Offsetting the Loss of Passporting Rights in Financial Services Regulation

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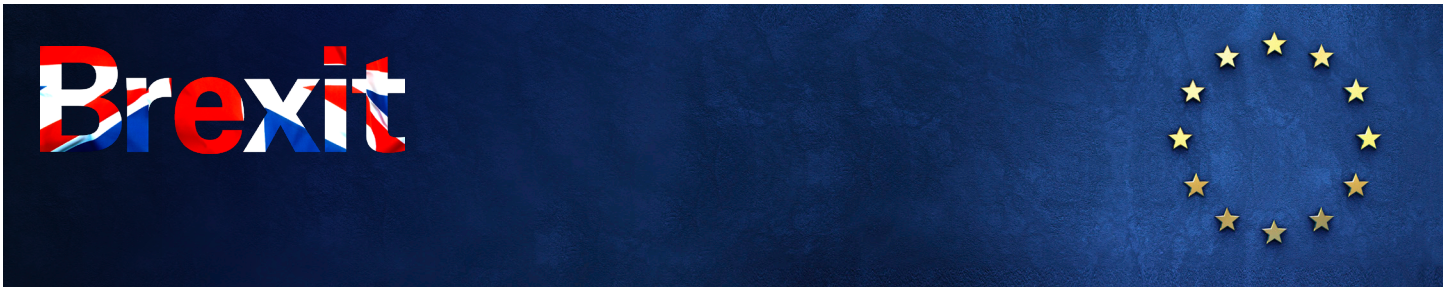

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The Trade and Cooperation Agreement (TCA) does not provide a comprehensive free trade arrangement for financial services between the EU and the UK. In particular, the TCA contains no measures to offset the loss of the EU-wide licensing cover UK firms previously enjoyed under a "passport." This key benefit to being within the EU single market for financial services had meant that London was selected as the location of choice for many firms and served as the main gateway to access the EU market.

Takeaways

- The TCA does not provide a solution to offset the loss of access to the EU market that UK firms previously enjoyed.
- Many larger UK banks and broker-dealers had already restructured their operations based on a "hard Brexit" scenario.
- Work is ongoing to establish a framework based on equivalence, but the outcomes are uncertain and likely to be uneven across financial services.
- The UK is likely to diverge from the EU in its rulemaking in certain areas such as in asset management.

Possible solutions to replace the loss of passporting rights, such as enhanced equivalence or mutual recognition arrangements, did not gain traction in negotiations with the EU. Even the prior nonbinding commitments on both sides to implement the existing (and limited) equivalence provisions did not materialise in the TCA (although, as set out below, equivalence provisions do form part of the discussions around the memorandum of understanding between the EU and the UK that the parties hope to be concluded by the end of the first quarter).

Instead, the TCA contains a commitment for both parties to implement international standards (*e.g.*, the Basel Committee's standards relating to the banking sector). This does not introduce any meaningful obligation, as both the UK and EU are already committed not only to adhere to international standards but also to participate in standard-setting bodies. There is also a provision requiring the maintenance of access to each other's payment and clearing systems run by central banks and other public authorities, as well as to establish a structure for regulatory cooperation between the two jurisdictions as set out in the Joint Declaration on Financial Services Regulatory Cooperation Between the EU and the UK (Joint Declaration) that was published alongside the TCA.

Accordingly, UK firms which previously enjoyed unhindered access to the EU market under the passport are effectively faced with a "hard Brexit" scenario. Such firms must now establish a licensed entity in the EU or augment the use of an existing EU-based entity. Alternatively, they will have to rely on licensing exemptions to the extent they are available. Most member states have not implemented meaningful exemptions from

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their regulatory licensing regimes that would be available to UK-based firms. Many larger UK banks and broker-dealers planned their post-Brexit business on the basis of a hard Brexit scenario and have already restructured their operations, but many smaller UK firms have not taken these steps due to the costs involved and additional resources required.

The EU has granted temporary equivalence for central counterparties and central securities depositories authorised in the UK, thus preserving access to critical UK financial market infrastructure. This measure is intended to alleviate the difficulties EU-based firms face when switching to an alternative clearing or settlement provider in the EU which may not yet be available, rather than to confer any benefit to UK clearinghouses and settlement systems. Some individual EU member states, such as the Netherlands and Italy, have put in place temporary, limited arrangements to enable UK firms to continue providing services to wholesale clients in their jurisdictions. Some UK firms are also relying on "reverse solicitation" (*i.e.*, an unsolicited instruction by the EU-based customer to the UK firm to provide services) in order to avoid licensing. However, there is ongoing scrutiny by the EU in relation to misuse or excessive reliance on this as a means of avoiding licensing.

