



# **Issues of Legal Uncertainty Arising in the Context of the Withdrawal of the U.K. from the E.U.—the Provision and Application of Third Country Regimes in E.U. Legislation**

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1 In view of the role of HM Government and the Bank of England in the preparations relating to the forthcoming withdrawal by the U.K. from the E.U., Stephen Parker and Sinead Meany took no part in the preparation of this paper and the views expressed should not be taken to be those of HM Treasury and the Bank of England.

2 Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.

3 The FMLC is grateful to Claire Swirski, previously of Clifford Chance LLP, for her contribution to earlier versions of this paper.

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# 1. PREFACE AND INTRODUCTION

## Preface

- 1.1. The role of the Financial Markets Law Committee (the “**FMLC**” or the “**Committee**”) is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.
- 1.2. Following the result of the E.U. Referendum, the FMLC announced that it would work with experts in law and financial services to identify, analyse and address legal uncertainties relating to the U.K.’s withdrawal from the E.U. (“**Brexit**”) and that it would establish a High Level Advisory Group (the “**HLAG**”) to give direction to the Committee's future work in this field. Its research programme is now well under way.<sup>4</sup>
- 1.3. At a meeting of the HLAG held in October 2016, the FMLC Chief Executive delivered a presentation entitled *Brexit: Transition and Standstill*, mapping the provisions of key E.U. regulatory measures and analysing related provisions governing market access by financial services providers based in jurisdictions outside the E.U. (“**Third Countries**”). At the meeting, members of the HLAG recommended that the FMLC engage further with issues of legal uncertainty arising in the process of secession and transition. The Committee agreed with this assessment and resolved, in accordance with the FMLC's educational remit, to produce a paper highlighting related issues of legal uncertainty and making recommendations to resolve them.
- 1.4. This paper focuses on issues of legal uncertainty specific to the application of E.U. legislation to U.K.-based financial services providers in the event that the U.K. withdraws from the E.U. without retaining access to the single market under any other legal provision. It is not for the FMLC to comment on matters of policy or the form that future regulatory approaches, if any, should take and this paper should not be understood to constitute comments thereon.

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<sup>4</sup> The text of the announcement and further details of the FMLC’s work in this area are available at: <http://www.fmlc.org/the-fmlcs-work-on-brexit.html>.

## Introduction and Executive Summary

- 1.5. In the months after the E.U. referendum, there arose a perception that the future of the U.K.'s relationship with the E.U. was beset by a significant lack of clarity. In the absence of any official roadmap, the debate revolved around the idea of a “soft Brexit”—with the U.K. retaining membership of the European Economic Area (“E.E.A.”) or at least the European Free Trade Association (“EFTA”)—or the “hard Brexit” options of concluding a completely new E.U.-U.K. trade agreement or leaving the E.U. without any treaty provision for trade.
- 1.6. HM Government’s intention to opt for a “hard Brexit” was made clear in a speech delivered on 17 January 2017 by the Prime Minister, in which she stated her intention to seek a customs agreement with the E.U. that would leave the U.K. free to reach individual tariff schedules at the World Trade Organisation (“WTO”). On 29 March 2017, HM Government officially served notice of the U.K.’s withdrawal to the E.U. under Article 50 of the Treaty on European Union (the “TEU”). On the following day, the U.K. Department for Exiting the European Union published a White Paper outlining HM Government’s proposals to repeal the European Communities Act 1972 and transpose the existing body of E.U. law—commonly known as the “*acquis*”—into U.K. law by way of a “Great Repeal Bill”.<sup>5</sup> Following the result of the June 2017 general election in the U.K., which established a hung Parliament, market participants and media commentators have suggested that the possibility of a “soft Brexit” has come back into focus.<sup>6</sup> At the time of the publication of this paper, the negotiations provided for in Article 50(2) of the TEU have only recently been initiated and the form of the future relationship between the U.K. and E.U. is unclear.
- 1.7. In a truly “hard Brexit” scenario, without treaty provisions of any kind, at the end of the two-year Article 50 notice period (29 March 2019), the U.K. will lose the benefits of membership of the E.U. and will become, from the perspective of E.U. law, a Third Country.<sup>7</sup> In these circumstances, the ability of U.K. firms to provide financial services into the E.U. from the day of Brexit would largely depend on the existing E.U. legal

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5 HM Government, *Legislating for the U.K.’s Withdrawal from the European Union*, (30 March 2017), available at: <https://www.gov.uk/government/publications/the-great-repeal-bill-white-paper>.

6 See, for example: Blitz, “Soft Brexit hopes seen providing a cushion for the pound”, *Financial Times*, (9 June 2017), available at: <https://www.ft.com/content/42679902-4cd5-11e7-919a-1e14ce4af89b?mhq5j=e3>.

7 Although this paper refers consistently to access by U.K. financial services providers to E.U. markets under E.U. law, this should be understood to include, *mutatis mutandis*, access to E.E.A. markets by virtue of the provisions of the Agreement on the European Economic Area (1994).

framework for service providers based in Third Countries. This framework comprises various regimes (“**Third Country regimes**”) written into key pieces of E.U. legislation.

- 1.8. The Third Country regimes offered by E.U. law are multiple and diverse but they do not, even in aggregate, offer comprehensive access to the single market, i.e. across the full range of financial services business lines. Direct access to E.U. markets is not facilitated by Third Country regimes, for instance, as far as the following E.U.-regulated activities are concerned: retail investment services,<sup>8</sup> retail fund offerings,<sup>9</sup> wholesale or retail banking services (i.e. deposit taking and lending),<sup>10</sup> or direct insurance.<sup>11</sup> This carries the necessary implication that withdrawal from the E.U. without a treaty agreement would entail a loss of E.U.-related business that could be transacted by U.K.-based financial services firms. Where access provisions do exist, they are often uncertain in their extent or restricted in their coverage. In section two, below, the FMLC analyses legal complexity related to the scope of Third Country regimes.
- 1.9. The diversity of Third Country regimes, the peculiarity of the decision-making mechanisms which characterise them and the specificity of the—often highly detailed and exacting—requirements they impose on firms in different industry sectors are explored in section three. A number of issues of legal complexity are identified here which may mean that firms based in a Third Country face difficulty or delay in bringing themselves within the parameters of the legislative requirements for access.
- 1.10. The issue of delay is further considered in section four. This section makes the point that the process of reaching a decision on the application of Third Country regimes to firms based in the U.K. will only begin, in all likelihood, once the U.K. has withdrawn

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8 The Third Country regime which will become available under Directive 2014/65/EU on markets in financial instruments (“**MiFID II**”) and Regulation (EU) No 600/2014 on markets in financial instruments (“**MiFIR**”), as of January 2018, is limited to services provided to professional clients and eligible counterparties.

9 Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast) (the “**Recast UCITS Directive**”) does not contain provisions establishing access for Third Country undertakings for collective investment in transferable securities (“**UCITS**”). Third Country UCITS may be marketed, under certain conditions, to professional investors in the E.U. under Directive 2011/61/EU on alternative investment fund managers (the “**AIFMD**”).

10 Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (“**CRD IV**”) and Regulation 575/2013 on prudential requirements for credit institutions and investment firms (the “**CRR**”) establish a Third Country regime which covers the prudential treatment of exposures to foreign institutions. This regime does not establish direct access to E.U. customers for Third Country banking services providers, although an E.U. Member State may permit Third Country firms to provide services through a branch established in its territory.

11 Directive 2009/138/EC (as amended by Directive 2014/51/EC) on the taking-up and pursuit of the business of insurance and reinsurance (“**Solvency II**”) only provides rights of direct access for reinsurance services providers, although an E.U. Member State may permit Third Country firms to obtain authorisation in respect of services provided through a branch in established in its territory.

from the E.U. It goes on to consider the factors which may affect the decision-making timetable followed by the E.U. authorities.

- 1.11. In each of these sections—two, three and four—the FMLC provides examples from a diverse range of wholesale financial industry sectors—banking; investment services; services offered by central counterparties (“**CCPs**”) and trading venues; alternative investment funds and fund management; insurance; and issuing securities—but this selection is considered only for the purposes of illustration. A large number of financial industry sectors and activities have been omitted on the grounds that not only would an account covering these areas represent a very significant challenge to the FMLC’s resources but the resulting wealth of technical detail might make it difficult to draw out the broader implications for operational, legal and regulatory continuity after Brexit.<sup>12</sup>
- 1.12. The three issues—scope, specificity and timing—which are explored in sections two to four of this paper represent for some or, possibly, all market participants a possible “cliff-edge” scenario at the point of the U.K.’s departure from the E.U. Those who currently provide services in areas not covered by Third Country regimes will, in the absence of an agreement, lose market access; other financial services providers may find that only a part of their offerings are permitted under Third Country provisions or will be permitted only after a substantial delay. The impact for firms of losing access rights are explored in section five. In section six, the FMLC offers a range of short and long term mitigants which may aid in the resolution of these uncertainties.
- 1.13. The impact of a “cliff-edge” scenario on the financial system as a whole is not explored in this paper. The FMLC is aware that it is widely inferred that an abrupt de-coupling of markets and financial service providers would lead to a fragmentation of liquidity and credit with consequential increases in costs and volatility, all of which could produce a series of shocks to the financial system.<sup>13</sup> A study of possible systemic effects, however, is beyond the scope of this paper. The FMLC notes that in this context, any

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12 Areas not considered, or not considered in detail, in this paper include but are by no means limited to: payment services, mortgage provision, securities depository services, securities settlement, treasury services, spot foreign exchange services, e-commerce and e-money services, trade repository services, audit and accounting services and advising on corporate finance.

13 For example, Federal Reserve Governor, Jerome Powell, has said that “splintering central clearing by currency area”—a reference to the possibility that the clearing of euro derivatives may be forced to relocate from London under newly proposed E.U. legislation—“would fragment liquidity and reduce netting opportunities, which in the case of events like Brexit could actually trigger even greater liquidity risk” (see Powell, “Central Clearing and Liquidity”, speech delivered on 23 June 2017, available at: <https://www.federalreserve.gov/newsevents/speech/powell20170623a.htm>); and Bank of England Governor, Mark Carney has observed that “[w]hatever is agreed, there are risks to financial stability both in the transition to the new [E.U.-U.K.] relationship and in the new steady state” (see Carney, “The high road to a responsible, open financial system”, speech delivered on 7 April 2017, available at: <http://www.bankofengland.co.uk/publications/Documents/speeches/2017/speech973.pdf>).

reverberations which may be felt by the U.K. financial system are likely to be experienced by the E.U. financial system too.<sup>14</sup> A related point of note is that, although this paper considers operational, legal and regulatory uncertainties in relation to access by U.K. financial services providers to the E.U., similar uncertainties will be faced by E.U. financial services providers in seeking access to markets in the U.K.

### A brief taxonomy of Third Country regimes

- 1.14. It is possible to identify four broad categories of Third Country regimes set out in E.U. legislation. These, outlined below, confer on firms in the Third Country—and, thus, in the U.K. following Brexit—varying degrees of permission to engage in cross-border business with the E.U.
- i. Third Country regimes which confer access rights for Third Country firms to provide services in the E.U., such as rights for Third Country investment firms to provide services and conduct investment activities with *per se* professional clients and eligible counterparties under Regulation (EU) No 600/2014 on markets in financial instruments (“**MiFIR**”).<sup>15</sup> Similar rights are codified in respect of clearing services under Regulation (EU) 648/2012 on OTC derivatives, central counterparties and trade repositories (“**EMIR**”).<sup>16</sup>
  - ii. Third Country regimes which permit financial products from outside the E.U. to be marketed or sold in the E.U., such as rights for Third Country alternative investment fund managers (“**AIFMs**”) to market Third Country alternative investment funds (“**AIFs**”) under Directive 2011/61/EU on alternative investment fund managers (the “**AIFMD**”).<sup>17</sup> Under Directive 2001/34/EC on the prospectus to be published when securities are offered to the public or admitted to trading (the “**Prospectus Directive**”), prospectuses drawn up under the laws of a Third Country can be approved by E.U. competent authorities for

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14 See Carney, *ibid*, at p.4: “London is Europe’s investment banker...”

15 Article 46 of MiFIR provides the general provisions for the provision of services and performance of activities by Third Country firms following an equivalence decision with or without a branch.

16 Article 25 of EMIR.

17 Articles 35 and 36 of the AIFMD provide the conditions for the marketing in the E.U. of Third Country AIFs by E.U. AIFMs with and without an AIFMD “passport” (for more on which, see paragraphs 2.16 to 2.19).



use in connection with an offer to the public or admission to trading on a regulated market in the E.U.<sup>18</sup>

- iii. Third Country regimes which permit the use of Third Country entities to meet E.U. market conduct obligations, including the use of recognised Third Country CCPs under EMIR to satisfy the mandatory clearing obligation in EMIR and the use of equivalent Third Country trading venues to meet the mandatory trading obligations for shares and derivatives under MiFIR.<sup>19</sup>
  - iv. Third Country regimes which permit arrangements with equivalent Third Country entities to be treated in a similar way for prudential purposes to arrangements with E.U. entities: both the treatment of reinsurance contracts with Third Country reinsurers under Directive 2009/138/EC (as amended by Directive 2014/51/EC) on the taking-up and pursuit of the business of insurance and reinsurance (“**Solvency II**”)<sup>20</sup> and the treatment of risk exposures to certain Third Country entities under Regulation 575/2013 on prudential requirements for credit institutions and investment firms (the “**Capital Requirements Regulation**” or the “**CRR**”) fall in this category.<sup>21</sup>
- 1.15. Other means of classifying Third Country regimes include a categorisation according to either: (i) the nature of the requirements that must be satisfied under the regime before a firm in the Third Country is able to provide services or to carry on activities within the E.U.; or (ii) the nature and freedom conferred once those requirements are satisfied. As to the latter, in some cases, Third Country provisions bestow upon the Third Country rights very similar to those encoded in the “passporting” regime applicable to E.U. Member States. In other cases, the Third Country regimes provide for only very limited rights of access.<sup>22</sup>
- 1.16. As to the nature of the requirements that must be satisfied, there is a diverse range of provisions, including, but not limited to, the following.

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18 Article 20 of the Prospectus Directive.

19 Article 28 of MiFIR

20 Article 227(1) of Solvency II

21 Article 107(3) of the CRR provides that exposures to Third Country investment firms, credit institutions or clearing houses and exchanges shall be treated in a manner similar to exposures to E.U. entities only if the Third Country applies prudential and supervisory requirements to that entity that are at least equivalent to those applied in the E.U.

22 Paragraphs 2.1 to 2.5 below.

- i. Access is most often, but not always, subject to the Third Country's ability to prove that its legal, regulatory and oversight regimes meet the requirements and thresholds set by the E.U. in relation to the activity in question. When this condition is met to the satisfaction of the European Commission, the Third Country is considered to be "equivalent" to the E.U. and is said to benefit from a positive equivalence determination. In some cases, for example with regards to clearing services, the equivalence determination must be made not only in respect of the applicable domestic regulation but also in respect of tangentially-related laws, such as those facilitating mutual recognition;<sup>23</sup>
- ii. In some cases the undertaking must also show that it is authorised in the jurisdiction in which its head office is established and prove that it is subject to effective supervision in that jurisdiction;
- iii. Third Country firms may be required to submit disputes to the jurisdiction of a court or tribunal in a Member State;
- iv. Some regimes impose a requirement for a supervisory cooperation agreement between the home regulator and the European Securities and Markets Authority ("**ESMA**") in addition to an equivalence requirement;
- v. Several Third Country regimes require individual undertakings to register with ESMA, normally in conjunction with an equivalence requirement and other requirements listed above;
- vi. CCPs and (in future) central securities depositories are required to go further than mere registration and obtain recognition from ESMA. Recognition will depend on the service provider satisfying several of the independent requirements listed above;
- vii. In one case (i.e. non-systemically important credit ratings provided by Third Country credit rating agencies), services may be subject to an E.U. certification requirement in addition to several of the requirements listed above;
- viii. The AIFMD, which will apply in the future to alternative investment funds and their managers, relies on the concept of a "Member State of Reference" and

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<sup>23</sup> Article 25(6) of EMIR provides that, in addition to any legal and supervisory oversight requirements, the Third Country from which a CCP seeks access to the E.U. must also provide for an equivalent system for the recognition of E.U. CCPs.

requires fund managers to obtain full authorisation, under prescribed conditions, from the competent authority in that Member State.

