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Brexit & financial services

Overview

Introduction

On 24 December 2020, the European Commission and the United Kingdom agreed the terms of the EU-UK Trade and Cooperation Agreement (**the TCA**) – the long-anticipated but theatrically negotiated "Deal" which, since 1 January 2021, now governs the economic, social and security arrangements between the UK and the EU. As also anticipated, whilst the TCA covers such matters as trade in goods and services, management of fish, transport connectivity and energy, it contains almost no provisions relating to the financial services industry.

In an agreement that is nearly 1,300 pages in length, just four pages[1] are dedicated to financial services, which includes a two-page "Definitions" section. While general services provisions in the TCA will apply to financial services, subject to specific and crucial carve outs, there is no preferential treatment for UK financial services firms accessing the European Economic Area (**EEA**).[2]

The extent to which the UK financial services industry is able to provide cross-border services into the EEA is now principally determined by the EU law framework that applies to third countries. Whilst that regime contains some mechanisms for recognising third country regimes as "equivalent", thereby affording financial services providers in those countries some limited degree of access to the EEA market, only two temporary "equivalence" determinations have so far been made by the European Commission. As a result, in respect of most forms of financial services (including banking, insurance and payment services) UK firms now have no greater access to the European market than their counterparts in Somalia. Instead, in the absence of equivalence decisions, those firms will have to comply with requirements imposed in EEA Member States in order to continue providing financial services. At the same time, the UK Treasury has issued a raft of its own "equivalence directions" granting EEA financial services providers a degree of (thus far unreciprocated) access to the UK market.

Looking ahead, the UK and EU have affirmed a commitment to regulatory cooperation in relation to financial services in the form of a non-binding Joint Declaration, which affirms the parties' intention to establish a Memorandum of Understanding (**MoU**) framework by March 2021. Therefore, much of the work on the future relationship between the UK and the EU in respect of financial services remains to be agreed.

This series of notes considers the consequences of Brexit on the financial services sector, and the legal framework which now applies in the UK following the implementation of the TCA. While the agreement itself contains only limited direct provisions related to financial services, the UK's departure from the EU has necessarily brought about changes to the way UK firms will have to operate in the EEA moving forward. Those changes are also considered in these notes.

We first set out a brief summary of the EU and UK technical backgrounds to the regulation of financial services.

1 TCA, pp 121-125.
2 Unlike the regime for the trade of goods between the UK and EEA.

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The EU Technical Background

The EU Internal Market

Article 3(3) of the Treaty on European Union (**the TEU**) commits the EU to establishing an 'internal market', that is 'an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties'.[3] The creation of that internal market based on these 'four freedoms' lies at the heart of the European project.[4]

The four freedoms are underpinned by the principle of non-discrimination in The Treaty on the Functioning of the European Union (**the TFEU**), Article 18 of which states: "within the scope of application of the Treaties … any discrimination on grounds of nationality shall be prohibited." The effect of this central principle of EU law is to require each Member State to ensure that persons, services and capital originating from other Member States enjoy the same treatment as their in-state equivalent.[5]

The freedom to establish and to provide services in a Host State

In particular, the TFEU gives an individual or an undertaking established in one Member State:

- Under TFEU, Article 49, the freedom of establishment in any other EU Member State, including the freedom to set up agencies, branches or subsidiaries in the Host State; and
- Under TFEU, Article 56, the freedom to provide services in the Host State.

Shared competence between the EU and Member States

The founding treaties of the EU contemplate that the EU will have three different kinds of competence. First, exclusive EU competence. Article 3(1) TFEU gives the EU exclusive competence in relation to (amongst other things) the customs union among Member States; the establishment of competition rules necessary for the functioning of the internal market; monetary policy for the Member States whose currency is the Euro; and common commercial policy. For present purposes, exclusive EU competence can be left to one side.

Second, shared competence between EU and Member States, under Article 2(2) TFEU. When the Treaties confer on the EU a competence shared with the Member States in a specific area, the EU and the Member States may legislate and adopt legally binding acts in that area. However, the Member States may exercise their competence only to the extent that the Union has not exercised its competence. Under Article 4(2) TFEU, shared competence between the EU and the Member States applies in relation to (amongst other areas) the internal market and consumer protection.

Third, Article 2(5) TFEU permits the EU a supporting competence "to carry out actions to support, coordinate or supplement the actions of the Member States, without thereby superseding their competence in these areas."

Different EU legislative measures have different effects

Article 288 TFEU sets out the legal effect of the various EU legislative measures:

- A Regulation shall have general application. It shall be binding in its entirety and directly applicable in all Member States;
- A Directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods;
- A Decision shall be binding in its entirety. A Decision which specifies those to whom it is addressed shall be binding only on them;
- Recommendations and opinions shall have no binding force.

