BREXIT: IS THE CLOCK STILL TICKING FOR ASSET MANAGERS?

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UK Asset Management and Investment Funds Alert

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INTRODUCTION

On 24 December 2020, Michael Barnier, the European Union's chief negotiator said, "The clock is no longer ticking". Four and a half years after the Brexit referendum, the United Kingdom and the European Union had finally concluded a free trade and cooperation agreement (TCA) that provisionally[1] became applicable on 1 January 2021. From that date, UK asset managers and other financial services firms lost their passporting rights. These rights had broadly allowed UK-licensed firms to provide their services into the EU from the UK, and EU-licensed firms to provide their services into the UK from the EU. But what has taken their place?

Not a great deal. In the absence of the passporting regime, financial services firms on both sides of the English Channel, and particularly UK firms looking to do business in the EU, are now facing a more complex compliance environment in relation to cross-border provision of their services. However, the clock is still ticking on the continuing discussions between the UK and the EU regarding the cross-border provision of financial services, with many hoping that the outcome will ease some of the post-Brexit compliance challenges.

This alert examines the TCA and the potential for further agreements between the UK and EU affecting the ongoing compliance environment for asset managers. We consider in particular the concept of "equivalence," which may provide certain access rights for asset managers and some other financial services firms in the future. Finally, we also take a look at the future of financial services regulation in the UK.

RELEVANCE OF THE TCA FOR ASSET MANAGERS AND OTHER FINANCIAL SERVICES FIRMS

Although the European Commission has noted that the TCA provides for a significant level of openness for trade in services and investment, in reality, it only has a small number of provisions governing financial services regulation. In a document stretching to over 1,200 pages, "financial services" appears only six times. Many have criticized the limited scope of the TCA, with even UK Prime Minister Boris Johnson conceding that the TCA "perhaps does not go as far as we would like" over access to EU markets for financial services firms.

The TCA is, however, accompanied by a nonbinding joint declaration committing the UK and the EU to cooperation on matters of financial regulation and to preserving financial stability, market integrity, and the protection of investors and consumers. Under the declaration, the parties agree to establish structured regulatory cooperation on financial services, with the aim of establishing a durable and stable relationship between autonomous jurisdictions. To this end, the Declaration also includes an agreement that the UK and the EU will seek to agree on a memorandum of understanding (MoU) by 31 March 2021 setting out a framework for the envisaged regulatory cooperation, in particular in relation to “equivalence determinations”:

> Both parties will by March 2021, agree a Memorandum of Understanding establishing the framework for this cooperation. The parties will discuss, inter alia, 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 on each side.

Although the MoU has not yet been finalised, we are not expecting anything particularly helpful to the asset management industry to emerge from the negotiations. In particular, the EU does not appear to have any current plans to provide clarification as to the timetable or process for any specific “equivalence” determinations that could be helpful for asset managers.

It has been reported, in fact, that the EU draft of the MoU is very similar to the MoU that the EU has with the United States. This would mean that, out of the starting gate, detailed provisions regarding any commitment to processes around equivalence are unlikely to be included in the draft MoU.”[2] In addition, the current draft of the MoU is built around a voluntary framework very similar to what the EU has in place with the United States. On 23 February 2021, John Glen, economic secretary to HM Treasury, told a conference of insurers that the MoU on financial services expected in March will be distinct from the equivalence process necessary for market access and that the EU's equivalence assessments, which are unilateral, will not be discussed with the Treasury as part of the talks for the MoU. In addition he is reported to have said that: “The EU is looking at us now as a third party outside. [Equivalence] is a process we can't control.”

It does remain possible that the concept of “equivalence” may, in time, lead to some regulatory relief for asset managers wishing to carry on business across the UK/EU border, and we therefore discuss below this concept, its limitations, and the current position regarding equivalence decisions between the UK and EU.

WHAT IS EQUIVALENCE, AND IS NOT THE UK EQUIVALENT ALREADY?

Equivalence is a concept under EU law (including EU law as now retained in the UK). Equivalence determinations may currently only be made where there is a specific mandate to be able to do that in relevant EU legislation. There is currently no facility for generalised equivalence determinations to be made, and the EU appears to have no enthusiasm for this as an approach.

