COVINGTON

Brexit: The Impact on Financial Services

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Financial Services and Regulation

The UK is currently the largest financial centre in the European Union ("EU"). A large number of global financial institutions have a presence in the UK, both in order to participate in the UK financial market and also as a hub to access clients and markets across the EU. Whatever form Brexit takes, it will have an enormous impact on the financial services industry. The extent of the impact will depend upon the chosen model for an on-going relationship with the EU and transitional arrangements made in the period whilst the UK negotiates arrangements with the EU.

Potential Models for an On-going Relationship with the EU

In the event of a Brexit, there are several possible models for a UK-EU relationship. The impact of Brexit on the industry will depend upon which model is chosen. Currently, there is no indication from the Government as to which model is likely to be the preferred option. It is notable that all models (barring European Economic Area ("EEA") membership) focus on goods - none focus on services, which will be the main concern for financial services firms.

EEA Membership

This is sometimes referred to as the "Norway model". This model would allow the UK continued access to the internal market of the EU and EU financial services legislation (existing and future), including passporting and the single licensing regime, would continue to apply. However, the UK would have no say or vote in the formulation of EU legislation. The UK is currently one of the global leaders in policy-making and so it would switch from being one of the global leaders in financial services policy-making to a mere follower of rules. In addition, EEA membership would not address many of the UK's political concerns. For example, the UK would still be required to make a substantial contribution to the EU budget and would not be able to impose restrictions on immigration.

Bilateral Free Trade Agreement ("FTA")

The UK and the EU would negotiate a comprehensive FTA. This would give some access to the EU market in certain areas, but would not allow the UK any influence over the EU regulation of those areas.

European Free Trade Association ("EFTA") Membership

EFTA membership would necessitate the negotiation of a set of bilateral accords governing UK access to the EU in various sectors. Potentially, this would involve negotiating and adopting a large number of individual accords, as well as agreeing FTAs in relation to other sectors. Switzerland has more than 100 separate agreements with the EU, negotiated over many years. However, despite following a very large percentage of EU financial services requirements, Switzerland still has no passporting or single licensing regime.

World Trade Organisation ("WTO") Approach

This is a "most favoured nation" model. It would require the WTO to require the EU to grant the UK trade advantages at least equal to those granted to the nation to which it gives the most favourable treatment. Although the UK would not be required to contribute to the EU budget, it would not be allowed access to the internal market of the EU. The UK would need to comply with EU rules and regulations, but would have no role or influence over the development or application of those rules and regulations.

Customs Union

This is similar to the current arrangement with Turkey. It would involve the creation of a free trade area and establishment of a common external tariff. However, it would relate to goods only, not services; non-tariff barriers would remain and there would be no free movement of capital. No current EU free trade agreement provides a single market regime for financial institutions. There would be no passporting or mutual recognition regime for financial institutions, except for certain limited third country "equivalence" regimes. Although the UK would not need to contribute to the EU budget, it would nevertheless be required to comply with EU regulations in relation to product standards, although again, it would have no influence over the development of those regulations.

Access to Markets: Passporting

The EU "passport" concept of mutual recognition amongst supervisory authorities in the EU works smoothly for investment activities. EU financial services legislation is based on the principles of "mutual recognition", "passporting" and the "single licence". In the UK, authorisation by the Prudential Regulation Authority and/or the Financial Conduct Authority provides a licence to conduct business in other EU and EEA states as well, without the need to obtain local authorisation, meet differing local prudential requirements or hold local capital. A large amount of legislation incorporates a passporting or single licence regime for EU and EEA firms:

- Capital Requirements Directive IV ("CRD IV"), in relation to credit institutions;
- the Markets in Financial Instruments Directive ("MiFID") - investment firms;
- Insurance Mediation Directive ("IMD") - insurance intermediaries;
- Solvency II - insurers, life officers and pure insurers;
- Payment Services Directive ("PSD") - payment services;
- Undertaking for Collective Investment in Transferable Securities ("UCITS") and the Alternative Investment Fund Managers Directive ("AIFMD") - provide a firm passport for managers and a product passport for funds;
- Mortgage Credit Directive - for non-bank mortgage lenders;
- Electronic Money Directives; and
- other EU legislation reflects similar principles, for example, the European Markets Infrastructure Regulation ("EMIR").