Article 29(1) TFEU provides that 'Member States shall adopt all measures of national law necessary to implement legally binding Union acts.' It follows that EU legislative measures like Directives do not form part of Member State law unless and until that Member State takes the legislative or administrative steps necessary to achieve that result.[6]

The European Economic Area and Switzerland

The EEA Agreement

On 17 March 1993 the then Member States of the EU concluded an agreement[7] (**the EEA Agreement**) with the member states of the European Free Trade Area (**EFTA**) created the EEA, with effect from 1 January 1994. As amended, the EEA Agreement allows current member states of EFTA (Norway, Iceland and Liechtenstein), but not Switzerland, to participate in the EU internal market without becoming Member States of the EU. In return, the participating EEA states are required to adopt all EU legislation related to the EU single market, except legislation on agriculture and fisheries. In the language of the European Commission "all new relevant … [EU] legislation is dynamically incorporated into the [EEA] Agreement and thus applies throughout the EEA, ensuring the homogeneity of the internal market."

The position of Switzerland

The Swiss Confederation is a member state of EFTA, but it chose not to participate in the EEA Agreement. Accordingly, as an alternative, the Swiss Confederation has concluded a series of bilateral agreements with the EU that enable Swiss nationals and undertakings to enjoy (amongst other things) certain preferential access to the EU internal market.

3 TFEU, Article 26(2). See also TFEU, Article 26(1).
4 For an introduction to the topic, see Barnard, C., The Substantive Law of the EC: The Four Freedoms, Oxford University Press, 2nd ed., 2007, Chapter 1.
5 Ibid, pp. 17 to 18.
6 But it is worth noting, for completeness, that the CJEU can, under some conditions, give citizens of a Member State the benefit of a Directive, even before that Directive is implemented in their Home State.
7 Agreement on the European Economic Area, OJ No. L 1, 31 March 1993, p. 3 (as amended).

The UK Technical Background

The general prohibition in FSMA 2000, s 19

UK financial services regulation is mostly 'activity based'. Specifically, the 'general prohibition' in s 19 Financial Services and Markets Act 2000 (**FSMA 2000**) read with s 22 provides that:

"No person may carry on a regulated activity [by way of business] in the United Kingdom, or purport to do so, unless he is (a) an authorised person; or (b) an exempt person."

Regulated Activities

The range of 'regulated activities' under FSMA 2000 is defined in general terms in FSMA 2000, Schedule 2, and in detail in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544), (**the RAO**).

Consequences of carrying on regulated activities without authorisation

Carrying on a regulated activity in the UK, by way of business and without authorisation is a criminal offence under s 23 FSMA 2000 (in the language of FSMA 2000, "an authorisation offence").

The civil consequences of an authorisation offence are specified by ss 26 and 28 FSMA 2000, which provides that, unless the Court directs otherwise (a) the relevant contract will be unenforceable against the customer and (b) the customer will be entitled to (i) recover any money or other property paid or transferred by him under the contract, subject to an obligation to account for any benefits received; and (ii) to compensation for having parted with that money or property.

Obtaining authorisation

There are two principal ways of becoming an 'authorised person'[8] under FSMA 2000. First, (prior to Brexit) by exercising either (a) rights under the EU Treaty;[9] or (b) passporting rights under an EU Directive,[10] to carry on business in the UK on a services basis or an establishment basis. Second, by applying for and obtaining a FSMA 2000 'Part 4A permission',[11] which is the route to authorisation followed by domestic UK entities and entities incorporated in third-countries.[12] In the case of a domestic entity or a third-country entity, therefore, authorisation under FSMA 2000 is obtained *indirectly*, by applying for 'permission' to carry on specific regulated activities.[13] If the necessary permissions are granted, the applicant will become (a) an authorised person under FSMA 2000;[14] and (b) in the jargon of the PRA Rulebook and the FCA Handbook of Rules and Guidance, 'a firm'. The specific regulated activities for which each domestic or third-country firm has permission are published on the Financial Services Register,[15] available online.

Threshold conditions for authorisation

FSMA 2000 s 55B(3) provides that:

'In giving or varying permission ... under any provision of this Part [4A], each regulator [(i.e. the PRA and the FCA)] must ensure that the person concerned will satisfy, and continue to satisfy, in relation to all of the regulated activities for which the person has or will have permission, the threshold conditions for which that regulator is responsible.'

The threshold conditions are, therefore, the minimum conditions that a firm must meet, in order to obtain, and maintain, authorisation under FSMA 2000. The conditions are specified in detail in FSMA 2000, Schedule 6.

