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BREXIT AND THE FINANCIAL SERVICES INDUSTRY

April 2018

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INTRODUCTION

On 29 March 2017, the United Kingdom (the "**UK**") submitted the notification of its intention to withdraw from the European Union (the "**EU**") pursuant to Article 50 of the Treaty on European Union. On 19 March 2018, chief Brexit negotiators: from the UK, David Davis MP and the EU's Michel Barnier, declared that a transition period would be implemented from 30 March 2019 (the "**withdrawal date**") to 31 December 2020. During this period, all EU laws will continue to apply in the UK and therefore financial services firms will continue to benefit from the passporting arrangements between the UK and European Economic Area ("**EEA**") until the end of the transition period, at which point the UK will then become a 'third country'. It is hoped that the transition period will allow the EU and the UK to have time to negotiate their future relationship and not least, the future of one of the UK's most important industries: financial services.

THE IMPORTANCE OF THE FINANCIAL SERVICES INDUSTRY

The financial services industry forms a significant part of the UK economy through the number of people it employs, its contribution to UK tax receipts and its contribution to balancing the UK's overall trade deficit with the rest of the world. The European Economic Area ("**EEA**") (comprising the EU and Iceland, Norway and Liechtenstein) is the largest market for the UK's financial services exports and the UK's market share of assets under management accounts for 37%, more than the total amount managed in the next three largest European countries, so it is beneficial to the EU as well as the UK that an agreeable solution is reached as European countries risk damaging their own economies if they are cut off from UK markets.

This newsletter begins by setting out what UK financial services firms can do to prepare for and capitalise on Brexit. It then considers in greater detail some possible outcomes of the Brexit negotiations for UK financial services and how it will be affected, whilst bearing in mind there is still a great deal of uncertainty at this stage.

A) PREPARING FOR BREXIT

1. HOW THE UK INVESTMENT MANAGEMENT INDUSTRY CAN CAPITALISE ON AND ADAPT FOR BREXIT

- it is important that the UK is able to seize new opportunities and be able to attract and retain global talent and capitalise on the competitiveness of the regulatory environment;
- outside the EEA, the UK could negotiate other passporting regimes;
- firms should shift their focus to be more international (i.e. look beyond the EU) in order to mitigate the impact of Brexit, for example, the Financial Services Trade and Investment Board is focused on boosting exports and investments in asset management and prioritising collaboration in financial services with China, India and the US;
- it is critical that continuity of service continues now, during the transition period and once the UK leaves the EU; and
- it is important that firms recognise that what is relevant and current in the UK domestic landscape, i.e. ageing population, green energy, pensions and infrastructure, is inherent across the globe.

2. WHAT SHOULD FIRMS DO NOW?

Financial services firms can Brexit-proof their operations by:

- reviewing their financial services contracts and identify those that, in particular, rely on passports;

- reviewing their derivatives contracts and examining derivative portfolios and identify those that, in particular, concern counterparties in the EU and counterparties in third countries to which the clearing obligation applies;
- notify clients/potential clients in good time of the impact of Brexit on the services they provide (MIFID);
- reviewing their commercial contracts and employment contracts to ensure they will still make commercial and practical sense in a post-Brexit world; and
- reviewing their European intellectual property portfolio.

B) THE NEGOTATIONS

1. EU VS UK

It was announced in December 2017 that 'sufficient progress' had been made in the Brexit negotiations and that discussions could now turn to reaching a trade deal. Since then, negotiators on both sides have publically indicated their positions on cross-border financial services. Davis called for a 'Canada Plus Plus Plus' ("**CETA +++**") trade agreement, which would use "*the best of Canada (CETA), the best of Japan and the best of South Korea and then add to that the bits that are missing, which is services*"[1]. A few days later, such an agreement covering financial services, appeared to be dismissed by Michel Barnier, the EU's chief negotiator, who said that *"There is no place [for financial services]. There is not a single trade agreement that is open to financial services."*[2] The EU has taken over 200 equivalence decisions on third country jurisdictions in financial services. More recently, in his Brussels speech on 9 January 2018, Barnier, suggested that any free trade agreement could not include all the benefits of the Customs Union and the Single Market and therefore, UK cross-border services after Brexit would be based on one of equivalence *"where allowed by our legislation"*[3] and after an assessment by the EU. This altered stance, has been considered, by some, as a 'softening' of the EU's position. It is also worth noting that the EU has taken over 200 equivalence decisions on third country jurisdictions in financial services.

In relation to financial services imports into the UK, the UK has already publicly stated that EU firms can continue to participate in the London market as they currently do.

What is clear, is that until a definitive solution is agreed between the two sides, we can only speculate on the possible impacts for financial services firms.