- ix. The concept of a “Member State of Reference” also makes an appearance in relation to services provided by Third Country benchmark administrators under the Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (the “**Benchmarks Regulation**”). A Third Country benchmark administrator which does not benefit from a positive equivalence requirement (or from an endorsement)<sup>24</sup> will be required to obtain recognition under Article 32 from the competent authority of its Member State of Reference if it wishes the benchmark to be used by supervised entities in the E.U.;
- x. In certain financial services sectors, Third Country provisions may stipulate that, if access is possible at all, the Third Country firm must satisfy discretionary national requirements for so-called “direct authorisation” (i.e. authorisation to conduct business through a branch established in the Member State in question) or apply for full authorisation on the basis of subsidiarisation within the Member State.

### **A preliminary question**

- 1.17. This paper is concerned with the legal uncertainties relating to the ability of U.K. financial services firms to continue to provide services to, and conduct activities with, E.U.-based customers following Brexit. It is not always clear, however, whether the level of a firm’s engagement with its clients amounts to “providing services” or, *mutatis mutandis*, amounts to “carrying on activities”. For instance, it may be doubted whether the existence of a policyholder in a Member State of the E.U. necessarily gives rise to the inference that the insurer in question is “carrying on” insurance business in that Member State. One factor which inevitably contributes to this ambiguity is the nature of financial services and activities themselves: they are often carried on remotely, on a cross-border basis and by means of electronic media, which means that identifying a *locus* for the provision of the service is challenging.
- 1.18. There is very little regulatory guidance dealing with this issue. The European Commission published an interpretative communication in 1997 entitled “Freedom to Provide Services and the Interest of the General Good in the Second Banking

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24 As to endorsement, see Article 33 of the Benchmarks Regulation.

Directive” (the “**1997 Interpretative Communication**”), which addressed, *inter alia*, the question of when a Member State was entitled to prevent a firm from exercising the freedom to provide services from another Member State.<sup>25</sup> The analysis necessarily involved an assessment of when a credit institution would be considered to be providing services “within the territory of another Member State”. The Commission’s preferred approach relied on a concept of “characteristic performance”, which led to the interesting observation that the provision of banking services through the internet “should not, in the Commission’s view, require prior notification” to the host Member State.<sup>26</sup> While this provides an insight into the European Commission’s decision-making process, the FMLC recognises that the guidelines are two decades old and that it is far from clear whether the approach and conclusions in the 1997 Interpretative Communication would be applied in the context of Brexit. Further analysis on this is beyond the scope of this paper. What is clear, however, is that, in some circumstances, there are significant legal complexities and uncertainties in determining whether access rights are required at all.

#### **A word about scope**

- 1.19. Beyond the threshold question mentioned above, there are a great many legal intricacies involved in considering how Third Country regimes might apply to firms in the U.K. when Brexit materialises. This paper aims to highlight some of these complexities but it is beyond the scope of this paper to explain the complicated web of issues which arise across the field of financial services as a whole.
- 1.20. Any difficulties faced by U.K. firms as a result of these intricacies will depend upon the legislation and the regime in question but they can include the following issues for particular financial services sectors.<sup>27</sup>

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25 European Commission, *Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive (SEC/97/1193)*, (20 June 1997), available at: [ec.europa.eu/internal\\_market/bank/docs/sec-1997-1193/sec-1997-1193\\_en.pdf](https://ec.europa.eu/internal_market/bank/docs/sec-1997-1193/sec-1997-1193_en.pdf).

26 *Ibid*, at p. 7.

27 European Commission staff have acknowledged the heterogeneity of equivalence regimes:

Each [equivalence] provision tends to follow the logic of the legal act it belongs to, presenting challenges to third-country authorities who may wish to seek commonality with EU equivalence procedures under different pieces of EU legislation.

See European Commission, *Commission Staff Working Document—E.U. Equivalence Decisions in Financial Services Policy: an Assessment*, (27 February 2017), at pp.12-13, available at: [https://ec.europa.eu/info/sites/info/files/eu-equivalence-decisions-assessment-27022017\\_en.pdf](https://ec.europa.eu/info/sites/info/files/eu-equivalence-decisions-assessment-27022017_en.pdf).

- i. **Limited or no coverage:** the applicable E.U. legislation may not, in fact, contain provisions allowing firms from a Third Country to offer the cross-border services in question into the E.U.;
- ii. **Interpretative uncertainty:** the Third Country regime and the applicable assessment criteria, may be subject to varying interpretations;
- iii. **Non-compliant supervisory practices:** A Third Country may be able to demonstrate a broadly compliant framework of laws and regulations and yet be unable to satisfy E.U. legal requirements as to supervision and control (usually involving a requirement as to enhanced supervisory cooperation with the E.U.);
- iv. **Falling short in practice:** even if its own legislative and regulatory rules are broadly consistent with the requirements of the E.U. law in question, firms' compliance records and/or regulators' enforcement records may not establish that those standards are, in fact, adhered to.
- v. **Changes required:** the Third Country may be required to make changes to its legislation or supervisory practice in order to fulfil the requirements of the Third Country regime, in which case the question arises whether it is able and prepared to do so, and within the stipulated timeframe;
- vi. **Lengthy timetable:** the (often prolonged) timetable for assessing equivalence or the fulfilment of other criteria specified by the Third Country regime is potentially disruptive and the risk arises that changes will occur either to the E.U. legislation or to the Third Country regulatory framework during the assessment period;
- vii. **Lack of clarity as to the role of the European Supervisory Authorities (the "ESAs"):** existing Third Country regimes do not offer a coherent or consistent answer as to what the role of the ESAs should be in Third Country assessments;<sup>28</sup>
- viii. **Discretion on the part of the European Commission in applying the criteria:** where it has a role to play, for example in relation to an equivalence decision, the European Commission adopts a risk-based approach to assessments and observes the principle of proportionality in the application of the necessary criteria, applying the legislative standard according to the specific features of

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28 *Ibid*, at p.11.

each individual case.<sup>29</sup> This inevitably implies a degree of discretion on the part of the European Commission and makes outcomes hard to predict;

- ix. **Possible imitations on the scope of the approval granted:** where the Third Country regime does depend upon an assessment or decision by the European Commission (e.g. as to equivalence), there may be difficulty caused by the limited extent of the approval granted, which may: (1) cover only some part of the activities falling within the scope of the legislation; (2) be dependent upon fulfilment of some prior condition(s) at the U.K. level; or (3) be time limited;
  - x. **Withdrawal of approval:** not only may the initial approval be limited but it is clear that it may—at least in the case of an equivalence decision—be withdrawn at any time;<sup>30</sup> and/or
  - xi. **Additional firm-specific requirements:** several Third Country regimes set out specific requirements for individual firms, including licensing, certification, registration and/or even authorisation requirements. In some cases these are in addition to an assessment or approval—e.g. a positive equivalence decision—which must first be granted to the Third Country as a whole.
- 1.21. Many of the complexities listed above are paradigmatically illustrated by the process of reaching an equivalence decision. Earlier this year, the European Commission published a Staff Working Document providing an overview of the E.U. equivalence framework for financial services (the “**European Commission Staff Paper**”), acknowledging the heterogeneity of equivalence regimes across regulations and across business sectors, identifying some of the challenges the regimes pose for Third Country authorities and noting the impermanence and mutability of the decisions themselves.<sup>31</sup>
- 1.22. It is important to note the policy underlying the availability of equivalence, which is underscored in the European Commission Staff Paper: the European Commission views equivalence as a tool to benefit and protect E.U. market participants and not a vehicle for liberalising international trade in financial services. Accordingly the European Commission Staff Paper states that equivalence is:

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29 *Ibid*, at p. 8.

30 As to withdrawal, see *ibid* at pp. 9-10. In the case of the U.K., this means that Third Country regimes cannot offer the long-term security of the “passport” to which the U.K. is entitled *qua* Member State.

31 *Supra*, references at n. 27.

a key instrument to effectively manage cross-border activity of market players in a sound and secure prudential environment with third-country jurisdictions that adhere to, implement and enforce rigorously the same high standards of prudential rules as the E.U.

It goes on to explain that the purpose of an equivalence decision is to achieve one or more of the following:

- i. reduce or even eliminate overlaps in compliance for the E.U. entities concerned and in the supervisory work of E.U. competent authorities;
- ii. allow the application of a less burdensome prudential regime in relation to E.U. financial institutions' exposures to an equivalent Third Country; and
- iii. provide E.U. firms and investors with a wider range of services, instruments and investment choices originating from Third Countries.<sup>32</sup>

- 1.23. The nature and features of the process by which the European Commission reaches an equivalence determination are discussed in greater detail in section three below.

## **2. THE RANGE AND EXTENT OF THIRD COUNTRY REGIMES**

- 2.1. A number of E.U. financial services regulatory instruments do not, as noted in paragraph 1.8 above, provide for access by Third Country firms at all, leaving financial services groups to establish fully authorised subsidiaries in the jurisdiction(s) where they wish to carry on activities (as to which, see below). Thus, for instance, there is no regime covering the marketing and sale to retail investors of units issued by Third Country undertakings for collective investment in transferable securities ("UCITS") under Directive (2009/65/EC) on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast) (the "**Recast UCITS Directive**").<sup>33</sup> There is

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32 European Commission Staff Paper, at p. 5.

33 Various provisions of the Recast UCITS Directive, however, provide that E.U. UCITS may themselves invest in Third Country collective undertakings, provided that those undertakings are subject to equivalent supervision and regulation vis-a-vis unit-holders in their home jurisdiction. See, for example, Article 50(e). Moreover, Third Country UCITS may be marketed under certain conditions to professional investors in the E.U. under the AIFMD.

also no legislative provision for access to E.U. markets in the case of insurance mediation and distribution.<sup>34</sup>

- 2.2. Certain other activities, some of which were also mentioned in paragraph 1.8 above, offer a more restrictive Third Country regime by which firms may obtain access not to the single market as a whole but to E.U. Member States on a country-by-country basis. Solvency II, for example, requires that an insurer must seek authorisation from a competent authority in an E.U. Member State in order to carry on insurance business there, and in order to apply for authorisation it must establish a branch in the territory of the Member State in question.<sup>35</sup> The provisions relevant to these sectors are considered in paragraphs 2.20 to 2.22 below.
- 2.3. Typically, however, Third Country regimes provide some kind of “gateway” to the single market for Third Country firms which satisfy the threshold requirements laid down in the legislation. The best known and most widely analysed of these threshold requirements is that the firm should be able to demonstrate a positive “equivalence” decision by the E.U. Commission with respect to the Third Country regulatory framework. According to the European Commission Staff Paper, 15 E.U. legislative acts relevant to the financial markets contain an equivalence regime.<sup>36</sup>
- 2.4. Thus Third Country regimes providing a gateway to the single market are available for certain types of market infrastructure providers such as CCPs and benchmark administrators.<sup>37</sup> Access to wholesale customers in the E.U. will be available, from 2018, for Third Country firms wishing to provide core investment services under MiFIR,<sup>38</sup> and Third Country issuers who wish to market securities in the E.U. may do so if they satisfy the requirements of the Third Country regime set out in the Prospectus Directive.<sup>39</sup> In each of these sectors, an equivalence threshold test is incorporated into

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34 Insurance intermediation is governed by Directive 2002/92/EC on insurance mediation (the “**Insurance Mediation Directive**” or the “**IMD**”), which will be replaced from 23 February 2018 by Directive (EU) 2016/97 on insurance distribution (recast) (the “**Insurance Distribution Directive**” or the “**IDD**”). Both measures provide no means of access for Third Country insurance intermediaries.

35 Article 162 of Solvency II.

36 European Commission, *List of Equivalence Decisions Adopted by the Commission in the Area of Banking And Finance*, (21 December 2016), available at: [https://ec.europa.eu/info/sites/info/files/file\\_import/equivalence-table\\_en\\_0.pdf](https://ec.europa.eu/info/sites/info/files/file_import/equivalence-table_en_0.pdf).

37 Paragraphs 2.12 to 2.15 and paragraph 2.23.

38 Paragraph 2.10.

39 Paragraphs 2.24 to 2.28.



the Third Country regime, although in none is it a stand-alone requirement. The threshold tests are considered in greater detail in the sections below.

- 2.5. Collectively, the legislative measures which comprise the E.U. framework for Third Country access to the single market offer patchy coverage, at best. In January 2017, the International Regulatory Strategy Group, in collaboration with Hogan Lovells International LLP, produced a report entitled *The E.U.'s Third Country Regimes and Alternatives to Passporting* (the “**IRSG Report**”),<sup>40</sup> which considered the scope of existing Third Country regimes, the challenges which might be faced by British financial services providers in order to make use of Third Country regimes, and the processes for securing access under such existing regimes. The IRSG Report concluded that Third Country regimes only cover a narrow range of activities and may not sufficiently obtain the “maximum possible access” to E.U. markets that is expressed to be the objective of HM Government in the context of Brexit.<sup>41</sup> Accordingly, financial markets participants have expressed concern that it will not be possible to provide a significant proportion of U.K. business lines currently provided into the E.U. under any existing Third Country regime, even assuming that threshold tests as to equivalence are satisfied under such regimes.<sup>42</sup> These concerns give rise both to operational and legal uncertainty about the conduct of existing (“legacy”) business, which is addressed in section five of this paper.
- 2.6. In the subsections below, the FMLC sets out a few key sectors for which Third Country access is limited and gives details of the ways in which the restrictions apply.

### **Banking**

- 2.7. The “**CRD IV Package**” is a suite of E.U. legislation establishing prudential rules for banks, building societies and investment firms, most of which have applied since 1 January 2014. The two primary measures in the CRD IV Package are: Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (the “**Capital Requirements**

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40 International Regulatory Strategy Group, *The E.U.'s Third Country Regimes and Alternatives to Passporting*, (23 January 2017), available at: <https://www.thecityuk.com/assets/2017/Reports-PDF/The-EUs-Third-Country-Regimes-and-Alternatives-to-Passporting.pdf>.

41 *Ibid.*, at p. 4. A different perspective has been expressed by other participants in the U.K. financial services. See, for example, Barney Reynolds, *A Blueprint for Brexit: The Future of Global Financial Services and Markets in the U.K.*, Politeia, (3 November 2016), available at: <http://www.politeia.co.uk/a-blueprint-for-brexit/>, which identifies the advantages to the U.K.'s financial services of leaving the single market and presents two models under which cross-border trade can continue in the future.

42 See, for example, Mahmud and Williams, “Brexit nears and financial regulation cast into limbo”, *Bloomberg Intelligence*, (9 February 2017), available at: <https://www.bloomberg.com/professional/blog/brexit-nears-financial-regulation-cast-limbo/>.

**Directive**”) and the CRR. The prudential requirements established by the CRD IV Package are treated by national competent authorities in the E.U. as conditions for continuing authorisation and permission to carry on certain banking activities, including deposit-taking, lending, payment services, issuing other means of payment (e.g. travellers’ cheques) and issuing e-money.<sup>43</sup> The firm’s ability to meet the requirements will be subject to regular supervisory assessment and a breach, or a threatened breach, of the requirements may be grounds for withdrawing authorisation and/or a determination that the institution in question has reached the point of non-viability and should be resolved under the E.U.’s bespoke restructuring regime for failing banks.<sup>44</sup>

2.8. Title V of the Capital Requirements Directive establishes the basic single market “passport” for banking services in the E.U. Article 33 provides that a Member State must allow banks based in other E.U. Member States to establish a branch and/or to provide services directly into their jurisdiction. There is no comparable passport for Third Country institutions: the CRD IV Package does not create a gateway for access by Third Country banks to the E.U. Article 47 of the Capital Requirements Directive, however, recognises that a Member State can, at its discretion, permit Third Country banks to establish branches in its territory with the caveat that the regulation and supervision of Third Country branches must be equivalent, if not more stringent, to that of branches established by banks from other Member States.<sup>45</sup> With a view to harmonising the treatment of Third Country banks, Article 47(3) records that the E.U. may negotiate an agreement with a Third Country which would ensure that branches of banks from that country are treated in the same manner in different Member States across the E.U.

### **Investment Services**

2.9. Several of the banking activities listed in Annex I of the Capital Requirements Directive are also investment services for the purposes of Directive 2004/39/EC on markets in financial instruments (“**MiFID**”).<sup>46</sup> In the case of these and other investment services,

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43 These activities are listed in Annex I of the Capital Requirements Directive.

44 Article 18(d) of the Capital Requirements Directive and also Article 32(4) of Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms (the “**BRRD**”), where one of the grounds for resolution is that the institution in question infringes, or will infringe in the near future, the requirements for continuing authorisation.

