

Brexit and Financial Services

Jeffrey M Bronheim; Miriam González Durántez

Summary

Although a detailed Brexit agreement has been reached between the UK and the EU on trade in goods and certain services, further work remains on the treatment of financial services. The EU must determine which UK financial rules and their applications will be deemed “equivalent” to EU rules, and therefore to what extent UK-based financial services firms will be able to operate in Europe.

Brexit Agreement

The United Kingdom concluded the vast UK-EU Trade and Cooperation Agreement (the “Brexit Agreement”) on the terms of its departure from the European Union right before the deadline at the end of 2020. The Brexit Agreement contains hundreds of pages of new rules governing trade in all manner of goods and certain services in both directions across the English Channel to replace the EU-wide free-trade arrangements (Single Market) previously in place. However, despite years of negotiations and the importance of financial services to the UK economy, the treatment of financial services is not resolved in the Brexit Agreement.

Trade in financial services is fundamentally different from trade in goods. For goods, physical standards and detailed characteristics can be analyzed and agreed for everything from beef to bricks or fruit to window glass. By contrast, financial services don’t get physically trucked or shipped; they can’t be inspected or weighed; and can’t be easily analyzed or tested for conformance to simplistic physical norms. Therefore, regulation of cross-border trade in financial services globally and within the EU has generally been based on the financial firms themselves rather than the particular products they create or promote.

Financial Services and the Passport

Offering a savings account or life insurance to consumers, or trading stocks, bonds, derivatives or interest rates between institutional counterparties across borders defies traditional trade arrangements and negotiations for physical goods. Even basic financial products are not uniform, and the financial services industry thrives on creativity and offering different and ever-evolving products and solutions. Internal EU financial regulation focuses on financial firms and the process of offering products, rather than exacting product definitions and regulations.

EU rules seek to ensure a uniform regulatory structure so that all firms have similar capitalization, risk management, and operating standards. Financial firms that are properly registered, capitalized, regulated and operating normally in one country may obtain the right to operate and sell their products in the others (subject to certain notification and registration requirements). This ability for a firm in one EU country to operate in another is referred to as the “Passport.”

UK banks, trading houses, insurers and asset managers took advantage of the Passport to easily operate in the EU; from simply selling their products to trading EU instruments or opening branches or subsidiaries across the continent. The Passport and EU rules also covered numerous technical issues such as trade execution and venue participation, counterparty risk weighting and exposure limits. For the asset management industry, the Passport allowed a UK-based firm to manage an EU-based fund (in Luxembourg or Ireland for example).

Full participation in European markets provided lucrative business growth in London over previous years while also greatly improving access to financial products in the EU. EU businesses gained access to vast sums of capital in various forms from London, while EU savers and investors could access a wide variety of saving, fund and borrowing options from UK firms. While financial firms in EU countries also take advantage of the Passport system to operate more widely across the EU, UK firms and London capital markets dominate finance and have been the biggest beneficiaries of the financial Passport system.

Because of their dominant position in providing needed capital and investment options across Europe, some in the UK financial services industry may have assumed that the EU would not take a detrimental negotiating position to block such capital flows after Brexit. For whatever reason, the UK financial services industry appears to have been poorly organized in lobbying on the Brexit Agreement, certainly compared to many other industries which took clear positions early on and pushed those consistently into the negotiations. The UK government never highlighted the importance of financial services in the Brexit negotiations and apparently didn't even try to trade off anything in exchange for better terms for financial services.

The EU understandably would like to develop into own financial markets and firms without relying on London following Brexit. Existing EU firms may certainly prefer to deny the Passport to UK firms for their own competitive benefit. Paris, Frankfurt, Luxembourg, Dublin, and Amsterdam as financial centers in particular will benefit if European financial services business must be conducted from within the EU. For all of these reasons, the EU may not want an agreement which would allow UK firms to continue to dominate EU financial services.

Many big UK-based banks and financial firms which rely on the Passport for European business (including US and other international firms with European bases in London) have already set up or expanded their operations in the EU in anticipation of an unclear or poor Brexit agreement on financial services.

In asset management, it has been hoped the UK firms could continue to provide asset management services to EU funds as "delegates" or "sub-advisers" to the EU-based managers of such funds. However, that is also uncertain as the EU will have to determine that such delegation practices to UK managers remain permitted as before. As recently as 13 January 2021, the European Securities and Markets Authority ("ESMA") issued a public statement as a "reminder to firms of the MiFID II rules on 'reverse solicitation' in the context of the recent end of the UK transition period"¹. This follows concerns highlighted by ESMA in the European Commission's October 2020 public consultation on AIFMD that delegation structures may be used by UK firms to sidestep AIFMD requirements via third party EU AIFMs (i.e. that UK firms will keep offering products and doing business in the EU through indirect means).

¹ https://www.esma.europa.eu/sites/default/files/library/esma35-43-2509_statement_on_reverse_solicitation.pdf

No Agreement

In concluding the Brexit Agreement, the UK and the EU did not agree on the treatment of financial services, but rather agreed to keep working on it in the months to come. Therefore, as of 1 January 2021, UK and UK-based firms have formally lost the benefit of EU financial services Passport. They can no longer automatically qualify to sell or offer their financial products, or even to conduct business, in the EU. By mid-January 2021, a number of EU regulators had already released warnings about UK firms' sales practices in the EU.

