Brexit: Financial Services Firms: Mapping the impact of Brexit to make sure high level strategic thinking can be delivered legally and operationally

- A current view of the Brexit debate
- Important decisions which financial services firms need to be addressing now

Summary

- The nature of the Brexit debate has changed and attitudes have hardened since the UK formally served notice on President Tusk of its intention to leave the EU. There seems to be limited political sympathy for financial services businesses, both in the UK and in the rest of the EU, so the likelihood of a special deal allowing maintenance of business as usual ("BAU") business models seems to be low. The UK Prime Minister said she wants the freedom to provide financial services cross border, but not within the existing framework.
- The Prime Minister's decision to call a General Election will bring Brexit front and centre. However, it does not provide any clarity. There may be confusion, potentially a longer process if there are political bumps in the road and may alter the spectrum of Brexit outcomes, but financial services firms still need to be ready for the possibility of a "cliff edge" departure with the UK becoming just a "third country" with no favourable market access rights to the EU.
- Given planning and implementation lead times, financial services firms need to be doing granular internal due diligence, to make sure they can actually implement their Brexit solutions (and that key counterparties and intermediaries are also lined up in support). Even financial services firms with strategic Brexit planning groups need to make sure they are covering detailed regulatory and operational bases.
- This note looks at the key background factors, the issues firms need to focus on given where things currently stand and why they need to be tackled now. Some background information and definitions of terms used are set out in the Appendix to this note.

The background

Since the UK's referendum vote to leave the EU, the debate has focused on what sort of exit the UK will have. Will it be a hard exit, or will there be a softer, negotiated deal, under which key industries deeply dependent on the EU cross border frameworks of mutual recognition and open markets maintain access?

The Prime Minister has put clarifying her mandate and ensuring political unity to enable her to progress Brexit negotiations unchallenged at the core of her election strategy. This fact, though, does not provide those responsible for planning with any new facts or indeed any more clarity on the direction of travel, other than to confirm that the time table remains tight and that both migration and the ECJ's jurisdiction remain "red line" issues. Statements from the EU Commission's lead negotiator confirm the tight time-table.

A fast Brexit has some clear implications:

- A fast Brexit is likely to be a hard Brexit – the challenges and complexity of negotiating special access rights, in particular for the financial services industry, make it hard to see at this stage what a favourable deal for the financial services industry might look like.
- The operational and legal complexity of delivering cross border products and services is not well understood. There is a broadly held belief that financial businesses are "plug and play" and can be easily shifted from one jurisdiction to another. To remedy these misapprehensions, sophisticated education is needed – and that takes time and coherently organised data, as well as a willingness to listen on the part of stakeholders in the Brexit debate.

- Not only are there some difficult issues to be addressed with politicians, legislators and regulators, the financial services industry itself has not defined what it really needs from the Brexit negotiations. Currently, relatively few financial services firms, other than the larger banks are actually doing more than gathering information and watching to see what other financial services firms will do. While there is a lot of information being gathered, and other than the desire for a sufficiently long transitional period of continuity to assure stability in financial markets, there is no detailed consensus on the "ask" from the industry. Without this, the financial services industry will not be able to make a persuasive case for special treatment (even if this were politically acceptable across the UK) in the short time there will be to negotiate following the triggering of Article 50.
- As a corollary to the point about lengthy planning cycles, a fast Brexit reduces the likelihood of a useful negotiated transition period.

The probability of a fast, hard Brexit means inactivity is no longer a prudent option – any financial services firm, whether it is a bank, broker dealer or asset manager, which has any sort of cross border business involving the EU needs to be planning now. As things currently stand, the only prudent scenario to plan for is one that assumes the UK becomes a "third country" with no special market access deal. The prospect of a delayed Brexit doesn't fundamentally alter this basic proposition.

Firms will not necessarily have to act on their analyses at once – but part of the thinking should also be to identify the milestones and the indicators which will trigger an active response and a transition from "observer" status.

What are the prudent operating assumptions if hard Brexit occurs?