2. POSSIBLE SCENARIOS

In essence, the basis for the UK's trade with the EU will either take the form of a bespoke free trade agreement or will otherwise fall back to the UK trading with the EU on the basis of both parties' World Trade Organisation (the "**WTO**") scheduled commitments (assuming the UK's position on participation in the single market does not change). Within these possibilities there are a range of factors that will determine the level of market access available to UK and EEA firms in practice.

2.1. No deal ('hard brexit')

If the two sides fail to reach agreement on financial services, they would each be required to fall back to WTO rules and, in particular, the WTO agreement governing trade in services:

[1] David Davis interviewed on 'The Andrew Marr Show', BBC1, 10 December 2017.

[2] https://www.theguardian.com/politics/2017/dec/18/uk-cannot-have-a-special-deal-for-the-city-says-eu-brexit-negotiator-barnier

[3] http://europa.eu/rapid/press-release_SPEECH-18-85_en.htm

the General Agreement on Trade in Services ("**GATS**"), which arguably does not adequately cover financial services. Under GATS, WTO members must adhere to the Most Favoured Nation obligation ("**MFN**") which prohibits discrimination between similar services from different WTO members, essentially a WTO Member must treat service suppliers from all other WTO Members equally. However, there is no obligation to allow financial services imports from any third country and as such, the function of GATS is essentially for members to set out the maximum commitments they will accept for granting market access in the absence of a free trade agreement.

Under GATS, the EU are unlikely to offer any preferential treatment to the UK in a WTO deal, as GATS requires the EU to immediately offer the same treatment to service providers from other WTO members, which will lead to a weaker trade position for the EU.

Without any special deal with the EU, the UK will only have the right to trade in services with the EU under the conditions and limitations imposed by the EU in its specific schedules of commitments and its rules for third country access (i.e. 'equivalence'). Some UK firms have opted to set up subsidiaries in EU member states to pre-empt such an outcome and allow them to continue to provide their services to clients across the EU using their subsidiary's authorisation and passporting rights. The establishment of a regulated EU subsidiary, however, is likely to involve considerable cost as well as compliance with additional legal and regulatory requirements, and related risk.

With the absence of a free trade deal, a 'no deal' brexit under WTO rules would mean the UK would have to negotiate new deals on its services, a process which could be very lengthy. In preparing for a 'no deal', the government is proposing to bring forward legislation that will:

- enable EEA firms and funds operation in the UK to obtain 'temporary permission' to continue their activities in the UK for a limited period after withdrawal; and
- give UK authorities the power to carry out functions currently undertaken by EU authorities, i.e. it will give the Bank of England functions and powers in relation to non-UK central counterparties ("**CCPs**") and non-UK central securities depositories ("**CSDs**").

2.2. Equivalence

Equivalence is a mechanism provided by some (but not all) European single market directives through which financial institutions located outside the EEA are able to provide services to clients within the EEA where the EU considers their home jurisdiction to have equivalent regulatory regimes. As such, if the EU is willing to determine the UK an "equivalent" jurisdiction for the purposes of the relevant directive, UK financial firms might benefit from limited access rights into the markets of EEA member states.

In Barnier's Brussels speech, he suggested UK cross-border services would be provided under the EU's existing equivalence regime. It is, however, unlikely that the UK government would consider reliance on the existing EU equivalence regimes to be a satisfactory outcome. Chancellor, Philip Hammond, has commented that the existing EU equivalence regime is *"wholly inadequate for the scale and complexity of UK-EU financial services trade"*[4]. This is for a number of reasons:

- the process for obtaining an EU equivalence decision is typically lengthy and there is no guarantee that the European Commission ("**EC**") will grant equivalence, for example, the EC has only in October 2017 determined that US regulation of CCPs is equivalent to the European Market Infrastructure Regulation ("**EMIR**"), some four years after commencing its equivalence assessment. As things stand, the UK would need to wait until it had left

[4] https://www.gov.uk/government/speeches/chancellors-hsbc-speech-financial-services

the EU before it could apply for such an equivalence decision creating further delays and uncertainty, especially during the interim;

- certain EU single market directives (such as CRD IV[5]) do not provide for third country access based on equivalence, so it is unlikely that such third country firm access would extend to key financial services (including key banking services such as deposit taking, lending, payment services or mortgage lending as well as insurance mediation and activities relating to UCITS[6] regulated funds) as well as certain categories of clients;
- the EC reserves the right to withdraw its equivalence decision at any time. In order to continue to benefit from equivalence, the UK would need to ensure that its regulatory regime remains closely aligned with the EU regime; and
- the EU is currently in the process of imposing increased requirements for the basis on which the EU grants equivalence so that the UK may be required to adhere to more stringent regulatory requirements than under the existing system.

It is worth noting that in some cases, equivalence regimes may also be dependent on the laws and further discretion of individual member states.

