



BREXIT: WHAT HAPPENS NOW?

**Passporting for UK financial institutions post-Brexit –
Sorting the myths and wishful thinking from reality**

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The future of the single market passport for UK-based financial institutions

With the dust beginning to settle following the initial shock of the EU referendum result, financial institutions are turning to consider in earnest the practical steps that need to be taken to protect their businesses in anticipation of the strong likelihood that the UK will, at some point over the coming years, cease to be part of the EU (and, indeed, the wider EEA).

Various claims have been made in the media – including by very senior economists – concerning the future availability of single market passporting rights to UK-based financial institutions. Many of these claims have involved over-generalisation of this complex area, and have consequently been misleading or even inaccurate. Given the very great importance to UK financial institutions of their passporting rights, this level of confusion is unhelpful.

In this article, we explain the legal framework for the passporting regime in respect of financial services under the single market Directives and assess what the future landscape might look like, focussing upon:

- What are the various EU Directives under which passporting rights are established in respect of the main categories of financial services activities?; and
- What is the position of “third country” firms (which the UK is very likely to become) in respect of passporting rights under each Directive?

What is the legal basis for these passporting rights?

The rights of freedom of establishment and freedom to provide services throughout the EU are fundamental to EU law and are enshrined in the Treaty on the Functioning of the European Union.¹

What is ‘passporting’ in a financial services context?

Passporting rights in respect of specific financial services activities are expressly provided for under a series of EU Directives, known as the single market Directives. These Directives focus on particular sectors of the financial services industry, for example banks, investment firms, insurers, retail fund managers and alternative investment fund managers. It follows that the passporting rights available to financial institutions must be analysed according to the relevant Directives.

Passporting is the exercise of the rights available to firms under the various EU single market Directives to carry on financial services activities in another EEA member state, without needing to be authorised outside their home member state, and without having to hold separate pools of capital in every jurisdiction in which they operate.

There are two categories of passporting rights:

1. the right to set up a branch in another EU or EEA member state (the “establishment passport”); and
2. the right to provide services to customers in other EU or EEA member states on a cross-border basis, without establishing a branch in any other member state (the “services passport”).

Rather than needing to be authorised in each member state in which they operate, financial institutions exercising their passporting rights under (and in compliance with) the relevant single market Directives merely need to follow a notification procedure² to tell the competent authority in their home state that they wish to exercise their passporting rights. The home state competent authority is then required to notify the host state competent authority, following which the firm is entitled to commence business in the host state after the expiry of a specified period.

¹ Articles 49 (freedom of establishment) and 56 (freedom to provide services).

² With the exception of reinsurance activities, as there are no notification duties for reinsurers exercising their passporting rights under Solvency II.

The table below sets out the single market Directives currently in force that provide passporting rights for financial institutions:

Directive	Activities
Capital Requirements Directive (2013/36/EU)	Deposit taking and lending by "credit institutions" ³
Markets in Financial Instruments Directive ("MiFID") (2004/39/EC)*	Investment services and activities (e.g. trading securities/derivatives, executing client orders, investment advice, portfolio management)
Payment Services Directive (2007/64/EC)	Payment services
Second Electronic Money Directive (2009/110/EC)	E-money
Alternative Investment Fund Managers Directive (2011/61/EU) ("AIFMD")	Management and marketing of Alternative Investment Funds (AIFs)
UCITS IV Directive (2009/65/EC)	Establishment and operation of retail (UCITS) funds regulated at EU level
Mortgage Credit Directive (2014/17/EU)	Mortgage lending
Solvency II Directive (2009/138/EC)	Insurance and reinsurance
Insurance Mediation Directive (2002/92/EC)	Insurance mediation

*The Markets in Financial Instruments Directive II ("MiFID II") and the Markets in Financial Instruments Regulation ("MiFIR") will replace MiFID from 3 January 2018. At present, it seems highly likely that MiFID II will have come into effect before the UK formally leaves the EU.

