderly situation; and
- (e) UK CSDs that were authorised prior to Brexit should satisfy the equivalence requirements but it will be important to ensure that they are able to continue to provide services following Brexit.

### **The need for access arrangements to be negotiated**

- 6.19 If the relevant activities are not regulated in the EU or the EU regulatory framework does not preclude member states from adopting domestic regimes for third-country firms, UK firms may be able to continue to provide services on a cross-border basis to EU clients following Brexit by relying on member state local law. However, there is no consistent approach across the EU, and relying on local member state regimes is not expected to provide the level of certainty required from a business structuring or systems and procedures perspective.
- 6.20 Given the above, in particular the uncertainty of equivalence, firms would clearly prefer to negotiate a bilateral arrangement enabling EU and UK firms to access each other’s markets on the basis that their respective regimes are broadly consistent. The issues that were identified in the course of the bilateral discussions and that are set out in this report will need to be considered as part of any UK-EU free-trade agreement.

### **Access to talent**

- 6.21 One of the reasons that the UK has been able to develop into the financial centre that it is today is the ability for firms to draw in talent. Continued access to such talent after Brexit is seen by firms as essential across all areas of the UK financial services sector.
- 6.22 In addition, many firms rely on the ability to move people around the EU. It is important to ensure that such arrangements can continue in the future.

### **Ecosystem impact**

- 6.23 The OW report identified the fact that the “UK-based financial services sector, together with the related professional services sector, has developed over many years into an interdependent and interconnected ecosystem comprising a large variety of firms providing world-class services, products and advice. This ecosystem brings significant benefits to financial institutions and to the corporations and households they serve.” The conclusion was that, as a result of this interconnectedness, which extends beyond the related professional services sector to asset management, investment banking and infrastructure, the effect of Brexit is likely to be felt beyond merely the business done with EU clients.
- 6.24 One of the difficulties in identifying the impact that Brexit may have on the broader UK financial services sector is that it is challenging to define precisely what is meant by this “ecosystem”. During the bilateral discussions, it was succinctly described by one person as the ability, when they want to get a deal done, to assemble quickly a group of experienced lawyers, accountants, bankers and other

professionals in a room. This relies on the network of strong and long-standing business relationships that exist in the UK, which would be impacted if front-office individuals and principals are forced to move away as a result of Brexit.

- 6.25 Even for firms that are not directly required to restructure or reorganise their business as a result of Brexit, there may still be an “ecosystem” impact. For example, one firm with a predominantly UK focus described the ecosystem impact on its activities as losing the ability to access intellectual capital and research from other market participants currently located in the UK if those firms were required to move away. This loss of knowledge could have a negative impact on business in the long term.
- 6.26 Ultimately, and at its most extreme, the impact of Brexit on the UK ecosystem could be a gradual erosion of its centre of gravity from a financial services perspective, which would in turn have a knock-on effect on other areas of the economy.

### **Opportunity to redesign the UK regulatory landscape**

- 6.27 Brexit may provide an opportunity for the UK to re-frame regulation so that it is more tailored to the specifics of the UK market, although the UK financial services sector is not seeking a “bonfire of regulation”. One area that has received industry attention is Solvency II, where some feel aspects of the regime are not appropriately framed for the UK market.
- 6.28 Whilst many in the UK financial services sector feel that the immediate focus for regulators and the UK Government needs to be on acquiring and transforming the *acquis communautaire* into UK law, securing an orderly Brexit, and ensuring an effective transition to a new UK-EU relationship, others will lobby the Government to consider changes that could be made to aspects of the UK regulatory regime, with a particular focus on facilitating business to be conducted in the UK.

### **Contractual continuity**

- 6.29 Ensuring continuity for existing contracts with EU counterparties is essential across the UK financial services sector, although this question is distinct from whether, as a matter of law, UK firms would legally be able to service existing contracts. Firms are seeking to ensure that language is included in the terms of the withdrawal agreement to guarantee the continuity of contracts. There is precedent for such wording from the introduction of the euro.
- 6.30 An arrangement guaranteeing the continuity of existing contracts would be beneficial for UK and EU counterparties alike, and would reduce potential disruption to essential products and services and risk to financial stability.