The Investment Association has noted that: "*As part of the negotiation on Brexit, specific improvements should be sought to the existing third country provisions. These include allowing conditional access to retail clients for third country firms providing MiFID services, 'turning on' of the AIF passport for UK funds, and seeking a framework for robust and predictable equivalence adjudications*"[7].

2.3. Bespoke trade agreement

As discussed above, WTO MFN trading arrangements are not an ideal solution for UK cross-border financial services exports, and existing third-party equivalence is not sufficient for the long-term future of the industry. That leaves a third scenario: a bespoke trade agreement with the EU which extends to financial services.

The UK government's position is to retain as much access to the single market as possible, and a trade agreement including certain agreements around mutual recognition for the purposes of equivalence and delegation regimes has been discussed. However, such a trade agreement would be unprecedented and therefore the practical and political obstacles involved would be significant. In particular, any deal providing equivalent access rights without accepting the EU's four freedoms[8] would arguably see the UK being accused of "cherry-picking" and undermine the fundamental principles, integrity and proper functioning of the single market. This could risk setting a precedent that other member states might seek to follow, making this an unpalatable option for remaining member states.

A number of UK politicians (including the Chancellor and members of the House of Lords) have called for UK access to the EU market based on an 'enhanced' equivalence regime. In its report[9] on financial services after Brexit, the House of Lords argued that *"the main purpose of any bespoke agreement, so far as financial services is concerned, will be to supplement the current equivalence regimes to mitigate any loss of access and ensure the continuation of equivalence decisions in order to maintain access".*

The UK government might therefore look to expand the existing equivalence regime by:

- introducing a framework that recognises international standards as 'equivalent' giving the UK greater scope to break away from EU regulations;

[5] Directive 2013/36/EU
[6] The Undertaking for the Collective Investment of Transferable Securities
[7] The Investment Association's Brexit Series
[8] The freedom of movement of goods, people, services and capital.
[9] https://www.parliament.uk/business/committees/committees-a-z/lords-select/eu-financial-affairs-subcommittee/news-parliament-2017/financial-regulation-supervision-report-publication/

- removing some of the existing conditions for equivalent third country firms to provide cross-border services;
- introducing certain protections so that the EU may not withdraw any equivalence decision or put up additional barriers to entry for UK firms; and
- expanding the scope of the equivalence regime to include single market directives (and, potentially, client types) not currently included.

If the aim of such a regime is to replicate as far as possible the existing passporting rights currently enjoyed by the UK, this would involve the negotiation of a financial services trade deal that is on a scale otherwise unseen in other such agreements. It might also be seen to undermine the EU's existing trade agreements with other countries.

In conclusion, the EU is unlikely to offer the UK the kind of bespoke deal that gives it the best of the single market's financial services benefits without the other rights and obligations of the single market i.e. free movement of people as this would be an unprecedented and highly controversial move.

3. CURRENT POSITION ON A FINANCIAL SERVICES TRADE DEAL

In a recent speech[10], Prime Minister Theresa May acknowledged that "*life is going to be different*". She also acknowledged that access to each other's markets would be "*less than it is now*". She further stated that everyone would "*not get everything they want*" in the negotiations but that the UK and EU had "*a shared interest in getting this right*."

May also responded to the EU's[11] criticism that the UK was attempting to "cherry-pick" (in terms of a bespoke trade agreement) the best parts of the EU's rules and May replied: "*the fact is that every free trade agreement has varying market access depending on the respective interests of the countries involved*." May went on to say that the Chancellor will be soon setting out how financial services can and should be part of a deep and comprehensive partnership with the EU, however, it has recently been reported that the Chancellor has warned Brussels that the UK government may reject a deal that doesn't include access to financial services markets.

4. IMPACTS FOR FINANCIAL SERVICES FIRMS POST-BREXIT

The principal areas for potential issues for the UK financial services industry during the course of Brexit negotiations and after the UK leaves the EU are:

- MiFID[12] and passporting rights;
- banking & payment services;
- post-trade financial services;
- asset management;
- ESMA and the potential for 'double regulation'; and
- intellectual property "**IP**" rights.

4.1. MIFID and passporting[13]

Authorisations

Once the transition period has ended, and if no bespoke trade deal has been arranged, UK investment firms will no longer benefit from the MiFID authorisation to provide MiFID investment services and activities in the EU (meaning that they will lose the so-called "EU

[10] https://www.gov.uk/government/speeches/pm-speech-on-our-future-economic-partnership-with-the-european-union
[11] Michel Barnier, speech in Brussels, December 2016.
[12] The Markets in Financial Instruments Directive
[13] https://ec.europa.eu/info/publications/180208-notices-stakeholders-withdrawal-uk-banking-and-finance_en

passport") and will be third-country firms. This means that those firms will no longer be allowed to provide services in the EU because they will not meet the current authorisation requirements which will mean as follows:

