

# COMMERCIAL BAR ASSOCIATION

## BREXIT REPORT

### FINANCIAL SERVICES SUB-GROUP

#### COMBAR Brexit papers

*Members of COMBAR are leading specialists in many of the areas of commercial legal practice that will or may be impacted by Brexit. A series of detailed papers explaining the potential effect of Brexit on these areas of practice have been produced by teams of COMBAR members, in some cases working with non-COMBAR specialists including solicitors, academics and retired judges in the following areas:*

- 1. Conflicts of Laws, Jurisdiction, Choice of Court Agreements, Choice of Law, Service of Legal Process and Judicial Assistance in Taking of Evidence.*
- 2. Banking.*
- 3. Financial Services.*
- 4. International Arbitration.*
- 5. Competition.*

*These papers were recently submitted to the Ministry of Justice following a meeting with the Lord Chancellor in December attended by a number of members of the COMBAR Brexit Committee. They are now being made available on the COMBAR website. Anyone is welcome to read them and to disseminate them on the understanding that, in doing so, the fact that they were produced by COMBAR will be acknowledged.*

*A second tranche of papers on other areas of legal practice affected by Brexit will be provided in the near future.*

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**AUTHORS / CONTRIBUTORS**

**Andrew Spink QC (joint Chair)**, Outer Temple Chambers

**Javan Herberg QC (joint Chair)**, Blackstone Chambers

**Andrew Henshaw QC**, Brick Court Chambers

**Deborah Sabalot**, Solicitor, Editor Butterworths *Securities and Financial Services Law Handbook and*  
Outer Temple Chambers Professional Associate

**Peter Dodge**, Radcliffe Chambers

**Saima Hanif**, 39 Essex Chambers

**Harris Bor**, 20 Essex Street

**Oliver Assersohn**, Outer Temple Chambers

**Farhaz Khan**, Outer Temple Chambers

**Miranda De Savorgnani**, Outer Temple Chambers

**Robert Purves**, 3VB

**Niamh Cleary**, Fountain Court Chambers

**Oliver Hyams**, Lamb Chambers

**Sarah Bousfield**, 39 Essex Chambers



## INTRODUCTION AND OVERVIEW

### A. The UK financial services sector

1. The outcome of the EU referendum and its consequences will have significant and far-reaching effects on the political, economic, social and legal development of the UK and will be critical to the future of domestic and international financial services of a United Kingdom outside the EU.
2. According to a recent House of Lords report on Brexit and its effect on financial services<sup>1</sup> the UK is the world's largest exporter of financial services and insurance and the UK financial services industry constitutes around 7% of UK gross domestic product, contributing a significant proportion of overall direct and indirect tax revenue and directly employs 1.1 million people, two-thirds of them outside London. In addition, related professional services involve over 314,000 professionals employed in legal services as well as some 483,000 in management consultancy and 391,000 in accounting services. Industry sources have estimated that the sector produces annual financial revenues at around £200 billion, £90–95 billion of which is domestic business, £40–50 billion relates to the EU, and £55–65 billion relates to the rest of the world.
3. The UK financial services sector is also important to Europe and industry research suggests that £40–50 billion of UK financial services revenues relate to the EU and that there was a trade surplus for financial services in the order of £19 billion for 2014. These numbers underline the importance of EU markets to the UK industry but also the extent to which the EU relies on the services provided by the UK.

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<sup>1</sup> <http://www.publications.parliament.uk/pa/ld201617/ldselect/ldecom/81/81.pdf>

4. The UK has traditionally had a strong but not always harmonious relationship with Europe and Brexit presents unique challenges in changing the legislative and regulatory framework to which we have all become very accustomed.