Equivalence generally refers to the regulatory and/or supervisory regimes of a third country (being a country that is outside of the EU, or, in relation to the UK, a country outside the UK) relating to an area of financial services being determined to be of an equivalent standard to that which applies under EU (or, as applicable, UK) law. In the EU, this concept allows EU authorities to rely on supervised entities' compliance with equivalent rules in the third country and may permit financial services firms based in third countries, such as, now, the UK, to gain some access to EU markets or to provide certain services to EU clients. However, equivalence is not a like-for-like replacement of the rights created by the EU passporting system, as it operates in fewer areas of the financial services market, is specific to particular situations but absent in others, and is less secure as a means of access to markets and customers, as discussed below.

In EU financial services legislation, the assessment that a third country's regulatory regime is equivalent is made by the European Commission based on input given by the European supervisory authorities (the European Banking Authority, the European Securities and Markets Authority (ESMA), or the European Insurance and Occupational Pensions Authority). Although the assessment of equivalence often involves a rigorous assessment of the third-country rules, it does not generally require that the third-country regulatory and supervisory framework is identical to the EU framework. The assessment typically looks at a close comparison of the intent and outcomes of the EU system and that of the third country. In the process, the EU typically invites the third country to contribute to fact-finding exercises on the way outcomes are delivered in the third country. In addition, the EU Commission conducts a risk assessment identifying risks to the EU financial system that may arise as a result of an increased exposure to the third-country framework. As part of this risk assessment, the European Commission assesses the impacts of cross-border activity of market participants on EU financial stability, market integrity, investor protection, and the level playing field in the EU internal market. It also assesses whether an equivalence decision will be compatible with EU policy in areas such as international sanctions, anti-money laundering, counter-terrorism financing, tax, good governance on a global level, or other relevant external policy priorities. These assessments help to ensure consistency of the EU's action on the international stage.[3]

On the face of it, it should be a relatively straightforward matter for the EU Commission to deem the UK equivalent in many areas based on the very close alignment between the UK's current financial services and other rules and those of the EU, as a result of the onshoring of EU legislation into the UK. However, there is by no means any guarantee that the UK's financial services rules will be deemed equivalent in all, or indeed any, of the areas in which equivalence determinations are envisaged in EU financial services legislation. This is largely because equivalence determinations have an important political dimension, and the bottom line is that EU equivalence decisions are unilateral and discretionary acts of the EU, a point that we understand the MoU is likely to reiterate. This political dimension is concerning for the UK, and for the asset management industry, and not only because of the general difficulties occasioned by the long, drawn-out Brexit process. In addition, the EU appears to have genuine concerns that the UK may seek to develop a more conducive environment for financial services firms than the EU with a view to out-competing the EU, and this could be a reason to withhold equivalence determinations and thereby restrict access to EU markets.

LIMITATIONS OF THE EUROPEAN UNION'S CONCEPT OF EQUIVALENCE

Provisions in EU legislation that envisage equivalence determinations are tailored to the particular circumstances covered by the relevant legislation and set out the conditions, criteria, and extent to which the EU Commission may take into account the regulatory and supervisory framework of a third country. As a result, equivalence can mean different things in different contexts.

By way of example, Article 46 of Markets in Financial Instruments Regulation (MiFIR)[4] gives third-country firms the right to provide investment services or perform investment activities to eligible counterparties and to per se professional clients without establishing a physical branch in the EU. To qualify for this, a firm must, among other things, appear in a register of third-country firms maintained by the EU. Registration is only possible where various conditions are met, including that the EU Commission has adopted an equivalence decision in relation to the relevant third country in accordance with Article 47 of MiFIR. Currently the EU Commission has not made any equivalence decisions under Article 47.[5] To be considered equivalent, the relevant prudential and business conduct framework of a third country must, in this context, fulfill an array of specific conditions, including being subject to sufficient capital requirements, adequate organisational requirements, and appropriate conduct of business rules.