- the current 27 member states of the European Union excluding the UK ("**EU-27**") subsidiaries (legally independent companies established in EU-27 and controlled by or affiliated to investment firms established in the United Kingdom) can continue to operate as EU investment firms if they have a MiFID authorisation in one of the EU member states;
- branches in the EU-27 of UK established investment firms will be branches of third country investment firms and will need to comply with national requirements applicable in the Member State where the branch is established or with the regime set out in Article 39-41 MiFID II[14] where applicable. The provision of services/activities is limited to that Member State's territory;
- UK market operators/investment firms operating a trading venue or execution venue will no longer benefit from the MiFID authorisation/licence. UK based regulated markets ("**RMs**"), multilateral trading facilities ("**MTFs**") or systematic internalisers will therefore cease to be eligible venues for trading shares subject to the MiFIR[15] share trading obligation, and consequently EU counterparts will no longer be able to undertake trades in shares subject to the trading obligation on such platforms. Further, UK based RMs, MTFs or organised trading facilities will cease to be eligible venues for the purposes of the MiFIR derivatives trading obligations, Consequently EU counterparts will no longer be able to undertake trades on these platforms. In both cases, EU counterparts would need to reassess their trading arrangements to ensure continued compliance with their obligations under the MiFID framework; and
- where previously available, UK based trading venues and central counterparties ("**CCPs**") will no longer benefit from the open and non-discriminatory access to EU trading venues, EU CCPs and EU benchmarks respectively.

However, under MiFID II there is an option for a third country entity to establish a branch in an EU member state – "a branch passport", which will allow them to provide investment services to all types of clients in that member state. If the UK were given access to that branch passport once the transition period has ended, it could mitigate against some of the disruption and uncertainty.

4.2. Consequences of losing MiFID authorisation

The loss of UK's MiFID authorisations could:

- negatively impact relationships with EU clients/counterparts as it will affect the ability of UK-established firms to continue performing certain obligations and activities deriving from existing contracts;
- stop EU established firms dealing in financial instruments subject to the MiFID trading obligations being able to use certain UK established firms/venues; and
- mean that clients no longer have direct electronic access to EU established trading venues via UK established firms.

Under MiFID, firms are required to take measures to ensure continuity in the performance of investment services and activities. To this end, firms should assess the impact of the withdrawal of the UK from the EU on their operations and identify and mitigate any compliance risks.

4.3. Other considerations for firms

[14] These articles set out the provisions related to the provision of investment services and activities by third country firms.
[15] The Markets in Financial Instruments Regulation (EU) No 600/2014.

The outsourcing of certain operational functions to UK providers may be undertaken only when in compliance with relevant MiFID requirements. In particular, the outsourcing of functions related to portfolio management to UK entities will only be permitted where the conditions under Article 32 of the MiFID Delegated Regulation[16] are met,[17] including the requirement that cooperation arrangements between the home Member State National Competent Authorities ("**NCAs**") and UK competent authorities are in place. Moreover, ESMA has issued opinions [18]with specific clarifications on these matters, in particular on the risks of letter-box entities which may arise from the use of outsourcing arrangements or from the use of non-EU branches for the performance of functions/services with respect to EU clients.

In light of MiFID obligations on disclosure of information to clients, firms providing investment services are required to provide clients or potential clients with accurate disclosure, in good time and in any case before clients are bound by any contract, on the impact on the provision of services and investors' rights that may emerge as a result of Brexit, including the upcoming loss by the firm of its MiFID authorisation. Firms providing investment services are also required to notify clients in good time about any material change to the information already provided, including if any material changes occur to the situation of the firm (arising out of or in connection with Brexit, for example)and any resulting consequences for contracts.

5. BANKING AND PAYMENT SERVICES[19]

Once the transition period has ended, and if no bespoke trade deal has been arranged The EU rules in the field of banking and payment services, particularly in relation to prudential supervision and requirements of: credit institutions; investment firms; and payment services in the internal market, will no longer apply to the United Kingdom. This will have particular consequences on the following:

- authorisations;
- arrangements and exposures; and
- contracts.

5.1. Authorisations

UK entities providing banking and payment services, as well as e-money issuing, may no longer benefit from the authorisation to provide those services and activities in the EU (they will lose the so-called "EU passport") and will be treated as third country entities with regard to their ability to establish branches or agents in other member states. This means that those entities will no longer be allowed to provide services in the EU on the basis of their current authorisations.

As of 31 December 2020, UK companies which have established branches in another member state and who are authorised by the FCA, will have to comply with the third country rules of that host member state. This includes being authorised by the relevant competent authority of the host member state. This may mean that companies will need to submit an application for authorisation as a branch or subsidiary and potentially result in changes for depositors, for instance where deposit guarantee arrangements would need to change. Payment institutions authorised by the FCA, as of 31 December 2020, will not be allowed to provide payment services in the territory of the EU cross-border or through the use of branches located in the member states.