### **Data transfer**

- 6.31 Firms rely on the ability to transfer and use personal data freely. Without an adequacy decision from the Commission or other arrangement agreed as part of the Brexit negotiations, such flows could be disrupted once the UK is considered to be a third country for the purposes of the GDPR. Given the need for legal certainty, ensuring that UK firms can receive and transfer personal data is a priority for the UK financial services sector.

### **Sectoral impact from the UK financial services sector**

- 6.32 As well as the general points set out above, the bilateral discussions identified a number of specific issues that will also need to be considered as part of the Brexit negotiations.



### **Investment firms**

- 6.33 Provided an equivalence determination is made, the ability of MiFID 2 investment firms to service EU clients on a cross-border basis from the UK will be limited following Brexit to per se professional clients and eligible counterparties. The loss of equivalence and passporting rights may lead to firms having to restructure their businesses.
- 6.34 The models that are being considered vary depending on the individual firm's structure but involve using and transforming (by way of bolstering operations and obtaining additional authorisations and permissions as required) EU entities and branch networks to ensure that they are able to continue to service their EU client-base on an ongoing basis following Brexit.
- 6.35 As a result of political and regulatory uncertainty, some firms are approaching their Brexit strategy in two phases:
- (a) the initial bridging period during and immediately after the two-year negotiation period, during which time short-term solutions will be put in place; and
  - (b) a long-term solution that will evolve during the adaptation period.
- 6.36 During the interim period, firms may not have visibility over what the end-state legal and regulatory framework will look like and will only be able to put in place short-term interim solutions enabling them to continue to serve as many customers with as little impact as possible on Day 1 after Brexit. This may involve firms ceasing to carry on certain activities for a period of time where it has not been possible to restructure business in the time available. Once a clearer picture of the end-state emerges, firms will then look to transfer to more permanent structures that will enable them to provide services in the longer-term.

### **Banks**

- 6.37 In scenarios 2 and 3, UK banks would lose the ability to provide CRD banking services to EU clients on a cross-border basis. As a result, they would need either to fall back on individual member state regimes, which do not provide a sufficiently harmonised basis upon which to build a business, or to consider structuring solutions to reorganise their business. It is therefore crucial that the UK Government secures access rights for banking services.

### **Insurers and reinsurers**

- 6.38 For some UK insurance firms, the impact of Brexit is mitigated by the fact that they do minimal cross-border business and where (particularly in the life sector) insurance policies are sold locally in the EU, this is done through separately authorised entities. However, this is not universal across the market and depends on the way firms are structured.
- 6.39 Given that it would not be possible to write new direct EU insurance business on a cross-border basis from the UK following Brexit if the passporting rights fall away and no new access arrangements are put in place, firms are implementing structuring solutions to ensure business can continue on Day 1 after Brexit.

### **Asset managers**

- 6.40 Asset managers provide an important source of liquidity and capital for the UK markets, and ensuring that they remain in the UK is considered important to the UK's position in financial services.

- 6.41 The ability of UK managers to continue to provide investment advice and portfolio management services in relation to EU funds following Brexit may rely, to a certain extent, on the ongoing viability of delegation. If EU regulators sought to prevent EU firms from delegating portfolio management to UK managers following Brexit, the same approach would also have to be taken in relation to the delegation to managers in other third countries. This could have wider implications on the ability of EU funds and managers to invest in non-EU markets.
- 6.42 As in other parts of the UK financial services sector, the way that business is currently structured will influence the impact of Brexit on activities. Several large investment managers have “hubs” both in the UK and the EU, and such business models may enable activities to continue in future without the need to move substantial numbers of people or activities to the UK or incur large costs.