## **B. The legislative architecture**

5. The Financial Services and Markets Act 2000 (FSMA or the Act)<sup>2</sup> is the cornerstone of financial services regulation in the UK. It provides the framework for regulation of the industry and contains provisions regarding the powers (including rulemaking powers) and responsibilities of the regulators, the authorisation and regulation of firms (including changes of control of authorised firms) carrying on certain specified activities including banking (deposit taking), insurance, consumer credit activities and regulated mortgage activities as well as provisions relating to the constitution of a compensation scheme and an ombudsman scheme for certain investors. It also includes provisions relating to the issuing of prospectuses and the listing of certain securities, the prohibition of activities constituting market abuse and the regulation of collective investment schemes.
6. This piece of legislation has, however, been used as a general dumping ground for an increasingly wide range of additional activities including regulated mortgages, consumer credit, high interest lending broadening the scope of regulated financial services activities and to transpose a number of EU Single Market Directive including:
  - Alternative Investment Fund Managers Directive (AIFMD)
  - Insurance Mediation Directive (IMD)
  - Markets in Financial Instruments Directive (MiFID)
  - Mortgage Credit Directive (MCD)

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<sup>2</sup> 2000, c. 8.

- Payment Services Directive (PSD)
  - UCITS Directive (UCITS)
  - Electronic Money Directive (EMD)
  - Capital Requirements Directive (CRD)
  - Solvency II Directive (Solvency II)
7. Other key EU directives include the Market Abuse Directive, the Prospectus Directive and others relating to the fundamental “plumbing” of financial services such as the Settlement Finality Directive and the Financial Collateral Directive. These EU requirements have been woven into the very fabric of UK law and regulation and their future post-Brexit remains unclear.
8. This interlacing of UK and European requirements can be demonstrated by the UK’s transposition of MiFID. FSMA defines regulated activities as those falling within Section 22 and Schedule 2 of the Act augmented by the provisions of the Financial Services and Markets Act 2000 (Regulated Activities) Order. Rather than aligning the definition of investment services and activities as set out in MiFID with the definition of investment activities set out in FSMA, HMT chose to adopt a modification approach. In order to bring the scope of FSMA into line with the scope of MiFID, the RAO contains a provision known as the “MiFID override”. Article 4(4) of the revised RAO provides that where an investment firm or credit institution subject to MiFID provides or performs investment services and activities on a professional basis and in doing so would be treated as carrying on an activity of a kind specified by a provision of this Part but for an exclusion in any of Articles 15, 16, 19, 22, 23, 29, 38, 67, 68, 69, 70 and 72E, that exclusion is to be disregarded and, accordingly, the investment firm or credit institution is to be treated as carrying on a regulated activity. This method arguably plugs any underlaps between UK legislation and the EU requirements by incorporating those investment activities and services defined in EU legislation by inference but it also leaves UK legislation linked to and heavily



dependent upon EU legislation and interpretation. De-coupling these provisions will be challenging.

9. Many UK laws also make references to EU agencies and institutions such as the European Supervisory Authorities setting standards or performing functions in relation to EU and UK law. Those roles such as the recognition of credit rating agencies by ESMA would presumably have to be taken back into the UK's regulatory framework assuming that the UK decides to implement this G20 commitment in its national law.

### **C. Business as usual**

10. Until such time as the UK Government invokes the Article 50 provision of the Treaty for the European Union (TEU) the FCA has made it clear that currently applicable financial regulation continues to apply until any changes are made by Government or Parliament. The FCA statement said "*Firms must continue to abide by their obligations under UK law, including those derived from EU law and continue with implementation plans for legislation that is still to come into effect*" and it has sought to reassure consumers that their rights and protections are unaffected by the result of the Referendum.<sup>3</sup>
11. John Redwood, MP, a long-time Eurosceptic and Leave campaigner, and others of that persuasion have argued that the legislative situation can simply be resolved by Parliament repealing the European Communities Act 1972 (ECA) which, they postulate, would have the effect of ending UK membership of the EU (and putting the UK in breach of its EU and international treaty obligations) and transferring all current EU law into UK law pending review and amendment<sup>4</sup>. Alternatively, Prime Minister Theresa May in setting out the Government's plans for a 'Great Repeal Bill' in October 2016 indicated they too would be based on the repeal of the ECA but only with effect from the

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<sup>3</sup><https://www.fca.org.uk/news/statements/statement-european-union-referendum-result>.

