Brexit Update


In late August the UK government introduced the EU Withdrawal Bill, in place of the so-called “Great Repeal Bill.” The EU Withdrawal Bill would accomplish two things. First, the UK would withdraw from the European Community Act. Second, the UK would incorporate EU law into the domestic law, so that there is legal continuity after the political separation. The laws to be incorporated must have become “operative” (i.e. they must have come into force and taken effect) by “Exit Day,” which is projected for March 2019. The FMLC recently opined in a letter to the Ministry of Justice that the distinction between operative laws vs. laws which are not yet operative is not black and white. Of special concern is the Second Payments Directive. A regulation made under the Directive to implement technical standards dealing with strong authentication and secure communication (which will fall into the “not yet in force” camp”) will be left out of UK domestic law. The Directive itself, however, which mandates the technical
standards in question would be incorporated, but would be difficult to apply without the accompanying regulatory technical standards.

Negotiations between the UK and the EU are underway regarding a financial settlement, the Irish border, and the position of EU citizens in the UK. The UK would also like to include a customs (trade relationship) agreement as part of negotiations, but the EU appears unwilling to discuss future trading arrangements until separation has been finalized—especially financial settlement for commitments to EU-funded projects.

Questions remain regarding future role of the European Court of Justice (“ECJ”). Many observers had assumed that its jurisdiction would end on Exit Day, but recent remarks have cast doubt on that premise. In particular, EU negotiators have insisted that the ECJ should continue to have jurisdiction over EU citizens in the UK.

It is unclear what the position of the UK will be vis-à-vis third countries after Exit Day. The UK is currently covered by EU umbrella trade deals, but that coverage will likely end on Exit Day. Theresa May visited Japan recently to discuss a trade deal.

Additional topics in upcoming negotiations will include emissions trading, scientific research, and nuclear material. The European Parliament recently proposed postponing the next round of negotiations for three months. This is would significantly increase the pressure to agree on a number of outstanding issues in the short period (i.e. less than eighteen months) before Exit Day.

Finally, the FMLC published a paper in August on the application of corporate insolvency law once the UK leaves the EU, entitled “Issues of Legal Uncertainty Arising in the Context of the Withdrawal of the U.K. from the E.U.—the Impact on Cross-Border Insolvency Proceedings.” In the paper, the FMLC questions what will happen to mutual recognition of insolvency proceedings—a salient feature of EU legislation governing corporate insolvency—once the UK leaves the EU.

**Extraterritorial application of MiFID II**

Thomas Donegan of Shearman & Sterling (substituting for FMLC member Barney Reynolds) covered two areas giving rise to market difficulties in which some market participants have questioned the extraterritorial reach of the EU’s second Markets in Financial Instruments Directive (“MiFID II”) and possible conflicts with US laws: (1) access to exchanges; and (2) dealing with European funds.

Among others, MiFID II regulates securities and derivatives activity for markets and market participants. Article 48 contains a requirement that, in accessing regulated markets, only
investment firms regulated under MiFID II are allowed to have direct electronic access. There is a similar provision for algorithmic trading—market participants must generally be locally regulated if trading on European exchanges. There is no third country equivalence regime in MiFID II for these activities or restrictions.

In practice, many entities outside of Europe have access to European exchanges. In the UK, the Regulated Activities Order provides an important exception from regulation called the “overseas persons exclusion.” This will be preserved under the UK’s implementation of MiFID II. Third-country firms that were previously trading on UK exchanges may continue to do so, subject to conduct-of-business and governance requirements. Most of the rest of Europe does not have a similar exemption from regulation for third country businesses, so non-EU firms accessing their local exchanges will most likely need a local regulatory license to continue performing such activities, creating hurdles to access continental exchanges. Some countries have announced a grace period for firms currently trading on their exchanges to apply for licenses (Germany) or have a limited ability to exempt entities in certain countries (the Netherlands, for example).

Regarding European funds, MiFID II introduces new pan-European rules on the receipt and payment of inducements which capture the provision of research and dealing commissions. MiFID II essentially permits only two ways in which a portfolio manager can pay for research from its broker. First, the portfolio manager pays from its own pocket, and does not on-charge to funds or portfolio management clients. Second, the broker sets up a “research payment account”, which has a fixed annual budget and gives fund manager discretion over which research to buy. The UK has extended these rules to fund managers as well as portfolio managers. The policy aim behind these regulations is that brokerage fees should (in theory) become limited to pure cost of execution and research should only be obtained and paid for by investors when it is needed.

These provisions may have extraterritorial effects in a number of ways. If the fund is an EU fund manager, it must apply these restrictions on receiving research regardless of where its broker is located. So, a U.S. broker providing services to an EU fund manager cannot charge an uplifted brokerage fee to cover research costs or provide any other non-monetary benefit. The U.S. broker would need to change its fee structure to accommodate the EU regulation to which the fund manager is subject. Conversely, an EU broker must change its fee structure even if its clients are outside of Europe. But if an EU broker charges a U.S. fund for its advice (and sends an invoice), that may make the broker need to register an “investment advisor”, triggering a separate U.S. regulatory regime. There are industry steps afoot to attempt to introduce measures that will permit US brokers to continue to provide research without becoming subjected to a need for investment adviser registration but it is unclear how extensive or timely these will be.
Participants discussed several possible scenarios that would affect U.S. funds engaging EU brokers, and vice versa, including complementary access to trading platforms.

**FMLG Best Practices Review**

FMLG Secretary Tom Noone provided an overview of an upcoming FMLG project, in which members are reviewing prior guidance and best practices in light of the newly published Global FX Code. Prior materials—dating back several decades—will be updated or taken off the FMLG’s public website. He asked FMLC members for their views about materials that have retained their currency or utility in their practices, and whether there were plans for a similar review in the UK.

**Quadrilateral Reflections**

Participants discussed a number of reflections on this year’s Quadrilateral meeting, including the timing (early to mid-July), invite list (inclusive on non-members), and duration (one day versus two days). There was consensus—or, at least, a lack of vocal dissent—that a conference in early to mid-July would be ideal, that participation (in the audience and on panels) by non-members beneficially increased the range of perspectives at the conference, and that the duration of the 2018 meeting will depend largely on the resources available to the host.

**Dates for 2018 Quarterly Conference Calls**

Mr. Noone suggested that Q3 and Q4 2018 calls be moved from July and November to September and December, respectively. Dr. Perkins offered to move the Q1 and Q2 calls from February and May to March and June. The FMLC will recirculate proposed dates.

Thomas M. Noone  
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