A further example is the third-country passport for alternative investment fund managers (AIFMs) under Article 37 of the Alternative Investment Fund Managers Directive (AIFMD).[6] If the passport is extended, it will permit third-country AIFMs to manage EU alternative investment funds (AIFs) and/or market third-country AIFs across the EU pursuant to an AIFMD passport. However, the European Commission may only switch this on with regard to a jurisdiction if ESMA has assessed the third country as presenting no significant obstacles regarding investor protection, market distortion, competition, and the monitoring of systemic risk impeding the extension of AIFMD passporting to the relevant country.[7] This is a form of equivalence-type determination, again subject to specific criteria applicable to this particular context. ESMA has to date issued two advices to the EU Commission on this issue. The second, in July 2016, addressed 12 countries.[8] Five of these countries, Canada, Guernsey, Japan, Jersey, and Switzerland, were considered by ESMA to present "no significant obstacles." These advices were notable for the depth that ESMA went into in assessing equivalence and for the range of reasons, some unconnected with the marketing of alternative investment funds in the relevant country, why certain jurisdictions, e.g., Hong Kong, Singapore, the United States, and the Cayman Islands, were at that time not considered to present "no significant obstacles." It is also notable that notwithstanding the ESMA advice, the EU Commission has not yet chosen to activate the AIFMD passport, even in relation to the jurisdictions that ESMA found to present "no significant obstacles."

In addition, only around a quarter of all EU financial services legislation contain provisions relating to equivalence. EU financial services law contains around 40 provisions allowing the European Commission to adopt equivalence decisions. Thus, in the absence of a more generalised equivalence concept, which, as noted, it does not seem that the EU wishes to adopt, the coverage offered by equivalence determinations is only partial. For example, there is no facility for equivalence determinations in the context of some core banking and financial services activities, such as providing investment services to retail investors, and the provision of payment services or e-money issuance.

A further significant limitation of equivalence decisions is that they are not permanent and can be revoked on short notice. The EU monitors the reliance on an equivalence finding, as it may bring new risks to the EU financial system, and the EU Commission has the ability to amend, suspend, or withdraw an equivalence decision when it deems necessary on as little as 30 days' notice. However, it is also possible under EU law that such a decision can take effect after a transition period, which can be applicable to the full decision or parts of it. The EU Commission may also grant time-limited equivalence decisions or set conditions or limitations to equivalence decisions, and, to date, the EU has taken two time-limited decisions in connection with the UK relating to central counterparty clearing and the settlement of Irish securities. The risk of a time-limited equivalence decision is that it may not be renewed.

As an example, a rolling time-limited 2017 EU Commission decision that certain Swiss stock exchanges were equivalent for the purposes of the EU's share-trading obligation at Article 23 of the EU Markets in Financial Instruments Regulation, was allowed to lapse on 1 July 2019. The original decision had noted that "when deciding on whether to extend the applicability of this decision, the Commission should in particular consider progress made towards the signature of an Agreement establishing that common institutional framework." Difficulties emerged in the negotiation of the referenced framework in 2019, and the equivalence decision was withdrawn as a result. The equivalence decision was entirely unrelated to the matters in dispute, and this incident therefore illustrates that EU equivalence decisions may be ended for entirely political reasons, in particular where they are already time-limited.

THE UNITED KINGDOM'S APPROACH TO EQUIVALENCE

To ensure that EU law is operable in a UK-only context post 31 December 2020, it has been necessary to amend certain aspects of the legislation to reflect the UK's new position outside the EU. Those changes were made as part of the process of onshoring EU law at the end of the Brexit transition period. Under the UK regime, the EU Commission's role in making equivalence determinations for overseas jurisdictions has been allocated to HM Treasury. Equivalence determinations by HM Treasury will be based on advice from the Bank of England, the Prudential Regulation Authority, and the Financial Conduct Authority. In a desire to promote stability for UK firms and overseas firms, the UK government has retained the equivalence decisions on countries outside the UK and EU that were taken by the European Commission before 31 December 2020.[9]

Details on the approach that the UK will apply regarding equivalence are set out in a guidance document from the HM Treasury published in November 2020.[10] In this document, HM Treasury sets out operating principles for the UK's equivalence framework. These principles closely resemble the EU's approach to equivalence determinations in that determinations will be outcome-focused, evidence-based, and will involve dialogue with third countries. HM Treasury will also consider whether these determinations will be compatible with the UK's policy priorities, including those relating to the rule of law, international sanctions, human rights, and efforts to combat money laundering.

Equivalence may also be withdrawn if the UK judges that the third country no longer delivers equivalent outcomes or is not compatible with the UK's policy priorities. However, the guidance document explicitly states that HM Treasury, on the advice of and working with the financial services regulators, will seek, where possible, to mitigate any adverse effects of withdrawal on financial stability and market disruption, bearing in mind the full range of regulatory tools. This includes mitigation by the use of appropriate adaptation periods to allow firms time to prepare for the changing circumstances. We are not aware that the European Commission has made any similar explicit statement that it will seek, where possible, to mitigate the adverse effects of a withdrawal of equivalence, although, as noted above, the option will be open to them. This therefore appears to represent a difference in approach between the UK and EU.