<sup>4</sup> <http://johnredwoodsdiary.com/2016/07/02/a-guide-to-getting-out-of-the-eu-we-have-a-plan/>

completion of the Brexit negotiations<sup>5</sup>. This Bill would also incorporate current applicable EU law into an Act of Parliament making these EU provisions UK law and then allow the Government to decide if and when to repeal, amend or retain individual measures in the future following Brexit.

12. Neither of these approaches arguably takes into account the impact of direct regulation through EU Implementing Regulations and Regulatory Technical Standards (RTSs). Post-Lisbon Treaty the emphasis in European financial services regulation has been on greater harmonisation and a new role for the European Supervisory Authorities (ESAs) through the use of implementing regulations and directly applicable regulatory technical standards (RTS). These RTSs apply directly to authorised firms without further legislation required by national authorities but presumably on the day these EU requirements will cease to have effect. It would be necessary to consider whether and how to incorporate these requirements into UK law and regulation in order to maintain parity with the EU requirements or to accept that the UK will go its own way and look for its own regulatory solutions.
13. Section 2(2) of the ECA at present applies to measures of EU law that are neither directly applicable nor have direct effect, and makes it possible to give effect in national law to such measures by secondary, or delegated, legislation, such as statutory instruments. Section 2(1) of the ECA currently provides that provisions of EU law that are directly applicable or have direct effect, such as EU Regulations or certain articles of the EU Treaties, apply automatically 'without further enactment' so as to be incorporated and binding in national law without the need for further UK legislation. Presumably neither the Redwood proposition nor the 'Great Repeal Bill' would repeal EU law which has already become part of UK law due to primary legislation (such as the Consumer Protection Act 1987), which would remain in force, although could be repealed or amended by Parliament at some future date.

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<sup>5</sup> <http://www.independent.co.uk/news/uk/politics/great-repeal-bill-brexit-law-eu-law-theresa-may-david-davis-a7343256.html>

14. Another mechanism which could be used for extricating some (but not necessarily all) EU provisions would be the use of a so-called Henry VIII clause. FSMA<sup>6</sup> (and other legislation) contains a provision which allows the primary legislation to be amended by the Treasury by statutory instrument which could be translated into an executive fiat without or with limited Parliamentary control over those statutory instruments. It is likely that there would be debate if not some controversy about the appropriateness of using this approach to introduce such extensive and substantive changes as would be required in this situation but it does at least arguably provide the Government with a means to amend primary legislation without having to go through the legislative process.

#### **D. Transitional provisions**

15. Given the Government's proposed timing of the Art. 50 procedure - giving notice by the end of March 2017<sup>78</sup> - the full panoply of European regulation will continue to apply to the UK and UK firms until the date on which the TEU ceases to have effect - either two years from the date on which Art. 50 is invoked or three years subject to the agreement of the EU members.
16. This period is extremely short in terms of the industry preparing and, if necessary, modifying their business models to meet the new reality and putting those arrangements in place. The banking industry in the UK has already proposed a five year transitional period and the House of Lords Committee report recommends a longer period of transition appropriate to the industry in order to achieve a considered and orderly transition and to avoid the "cliff-edge" which would potentially impact the UK's financial stability in the short and medium term<sup>9</sup>.

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<sup>6</sup> FSMA, s. 426.

<sup>7</sup> <http://www.bbc.com/news/uk-politics-37532364>

<sup>88</sup> <https://www.ft.com/content/fbe3b3c0-7b6b-11e6-ae24-f193b105145e>

<sup>9</sup>

[http://www.publications.parliament.uk/pa/ld201617/ldselect/ldcom/81/8108.htm#\\_idTextAncHor055](http://www.publications.parliament.uk/pa/ld201617/ldselect/ldcom/81/8108.htm#_idTextAncHor055), Chapter 5, para. 96-110.

