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Brexit: What does the Withdrawal Agreement mean for financial services?

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On 13 November 2018, the EU and UK negotiators reached an agreement on the conditions for the withdrawal of the UK from the EU (the **Withdrawal Agreement**) and on 25 November, the EU and UK leaders approved the Withdrawal Agreement and reached an agreement on the political declaration regarding the framework for their future relationship (the **Political Declaration**). The Withdrawal Agreement is now due to undergo the formal parliamentary ratification process.

What does the Withdrawal Agreement cover?

In its nearly 600 pages, the Withdrawal Agreement sets out the conditions for the withdrawal of the UK from the EU, by among others, cementing the citizens' rights, designing the structure for judicial and administrative cooperation and procedures, temporarily maintaining the customs union, providing the framework for the relationship during a transition period and beyond as well as dealing with the financial bill to be settled by the UK.

Where do financial services stand?

There is no section in the Withdrawal Agreement specifically dedicated to financial services. Financial services are nevertheless mentioned in the Political Declaration that is meant to set out the terms of the future relationship between the UK and the EU past the 21-month (or more) transition period.

The Transition Period

The Withdrawal Agreement provides for a transition (EU language) or implementation (UK language) period running from 29 March 2018 until 31 December 2020, which can be extended until the end of 2021 or 2022 by a single decision of the joint committee formed of representatives from the UK and the EU (to be taken before 1 July 2020) (the **Transition Period**). While no longer a member state of the European Union, the UK will nevertheless be considered as part of the customs union and the Single Market. EU law and jurisdiction will continue to apply to the UK during the Transition Period.

Financial services during the Transition Period

During the Transition Period, it will be in principle "business as usual" for UK and EU financial services firms and activities.

UK firms will continue to be able to provide services in other EU member states via the passports currently available (e.g. management and marketing of investment funds, investment advice, portfolio management) and vice-versa. UK-based financial market participants shall, in return, comply with the legally binding EU legislation, including the technical standards issued by the ESMA, EBA, EIOPA (the European Supervisory Authorities), including an obligation to submit ongoing, clear and detailed reports to confirm that they comply with their guidelines and recommendations.

In addition, the UK will need to ensure full application and implementation of EU legislation (directly applicable regulations, directives and secondary implementing legislation) adopted until the last day of the Transition Period. Moreover, during this time, EU legislation applicable in the UK should be interpreted and applied in accordance with the same methods and general principles as those applicable within the EU (e.g. free movement of capital, freedom of establishment or to provide services, etc.).

Financial services after the Transition Period

The end of the Transition Period is likely to bring significant disruption to the cross-border provision of financial services between the UK and the EU, due to the highly fragmented legal framework concerning the access of financial services firms established in non-EU countries to EU markets and customers. On 31 December 2020 (or at the end of the extended Transition Period), the UK will become a "third country" for the purpose of financial services and the UK-based firms will in principle lose their access to the Single Market that they currently enjoy via financial services passports. The same applies for EU firms, which will lose their passport and ability to freely provide these services in the UK. This means that UK firms will no longer be able to freely provide services on a cross-border basis in EU member states, nor be allowed to freely establish branches therein, and vice-versa.

However, the Political Declaration aims to foster a close relationship on services and investment, including financial services, between the UK and the EU once the Transition Period is over. The UK and the EU undertake to enable free movement of capital between them and to allow the establishment of subsidiaries within their territories, subject however to exemptions (i) to be negotiated should the Political Declaration be translated into legally binding treaties, and (ii) currently applicable to the authorisation of firms providing cross-border financial services.

The Political Declaration seals the UK's and the EU's commitments to:

1. preserve financial stability, market integrity, investor protection and fair competition,
2. respect the other party's regulatory and decision-making autonomy, and their ability to take equivalence decisions in their own interest,
3. observe the other party's ability to adopt or maintain any measure where necessary for prudential reasons,
4. engage in close cooperation on regulatory and supervisory matters through international bodies,
5. start equivalence assessments of each other's frameworks as soon as possible after the UK's withdrawal from the EU, endeavouring to conclude these assessments before the end of June 2020, and then to keep their respective equivalence frameworks under review, and
6. work towards a close and structured cooperation on regulatory and supervisory matters, grounded in the economic partnership and based on the principles of regulatory autonomy, transparency and stability.

Equivalence assessments and regimes

"Equivalence" regimes for third countries and firms under the existing EU legislation are a collection of provisions covering various aspects for the provision of financial services. The UK will adopt and retain EU legislation entering into force until the end of the Transition Period, and thus it should in principle create the conditions to implement an "equivalence" framework post-Transition Period.

The UK and the EU will begin equivalence assessments with respect to each other's financial services sectors and legislation during the Transition Period. These equivalence assessments should be concluded by June 2020 in order to allow for the implementation of equivalence regimes under the existing framework from January 2021. However, the Political Declaration does not really open the door for further extension or deepening of the current equivalence regimes. Moreover, the EU and the UK commit to mutual consultation in the process of adoption, suspension and withdrawal of equivalence decisions. Furthermore, they pledge to exchange information and to consult each other on regulatory initiatives.

Not all financial services legislation contains equivalence clauses, and even when present, not all equivalence clauses grant "passport-like" access to the EU's Single Market.

For instance, if equivalence is recognised under MiFIR, UK credit institutions and investment firms could provide investment services (e.g. investment advice or portfolio management) to professional clients anywhere in the EU under a "passport-like" regime. This would enable them to freely provide services in EU member states territories or to establish branches therein. By contrast, this is not the case for UCITS. There are no equivalence clauses, nor "passport-like" access under an equivalence regime in the UCITS Directive. Therefore, UK-based UCITS funds and UCITS management companies are likely to be the most affected once the Transition Period is over. Management companies located in the UK will no longer be entitled to manage UCITS set up in the EU and the UK-based UCITS will no longer be distributed into the Union to retail investors.

