MACFARLANES

POST-BREXIT REGULATORY LANDSCAPE - RADICAL DEPARTURE OR BUSINESS AS USUAL?

This article outlines possible changes to the UK financial services regulatory landscape following the UK voting to leave the European Union (EU) on 23 June 2016. We consider a number of key issues posed by Brexit to a cross-section of financial services institutions. Two key concerns are likely to be on the minds of governing bodies of UK financial services firms:

- the ability to continue to access the EU market post-Brexit; and
- the subsequent nature and intensity of post-Brexit financial services legislation.

We consider these matters through the prism of possible Brexit scenarios.

The exact shape Brexit takes will make a big difference to its practical impact on financial services firms. This is because theoretically possible outcomes range from the abolition of a significant proportion of regulation through to little practical change. However, we can identify three factors which together suggest that radical changes to the regulatory landscape may be a less likely outcome, whichever Brexit model is chosen:

- UK thought-leadership in recent EU regulatory developments;
- the international origins of post-crisis financial services legislation; and
- the need to maintain equivalent regulatory measures to allow for continued access to the EU financial services marketplace.

SOME POSSIBLE BREXIT OPTIONS

There is no single obvious Brexit model. The details of the UK's on-going relationship with the EU and its member states will only become clear following an intensive, and perhaps extended, period of negotiation. However, commonly cited Brexit models include:

- **Norway** – The UK would join the European Economic Area (EEA) and the European Free Trade Association (EFTA). It would maintain access to the single market. However, the UK would be subject to EU standards and regulation with minimal ability to influence their development.
- **Switzerland** – The UK would apply to join the EFTA and negotiate bilateral agreements governing UK access to the single market on a sector-by-sector basis. The UK would follow regulation in the covered sectors but would otherwise negotiate free trade agreements (FTAs).
- **FTA** – The UK's relationship with the EU would be governed by an FTA.
- **Turkey** – The UK would enter into a customs union with the EU. The UK would be subject to EU external tariffs.
- **World Trade Organisation (WTO)** – The UK would rely on WTO membership as the basis for its trade relationship with the EU.

IMPACT OF BREXIT ON DIFFERENT TYPES OF FINANCIAL SERVICES BUSINESS

Ultimately, the impact will be determined by the Brexit scenario adopted, with a firm-by-firm assessment of individual exposure to the EU/UK and the ability or willingness to undertake business elsewhere. We consider the possible impact on different types of business below.

Private equity

The cost of compliance with the Alternative Investment Fund Managers Directive (AIFMD) is well documented. This has been a key criticism of the current EU approach to financial services legislation.

However, the AIFMD also provides the ability for EU alternative investment fund managers (AIFMs) to market alternative investment funds (AIFs) throughout the EU. Subject to negotiations, UK AIFMs are likely to be treated as non-EU AIFMs and, therefore, only able to market AIFs to EU investors under national private placement regimes, where available. The market expects the extension of the passport to cover non-EU AIFMs domiciled in those jurisdictions, where the European Securities and Markets Authority has made an equivalence assessment. However, if the AIFMD marketing passport is extended, it is expected that non-EU AIFMs not domiciled in equivalent jurisdictions will no longer be able to market into the EU on the basis of national private placement regimes.

European investors are significant investors in UK private equity therefore equivalency is likely to be desirable.

Hedge funds and managers

The possibility of Brexit has resulted in mixed views from the hedge fund industry. The opinions of different hedge fund managers are, to some extent, dependent on the breakdown of EU clients and the focus of some funds on other geographical locations, for example, the US or Asian markets.

On completing Brexit, and prior to the expected introduction of the passport for non-EU AIFMs, UK-based hedge funds would only be able to passport their funds into the EU by utilising national private placement regimes. This would be subject to any other re-negotiation by the UK.

The hedge fund industry has been subject to a raft of post-crisis regulatory developments, including the European Markets Infrastructure Regulation (EMIR) with respect to derivatives trading. However, EMIR implemented the G20's 2009 commitment to reform the derivatives market and the UK will remain subject to those commitments. It is therefore likely that the UK regulators will not adopt a (fundamentally) different regulatory approach post-Brexit, irrespective of the Brexit model adopted.