Dual regulation

Section 55(1) FSMA 2000 provides that an application for permission may be made to "the appropriate regulator". The appropriate regulator means[16] the UK Prudential Regulation Authority (**the PRA**), in a case where the regulated activities to which the application relates "consist of or include a PRA-regulated activity"; or the Financial Conduct Authority (the FCA), in any other case.

A regulated activity is a "PRA-regulated activity" only if it is designated as such in subordinate legislation[17] made under s 22A FSMA 2000. Sections 417 and 2B(5) then define a "PRA-authorised person" as a person that has permission to carry on a regulated activity that is designated as a PRA-regulated activity. Authorisation by the PRA subjects a firm to regulation by the PRA in respect of matters relevant to the PRA's statutory objectives, but does not relieve the firm of regulation by the FCA in respect of matters relevant to the FCA's separate statutory objectives. Accordingly, FSMA 2000 uses the term "PRA-authorised person" as shorthand for a firm that is *dual-regulated* by both the PRA and the FCA.

As of September 2018, only the regulated activity of accepting deposits, the regulated activities of effecting or carrying out contracts of insurance and the regulated activities specific to the operation of the insurance market at Lloyd's of London have been designated as PRA-regulated activities.[18] As a consequence, the PRA's regulatory remit extends only to deposit taking businesses (i.e. banking businesses) and to insurance businesses.

8 See s 417(1) FSMA 2000, read with s 31 FSMA 2000.
9 Pursuant to FSMA 2000, Schedule 3.
10 Pursuant to FSMA 2000, Schedule 4.
11 FSMA 2000, s 55A(5).
12 The corollary, in s 55A(4) FSMA 2000, is that an EEA firm may not apply for permission to carry on a regulated activity which it is, or would be, entitled to carry on in exercise of an EEA right, whether through a United Kingdom branch or by providing services in the United Kingdom.
13 See, for example, s 31(1)(a) FSMA 2000, which provides that an 'authorised person' under FSMA includes 'a person who has a Part 4A permission to carry on one or more regulated activities'.
14 See, for example, s 31(1)(a) FSMA 2000, which provides that an 'authorised person' under FSMA includes 'a person who has a Part 4A permission to carry on one or more regulated activities'.
15 Maintained by the FCA, both for itself and for the PRA.
16 FSMA 2000, s 55(2).
17 The Financial Services and Markets Act 2000 (PRA-regulated Activities) Order 2013 (SI 556/2013).
18 *Ibid*, Art. 2.

The EEA Passporting Regime

Passporting is the exercise of a right by a firm located in one EEA Member State, authorised under one of the EU Single Market Directives, to carry on a regulated activity in another EEA Member State. Passporting is a key feature of the EU Single Market, as it gives financial institutions the right to carry out their activities across the EEA without establishing separate corporate entities or obtaining separate authorisations in EEA Member States in which those activities are carried out. Those rights are based on the home state's authorisation and rely on two of the fundamental freedoms that come with membership of the Single Market: freedom of establishment and freedom to provide services.

The European passport gives financial institutions two options for their operations in other EEA Member States:

1. They can establish a branch in the host Member State, which is subject to certain host state rules; or
2. They can provide financial services on a cross-border basis.

Passporting under the Single Market Directives

The Single Market Directives which grant passporting rights are:

1. The Alternative Investment Fund Managers Directive (2011/61/EU) (**AIFMD**), which grants passporting rights to alternative investment fund managers.
2. The CRD IV Directive (2013/36/EU), which grants passporting rights to credit institutions (banks and building societies) and their unauthorised subsidiaries.
3. The Insurance Distribution Directive ((EU) 2016/97) (**IDD**), which grants passporting rights to insurance undertakings.
4. The MiFID II Directive (2014/65/EU) (**MiFID 2**), which grants passporting rights to investment firms.
5. The Mortgage Credit Directive (2014/17/EU) (**MCD**), which grants passporting rights to mortgage intermediaries.
6. The Solvency II Directive (2009/138/EC), which grants passporting rights to insurance undertakings and reinsurance undertakings.
7. The UCITS Directive (2009/65/EC), which grants passporting rights to UCITS management companies.

Each of the Single Market Directives specify a notification procedure that firms should follow when seeking to exercise passporting rights. These notifications are made to the relevant EEA Member State's Regulator.

In view of the fact that separate passports are available for the provision of specified activities according to different Single Market Directives, financial institutions tend to benefit from multiple passport use to provide integrated banking services in EEA Member States.

When is an activity deemed to take place in a particular EEA Member State?