- The UK becomes a "third country" – the right to provide services and establish branches under the passporting regimes of e.g., MiFID and AIFMD into or from the UK will cease.
- Cross border client solicitation and servicing between the UK and EU will no longer be easy; the ability of branches within the EU to do business across borders will remain open to question.
- Consistent with the Prime Minister's speech, the UK will try to preserve some foundational EU financial services legislation, as unchanged as possible, as well as various international "equivalence" arrangements with non-EU jurisdictions, but this won't amount to "passport rights" and will be a challenge because the roles ascribed to EU institutions under that legislation won't transfer easily for the UK once it ceases to be a member of the EU.
- The UK will be unlikely to try to make its financial services environment attractive through regulatory "arbitrage" – the core prudential requirements flow directly from FSB rules and Basel requirements and the credibility of UK regulation would be adversely affected if there were clear attempts to "game" the system.
- There is unlikely to be an immediate general EU wide identification of the UK's financial services regulatory framework as "equivalent".
- There is a risk that "equivalence", even if it provides an initial safe harbour for access, will be unlikely to be a long term reliable hat on which to hang future EU market access, as regimes well may diverge over time and bring "equivalence" into question.
- Certain categories of financial transaction will be likely to be "relocated". There is pressure to move clearing and settlement of Euro-denominated transactions into the Eurozone.
- Freedom of access for UK established firms to the EU domiciled exchanges and financial market infrastructure and vice versa for EU firms into UK exchanges and financial market infrastructure may be restricted – the ability of branches of non-EU banks within the EU to access Target 2 remains an open question.
- Cross border financial structures and outsourcing arrangements between operations established in the UK and elsewhere in the EU will become subject to increased regulatory scrutiny and possible challenge – those firms that have already carried out material re-organisations by creating service delivery companies in low cost jurisdictions which support EMEA based operations will need, in particular, to consider how these function in detail.
- While certain EU jurisdictions are indicating that the welcome mat is out for firms seeking to relocate from the UK, such welcome may well be tempered in practice by both lack of regulatory capacity properly to serve incomers and the lack of infrastructure (both public and private) to support a large influx of businesses.
- In addition to financial services specific issues, the restrictive impact of the UK becoming a third country for the purposes of movement of staff and the transmission of data will need to be carefully considered.

On what issues should businesses be focusing?

We recommend that financial services firms take some actions right now. The focus of action will be a direct corollary of the complexity of a firm's business and footprint, but some analysis is likely to be required at all levels.

- Senior management need to understand how their individual business lines currently fit within the regulatory framework. Internal due diligence is needed to ensure that there is a clear understanding of who does what for whom and where.
- The mapping needs granularity and needs to extend externally as well, so that financial services firms have a very clear picture of:
  - Where and how they solicit and service clients and where they book business – exactly which passports and permissions are being relied on for what services?
  - Where, if they offer bundled products and services, different components of the "bundle" rely on different permissions? Can products be unbundled and remain economically viable and practicable to deliver?
  - Where and how they outsource services both cross border within the EU and to third countries;
  - Where they access exchanges, CCPs, CSDs and other infrastructure;
  - Where their key financial intermediaries and counterparties are located and what access points to EU or UK market infrastructure those intermediaries have, upon which a business is dependent;
  - Whether they take advantage of particular provisions of CRDIV or CRR to manage their group balance sheets, if they operate across border through affiliates; and, if so, how those arrangements will potentially be affected?
  - Whether there are any particular business or product lines where the loss of ability to net or the forfeiture of intragroup exemptions from net margin requirements will adversely affect the economic viability of that business/product?
- The mapping needs to have a clear legal entity focus and cut across line of business management structures. It also needs to dig deep into operational areas.
- What are client expectations? Will they be willing to adjust the way they are serviced? Do they have flexibility or will they be expecting firms to provide solutions? If existing client books of business need to be relocated, have the tax consequences been evaluated? Will Brexit require substantial repapering (can this be co-ordinated with repapering required under e.g., MiFID II or BRRD)?
- What impact, for those affected by it, will Brexit have on BRRD and recovery and resolution planning generally?
- What will the impact of Brexit be on other regulatory programmes the firm may be running – has the firm identified the interdependencies with other regulatory programmes apart from BRRD – i.e., MiFID II, EMIR, payments services and UCITS V?
- Firms need to have a clear picture of their operational plumbing. If they have services which are outsourced "cross border" or distributed product manufacture, do they have a clear view on how oversight and control will be maintained post Brexit?
- Data: do firms have a clear picture of how their data, both client and employee, moves and when it moves across border or to affiliates and third parties?
- People/talent: to what extent do firms rely upon talent or specific skills vested in individuals who may not be easily employable in the same locations post Brexit, if stringent rules on the free movement of people are introduced?

Conclusion

How a firm "solves" for Brexit will be a direct product of its business strategy and the extent to which it can limit the BAU impact. Charting what that impact may be requires a clear map. Producing that map can take time and, if the route to Brexit becomes short and there are no lengthy transitional periods, firms may be faced with making choices without the opportunity for proper planning.

While the largest banks, subject to close and continuous supervision by the PRA and BoE are far advanced in their Brexit contingency planning, many other firms have had one of two approaches – "wait and see" or "high level strategic option analysis", tempered by a dose of "wait and see". While this was sensible immediately prior to and following the referendum vote, neither approach appears prudent now.