UCITS funds and managers

Brexit may have a material impact on UK-domiciled UCITS. UCITS funds must be EU domiciled and self-managed or managed by an EU management company. This means that there is a material risk that many of the benefits of the UCITS regime could be lost to UK funds and managers post-Brexit, whichever model is chosen.

As a result, (subject to the terms of any negotiation) UK UCITS funds or management companies would have to re-locate to another EU state or cease being a UCITS. UK UCITS managers may have to adopt a similar structure to US UCITS managers (delegated managers of EU domiciled funds, often established in Luxembourg or Ireland). This would involve additional cost and administrative burden.

Banks

Banks can provide services and products to the EU from the UK under a European regulatory passport. For example, a US bank can access the EU from a subsidiary established in the UK. The UK would be unlikely to retain the same passporting rights, forcing banks to relocate some or all of their operations to the EU. Even if the UK successfully negotiates an ability for its banks to use EU passporting rights following Brexit, the initial uncertainty may mean that a number of international banks relocate elsewhere in the EU before that outcome is achieved.

Some domestic banks might view the loss of passporting rights as a corollary to reduced regulation. However, it is by no means clear whether Brexit will actually result in a reduced regulatory burden for domestic banks. After the financial crisis, a large degree of financial services regulation was imposed on the banking industry, of both domestic and European origin. Nevertheless, even in areas where the UK regulators have actively opposed European regulatory developments, for example, in the area of remuneration, the UK may need to maintain equivalent regulation post-Brexit. This is because the EU would require the UK to pass an equivalence assessment before it would be willing to allow anything close to free access to EU financial services markets. Both the Norway and Switzerland Brexit models in practice require these countries to adhere to many EU-imposed standards.

Insurance

Many insurers utilise the passporting system, allowing the establishment of branches in other EU member states. Insurance brokers can also operate throughout the EU on the basis of passports and home state prudential supervision. This means that UK insurers risk losing their existing levels of access to the EU market. A Norway or Switzerland Brexit model might allow the UK to regain some of this access, however.

The key EU regulation affecting insurers is Solvency II. However, the UK regulators have supported and developed the Solvency II requirements, although they have criticised elements of its implementation. Therefore, it is far from clear that Brexit would reduce insurers' regulatory burdens.

Market infrastructure

Market infrastructure is of fundamental importance to the operation of the financial services industry. Under MiFID, EU member states are required to permit investment firms from other member states to access regulated markets.

Under EMIR, central counterparties (CCPs) authorised in an EU member state are treated as authorised across the EU. Post-Brexit, UK CCPs are likely to require "recognition" under EMIR. This may add additional administrative burden without resulting in significantly different regulatory obligations.

Family offices

Some regulated family offices rely on the ability to provide services throughout the EU under the regulatory "passporting" system (under MiFID). As with the other passporting regimes, this ability would be lost subject to negotiations between the UK and the EU.

WHAT KEY ISSUES UNDERPIN THESE CONCERNS?

In our view, two key issues underpin the potential outcomes for the different businesses discussed above:

- **Access to the EU** – The need to continue to access the EU is key for many financial institutions in post-Brexit negotiations. The ability to achieve this goal varies between the different Brexit models.

- **The nature and intensity of post-Brexit financial services regulation** – The extent to which the UK regulators will continue to apply post-crisis regulatory developments is unclear. The UK might need to apply those regulations in order to gain access to favourable trading terms with the EU (like Norway and Switzerland). Alternatively, the UK might choose to apply those requirements as a result of domestic political pressures. In that context, it is important to note that the UK has actually been at the forefront of many regulatory developments in Europe, although it has also opposed some developments.

HOW DOES EACH BREXIT OPTION ADDRESS THE KEY ISSUES?

Norway

- **Access to the EU** – As a member of the EEA, there would be free movement of goods, services, capital and people. However, the UK's ability to input into decision-making would be reduced and full access to the UCITS system would not be available.

- **The nature and intensity of current EU legislation** – UK regulators would lose the ability to directly influence EU regulatory developments. They would not have been able to temper any perceived regulatory excess in the post-crisis era.

Switzerland

- **Access to the EU** – It is important to note that Switzerland and the EU have not reached a comprehensive agreement governing the provision of services. The EU is under no obligation to provide the UK with access to the single market. However, Switzerland has succeeded in gaining partial access to the EU financial services market through bilateral treaties. To gain this access, Switzerland agreed to comply with a number of EU-imposed standards.

