



Post-Brexit: the way ahead in international capital markets

By Paul Richards

Summary

Whether there is an EU/UK agreement before the end of the year or not, passporting rights will cease when the post-Brexit transition period ends on 31 December 2020. The Single EU Market will then become two separate markets. Market firms need to be ready for the loss of passporting rights. This assessment considers the issues that arise, both for market firms based in the EU and in the UK, under six main headings: loss of passporting rights; market access; regulatory equivalence; cliff-edge risks; the need for regulatory and supervisory cooperation; and the state of market preparations.

Introduction

1 Although the UK left the EU at the end of January 2020, and has not been involved in EU decision-making since then, the other changes in EU/UK relations arising from Brexit - including changes affecting capital markets - are still to come at the end of the transition (or "implementation") period. There was provision in the EU/UK Withdrawal Agreement to extend the transition period from the end of 2020 for up to a further two years, if both sides agreed by the end of June 2020. But, as expected, the UK formally decided in June not to extend the transition period, which will therefore end on 31 December 2020.

Loss of passporting rights

2 The EU and the UK are currently negotiating a Free Trade Agreement, which they hope to agree and ratify in the EU and the UK before the end of this year. It is not yet clear whether they will succeed in reaching an agreement or not. An agreement would need to be reached well before the end of the year in order to leave time for ratification in the EU and the UK. While an agreement is likely to be

a better outcome for capital markets than no agreement, the key point for market participants is that, whether there is an EU/UK agreement before the end of the year or not, passporting rights¹ will cease when the transition period ends on 31 December 2020. The Single EU Market will then become two separate markets.²

3 The loss of passporting rights has significant implications for firms operating in capital markets across borders between the EU and the UK. Market firms need to be ready for the loss of passporting rights so as to keep to the minimum the risk of market disruption arising from the fragmentation of the Single Market into two separate markets. At the minimum, the loss of passporting rights means that market firms currently authorised to operate in the EU and the UK through one single establishment in either the EU or the UK will need to be authorised to operate in both the EU and the UK separately. Market firms have been warned by the authorities in both the EU and the UK to prepare for all eventualities, both in their capacity as market firms in their own right, but also by providing appropriate information to their clients.³ In all cases, the

1. European Commission Communication: "Currently, financial services can be provided from the UK to the EU with a single authorisation or "passport" per relevant financial services area, issued by the UK authorities. EU operators can use the "passports" of their home state to provide financial services to and in the UK. As of 1 January 2021, authorisations to provide services from the UK across the EU will stop applying.": *Getting Ready for Changes*, 9 July 2020.

2. In addition to leaving the Single Market at the end of the transition period, the UK will also leave the Customs Union and all EU international agreements. "As of 1 January 2021, the EU and the UK will be two separate regulatory and legal spaces.": European Commission Communication, *Getting Read for Changes*, 9 July 2020.

3. See, for example, ESMA: "On 1 January 2021, once the UK's transition period ends, financial market participants whose activity might be impacted should have fully implemented their preparatory measures to mitigate any risks stemming from the end of the transition period. All entities should also have provided appropriate information to their clients on any resulting consequences.": 17 July 2020.

time available to prepare has been shortened in practice by the market impact of the coronavirus (COVID-19) pandemic.

Market access

4 Once passporting rights cease at the end of the transition period, the UK is proposing to operate a Temporary Permissions Regime (TPR) and a Temporary Transitional Power (TTP):

- The TPR will allow EEA firms and funds currently using a passport to continue to operate in the UK for a maximum period of three years when passporting rights cease at the end of the transition period while they seek authorisation from the UK PRA/FCA.⁴ This is intended to help the PRA and FCA ensure a smooth and orderly authorisation process and avoid risks to financial stability.
- The TTP will in general give regulated firms relief from the end of the transition period until 31 March 2022 in order to complete preparations to implement changes in UK law arising from the end of the transition period, subject to certain exceptions where transitional relief will not be granted.