Those firms which have had a "wait and see" approach risk being left behind as service providers' and regulators' capacity to handle change requests becomes tested. Those which have focused on "high level strategic option analysis" risk a mismatch between the strategic conclusions being debated in the C suite and the operational and legal practicability of what is being proposed. Larger firms, who will have mobilised a Brexit team, need to ensure their Brexit plans are deliverable.

Brexit Appendix

This appendix contains a brief description of the key EU financial services directives (excluding the insurance sector) which create the core regulatory framework within which financial services firms principally operate as well as basic definitions of some other acronyms used. It also contains a brief discussion of what is meant by "passporting" and what the preconditions to passporting are.

Part 1

Article 50: Article 50 of the Lisbon Treaty on European Union. This sets out the mechanism by which a state may exit the EU. It creates a negotiating framework and sets down a timeframe but does not prescribe any legal outcomes. The two year timetable specified by Article 50 may be extended by unanimous member state agreement, but not otherwise.

AIFMD: the Alternative Investment Fund Managers Directive: the directive prescribing the regulatory framework to govern the prudential and conduct regulation of alternative investment fund managers and their core service providers, particularly depositories. The AIFMD contains specific rules for passporting and establishing equivalence for third country regulatory regimes.

BRRD: the Bank Recovery and Resolution Directive: the directive establishing the framework for the recovery and resolution of EU credit institutions and investment firms, and setting out the various regulatory tools to be deployed in times of stress (e.g., bail in) and the frame work for the establishment of minimum levels of own funds and eligible liabilities, known as MREL.

CCP: A central counterparty clearing house: an organisation established to facilitate trading done in derivatives and equities markets. CCPs bear most of the credit risk of buyers and sellers when clearing and settling market transactions. CCPs are corporate entities that reduce counterparty, operational, settlement, market, legal and default risk for traders by becoming the counterparty to the buyer and the seller and guaranteeing the terms of a trade even if one party defaults. CCPs receive and hold enough margin (cash or eligible securities) from each buyer and seller to cover their respective obligations under their contracts, with obligations being marked to market.

CRD IV: The Capital Resources Directive IV: The framework directive providing the architecture for the regulation of deposit taking (banking) activities across Europe. It creates a framework of prudential regulation for subsidiaries and branches and creates the framework for cross border regulation for banking business. It contains passporting rules for the provision of certain banking activities in another Member State on either a branch or cross-border services basis.

CSD: Central Securities Depository: a CSD is an entity which provides a central point for depositing financial instruments ("securities"), for example bonds and shares. CSDs' clients are typically financial institutions themselves (such as custodian banks and brokers) rather than individual investors. The core functions of EU CSD are to (a) operate a securities settlement system; (b) record newly issued securities in a book-entry system; and (c) provide and maintain securities accounts at the top tier level. CSDs operate IT platforms allowing for the recording of entitlements to securities and the settlement of securities transactions.

ICSD: International CSDs: Whereas CSDs were primarily created to serve their domestic market, ICSDs or "international CSDs" were created in the 1970s to settle eurobonds, i.e., international bonds denominated in a different currency from that of the country in which they are issued. ICSDs have extended the scope of their services to cover all types of internationally-traded financial instruments, including equities and investment funds. There are two ICSDs in the European Union: Clearstream Banking Luxembourg and Euroclear Bank in Belgium. Both hold a banking license and provide settlement in different currencies.

EEA: European Economic Area: EU members plus three of the four members of the European Free Trade Association (Norway, Iceland, Liechtenstein). Provides access to the EU internal market but without being subject to certain policies (agriculture/fisheries) but subject to obligations to make certain payment to EU but no involvement in substantive decision making. The EEA does provide a framework for cross border provision of financial services distinct from the "third country" provisions of CRD IV and MiFID but its operation has not caught up with recent changes in EU financial services regulation, in particular the roles and rule making responsibilities of the EBA, ESMA and EIOPA.

FSB: The Financial Stability Board: The FSB was established in April 2009 at the Pittsburgh Summit, by the Heads of State and Government of the Group of Twenty who endorsed the FSB's objectives and mandate to assume a global key role in promoting the reform of international financial regulation and to promote financial stability.

MiFID: The Markets in Financial Instruments Directive (in process of being updated by MiFID II – implementation date January, 2018) and to be read with the Markets in Financial Instruments Regulation (MiFIR) – the framework directive and regulation providing the architecture for the regulation of investment services across Europe. MiFID governs the process of authorising/licencing entities and the regulatory environment with which all MiFID firms must comply and creates the framework for Passporting of investment business.