[16] Commission Delegated Regulation (EU) 2017/565
[17] This article sets out provisions related to service providers located in third countries.
[18]https://www.esma.europa.eu/sites/default/files/library/esma35-43-762_opinion_to_support_supervisory_convergence_in_the_area_of_investment_firms_in_the_context_of_the_united_kingdom_withdrawing_from_the_european_union.pdf
[19] https://ec.europa.eu/info/publications/180208-notices-stakeholders-withdrawal-uk-banking-and-finance_en

Companies authorised by the NCAs in the EU, including their branches, will have to comply with the conditions of their authorisation on a continuing basis. Where entities authorised by a NCA in the EU have established branches in the UK, these branches will have to comply with the scope of the authorisation granted to the entities of which they are an integral legal part. This includes compliance with regard to their programme of operations and structural organisation and the requirement that the effective exercise of supervisory functions is not prevented by difficulties involved in the enforcement of the laws, regulations or administrative provisions of the third country. The services covered by the scope of the authorisation, including services provided by any branches of the authorised entity located in a third country, will continue to be subject to the supervisory powers of the competent authority which has granted the authorisation, including in particular the power to restrict or limit the business, operations or network of institutions or to request the divestment of activities that pose excessive risks to the soundness of an institution. The services provided by these branches will as well be subject to the relevant requirements which are set out in the EU legal framework.

5.2. Arrangements and exposures

Post-Brexit, arrangements which may affect the ability of companies authorised in the EU to have an autonomous risk management and control framework, and sufficient operational resilience, including trading and hedging capabilities, in crisis will have to be assessed by the competent authority which has granted the authorisation. The assessment will e.g. consider whether, as of the withdrawal date, companies authorised by a competent authority in the EU are allowed to continue to rely on: outsourcing or supervisory arrangements; exemptions from the application of large exposures; or risk mitigation requirements, involving counterparties established in the UK – including parent institutions or other institutions of the same group.

The prudential treatment of exposures to third parties established in the UK will also be affected as of the withdrawal date. This is without prejudice to any equivalence decision that may be adopted by the EU in relation to specific prudential treatment referred to in the CRD. Similarly, in the resolution framework, as of the withdrawal date, the assessment of the eligibility of liabilities for the minimum requirement for own funds and eligible liabilities may have an effect on those liabilities issued under UK law.

6. POST-TRADE FINANCIAL SERVICES

As of 31 December 2020, EU rules on financial markets will no longer apply to the UK, in particular:

- EMIR[20] on OTC derivatives, central counterparties and trade repositories;
- MiFIR, SFTR[21] on transparency of securities financing transactions and of reuse; and
- SFD[22] on settlement finality in payment and securities settlement systems.

6.1. Derivatives

Subject to any transitional arrangement and a Brexit deal, as detailed in a Notice to Stakeholders from the European Commission dated 8 February 2018[23], from a strict point of view, as of the withdrawal date, derivatives traded on a UK regulated market may no longer fulfil the definition of exchange traded derivatives ("**ETDs**") under EU law. According to Article 2(32) of MIFIR,[24] ETDs are derivatives traded on an EU regulated market, or on a third-country market considered to be equivalent. Thus, under EU law, as of the withdrawal date, ETDs traded on a UK regulated market may become over-the-counter ("**OTC**")

[20] The European Market Infrastructure Regulation (EU) No 648/2012
[21] The Securities Financing Transactions Regulation (EU) 2015/2365
[22] The Settlement Finality Directive 98/26/EC
[23] https://ec.europa.eu/info/publications/180208-notices-stakeholders-withdrawal-uk-banking-and-finance_en
[24] This article provides the definition of an ETD

derivative contracts. An ETD that becomes an OTC derivative will thus become subject to all EMIR requirements applicable to OTC derivatives transactions. All OTC derivatives transactions count towards the calculation of the clearing threshold in accordance with the provisions of EMIR and will be subject to the EMIR clearing obligation where one has been adopted as well as certain risk mitigation techniques (notably the exchange of margins).

Certain over-the-counter (**"OTC"**) derivatives are or will be, in the future, subject to the clearing obligation set out by EMIR and therefore have or will have to be cleared by a CCP which is authorised and established in a Member State of the EU or a CCP established in a third-country and which is recognised by ESMA under Article 25 of EMIR[25] to clear that class of OTC derivative. As of the withdrawal date, CCPs established in the UK may be third-country CCPs which would need to be recognised under EMIR before they could be used to clear derivatives captured by EMIR's clearing obligation.

A potential loss of EU authorisation of CCPs established in the UK would affect their ability to continue performing certain activities (e.g. compression) and fulfilling certain obligations (e.g. default management) with regard to contracts concluded before the withdrawal date.