### **E. Splitting domestic and wholesale financial services**

17. Another opportunity which Brexit potentially presents is if the UK could adopt a more clear-cut two part approach by differentiating between the regulatory frameworks for the retail and wholesale markets. This “twin peaks” approach was much in favour with the Government and UK regulators in the 1990’s but fashions changed. This new theory suggests that there are still two very different markets at work – retail financial services and wholesale financial services - and that a regulatory regime which tries to be “all things to all men” is no longer appropriate<sup>10</sup>.
18. The concept has been modified somewhat to fit the new model of separate conduct and prudential regulation. However, moving away from an EU mandated framework could allow the UK to take further the bifurcation of regulation into a consumer market regulator and a wholesale market regulator. Such an approach would be consistent with the direction of movement of the Government’s towards the empowerment of the Bank of England as a direct regulator, but could potentially compromise the independence of the Bank in its role as central banker. It also might raise issues with the EU authorities in terms of the recognition of UK equivalence for the purposes of third country status.

### **F. A London International Financial Centre**

19. There has also been some discussion as to whether the UK could create an “international financial centre” or “free trade zone” similar to those created in Malta, Dubai, Abu Dhabi, Bahrain and others with separate legal and regulatory systems within another sovereign state. If anything, the City of London Corporation stands as a precedent for an enclave within a larger legal and regulatory framework. How this model would operate under MiFID II’s third

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<sup>10</sup> <https://www.ft.com/content/32ebdd78-97bf-11e2-97e0-00144feabdc0>

country regime would have to be explored, but it might offer some solution to the industry, which wishes to retain the benefits of the Single Market, without the UK having to accept the wider political issues regarding freedom of movement.

### **G. An uncertain future**

20. Both the industry and the House of Lords Committee have expressed their concerns that the absence of clarity over the future relationship will lead to firms pre-empting the final outcome by relocating or restructuring, including establishing subsidiaries or transferring staff, even though such changes may ultimately prove to be unnecessary. Uncertainty has been expressed as the greatest risk of the Brexit process and this is a theme which receives much emphasis, not only in the individual Chapters of this Report which follow, but in the Reports prepared by the other COMBAR Brexit sub-groups. In these circumstances, it is vital that the Government works very speedily and closely with the different sectors of the financial services industry to provide some degree of certainty in order to remove or at least substantially mitigate this very pressing and substantial risk.

## **CHAPTER 1 - THE PASSPORTING AND EQUIVALENCE REGIMES: GENERAL CONCEPTS AND OPERATION**

### **A. The EEA passporting regime**

1. Passporting (also known as a single market passport, or single licence) enables the free movement and establishment of services in the financial sector in the European Economic Area (“EEA”). It allows financial institutions authorised to carry out certain activities in one EEA state to carry on the same activities in any of the other EEA states either remotely (such as via post, telephone or internet) or via a branch office without the need to seek additional authorisation in the host state. Passporting is based on mutual recognition across the EEA of national authorisations to carry out financial services as well as minimum prudential requirements harmonised at the EU level. To date, there has been no precedent permitting passporting rights without either full membership of the EU or acceptance of all relevant EU rules and regulations (the EEA model). The EU passport has not been made available to institutions located in third countries.
2. The passporting regime applies to most regulated activities carried out by a wide range of financial institutions, including banks, mortgage brokers, investment firms, insurers, payment and electronic money institutions, alternative investment fund managers (AIFMs) and UCITS management companies.<sup>11</sup> The passporting system saves EEA firms the otherwise significant administrative and cost burdens (including the need to satisfy ongoing capital requirements) in each EEA state where they operate and has effectively developed a single market in financial services. In the UK, nearly 6,000 UK firms benefit from passporting to the EEA while over 8,000 EEA firms use their passporting rights in the UK. In addition to obtaining authorisation to carry out financial services activities in at least one EEA country, financial institutions must still abide by local conduct of

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<sup>11</sup> Consumer credit is a notable exclusion from the passporting regime.

business and financial promotion rules in any country where they have established a branch.