From the European perspective, EU firms seeking to provide cross-border services in the UK are also impacted by the hard Brexit approach and the loss of the passport in terms of accessing the UK market. The UK has adopted measures to ease the transition for these EU firms, including the Temporary Permissions Regime which affords a license for a limited time until a stand-alone UK license is obtained. Temporary licensing cover is also afforded to those EU firms intending to wind down business and exit the UK market. Ultimately, EU firms seeking to do business in the UK will be required to have appropriate UK licenses or rely on an exemption to provide financial services to UK customers. The UK has unilaterally granted equivalence determinations in many but not all sectors, which will benefit EU firms in certain contexts (*e.g.*, when acting as market-makers subject to the UK Short Selling Regulation) as well as UK firms in some respects. For instance, as a result of the UK's equivalence measures, UK banks and broker-dealers will not be penalised for their credit exposures to EU counterparties relative to UK counterparties.

The UK has chosen not to implement the full range of equivalence measures which could have been adopted as, in the UK's view, granting equivalence in certain areas without reciprocity from the EU would not be beneficial for UK firms. On this basis, the UK has chosen not to grant equivalence enabling EU broker-dealer firms to provide investment services in the UK on a cross-border basis. There is also no equivalence for EU trading venues for the purposes of the UK's equities and derivatives trading obligation. This has had the effect of bifurcating UK and EU markets and adversely affecting the liquidity of many financial products. More broadly, UK versions of existing EU financial services legislation have created issues of duplication and conflict in certain areas, with consequent disruption and uncertainty. For instance, EU firms with UK branches will be subject to both the UK and EU versions of the trading obligation and will not be able to comply with both. This conflict may have the effect of pushing trading of in-scope contracts entered into between UK and EU counterparty pairs to US trading venues, which are recognised under both the UK and EU trading obligations.

Work is ongoing to implement the commitment set out in the Joint Declaration in order to establish a framework for regulatory cooperation. The framework will be designed to enable the following to take place between UK and EU regulators:

- Bilateral exchange of views and analysis relating to regulatory initiatives;
- Transparency and appropriate dialogue in the process of adoption, suspension and withdrawal of equivalence decisions; and
- Enhanced cooperation and coordination, including through international bodies.

The Joint Declaration sets a 31 March 2021 deadline for conclusion of these discussions. The resulting agreement will be included in a memorandum of understanding (MoU) between EU and UK regulators.

The goal of the Joint Declaration is limited in scope. No provision is made for discussion of enhanced equivalence or mutual recognition. Only existing equivalence frameworks will be discussed, and any decision-making with respect to equivalence will be unilateral and autonomous for each party. There will therefore not be a bilateral equivalence mechanism, although the procedure for withdrawal of equivalence decisions (they can currently be withdrawn on 30 days' notice) is up for discussion, so there may be additional safeguards in this regard.

Given the limited scope of the Joint Declaration and the paucity of current equivalence regimes, the UK may determine that the loss of regulatory autonomy outweighs the benefits of equivalence, depending on the approach the EU takes in the discussions surrounding the MoU. To date, the EU has been reluctant to grant equivalence to the UK, even though the underlying EU and UK regulatory frameworks are substantively identical. The EU has taken the view that its own regulations are in flux, so there is no appropriate benchmark for comparison with the UK framework. In addition, the EU has made clear that the onus is on the UK to indicate that the future direction of UK regulation will be in line with EU rulemaking before equivalence is granted.

Brexit

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The EU's position on equivalence is considered to be inflexible by some UK decision-makers, who may argue for the UK to be able to diverge from the EU's financial services regulatory regime rather than accept equivalence on the EU's terms. As financial services regulation is not covered by the forward-looking nonregression provisions of the TCA, the UK is able to break from the EU when developing financial services legislation without risking trade retaliation measures. The chancellor of the exchequer has already indicated potential areas of divergence from EU policymaking in areas such as fintech regulation, the development of UK measures to promote sustainable investment, the development of the UK asset holding company regime in the asset management sector and in relation to the treatment of overseas firms.

The potential benefits of divergence must be balanced against the potential impact on UK firms. Significant differences between the EU and UK regulatory frameworks would increase the compliance burden for firms that are required to comply with both sets of rules, especially those which provide cross-border services.