5 There is no EU equivalent to the TPR at EU level, though transitional arrangements have been made in some EU Member States.⁵ The FCA has set out the circumstances in which UK firms can undertake business in the EEA on the same legal basis as now after the end of the transition period. They include: whether an activity is covered by an EU decision on the UK's equivalence; whether an EU Member State has put in place a regime to provide continuity of business for a temporary period; whether there are local exemptions in the EEA country concerned; whether permission is given under local law or based on rules of local financial market infrastructure; and whether "reverse solicitation" is permitted without local authorisation. Otherwise, new regulatory permissions will be needed.⁶

6 Across the euro area, the ECB has recently reassessed banks' preparedness for the end of the transition period, focusing on three priorities: contingency planning to ensure banks are prepared for any stresses on funding and trading

markets; strengthening risk management and governance arrangements to support banks' ability to manage their business safely in and from the EU; and reducing remote booking of EU activities (ie back-to-back booking), so that banks retain full local oversight of the business they originate and manage. The ECB has stated that banks should relocate assets if, or once, commensurate onshore risk management capability is in place. Staff relocations can be delayed only on account of new lockdown measures or travel restrictions arising from the COVID-19 pandemic. "The ECB's expectation is very clear: all activities related to European products or European customers should, as a general principle, be managed and controlled from entities located in the EU."⁷

Regulatory equivalence

7 Until the end of the transition period, law in the UK is subject to EU law, including for new EU legislation.⁸ At the end of the transition period, outstanding EU law is due to be onshored into law in the UK. The question is what will happen after the end of the transition period, once passporting rights have ceased. The EU and the UK authorities have different views about access to cross-border financial services, following the loss of passporting rights. In a draft Treaty published in May, the UK proposed that "each party shall accord financial services and cross-border financial service suppliers treatment no less favourable than that it accords to its own like financial services and like financial service suppliers."⁹

8 The EU's approach to cross-border financial services with third countries (eg the UK) is to decide whether or not to grant regulatory equivalence. It is important to note that regulatory equivalence is a patchwork. There are provisions for equivalence in some but not all EU financial services regulations: the provisions do not cover capital markets (or financial services) as a whole. There are around 40 specific provisions which provide for equivalence in 17 EU Regulations and Directives, mostly in more recent EU legislation. Around 240 such decisions have been taken by the EU so far affecting 30 countries. Examples where equivalence has been granted include central clearing

4. See Bank of England website: "Under the TPR, a firm that is authorised to carry on regulated activities in the UK through Freedom of Establishment or Freedom of Services passporting can obtain a deemed Part 4A permission to carry on those activities for a maximum of three years from the end of the transition period, subject to HM Treasury's power to extend the duration of the regime by increments of twelve months."

5. European Commission Communication: "The provision of financial services from the UK to the EU will be possible subject to the relevant third country rules of the Member State concerned.": *Getting Ready for Changes*, 9 July 2020.

6. FCA, 3 February 2020.

7. Yves Mersch, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB: *Brexit: Banks Must Prepare for the End of the Transition Period*, 9 July 2020.

8. It is not yet clear how EU legislation "in flight" at the end of the transition period will be treated in the UK.

9. UK proposal for EU Free Trade Agreement, May 2020.

counterparties (CCPs) and central securities depositories (CSDs). In the case of investment firms, the European Commission has stated that a new and improved equivalence framework will enter into force in mid-2021 (ie six months after the end of the transition period). But there are no provisions for equivalence in insurance, commercial bank lending or deposit-taking.¹⁰

9 The determination of regulatory equivalence is not formally part of the EU/UK negotiations on a Free Trade Agreement. This is because the European Commission decides unilaterally on behalf of the EU whether to grant equivalence or not. Under the Political Declaration attached to the Withdrawal Agreement, the EU and the UK were due to complete their technical assessments of regulatory and supervisory equivalence by the end of June. The UK has completed its equivalence assessment of the EU's financial services regulatory and supervisory regime.¹¹ While the EU has been undertaking equivalence assessments of the UK's regime, the European Commission has already stated that it will not assess the UK in nine areas, including the direct provision of cross-border investment banking services, in the short or medium term.¹² Once assessments have been made, any determinations of equivalence by the European Commission are not expected to take place until later. Although determinations of equivalence are separate from the trade negotiations, they may in practice be subject to progress in the political negotiations.¹³