45 Article 47(1) of the Capital Requirements Directive.

46 Annex I, sections A and B, of both MiFID and MiFID II. Examples of overlap with the activities listed in Annex I of the Capital Requirements Directive include but are not limited to: trading in financial instruments for the account of customers; portfolio management; underwriting securities issues; and (on an ancillary basis): advising on mergers and acquisitions; foreign exchange services; custodianship and the safekeeping of securities.

Third Country banks and other Third Country providers may be able to benefit from the access provisions set out in the “**MiFID II Package**”, a suite of E.U. legislation establishing market conduct rules for investment services providers, which will apply from 3 January 2018.<sup>47</sup> The primary measures in the MiFID II Package are Directive 2014/65/EU on markets in financial instruments (“**MiFID II**”) and MiFIR.

- 2.10. Article 46 of MiFIR also provides a gateway mechanism for Third Country access whereby Third Country firms can register with ESMA in order to provide services to eligible counterparties and *per se* professional investors in the E.U. on a cross-border basis. This provision is dependent on, among other supplementary requirements, the adoption by the European Commission of an equivalence decision, in accordance with Article 47(1) of MiFIR, which states that the Third Country’s legal and supervisory arrangements align with those of the E.U. For the three years that follow the adoption of an equivalence decision under Article 47(1), Third Country firms may either register with ESMA or, in the alternative, continue to conduct investment services business with eligible counterparties or professional clients in compliance with Member States’ national regimes, by virtue of transitional provisions set out in Article 54 of MiFIR.
- 2.11. Under Article 39 of MiFID II, Member States may require that Third Country firms intending to provide investment services to retail and elective professional clients within the territory establish a branch within the jurisdiction. This provision means that Member States may choose not to require establishment of a branch to provide services in this way, and may choose to allow services to be provided on some other basis. Article 39 sets out certain requirements with which a branch of a Third Country firm will have to comply in order to be authorised by the national competent authority. Where a Member State implements MiFID II to require the establishment of branches, a Third Country firm that has not established a branch in that Member State will not be able to provide investment services to retail clients or elective professional clients. Where a Member State does not implement the requirement to establish a branch, the provision of services to retail clients and elective professional clients will be subject to existing national law and regulation. The U.K. has decided to retain its “overseas persons exemption” in Article 72 of the Financial Services and Markets Act 2000 (Regulated Activities) Order (SI 2001/544, the “**RAO**”)—allowing Third Country firms to provide services to U.K. clients without needing to establish a branch—but this approach is by no means uniform across the European Union.

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<sup>47</sup> MiFID does not contain any provisions on Third Country access, leaving the decision on whether to provide access to each Member State’s discretion.

### Infrastructure: trading venues and CCPs

- 2.12. The list of investment services regulated by the MiFID II Package includes the activity of operating a Multilateral Trading Facility (“MTF”) or an Organised Trading Facility (“OTF”). These services are subject to the same market access regime for Third Country providers as other investment services listed in Annex I of MiFID II. An MTF or OTF operator in a Third Country will also be able to request access to E.U. CCPs, provided that the European Commission has adopted a decision stating that the legal and supervisory framework for trading venues in that Third Country is equivalent to the requirements for trading venues under MiFIR. There is no Third Country Regime for the provision into the E.U. markets of trading platform services other than by means of an MTF or OTF.
- 2.13. Third Country firms that act as CCPs benefit from access provisions in two key E.U. regulatory measures—EMIR and MiFIR. Article 25 of EMIR provides for access to E.U. markets if the Third Country CCP satisfies a number of requirements, including a positive equivalence determination by the European Commission vis-à-vis the regulatory and prudential framework for CCPs in the Third Country in question. A Third Country CCP whose jurisdiction has been granted equivalence in this way will obtain access across the E.U. by virtue of it subsequently being “recognised” under Article 25(2) of EMIR by ESMA.<sup>48</sup> It will thereby also attain the status of “qualifying central counterparty” for the purposes of favourable treatment of its clearing participants’ own funds requirements for CCP exposures under the CRR.<sup>49</sup>
- 2.14. In addition to the provisions for CCPs under EMIR, Third Country CCPs may also benefit the following provisions under MiFIR.
- i. **Access to trading venues:** under Article 38(1) of MiFIR, a CCP established in a Third Country may request access to a trading venue in the E.U. subject to that CCP being recognised under Article 25 of EMIR. In addition, it is required that the Commission adopt a decision with regards to the legal and supervisory framework of the Third Country in accordance with Article 38(3) of MiFIR, confirming that it provides an effective equivalent system for permitting CCPs and trading venues authorised under foreign regimes access to CCPs and trading venues established in that Third Country.

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48 Third Country CCPs granted EMIR Article 25(2) recognition status by ESMA are listed on the ESMA website.

49 Article 4 of EMIR.

- ii. **Access to trade feeds:** Third Country CCPs which have been recognised by ESMA under EMIR will also be granted the non-discriminatory access to trade feeds from trading venues as guaranteed to E.U. CCPs by Article 36 of MiFIR.
- iii. **Access to E.U. benchmarks:** similarly, Third Country CCPs which have been recognised by ESMA under EMIR will be granted non-discriminatory access to E.U. benchmarks as guaranteed to E.U. CCPs by Article 37 of MiFIR. The Third Country CCP is required to apply to the benchmark administrator itself for a licence to use the benchmark.

2.15. The European Commission has recently published proposed amendments (the “**EMIR Review Proposal**”) to the EMIR Third Country regime for CCPs in the context of the debate about London's status as a clearing hub for euro-denominated derivatives after Brexit.<sup>50</sup> Proposed amendments to Articles 6 and 25 and a new Article 25a are designed to bolster the EMIR Third Country regime in the following ways, among others:

- i. to enhance the implementation of the equivalence criteria by allowing the European Commission to specify the applicable criteria by means of a delegated act, adding further conditions to those set out in EMIR;<sup>51</sup>
- ii. to provide for the classification by ESMA of Third Country CCPs as systemically important or non-systemically important;<sup>52</sup>
- iii. to lay down four criteria—which are subject to further specification by the Commission—for the classification of Third Country CCPs as systemically important;<sup>53</sup>
- iv. to stipulate additional conditions for the recognition of systemically important Third Country CCPs;<sup>54</sup>

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50 Proposal for a Regulation amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs COM(2017) 331 final, available at: [http://ec.europa.eu/finance/docs/law/170613-emir-proposal\\_en.pdf](http://ec.europa.eu/finance/docs/law/170613-emir-proposal_en.pdf).

51 New Article 25(6a).

52 New Article 25(2)(e)

53 New Article 25(2a).

54 New Article 25(2b).

- v. to introduce a system of “comparable compliance” vesting ESMA with powers—similar to the powers of U.S. regulators to recognise “substituted compliance”—to allow a Third Country CCP to rely on its compliance with the regulatory framework of the Third Country in question;<sup>55</sup>
- vi. to allow ESMA to determine, in agreement with E.U. central banks, that the risks posed by a Third Country CCP are of such magnitude that the CCP should not be recognised at all;<sup>56</sup>
- vii. to empower the European Commission to take a decision that a Third Country CCP should not be recognised as such and should only be allowed to provide clearing services on the basis of establishment in a Member State and full authorisation;<sup>57</sup>
- viii. to specify that ESMA must keep the recognition of Third Country CCPs under regular review;<sup>58</sup> and
- ix. to add a requirement that cooperation arrangements with Third Country regulatory authorities must be effective in practice<sup>59</sup> and should allow on-site inspections by ESMA and “the central bank(s) of issue”.<sup>60</sup>

### **Investment Funds and their Managers**

- 2.16. The AIFMD does not establish an equivalence regime in the manner of the regime for CCPs under Article 25 of EMIR. Instead it provides two regimes for access to the E.U. market by Third Country AIFMs:<sup>61</sup> (i) Article 42 which sets out the minimum conditions which E.U. Member States must apply in order to allow a Third Country AIFM to carry on marketing activities in respect of any AIF without an AIFMD

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55 New Article 25a.

56 New Article 25(2c).

57 *Ibid.*

58 New Article 25b.

59 New Article 25(7).

60 New Article 25e.

61 The term “non-E.U.” is used throughout the AIFMD but E.U. institutions have subsequently adopted the term “Third Country” when speaking about non-E.U. AIFs. This paper adopts “Third Country” in relation to such AIFs and AIFMs for the sake of internal consistency.

“passport”;<sup>62</sup> and (ii) Articles 37 and 39 to 41 which in aggregate provide for the authorisation of Third Country AIFMs intending to market and manage E.U. or Third Country AIFs with an AIFMD “passport”. Articles 35 and 36 govern the situation in which an E.U. AIFM wishes to carry on marketing activities in respect of a Third Country AIF and apply to situations in which the AIFMD “passport” is either available (Article 36) or unavailable (Article 35).

- 2.17. Article 42 of the AIFMD provides the national private placement regimes (“**NPPRs**”), by which individual Member States may allow Third Country AIFMs to market AIFs to professional investors in their territory subject to certain conditions (as to which, see paragraphs 3.23 to 3.24 below). The marketing to professional investors in the E.U. of Third Country AIFs by Third Country AIFMs is also governed by Article 42 of the AIFMD. Third Country AIFMs must comply with each Member State’s individual regime when they market AIFs in that country.
- 2.18. The AIFMD provides for a second and separate regime under which, after a transitional period and the entry into force of a delegated act by the European Commission, a harmonised firm-specific “passport” regime is to become applicable to: (i) Third Country AIFMs performing management and/or marketing activities within the E.U.; and (ii) E.U. AIFMs managing Third Country AIFs. The requirements of this regime are set out in Article 37 and Articles 39 to 41 of the AIFMD. In this context, the term “passport” refers not to Member States’ access to the single market but rather to the stringent regulatory framework for the activities of Third Country AIFMs which establishes the conditions subject to which a Third Country AIFM can obtain an authorisation to manage E.U. AIFs and/or to market AIFs to professional investors in the E.U. In other words, rather than a liberalising measure for international trade in fund management services, it is a licensing measure which requires Third Country AIFMs to submit an application for authorisation in the E.U. This regime is, however, not yet in application.
- 2.19. Unlike the AIFMD, the Recast UCITS Directive does not contain provisions establishing access for Third Country providers. This means that Third Country UCITS cannot be marketed in the E.U. as retail funds. They may, however be marketed, under the conditions outlined above, to professional investors as alternative investment funds under the AIFMD.

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62 On a point of disambiguation, the AIFMD Third Country “passport” is to be distinguished from the so-called single market “passport” which Member States of the E.U. enjoy by virtue of their membership. For further details, see paragraph 2.18.

## Insurance and reinsurance

- 2.20. Solvency II implements the main framework for insurance and reinsurance regulation throughout the E.U. While Solvency II contains the concept of equivalence, it does not provide for cross-border access in a uniform manner. Article 162 specifically states that the provision of direct insurance within the E.U. by a Third Country insurer must be subject to local authorisation through a branch in each Member State in which it wishes to write business. There is no consistent approach relating to the treatment of cross-border services business (often referred to as "non-admitted" insurance) from outside the E.U. In some E.U. states, the prudential regime may be triggered when a Third Country firm covers risks located in the state in question but has no other presence there; in others, an on-going presence is required before any regulatory authorisation becomes necessary.
- 2.21. The equivalence provisions in Solvency II only apply in the following three contexts, none of which relate to mutual access.
- i. **Reinsurance provided by a Third Country reinsurer:** under Article 172 of Solvency II, reinsurance contracts between an E.U. cedant and a Third Country reinsurer which is located in a jurisdiction whose solvency regime is assessed to be equivalent for the purposes of Article 172 must be treated in the same manner as if the contract were concluded with an E.U. reinsurer.
  - ii. **Group solvency:** Article 227 provides that where a Solvency II group contains a Third Country (re)insurer which is located in a jurisdiction whose solvency regime is assessed to be equivalent for the purposes of Article 227, the group may apply to use local rules for the Third Country (re)insurer in their group capital calculations carried out under the deduction and aggregation method rather than having to apply Solvency II rules to the Third Country (re)insurer.
  - iii. **Group supervision:** under Article 260, where a Solvency II group is headquartered in a Third Country which is assessed as having a system of group supervision that is "equivalent" to that operated under Solvency II, E.U. supervisors must rely on the supervision of that group at a worldwide level by the national supervisor in that jurisdiction. This does not, however, prevent E.U. regulation at a European sub-group level.
- 2.22. Insurance intermediation is currently subject to a single market "passport" throughout the E.U. under Directive 2002/92/EC on insurance mediation (the "**Insurance**



**Mediation Directive**” or the “**IMD**”). This will be replaced from 23 February 2018 by Directive (EU) 2016/97 on insurance distribution (recast) (the “**Insurance Distribution Directive**” or the “**IDD**”). There is no Third Country regime under either measure that provides a means of access for Third Country insurance intermediaries.

### **Benchmark Administrators**

- 2.23. The Benchmarks Regulation will become applicable in January 2018, following which financial institutions in the E.U. will only be able to use benchmarks registered with ESMA. For Third Country administrators, registration is only possible on the basis of: (i) a positive equivalence decision; (ii) recognition by the competent authority in the administrator’s “Member State of Reference”; or (iii) endorsement by an E.U. administrator, with full authorisation, of the benchmark(s) which it provides. The Benchmarks Regulation lays down, in Articles 32 and 33, specific requirements which must be fulfilled for either recognition or endorsement to occur and which may, in part, be satisfied by demonstrating compliance with certain international standards.<sup>63</sup>

### **Issuers**

- 2.24. The Prospectus Directive has established common and enhanced standards for the issue of securities within the E.U. and also permits the “passporting” of a prospectus which has been approved by an E.U. Member State’s competent authority across the E.U. Under certain circumstances, a prospectus issued by a Third Country issuer under the laws of a Third Country may also be approved by the competent authority of an E.U. Member State and then “passport” into other Member States.<sup>64</sup>
- 2.25. Specific provisions for issuers registered in a Third Country are established by Article 20 of the Prospectus Directive. These provide that the competent authority of the “home Member State” of the issuer in question can approve a prospectus for an offer to the public or for admission to trading on a regulated market in the E.U., subject to certain additional requirements relating to disclosure and information.<sup>65</sup> Here, “home Member

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63 I.e. those standards established by the International Organisation of Securities Commissions (“**IOSCO**”) in its *Final Report of July 2013 on Principles for Financial Benchmarks*, available at: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf>.

64 On a point of disambiguation, “passport” here refers to the means by which a prospectus can be approved in one Member State and relied upon by the issuer in other Member States for the purposes of a public offering or for admitting securities to trading. It is to be distinguished from the single market passport which is available to Member States by virtue of their membership of the E.U. The use of the term in relation to prospectuses can be seen, for example, in an opinion given by ESMA on the “Framework for the assessment of third country prospectuses under Article 20 of the Prospectus Directive”, (20 March 2013), available at: <https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-317.pdf>.

65 These are discussed further below in paragraph 3.46

State” is a concept not entirely dissimilar to that of “Member State of Reference” in other E.U. measures and, according to the definition in Article 2, means, very broadly, the Member State where the securities are intended to be offered to the public by the issuer for the first time or where the first application for admission to trading on a regulated market is made, subject to an element of election on the part of the Third Country issuer.

- 2.26. Currently, the U.K. Listing Authority (“UKLA”), which is part of the Financial Conduct Authority (“FCA”), is the competent authority in the U.K. and can approve Prospectus Directive-compliant prospectuses for Third Country issuers whose “home Member State” is the U.K. Once the U.K. leaves the E.U., approval granted by the UKLA will no longer enable the provision of such prospectuses in the E.U.
- 2.27. There are, however, a number of exemptions in the Prospectus Directive from the requirement to prepare a Prospectus Directive-compliant approved prospectus.<sup>66</sup> Where an offer of securities falls within an exemption, it may be possible to use a Third Country prospectus or similar offering document within the E.U. One exemption is available where the offer is made solely to “qualified investors”.
- 2.28. A new Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market (“PD III”), which repeals the Prospectus Directive, enters into force on 20 July 2017 and will apply from July 2019. Chapter VI of PD III establishes specific rules in relation to issuers established in Third Countries and provides two means by which a prospectus drawn up by an issuer established in a Third Country may form the basis of an offer of securities in the E.U.:
- (a) by virtue of Article 28, a Third Country issuer intending to offer securities to the public in the E.U. and to seek admission to trading on an E.U. regulated market may draw a prospectus up in accordance with PD III and seek approval of its prospectus from the competent authority of its “home Member State”. Once such approval is received, the prospectus will entail all the rights and obligations provided for a prospectus under PD III; and
  - (b) under Article 29—which is set out in terms very similar to those in Article 20 of the Prospectus Directive—the competent authority of a Third Country issuer’s

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66 These exemptions are listed in Article 4 of the Prospectus Directive.