### **Market infrastructure**

- 6.43 Financial market infrastructure (ie CCPs and CSDs) is of systemic importance to the financial system and ensuring continuity is essential. As part of this, UK firms need to be able to continue to access EU financial market infrastructure and similarly EU firms must be able to access UK infrastructure on an ongoing basis.
- 6.44 Central to this is ensuring the equivalence of UK CCPs as qualifying CCPs. Under current legislation, if UK CCPs are not deemed equivalent, they could not provide clearing services to EU clients and could not be used by EU clients to satisfy the EU mandatory clearing obligation under EMIR. This may result in capital costs for firms, which could ultimately impact the end-users of financial services.
- 6.45 Continued membership of SEPA is also important for UK firms given the capital implications that could result should this not be the case.

### **Legal services**

- 6.46 TheCityUK published a detailed report on the impact of Brexit on the UK-based legal services sector in December 2016.<sup>16</sup> This report does not intend to replicate work that has already done and instead provides only a high-level assessment of the likely impact.
- 6.47 The EU single market framework gives UK legal services near-full access to other member states’ equivalent markets (with the exception of restricted activities, which are defined on a state-by-state basis) and is crucial to its success. Without this framework, UK lawyers in the EU would be governed by local Bar requirements. The framework is founded on the following specific legal rights derived from treaties and directives:
- (a) the free movement of legal services, which enables UK law firms to: (i) second lawyers for short periods of time within the EU; (ii) provide fly-in-fly-out legal advice when visiting clients in other EU member states; and (iii) provide cross-border legal services from one EU member state into another;
  - (b) the rights of establishment for lawyers, which facilitates the permanent relocation of UK lawyers to alternative EU network offices;

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<sup>16</sup> <https://www.thecityuk.com/assets/2016/Reports-PDF/The-impact-of-Brexit-on-the-UK-based-legal-services-sector.pdf>

- (c) the mutual recognition of professional qualifications, which precludes the requirement for UK lawyers to prove their professional qualifications when providing legal services or establishing their practices permanently in another member state;
- (d) automatic legal privilege for EU-qualified lawyers' communications in EU cases provided that the relevant communications are: (i) made in the interests of the client's right to defence; and (ii) emanate from an independent lawyer entitled to practise in the EU who is not bound to the client by a relationship of employment. Where it applies, this right allows documents that contain legal advice to be withheld in disclosure exercises involving the Commission; and
- (e) appearance rights before the CJEU for UK-qualified lawyers. According to the CJEU Protocol "only a lawyer authorised to practise before a court of a Member State or of another State which is a party to the Agreement on the EU may represent or assist a party before the Court."

6.48 In scenario 3, where the UK is not deemed to be equivalent and no new access arrangements are negotiated, UK-qualified lawyers would lose the benefits of the five rights discussed above.

### **Consultancy**

- 6.49 Consultancy is generally (other than the actuarial arm of some organisations) unregulated and therefore Brexit is likely to have only a secondary impact on firms' activities. There are a few points to note:
- (a) many of the large consultancy firms already have extensive operations (and a physical presence) in the EU. These local entities are used to service clients in relevant jurisdictions under local contracts. Whilst the business of large market participants is unlikely to be severely impacted by Brexit, there is already evidence that smaller participants are being impacted;
  - (b) to the extent that the practices of public-sector procurement change as a result of Brexit, there is an additional risk that European regulators could require contracts to be entered into locally and serviced by local entities. Again, large consultancy firms that already have a network of offices in the EU are already set up to deal with this but for others, it may be necessary to adapt their business model; and
  - (c) large consultancy firms rely on the free movement of people and it is important that such rights are retained following Brexit.
- 6.50 Even for those large consultancy firms that are not anticipating Brexit having a detrimental short-term impact on their business, there is a risk of a secondary impact if the client-base diminishes over time. Whilst the largest firms may be able to counter the impact on their UK balance sheet with growth in other jurisdictions as business is absorbed by network offices, smaller firms may not be as well placed to deal with these changes.