## **B. Third country equivalence regimes**

3. There is a limited passporting-type regime available for financial institutions from countries outside the EEA, referred to as “third country equivalence”, but it operates on a much more piecemeal basis. The fundamental difference between the regimes is that, while the EEA regime is based on the presumption that EEA authorisation standards are equivalent, under the third country regime, the EU must assess substantively whether the third country’s regulatory regime in relation to a particular sector is of an equivalent standard to that of the EU. Equivalence decisions take the form of legally binding implementing or delegated acts, in accordance with what is envisaged in the corresponding equivalence provision.
4. Third country equivalence can only be requested by third countries where such a regime is explicitly provided for in EU legislation. This is currently limited to a narrow range of financial services activities covered by the Markets in Financial Instruments II Directive (which will apply from 2018), the Alternative Investment Fund Managers Directive (AIFMD), the Solvency II Directive (in relation to reinsurers), and the European Market Infrastructure Regulation (EMIR) (in relation to central clearing counterparties (CCPs)). A notable gap in the equivalence regime is the banking sector, which benefits from no passport-type equivalence. Furthermore, even where third country passporting is allowed, it applies only to financial services offered to “per se professional clients” and eligible counterparties and excludes retail or high-net-worth individuals or local authorities. Finally, third country equivalence is significantly more complicated to obtain, and it may be withdrawn with 30 days’ notice, although there is no precedent to date of such withdrawal.

5. Apart from third country passporting, there are also other types of equivalence clauses in EU legislation which serve other limited purposes (e.g. in relation to risk-weights to be applied by EU financial institutions to exposures to third-country firms for the calculation of prudential ratios under the Capital Requirements Directive (CRD IV)), but they are irrelevant in terms of EEA market access for third country firms.
6. In financial services, the technical assessment of whether a third country's regulatory regime is equivalent is usually made by the European Commission (the Commission) (DG FISMA), based on advice from the European Supervisory Authorities (ESAs), that is the European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Banking Authority (EBA), on how the third country's laws and regulations compare to the corresponding EU requirements.
7. Assessments usually entail a close exchange with the third country assessed. The timeline for equivalence decisions varies across cases as the Commission is under no specific obligation to decide within a specific timeframe. By way of example, EMIR entered into force in August 2012, but the Commission took nearly 4 years to assess the equivalence regime of US CCPs before taking its decision in March 2016. Part of the reason for this is the size of the US market and the wide-ranging implications of the decision.
8. Before an equivalence decision is confirmed, the Commission's proposed decision is subject to the EU legislative process for an implementing or delegated act, whereby a qualified majority of the EU27 Member State governments must vote in favour of it. An equivalence determination may be "conditional" rather than full, and it may be "temporary" where progress is being made towards equivalence. The relevant ESA and the Commission consider a number of factors when determining whether a third country regime is equivalent, including:



- a. whether the regime is broadly similar to that of the EU and is applied consistently;
  - b. whether the regime adequately implements internationally agreed standards, such as those reflecting G20 initiatives;
  - c. whether the regime allows EEA financial institutions access to the third country's markets (i.e. reciprocity); and
  - d. whether the regime contains obstacles relating to investor protection, market disruption, competition and the monitoring of systemic risk.
9. To date, 33 third countries including the US, Canada, Japan, Bermuda, Mexico, Switzerland, Hong Kong and Singapore, have been granted at least one equivalence determination. However, full third country passporting-type equivalence has thus far been limited to a narrow range of range of activities, including reinsurance or derivatives clearing.
10. The COMBAR Brexit Report, of which this forms Chapter 1, addresses specific issues concerned with passporting and equivalence in the context of particular areas of financial services in Chapters 2 to 9 below<sup>12</sup>. This Chapter sets out more general thoughts on the impacts and challenges of forms of “soft” and “hard” Brexit on passporting and equivalence regimes. We also raise the possibility of a more tailored regime.

### **C. Impact of a “soft” Brexit**

11. There would, in general terms, be very limited practical impact on financial services firms if the UK left the EU but remained a member of the EEA and joined

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<sup>12</sup> Chapter 2 - Under MiFID / MiFID II / MiFIR; Chapter 3 - Insurers, life offices and pure reinsurers under Solvency II Directive; Chapter 4 - Business Transfers under FSMA; Chapter 5 - Funds under the AIFM Directive; Chapter 6 - CRD IV; Chapter 7 - Central counterparties and trade repositories under EMIR; Chapter 8 - Payment Services Directive; Chapter 9 - Mortgage Brokers under the Mortgage Credit Directive.