“home Member State” can also approve a prospectus drawn up under the laws of the Third Country. In these circumstances it must apply requirements similar to those laid down in Article 20 of the Prospectus Directive and also satisfy itself that it has concluded adequate cooperation arrangements with the relevant supervisory authorities of the Third Country in question.

### 3. SPECIFICITY OF THRESHOLD CONDITIONS

- 3.1. In section two, above, two broadly different approaches to Third Country access were observed in E.U. legislation: a restrictive, country-by-country approach relying on authorisation for market participants in Member States; and a “gateway” approach relying on threshold requirements which, if satisfied, allow a Third Country firm to obtain access to the single market. One characteristic which is common to both approaches is the need for a decision by European authorities. Another is predictive uncertainty about the progression, timing and detail of the decision-making process.
- 3.2. As far as authorisation is concerned, an Opinion published by ESMA in May 2017, which provides to the national competent authorities of E.U. Member States nine general principles to support supervisory convergence in the context of Brexit (the “**2017 ESMA Opinion Paper**”), provides some indication of the likely approach.<sup>67</sup> It offers, even at a liberal reading, a disappointing response to those who argue that the U.K.’s withdrawal from the E.U. need not adversely affect regulatory continuity. For instance, principle one provides that existing authorisations of U.K.-based entities will not automatically be recognised in the 27 remaining E.U. Member States upon Brexit.<sup>68</sup> Even though the U.K. will remain a Member of the E.U. until at least 29 March 2019, authorisations granted by the Prudential Regulation Authority or the FCA in the two intervening years will not be automatically recognised.
- 3.3. The 2017 ESMA Opinion Paper also encourages competent authorities to scrutinise applicant firms’ governance structures, human and technical resources, geographical distribution of activities, outsourcing and delegation arrangements. ESMA encourages competent authorities to verify the objective reasons for relocation, warns against the

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<sup>67</sup> European Securities and Markets Authority, “General Principles to Support Supervisory Convergence in the Context of the United Kingdom Withdrawing from the European Union”, (Brussels, 31 May 2017), available at: [https://www.esma.europa.eu/sites/default/files/library/esma42-110-433\\_general\\_principles\\_to\\_support\\_supervisory\\_convergence\\_in\\_the\\_context\\_of\\_the\\_uk\\_withdrawing\\_from\\_the\\_eu.pdf](https://www.esma.europa.eu/sites/default/files/library/esma42-110-433_general_principles_to_support_supervisory_convergence_in_the_context_of_the_uk_withdrawing_from_the_eu.pdf).

<sup>68</sup> *Ibid*, at p. 3.

establishment of letterbox offices and sets out stricter conditions for the outsourcing and delegation of business to Third Countries.<sup>69</sup> Given that assessments of equivalence are sometimes performed by the European Commission on the basis of technical advice from European supervisory agencies,<sup>70</sup> including ESMA, it is not unreasonable to expect ESMA’s strict stance on the authorisation of relocating entities to be replicated in reference to equivalence assessments vis-à-vis the U.K.

- 3.4. The European Commission Staff Paper referred to in section one above makes it clear that each equivalence decision is not only discretionary but may also be changed or rescinded at any time by the Commission.<sup>71</sup> This discretionary element and the risk that the decision will be rescinded necessarily contribute to the difficulty that Third Country firms and authorities have in assessing the likelihood of obtaining access to E.U. markets by this route.
- 3.5. A significant proportion of the predictive uncertainty experienced by Third Country authorities and firms is attributable to the European Commission’s normative approach to the assessment process, which is described in the European Commission Staff Paper as “risk-based” and guided by the “principle of proportionality”.<sup>72</sup> When seeking to determine whether a Third Country’s regulatory system might be compliant with its own, the European Commission first identifies risks to which the E.U. financial system might be exposed by granting equivalence to the Third Country. The assessment is undertaken in respect of those particular risks. Although equivalence provisions are tailored to the needs of each specific act, the European Commission’s assessment with regards to a particular Third Country’s framework may look beyond the prescribed technical solutions and the decision may be taken to ensure regulatory objectives and protect the E.U. financial system from the risks identified.
- 3.6. Crucially, as the European Commission Staff Paper points out, the interconnectedness of the Third Country’s market with the E.U. financial market, and thus also its share of

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69 Principles 2 to 5, in *ibid*, at pp. 3-5.

70 European Commission Staff Paper, at p.8. Alternatively, the European Commission’s equivalence assessment process may begin by a consideration of recommendations from international organisations, public bodies or stakeholder organisations.

71 *Ibid*, at p. 7.

72 *Ibid*, at p. 8.

the single market, form integral components of the risk exposures which need to be addressed.<sup>73</sup>

- 3.7. The legislation that embodies the equivalence requirement may itself prescribe the characteristics by which equivalence is to be assessed. In addition to a broad alignment of regulatory rules, it may require any or all of the following: (i) an alignment of incidental rules (e.g., on the conflict of laws);<sup>74</sup> (ii) an alignment of prudential standards to support an equivalence decision on conduct regulation (and vice versa);<sup>75</sup> (iii) close coordination of supervisory practices;<sup>76</sup> and/or (iv) adherence by the Third Country in question to shared international commitments and standards.<sup>77</sup> In this regard, the prevalent equivalence requirement that Third Country frameworks demonstrate “effective supervision and enforcement”<sup>78</sup> in their jurisdiction gives rise to particular difficulty. There is little guidance in the relevant regulations themselves about how the European Commission might judge a supervisory authority “effective” for these purposes.
- 3.8. An equivalence decision is, in any event, only the beginning of the process by which Third Country firms may gain access to E.U. markets. Where the European Commission has made a positive equivalence decision, an implementing act must be confirmed by a regulatory committee, which contains representatives of Member States, and adopted. Thereafter, the firms are likely to have to satisfy a range of other criteria or threshold tests, of which typical examples are given for the purpose of illustration in paragraph 1.16 above.
- 3.9. Below, this paper continues the discussion, which began in section two, of the Third Country threshold requirements established for certain key industry sectors. Section two provided an introduction to each regime and an outline of its scope. The paragraphs below provide further detail, highlighting technical differences among the various regimes and the specificity and exacting nature of the requirements themselves.

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73 European Commission Staff Paper, at pp. 8-9.

74 See, for example, Article 25(6) of EMIR. For more on which, see also paragraph 3.19.

75 Article 25(2) of EMIR.

76 See, for example, Article 30(2) of the Benchmarks Regulation.

77 Article 30(2)(a) of the Benchmarks Regulation.

78 Article 30(2)(b) of the Benchmarks Regulation.

### Investment services

- 3.10. Under MiFID II, Member States may allow Third Country firms to provide services from a branch in that Member State where it determines that: (i) the relevant firm is subject to authorisation and supervision in its home country; (ii) the Third Country pays due regard to any Financial Action Task Force (“**FATF**”) recommendations on anti-money laundering and countering terrorist financing; (iii) there are appropriate cooperation agreements in place between the competent authorities of the Member State and the relevant Third Country; and (iv) the relevant Third Country has signed an tax exchange agreement, which is compliant with standards set by the Organisation for Economic Cooperation and Development (“**OECD**”), with the relevant Member State. The decision on whether the Third Country framework meets these requirements is, therefore, taken by each relevant E.U. Member State under MiFID II.<sup>79</sup>
- 3.11. Under MiFIR, Third Country firms can seek to be registered with ESMA, as discussed in paragraph 2.10 above, where the European Commission has adopted an equivalence decision. This requires the Commission to determine that the legal and supervisory arrangements of the relevant Third Country ensure that firms comply with legally binding prudential and conduct of business arrangements equivalent to the requirements of MiFIR and MiFID II. ESMA is required to establish cooperation agreements with the competent authorities of Third Countries judged by the European Commission to be equivalent.
- 3.12. Under Article 46(6) of MiFIR, Third Country firms must, before providing any service or performing any activity in relation to a client established in the E.U., “offer to submit any disputes relating to those services or activities to the jurisdiction of a court or arbitral tribunal in a Member State”. Although this requirement does not appear in other Third Country regimes, it is noteworthy that the MiFID II Package contains one of the most recent Third Country regimes to be developed. It is unclear how literal any interpretation of this provision must be and there is uncertainty around whether the Third Country firm is required to submit to the court in the Member State or if it is only required to make the offer with the option for the E.U. counterparty to waive it.
- 3.13. EMIR imposes clearing and reporting obligations on investment firms and credit institutions that wish to enter into certain types of derivative contracts. These obligations are deemed to have been fulfilled by Third Country firms where the

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79 Article 39(2) and (3) of MiFID II.

European Commission has adopted an equivalence decision. Article 13 of EMIR stipulates that the European Commission must determine that the legal, supervisory and enforcement arrangements of the Third Country are equivalent to the conditions imposed by EMIR on the E.U. Member State, including the provision on the protection of professional secrecy.

### **Infrastructure: CCPs**

- 3.14. A Third Country CCP can provide services into the E.U. under Article 25 of EMIR, if it satisfies the following requirements:<sup>80</sup>
- i. the European Commission is able to determine that the CCP's home jurisdiction has an equivalent regulatory regime and it provides for reciprocal arrangements for foreign CCPs;
  - ii. the CCP is subject to effective supervision and enforcement in the Third Country jurisdiction in which it is authorised;
  - iii. ESMA and the Third Country's regulator have negotiated a cooperation agreement; and
  - iv. the Third Country has an equivalent anti-money laundering regime.

The equivalence assessment undertaken by the European Commission will take into account technical advice from ESMA in each case.

- 3.15. The Third Country regime for CCPs under EMIR is already operational. Since 2012 the European Commission has assessed a number of regulatory frameworks in Third Countries and recognised a number of individual CCPs.<sup>81</sup> In some cases the assessments have proceeded smoothly. The decision-making process proved particularly complex and lengthy, however, in the case of the United States. As a case study, the U.S. assessment provides an illustrative example of how complex an equivalence determination can become when negotiations between the E.U. and a Third Country do not run smoothly.

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80 As discussed above in paragraph 2.15, the European Commission has recently proposed amendments to these rules.

81 Several jurisdictions have been determined to have equivalent regulatory regimes for CCPs under EMIR, including Australia, Brazil, Canada, the Dubai International Financial Centre, Hong Kong, India, Japan, Japan Commodities, Mexico, Singapore, South Africa, South Korea, Switzerland and the U.S.

- 3.16. E.U. and U.S. regulators were unable to agree that the E.U. and U.S. regulatory systems for CCPs guaranteed similar market conduct and prudential outcomes because of technical differences between the two systems. The most frequently publicised grounds for disagreement were the differing margining periods and netting rules applied by the two regulatory regimes. Regulatory standards in the E.U. specified a two-day liquidation period for calculating initial margin on exchange-traded derivatives, whereas U.S. rules allowed only a one-day period. On the other hand, U.S. rules required the provision of margin on customer positions on a gross basis whereas the E.U. rules would allow margin to be provided on a net basis on omnibus accounts.<sup>82</sup>
- 3.17. Market participants followed the process of negotiations with concern. Many E.U. firms rely on clearing services provided by the Chicago Mercantile Exchange (the “**CME**”) to clear popular “Eurodollar” derivatives, which are purchased as a hedge against movements in U.S. interest rates.
- 3.18. Four years after EMIR came into force and with the “cliff edge” deadline for mandatory clearing hanging over E.U. firms, E.U. regulators adopted a positive equivalence determination vis-à-vis the U.S. system. The CME was recognised by ESMA shortly afterwards. As a condition of the decision, the U.S. was required to extend mutual recognition to E.U. CCPs. This was done this in March 2016 by means of the “substituted compliance” mechanism.
- 3.19. The example illustrates two important and often overlooked aspects of the equivalence assessment process. The first is that even where the European Commission’s approach to equivalence determination is said to be broadly outcomes-based,<sup>83</sup> it may refuse or delay a positive decision on the basis of regulatory differences which have not been shown to introduce market conduct or systemic stability risks. The second is that some equivalence regimes, such as the one set out in Article 25 of EMIR, introduce an additional conflicts of law requirement, namely that the Third Country’s legal system must itself incorporate rules facilitating regulatory recognition in the same way that the E.U.’s own financial services framework does.

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82 For further analysis and discussion see Committee on Capital Markets Regulation and FMLC, *Resolving Issues of Legal Uncertainty Relating to the Recognition and Supervision of Central Counterparties: a Comment Paper*, (1 September 2015), available at: [http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc-ccmr\\_joint\\_statement\\_1\\_september\\_2015.pdf](http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc-ccmr_joint_statement_1_september_2015.pdf). The Comment Paper argued that mutual recognition was important to avoid fragmentation of the \$657 trillion global market for swaps and futures.

83 “If the requirements achieve the same regulatory outcomes in terms of reduction of systemic risk, the European Commission may determine equivalence.” See European Commission Press Release, “First ‘equivalence’ decisions for central counterparty regulatory regimes adopted today”, (30 October 2014), available at: [http://europa.eu/rapid/press-release\\_IP-14-1228\\_en.htm?locale=en](http://europa.eu/rapid/press-release_IP-14-1228_en.htm?locale=en).



3.20. The EMIR Review Proposal establishes additional criteria—and powers for E.U. authorities to supplement existing criteria—both for a positive equivalence determination and recognition of an individual Third Country CCP. In particular, the proposed amendments would:

- i) allow the European Commission to specify the applicable equivalence criteria by means of a delegated act, adding further conditions to those set out in EMIR;
- ii) stipulate additional conditions for the initial and ongoing recognition of Third Country CCPs which are systemically important or “likely to become systemically important”, including a) ongoing compliance with the prudential requirements established by EMIR for E.U. CCPs; b) written confirmation from “relevant E.U. central banks of issue” that it complies with any requirements imposed by those central banks in the exercise of their monetary policy functions; and c) written consent from the Third Country CCP itself to ESMA accessing any information held by the CCP and any of its business premises on request.

3.21. The proposals are very new and may change significantly in the course of co-decision by the European Council and Parliament. Moreover, even were the EMIR Review Proposal draft legislation already adopted, it would be hard to foresee how the new provisions would apply in practice. The following additional features should be noted, however, as giving rise to legal complexity in the recognition process:

- i) there is significant ambiguity in the concepts of “systemically important” and “likely to become systemically important”, introduced by a new Article 25(2a), which are not defined and which may, in practice, confer a wide discretion on ESMA;
- ii) under the new Article 25(2b) a systemically important Third Country CCP must satisfy a recognition condition by providing “unconditional written consent” to provide data on request. Given existing legal, practical and regulatory restrictions on data transmission, it may be difficult for Third Country CCPs to provide consent that is truly unconditional; and
- iii) recognition can be withdrawn by ESMA in the circumstances laid down in the proposed new Article 25m, which does not prescribe a timetable or a notice period for the withdrawal. Third Country CCPs may find that an undefined and unlimited power of withdrawal of this kind, which arguably itself represents a systemic risk, affects their regulatory status in other jurisdictions outside the E.U.

### Alternative Investment Funds and their Managers

- 3.22. One Third Country framework which takes a very different approach is that set out by the AIFMD, which, as noted above, offers two regimes—with and without the AIFMD “passport”—for Third Country AIFs and Third Country AIFMs.
- 3.23. Article 42 (*Conditions for marketing in Member States without a passport of AIFs managed by a non-EU AIFM*) provides that Member States may allow Third Country AIFMs to market AIFs to professional investors in their territory subject to certain conditions. One such condition is that:

appropriate cooperation arrangements for the purpose of systemic risk oversight and in line with international standards are in place between the competent authorities of the Member States where the AIFs are marketed, insofar as applicable, the competent authorities of the EU AIFs concerned and the supervisory authorities of the third country where the non-EU AIFM is established and, in so far as applicable, the supervisory authorities of the third country where the non-EU AIF is established in order to ensure an efficient exchange of information that allows competent authorities of the relevant Member States to carry out their duties in accordance with this Directive.