Will passporting rights for UK financial institutions survive the UK's withdrawal from the EU?

If the UK were to remain within the EEA following its withdrawal from the EU, UK financial institutions would continue to benefit from the same passporting rights in respect of financial services. However, this is currently regarded as unlikely from a political standpoint, as EEA membership would require the UK to agree to continued freedom of movement, the abolition of which was a main tenet of the Leave campaign.

As a result, the continued availability of passporting rights for UK-incorporated financial institutions is most likely to be confined to those areas where there are third country passporting rights.

What are third country passporting rights?

Whilst the original single market Directives were primarily focussed on offering passporting rights to firms in one EEA member state to provide services in, or into, other EEA member states, certain more recent Directives (discussed below) have expanded this principle to firms based in third countries.

A "third country" in this context is defined as a jurisdiction outside the EEA.

A "third country firm" is a firm that is incorporated in a jurisdiction outside the EEA but that would need to be authorised if it were operating within the EEA.

³ The definition of "credit institution" for the purposes of the CRD IV Directive is set out in Article 4(1)(1) of the Capital Requirements Regulation (Regulation 575/2013) (CRR): "an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account".

How far do third country passporting rights extend?

As explained above, the legal basis for passporting rights differs according to the particular Directive under which they are granted, with different Directives applying to different activities. For this reason, the generalised claims being made by some commentators that the implementation of MiFID II and MiFIR will mean that UK financial institutions will retain their passporting rights, are misleading.

The correct position, assuming that there are no EEA or negotiated passporting rights, is that the continuing availability of passporting rights for financial institutions following the UK's withdrawal from the EU depends upon both:

1. the activities that they perform falling under one (or more) of the Directives under which third party passporting rights will be provided for; and
2. the UK meeting the relevant criteria under which third countries are given access to those passporting rights.

Directives providing for third country passporting

MiFID II – Investment Services

There are no passporting rights for third country firms under the current MiFID regime, but that position is set to change when the MiFID II / MiFIR regime comes into force in January 2018.

Under the new MiFID II / MiFIR regime, third country firms will have passporting rights in limited circumstances. This will effectively be a two tier regime, with services provided to sophisticated customers (eligible counterparties" and "per se professional clients") under a more permissive regime, and services to less sophisticated customers ("retail clients" and "elective professional clients") under a much more restrictive regime.

Sophisticated customers

For services provided to more sophisticated customers, Article 46 of MiFIR will provide a right (subject to certain conditions) for third country firms to provide cross-border services into the EU, without needing to establish a branch within the EU. There are three pre-conditions for the exercise of the cross-border services passport for third countries:

1. The third country firm must be **registered** in the register of "equivalent" third-country firms kept by ESMA in accordance with Article 47. Under Article 47(1), equivalence may (not must) be granted where the regulatory framework of a third country fulfils all the following conditions:
 - a. "firms providing investment services and activities in that third country are subject to authorisation and to effective supervision and enforcement on an ongoing basis;
 - b. firms providing investment services and activities in that third country are subject to sufficient capital requirements and appropriate requirements applicable to shareholders and members of their management body;
 - c. firms providing investment services and activities are subject to adequate organisational requirements in the area of internal control functions;
 - d. firms providing investment services and activities are subject to appropriate conduct of business rules;
 - e. it ensures market transparency and integrity by preventing market abuse in the form of insider dealing and market manipulation".
2. The third country firm must be **authorised** in the jurisdiction where its head office is established, with the requisite permissions to provide the investment services or activities that it intends to provide into the EU, and must be subject to effective supervision and enforcement in its home country; and

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3. **Cooperation arrangements** between ESMA and the relevant third country regulator must have been established pursuant to Article 47(2).

If these conditions are met, third country firms will be able to provide investment services and activities to eligible counterparties and per se professional clients (but not to elective professional clients). Before doing so, they will be required to inform clients that they can only provide services to clients in these categories.