## Accountancy<sup>17</sup>

- 6.51 The auditing profession (and certain related professional services) is the most heavily regulated of professional services. In the UK, the FRC<sup>18</sup> is responsible for the public oversight of statutory auditors, as required under EU law, and is recognised as an appropriate regulatory authority throughout the EU.
- 6.52 This enables the auditors that it regulates some limited involvement in audits for overseas entities and reduces barriers to the audit trade within the single market.
- 6.53 It is not clear whether the FRC will continue to be recognised as a competent authority once the UK leaves the EU. Absent specific permissions, it is presumed that it would not. This could curtail significantly the ability of UK audit professionals to provide services to EU clients. The most likely outcome is that Brexit negotiations will ultimately end up with the FRC treated as either equivalent to, or mutually recognised by, its EU counterparts. However, this is by no means certain.
- 6.54 Aligning the UK's regulatory framework with global (as well as EU) standards, and ensuring ongoing regulatory collaboration with the EU, are the most practical means of achieving equivalence or mutual recognition of regulatory bodies (as opposed to the "bonfire of the regulations" that some have espoused).
- 6.55 Even if eventually the negotiations provide a useful outcome, there is a risk that there will be a period of several years after Brexit before any new agreement takes effect, during which time UK audit businesses will be excluded from the single market. Unlike for goods businesses, this is not just a mere raising of barriers (ie tariffs) but is an effective exclusion from practice altogether in so far as audit and certain related services are concerned.

## *Mutual recognition of professional qualifications*

- 6.56 Entry to the audit/accounting profession is controlled through the attainment of professional qualifications, which take several years of both examination and on-the-job experience to complete via professional bodies such as the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants in Scotland. Practitioners are further required to maintain both technical and ethical standards via continuous professional development. Further, under the eighth Company Law Directive, ultimate ownership of audit firms must be held by persons with recognised EU or EEA audit qualifications (as measured by majority voting rights) in order to practise.
- 6.57 In theory, audit qualifications attained in one member state should be recognised across all EU member states. However, each member state has its own requirements for statutory audits, and member states can and do require examination of those areas, which creates a significant barrier to the provision of statutory audit services across EU borders. Auditors' activities are, therefore, limited by the rules of the local professional bodies of host member states.
- 6.58 Consequently, the mutual recognition of professional qualifications for auditors does not confer equal rights for UK auditors in all EU member states when compared to their local counterparts. Most notably, an individual holding the relevant professional qualification to sign an audit report in one

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<sup>17</sup> With thanks to Deloitte, Grant Thornton, EY and KPMG for input into this section.

<sup>18</sup> The FRC is responsible for: (i) the approval and registration of statutory auditors; (ii) technical standards and standards of professional ethics and internal quality control of statutory auditors and audit work; (iii) continuing education of statutory auditors; (iv) monitoring (by means of inspections) of statutory auditors and audit work; (v) investigation of statutory auditors and audit work; and (vi) imposing and enforcing sanctions.

member state will not be able to sign an audit report in another member state without first undergoing the professional qualifications testing of that second member state. While exemptions may be available in some member states, an individual who is qualified in one country will currently have to pass several exams in another (usually a minimum of tax and law) to be able to practise in that other state. By contrast, European actuaries enjoy mutual recognition of professional qualifications through membership of professional bodies such as fellowship of the Institute and Faculty of Actuaries.

- 6.59 This adds a fractional cost to the provision of auditing services at a time when standards in accounting and audit are increasingly global rather than EU driven, eg International Financial Reporting Standards (IFRS).<sup>19</sup>
- 6.60 True mutual recognition of audit qualifications would be beneficial for the trade in such services within the single market, and is one potential upside of the UK and the EU ultimately agreeing a free-trade agreement that liberalises the provision of audit services.
- 6.61 It should also be acknowledged that in 1998 the World Trade Organisation (WTO) adopted disciplines on domestic regulation in the accountancy sector. They remain the only industry-specific disciplines related to domestic regulation adopted by the WTO. They have not been implemented, as their implementation was derailed by various unrelated trade issues; however, they remain very relevant to today's conversation on regulation and trade, and have been leveraged into the draft texts of several plurilateral trade agreements such as the Trade in Services Agreement. The disciplines could be used by the UK to form the bedrock of a professional services schedule in its forthcoming negotiations with the EU.