- **The nature and intensity of current EU legislation** – The UK would, in theory, have the flexibility to "opt-in" to legislative measures in which it wanted to participate. However, in practice, in order to access the EU the UK would have to undergo equivalency assessments.

FTA

- **Access to the EU** – An FTA could potentially cover both goods and services, for example, the EU's FTA with the EFTA. However, such agreements in financial services historically have proven difficult. This is because the respective parties to the agreement would need to deem the other party's financial services regime equivalent.

- **The nature and intensity of current EU legislation** – In order to access the EU, the UK would need to comply with the EU single market regulations. Therefore, the UK's regulatory obligations would remain similar but it would lose the ability to input into decision-making on new EU regulations.

Turkey

- **Access to the EU** – A customs union does not extend to services. The UK would not be part of the single market for services. The Turkey Brexit model (unless amended) would not provide the UK with preferential access to the EU financial services market. The UK, therefore, would be in a similar position to countries like the USA or Singapore when providing financial services into the EU.

- **The nature and intensity of current EU legislation** – UK regulators would not have the ability to directly influence EU regulatory developments and the UK would not be subject to those developments.

WTO

- **Access to the EU** – The UK would be subject to WTO rules on the trade of services between WTO members. Such rules are less developed than current EU rules on the trade in services. The UK may nevertheless be able to negotiate an FTA with the EU.

- **The nature and intensity of current EU legislation** – UK regulators would not have the ability to directly influence EU regulatory developments and would not be subject to those developments.

IS THE UK REGULATORY LANDSCAPE ULTIMATELY LIKELY TO UNDERGO RADICAL CHANGES?

Given the current lack of detail about which Brexit model the UK might choose to pursue, (almost) anything is technically possible. However, the three factors below may together make radical regulatory change a less likely outcome:

- **UK thought-leadership** – Although in some contexts the presence of the UK regulator in EU regulatory debates has (arguably) tempered the perceived excesses of certain developments, the UK has been a driving force behind some other developments. It is unlikely that the role of the FCA or PRA post-Brexit would substantially change irrespective of the Brexit model adopted. Indeed, the choice of a "twin peaks" regulatory system with two regulators was itself a purely domestic UK decision.

- **International nature of regulatory developments** – Financial services regulation is not unique to the EU. Post-crisis financial services regulation often stems from commitments at an international level. For example, much of EMIR originates from the G20 commitments made in Pittsburgh in September 2009. The UK is still bound by its international commitments.

- **Equivalency decisions** – As discussed above, firms with UK/EU exposure will want to continue to access the single market. In practice, this will necessitate equivalency decisions between the UK and EU. Therefore, the UK may need to agree to apply much EU regulation to allow its financial services firms to access the EU market.

WHAT ARE THE NEXT STEPS?

The EU treaties state that the UK has to formally notify the European Council of the decision to leave the EU. The UK and the EU will enter into an intensive period of negotiation to agree the UK's withdrawal. A qualified majority of the Council of Ministers, having received the consent of the European Parliament, could adopt the agreement within two years. The negotiation period may be extended by a further two years or the UK leaves the EU and loses all associated benefits.

CONTACT DETAILS
If you would like further information or specific advice please contact:

PAUL ELLISON
PARTNER
FINANCIAL SERVICES REGULATION
DD +44 (0)20 7849 2744
paul.ellison@macfarlanes.com

JUNE 2016

MACFARLANES LLP
20 CURSITOR STREET LONDON EC4A 1LT
T +44 (0)20 7831 9222 F +44 (0)20 7831 9607 DX 138 Chancery Lane www.macfarlanes.com

This note is intended to provide general information about some recent and anticipated developments which may be of interest.
It is not intended to be comprehensive nor to provide any specific legal advice and should not be acted or relied upon as doing so. Professional advice appropriate to the specific situation should always be obtained.

Macfarlanes LLP is a limited liability partnership registered in England with number OC334406. Its registered office and principal place of business are at 20 Cursitor Street, London EC4A 1LT.
The firm is not authorised under the Financial Services and Markets Act 2000, but is able in certain circumstances to offer a limited range of investment services to clients because it is authorised and regulated by the Solicitors Regulation Authority.
It can provide these investment services if they are an incidental part of the professional services it has been engaged to provide. © Macfarlanes June 2016