It is an obvious point but worth stating that, the U.K. has not, to date, needed to enter into supervisory cooperation arrangements with competent authorities in E.U. Member States. Whether it can and will do so and the time taken to implement the arrangements once agreed are factors which will affect the availability and timing of access to E.U. investors by U.K. funds after Brexit. They are, however, questions which are wholly unclear at this time.

- 3.24. Another requirement set out in Article 42 is that the AIFM must comply with the transparency requirements laid down in Articles 22 to 24 of the AIFMD. Even so, Member States are permitted, under Article 42(2) to impose stricter rules on Third Country AIFMs than are applicable under the AIFMD
- 3.25. Similar requirements must be satisfied under Article 36 in respect of an E.U. AIFM marketing a Third Country AIF, including the requirement for appropriate cooperation arrangements. In addition, the AIFM must comply with all the requirements of the AIFMD, excepting only the rules on the appointment of depositories.

- 3.26. The alternative access provisions “with a passport” set out in Article 37 and Articles 39 to 41 of the AIFMD do not yet apply. In order for the regime provided under these Articles to be brought into application, the requirements of Article 67 of the AIFMD must be satisfied. These include, sequentially: (i) positive advice to the European Commission by ESMA on the application of the passport to Third Country AIFMs and AIFs—which advice is to be based on the existing marketing and management of those entities in Member States under the NPPRs—and (ii) a delegated act by the European Commission under Article 67(6).
- 3.27. Under Article 67(4), ESMA’s positive advice to the European Commission must include advice to the effect that “there are no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risk” (emphasis added) which would impede the application of the “passport” to Third Country AIFMs and AIFs. Similar issues must be taken into account under Article 67(6) by the European Commission before it can adopt a delegated act. The natural inference is that ESMA will, in examining the existing use of the NPPRs by Third Country AIFMs and AIFs, consider whether the legal and regulatory frameworks in place in their home jurisdiction establish adequate standards on investor protection, market conduct, competition and systemic risk.
- 3.28. Although Article 67 the AIFMD only refers in general terms to a single positive advice from ESMA (to be issued by 22 July 2015) and a single delegated act required to bring Articles 37 to 41 into application, ESMA has, in fact, taken a country-by-country approach, releasing advice in relation to specific Third Countries on separate occasions. A first set of advice on the application of the passport to six countries (Guernsey, Hong Kong, Jersey, Singapore, Switzerland and the United States) was published in July 2015 and a second, on the application of the passport to 12 countries (Australia, Bermuda, Canada, Cayman Islands, Guernsey, Hong Kong, Isle of Man, Japan, Jersey, Singapore, Switzerland and the United States) was published in September 2016.<sup>84</sup> In this latest report, ESMA has suggested that the European Commission may wish to wait until ESMA has delivered positive advice on a sufficient number of Third

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84 ESMA, “Advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-E.U. AIFMs and AIFs”, (30 July 2015), available at: [https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1236\\_advice\\_to\\_ep-council-com\\_on\\_aifmd\\_passport.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1236_advice_to_ep-council-com_on_aifmd_passport.pdf); and

ESMA, “Advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-E.U. AIFMs and AIFs”, (12 September 2016), at p. 12, available at: <https://www.esma.europa.eu/press-news/esma-news/esma-advises-extension-funds-passport-12-non-eu-countries>.

Countries before triggering the legislative procedures foreseen by Articles 67(5) and (6).<sup>85</sup>

3.29. Once the U.K. has withdrawn from the E.U. and is considered a Third Country, its regulatory and oversight framework will presumably also be assessed by ESMA. The FCA rules which apply to the authorisation of E.U. AIFMs in the U.K. and to the marketing to professional investors in the U.K. of E.U. AIFs could influence ESMA in its assessment of the U.K.

3.30. In its second advice, ESMA given the following examples of questions that may be applied under the heading “obstacles to competition”:<sup>86</sup>

a) Is the process operated by the Third Country [regulatory authority] to authorise E.U. AIFMs or allow marketing of E.U. AIFs in the Third Country reasonable in terms of clarity, predictability, cost and regulatory expectation? Is there a level playing field between E.U. and Third Country AIFMs as regards market access, particularly in view of the procedures that would apply to the authorisation of Third Country AIFMs in the event that the “passport” is extended?

b) Are E.U. AIFMs and E.U. AIFs treated in the same way as managers and collective investment undertakings of the Third Country in terms of regulatory engagement, including regulatory fees and documentation to be provided prior to authorisation?

c) Does the Third Country [regulatory authority] treat all E.U. Member States equally?

3.31. Since the U.K. has implemented the AIFMD in full, it could be expected that ESMA would find no significant obstacles to competition. It is worth noting, however, that in its advice on AIFMs and AIFs based in Hong Kong, Singapore and Australia, ESMA noted, in considering whether a level playing field existed under the heading “obstacles to competition”, that the local regimes facilitated market access by retail funds (including UCITS) from only certain E.U. Member States.<sup>87</sup> It is therefore possible that,

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85 *Ibid* (12 September 2016), at p.7.

86 *Ibid*, at p. 12.

87 *Ibid*, at pp. 45, 57 and 67.

in assessing whether to give positive advice in relation to the U.K. on AIFMs and AIFs, the basis on which UCITS from Member States are granted access to investors in the U.K. may be a consideration.

- 3.32. With regard to obstacles to the monitoring of systemic risk, ESMA is required to base its advice, *inter alia*, on the existence and effectiveness of cooperation arrangements for the purpose of systemic risk oversight between the competent and supervisory authorities of the Member State and the Third Country. As the U.K. is currently not party to any such cooperation arrangements, it is uncertain how ESMA would carry out this part of its assessment, particularly as ESMA's assessment for the purposes of its advice requires a consideration of how well the cooperation arrangements in question are working and, in the absence of evidence in relation to the working of an existing cooperation agreement, whether previous supervisory engagement provides support for the expectation of good supervisory cooperation.
- 3.33. Other issues which ESMA has indicated the European Commission may also wish to consider alongside its advice, which are not expressly referred to in the AIFMD, include: (i) fiscal matters in the Third Country; and (ii) the anti-money laundering and counter-terrorism financing regime in the Third Country.<sup>88</sup> If the Commission determines to adopt these criteria, it is uncertain how it will apply them in relation to the U.K.
- 3.34. Although Article 67 of the AIFMD only refers in general terms to a single positive advice from ESMA (as noted above) and a single delegated act required to bring Articles 37 to 41 into application for all Third Countries, ESMA's approach to date suggests that the evaluation of a Third Country's regulatory framework will be relevant to the prospects of funds based in that jurisdiction for obtaining access to the E.U. It may be that legislative revisions to the all-or-nothing approach set out in Article 67 will be proposed at a later date or that the European Commission will imply a power to bring the AIFMD "passport" into application on a country-by-country basis. In any event, it is likely that ESMA's country-by-country assessments will become relevant to a Third Country AIFM's application for authorisation under the comply-or-demonstrate-equivalence approach which is to be applied by E.U. competent authorities under Article 37(8) (see paragraph 3.37).

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88 *Ibid*, at p. 12

3.35. If and when the “passporting” regime comes into application, by virtue of the delegated act specified in Article 67(6), Third Country AIFMs and E.U. AIFMs managing Third Country AIFs will be subject to an authorisation and licensing regime. The authorisation of Third Country AIFMs is provided for in Article 37 AIFMD, which requires a Third Country AIFM to become authorised in a Member State of Reference and thus to comply with the provisions of the AIFMD as implemented in that Member State. Consequently, a U.K. AIFM, which intended either to manage an E.U. AIF or market a Third Country AIF in the E.U., would have to comply both with AIFMD as implemented in its Member State of Reference and also with the rules applied to it by the FCA in the U.K. This could in due course lead to legal uncertainty, in particular if the FCA rules were to diverge from those in the Member State of Reference.

3.36. Article 37(7) AIFMD provides that no authorisation shall be granted to a Third Country AIFM unless the following requirements, *inter alia*, are met:

- (d) appropriate cooperation arrangements are in place between the competent authorities of the Member State of Reference, the competent authorities of the home Member State of the E.U. AIFs concerned and the supervisory authorities of the third country where the non-E.U. AIFM is established, in order to ensure an efficient exchange of information that allows the competent authorities to carry out their duties in accordance with [the AIFMD];

[and]

- (f) the third country where the AIFM is established has signed an agreement with the Member State of Reference, which fully complies with the standards laid down in Article 26 of the [OECD] Model Tax Convention on Income and on Capital and ensures an effective exchange of information in tax matters, including any multilateral tax agreements.

At the present time the U.K. has not entered into any such arrangements or agreement and it is uncertain how long it will take to put them in place.

3.37. In addition, Article 37(8) provides that the authorisation of Third Country AIFMs shall be subject not only to the criteria laid down for E.U. AIFMs by Chapter II of the AIFMD but also to additional criteria which include the provision of supplementary

information, including a requirement to show that, where compliance with an E.U. rule is impossible

the relevant third country law provides for [an equivalent rule], which has the same regulatory purpose and offers the same level of protection to investors of the relevant AIFs and that the AIFM complies with that equivalent rule[.]

ESMA is mandated under Article 37(23) to develop regulatory technical standards specifying the conditions under which a Third Country rule can be considered equivalent and to have the same regulatory purpose while offering the same level of investor protection.

- 3.38. Another aspect of the regime which is worthy of note is that introduced by Article 38: *Peer review of authorisation and supervision of non-EU AIFMs*. Under this article, ESMA may issue guidelines and recommendations with a view to “establishing consistent, efficient and effective regulatory practices” by Member States’ competent authorities with regard to the Third Country AIFMs which are authorised in each Member State.

#### **Insurance and reinsurance**

- 3.39. The Solvency II regime sets out a list of the conditions which must be fulfilled by a Third Country for an equivalence determination in each of the three cases mentioned previously.<sup>89</sup> The criteria include: (i) a provision for the existence of a risk-based supervisory system; (ii) sufficiently resourced and empowered supervisory authorities which are able to protect policyholders and beneficiaries; (iii) adequate capital requirements imposed on (re)insurers; and (iv) effective governance systems.<sup>90</sup> On the day that the U.K. separates from the E.U., the U.K. will have implemented all of Solvency II as required, which in theory implies that U.K. regulators and insurance providers could be considered eligible to meet the criteria for Third Country equivalence.
- 3.40. In practice, however, these conditions have proved difficult to satisfy. Only two countries currently have full equivalence in all three areas—Switzerland and Bermuda. In the case of Bermuda, the European Commission’s decision was the result of an

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<sup>89</sup> *Supra* paragraph 2.21. That is, reinsurance provided by a Third Country reinsurer, group solvency and group supervision, covered by articles 172, 227 and 260 of Solvency II.

<sup>90</sup> In respect of reinsurers, the equivalence requirements are set out in Article 378 of Commission Delegated Regulation (EU) 2015/35. See also, Articles 379 and 380 with respect to Third Country insurance groups.

iterative process where only provisional equivalence for group solvency was granted on the first assessment. Japan has temporary equivalence for reinsurance (until 31 December 2020) and provisional equivalence for group solvency calculations for ten years, as do Australia, Brazil, Canada, Mexico and the U.S.

### **Benchmark Administrators**

- 3.41. Although the Benchmarks Regulation offers access to Third Countries by way of equivalence, recognition or endorsement, there continues to be ambiguity about the standards that apply to each threshold test for access. The availability of a positive equivalence determination in favour of the U.K. will depend on the application of the requirements set out in Article 30(2) and 30(3) of the Regulation. Those paragraphs require that the framework must be equivalent

taking account of whether the legal framework and supervisory practice of [the Third Country] ensures compliance with the IOSCO principles for financial benchmarks...

- 3.42. In addition, a positive equivalence decision will only be granted where benchmark administrators are subject to effective supervision and enforcement on an on-going basis in the Third Country in question.
- 3.43. It is difficult to predict how these requirements will be applied when the Benchmarks Regulation begins to apply in January 2018 but it is expected that, by the time the U.K. withdraws from the E.U. it will have implemented the Regulation fully and will, on that basis, be potentially eligible for a positive equivalence determination. As in all other sectors, eligibility for an equivalence decision does not necessarily guarantee that one will be available immediately after the U.K.'s withdrawal from the E.U., unless transitional arrangements have been adopted. (The issue of timing is discussed further in the next section.)
- 3.44. By virtue of Article 30(1), a Third Country administrator which is established in a jurisdiction which benefits from a positive equivalence decision will be in a position to register with ESMA as a benchmark provider in the E.U. only if it can also show:
- i) that it is authorised or registered, and is subject to supervision, in the Third Country in question;



- ii) that ESMA has been notified of the list of the benchmarks for which the administrator has given consent to be used and of the home competent authority responsible for its supervision in the Third Country; and
- iii) that cooperation arrangements are operational as between ESMA and the administrator’s home competent authority.<sup>91</sup>

### **Issuers**

- 3.45. If a Prospectus Directive-compliant approved prospectus is required—for example, where a U.K. issuer that intends to list on a U.K. trading venue wants to extend a retail offer to E.U. investors—then, following Brexit, the issuer would need to have its prospectus approved by an E.U. competent authority, namely the competent authority of its “home Member State”. Approval by the UKLA would not be sufficient in the circumstances of the U.K.’s withdrawal without a bespoke agreement or transitional arrangements. If the U.K. retains rules post-Brexit which require U.K. prospectuses to meet the same standards as a Prospectus Directive-compliant prospectus, then it may be the case that (subject to any translation required) essentially the same document can be submitted to a competent authority for approval for use in the E.U.
- 3.46. A prospectus can only be approved by a competent authority in the E.U. under Article 20 of the Prospectus Directive if it has been drawn up in accordance with international standards on disclosure. The issuer is also required to show that the information requirements laid down by legislation in the country where it has its registered office are “equivalent” to requirements under the directive. Under Article 20(3), the European Commission is empowered to determine that a Third Country “ensures the equivalence of prospectuses drawn up in that country with this Directive”. As of July 2017, however, no equivalence decision has been adopted in respect of a Third Country under this provision. In March 2013, ESMA published advice identifying the information that may be added to a prospectus drawn up under the laws of a Third Country—a process that ESMA referred to as adding “an equivalence wrap”—so that the resulting document meets the standards of the Prospectus Directive.<sup>92</sup> By this means a prospectus drawn up by a Third Country issuer is able to meet an “equivalence” standard even if

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91 On 1 June 2017, ESMA published draft Regulatory Technical Standards on cooperation arrangements with Third Countries, available at: [https://www.esma.europa.eu/sites/default/files/library/esma70-145-81\\_final\\_report\\_draft\\_rts\\_on\\_cooperation\\_with\\_third\\_countries\\_bmr\\_0.pdf](https://www.esma.europa.eu/sites/default/files/library/esma70-145-81_final_report_draft_rts_on_cooperation_with_third_countries_bmr_0.pdf).

92 *Ibid*, ESMA, “Opinion: Framework for the assessment of third country prospectuses under Article 20 of the Prospectus Directive”, 20 March 2013.

the information requirements laid down by law in the Third Country are not equivalent for the purposes of Article 20.

- 3.47. Article 29 of the PD III, which will apply from 20 July 2019, is similar to Article 20 of the Prospectus Directive and provides that an offer of securities can be made to the public or admitted for trading on a regulated market on the basis of a prospectus drawn up under the laws of a Third Country if it is approved by the competent authority of the issuer's "home Member State". A prospectus can only be approved by the competent authority in question if it has been drawn up in accordance with international standards on disclosure and the issuer can show both: i) that cooperation arrangements on supervision are in place between the "home" competent authority and authorities in the Third Country; and ii) that the information requirements laid down by legislation in the country where it has its registered office are "equivalent" to requirements under PD III.
- 3.48. Under Article 29(3), the European Commission is empowered to adopt delegated acts establishing general equivalence criteria as well as to take an implementing decision on whether the particular information requirements imposed in a Third Country jurisdiction meet the equivalence requirement. At the end of February 2017, the European Commission issued mandates to ESMA to advise on the development of delegated acts on, *inter alia*, the general equivalence criteria for Third Country prospectuses. It is anticipated that these acts will be finalised by early 2019. Although the Prospectus Directive contained a similar Third Country equivalence requirement (in Article 20(3)), no positive equivalence determination was made under this provision. It is difficult in these circumstances—and before ESMA has published its advice—to predict the nature of the equivalence standards that will be applied.
- 3.49. Alternatively, a Third Country issuer can seek approval for a prospectus under Article 28 from the same competent authority on the basis that the prospectus itself has been drawn up in accordance, not with the laws of the Third Country in question, but in accordance with PD III.