Equivalence

As described above, the EU system of financial regulation seeks to create identical financial regulations and requirements in each country to ensure that banks and financial firms, and the products they offer, are uniformly safe and secure. The UK has been one of the leading nations driving EU financial regulation, and as of the end of 2020 UK financial services law was fully EU compliant and precisely matched EU laws – it was exactly “equivalent.”

However, rather than agreeing to permit UK firms to continue to operate in the EU on the basis of mutual recognition of such identical regulation, the Brexit Agreement provides that UK firms will only be able to offer products and operate in the EU (with something akin to the Passport) if the relevant UK financial services regulation and its application are determined to be “equivalent” to corresponding EU regulation and application. Initially of course this must be true: UK law and application of it matched EU law on 1 January 2021. Nonetheless, the EU has not yet determined that any UK financial services rules are equivalent (there is an 18-month grace period during which UK clearing houses (CCPs) are listed as equivalent for derivatives transactions). So strangely, despite having identical rules on 1 January 2021, because the EU has yet to formally determine if any UK rules are “equivalent”, UK firms cannot rely on the Passport today.

The EU is specifically reviewing 28 areas of financial rules and their application for equivalence. Because the UK Chancellor has already claimed that the Brexit Agreement allows the UK to regulate things “a little bit” differently, the EU is also considering how some rules may be changed or enforced differently in the future.

It is hoped that the EU will find some or all of the current UK rules to be “equivalent” to their EU counterparts, but this is left in the hands of EU officials and there is no certainty. Even though the equivalence determinations should be purely technical, some suspect that political or protectionist tendencies could influence the outcome. It has even been suggested that with the Brexit Agreement completed, the EU has no incentive to find any equivalence and grant UK firms the right to operate in the EU.

Even if the EU – via ESMA or otherwise – determines that some or all of the UK financial services laws, rules, and their application are equivalent to their EU counterparts, the EU will retain the unilateral right to reverse all or part of such determination on thirty days' notice at any time².

² The UK had wanted a longer period, including a form of arbitration, for the EU to reverse an equivalence determination.

Furthermore, both EU and UK financial services laws and rules will evolve. Each change by either side will leave the UK at perpetual risk of its rules being determined not to be equivalent, and the Passport/other equivalent determination for such area revoked.

Additional Provisions

Prudential carve-out. The Brexit Agreement contains a “prudential carve-out” which allows the UK or the EU to impose additional requirements such as increased capitalization on firms for prudential reasons (such as financial stability), even if the other side doesn’t apply similar measures.

Memoranda of Understanding (MoUs). ESMA and the various European securities regulators agreed on two Memoranda of Understanding (MoUs) with the UK Financial Conduct Authority (FCA) in 2020 in anticipation of the Brexit Agreement. These MoUs cover (a) the exchange of information in relation to the supervision of credit rating agencies and trade repositories, and (b) supervisory cooperation, enforcement, and information exchange between individual EU regulators and the FCA, allowing them to share information relating to market surveillance, investment services, and asset management activities. The second MoU may allow certain activities, such as fund manager outsourcing and delegation, to continue to be carried out by UK based entities on behalf of counterparties based in the EU.

The two sides have targeted agreeing a broader MoU on regulatory cooperation by March 2021, but this is not a fixed deadline.

Non-discrimination. Most trade agreements generally prevent each side from discriminating against firms from the other (for example in the application of laws or regulations). For financial services, the Brexit Agreement only contains such protections for branches or subsidiaries of UK firms operating in the EU, and not for UK firms offering financial services into the EU from the UK.

Most Favored Nations. In recent years, trade agreements tend to contain provisions which automatically improve their terms to match subsequent agreements with couter countries. In this way, older agreements grow to be consistent with newer arrangements, creating an efficient and consistent framework across nations. However, the Brexit Agreement does not contain such most favored nations provisions for financial services.

UK Participation in International Organizations/Standards. On leaving the EU, the UK ceased to be a member of many international financial regulatory bodies. The Brexit Agreement contains a “best endeavors” commitment for the UK to implement/join many of these, including the Financial Stability Board, the Basel Committee on Banking Supervision (in particular its “Core Principle for Effective Banking Supervision”), the International Association of Insurance Supervisors (in particular its “Insurance Core Principles”), the International Organization of Securities Commissions (IOSCO - in particular its “Objectives and Principles of Securities Regulation”), the Financial Action Task Force, and the Global Forum on Transparency and Exchange of Information for Tax Purposes of the Organization for Economic Cooperation and Development. Failure to join or follow any of these could threaten relevant equivalence determinations.

In a classic case of British understatement, UK Prime Minister Boris Johnson admitted that the Brexit Agreement “perhaps does not go as far as we would like” on financial services.

Conclusion

UK financial services firms remain subject to further uncertainty in operating in the EU following the Brexit Agreement. Rather than ongoing trade negotiations, over the coming months the EU will determine which UK financial laws and regulations are “equivalent,” and therefore which UK financial services can be offered into the EU, if any. Even following any such positive determination, the EU will be able to lock-out UK firms if a determination is made that subsequent UK laws or rules diverge from their EU counterparts. This leaves the entirety of EU-related business of the UK financial services industry subject to ongoing uncertainty and possibly politically motivated decisions made by the EU.

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The Authors



Jeffrey M Bronheim
Partner

+44 (0) 20 8037 2320
[Email Jeff](#)



Miriam González Durántez
Of Counsel

+44 (0) 20 8037 2354
[Email Miriam](#)

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New York | Paris | Washington DC | London

www.cohengresser.com
info@cohengresser.com
+44 (0) 20 8037 2330



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