THE CURRENT STATUS OF UK/EU EQUIVALENCE DECISIONS

So, where do things stand currently on the granting of financial services-related equivalence decisions on both sides?

EU: As mentioned above, the EU has to date taken two time-limited equivalence decisions in connection with the UK relating to central counterparty clearing and the settlement of Irish securities. This compares unfavourably with jurisdictions, including Australia, Canada, China, Hong Kong, Japan, Singapore, Switzerland, and the United States, as shown on the EU Commission's chart of equivalence decisions as of 10 February 2021.[11] In relation to equivalence decisions in 28 other areas, and according to the Q&A relating to the TCA,[12] the EU Commission cannot finalise its assessment of the United Kingdom's equivalence until further clarifications are received, in particular, how the UK will diverge from the EU frameworks after 31 December 2020, how it will use its supervisory discretion regarding EU firms, and how the UK's temporary regimes will affect EU firms. This approach could be strung out indefinitely, and we believe that it demonstrates the EU's concern about potential competition from the UK as the UK gradually moves away from the level playing field of standardised EU rules.

UK: In November 2020, HM Treasury granted 17 equivalence decisions to the EU. These decisions were in addition to the existing decisions made in 2019 in relation to the Prospectus Regulation and Transparency Directive, and brought the total number of UK equivalence decisions in respect to the EU to 28.[13] The November 2020 decisions related to the European Market Infrastructure Regulation, the Capital Requirements Regulation, the Solvency II Regulation, the Central Securities Depositaries Regulation, the Benchmarks Regulation, the Credit Rating Agencies Regulation, the Short Selling Regulation, and the Central Counterparties Regulation. Seven of the 17 decisions related to provisions of the Capital Requirements Regulation and were intended to ensure that UK firms would not be subject to increased capital requirements as a result of the their exposures in European Economic Area states.[14]

The UK government has confirmed it is not ruling out further equivalence decisions for the EU in the future, as it continues to believe that comprehensive mutual findings of equivalence between the UK and the EU are in the best interests of both parties. However, the UK has yet to confirm its assessment of the 12 areas in which it has not declared the EU equivalent, as it awaits clarity from the EU as to its intentions with regard to EU equivalence determinations on the UK. Accordingly, in these additional 12 areas, there is currently something of a standoff, and it appears that talks between the UK and EU have not been easy on these points. Signs of frustration have certainly been evident in public statements. For example, Andrew Bailey, governor of the Bank of England recently said that:

> [T]he post-Brexit equivalence process between the UK and EU has not been straightforward … it would be reasonable to think that a common framework of global standards combined with the common basis of the rules – since the UK transposed EU rules from the outset – would be enough to base equivalence on global standards, Less than this was enough when Canada, the US, Australia, Hong Kong and Brazil were all deemed equivalent.[15]

WHAT THEN IS THE LIKELY OUTLOOK FOR UK/ EU COOPERATION IN FINANCIAL SERVICES?

Equivalence may yet turn out to be politically untenable for both the EU and the UK, given that the UK does not want to be a rule taker, and the EU seems reluctant to grant equivalence to the UK in those circumstances. There are certainly no guarantees that equivalence offers a viable way out of current compliance complexity for firms trying to operate between the UK and EU. Michael Barnier, the EU's former chief Brexit negotiator has, in particular, dismissed suggestions that the EU would or should be in a hurry to award equivalence to the UK stating that: “The EU will consider an equivalence decision when it is in the EU's interest.”

Even if a number of further mutual equivalence determinations are made by the UK and EU, it now seems a certainty that UK asset managers and other financial services firms will have much more limited potential access to EU financial markets than under the EU passporting regime. It is also clear that, unless changes are made, equivalence determinations will not offer businesses the certainty, or breadth, of access that they have been used to under the passporting regime of the single market.

Therefore, with political machinations showing no real signs of an early resolution, affected UK firms which do not have EU licensing may need to move on and concentrate on business that is permitted. Some of them will surely need to look to a greater extent to markets outside the EU for future growth.