PSD: The Payment Services Directive: The framework directive providing the legal foundation for the creation of an EU-wide single market for payments. The PSD aims at establishing a modern and comprehensive set of rules applicable to all payment services in the European Union. The target is to make cross-border payments as easy, efficient and secure as 'national' payments within a Member State. The PSD also seeks to improve competition by opening up payment markets to new entrants, thus fostering greater efficiency and cost-reduction. At the same time the Directive provides the necessary legal platform for the Single Euro Payments Area. PSD provides harmonising rules for conduct of business, execution times, and client classification and treatment.

Settlement Finality Directive: The Settlement Finality Directive adopted in May 1998 is aimed at reducing the systemic risk associated with participation in payment and securities settlement systems, and in particular the risk linked to the insolvency of a participant in such a system. The Directive applies to payment and securities settlement systems as well as any participant in such a system and to collateral security provided in connection with the participation in a system, or operations of the central banks of the Member States in their functions as central banks and, in particular, specifies when a transfer of a security becomes final. It is closely associated with the **Financial Collateral Arrangements Directive** which facilitated cross border use of collateral and removed many historical processes which impeded the swift and effective grants of security interests. Both sets of rules are foundational to the security and efficiency of liquidity provision across the EU.

SMCR: The Senior Management and Certification Regime of the UK, which replaces the UK's approved persons regime and creates the framework for ensuring the fitness and propriety of senior staffing working in UK Credit Institutions and establishing a framework for direct personal accountability for the most senior levels of management to regulators for breaches of financial services regulations occurring in their areas of responsibility.

"Third Country": any country that is not a member of the EU, or in some cases the EEA. In essence it means a country not subject to EU rules but without benefit, other than under very specific conditions, of access to specific EU markets in respect of specific products or services.

UCITS V: the directive establishing the regulatory framework governing asset managers and their depositories servicing the retail funds industry across the EU. The regime specifies prudential, conduct, investment and disclosure rules. It is the equivalent in the retail funds space to the AIFMD. It contains a passporting mechanic.

Part 2

How do firms provide services "cross border"? Licensing and Passporting are the key concepts:

Entities may operate in the EU through either locally established subsidiaries, which will be separately capitalised (and subject to EU prudential capital rules) and be subject to direct regulation in all aspects of operation by the National Competent Authority ("NCA") of the jurisdiction where they are established, or through branches. A branch may be of either an EU credit institution (in which case it will be subject to both home state (location of incorporation of legal entity) regulation and host state (location of branch) regulation, or of a non-EU authorised bank or broker dealer, in which case the EU NCA will defer some elements of prudential regulation to the jurisdiction of incorporation but will regulate most other matters including e.g., liquidity, governance and conduct.

To provide banking or investment services in the EU, entities (whether from branches or separate legal entities), need to be authorised under MiFID and/or CRD in the EU jurisdiction in which they are set up. A branch of a non-EU entity can ONLY provide services in the EU jurisdiction within which it is set up and authorised.

Passporting is the ability of an EU authorised *legal entity* to provide services in jurisdiction "A" from an entity in jurisdiction "B". It is a very important EU regulatory concept. Passporting out of London to other EU locations is a very common operating model for financial institutions.

The concept of passporting is in practice mostly utilised for activities conducted under MiFID. Core deposit taking activities which underpin banking activities are regulated under CRD which most banks do not rely on. MiFID does have a passporting mechanic for certain deposit taking and custody functions but these are "ancillary" to the securities related activities which MiFID primarily regulates.

Passporting is not "automatic" – an application needs to be filed with regulators. But generally speaking, applications for passporting by EU authorised entities will be granted.

Non-EU entities e.g., EU established branches of US bank and, following the final departure of the UK from the EU, UK authorised entities) do **NOT** have passporting rights in respect of their branches in the EU (e.g., a US bank Frankfurt branch cannot provide services in France, for example).

White & Case contacts

Dr. Henning Berger
Partner, Berlin

T +49 30 880911 0
E hberger@whitecase.com

James Greig
Partner, London

T +44 20 7532 1789
E james.greig@whitecase.com

Dennis Heuer
Partner, Frankfurt

T +49 69 29994 0
E dheuer@whitecase.com

Kevin Petrasic
Partner, Washington, DC

T +1 202 626 3671
E kevin.petrasic@whitecase.com

Dr. Andreas Wieland
Partner, Frankfurt

T +49 69 29994 1164
E andreas.wieland@whitecase.com

Stuart Willey
Partner, London

T +44 20 7532 1508
E swilley@whitecase.com

LON1116009_13

whitecase.com

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