Firms need only make passporting notifications in relation to specified activities or services carried out "within the territory" of another EEA Member State.

In view of the different activities and services covered by the Single Market Directives, "within the territory" can have a different meaning. For example, for the purposes of the Solvency II Directive, an insurance undertaking should comply with the notification procedure when it effects contracts of insurance covering risks or commitments situated in another EEA Member State.

Whereas, credit institutions and MiFID investment firms should apply the "characteristic performance" test when considering if prior notification is required. The "characteristic performance" test establishes that the specified regulated activity or service is carried out in the place where the characteristic element of the service or activity is provided. However, the test must be treated with a degree of caution, as it is neither binding on EEA Member States, nor has it been consistently followed. To illustrate this point, in its Handbook, the FCA Notes at Supp App 3.6.8G that EEA Member States "may take a different view… some… may apply a solicitation test".

The solicitation test identifies the location of the specified activity or service by reference to whether the firm has actively marketed its services in the relevant EEA Member State.

The Effect of Brexit

Exit from Single Market – so an end to passporting

The European Union (Withdrawal) Act 2018 (**the Withdrawal Act**) received Royal Assent on 26 June 2018. As a result, the UK left the European Union and thus the Single Market on 31 January 2020. A transition period applied to the UK from the date of its departure from the EU on 31 January 2020 until 31 December 2020. During this transition period, the UK was treated as part of the Single Market in financial services. Among other things, this continuation of financial services between the EU and UK meant that passporting rights continued to apply, allowing UK firms to carry out regulated activities in EEA Member States. From 1 January 2021, the TCA governs the relationship between the UK and EU. Crucially, the TCA has not retained passporting rights for UK firms which have, as a result, lost automatic access to EEA markets.

Continuity of existing cross-border financial services contracts

The loss of passporting rights will also have significant implications for the continuity of existing cross-border financial services contracts, in particular insurance and derivative contracts. A general consequence of passporting rights ending is that it may be illegal, impractical or impossible for UK firms to perform the underlying contracts without the benefit of those passporting rights.

In relation to insurance contracts, particular problems include policies provided by firms, which are contracted to collect premiums and provide benefits in the future to individual policyholders and liability policies giving rise to long-tail claims years after the policy has expired. In both cases, the future obligations arising under the insurance contracts may anticipate passporting rights still being valid.

In relation to derivatives contracts, the main issue is whether certain life-cycle events, such as roll-over, novation and portfolio compression, imply the creation of new rights and obligations, for which an authorisation under EU or national law may be required, as the counterparty firm would no longer be a beneficiary of passporting.

In order to avoid these consequences, firms have had to take pro-active measures, including transferring, restructuring or terminating insurance and derivatives contracts.

Onshoring of EU regulations

The Withdrawal Act gave the Government the power to make secondary legislation to amend UK and domesticated EU legislation, which ensured that it was operative following the end of the transition period. To that end, the UK Government replicated certain parts of EU law by passing mirrored legislation and regulations under UK law, which became effective at the end of the transition period. This process is referred to as domestication or onshoring.

The Financial Regulators' Powers (Technical Standards etc.) (Amendment etc.) (EU Exit) Regulations 2018 (SI 2018/1115) also give the FCA, PRA and the Bank of England the power to make amendments to domesticated EU technical standards to reflect the UK's status after leaving the EU. These include technical standards under the Fourth Money Laundering Directive, the Payment Services Directive, the Securities Financing Transactions Regulation, the Securitization Regulation and the Bank Recovery and Resolution Directive.

UK Firms Operating In The EEA

Establishment of new subsidiaries

Many UK firms have relocated their operations to newly incorporated subsidiaries in EEA Member States in order to retain access to the Single Market. EU regulators, including the European Central Bank (ECB) and European Supervisory Authorities (ESAs), have produced guidance for UK firms relocating as a result of Brexit. Though this guidance is specific to particular financial services sectors, there are a number of common themes. For example, there is no automatic recognition of UK firms that operated in the EEA on the basis of previously held passport rights, and for relocated firms, it is expected that key personnel will be located in the EEA Member State in which the new entity is established. In particular, these newly-established entities should not be "empty shells" or "letter box entities", which outsource their key functions to UK group entities.

If a UK firm establishes a separate entity in an EEA Member State and obtains authorisation to carry out financial services from the appropriate regulator, that EEA entity could benefit from passport rights to provide cross-border services within the EEA. However, notice should be taken of the ECB's warning against establishing business models which rely on outsourcing of services by an EEA entity that simply acts as an "empty shell" and which delegates performance of those services to a UK group entity. Establishing a separate EEA entity will also be very expensive and it may take a significant period of time to obtain authorisation from local regulators, depending on the complexity of the firm's business.