EFTA.<sup>13</sup> This is because the EEA Agreement is based on the principle that all the EU legislation that is relevant to it should be implemented by EEA members. Therefore, the UK would continue to be bound by existing and future EU legislation, although it would have a limited say in what future legislation came into force.

12. There would be some additional practical changes for the UK. As a member of EFTA, judicial control over passporting rights extended to the UK would be exerted by the European Free Trade Area (EFTA) Court. The UK would also continue to contribute to the EU's operational costs. In 2015, the total contribution of the EFTA members (including Norway, Liechtenstein, Iceland and Switzerland) to the EU amounted to EUR 421 million, an increase by EUR 30 million compared to 2014. In any event, the UK's personal contribution would be significantly less than it is at present.

#### **D. Impact of a "hard" Brexit**

13. *Prima facie*, a "hard" Brexit for the UK means that it would become a "third country" for the purposes of EU legislation and financial services passporting. It would be able to request third country equivalence for certain financial activities, but in many areas, financial institutions established in the UK would need to file for authorisation by the competent supervisor in each EEA state where they planned to operate or, alternatively, relocate to another EEA state, from whence they could obtain authorisation and continue to benefit from a passport to market financial services throughout the EEA.
14. In these circumstances, the various options to preserve the benefit of market access to EEA financial services market should be thoroughly canvassed. The FCA, in a letter to the Treasury Committee in August 2016, set out its view of what an optimal future framework for financial services would look like. The

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<sup>13</sup> Complications would arise if the UK were to remain in the EEA but were not able to join EFTA. Such complications are outside the scope of this paper.

FCA outlined five broad principles which in its view should form the basis of negotiations:

- **Cross-border market access**, in particular with regard to the wholesale and insurance business;
- **Support for the principle of consistent global standards where markets are global** in order to minimise regulatory arbitrage and fragmented markets;
- **Cooperation between regulatory authorities** to ensure that regulatory standards and outcomes are met and enforced;
- **Influence over standards** in order to ensure that consumers are protected and markets are competitive and well-functioning;
- **Opportunity to recruit and maintain a skilled workforce**, implying some form of free movement of people.

15. It also outlined some of the advantages that operating outside the EU might give, including:

- the ability to deny access to inadequately vetted and capitalised EU firms such as in relation to the marketing of swaps;
- greater flexibility to set rules that are specifically designed for the domestic market and consumers, in comparison to EU rules which are often the product of compromise between widely varying practices across the EU.

16. Various representatives from the financial services industry have also issued “wish lists” to the UK government, which include desirables such as:

- securing a regulatory environment that is appropriate for the UK market;
- retaining the ability to passport out of, and into, the UK;

- mutual recognition of UK and EU data protection regimes as adequate for cross-border data transfer;
- establishment of regulatory co-operation mechanisms, especially for prudential supervision;
- strong focus on regulatory dialogue and international agreements in overseas financial services markets, especially in India and China.

### **E. Expanded third country equivalence?**

17. Aside from the option of remaining a EEA state and joining EFTA, the most straightforward way of preserving existing passporting rights would result from the UK firms having the ability to obtain third country passports in sectors where they are available, and extending the third country passport regime to cover other sectors of financial services. Both elements would obviously require the EU's agreement.
18. As for the existing third party regimes, one would expect the process of obtaining third country equivalence in all the areas where it is currently available to be in principle a straightforward process for the UK, given that it has already implemented EU financial services legislation as a member of the EU. In practice, however, the process is likely to be lengthy and subject to political considerations. And although the Court of Justice of the EU (CJEU) has jurisdiction over acts of the Commission and EU Member States including the legality of equivalence decisions, it would not have competence to review any 'inaction' by the Commission where it is under no obligation to grant equivalence.
19. A further relevant consideration is that, even where equivalence is granted, the obligation of continuing equivalence is ongoing. Therefore, when future changes are made to EU regulation, the UK would either have to incorporate them or would be required to show that similar outcomes are nevertheless achieved by

existing UK regulation. This would require that the UK would, over the long term, have to align its regulatory regime closely with that of the EU - without any formal involvement in the EU legislative process.