10 At the end of the transition period, when passporting rights cease, EU and UK rules will initially be the same. So the scope for regulatory equivalence should be considerable, unless the EU and the UK cannot agree on a level playing field intended to prevent unfair competition or on a framework for regulatory divergence later. On the first issue, the key question is whether the UK should be treated differently by the EU from other third countries because of its geographical proximity to the EU and the high degree of economic interdependence between them.

11 On the second issue, the key question is whether, once EU law has been onshored into law in the UK at the end of the transition period, the UK authorities will exercise their right for UK regulation to diverge from EU regulation in future, and if so in what way. The UK authorities have emphasised that:

- (i) the UK "cannot outsource regulation and supervision of the world's leading complex financial system to another jurisdiction";¹⁴
- (ii) the UK approach to regulation is based on common law, under which decision-making may be delegated to relevant authorities (eg the PRA and FCA), with appropriate oversight by - and accountability to - Parliament; this is different from the EU approach, which is based on civil law and involves detailed rule-making standardised across the 27 EU Member States;¹⁵ and
- (iii) the UK authorities have already proposed a number of changes in the UK to EU regulations to ensure that they work as effectively as possible in the UK context.¹⁶

12 The UK authorities have argued that regulatory divergence should not affect equivalence, as long as the EU and the UK are both seeking to achieve equivalent outcomes¹⁷ (eg ensuring financial stability, market integrity, investor and consumer protection, fair competition, and the prevention of regulatory arbitrage). In particular, the FCA has stated that equivalence assessments should be conducted on an "outcomes basis": ie that each country's rules and supervision lead to equivalent outcomes, rather than needing to be identical.¹⁸ The desired outcomes are, for example, the same when the EU and the UK are both implementing commitments made by the G20 at global level. So the question is whether the same rules are needed in practice to achieve the same outcomes. It is relevant to note that the EU has reached comprehensive agreements with other third countries (eg Canada and Japan), whose detailed rules are not the same as those of the EU.

10. European Commission Communication: *Getting Ready for Changes*, 9 July 2020.

11. Bank of England Financial Stability Report, August 2020.

12. Bank of England Financial Stability Report, August 2020.

13. Michel Barnier: "the time for decisions is in the autumn": evidence to the House of Lords EU Committee: *Financial Services After Brexit*, 27 March 2020.

14. Sir Jon Cunliffe, Deputy Governor for Financial Stability, Bank of England: *Governance of Financial Globalisation*, Berlin 11 February 2020.

15. See, for example, evidence given by the UK authorities to the House of Lords EU Committee: *Financial Services After Brexit*, 27 March 2020.

16. eg CSDR (settlement discipline provisions); SFTR (reporting by non-financial counterparties); Benchmark Regulation (wind-down of tough legacy LIBOR contracts); and PRIIPs.

17. Steven Maijoor, Chair of ESMA: "EU equivalence decisions taken in financial markets have been overwhelmingly outcome-based resulting in reliance on home country regulation and supervision.": June 2019.

18. Nausicaa Delfas, Executive Director of International, FCA: *FCA's National and International Response to Coronavirus and Brexit*, 6 May 2020.