An additional consequence of UK CCPs ceasing to be able to clear particular classes of derivatives would be that higher capital charge will apply to exposures resulting from positions in derivatives held by credit institutions and investment firms established in the EU and their subsidiaries in non-recognised CCPs established in the EU. This is because only authorised CCPs established in the EU and recognised CCPs established in a third country are qualifying CCPs which have a favourable treatment under CRR.

Counterparties with derivatives positions subject to EMIR's clearing obligation that are likely to remain live and cleared through UK CCPs, should consider the consequences of any such CCPs ceasing to be authorised to clear derivatives for the purposes of EMIR.

6.2. Trade repositories and reporting

Derivatives or securities financing transactions which are subject to the reporting obligation under EMIR or SFTR must be reported by counterparties to an EU registered trade repository or to a third-country trade repository recognised by ESMA[26] under Article 77 of EMIR.[27] As of the withdrawal date, trade repositories established in the UK will be third-country trade repositories and will need to be recognised by ESMA to be able to continue registering and recording derivatives transactions.

The obligation to report derivative contracts to a duly registered or recognised trade repository falls to the counterparties and all counterparties (whether financial or non-financial) must ensure that these obligations are complied with. Where reporting to a trade repository is delegated to a third party, counterparties should ensure that their derivative contracts guarantee continued compliance with all applicable legal requirements in EMIR and/or SFTR after the withdrawal date.

Securities settlement systems will no longer be able to be designated by the UK under the SFTR. As of the withdrawal date, systems currently designated by the UK will lose their designation under the SFTR along with the rights and benefits that entails for them and their participants. This is without prejudice to any specific provisions in national law of member states.

7. ASSET MANAGEMENT[28]

As of 31 December 2020, the passporting rights afforded by, in particular the UCITS Directive[29] and AIFMD[30], will no longer apply to the United Kingdom. This will have particular consequences on the UK and EU asset management industry.

25 This article sets out provisions related to the recognition of a third-country CCP
26 The European Securities and Markets Authority
27 This article relates to the recognition of trade repositories.
28 https://ec.europa.eu/info/publications/180208-notices-stakeholders-withdrawal-uk-banking-and-finance_en

UK authorised UCITS Management Companies and AIFMs: UK UCITS management companies and UK Alternative Investment Fund Managers ("**AIFM**") will lose their EU management passports and therefore in order for UK firms to continue to manage EU funds then they would have to appoint an EU UCITS management company or AIFM, or the funds would have to become self-managed. The Investment Association have said: "*after Brexit, UK funds will no longer be capable of being classified as UCITS. As a result, they will lose access to the UCITS fund passport and will not be freely marketable to retail investors in the EEA unless the UK arrives at a deal with the EU to preserve the ability for UK funds to retain UCITS status*"[31]. The Investment Association further note that UK UCITS management companies could still continue to provide services to EU UCITS from outside the EU on a delegated basis, subject to complying with the UCITS delegation regime. Member states may allow AIFMs who are not established and authorised in the EU to market AIFs (EU AIFs and non-EU AIFs) only in their territory under the so-called National Private Placement regimes ("NPPR"). AIFMD provides member states with discretion as to whether to activate NPPR and allow for stricter rules in addition to the minimum requirements in that Directive. Some member states do not allow for the NPPR, while other member states only allow marketing to professional investors.

UK domiciled investment funds: UK-domiciled UCITS would no longer be able to use the EU marketing passport. In order for a fund to be marketed in Europe, marketing could take place under the national private placement regimes or the fund could re-domicile to an EU Member State such as Ireland. If the AIFMD passport is extended to third countries, UK domiciled AIFs could continue to be marketed in the EU without any great change and UK UCITS could then be marketed to professional investors in the EU as UK AIFs. Extending the AIFMD third country passport to the UK would require an equivalence of UK law to EU law assessment by ESMA and a recommendation to the European Commission. Additional local requirements will need to be met for UK AIFs to be marketed to retail investors.

UK portfolio managers: UK-based portfolio managers would need to comply with local third country rules to continue EU portfolio management activity. Alternatively, a new portfolio management entity could be established in an EU Member State. However, if the UK is designated as equivalent under MiFID II, UK portfolio managers would be able to continue to manage the assets of EU professional clients without substantial change.

EU domiciled UCITS and AIFS: as of the withdrawal date, EU UCITS and AIFs authorised or registered in the UK in accordance with the UCITS Directive or AIFMD will be non-EU AIFs and would lose their rights to be marketed in the UK.

8. CONTINUED AIR OF UNCERTAINTY

The EC has told UK-based asset managers they must prepare for all Brexit scenarios, with the industry facing considerable uncertainties as the country prepares to leave the bloc. In a letter written by the EC's Directorate-General for Financial Stability, Financial Services and Capital Markets Union, asset managers were told "*in view of the considerable uncertainties, in particular concerning the content of a possible withdrawal agreement, stakeholders, including managers of investment funds and investors are reminded of legal repercussions which need to be considered when the United Kingdom becomes a third country*."