Different level of access through "equivalence"

Certain pieces of EU legislation allow third countries to access the Single Market under specific conditions. An important element of such access is the principle of "equivalence". According to that principle, the European Commission can determine that the regulatory, supervisory and enforcement regime of the relevant third country is equivalent to the EU regime, with the advice of one of the ESAs.[19] An equivalence determination can only be made where the legislative instrument allows. If there is no equivalence provision in the legislative instrument, then no equivalence assessment and decision can be carried out. This is a crucial limitation in respect of the Single Market Directives related to financial services.

Equivalence regimes giving access to the single market

The following banking and financial activities do allow access to the internal market under equivalence regimes:

- Alternative investment funds under the AIFMD for professional investors;
- Clearing under the European Market Infrastructure Regulation (EMIR) (this equivalence regime has been reviewed by EMIR 2.2); and
- Provision of investment services for professional clients and eligible counterparts under MiFIR.

19 European Banking Authority, European Securities and Markets Authority and European Insurance and Occupational Pensions Authority.

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Financial activities not subject to equivalence regime

It is important to be aware, however, that the majority of the Single Market Directives do not contain equivalence provisions giving access rights to firms in third countries. In particular:

- The CRD IV Directive contains only limited provisions for third country firms and there are no third country passporting benefits relevant to regulated banking activities.
- There are no passporting rights for third country mortgage brokers under the MCD.
- Neither the Payment Services Directive nor the Second E-Money Directive contain provisions for third countries to benefit from passporting of payment and e-money issuer services.
- There are no passporting rights for third country insurers under the Solvency II Directive, although EEA Member States may authorise some third country access subject to certain conditions (e.g., establishing a branch duly authorised in the Member State).
- UCITS funds and management companies do not benefit from the third country passports under the UCITS IV Directive. As a result, a UCITS management company in the UK will lose its right to manage UCITS funds in another EEA Member State. There is also no regime covering the marketing of UCITS funds.
- Neither the Insurance Mediation Directive nor the IDD contain mechanisms to allow market access rights to insurance companies located in third countries.

Given that these Single Market Directives do not contain equivalence provisions, no equivalence assessment and decision can be carried out in respect of them. This provides a crucial limitation for UK firms, which have also lost the benefit of passporting rights following the end of the transition period.

In addition, the European Parliament's Committee on Economic and Monetary Affairs (**ECON**) has prepared a report on the Investment Firm Review, which suggests further restrictions may apply to equivalence, which would exclude:

- dealing on one's own account;
- the underwriting of financial instruments; and
- the placing of financial instruments on a firm commitment basis.

The EU approach to equivalence

The UK and EU had stated an intention to determine comprehensive mutual findings of equivalence post-Brexit, and despite endeavouring to do so by 30 June 2020, that deadline was not met. In June 2020, the UK Government published a draft SI[20] which provided for a UK future regime for equivalence, and which set out the process by which another country's regulatory and supervisory regime could be deemed equivalent to the UK's corresponding regulatory framework during and at the end of the transition period. That equivalence regime is overseen by HM Treasury, with the assistance of the Bank of England, the PRA and the FCA. The UK has now granted equivalence to the EU in most areas.

By contrast, the EU has taken a more stringent approach. The European Commission has so far adopted just two time-limited equivalence decisions relating to UK central clearing counterparties (CCPs) and Central Securities Depositories (**CSDs**) that applied from 1 January 2021. These are contained in Commission Implementing Decision (EU) 2020/1308 and Commission Implementing Decision (EU) 2020/1766.

- Commission Implementing Decision (EU) 2020/1308 was made in September 2020. It provides that legal and supervisory arrangements applicable to CCPs already established and authorised in the UK are considered to be equivalent to the requirements laid down in the EMIR from 1 January 2021 until 30 June 2022.
- Commission Implementing Decision (EU) 2020/1766 was made in November 2020. It provides that the legal and supervisory arrangements of the UK applicable to CSDs already established and authorised in the UK are considered to be equivalent to the requirements laid down in the Central Securities Depositories Regulation from 1 January 2021 until 30 June 2021.

Since the end of the transition period, the EU Commission has noted explicitly in a press release that the TCA "does not cover any decisions relating to equivalences for financial services". Somewhat ominously, the press release provides the following warning: "Indeed, these [determinations on equivalence] are unilateral decisions of the EU and are not subject to negotiation".[21]

The EU's cautious approach to equivalence is a response to the likely prospect of the UK's divergence from the EU. Indeed, the UK has already announced a number of matters in which it intends to depart from the EU in respect of the processes by which it delivers certain shared financial services regulatory policy outcomes, while retaining the same policy outcomes as its goal.