13 Where UK regulation follows a different path from the EU, it is not yet clear whether, and if so how, the EU will respond.¹⁹ But the European Commission has already stated that, in determining equivalence, it will consider not only the position at the outset, but also intentions in future;²⁰ and it will consider equivalence in terms only of the EU's interests rather than the interests of the EU and the UK together. If, once equivalence has been granted, the Commission considers that it is no longer appropriate, the grant of equivalence can subsequently be withdrawn with a minimum of 30 days' notice: a very short time for contingency planning by market firms.²¹ Joint monitoring and arbitration to resolve disputes should in theory make it possible for both the EU and the UK to consider the regulatory consequences of divergence sufficiently in advance, but it remains to be seen whether this will be possible in practice.²²

Cliff-edge risks

14 When passporting rights cease at the end of the transition period, and where regulatory equivalence has not been granted, cliff-edge risks are likely to arise.²³ (See Box.) There are a number of points to note:

- The Bank of England's assessment is that "most risks to UK financial stability that could arise from disruption to cross-border financial services, should the transition period end without the UK and EU agreeing equivalence or other arrangements for financial services, have been mitigated. This reflects extensive preparations made by authorities and the private sector." But "further action is needed to minimise disruption to cross-border financial services in some areas."²⁴

- It is not yet clear to what extent the EU and UK authorities will agree on addressing remaining cliff-edge risks case by case, as they proposed to do in the event of "no deal" before Brexit, so as to minimise risks to financial stability arising from market disruption. As the previous agreements were conditional on "no deal" before Brexit, they will not necessarily apply at the end of the transition period unless the authorities decide that they should. But, if they did, this would reduce the risk of market disruption. It is therefore helpful that ESMA confirmed on 17 July that previously agreed MOUs with the FCA on cooperation and information exchange remain valid and will come into effect at the end of the transition period.²⁵ This should enable asset managers to continue to delegate the management of assets to the UK, at least for the time being.

- It is also important to note that "where equivalence is time-limited, the cliff is still there: it is simply further away."²⁶ So, in the European Commission's view, a time-limited decision on CCPs would allow EU-based CCPs to develop their capacity to clear relevant trades and EU clearing members to reduce their systemic exposure to UK market infrastructure. This is the only area in which the Commission has identified risks to financial stability.²⁷ As a result, on 21 September the Commission adopted a temporary equivalence decision for UK CCPs, which were recognised by ESMA on 28 September, and are regarded by ESMA as critical to the stability of the EU's financial system.
- While agreement to address cliff-edge risks is in the interests of both the EU and the UK, the outcome may depend on the political climate in which the negotiations take place.

19. In the case of the CSDR, the Commission is expected to delay the implementation of the settlement discipline provisions for a further year. In the case of the Benchmark Regulation, the Commission has proposed reforms for winding down tough legacy LIBOR contracts which are not the same as the UK.

20. "The UK Government's stated intention to diverge from the EU's regulatory and supervisory frameworks in the area of financial services after the transition period requires that the Commission assesses UK equivalence in each area on a forward-looking basis.": European Commission Communication: *Getting Ready for Changes*, 9 July 2020.

21. European Commission: "Equivalence decisions can be unilaterally withdrawn at any time, in particular if third-country frameworks diverge and the conditions for equivalence are no longer fulfilled.": Communication, *Getting Ready for Changes*, 9 July 2020. Equivalence has been withdrawn by the EU in two recent cases: equivalence for the trading of Swiss shares in the EU; and equivalence under the CRA Regulation in the cases of Australia, Brazil, Canada and Singapore.

22. Bank of England: "The UK Government has sought to include provisions for the structured withdrawal of equivalence as part of the broader FTA negotiations.": Financial Stability Report, August 2020.

23. President of the European Commission: "In case we cannot conclude an agreement by the end of 2020, we will face again a cliff-edge situation. This would clearly harm our interest, but it will impact the UK more than us.": European Parliament, 18 December 2019.

24. Bank of England Financial Stability Report, August 2020.

25. ESMA, 17 July 2020.

26. Yves Mersch, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB: *Brexit: Banks Must Prepare for the End of the Transition Period*, 9 July 2020.

27. European Commission Communication: *Getting Ready for Changes*, 9 July 2020.

Cliff-edge risks at the end of the transition period and steps to avoid them²⁸

Investment services: The EU has stated that in the short to medium term it will not assess the equivalence of the UK's regulatory and supervisory regime to its own for the purposes of MiFIR Article 47, which covers investment services.²⁹ This would have allowed for material cross-border access to investment services, reducing the residual risk of disruption.