#### *Brexit negotiation objectives for the audit/accounting profession*

- 6.62 Falling back to WTO trading would represent a material risk to the UK audit/accounting profession. It is unclear whether, and to what extent, the UK's access to the EU market would worsen based upon the EU's schedule to the WTO's General Agreement on Trade in Services (GATS) because market access to the EU by third-country businesses is generally better than in the GATS schedules. However, this favourable market access environment could change at any time, giving rise to considerable uncertainty. It is likely that this would also be the case for other parts of the UK financial services sector.
- 6.63 For the audit/accounting profession, the UK Government's key objectives should be:
  - (a) agreeing either equivalence or (preferably) mutual recognition of UK regulators, accepting that doing so will necessarily restrict the extent to which the UK can allow its regulations to diverge from internationally accepted norms;
  - (b) maintaining, or even improving, mutual recognition of professional qualifications;
  - (c) securing strong and effective rules for all parts of the services sector;
  - (d) guaranteeing free flow of data;

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<sup>19</sup> The version of IFRS adopted in the EU has been modified from the international standard by the EU. Following Brexit, we could see divergence between UK and EU IFRS adding to complexity and cost or even, ultimately, an inability of companies to meet the requirements of both even when obliged to do so.

- (e) developing an immigration system that allows the sector to easily access and deploy the best and brightest talent (whether from the EU or beyond) in an efficient manner, regardless of residency or location of work; and
- (f) securing the best possible access to the EU single market throughout the inevitable transition period between the UK leaving the EU and its ongoing relationship with the EU being regularised (whether that relationship is based on EEA membership, a “best-in-class” free-trade agreement or some other form).

6.64 Historically, there has been a tendency for trade negotiations to focus on trade in goods. It is critical that the Government takes note of the importance of the professional services sectors to the UK economy, not least its trade surplus and role in the UK’s exports drive, and ensures that the trade in services is given appropriate weight in its negotiations. Exports of non-financial services are of the same order of magnitude as exports of financial services, but the financial services trade enjoys greater prominence.



## APPENDIX 1

### Summary of impact of Brexit scenarios on business lines

The table below summarises the impact of scenarios 2 and 3 on business currently being conducted from the UK. It is assumed for the purposes of scenario 2 that all relevant conditions required for equivalence will be satisfied, not only that a simple equivalence determination will be made.

Although member state local law may be relevant to the analysis, no detailed jurisdiction-by-jurisdiction assessment has been conducted to determine how different member states would treat the cross-border provision of services into their jurisdiction. In addition, the question of where the characteristic performance of an activity is deemed to take place has not been considered – this may impact a firm's ability to service EU clients from the UK.

This material is for general information only and is not intended to provide legal advice. The colour coding that has been used is intended to be indicative only, and the impact on individual firms may vary.

#### **Key**

In this table, a traffic-light system has been used to indicate the following:

Not able to provide services on a cross-border basis	●
May be able to provide services, but it depends on factors such as local law, the acceptance of delegation and the relevant underlying activity	●
Able to provide services on a cross-border basis	●

Business line	Activity		Brexit scenario	
			Scenario 2 Equivalence where the provision already exists but no additional access rights granted	Scenario 3 Third-country agreement
<b>Debt capital markets (including marketing new issues and block trades)</b>	Client-facing and sales	Origination <sup>20</sup>	●	●
	Execution	Syndication	●	●
		Underwriting and placing	●	●
		Distribution <sup>21</sup>	●	●
	Back office	Administration	●	●
		Documentation	●	●

<sup>20</sup> “Origination” in this context refers to the part of the business that has the relationship with the issuer and involves the marketing of underwriting and distribution services.