Under AIFMD, even if there are no equivalence clauses as such, the Directive allows the European Commission to extend the AIFM passport to non-EU managers in order to allow them to manage and market alternative investment funds in the EU. The extension of the passport is conditional upon a positive advice from ESMA. Until now, no third country AIFMD passport has been granted, despite ESMA having undergone reviews of some third country regimes in 2015 and making positive recommendations with respect to Guernsey and Jersey. There is a little – but existing – chance that the third country passport could be granted to UK AIFMs after the Transition Period. However, as a reminder, ESMA did not make a positive recommendation with respect to US managers, due to concerns in particular relating to competition distortion and market access. This clues us in on what the points of attention of the EU will be when negotiating its access with the UK.

Should a third country passport be granted to UK-based AIFMs, they would need to obtain an authorisation from the supervisory authorities of an EU member state of reference and to appoint a legal representative in the EU.

If the third country passport is not granted to UK AIFMs, they will need to set up fully capitalised subsidiaries in the EU in order to manage and market AIFs. In addition, EU AIFMs may not be able to delegate portfolio management to UK managers if the national supervisory authorities of the EU member states did not enter into cooperation agreements resulting in memoranda of understanding with the UK's Financial Conduct Authority.
In the absence of equivalence recognitions, for the time being it is uncertain how financial services firms in the EU member states will be able to access financial markets and customers in the UK, and whether the UK would bring forward the "temporary permissions' regime" it had prepared for a "no-deal" Brexit no later than one month ago.

What else is relevant for the financial services sector?

The Withdrawal Agreement and the Political Declaration cover other areas which are not directly addressed to financial services, but which will have an impact on them.

For instance, they:

- set out the principles of (i) market-access (however, only within the conditions agreed, which means that it is possible to introduce discriminatory barriers) and (ii) non-discrimination in relation to the establishment of professional firms and of commercial presence of UK firms in the Union and vice-versa;
- guarantee the freedom of movement, "visa-free" travel of individuals for business purposes between the UK and the Union, beyond the Transition Period;
- guarantee the rights of residence of EU and UK residents after the Transition Period;
- contain engagements to ensure the continued free flow of personal data between the UK and the EU under the highest standards of protection, and the EU's engagement to proceed to a (continuous) adequacy assessment of the UK's implementing measures;
- see the parties commit to full compliance with FATF standards and to cooperation within FATF, with the UK and the EU going beyond those standards with regard to beneficial ownership transparency and ending the anonymity associated with the use of virtual currencies;
- in the area of taxation, see the parties committing to good governance in the area of taxation, transparency and exchange of information, and the implementation of the OECD BEPS standards;
- see the UK committing to continue to apply, after the Transition Period, the provisions implementing EU legislation into their domestic laws and regulations on administrative cooperation in the field of taxation, ATAD and country-by-country reporting;
- commit to enable the free movement of capital and payments, but subject to certain exceptions which will be further determined during the negotiations.

What are the next steps?

The Withdrawal Agreement and the Political Declaration will be presented to the UK Parliament on 11 December. A "meaningful vote" is expected by the UK government. However, a positive vote is far from being guaranteed, as currently no majority seems to be rallying behind the treaty in the House of Commons.

Should the Withdrawal Agreement be approved by the UK Parliament, it will need to be implemented into domestic legislation and an EU Withdrawal Agreement bill will be introduced thereafter. In parallel, the Withdrawal Agreement will need to undergo the legislative process in the EU Parliament (a simple majority is needed) and to be voted by the EU Council (agreement by 20 countries representing minimum 65% of the population) in early 2019.

The Political Declaration will further need to be translated into legally binding agreements. The future relationship between the UK and the EU will begin to take shape only after the Transition Period but the implementing agreements will hopefully be negotiated and finalized by the end of it.

In case the UK Parliament does not vote the Withdrawal Agreement, the UK Government is given, according to the European Union (Withdrawal) Act 2018, 21 days to put forward another plan. The other EU member states have already ruled out any renegotiation of the Withdrawal Agreement by agreeing on the fact that "this deal was the best possible deal".

Outcomes in case of rejection range from a "no-deal Brexit" to a UK general election (with an uncertain outcome), a second referendum (with an uncertain outcome), the extension of the negotiation period under Article 50 (requiring willingness and unanimity on the EU side) or the withdrawal of the Article 50 notification (provided the CJEU recognises that a unilateral withdrawal of the notice to withdraw is legally valid).

On the EU side, it is worth remembering that the day before the draft Withdrawal Agreement was finalised, the EU Commission published detailed information on its ongoing preparedness and contingency work in the event of a no-deal Brexit. The Commission had urged the ESAs to put in place cooperation agreements with the UK supervisors, to be in force as soon as the withdrawal date kicks in. On the UK side, the FCA initiated a number of consultations on the implementation of a temporary permissions regime to counter the cliff-edge effects of a no-deal Brexit for EU financial services firms operating in the UK or the EU funds distributed in the UK.

Conclusion – don’t put your contingency plans on hold

The news of consensus between the UK and the EU regarding the Withdrawal Agreement may have brought some temporary relief to financial services firms. However, they will need to continue and adapt their contingency plans, considering that the final outcome of the legislative process is currently unknown and uncertain. For some, the current passport regime could be replaced by a scant and patchy equivalence regime. Moreover, a hard Brexit causing considerable disruption to the financial services sector is not off the table and may still occur in the following four months.

Feel free to reach out if you need any assistance.

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