Cleared OTC derivative contracts: The UK Government has legislated to ensure that UK businesses can continue to use clearing services provided by EU-based clearing houses. On 21 September, the European Commission adopted a temporary equivalence decision of 18 months for the regulatory framework for UK CCPs, which were recognised by ESMA on 28 September.

Non-cleared OTC derivative contracts: The UK Government has legislated to ensure that EU banks can continue to perform life-cycle events on their non-cleared derivative contracts with UK businesses after the end of the transition period. The European Commission has not reciprocated in the case of UK-based banks' contracts with EU businesses. Some EU Member States have permanent national regimes which could enable life-cycle events on certain contracts to be performed.

Banking services: The UK Government has legislated to ensure that UK households and businesses can continue to be served by EU-based banks after the end of the transition period. The EU authorities have not taken similar action. As a result, major UK-based banks are transferring their EU clients to subsidiaries in the EU so that they can continue providing services to them. All material subsidiaries are now authorised, fully operational and trading.

Asset management: Cooperation agreements between the FCA, ESMA and EU NCAs have been agreed, and the FCA and ESMA have confirmed that they will apply from the end of the transition period. This enables EU asset managers to delegate the management of their assets to the UK. The UK Government has legislated for EU asset management firms to continue operating and marketing in the UK. And to operate in the EU, the largest UK asset managers have completed their establishment of EU authorised management companies.

Insurance contracts: EIOPA has published recommendations to national authorities supporting recognition or facilitation of UK insurance companies' continued servicing of EU contracts at the end of the transition period.

Personal data: The UK Government has legislated to allow the free flow of personal data from the UK to the EU after the transition period. If the EU does not deem the UK's data regime adequate, companies can add standard contractual

clauses (SCCs) into contracts in order to comply with the EU's personal data transfer rules. UK firms are generally well advanced in implementing these clauses. In July, the EU Court of Justice ruled that the use of SCCs is a valid means of transferring personal data from the EU to non-EU countries.

Access to euro payments systems: UK firms will need to maintain access to TARGET2 to make high-value euro payments. UK banks intend to access TARGET2 through their EU branches or subsidiaries or correspondent relationships with other banks. The European Payments Council has confirmed that the UK will retain SEPA access after the end of the transition period subject to its continued compliance with the established participation criteria.

Ability of EEA firms to trade on UK trading venues: The EU and UK could deem each other's regulatory frameworks as equivalent for the purposes of relevant regulations, thereby comprehensively mitigating risks of disruption. ESMA has proposed excluding from the EU Trading Obligation EU shares which are traded on third country venues in the local currency of the third country. Absent a finding of equivalence, this would provide a partial mitigant to risks of disruption. It is unclear whether the proposal will be adopted before the end of the transition period.

Prudential requirements: UK regulators have confirmed that they will delay the application of some requirements for 15 months to end-March 2022. EU regulations will subject EU banks' and insurance companies' UK exposures to stricter capital and liquidity requirements.

Credit rating agencies: The FCA and ESMA have confirmed that their cooperation agreement will apply from the end of the transition period.

Settlement finality: Some but not all EEA countries have implemented national legislation intended to provide settlement finality protection in the event of insolvency of local firms using financial market infrastructure in non-EU countries.

Central securities depositories: The UK Government has legislated transitional provisions to allow CSDs established outside the UK to continue to provide CSD services in the UK after the transition period. But for UK CSDs to continue to provide CSD services to issuers in respect of securities issued under EU law after the end of the transition period, the UK and UK CSDs will respectively require either permanent or temporary equivalence and recognition from EU authorities.

28. Bank of England Financial Stability Report, August 2020; European Commission announcement of 21 September and ESMA announcement of 28 September on CCPs.