When determining if a third country is equivalent, the European Commission takes a risk-based approach and is guided by the principle of proportionality. Tellingly, in a 2017 study carried out by ECON, it noted that the European Commission is "likely to apply stricter scrutiny when assessing 'high-impact' third countries which potentially pose significant risks to the EU financial markets, such as the UK…".[22]

20 The Equivalence Determinations for Financial Services (amendments etc) (Exit) Regulations 2020.
21 www.ec.europa.eu/info/relations-united-kingdom/eu-uk-trade-and-cooperation-agreement_en.
22 www.europarl.europa.eu/RegData/etudes/STUD/2017/602058/IPOL_STU%282017%29602058_EN.pdf

In July 2019, the European Commission published a Communication on "Equivalence in the area of financial services",[23] which explained the Commission's intended approach to equivalence assessments. In particular, that Communication noted that "high-impact" third countries, which had greater exposure to EEA markets, would pose greater risks to the EEA's integrity, for the purposes of determining equivalence. While third-country regimes did not need to be identical to those in the EEA, those regimes would need to protect outcomes in the EU regulatory framework. The Commission would also consider the treatment the relevant third country afforded to the EU regulatory framework, including the treatment that third country gave EEA market participants present in its jurisdiction. The July 2019 Communication further emphasised that there was no standard approach to equivalence and that the nature of the assessment required would vary between different equivalence mechanisms. Most important of all, the Commission confirmed that a third country had no right to receive a determination of equivalence even if that third country could demonstrate that its regulatory regime fulfilled necessary criteria laid down by the Commission.

Despite the fact that the UK implemented financial services legislation as a former EEA Member State, the equivalence process is likely to be drawn out, given the political consequences of such determinations. Most crucial of all from the EU's perspective is whether the UK in fact intends to align its regulatory regime with the EEA moving forward, which would be a necessary precursor to any equivalence determination. The Commission gave voice to this concern in a question-and-answer document published on 24 December 2020. In answer to the question, "What about the equivalence decisions on financial services?", the Commission responded:[24]

"The Agreement does not include any elements pertaining to equivalence frameworks for financial services. These are unilateral decisions of each party and are not subject to negotiation.

The Commission has assessed the UK's replies to the Commission's equivalence questionnaires in 28 areas. A series of further clarifications will be needed, in particular regarding how the UK will diverge from EU frameworks after 31 December, how it will use its supervisory discretion regarding EU firms and how the UK's temporary regimes will affect EU firms. For these reasons, the Commission cannot finalise its assessment of the UK's equivalence in the 28 areas and therefore will not take decisions at this point in time. The assessments will continue. The Commission has taken note of the UK's equivalence decisions announced in November, adopted in the UK's interest. Similarly, the EU will consider equivalence when they are in the EU's interest."

The Commission's present stance, therefore, is that it will need further clarification on the UK's potential divergence before it will consider equivalence in respect of the 28 areas already consulted on with the UK. As a result, the European Commission is unlikely to grant any equivalence decisions in the short term.

That is not to say that there will be no equivalence determinations in the longer term. For a start, there will be political pressure within the EU to make those determinations, given that financial services firms located within EEA Member States will be disadvantaged in certain circumstances in their absence. For example, exposure to the UK financial services sector held by banks located in the EEA will be treated as third country exposure under the Capital Requirements Regulation. As a result, those banks will be required to hold extra capital, which will be an undesirable consequence of the lack of an equivalence determination.

It is in the European Commission's discretion whether a third country is equivalent, which means that political considerations will affect the outcome of any determination. In addition, the Commission has the power to withdraw an equivalence determination at any time. As a result, the UK may be required to maintain a regulatory regime broadly in line with the EEA regime. Otherwise, the UK would risk losing its equivalence status should it adopt a significantly divergent regulatory policy to that maintained in the EEA. In certain instances, the EEA may require reciprocal recognition as a condition of granting equivalence in the first instance.

Therefore, any general reliance by the UK on "equivalence" for the purposes of gaining access to the Single Market must be treated with caution: the UK may be deemed equivalent at one point following its departure from the EU but may not remain so. The European Commission has a discretion when to grant and when to withdraw a determination of equivalence, in effect blocking a third country, such as the UK, from accessing the Single Market. That is in addition to the key limitation that equivalence only applies to certain financial services Directives.

