STEPHENSON HARWOOD

BREXIT AND FINANCIAL SERVICES[1]

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EU leaders cautiously welcomed the general election result, calling for the swift ratification of the Brexit legislation to enable the UK and EU to move on to the next phase of Brexit negotiations. Brexit Phase Two will involve the arduous task of agreeing the future relationship between the two sides – something which Boris Johnson promised voters would be signed, sealed and delivered by the end of 2020.

So what does the future hold in terms of Brexit? The possible routes (putting to one side the highly unlikely scenario of the House of Lords throwing a spanner in the works in relation to the Withdrawal Agreement Bill) are as follows:

- the UK officially leaves the EU on 31 January 2020 and subsequently negotiates a trade agreement with the EU by no later than (approximately) the end of October 2020 to allow sufficient implementation time for ratification by the UK and EU parliaments, and for the new arrangements to be put in place on the ground so that the Brexit transition period can end on 31 December 2020;
- the UK officially leaves the EU on 31 January 2020 but fails to agree and ratify a future trade deal with the EU and therefore "crashes out" at the end of the transition period on 31 December 2020 meaning that it must revert to trading on World Trade Organisation (WTO) terms; or
- the UK officially leaves the EU on 31 January 2020 but fails to secure a future trade deal with the EU in the coming months. To avoid the UK leaving the EU without a future trade agreement having been agreed (and therefore having to trade on WTO terms instead) the UK and the EU agree to extend the transition period beyond 31 December 2020. Note, however, that the revised version of the Withdrawal Agreement Bill which the government laid before Parliament after the general election included a new provision **explicitly prohibiting** any UK Minister from agreeing an extension of the transition period – despite the fact that Article 132 of the Withdrawal Agreement (signed by the UK and the EU on 19 October 2019) provides for an extension of the transition period by up to 2 years.

The new President of the European Commission, Ursula von der Leyen, has made clear her reservations surrounding Boris Johnson's plan to conclude negotiations on the future relationship between the UK and the EU by the end of the year. Speaking at the London School of Economics in early January 2020, she said: "*Without an extension of the transition period beyond 2020, you cannot expect to agree on every single aspect of our new partnership*", adding that the UK could face difficult trade-offs between market access and regulations: "*Without a level playing field on environment, labour, taxation and state aid, you cannot have the highest quality access to the world's largest single market*". In addition, the EU's chief negotiator, Michel Barnier, in a speech delivered in Stockholm shortly afterwards, reiterated this message, referring to the "*hugely challenging timescale*" being proposed by the UK. According to the Guardian newspaper: "*A scrappy, relatively unambitious, low-alignment trade deal is arguably the most plausible landing zone, in contrast to a deal that keeps both sides economically close and the UK locked into the EU's regulatory orbit*".

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[1] For further information on the current position in relation to the negotiation of a Free Trade Agreement between the UK and the EU, refer to our client briefing ***"Brexit: where do we go from here?"*** (February 2020).

Financial services: What will (and will not) change on a no deal Brexit, and what areas of uncertainty are there?

If the UK leaves the EU without a deal, "passporting" (that is the ability of a financial services firm authorised in one EEA State to establish a branch or provide cross-border services in another EEA State) will cease immediately.

Had a no-deal exit materialised on 31 January 2020, the legal position for outgoing and incoming firms would have been tolerably clear. With the date of any hard exit now postponed until 31 December 2020 there is again uncertainty as to what measures will be put in place to avoid a cliff edge – although it is perhaps likely that the UK will adopt a temporary permission regime for incoming firms in that scenario.

Outgoing firms (i.e. UK firms that have been relying on passports to operate branches, provide services or market funds in the EEA) will need to take steps to ensure they can continue to operate lawfully in the EEA. With minor, time-limited exceptions in the markets area, the EU did not make special arrangements to facilitate continued access to the EEA by UK firms following a no-deal Brexit, accordingly, from exit day, UK firms will be treated like third country firms. The minor exceptions at EU level related to facilitating continued access by EEA firms to clearing and central securities depositaries in the UK and providing a mechanism for novating OTC derivatives to EU entities.

A number of EEA jurisdictions put in place national measures to avoid a cliff-edge. These varied jurisdiction by jurisdiction and activity by activity. In some cases they were limited to permitting run-off of existing business, and in some cases were more generous. Local advice will be required.