## **4. TIMING**

- 4.1. A further issue of legal complexity is presented by uncertainty as to timing in the process of meeting threshold conditions established by Third Country regimes.

- 4.2. It is strongly to be inferred that the process of reaching a decision on the application of Third Country regimes to the U.K. will only begin once the U.K. has withdrawn from the E.U. Taking equivalence as a case study, it is to be doubted whether a decision can be adopted, weighed by the European Commission, or even sought by the applicant under E.U. law in respect of an existing Member State of the E.U. (which is not, *ipso facto*, a Third Country). Therefore, assuming that the process itself takes at least a little time, a *hiatus* will likely occur between this event and the conferring of access as a Third Country on the basis of a positive equivalence determination or satisfaction of any other threshold requirement.
- 4.3. There is the related question of the length of time the European authorities might require to make a decision on equivalence or any other requirement. There exists no guidance, for example, as to the timetable for progressing an equivalence decision and the length of time any assessments and deliberations might take remains open-ended. The 2017 ESMA Opinion Paper acknowledged that any assessment processes for entities looking to relocate will take time and urged firms to approach competent authorities as early as possible. The timetables for the assessments of Third Country regulatory frameworks are likely to be similarly long and fraught with uncertainty. For instance, while ESMA negotiated 11 cooperation agreements in relation to access to Third Country CCPs under EMIR in under two years, the deliberations pertaining to the U.S. application for equivalence with regards to CCPs—referred to in paragraphs 3.15 to 3.19 above and discussed further in paragraph 4.6 below—extended over nearly four years. The period of time taken to reach equivalence decisions with respect to credit rating agencies under the Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies (the “**CRA Regulation**”) have been similarly diverse and unpredictable: one (Japan) took just over six months, three (Australia, Canada and the U.S.) took between 18 months and two years and five (Argentina, Brazil, Hong Kong, Mexico and Singapore) took over four years.<sup>93</sup>
- 4.4. Once a Third Country has received a positive determination of equivalence from the E.U., individual Third Country firms are required to file applications for access to the E.U. financial market.
- 4.5. The question of timing is considered in relation to three illustrative industry sectors below.

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93 The IRSG Report, p. 50

### **Infrastructure: CCPs**

- 4.6. In the example of the CME and its application for admission to the E.U. market as a provider of clearing services (paragraphs 3.14 to 3.19 above), the process of obtaining recognition took four years. The CME was obliged by Article 89 of EMIR to apply for recognition by 15 March 2013 but the process assessing the U.S. regulatory regime for the purposes of an equivalence determination began much earlier when EMIR came into force in 2012. ESMA published positive technical advice on equivalence in relation to the U.S. on 1 September 2013 but it was not until two and a half years later that the European Commission passed an implementing measure adopting a positive determination. During this time, negotiations advanced slowly, then stalled, and a deadline for an agreement was ultimately pushed back twice in 2016. At one point, the executive chairman of CME, frustrated with the E.U.'s approach to equivalence, called for access by E.U. CCPs to U.S. markets to be restricted by the Commodity Futures Trading Commission in a tit-for-tat move.<sup>94</sup>
- 4.7. Given that the new EMIR Review Proposal introduces several new criteria for an equivalence determination and recognition of a Third Country CCP, it is safe to say that the amendments proposed could appreciably lengthen either process, particularly in cases where the Third Country CCP seeking recognition is held to be “systemically important” or “likely to become systemically important”. No timeframes have been given, however, in the draft legislation so the issue remains subject to a significant lack of clarity.

### **Alternative Investment Funds and their Managers**

- 4.8. Under the NPPRs, provided for by Article 42 of the AIFMD, cooperation agreements need to be signed between the Third Country and the Member State of Reference. As noted above, the U.K. is currently not party to any such cooperation arrangements with any Member State and it is uncertain how long it will take to put them in place.
- 4.9. The issue of timing is complicated further by the “passporting” regime provided for by Article 37 and Articles 39 to 41 of the AIFMD, which do not yet apply. Prior to their being brought into application, Article 67(4) of the AIFMD requires that ESMA make the determinations listed in paragraph 3.27 above. Article 67(6) of the AIFMD goes on to provide that the European Commission will adopt a delegated act within three

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<sup>94</sup> See: Stafford, “CME urges tougher US response to EU clearing dispute”, *Financial Times*, (25 March 2015), at: <https://www.ft.com/content/ef6e0ee0-d2db-11e4-a792-00144feab7de?mhq5j=e2>.

months of receiving positive advice from ESMA specifying the date when Article 37 and Articles 39 to 41 of the AIFMD become applicable in all Member States. ESMA has to date published advice on the application of the AIFMD “passport” to 18 Third Countries in respect of some of which it issued positive advice. The timeframe for assessing additional countries is unclear and it appears that this will be an ongoing process.

- 4.10. Further, ESMA has suggested that the European Parliament, the Council and the European Commission may wish to consider whether to wait until ESMA has delivered positive advice on a sufficient number of Third Countries before triggering the legislative procedures which would require the European Commission to adopt a delegated act.<sup>95</sup> As such, the “passporting” regime may not come into force until ESMA considers a sufficient number of Third Countries have qualified. As the European Commission may or may not choose to follow ESMA’s suggestion, the timing of the extension of the AIFMD “passport” is uncertain.<sup>96</sup>
- 4.11. As noted above in paragraph 3.34, if and when the “passporting” regime comes into application, Third Country AIFMs and E.U. AIFMs managing Third Country AIFs will still be subject to an authorisation and licensing regime. A Third Country AIFM must obtain authorisation in its Member State of Reference. Since the “passporting” regime is as yet untested, it is unclear how long the authorisation process will take.

### **Insurance and reinsurance**

- 4.12. There are several steps which lead up to an equivalence determination for insurance and reinsurance business.<sup>97</sup> First, an assessment of the Third Country’s regulatory regime is undertaken by the European Insurance and Occupational Pensions Authority (“EIOPA”) against the criteria set out in Solvency II and expanded upon in the previous sections of this paper. EIOPA may publish a report on its findings and may undertake a consultation, as was the case during the first wave of assessments in 2014

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95 ESMA Press Release: “ESMA advises on extension of AIFMD passport to non-EU jurisdictions”, (30 July 2015), at p. 2, available at: [https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1238\\_esma\\_advices\\_on\\_extension\\_of\\_aifmd\\_passport\\_to\\_non-eu\\_jurisdictions\\_0.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1238_esma_advices_on_extension_of_aifmd_passport_to_non-eu_jurisdictions_0.pdf).

96 It is worth noting that under Article 68 of the AIFMD, which offers rules for switching from the NPPR to the “passporting” regime, ESMA shall issue advice to the Commission on the termination of the NPPRs provided for by Article 42 of the AIFMD three years after entry into force of the delegated act by which the Commission specifies the date when the “passporting” regime under the AIFMD becomes applicable. Following this, the Commission is required to adopt a delegated act within three months “switching off” the NPPRs.

97 European Insurance and Occupational Pensions Authority, *Guidelines on the methodology for equivalence assessments by National Supervisory Authorities under Solvency II*, (2 February 2017), available at: <https://eiopa.europa.eu/publications/eiopa-guidelines/guidelines-on-the-methodology-for-equivalence-assessments>. See “Technical Annex I – Equivalence assessment under Article 227 of Solvency II Directive” at p. 6.

which covered Switzerland, Bermuda and Japan. The findings are then presented to the European Commission, which is required to consult with EIOPA about its technical assessment.

- 4.13. An equivalence finding is made at the discretion of the Commission and there are no set periods within which a decision or finding must be made. By way of example, the European Commission’s decision to grant equivalence to Bermuda under Solvency II was a product of six years of negotiations.<sup>98</sup> Once a decision is made, the European Council and Parliament have three months—or within six months if the objection period is extended—within which they may register any objections to the decision.
- 4.14. Equivalence assessments may also be carried out by E.U. supervisors in accordance with EIOPA guidelines where such an assessment is not made by EIOPA.<sup>99</sup> Positive assessments require regular review every three years or following significant developments in the jurisdiction assessed.

## **5. IMPACT**

- 5.1. Given the preponderance of uncertainties inherent in the scope, process and timing of Third Country threshold requirements for access to E.U. markets as a Third Country, financial services providers based in the U.K. are likely to come up against a number of legal uncertainties related to the continued operation of their business following Brexit.
- 5.2. In March 2019, when the Article 50 notice period runs out and in the absence of a bespoke deal with the E.U. for trade in services entering into force and/or special transitional arrangements providing continuity with the current regulatory regime, financial markets participants in the U.K. will presumably lose their “passports” to the single market. At that point, they face the prospect that they are no longer able to initiate new business in the E.U. Moreover, it seems unlikely that they will be permitted to continue servicing legacy business, since this in itself would constitute providing services or carrying out activities in the E.U. This question of legacy business alone would give rise to considerable market disruption—in addition to the market dislocation experienced in regard to new and future business—and litigation risk, since

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98 See Bermuda Monetary Authority, Press Release: “E.C. declares Bermuda’s commercial (re)insurance regime fully equivalent to Solvency II”, (26 November 2015), available at: <http://www.bma.bm/Lists/News/AllItems.aspx>.

99 Under Article 227(2) of Solvency II Directive, the group supervisor can carry out the verification of the equivalence of the Third Country regime for the purpose of the group solvency calculation.

contracts do not always make clear or certain provisions for the allocation of risks associated with regulatory displacement when it arises from an Act of State and the interplay of geopolitical forces.

- 5.3. These risks represent a “cliff edge” scenario for those market participants who currently provide services in areas not covered by Third Country regimes and who will, in consequence, undoubtedly lose market access (subject to what is said elsewhere about bespoke deals and transitional arrangements). It is, however, likely that Brexit would also represent a risk of significant dislocation for those firms who provide services in sectors covered by Third Country regimes on account of the multiplicity of factors listed above that make a decision by E.U. authorities on whether threshold conditions have been satisfied uncertain as to timing and outcome.

#### **Short-term Impact**

- 5.4. Accordingly, ahead of Brexit and immediately after withdrawal, one of the most significant features of the landscape is likely to be operational, practical, legal and regulatory uncertainty. It is to be expected that market participants will engage with both their advisers and the authorities, in the U.K., in the E.U. and in E.U. Member States, at heightened levels of enquiry in a bid to bring light to bear. Another, related feature of the Brexit landscape in this period may be business restructurings which allow market participants to maximise the opportunities for continued access to E.U. markets in the face of potential market dislocation and so create their own solutions to the uncertainty. (This feature is discussed in greater detail in section six, below.)
- 5.5. Many of the questions and uncertainties which firms will wish to address around Brexit can be determined or ameliorated in the discussions which will undoubtedly take place with professional advisers and with authorities. These include some questions relevant to determining access to the E.U. as a Third Country firm. A good example is the preliminary question, identified in section one above, about when a firm will be considered to be “providing services” or “carrying out activities” in the E.U.
- 5.6. Many other questions concerning the availability of market access, however, may not prove so tractable or susceptible to legal clarification, including the overarching question: “when, if at all, will the threshold conditions be satisfied for Third Country access by U.K. firms?”
- 5.7. For those business sectors where the dominant regulation includes an equivalence test, the equivalence decision itself is likely to be the most uncertain element in determining

whether threshold conditions have been satisfied. This can be readily inferred from the features of the equivalence standard outlined in the European Commission Staff Paper at paragraph 1.22 and discussed in sections one and three. The uncertainty is not likely, however, to be much less significant in those sectors where the Third Country regime relies on different threshold criteria, given the prevalence of requirements focusing on discretionary or risk-based determinations by E.U. authorities.

### **Long-term Impact**

- 5.8. In the longer term, market participants in the U.K. face restrictions and limitations on doing business in the E.U. coupled with uncertainty as to both: (i) the availability and scope of authorisation in E.U. Member States; and (ii) the possibilities for conducting business in the E.E.A.—including legacy business—without authorisation.
- 5.9. Access to the single market for U.K. participants would mean acquiring authorisation (either for a subsidiary or for the U.K. firm “directly” via a branch). For many, this would require establishing a new entity within an E.U. Member State or otherwise restructuring the group.
- 5.10. In order to establish and resource a subsidiary that is large enough to conduct the volume of business that is currently “passported” out of London, a large group is likely to require a significant period of time. Drawing up an application for authorisation, and the determination itself, may take many more months, particularly in a bottleneck situation. The direct authorisation process typically requires the participation of the “home” supervisory authority (a Memorandum of Understanding between home and host authorities may be required), and can take even longer. These processes could become more fraught in the context of the Article 50 negotiations.
- 5.11. The longer-term impact of withdrawal and the legal and regulatory uncertainty which is bound to accompany it is considered below in greater detail for certain key financial services sectors.

### **Infrastructure: CCPs and trading venues**

- 5.12. In the absence of a bespoke deal with the E.U. and/or special transitional arrangements providing regulatory continuity, CCPs in the U.K. will lose their status as “legal person[s] established in the Union” on Brexit and, as a logical corollary, lose their status as CCPs authorised under Article 14 of EMIR. If they do not then immediately become Third Country CCPs recognised under Article 25 of EMIR, market participants (i.e. “financial counterparties” and “non-financial counterparties” within the meaning of



Article 2 of EMIR) can no longer satisfy the regulatory clearing obligation set out in Article 4 of EMIR by using their services in respect of OTC derivative contracts. Moreover, the CCPs themselves will be in breach of Article 25, which permits a CCP to provide services to E.U. clearing members only where the CCP in question has first obtained recognition from ESMA.

- 5.13. The potential systemic effects of even a temporary withdrawal of clearing services from the E.U. by U.K. CCPs have been widely commented on. The International Regulatory Strategy Group has observed that

If no arrangements are made to manage the transition between regimes at Brexit, there is a risk of market disruption and sharply increased costs of clearing, both of which will affect the nonfinancial end-users of markets in both the [U.K. and the 27 remaining E.U. Member States].<sup>100</sup>

- 5.14. Media comment has so far focused on the need for transitional arrangements for U.K. CCPs because it is expected that, although there may be a worrying *hiatus* at the point of departure, in the long run U.K. CCPs will obtain recognition under Article 25 of EMIR and be permitted to provide clearing services to E.U. clearing members on that basis.<sup>101</sup> The grounds for this view are said to be chiefly that, if the *acquis* is received into U.K. law as expected, the U.K. regulatory regime will be not only equivalent, but identical, to the EMIR framework for E.U. CCPs after Brexit. The EMIR Review Proposal, however, has made this prospect much less certain in respect of London's largest CCPs, which are very likely to be classified as "systemically important" under proposed amendments.
- 5.15. The EMIR Review Proposal has been introduced in the context of calls by politicians from Euro Area Member States for the activity of clearing euro-derivatives to be relocated away from London and into the Euro Area. The reasons given for this move are said to be that, given the role of the European Central Bank as a liquidity backstop in relation to the euro, euro-denominated clearing should take place in a CCP subject to its supervision and control. Although the EMIR Review Proposal does not impose general relocation requirements it does set out provisions which would:

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100 International Regulatory Strategy Group, *CCPs post-Brexit: Implications for the users of financial markets in the UK and EU27*, (27 February 2017), p.2, available at: <https://www.irsg.co.uk/resources-and-commentary/irsg-paper-on-ccps-post-brexit/>

101 See, for example, Kirton, "No transition deal for UK's clearing houses post-Brexit will hurt the other EU member states", City A.M. 20 February 2017, available at: <http://www.cityam.com/259365/no-transition-deal-uks-clearing-houses-post-brexit-hurt>.

- a) allow ESMA to determine, in agreement with E.U. central banks, that the risks posed by a Third Country CCP are of such magnitude that the CCP should not be recognised at all; and
  - b) empower the European Commission to take a decision that a Third Country CCP should not be recognised as such and should only be allowed to provide clearing services on the basis of establishment in a Member State and full authorisation.<sup>102</sup>
- 5.16. These amendments raise the spectre of the eventual re-location of euro-denominated derivatives clearing activities away from the U.K. The damaging long-term effects of this outcome on the U.K. economy and the risks to financial stability in the E.U. have previously been the subject of comment by leading figures from the public and private financial sectors.<sup>103</sup>
- 5.17. U.K. operators of MTFs and OTFs may also find themselves facing a regulatory *hiatus* and a temporary loss of market access on the U.K.'s withdrawal from the E.U. This is again because, under the MiFID II Package, U.K. MTF and OTF operators provide their services on the basis of authorisation as required by Title II of MiFID II. On the U.K.'s withdrawal from the E.U. authorisations granted by the U.K. authorities will *prima facie* lapse. It is then to be expected for reasons given elsewhere in this paper that the process of re-establishing operations in the E.U. (either as a branch or as a provider registered with ESMA)<sup>104</sup> from the U.K. will take time.
- 5.18. Assuming U.K. MTF and OTF operators are able to access the E.U. as Third Country providers in due course, they may nevertheless face an additional element of operational complexity as a result of legal uncertainty under the MiFID II Package. There are certain legislative provisions for Third Country access in MiFID II which are inconsistent with the guidance provided in MiFIR and which give rise to legal uncertainty. Article 23 of MiFIR provides that an E.U. investment firm must ensure that its trades in shares admitted to trading on a regulated market or traded on a trading venue must take place

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102 See paragraph 2.15 above.

