



Certain legal implications of Brexit

Nordic Capital Markets Forum | 17 January 2019

Agenda

1. Introduction - Status on Brexit
2. Impact on financial services
3. Regulatory equivalence
4. Contractual continuity
5. Authorisations and relocation



1. Introduction - Status on Brexit

Status on the Withdrawal Agreement

- The UK and EU have agreed on a **Withdrawal Agreement** and a **Political Declaration** governing the UK's exit from the EU
- The EU (Withdrawal Agreement) Bill will implement the Withdrawal Agreement in UK domestic law
- First draft of the Withdrawal Agreement was published **on 19 March 2018**
- The Withdrawal Agreement included the possibility of a **transitional period** running from **29 March 2019** to **31 December 2020**, during which the UK will continue to participate in the Single Market and Customs Union.
- Also, certain **grandfathering provisions** have been negotiated.
- UK vote on 15 January 2019 rejected the Withdrawal Agreement – next step ?



The Political Declaration and financial services

- The Declaration confirms that formal negotiations on the future UK-EU relationship will begin only after UK withdrawal on 29 March 2019.
- Agreements will have to be reached by **June 2020**, the point at which the UK will have to decide whether to request an extension to the transition period
- The Declaration offers a generalised commitment to preserving “*financial stability, investor and consumer protection and fair competition*”, but qualifies this by acknowledging the UK’s and the EU’s regulatory and decision-making autonomy.
- It also records an agreement “*to engage in close cooperation on regulatory and supervisory matters in international bodies*”
- The Declaration makes clear that the future relationship will be on the basis of “**equivalence frameworks**” and states that both sides will endeavour to conclude these assessments before the end of June 2020.



Specific measures from the Commission

After a thorough examination of the risks linked to a no deal scenario in the financial sector, the Commission has found that only a limited number of contingency measures is necessary to safeguard financial stability in the EU27.

The Commission has therefore adopted the following acts:

- A temporary and conditional **equivalence** decision for a fixed, limited period of 12 months to ensure that there will be no immediate disruption in the central clearing of derivatives.
- A temporary and conditional **equivalence** decision for a fixed, limited period of 24 months to ensure that there will be no disruption in central depositaries services for EU operators currently using UK operators.
- Two Delegated Regulations facilitating novation, for a fixed period of 12 months, of certain over-the-counter derivatives contracts, where a contract is transferred from a UK to an EU27 counterparty.

Legal status on Brexit and financial services

- In relation to financial services the Withdrawal Agreement is effectively not stipulating any long-term solutions – these are to be agreed upon during the stipulated transition period
- The Commission has found that only a limited number of contingency measures is necessary to safeguard financial stability in the EU27 – however this leaves open a gigantic pile of issues
- “No deal” planning intensified as hard Brexit has become a realistic outcome
- Increased need to rely on regulatory equivalence and contractual continuity

When will “hard” brexit/”cliff-edge risks” occur?


If the UK leaves the EU
without an agreement
on 29 March 2019

or


If a (new) withdrawal
agreement is approved
(though at present
unlikely), at the end of
the transition period
(31 December 2020),
unless extended



Damage control and preparedness



The **EBA** has asked the EU Competent Authorities to ensure *“that financial institutions take practical steps now to prepare for the possibility of a withdrawal of the UK from the EU with no ratified Withdrawal Agreement in place, and no transition period”*



EU Commissioner:
“at this stage my impression is that most risks can be addressed through timely adaption by the industry”

Preparations on many levels

- The **EU Commission** has issued >60 ‘preparedness notices to stakeholders’ – i.e. **warnings on the potential effects of Brexit** in various industries / areas
- **EBA, ESMA** and **EIOPA** have prepared opinions on preparations for the withdrawal from the EU
- **Trade organisations**, such as ICMA, LMA, ISDA and AFME, have prepared memorandums, Q&As, opinions, etc. on various legal issues relating to Brexit
- Diligent preparations on **government level in each member state** together with industry interests
- Preparations/actions on a **company level**