Where there are no local transitional measures in place, in many cases UK firms will need to obtain authorisation in at least one EU State in order to continue to operate in the EU. In some cases alternatives may be possible, for example:

- It is a matter of local law whether a particular service or activity is deemed to be carried on in a given EEA State. This will generally turn on where "characteristic performance" occurs. Some EEA States might accept that the characteristic performance of a given regulated activity takes place offshore, for example some EEA States may accept that portfolio management activities take place where the manager, rather than where the client, is located.
- Similarly, some EEA States will accept that where the business carried on resulted from reverse solicitation (i.e. at the initiative of the client rather than the firm), authorisation in that State is not required.
- In some cases a firm may be able to use the tied agents regime under the Markets in Financial Instruments Directive to carry on some investment services with the authority and under the responsibility of a firm authorised in an EEA State.

Incoming firms (i.e. EEA firms operating branches, providing services or marketing funds in the UK) also require authorisation to continue to operate in the longer term. However, in readiness for a no-deal Brexit the UK provided a Temporary Permission Regime (**TPR**) which would have allowed firms to convert passports in place at exit day into temporary permission lasting for up to three years by giving a straightforward notice to the PRA or FCA as applicable.

Incoming firms under the TPR would have been subject to UK rules to a limited extent. The FCA summarised the position on its website. In very broad terms:

- UK rules that applied to incoming firms pre-exit would continue to apply to TPR firms;
- In addition, UK rules which implemented provisions of EU directives in relation to UK firms (i.e. home state requirements) would apply to TPR firms. This however was subject to "substituted compliance" – i.e. the FCA accepting that an EEA firm which is complying with the equivalent rules in its home EEA State in relation to its UK business is complying with UK requirements);
- Furthermore, certain other UK rules where protections would otherwise fall away, for example in relation to FSCS cover, status disclosure and client money would be applied to TPR firms.

The statutory instruments which gave effect to the temporary permissions regime have now been amended to defer their effect until the end of the implementation period (see below). The FCA has said that it will reopen the application window for incoming firms to apply for temporary permission at a date to be announced. The PRA has said that it will not reopen the application window, but firms applying for Part 4A permission during the implementation period will benefit from temporary permission if their applications have not been determined by the end of the implementation period. It seems that in both cases, applications that were validly made prior to exit day will continue to be valid for TPR as it applies following the implementation period.

Implementation period

- During the implementation period agreed between the UK and EU, passporting will continue. The position at the end of the implementation period depends on any trade deal that is agreed.
- The UK will continue to implement new EU legislation that comes into force.
- The political agreement agreed by Theresa May's government, and in this respect, adopted by Boris Johnson, only provides that the parties will work together to put in place equivalence decisions under existing EU financial services law that provides for them. This is far from a complete picture (link to Commission equivalence decisions overview table) and so in many cases, for outgoing firms, measures that were put in place in the case of a hard Brexit will be required in any case. Incoming firms will need to consider whether they need to obtain UK authorisations to continue their business at the end of the implementation period and any the further temporary regime.

How are other companies/ the market dealing with these issues?

In financial services, we understand that most outgoing firms that will be significantly impacted have taken steps to ensure they can continue to operate within the EEA. In general this means they have applied for authorisation in at least one EU country if they did not already have an EU entity.

Law and practicalities

Legislation

A substantial proportion of UK financial services law is derived from EU law. In many cases, EU Regulations containing detailed provisions apply directly in the UK. During the implementation period, current rules (including EU Regulations) will continue to apply. Following the implementation period, assuming no change of direction, the rules that apply at the end of the implementation period will continue to apply for the foreseeable future thereafter with only essential modifications being made (for example to disapply passporting, and to apply the rules currently applicable to third country firms to firms from the EEA).

This will be achieved through a huge exercise (known as "onshoring") of re-enacting EU Regulations with minor textual amendments as UK law and through the making of consequential amendments to UK statute law and FCA and PRA rules. A substantial volume of legislation and Handbook amendments to give effect to onshoring have been published on the Treasury, FCA and PRA websites. More will follow as the UK will continue to implement EU law coming into force during the implementation period.

In a small number of cases, where the consequences of applying third country treatment to EU entities and concepts would be particularly disruptive, substantive changes will be made to UK rules, for example UK UCITS funds will still be permitted to invest in EU securities on the more favourable basis that applied before exit day – the alternative, of treating EU investments like third country investments would force UK UCITS to sell significant proportions of their portfolios to stay within investment limits.

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