103 See references at n.13 *supra* and see also Rolet, *Oral evidence to the Treasury Select Committee: The UK's future economic relationship with the EU* (10 January 2017), Q242 to Q254, available at: <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/the-uks-future-economic-relationship-with-the-european-union/oral/45035.pdf>.

104 See paragraph 2.12 above where the point is made that operating an OTF or MTF is treated in the same way under the MiFID II Package as other wholesale investment services, as to which see paragraphs 2.9 to 2.11.

on a regulated market, multilateral trading facility or systematic internaliser, or a Third-Country trading venue assessed as equivalent in accordance with Article 25(4)(a) of [MiFID II].

Article 25(4)(a) of MiFID II, however, only refers to Third Country markets which have been considered equivalent to regulated markets, without any mention of Third Country MTFs or OTFs. It is not clear whether this inconsistency is intentional or a drafting oversight, but as it stands the wording suggests that E.U. investment firms and credit institutions may not be permitted to trade equities on Third Country MTFs and OTFs unless those trades come within the relevant exceptions.

- 5.19. There is no Third Country regime for the provision into the E.U. markets of trading platform services other than by means of an MTF or OTF nor, however, is there any existing, formal “passporting” regime between E.U. Member States in respect of such platform services. Operators of regulated markets located within one E.U. Member State are generally permitted by E.U. competent authorities to operate in other Member States for the purposes of facilitating trading by members in those Member States but it seems likely that this practice will cease once the U.K. withdraws from the E.U. In this case, U.K.-based operators of regulated markets such as the London Stock Exchange, LIFFE or NYSE Euronext may face the prospect of losing access to E.U. markets.

#### **Insurance and reinsurance**

- 5.20. In preparation for losing access to the E.U. single market, many (re)insurance groups have begun the process of establishing new subsidiaries in the E.U. or applying for the authorisation of branches in order to be able to continue to write new business in the E.U. post Brexit.<sup>105</sup> These authorisation procedures are quite intensive and their completion can take up to a year once an application is submitted. There are also significant questions as to how much of a presence will be required locally and which activities can be outsourced back to the U.K.—and the consequent requirements imposed by supervisors locally and in the U.K.
- 5.21. The issue of how (re)insurers will continue to deal, post-Brexit, with existing cross-border business is one of even greater and immediate importance. This is relevant for both existing (pre-Brexit) business written from an E.U. branch of a U.K. insurer and from the U.K. branch of an E.U. insurer. It also arises for business written on a services

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105 See Ralph, “London’s insurers rush to cover the Brexit bases”, *Financial Times*, (London, 29 September 2016), available at: <https://www.ft.com/content/11a6e368-7e86-11e6-bc52-0c7211ef3198>.

basis either into or out of the U.K. and is a particular concern for U.K. life insurers with retired policyholders in E.U. jurisdictions. The position for U.K. (re)insurers with E.U. policy-holders or covering E.U. risk is not uniform across the 27 E.U. Member States and in some jurisdictions there is no clarity. In Ireland, for example, paying claims in Ireland would be viewed as carrying on insurance business and thus be considered an offence by an unauthorised insurer. Legislation in some other jurisdictions is silent on the point.

5.22. Finally, Solvency II is silent on many aspects of insurance business, including the access requirements for reinsurers to access the E.U. Reinsurance business is then dependent on the position of individual Member States.

5.23. As there is currently no Third Country regime applicable to insurance intermediation, U.K. insurance intermediaries will have to consider various practical alternatives. These may include:

- i. to the extent allowed by the law of the relevant E.U. Member State, establishing branches in other jurisdictions and obtaining authorisation for such branches;
- ii. setting up a new legal entity in an E.U. Member State and applying to the local regulator for the necessary insurance intermediation permissions; and
- iii. acquiring an existing intermediary that is already authorised in an E.U. jurisdiction.

5.24. Insurance intermediaries who have set up or acquired an E.U. authorised insurance intermediary in an E.U. Member State would, in principle, be able to exercise their “passporting” rights derived from the IDD in order to carry on business in, or establish a branch or permanent presence in, any other E.U. Member State.

5.25. A particular point of note is that insurance intermediaries which act as the agent of the insurer rather than the insured customer (for example, managing general agents), and their insurer principals, will need to consider the extent to which such agents are able to underwrite contracts of insurance and/or carry out other activities on behalf of U.K. and/or E.U. insurers without causing the relevant insurers to be deemed to be effecting or carrying out contracts of insurance in a jurisdiction in which the insurer is not authorised. For example, there is a risk that a U.K. insurer could be deemed to be carrying on insurance business in France if it were to have an agent entering into binding contracts of insurance on its behalf in France. Similarly, a French authorised

insurer bound by a managing general agent operating in the U.K. could, in principle, be brought within the U.K. regulatory remit and therefore need to be directly authorised under the U.K. regime.

### **Benchmark Administrators**

- 5.26. Although the Benchmarks Regulation provides for Third Country access through recognition or endorsement as an alternative to registration with ESMA on the basis of a positive equivalence decision, the application of those alternatives is not without uncertainty. E.U. supervised firms, for example, may only use a Third Country benchmark which benefits from recognition until such time as a positive determination of equivalence is reached.<sup>106</sup> It would appear to be a logical corollary of this that there may be a temporal lacuna *after* an equivalence determination is made but before the administrator has satisfied the other threshold conditions set out in Article 30 (such as the requirement for cooperation arrangements to be in place). Third Country benchmark administrators may thus find themselves in the inconvenient situation where they are technically unable to rely on recognition but access is not yet available on the basis of equivalence.
- 5.27. The impact of Brexit on regulatory continuity for benchmark administrators could present a serious issue for legacy contracts and existing funds entered into by E.U. supervised entities which reference benchmarks produced by U.K. administrators (including benchmarks such as LIBOR, SONIA, ICE Brent, LBMA Gold Price).<sup>107</sup> The E.U. Benchmarks Regulation includes transitional provisions allowing the use of benchmarks produced by Third Country administrators until 1 January 2020.<sup>108</sup> These provisions are not, however, a panacea for the difficulties to which Brexit may give rise owing to the obvious and significant consideration that the processes by which U.K. benchmark administrators can obtain registration with ESMA as a Third Country provider on the basis of equivalence, recognition or endorsement, may drag on past 1 January 2020. (There is additional debate as to whether these provisions cover only benchmarks that exist on the date of entry into force of the Benchmarks Regulation, or on its date of application, or whether they also cover new benchmarks developed—say,

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106 Article 32(1) of the Benchmarks Regulation.

107 Under Article 29 of the Benchmarks Regulation, E.U. supervised entities are only permitted to use compliant benchmarks registered with ESMA once the regulation comes into application.

108 Article 51 of the Benchmarks Regulation.

in response to calls for benchmark reform—between 1 January 2018 and 1 January 2020.)

- 5.28. Additional transitional provisions for legacy contracts in Article 51(4) do not appear to apply to Third Country benchmarks given that they refer to continuity measures which may be taken by “the competent authority of the Member State where the index provider is located”.

## 6. SOLUTIONS AND MITIGANTS

### Short-term mitigants

- 6.1. As highlighted in the sections above, the limitations of the patchwork of Third Country regimes which are incorporated in E.U. financial services legislation and uncertainties relating to the satisfaction of the threshold requirements for these regimes could mean that U.K. providers of financial services will be—at least temporarily—deprived of access to key E.U. markets on the withdrawal of the U.K. from the E.U., unless they first individually acquire authorisation (either for a subsidiary or for the U.K. firm “directly” via a branch).
- 6.2. As regards equivalence decisions, in particular, this paper has set out some of the complexities attached to the processes for securing equivalence decisions relating to provisions in European legislation that provide a basis for some types of Third Country firms to access E.U. markets. Whilst the legislative test of equivalence adopted by the E.U. has evolved, a central requirement is the alignment of core substantive provisions governing the conditions on which licences are granted and the ongoing prudential and other requirements to be met in carrying on business. A positive equivalence determination for the U.K. will likely require the E.U. authorities to have confidence in the effectiveness of the supervision and enforcement processes as well as in the U.K.’s ongoing commitment to cooperation and adherence to recognised international standards. These requirements contribute to uncertainty about the timeframe within which a positive equivalence decision might be available. In any event, positive equivalence determinations, although helpful in many cases, would not resolve the issues facing, for example, U.K. AIFMs, as under the AIFMD access to the E.U. for Third Country firms is not subject to an equivalence decision. Nor would it address areas, such as retail investment services, where no Third Country regime is available except by establishment (e.g. as a branch) and authorisation in the E.U.

- 6.3. Transitional plans could alleviate some of the difficulties and uncertainties outlined in this paper by reducing practical uncertainty about access to the single market for a period beyond the two-year period specified in Article 50(3) of the Treaty of the European Union. The FMLC has previously expressed support for the desirability of transitional plans, most recently in a letter to the U.K. Treasury Select Committee (the “**TSC Letter**”), in which it encouraged a staged approach to negotiating and developing such provisions.<sup>109</sup>
- 6.4. In this regard, the FMLC is of the view that transitional arrangements, as well as any newly-negotiated agreements between the U.K. and the E.U. could usefully include some form of “grandfathering” under which any “legacy” products issued before Brexit will continue to be regarded as valid in all relevant jurisdictions to avoid significant disruption.

#### **Transitional Equivalence**

- 6.5. The U.K. has over several decades played a significant role in the development of European and international financial regulation. HM Government has made clear its intention to transpose E.U. law, including financial regulatory law, into U.K. law through the Great Repeal Bill, so that the body of European financial regulation that applies at the point of Brexit will continue to apply in the U.K. Accordingly, at the point in time that the U.K. leaves the European Union, it would be odd— notwithstanding the procedural and other complexities and uncertainties discussed in section three above—if the U.K. were not regarded as meeting the substantive tests for equivalence across the full range of financial services for which equivalence-based Third Country regimes are available.
- 6.6. Arguably, then, it should be possible for the terms of the U.K.’s withdrawal from the E.U. to include a late-stage transitional provision for the recognition of the U.K.’s equivalence as a Third Country for the purpose of the various tests contained in E.U. financial regulatory legislation. On the assumption that the “soft Brexit” option set out below is rejected as a long term solution, “transitional equivalence” recognition would ideally come into late effect as part of a phased approach to transition. That is, it would come into effect following the expiry of more inclusive and comprehensive (or, in the language of political commentary, “softer”) arrangements contemplating wider access to the E.U. for U.K. service providers, which would arguably be an appropriate early

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109 FMLC, *Letter to the Treasury Select Committee on Transitional Arrangements*, (31 January 2017), available at: <http://www.fmlc.org/letter-to-treasury-select-committee-on-transitional-arrangements.html>.

staging post immediately after the U.K.'s withdrawal. "Transitional equivalence" could either remain in place for so long as no contrary determination is made—which would surely be the least administratively burdensome option for the institutions of the E.U.—or until the expiry of a defined transitional period. The FMLC recommends that HM Government give careful consideration to securing—or attempting to secure—transitional provisions of this kind, which would reduce uncertainty and the impending "cliff edge" effect in some industry sectors.

### Longer-term mitigants

- 6.7. The sections above demonstrate the limited nature of the provisions currently available to Third Countries for access to the E.U. single market for financial services. In order to ensure access for U.K. financial service providers to the E.U. markets, the FMLC has set out below seven proposed potential mitigants to the issues of legal uncertainties raised above. These mitigants imply different models of E.U.-U.K. relationship following British withdrawal. It is not for the FMLC, however, to comment on matters of policy or the form that the regulatory landscape should take in the U.K. post-Brexit.

### Soft Brexit

- 6.8. A simple option by which the U.K. can gain access to the E.U. single market is by retaining its membership of the E.E.A. The U.K. is already a party to the E.E.A. Treaty as an E.U. Member State and, although the question is not legally certain, it is generally believed that the U.K. will leave the E.E.A. when it leaves the E.U.<sup>110</sup> Even if this is correct, the option exists for the U.K. to re-join the E.E.A by becoming a signatory to the E.E.A Treaty as an EFTA member state. In order to do this, the U.K. would be legally required to join EFTA.
- 6.9. As a member of the E.E.A., the U.K. would be subject to the common rules and equal conditions of competition which apply across the E.E.A. by virtue of the Agreement on the European Economic Area ("**E.E.A. Agreement**"). This imposes an obligation of "homogeneity" on contracting states which is currently satisfied on their behalf by certain EFTA institutions, including: the EFTA Surveillance Authority, which has

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110 In *Yalland and others v Secretary of State for Exiting the E.U.* [2017] EWHC 630, the Applicants sought a declaration that it would be unlawful for the Prime Minister to take the U.K. out of the E.E.A. by serving a withdrawal notice under Article 127 of the Agreement on the European Economic Area (the "**E.E.A. Agreement**") and that, absent such notice, the U.K. remains bound as a Contracting Party to the E.E.A. Agreement. One limb of the Appellants' argument rested on the contention that an action under a Treaty to which EFTA states were not party, i.e. under Article 50 of the Treaty of the European Union, could not unilaterally affect the rights of those states vis-à-vis the U.K. under the E.E.A. Agreement. The High Court refused to hear the case in February 2017 on the grounds that the application was premature. Since then HM Government has submitted an Article 50 withdrawal letter which makes no mention of the need to give notice under Article 127 of the E.E.A. Agreement.



powers similar to the European Commission to pursue breaches of competition law and other lapses in the standards which are applied throughout the E.E.A., and the EFTA Court. There is no written obligation on the courts of last resort of EFTA member states to make a reference to the EFTA Court and its preliminary rulings are not binding on national courts. (They are termed “advisory” opinions.) The E.E.A. Agreement’s homogeneity rules, however, bind the EFTA Court to follow relevant ECJ case law.

- 6.10. By this route, U.K. financial services firms would obtain continued access to the single market on terms very similar, if not identical, to the terms on which business is conducted today.<sup>111</sup> E.U. regulatory measures in all fields would continue to apply to the U.K. much as they did pre-Brexit.

### **Bespoke Deal**

- 6.11. Many who campaigned for the U.K. to “Leave” the E.U. view a bilateral Free Trade Agreement (“**FTA**”) between the U.K. and the E.U. as the most efficient model for their future relationship. The proponents of such a bespoke deal hope for “preferential access” for U.K. services providers to the E.U. market on terms which would mimic the single market framework for financial services.
- 6.12. Before the U.K. can negotiate an FTA with the E.U. (or indeed any other country), its schedules at the WTO must be established and confirmed so as to provide context to negotiations with respect to the terms being offered to the rest of the world. A degree of uncertainty is raised in relation to the General Agreement on Trade in Services (“**GATS**”) of the WTO, which contains “most favoured nation” (“**MFN**”) provisions. These require, subject to exceptions, WTO member countries not to discriminate between services and service providers from other WTO member countries.<sup>112</sup> While the GATS, in effect, exempts certain mutual recognition agreements between WTO member countries from this strict version of MFN, there is legal uncertainty about the scope and ultimate effects of these provisions which will have, therefore, to be taken into account as any FTA is designed and agreed.
- 6.13. Another uncertainty that arises in relation to any bespoke deal is the question of the appropriate dispute resolution mechanism. HM Government has said that Brexit will end the jurisdiction of the European Court of Justice (the “**CJEU**”) in the U.K. which

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111 Membership of the E.E.A. would end the “determination” rights of the U.K. to vote on E.U. legislation. Implementation of E.U. directives in E.E.A. states is also subject to a time lag, which may give rise to complexities in the passporting of cross-border business.