2. Impact on financial services

Legal consequences for financial institutions

- The UK may become a **third country** for the purposes of the EU's legal framework (i.e. not possible to rely on the passporting regime)
- If no withdrawal agreement is ratified, the UK will not benefit from the rights (or be subject to the obligations) under Union law.
- An EU financial institution/ financial services firm can passport under one of the following Single Market Directives:
 - AIFMD
 - CRD IV
 - Insurance Mediation Directive
 - MiFID II
 - Mortgage Credit Directive
 - Solvency II
 - UCITS IV



Main legal risks when passporting rights ceases

When passporting ceases, financial institutions may face a number of additional specific **cliff-edge risks** such as:

- no longer being able to fully service **outstanding contracts**;
- no longer having the necessary **permissions** to service over-the-counter (OTC) derivative contracts with parties in the other jurisdictions;
- the risk that the **holding and sharing of data** may be in breach of national law, with the result that barriers to the cross-border flow of personal data disrupt the provision of financial services;
- the risk that **liabilities** (notes) already issued under UK law may no longer count towards the minimum capital requirement for own funds and eligible liabilities (MREL); and
- the risk that **automatic recognition of resolution actions** under the Bank Recovery and Resolution Directive across the EU may no longer apply between the EU27 and the UK.

Solutions if or when passporting rights ceases

- **Regulatory equivalence** by relying on same regulatory framework between the UK and EU (requires a decision from the Commission and only applicable to certain areas of financial services - *“equivalence is not automatic and is not a right”*)
- **Contractual continuity** by performing contractual obligations agreed under existing transactions
- **New authorisations** as a third country (by applying local licensing regimes)
- **Relocation** (to subsidiary within EU - The Swiss model by operating through subsidiaries without passporting rights)



3. Regulatory equivalence

Regulatory equivalence

- Regulatory equivalence is often cited as the main fall-back option for UK financial services after Brexit.
- Certain EU financial regulations envisage the possibility for third countries to obtain ‘**equivalence**’. In practice, this means the EU acknowledges that the legal, regulatory and/or supervisory regime of a third country is “as good as its own”
- The EU concept of regulatory 'equivalence' is governed by individual directives, and allows certain financial services firms from non-EU countries to provide services to clients in the EU provided that they meet a **minimum level of regulatory standards**. However, there are no equivalence rules for certain activities, particularly in relation to insurance.

Regulatory equivalence

- Regulatory equivalence requires a decision from the Commission and only applicable to certain areas of financial services - “*equivalence is not automatic and is not a right*”) - Usually based on advice from the three pan-EU financial supervisors – EBA, ESMA and EIOPA
- Several third countries have already obtained equivalence in some areas, e.g. the US, Australia, Canada and others have been judged equivalent with regard to Central Counterparties (CCPs) for the clearing of over-the-counter derivatives and Switzerland and Bermuda have obtained full equivalence under Solvency II.

4. Contractual continuity

Continuity of financial contracts

Will the performance of existing – sometimes called “legacy” – financial contracts continue or would Brexit make their performance illegal, impractical or impossible in some way?

Important distinctions - Contractual continuity relates to existing transactions and refers to both:

- The ability to perform contractual obligations agreed under **existing transactions**
- The ability to perform other important **lifecycle events** (including risk management activities) for such transactions

ISDA
International
Swaps and
Derivatives
Association

afme/
Association for
Finance in
Europe

**Contractual Continuity in
OTC Derivatives
Challenges with Transfers**

July 2018



Continuity of financial contracts – Performance of existing obligations

- The institution must be authorised **at the time** it enters the contract (if regulated activities).
- The **general view** has been that the performance of transactions which were covered by an authorisation at the time they were made **will not be affected by a subsequent loss of authorisation**.
- On that basis, **loss of authorisation** will not affect the institution's performance of existing obligations under a transaction made as principal, such as:
 - making or collecting payments that become due;
 - the provision or return of collateral (even in the form of transferable securities, including under a title transfer financial collateral arrangement); or
 - the termination of an existing transaction.
- No re-negotiation, new products, services, etc.