In addition, under Article 47(3) of MiFIR, third country firms will be able to provide investment services and activities to sophisticated clients on a cross-border basis from an authorised branch within the EU, so long as (a) the third country in which they are incorporated has received an "equivalence" decision from the Commission, and (b) the EU member state in which the branch has been authorised has implemented Article 39 of MiFID II, which sets out a prescribed procedure for third country branch authorisation. All member states except for Germany and the UK are currently expected to implement Article 39.

In the present circumstances, there is clearly significant political risk in relation to obtaining any equivalence decision from the Commission. Any divergence between the UK's conduct of business regulatory regime and that of the EU could give rise to an argument that limb (d) of Article 47(1) (above) is not fulfilled. Further, the word "may" in Article 46 means that fulfilment of the five-limbed test does not automatically give rise to an equivalence decision.

Less sophisticated customers

For services provided to less sophisticated customers, third country firms will need to seek authorisation to establish a branch in that member state, either under Article 39 of MiFID II (above) where the relevant member state has implemented that Article, or (in the case of Germany, which has not) under the relevant national law.

In either case, there is no right for third country firms to use a single EU branch to provide services to less sophisticated customer on a cross-border basis into other EU member states. There is also no right for third country firms to provide services to retail clients in the EU on a cross-border basis (in other words, a branch would potentially be needed in each jurisdiction that permitted it).

AIFMD – Alternative Investment Fund Managers Directive

AIFMD has set up a complex net of different passporting rights covering both the ability to manage funds in other EEA jurisdictions (whether on a cross border basis or through a branch) or to market them. There are also passporting rights for third country firms. However, these third country rights have not yet been switched on and we are still awaiting guidance from ESMA and the European Commission as to when that may take place and the form that it will take.

Currently, the only way that a third country fund manager can access the EEA market is through an "Article 42" private placement notification. This is an often time consuming and costly process whereby managers need to apply on a country-by-country basis for permission to market individual funds on a private placement basis. At present, some jurisdictions are imposing additional requirements on managers which is making the Article 42 process unattractive for certain jurisdictions. The EEA is looking into how to create a more level playing field for cross-border marketing of funds, but the outcome of this is not expected for some time.

As and when the third country rights are activated, third country managers will be able to apply to become authorised in the most relevant EEA jurisdiction (with detailed guidance on how to determine which jurisdiction is likely to be the appropriate one) which will then allow them to manage EEA AIFs or to market EEA or non-EEA AIFs across the EEA. They will also then be able to obtain passports to market their funds on a cross-border basis. Any such authorisation and passporting rights will depend on an equivalence assessment as well as co-operation agreements being put in place.

Managers in third countries such as Jersey and Guernsey are hopeful that the Article 42 private placement route will remain available when the passporting rights are switched on, but this is not yet certain. In the meantime, they are already adopting equivalent AIFMD regimes in readiness for the third country passport.

Making plans for the post-Brexit phase

The availability of passporting rights for third country firms in the period following the UK's withdrawal from the EU is likely to be (a) restricted to a limited number of financial services activities (and, in the case of investment services and activities, to dealings with professional clients only), and (b) likely to be dependent upon the UK securing an equivalence assessment from the Commission, which process may be subject to wider political considerations.

In these circumstances, the more prudent approach is clearly for UK-incorporated financial institutions to plan on the basis that there will be no third country passporting rights for UK firms. While this may lead to a degree of unnecessary business restructuring, should third country passporting rights be successfully negotiated by the UK in years to come, the availability of these rights for UK firms in future is currently far too uncertain to be factored into firms' longer term business planning.

In the meantime, firms standing to be affected by the loss of the single market passport can be active participants in the movement to lobby relevant stakeholders, both at national and EU level (and whether directly or through trade bodies), emphasising the importance to UK business of prioritising passporting rights in the UK's exit negotiations.

If you would like to meet up to talk through these points and how they impact your business, and to consider what would be the most effective way forward, then please do get in touch.



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This document is generic in its approach and involves assessment of a range of significant uncertainties – specific legal advice should be obtained on individual circumstances.

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