The EC's letter also said that UK firms are required to "*take a number of steps to inform investors of the consequences of the withdrawal of the United Kingdom from the EU*":

[29] Directive 2009/65/EC
[30] Directive 2011/61/EU
[31] https://www.theinvestmentassociation.org/assets/components/ima_filesecurity/secure.php?f=reports/20161216-anewrelationshipwiththeeu.pdf

- AIFMs must include in their annual report any material change to the information to be disclosed to investors, "*which includes, but is not limited to, the legal implications of the contractual relationship*"; and
- UCITS management companies, which are required to prepare a KIID[32] that must be kept up to date, will need to update the information on which member states they are authorised in.

Therefore, it is advisable that UCITS management companies and AIFMs assess whether the change of the legal status of the investment fund will still be compliant with the investment strategy of the fund as communicated earlier to investors.

9. ESMA AND POTENTIAL FOR DOUBLE REGULATION

The EU has issued proposals that would see ESMA's powers expanded, enabling it to continue to regulate UK asset managers after Brexit and effectively add an extra layer of regulation. The initial proposals, which form part of an EC review aiming to strengthen European supervisory authorities ("**ESAs**"), would also reduce the influence of national regulators and see ESMA take direct supervision of some investment funds. Therefore, UK asset managers potentially face what amounts to "double regulation" post-Brexit, both from ESMA and the FCA, but further clarity on what the proposals mean for ESMA's power is required. As such, there is still a great deal of uncertainty about what ESMA's ESA review and proposals would mean for firms.

Consultation on the proposals closed at the end of January and ESAs are currently in the process of assessing feedback.

10. IP RIGHTS

IP is an important asset for all businesses including those in the financial services industries. Currently, certain registerable IP rights such as trademarks and community designs, can be registered in the firm's home member state and then a concurrent application can be lodged throughout the EU. Further, all EU registered IP rights are enforceable in the UK. The prospect of Brexit is therefore concerning as it is unclear how the relationship between IP rights in the EU and the UK will continue.

On the withdrawal date, the three possible scenarios in relation to IP rights are as follows:

- to take no action;
- to negotiate; or
- to enact UK legislation.

10.1. No action is taken

This would mean that EU IP rights no longer take effect in the UK, the consequences of which would be as follows:

- rights holders will no longer be able to challenge infringers in the UK based on EU registered rights;
- re-filing may not be a remedy due to potential intervening rights and/or loss of novelty;
- commercial arrangements may therefore be impacted; and
- all pending litigation based on EU rights may collapse.

10.2. Negotiation

[32] Key Investor Information Document

Negotiate with remaining EU member states for bilateral arrangements where the UK remains part of the EU IP system post-Brexit, the consequences of which would be as follows:

- this scenario will require bilateral arrangements with the remaining member states which is unlikely to be feasible;
- this scenario maintains status quo and avoids placing burden on owners of unitary rights; and
- this scenario involves the creation of an EU IP area which is attractive to Switzerland and EEA countries but could lead to issue around divergence of EU and UK decisions and UK judiciary will still be bound by EU rulings.

10.3. Enact UK legislation

Enact national UK legislation to allow the owner of EU IP rights to continue owning rights in the UK post-Brexit, the consequences of which will be as follows:

- EUTMs[33] and community designs will continue to have protection in the UK post-Brexit; and
- there is current uncertainty as to administrative burden and costs and what this would look like.

10.4. UK Government response

The government's White Paper on Brexit from February 2017[34] did not give any specific intellectual property commitments but did provide a general statement that the government would want to keep trade as free as possible.

The EC issued a paper on Trade Marks and Designs in December 2017[35] which has broadly been more positive (although it does not discuss technical issues) as follows:

- the paper recognises the critical need to ensure that there is no gap in the protection by EU trademarks and designs ceasing to cover the UK at Brexit;
- the EC envisages automatic recognition of registered rights (rather than the rights holder having to take action);
- no additional financial costs to rights' holders and minimal administrative burden;
- the EC envisage applicants of pending applications being able to seek equivalent protection in the UK post-Brexit whilst maintaining the same priority date as the pending EU application; and
- intellectual property rights which were exhausted in the EU territory at Brexit should remain exhausted in both the remaining EU member states and the UK.

There is a risk of potentially cluttering the UK register if, on or immediately after the withdrawal date, there was immediate dumping of a large number of EU registered intellectual property rights on UK registers.