<sup>21</sup> “Distribution” in this context refers to the part of the business that sells the debt that has been issued to the market.

Business line	Activity		Brexit scenario	
			Scenario 2 Equivalence where the provision already exists but no additional access rights granted	Scenario 3 Third-country agreement
Equity capital markets (including marketing new issues and block trades)	Client-facing and sales	Origination <sup>22</sup>	●	●
	Execution	Syndication	●	●
		Underwriting and placing	●	●
		Distribution <sup>23</sup>	●	●
	Back office	Administration	●	●
		Documentation	●	●

<sup>22</sup> “Origination” in this context refers to the part of the business that has the relationship with the issuer and involves the marketing of underwriting and distribution services.

<sup>23</sup> “Distribution” in this context refers to the part of the business that sells the debt that has been issued to the market.

Business line	Activity		Brexit scenario	
			Scenario 2 Equivalence where the provision already exists but no additional access rights granted	Scenario 3 Third-country agreement
Sales and trading (including secondary market loan trading) in relation to MiFID 2 financial instruments	Client-facing and sales		●	●
	Execution	Execution of transactions	●	●
		Acting as clearing member	●	●
	Risk management <sup>24</sup>	Pricing/hedging	●	●
	Back office		●	●

<sup>24</sup> “Risk management” in this context refers to the way that the relevant entity mitigates its own risk exposure (assuming that the entity will not be acting as a market maker).

Business line	Activity		Brexit scenario	
			Scenario 2 Equivalence where the provision already exists but no additional access rights granted	Scenario 3 Third-country agreement
<b>M&amp;A and corporate finance advisory</b>	Client-facing and sales	M&A advisory	●	●
		Corporate finance advisory	●	●
	Advising		●	●
	Back office		●	●
<b>Research</b>	Client-facing and sales		●	●
	Back office		●	●

Business line	Activity		Brexit scenario	
			Scenario 2 Equivalence where the provision already exists but no additional access rights granted	Scenario 3 Third-country agreement
<b>Pure commercial (non-consumer) lending (trade finance, finance lending and receivables financing)</b>	Client-facing and sales	Origination	●	●
		Marketing	●	●
	Execution	Evaluation	●	●
		Approval	●	●
		Closing	●	●
	Risk management	Credit assessment	●	●
	Back office	Loan and asset servicing	●	●



Business line	Activity		Brexit scenario	
			Scenario 2 Equivalence where the provision already exists but no additional access rights granted	Scenario 3 Third-country agreement
<b>Pure consumer (ie retail) lending (including credit cards)</b>	Client-facing and sales	Origination	●	●
		Marketing	●	●
	Execution	Evaluation	●	●
		Approval	●	●
		Closing	●	●
	Risk management	Credit assessment	●	●
	Back office	Loan and asset servicing	●	●

Business line	Activity		Brexit scenario	
			Scenario 2 Equivalence where the provision already exists but no additional access rights granted	Scenario 3 Third-country agreement
<b>Mortgages</b>	Client-facing and sales	Origination	●	●
		Underwriting	●	●
	Execution	Advancing loan	●	●
	Risk management	Credit risk assessment	●	●
	Back office	Processing	●	●
<b>Pure deposit-taking</b>	Client-facing and sales		●	●
	Execution		●	●
	Back office		●	●

Business line	Activity		Brexit scenario	
			Scenario 2 Equivalence where the provision already exists but no additional access rights granted	Scenario 3 Third-country agreement
Payment services	Provision of payment services		●	●
Prime brokerage	Client-facing and sales		●	●
	Execution	Margin lending	●	●
		Securities financing	●	●
		Custody	●	●
		Acting as clearing member	●	●
		Settlement	●	●
	Risk management		●	●
	Back office		●	●