Until the model for the UK's ongoing relationship with the EU is more certain, it is very difficult for firms to make precise plans regarding the optimum structure for their ongoing operations.

Key Issues for Financial Services Firms

Some key issues for financial services firms will be as follows.

Banking and Investment Services

Where firms are purely UK-focused, there should not be too much impact. However, for firms that use the EU passport, the key issue will be whether the passport system will continue and if so, in what form. If the passport system were to lapse, it would be necessary to consider how business models and group structures would need to change. The greatest impact in this regard will be on banks, as CRD IV provides no framework for third country access and so therefore, there would be a need for banks to have EU subsidiaries that could passport services into the EU. EU firms wishing to provide banking services into the UK would need to establish a UK subsidiary.

Funds

The impact on fund managers would depend upon the extent to which they were UK, EU or non-EU focused and the types of products offered to investors. Firms are likely to lose out on the marketing and management passport benefits they currently utilise. There would be an impact on UK domiciled UCITS, as these would need to be EU domiciled and self-managed, or managed by an EU management company. There is a possibility of UCITS relocating to Luxembourg and/or Dublin.

The position under the AIFMD is less certain and it will depend upon the arrangements negotiated. For example, where a firm is classified as a non-EEA manager under the AIFMD, the impact may not be so significant, if the non-EU passport has been introduced.

Derivatives

In 2009, the G20 made a commitment to reform the derivatives markets globally. Given the UK's role in this commitment and the size of its derivatives market, the authorities would not be likely to seek to deregulate that market. The global reforms in place (or which are being finalised at the moment) would mean that the UK would continue to apply mandatory clearing, minimum margin requirements and reporting to a centralised trade repository, whether it was in the EU or not. The main question is, how would the UK do this?

Insurance

Passporting issues will also apply to the insurance sector. Firms currently relying on the passporting regime may have to rely on authorisation as a third country branch under Solvency II. A key question for the insurance sector would be whether the UK is granted equivalence under Solvency II. Although it seems likely that any new regime would closely resemble Solvency II, this is by no means certain.

Market Infrastructure

In the event of Brexit, the benefits of MiFID and EMIR may be lost and in that case, firms operating UK-based trading venues or clearing or settlement systems would need to consider how to continue servicing EU-based firms, or whether to link up with an EU-based

market infrastructure. Given the fundamental importance of the financial market infrastructure to the operation of UK capital markets, the UK Government would be likely to focus on ensuring that EU firms continue to be given access, possibly through the adoption of grandfathering measures.

Ring-fencing and Banking Structural Reform

If the Regulation on Banking Structural Reform (the "BSR Regulation") is enacted, it would impose fundamental structural reforms on EU banks that were in-scope and would prevent them from carrying out certain activities, including proprietary trading. It is possible that the UK will have left the EU by the time the BSR Regulation comes into force, in which case, its provisions will no longer be relevant. However, the UK has already introduced similar requirements under the Financial Services (Banking Reform) Act 2013 ("Banking Reform Act"), which requires banks to separate core banking services critical to individuals and small and medium sized enterprises from their wholesale and investment banking services by January 1, 2019. As a result, neither outcome would offer any hope of respite for banks currently grappling with the huge commitment and expenditure required by the new ring-fencing environment.

Bank Resolution and Recovery Directive ("BRRD")

It is unlikely that the UK will significantly change its position with regard to the BRRD. The UK is a member of the Financial Stability Board ("FSB") and has been one of the main advocates for the post-crisis EU-wide efforts. If the UK ceases to be a member of the EEA, English law-governed contracts that EEA lenders are party to will need to include a bail-in clause, in order for EEA lenders to comply with the requirements of Article 55 of the BRRD, as implemented by individual states.

Action to Be Considered

Although it is difficult to prepare firms' agreements with clients, suppliers and other third parties should be reviewed to determine whether - and to what extent - they will be impacted by Brexit. Until the path is clear, firms should be considering now the impact that the potential post-Brexit models may have on their businesses. In addition, it is essential that all firms lobby for the continuation of the single passport and single licensing regime: the mere free movement of goods is not acceptable and is of little use to the financial services industry. Firms should also lobby for a transitional regime and grandfathering provisions. It is essential that the new regime is agreed and in place by the Brexit implementation date.

If you have any questions concerning the material discussed in this client alert, please contact:

Charlotte Hill +44 20 7067 2190 chill@cov.com

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