23 www.ec.europa.eu/transparency/regdoc/rep/1/2019/EN/COM-2019-349-F1-EN-MAIN-PART-1.PDF
24 www.ec.europa.eu/commission/presscorner/detail/en/qanda_20_2532

EEA Firms Operating in the UK

For incoming EEA firms post-Brexit (i.e. those accessing the UK market), HM Treasury has confirmed that the existing UK regime for third countries would provide the basis for regulating EEA firms doing business in the UK. These arrangements comprise a Temporary Recognition Regime (**TRR**) and a Temporary Permissions Regime (**TPR**) to enable EEA firms to continue to operate in the UK for a fixed period post-Brexit. The purpose of these temporary regimes is to allow EEA passporting firms and funds to operate in the UK for a limited period of time from 1 January 2021 while they seek full authorisation from the UK regulators. Non-UK CCPs will benefit from the TRR and the TPR, allowing them to continue their specified regulated activities for a period of time following the conclusion of the transition period. In addition, the UK established the financial services contracts regime (**FSCR**), which provided a mechanism for EEA firms outside the scope of the TPR to leave the UK market at the end of the transition period. The FSCR contains two procedures, supervised run-off (**SRO**) and contractual run-off (**CRO**).

The Temporary Permissions Regime

In November 2018, HM Treasury published regulations[25] that removed the ability of EEA firms to do financial services business in the UK on the basis of either (a) Treaty rights; or (b) passport rights. However, Chapter 2 of those regulations provide for the TPR, the bare essentials of which are as follows:

- An incoming EEA firm[26] could, before the end of the transition period make an application[27] to the appropriate regulator for a (new or varied) FSMA 2000, Part 4A permission.
- If the application gained approval, the incoming EEA firm would, following the conclusion of the transition period, be deemed to have permission under Part 4A FSMA 2000 to carry on the same regulated activities as it was permitted to carry on pursuant to its Treaty rights or passport rights.
- The PRA and the FCA will have the same powers in relation to firms with a deemed Part 4A permission (including the power to vary or cancel that permission), as they have in relation to any other firm with a Part 4A permission.

The FCA and the PRA have both made rules that will apply to a firm in the TPR, while its application for a Part 4A permission is dealt with, including to provide transitional relief, as the firm moves to full regulation under FSMA 2000.

A firm with a deemed Part 4A permission will exit the TPR (a) when its application for a Part 4A permission is determined (i.e. accepted or rejected); (b) if its deemed Part 4A permission is removed by the FCA or the PRA; or (c) three years from the end of the transition period.

If a firm's application for a full Part 4A permission is rejected, so that it falls out of the TPR, it will be expected to run-off its existing UK regulated activity and is expected be placed in the FSCR.

The Financial Services Contracts Regime

In 2019 HM Treasury published[28] draft regulations intended to provide a run-off regime for (amongst other Brexit-related temporary regimes), the TPR. The FSCR comprises both: (a) a regime for contractual run-off the CRO and a regime for supervised run-off the SRO.

The CRO regime:

- Applies automatically to incoming EEA firms without a UK branch, that (a) are authorised by their Home State regulator; (b) operate in the UK under a freedom of services passport immediately before the end of the transition period; (c) do not have a Part 4A permission; and (d) do not enter the TPR;
- Provides a limited exemption from the general prohibition in s 19 FSMA 2000 to allow the firm to carry on regulated activities in order to (a) perform a pre-existing contract; (b) reduce the financial risk to counter-parties and third parties affected by the performance of a pre-existing contract; (c) transfer the property, rights or liabilities under a pre-existing contract; and (d) comply with legal and regulatory requirements.

The SRO regime:

- Applies automatically to a range of incoming EEA firms, including (a) firms with a UK branch, operating under a freedom of establishment passport immediately before the end of the transition period, that did not enter the TPR; or (b) firms that entered the TPR but exited it without a Part 4A permission in respect of all regulated activities that the firm carries on in the UK;
- Allows the relevant firms to carry out regulated activities which are necessary to perform pre-existing contracts. Certain firms in the SRO regime are also expected to be permitted to carry on regulated activities which are necessary to (a) reduce the financial risk to counter-parties and third parties affected by the performance of a pre-existing contract; (b) transfer the property, rights or liabilities under a pre-existing contract; and (c) comply with legal and regulatory requirements.

The UK equivalence regime

As noted above, the UK has introduced its own equivalence regime which is administered by HM Treasury, and independent of the European Commission, which previously had the authority to make equivalence determinations. Similarly, the Bank of England, the FCA and the PRA have taken over the responsibilities previously held by the ESA. There is no reciprocity between those regimes, so a finding of equivalence by the EU will not necessarily entail a corresponding determination of equivalence by the UK, and vice versa.