Business line	Activity		Brexit scenario	
			Scenario 2 Equivalence where the provision already exists but no additional access rights granted	Scenario 3 Third-country agreement
<b>Insurance: effecting and carrying out contracts of direct insurance</b>	Client-facing and sales	Broking, intermediation and distribution	●	●
	Execution	Underwriting	●	●
		Contact between broker and underwriter	●	●
	Back office <sup>25</sup>		●	●
<b>Reinsurance: effecting and carrying out contracts of reinsurance, but not direct insurance (ie “pure” reinsurance)</b>	Client-facing and sales	Broking, intermediation and distribution	●	●
	Execution	Underwriting	●	●
		Contact between broker and underwriter	●	●
	Back office <sup>26</sup>		●	●

<sup>25</sup> “Back office” in this context includes claims-processing and policy-servicing activities.

<sup>26</sup> “Back office” in this context includes claims-processing and policy-servicing activities.

Business line	Activity		Brexit scenario	
			Scenario 2 Equivalence where the provision already exists but no additional access rights granted	Scenario 3 Third-country agreement
Insurance and reinsurance: insurance mediation and distribution	Client-facing and sales	Broking	●	●
	Execution	Distribution	●	●
	Risk management		●	●
	Back office		●	●

Business line	Activity		Brexit scenario	
			Scenario 2 Equivalence where the provision already exists but no additional access rights granted	Scenario 3 Third-country agreement
Portfolio management	Client-facing and sales		●	●
	Distribution of funds		●	●
	Portfolio management		●	●
Private wealth management	Investment advice		●	●
	Portfolio management		●	●
	Lending	On an ancillary basis to MiFID 2 activities	●	●
		On a standalone basis	●	●
	Dealing		●	●



Business line	Activity		Brexit scenario	
			Scenario 2 Equivalence where the provision already exists but no additional access rights granted	Scenario 3 Third-country agreement
<b>Fund management: managing an undertaking for collective investment in transferable securities (UCITS)</b>	Fund management <sup>27</sup>	EU-domiciled UCITS	●	●
	Investment advice and portfolio management	EU-domiciled UCITS	●	●
	Client-facing and sales – marketing and distribution	UK-domiciled former UCITS	●	●
		EU-domiciled UCITS	●	●
	Depository activities	EU-domiciled UCITS – acting as depository	●	●
		EU-domiciled UCITS – acting as sub-custodian	●	●

<sup>27</sup> “Fund management” in this context refers to acting as the management company of the relevant fund.

Business line	Activity		Brexit scenario	
			Scenario 2 Equivalence where the provision already exists but no additional access rights granted	Scenario 3 Third-country agreement
<b>Fund management: managing an alternative investment fund (AIF)</b>	Fund management <sup>28</sup>	EU AIFs	●	●
	Investment advice and portfolio management	EU AIFs	●	●
	Client-facing and sales – marketing and distribution	UK and EU AIFs	●	●
	Depositary activities	EU AIFs – acting as a depositary	●	●
		EU AIFs – acting as sub-custodian	●	●
<b>Custody and custodians</b>	Safeguarding/administration		●	●

<sup>28</sup> “Fund management” in this context refers to acting as the management company of the relevant fund.

Business line	Activity		Brexit scenario	
			Scenario 2 Equivalence where the provision already exists but no additional access rights granted	Scenario 3 Third-country agreement
Central counterparties (CCPs)	Clearing services		●	●
	Access to CCPs		●	●
Central securities depositories	Settlement services		●	●
Credit rating agencies	Client-facing and sales		●	●
	Execution <sup>29</sup>		●	●
	Risk management <sup>30</sup>		●	●
	Back office		●	●
Trading venues	Operating a trading venue		●	●

<sup>29</sup> “Execution” in this context means the production and dissemination of ratings.

<sup>30</sup> “Risk management” in this context means the control infrastructure.

Business line	Activity		Brexit scenario	
			Scenario 2 Equivalence where the provision already exists but no additional access rights granted	Scenario 3 Third-country agreement
Trade repositories	Trade repository services		●	●
Data reporting services providers	Provision of data reporting services		●	●
Benchmark providers	Provision of a benchmark		●	●

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