The UK, meanwhile, is looking to its future as an autonomous nation outside the EU, and this may in time lead to changes in domestic legislation affecting asset managers.

LOOKING TO THE FUTURE: THE UNITED KINGDOM'S PLANS TO “REGULATE BETTER”

The UK's departure from the EU, while somewhat messy, presents an opportunity for a substantive overhaul of the UK's current financial services regulatory framework. John Glen, MP, economic secretary to HM Treasury, recently wrote that: “We can now be guided by what is right for the UK, regulate differently where we need to, and regulate better.”[16]

The UK government has made clear that the current onshored rulebook is a temporary fix that will work, alongside other temporary provisions such as the temporary permissions regime[17] to provide business continuity for affected entities. However, moving forward and eventually beyond the immediate concern of managing Brexit, the UK's approach to financial services regulation is expected to change.

The Future Regulatory Framework Review (FRF Review), led by HM Treasury, is an ongoing review of UK financial services regulation, with a view to establishing a fit-for-purpose, future-proof UK regime. The FRF Review has been underway since June 2019, most recently involving a public consultation—the first arm of its “Phase II” review of the UK's broad framework.

This FRF Review consultation sets out a proposal that builds on the strengths of the model of regulation under the Financial Services and Markets Act 2000 rather than designing a new framework from scratch. The proposal envisages a clear allocation of responsibilities between Parliament, HM Treasury, the Financial Conduct Authority (FCA), and the Prudential Regulation Authority (PRA) with more policy discretion being given to the FCA and the PRA on how regulatory requirements should be designed to meet the policy steers of Parliament.

Adopting this approach will represent a major reallocation of responsibility in the UK, and will necessitate provisions to ensure that the PRA and FCA are accountable and exercise their widened responsibilities transparently. HM Treasury is confident that this approach offers the possibility for the UK to be flexible and agile in the face of changing market conditions. It should enable the FCA and the PRA to regain control over financial regulation in the UK in a way that was not previously possible within the constraints of detailed legislation prescribed by rule-makers in the EU.

The FRF Review Phase II Consultation closed on 21 February 2021, and HM Treasury is currently analysing the feedback received.

FOOTNOTES

[1] The UK Parliament approved the TCA on Wednesday 30 December 2020, under the European Union (Future Relationship) Bill, and it entered into law in the UK from 11 p.m. on 31 December 2020. However, the application of the TCA remains provisional pending necessary approval in the EU. The TCA is currently being considered by the European Parliament, which has to give its consent before the TCA can be concluded by the European Council on behalf of the EU."

[2] James Silver, *EU financial services chief warns of long road ahead for UK-EU equivalence deal*, CITY A.M. (Feb. 12, 2021).

[3] See the EU's July 2019 communication on equivalence decisions here.

[4] The Markets in Financial Instruments Regulation (EU Regulation 600/2014/EU)

[5] See the European Commission's list of equivalence decisions as at 10 February 2021, found here.

[6] The Alternative Investment Fund Managers Directive 2011/61/EU.

[7] Article 67(4) of AIFMD.

[8] Press Release, Eur. Sec. & Mkts. Auth., ESMA Advises on Extension of Funds Passport to 12 Non-EU Countries (July 19, 2016).

[9] There is one exception to this approach. The government did not onshore equivalence decisions for central counterparties that the EU made under Article 25 of the European Market Infrastructure Regulation (EMIR – EU Regulation 648/2012).

[10] Guidance Document for the UK's Equivalence Framework for Financial Services (Nov. 9, 2020).

[11] Equivalence Decisions taken by the European Commission, Europa.Eu (Feb. 10, 2020).

[12] Questions & Answers: EU-UK Trade and Cooperation Agreement, European Commission (Dec. 24, 2020).

[13] See the HM Treasury table of equivalence decisions as at 14 January 2021 here.

[14] HM Treasury press release (Nov. 9 2020).

[15] Andrew Bailey, Speech at the Financial and Professional Services Address, Mansion House: The case for an open financial system (Feb. 10, 2021).

[16] Ministerial Foreword, Financial Services Future Regulatory Framework Review, Phase II Consultation, October 2020.

[17] See Philip J. Morgan, Joanna Treacy & Katherine McDermott, *Second Bite of the Cherry: Returning to the UK's Temporary Permissions Regime*, K&L GATES HUB (Sept. 30, 2020).

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