In the latest draft of the Withdrawal Agreement (19 March 2018)[36] the UK Government and European Commission negotiators appear to have agreed text providing for the replacement of EU-wide IP rights having effect in the UK with equivalent UK rights at the end of the transition period post-Brexit (until 31 December 2020). Further, during the transition period, EU-wide rights will still apply to the UK due to the effect of Article 122 which provides that

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33 EU Trademarks

34 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/589191/The_United_Kingdoms_exit_from_and_partnership_with_the_EU_Web.pdf

35 https://ec.europa.eu/docsroom/documents/26683/attachments/1/translations/en/renditions/native.

36 https://www.gov.uk/government/publications/draft-withdrawal-agreement-19-march-2018

EU law will be applicable to the UK during the transition period and that it will produce the same legal effects in respect of and in the UK as those which it produces within the EU and its Member States and shall be interpreted and applied in accordance with the same methods and general principles. Further, during the transition period, any reference to Member States in EU law shall be understood as including the UK. However, there are still unresolved issues for those who hold IP rights in the EU and those who license (in or out) EU-wide IP rights or have agreements linked to the "EU" as territory.

10.5. Steps to consider taking now or in the near future

The following are practical steps that firms can take now to minimise Brexit IP risk:

- review IP portfolios to ascertain current protection;
- if only EU protection is in place for key branding, consider re-filing for UK protection (depending on risk tolerance); and
- review licences to assess whether they only cover EU rights and if they only cover EU rights consider whether any variations are required.

It is worth noting that it may not be possible to refile community registered designs unless within the priority period due to the novelty requirement for designs.

11. FCA RESPONSES

The FCA's position is that they welcome the progress that has been made and are supportive of open markets and free trade in financial services underpinned by strong regulatory standards. Further, the FCA welcomes the intention to provide for an implementation period to ensure a smooth and orderly exit of the UK from the EU. The House of Lords Select Committee on the EU has published a transcript of oral evidence by Chris Woolard, FCA director of strategy and competition, taken from a hearing on 10 October 2017[37] on consumer protection rights in relation to Brexit.

Among other things Mr Woolard refers to certain principles the FCA thinks are important in the context of the Brexit, these being:

- the FCA believes fundamentally that, for market conditions to work well for consumers, open markets provide the best possible outcome. For healthy competition to exist, some degree of cross border market must still occur post Brexit;
- the FCA would support globally consistent standards for financial services regulation. This is an important part of dealing with markets that are, in themselves, global; and
- the FCA believes strongly in the co-operation between regulatory authorities that will need to occur, both member state to member state and UK to pan-European bodies. The FCA believes that the best way of achieving this is by having a robust framework in place for it to occur in, which means that continued co-operation can still occur.

On 20 December 2017, HM Treasury announced[38] that if necessary, the Government will legislate for a temporary permissions regime. This regime will enable relevant firms and funds to undertake new business within the scope of their permission, enable them to continue performing their contractual rights and obligations, manage existing business and mitigate risks associated with a sudden loss of permission.

Firms and funds that are solely regulated in the UK by the FCA would need to notify the FCA before exit day of their desire to benefit from the regime but this notification for temporary

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[37] http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/eu-justice-subcommittee/brexit-consumer-protection-rights/oral/71122.html

[38] http://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2017-12-20/HCWS382/

permission will not require the submission of an application for authorisation. Further details will be provided by the FCA in due course.

12. CONTRACTS

Contract continuity for relationships between parties established in the EU and in the UK, will be affected by the loss of the single passport, as this will impair the ability of UK based entities to continue performing certain obligations and activities and ensure service continuity with regard to contracts concluded before the withdrawal date. As of the withdrawal date, the EU rules on conflicts of laws and jurisdictions may no longer apply to the UK. Where contracts are governed by the law of the UK, or contain a choice of law or an agreement in favour of the jurisdiction of a court in the UK, parties to those contracts should carefully assess the impact of the withdrawal of the UK on the validity and enforceability of those contracts and mitigate any risks, including any risks to their clients. This can be done by examining key commercial contracts in light of the following:

- parties which contracted on the basis of the EU (which included the UK), could face difficult questions of interpretation following Brexit. For example, a distributor with permission to market a product within the EU will want to know whether it is still permitted to sell within the UK following Brexit; and
- similarly, if Brexit results in different tariffs applying to cross-border sales (for example), some parties may try to break their agreements entirely through ‘frustration’ of the contract or relying on ‘force majeure’ majeure event meaning that the party or parties no longer need to perform their obligations under the contract.

13. NEXT STEPS

To support this and to provide consistent and effective supervision, the FCA will continue to cooperate closely with the home state regulators of EEA firms and the European Supervisory Authorities and will issue further announcements in due course. However, much remains to be seen with overall very little certainty as to what form Brexit will take and what the consequences will be.

For more information, and any guidance or advice on Brexit and its impact on your firm, Cleveland & Co External in-house counsel, your specialist outsourced legal team, are here to help.