Continuity of financial contracts - Lifecycle events

- Certain so-called ‘**lifecycle events**’ or further activities that arise during the life of the contract may be regarded as constituting regulated activities in the jurisdiction where the client or counterparty is located, thus triggering the application of local licensing requirements after Brexit.
- Examples of events which may trigger local licensing requirements:
 - ✓ Rolling an open position
 - ✓ Novation
 - ✓ Unwinds / portfolio compression (where a new transaction is entered into)
 - ✓ Material amendments
- ISDA has commissioned **legal analysis** of the likely post-Brexit regulatory treatment of certain events during the life of a transaction, which may involve more than the mere performance of existing contractual obligations.

Continuity of financial contracts - Lifecycle events

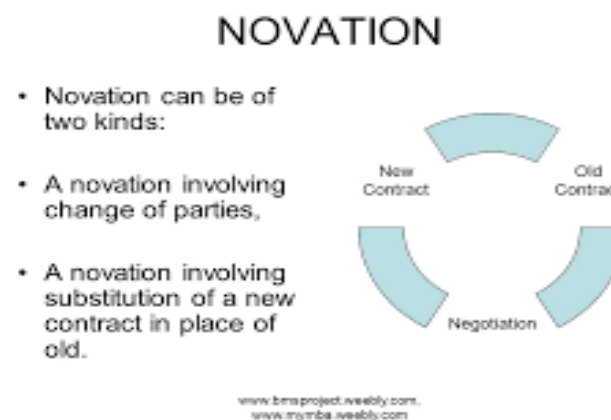
- **Conclusion:** **Very complex** and there is currently no consistent view across Member States determining which lifecycle events for legacy contracts would be considered regulated activities triggering licensing requirements.
- **Unlawfulness** may arise due to **loss of passporting rights** as a result of Brexit, but the consequence of this loss will depend upon the terms of the contract in question (e.g. is it covered by a force majeure or illegality clause?) and local law in the relevant jurisdiction.



Continuity of financial contracts - Lifecycle events

Solutions to be considered (if the activities are regulated):

- **Reliance on the reverse solicitation exemption:** The client initiates the provision of the service on their own initiative - There are inherent uncertainties in and limitations on reliance on these exemptions, such as that not all Member States adopt it as the relevant test for determining whether cross-border services have occurred.
- **Contract transfers or novation to authorised entities within the EU**
 - Counterparts may refuse to give consent
 - Time consuming
 - New legal opinions
 - Due diligence on new counterpart
 - New margin requirements
 - Tax impact
 - New documents



5. Authorisations and relocation

Authorisations / relocation



The ESMA opinion sets out nine principles (re. investment management):

1. No automatic recognition of existing authorisations
2. Authorisations granted by EU27 NCAs should be rigorous and efficient
3. NCAs should be able to verify the objective reasons for relocation
4. Special attention should be granted to avoid letter-box entities in the EU27
5. Outsourcing and delegation to third countries is only possible under strict conditions
6. NCAs should ensure that substance requirements are met
7. NCAs should ensure sound governance of EU entities
8. NCAs must be in a position to effectively supervise and enforce Union law
9. Coordination to ensure effective monitoring by ESMA

Authorisations - The Danish approach

- The Danish FSA has agreed to a procedure whereby the UK financial institutions may hand in an application for a third country license now (in relation to investment services).
- The Danish FSA will be able “**up front**” to indicate if the Danish FSA can grant the authorisation upon a “Hard Brexit” provided that certain conditions are fulfilled.
- The first indications by the Danish FSA were received by an applicant in October 2018. There are, however, still significant uncertainties related to this approach.



Authorisations - The Danish approach

Conditions:

1. The UK will be considered as a **third country**
2. A **cooperation agreement** between the NCAs in Denmark and UK is in place
3. The UK financial regulation and the UK supervisory authorities are in all material respects **identical** to the current Danish and European regulation and supervisory regime
4. The contemplated cross border services and activities are **covered by the authorisation** issued by the UK supervisory authorities and moreover are permitted under Danish and European law
5. **No changes** have been made in the Danish or European regulations on financial services from “third countries” on the approval date which could have an impact on the approval of the authorisation to carry out cross border services into Denmark



Any questions?