112 Article 2 of the GATS.

raises the question of which court or tribunal would have the power to hear disputes arising out of the operation of any bilateral agreement between the E.U. and the U.K. In this regard, the relationship between Switzerland and the E.U. may be illustrative of the problems that can arise.<sup>113</sup>

- 6.14. The E.U.-Swiss relationship is marked out by over 120 sectoral agreements. (It is important to note that there is, as yet, no sectoral agreement in financial services and reports suggest that there is no appetite in the E.U. for concluding one.) When a dispute arises over the application of one of these agreements, the resolution of the dispute is submitted to one of many diplomatic joint committees. There is no common surveillance institution for the agreements and no common court. According to reports, the E.U. authorities have informed the Swiss government that no new market access agreements will be concluded without supra-national surveillance and dispute resolution mechanisms. The solution that has allegedly been proposed is the so-called “docking solution” whereby Switzerland agrees to accept oversight by the EFTA surveillance authority and the EFTA Court of proceedings relating to the sectoral agreements.<sup>114</sup> The Swiss government is reportedly antagonistic to this solution which, it says, would cede jurisdiction to a partial entity dominated by judges who are steeped in E.U. jurisprudence and principles but not in Swiss law. It is unclear whether HM Government would, in the case of one or more bilateral agreements with the E.U., consider that accepting oversight by the EFTA Court would breach its resolve to “take back control of our laws and bring an end to the jurisdiction of the European Court of Justice in Britain”.<sup>115</sup>

### **Expanded equivalence**

- 6.15. A third model for the future relationship between the U.K. and the E.U. is the adoption by the E.U. of an expanded or enhanced framework for equivalence decisions.

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113 A more in-depth look at the Swiss-E.U. FTA and dispute resolution mechanisms is available in: U.K. House of Lords, 5th Report of Session 2016-17, *Brexit: The Options for Trade*, (13 December 2016), pp. 40-45, available at: <https://www.publications.parliament.uk/pa/ld201617/ldselect/ldeucom/72/72.pdf>.

114 An overview of the “docking solution” can be found in a speech delivered by Professor Dr Carl Baudenbacher, President of the EFTA Court, “After Brexit: Is the E.E.A. an option for the United Kingdom?” (13 October 2016), at pp. 5-6, available at: <https://www.kcl.ac.uk/law/tli/about/Baudenbacher-Kings-College-13-10-16.pdf>.

115 Speech by Prime Minister Theresa May “Negotiating Objectives for Exiting the E.U.”, (17 January 2017), available at: <https://www.gov.uk/government/speeches/the-governments-negotiating-objectives-for-exiting-the-eu-pm-speech>. These sentiments were reiterated by Mrs May in Parliament on 29 March 2017 on the occasion of giving notice under Article 50 of the Treaty on European Union, see <http://www.telegraph.co.uk/news/2017/03/29/full-theresa-mays-article-50-statement/>.

- 6.16. As mentioned above, unless the current scope of equivalence regimes were significantly expanded, this would not resolve the issues facing, for example, U.K. AIFMs given that, under the AIFMD, access to the E.U. is not subject to an equivalence decision. Nor would it address areas, such as retail investment services, where no Third Country regime is available except by establishment (e.g. as a branch) and authorisation in the E.U.
- 6.17. It has been suggested that, building upon the interdependence of the U.K. and the remaining Member States, a solution could be negotiated by filling in these sizeable gaps.<sup>116</sup> The expanded framework, it is said, could either be negotiated piecemeal or achieved by means of the adoption into E.U. law of a proposal which introducing a general right of Third Country access by way of a framework Regulation would provide for Third Country access in all sectors of the single market in financial services.

#### **Overseas Persons Exemption**

- 6.18. Another option for consideration may be for the U.K. to seek an arrangement with the E.U. by which U.K. firms would be permitted to provide investment services into the E.U. under some form of exemption specifically designed for Third Country market participants. The U.K.'s overseas persons exemption under Article 72 of the RAO can be used by an overseas person<sup>117</sup>—defined as a person who carries on certain regulated activities but not from a permanent place of business in the U.K.—to carry on business either (i) with or through a person authorised by the FCA or the Prudential Regulation Authority or a person considered exempt under the RAO, such as certain regulated exchanges and clearing houses and various non-governmental bodies; or (ii) as a result of a “legitimate approach”, i.e., without having breached the U.K.'s restrictions on financial promotions.
- 6.19. It has been suggested that a similar regime could be developed to grant U.K. firms access to the E.U. There are, however, currently no E.U.-wide exemptions of this kind on which U.K. firms could rely to secure access. There are some exemptions in certain individual Member States but to rely on these the U.K. would have to consider its position with each Member State separately.

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116 See references at n. 41 *supra*

117 See paragraph 2.11 above.

### **U.K. de-subsidiarisation for E.U. groups**

- 6.20. An option that is gaining traction among financial markets commentators as a solution for E.U. financial services groups is sometimes referred to as “de-subsidiarisation”. This would involve a partial reversal of the process of local subsidiarisation which was implemented in the wake of the financial crisis to ensure that firms operating in the U.K. could be resolved locally. Where complex groups have an operating company in the remaining 27 Member States of the E.U., it may be easier to conduct business in the U.K. through a branch, rather than a subsidiary, after Brexit. The London-based branch of an E.U. parent may find it easier to satisfy competent authorities in one or more of the remaining 27 Member States of its regulatory standing to provide wholesale investment services into the E.U. than would a U.K. operating company or subsidiary.

### **E.U. establishment, authorisation and booking models for U.K. groups**

- 6.21. Correlatively, a U.K. firm could either establish a subsidiary in the E.U. and apply for authorisation to provide services through that subsidiary or apply directly to a local regulator for authorisation in a Member State. In the case of “direct” authorisation of the latter kind, the U.K. firm would typically have to establish a branch office in the Member State in order to obtain authorisation. This is, however, only permitted in some Member States. In an attempt to avoid a race to the bottom amongst the Member States’ regulatory standards to attract relocating firms and to prevent firms’ from forum-shopping, ESMA has hinted at plans to establish a Supervisory Coordination Network, which will provide a forum for the national competent authorities of the remaining E.U. Member States to report and discuss Third Country applications and ensure consistency in decision-making.<sup>118</sup> As briefly mentioned in section three, authorisations granted by the U.K.’s competent authorities will no longer be recognised in the E.U., and U.K. entities will have to undergo the process of obtaining separate authorisation.
- 6.22. The process of obtaining authorisation, or amending or upgrading an existing license in a Member State, is likely to prove time consuming and costly. The Opinion issued by ESMA earlier this year warns that the process for the authorisation of relocating entities will be time-consuming and that firms should factor such time into their plans.<sup>119</sup> Costs could include moving staff and infrastructure (such as risk management and regulatory reporting systems) to the new jurisdiction and legal and compliance expenses in setting up or expanding a subsidiary. It is also possible that regulators will require an increase

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118 2017 ESMA Opinion Paper, p. 7.

119 2017 ESMA Opinion Paper, p. 3.

in the capital resources required to be maintained to support the group's operations in that jurisdiction.

- 6.23. Furthermore, the extent to which a newly authorised entity will be permitted to outsource activities such as risk management and trading back to a U.K.-based firm is subject to stricter conditions established in the 2017 ESMA Opinion Paper. As a general principle ESMA advises firms to only outsource or delegate tasks or functions, not responsibilities. It also requires as part of the authorisation process all data related to outsourced activities and that outsourcing and delegation arrangements should not have an impact on business continuity, confidentiality and conflicts of interest. ESMA also directs competent authorities to scrutinise applicant firms' integral functions, such as internal control functions, risk assessment, compliance functions, key management functions and sector-specific functions.<sup>120</sup> The process of gaining authorisation for a branch in an E.U. Member State is then only some degrees less complex than applying for equivalence but may, at least, offer more comprehensive access to the single market.
- 6.24. For many global banks, the U.K. authorised bank or investment firm operates as the main booking entity for E.U. and some Asian trading business. As with outsourcing, E.U. and national regulators will wish to understand and supervise any arrangements by which E.U. client trades are ultimately booked through a U.K. entity, either through intra-group back-to-back trades or through direct booking with the U.K. firm.

#### **Partial or sectoral solutions**

- 6.25. Finally, the FMLC calculates that there are partial solutions available in respect of many sectors of the wholesale financial markets. Enumerating each of these solutions is beyond the remit of this paper. One in particular, however, is suggested below by way of outline.
- 6.26. In the fields of insurance and reinsurance, Solvency II offers guidance as to the establishment of an insurer in the E.U. but no guidance with regards to the establishment of a branch of a Third Country reinsurer in the E.U. or the provision of reinsurance services by a Third Country reinsurer into the E.U. Each Member State is thus free to determine its own preconditions for access. The only restriction to which a Member State is subject is the requirement that the Third Country reinsurer is not treated more favourably than an E.U. reinsurer. This route paves the way for U.K. reinsurers to continue servicing business in the E.U. It has also been suggested that this

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120 2017 ESMA Opinion Paper, p. 5-6.

may provide a partial solution for U.K. writers of direct insurance. It is likely, however, that obstacles will remain, particularly in relation to the active marketing of business in the E.U., and the viability of this option may be subject to a review of the requirements imposed by each Member State and on the ease of the withdrawal negotiations.

## **7. CONCLUSION**

- 7.1. In this paper, the FMLC has examined the provision of services by U.K. financial markets participants into the E.U. single market in the event the U.K. were to become, from the perspective of European legislation, a Third Country, with no treaty provision governing the supply of financial services. In such circumstances, the ability of U.K. financial services providers to access the E.U. single market will be delimited by existing provisions for Third Countries, where these are written into relevant E.U. legislation. These provide, for the most part, either: (i) access by Third Country firms to E.U. Member States on a country-by-country basis; or (ii) threshold requirements (most often for equivalence), having met which Third Country firms may be allowed to operate across the single market.
- 7.2. The analysis above has drawn attention to the partial, complex and uncertain nature of Third Country regimes and to the market disruption which may potentially arise at the point at which the U.K. withdraws from the E.U. if no additional provision is made. To that end, the FMLC has highlighted the following complexities relating to the use of Third Country regimes: their scope; the specificity of conditions which must be met in order to gain access under these regimes; and the uncertainty in the timing of any assessment. The FMLC has not undertaken an exhaustive examination of Third Country regimes; rather, the case studies of specific sectors presented in this paper are illustrative of these risks.
- 7.3. The provisions in E.U. financial markets legislation for Third Countries exclude important business lines, like deposit-taking, lending and retail fund offerings, leaving providers to seek establishment and authorisation in the E.U. As explored in section two of this paper, even where Third Country provisions are offered, they may be limited in scope, often only enabling the provision of specific services by Third Country firms in the E.U.
- 7.4. In section three, the paper examined the stringency and particularity of the rules for Third Country firms written into each Third Country regime. For each E.U. legislative

measure, the threshold criteria for admission vary and are internally complex. The diversity and specificity of the conditions applied, combined with an almost universal requirement in these regimes for the adoption of a discretionary decision by ESMA, the European Commission and/or E.U. national competent authorities means that an application for access under a Third Country regime is often fraught with uncertainty.

- 7.5. The regimes apply, eponymously, to “Third Country” regulatory systems and firms. The U.K. and U.K. services providers will not acquire this status until the end of the two-year Article 50 notice period, which implies that the application process cannot start until the U.K. leaves the E.U. The time taken for each assessment, decision and implementing act are similarly diverse and unclear.
- 7.6. Together, these uncertainties paint a daunting picture for U.K. market participants who have been, and would like to continue, providing services into the E.U. The risk of a “cliff edge” presents a substantial danger of market disruption and of litigation in relation to legacy business.
- 7.7. The FMLC sets out, in section six, a range of short- and long-term mitigants to these uncertainties, while acknowledging that the uncertainties raised in this paper will not be easily resolved. In the short-term, the FMLC has already recommended prioritising the negotiation of transitional provisions. For the long-term, the FMLC has identified actions which financial markets participants might take themselves to ameliorate uncertainty—including “de-subsidiarisation”, establishment and authorisation in the E.U. and other sector-specific solutions—as well as mitigants which might be reflected in forthcoming negotiations between the E.U. and the U.K.—such as a bespoke FTA, an expanded equivalence model, or the development of a regime similar to the U.K.’s overseas persons exemption.

## **GLOSSARY OF TERMS**

“1997 Interpretative Communication” refers to the European Commission’s interpretative communication entitled *Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive (SEC(97) 1193)*, published in June 1997.

“2017 ESMA Opinion Paper” refers to the General Principles to Support Supervisory Convergence in the Context of the United Kingdom Withdrawing from the European Union published by the European Securities and Markets Authority in May 2017.

“AIF” means alternative investment fund.

“AIFM” means alternative investment fund manager.

“AIFMD” refers to the Directive 2011/61/EU on alternative investment fund managers.

“Benchmarks Regulation” refers to the Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds.

“Brexit” refers to the U.K.’s withdrawal from the European Union.

“BRRD” means Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms.

“Capital Requirements Directive” refers to Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

“Capital Requirements Regulation” and “CRR” refer to the Regulation 575/2013 on prudential requirements for credit institutions and investment firms.

“CRD IV Package” refers collectively to the Capital Requirements Directive, the CRR and secondary E.U. legislation implementing these measures.

“CCP” means central counterparty.

“CJEU” refers to the European Court of Justice.

“CME” means CME Group Inc. or the Chicago Mercantile Exchange, as the context requires.

“CRA Regulation” refers to the Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies.

“E.E.A.” means the European Economic Area.

“E.E.A. Agreement” refers to the Agreement on the European Economic Area, which entered



into force in 1994.

“E.U.” refers to the European Union.

“E.U. Member States” or “Member States” refers to member states of the European Union.

“EFTA” means the European Free Trade Association.

“EIOPA” is the European Insurance and Occupational Pensions Authority.

“EMIR” refers to the Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

“EMIR Review Proposal” refers to COM(2017) 331 final: Proposal for a Regulation amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs .

“ESAs” refers to the European Supervisory Authorities.

“ESMA” refers to the European Securities and Markets Authority.

“European Commission Staff Paper” refers to a European Commission Staff Working Document, entitled *E.U. Equivalence Decisions in Financial Services Policy: an Assessment*, which was published on 22 February 2017.

“European Commission” is the E.U.’s executive body.

“FATF” is the E.U.’s Financial Action Task Force.

“FCA” is the U.K.’s Financial Conduct Authority.

“FTA” refers to a free trade agreement.

“GATS” refers to the General Agreement on Trade in Services of the WTO.

“Insurance Distribution Directive” and "IDD" refer to the Directive (EU) 2016/97 on insurance distribution (recast).

“Insurance Mediation Directive” and "IMD" refer to the Directive 2002/92/EC on insurance mediation.

“IRSG Report” refers to a report entitled *The E.U.’s Third Country regimes and Alternatives to Passporting*, published in January 2017 by the International Regulatory Strategy Group in collaboration with Hogan Lovells International LLP.

“MFN” refers to the Most Favoured Nation provision of the WTO GATS which requires WTO

member countries not to discriminate between services and service providers from other WTO member countries.

“MiFID” refers to the Directive 2004/39/EC on markets in financial instruments.

“MiFID II” refers to the Directive 2014/65/EU on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

“MiFIR” refers to the Regulation (EU) No 600/2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

“MTF” refers to a multilateral trading facility within the meaning of MiFID II.

“NPPRs” means the national private placement regimes, provided for under the AIFMD.

“OECD” is the Organisation for Economic Cooperation and Development.

“OTF” refers to an organised trading facility within the meaning of MiFID II.

“PD III” refers to the Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC.

“Prospectus Directive” refers to the Directive 2001/34/EC on the prospectus to be published when securities are offered to the public or admitted to trading.

“RAO” refers to the Financial Services and Markets Act 2000 (Regulated Activities) Order (SI 2001/544).

“Recast UCITS Directive” means Directive (2009/65/EC) on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast).

“Solvency II” means the Directive 2009/138/EC (as amended by Directive 2014/51/EC) on the taking-up and pursuit of the business of insurance and reinsurance.

“Third Country” refers to a jurisdiction outside of the E.U./E.E.A.

“Third Country regimes” refers to the various provisions written into E.U. legislation which permit, under specific conditions, non-E.U. countries to provide services into the E.U.

“TEU” refers to the Treaty on European Union.

“TSC Letter” refers to a letter sent by the FMLC to the U.K. Treasury Select Committee in response to a consultation on the need and importance of transitional arrangements between the U.K. and the E.U., upon Brexit.

“UCITs” are undertakings for collective investment in transferable securities.

“UKLA” is the U.K. Listing Authority.

“WTO” refers to the World Trade Organisation.

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