29. European Commission Communication: "New and improved equivalence framework for investment firms will enter into force in mid-2021": *Getting Ready for Changes*, 9 July 2020.

Regulatory and supervisory cooperation

15 Besides cliff-edge risks of market disruption arising from the need for market firms to comply with the requirements of two separate EU and UK regulatory regimes, there is an additional risk of market disruption unless regulatory and supervisory cooperation between the EU and the UK continues after passporting rights cease.³⁰ The ESMA/FCA MOU announced on 17 July should help to reduce this risk. Both the EU and the UK have shared objectives in ensuring financial stability, market integrity, investor and consumer protection, fair competition and the prevention of regulatory arbitrage. It is also important to avoid extra-territorial conflicts between them.

16 How should regulatory and supervisory cooperation work? Large EU financial institutions active in London will need to be able to reassure the UK authorities about risks they import into the UK, as the Bank of England has made clear that it is committed to maintain a level of financial sector resilience which exceeds the requirements of international standards. The EU has a similar concern to ensure as far as possible that its regulatory system is not undermined by risks affecting the EU arising from the activities of financial firms in third countries outside its control, including the UK. Where the EU considers that systemic risks are greatest, EU regulatory and supervisory oversight can be expected to be the most intense. Finally, a degree of joint supervision will also be needed in some cases (eg colleges of supervisors for the financial market infrastructure).

17 It is not yet clear from the negotiations on the proposed Free Trade Agreement whether the EU and the UK will be able to agree on a chapter on financial services.³¹ There is a case for setting out, either in the Agreement itself or in a publicly available MOU, the regulatory framework and supervisory arrangements within which both the EU and the UK will seek to cooperate in future. This should help reassure firms that EU/UK cooperation in capital markets will continue to be based on transparency, trust and mutual understanding in a predictable and sustainable way.

Preparations by capital market firms

18 Most large sell-side and buy-side market firms have prepared for the fragmentation of the Single Market into two separate markets in the EU and the UK by seeking and obtaining the necessary authorisations to operate in both the EU and the UK. In that sense, they are as well prepared as they can be, despite the impact of the COVID-19 pandemic. But firms also need to be prepared to address

any remaining cliff-edge risks across borders between the EU and the UK when passporting rights cease at the end of this year. While EU/UK negotiations may help address cliff-edge risks, they are unlikely to eliminate them altogether. It is also not clear whether smaller firms are as well prepared as larger firms. Finally, all market firms need to work closely with their clients to help ensure that they are ready in time for the end of the transition period.

ICMA's role and approach to Brexit

ICMA's role is to encourage efficient and integrated capital markets, which are necessary to support sustainable economic growth.

ICMA's approach has been to focus on the potential impact of Brexit on international capital markets, particularly the need to address and avoid cliff-edge risks which arise when passporting rights between the EU and the UK cease.

ICMA is not lobbying for any particular financial centre. ICMA's members are based in London, the EU and more broadly.

ICMA has been discussing capital market preparations for the end of the transition period after Brexit with members through its main ICMA Market Practice and Regulatory Policy Committees, including ICMA's own documentation, and reporting to the Board.

ICMA is keeping in contact with the authorities in the UK, the EU and the euro area.

ICMA is cooperating with other trade associations by sharing information, wherever possible.

ICMA is keeping members up-to-date on Brexit by giving them regular assessments through the ICMA Quarterly Report and conference calls.

ICMA is keeping its Brexit webpage up-to-date, both with its own work, and also with electronic links to key documents published by the authorities in the EU and the UK and with links to the webpages of law firms and others.

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30. See, for example, the ESMA/FCA MOU announced by ESMA on 17 July 2020: "ESMA's previously published Brexit statements, in particular ESMA's general opinion to support supervisory convergence in the context of the UK withdrawing from the EU issued on 31 May 2017 and sector-specific opinions issued on 12 July 2017, remain relevant and should continue to be followed."

31. See, for example, the EU agreements with Canada (CETA) and Japan (EPA).