While the structure of the UK's equivalence regime largely mirrors that in place in the EU, the decisions taken by HM Treasury and the Commission on equivalence in the lead up to, and since the conclusion of, the transition period, are contrasting.

25 The EEA Passport Rights (Amendment, etc., and Transitional Provisions) (EU Exit) Regulations 2018 (SI 2018/1149).
26 That is, an EEA entity doing business in the UK in reliance on Treaty rights or passport rights.
27 The Regulations also provide for an incoming EEA to notify the relevant regulator (within a time limit specified by the regulator) of its intention to apply for a Part 4A permission. The benefit of notification is a two year breathing space within which to apply for a Part 4A permission.
28 www.assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/765261/Draft_Financial_Service_Contracts_Transitional_and_Saving_Provision_SI.PDF

The UK has determined that all equivalence decisions made during the period of the UK's membership of the EU would be incorporated into the UK's regime following the expiry of the transition period.

On 10 November 2020, the UK made a number of equivalence directions in respect of EEA Member States, as follows:

1. The Benchmarks Regulation Equivalence Directions 2020.
2. The Central Securities Depositories Regulation Equivalence Directions 2020.
3. The Credit Rating Agencies Regulation Equivalence Directions 2020.
4. The Short Selling Regulation Equivalence Directions 2020.
5. The European Market Infrastructure Regulation (Article 2A) Equivalence Directions 2020.
6. The European Market Infrastructure Regulation (Article 13) Equivalence Directions 2020.
7. The Capital Requirements Regulation Equivalence Directions 2020.
8. The Solvency 2 Regulation Equivalence Directions 2020.

These directions came into force on 1 January 2021 and provide some degree of market access into the UK for EEA firms providing relevant cross-border financial services.

The future of Financial Services between the UK and EU

Current position and limitations

Given the complexities associated with the conclusion of an agreement covering financial services, and the focus on particular points of contention (such as fisheries and competition policies) it was perhaps not a surprise that the TCA paid fairly scant attention to financial services. Among those limited provisions, there is a general commitment to implement international standards in prudential, anti-money laundering, tax avoidance and anti-terrorism regulations.[29] However, the TCA also contains a prudential carve out,[30] which permits either side to adopt measures that protect consumers and investors or that ensure the integrity and stability of that party's financial system.

UK firms based in the EEA, and EEA firms based in the UK, will continue to have access to payment and clearing systems operated by public entities,[31] and UK and EEA exchanges and clearing houses must admit the other side's firms on a non-discriminatory basis.[32]

While the general rules on services contained in the TCA notionally apply to firms providing financial services, there are a number of important reservations. For example, the most favoured nation provisions[33] do not apply to the provision of financial services. Therefore, preferable agreements and terms extended to other states or trading blocs do not have to be granted by the UK to the EU, or vice versa.

The Joint Declaration on Financial Services Regulatory Cooperation

In recognition of the limited financial services provisions contained in the TCA, the UK and EU have issued a "Joint declaration on financial services regulatory cooperation between the European Union and the United Kingdom", by which the parties: "agree to establish structured regulatory cooperation on financial services, with the aim of establishing a durable and stable relationship between autonomous jurisdictions." The Joint Declaration states:

"Both parties will, by March 2021, agree a Memorandum of Understanding establishing the framework for this cooperation. The Parties will discuss… how to move forward on both sides with equivalence determinations between the Union and United Kingdom, without prejudice to the unilateral and autonomous decision-making process of each side."

In reality, the Joint Declaration and MoU simply pave the way for further discussions and negotiations about the future relationship of cross-border financial services, which were largely left out of the TCA.

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29 TCA, Article 5.41.
30 TCA, Article 5.39.
31 TCA, Article 5.44.
32 TCA, Article 5.43.
33 TCA, Articles 2.4(3)(b) and 3.5(2)(b).

3VB Three Verulam Buildings Barristers

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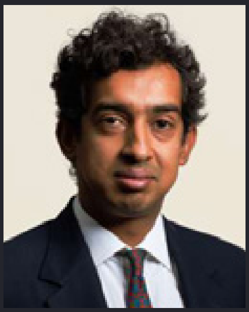

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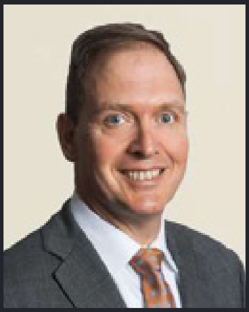

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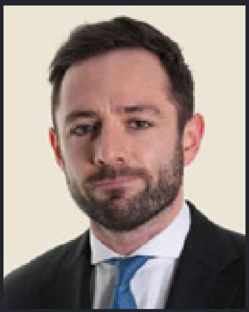

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