20. Most important of all, unless the EU could be persuaded to extend third party passports to the rest of the financial services industry, the third country passports would not be relevant to a large proportion of the UK's financial services sector. Given that, historically, the UK has been at the forefront of extending third party regimes, traditionally conservative EU member states such as Germany and France may block efforts to extend the regime further.

#### **F. Bespoke bilateral agreements?**

21. A possible alternative approach would be to seek to negotiate one or more bespoke trade agreements with the EU that would address reciprocal market access for UK and EEA firms across the financial services sector, subject of course to the appetite of EU Member States to countenance such side agreements in the absence of a collective solution to Brexit at an EU level. This approach would in theory give more flexibility to the parties to negotiate preferential terms for the UK, as opposed to the EU having to extend equivalence for all third countries. However, if some form of continued passporting rights is envisaged, the UK would undoubtedly be obliged to maintain an equivalent regulatory framework to that of the EU. Further, it is likely that negotiating the detail of such trade agreements would be lengthy, complex and the final outcome uncertain given that they are without current precedent and the outcome of each negotiation would depend to some extent on individual factors applying specifically to each of the particular areas of market activity to which the proposed agreement would apply.
22. In practical terms, such an arrangement could take various forms, building on a relationship similar to that of the EEA, one similar to the Swiss relationship with

the EU, or the World Trade Organisation (WTO) framework for international trade (considered under 'Extra-EU frameworks' below).

23. An EEA-style agreement would be likely to represent the closest level of integration and would guarantee continued access to the single market. It might also be likely to involve the least uncertainty and the lowest transitional costs, given that it would be based upon the precedent of an existing relationship. It might also be thought to be, potentially, the quickest option to negotiate compared with a more novel form of bilateral agreement, although this would be highly dependant on whether, as a matter of principle, the EU would have the appetite or regard itself as having sufficient incentive to approach the negotiations on this kind of basis at all and, even then, the fact that the aim would be and to seek to address all or most areas of market activity within the same agreement which might of itself give rise to additional negotiating complexity. Whilst this remains speculation ahead of any negotiations, if adopted, such an approach might lead to a watered down version of EEA/EFTA membership. As such, it would be likely to require EU budget contributions and some level of free movement of people. In theory, a bespoke agreement might enable a greater level of involvement by the UK in the making of EU financial regulation than that currently available to EFTA countries.
24. A Swiss-style agreement would consist of single market access negotiated separately for individual sectors on a bilateral basis. It might be thought likely that this would take the longest time to negotiate, because of the number of different individual agreements required, and could be more disruptive in the short-term.
25. A possible third way could be third country equivalence where it is available, topped up by negotiated bilateral agreements where it is not available to preserve existing passports. The bespoke agreements with Switzerland in specific sectors could serve as precedents.

## G. Extra-EU frameworks?

26. In general, cross-border trade in financial services is covered by bilateral and multilateral trade agreements, which deal principally with issues of market access and non-discrimination. Both the UK and the EU are members of the WTO. Therefore, if the UK and the EU did not reach some form of bilateral arrangement, the UK's access to the EEA market would be governed by WTO protocols.
27. The multilateral General Agreement on Trade in Services ("GATS") under the WTO framework provides for trade on the basis of two main principles, namely "most-favoured nation" ("MFN") treatment and "national treatment". MFN treatment requires that any WTO members granting favourable market access to another member must grant the same treatment to all other WTO members. National treatment requires that once a service enters a market, members must treat that service no less favourably than domestic equivalents. Crucially, the EU, as a club of countries which offer each other preferential access, falls within an exception for agreements liberalising trade in services under Article V of GATS.
28. Under the GATS, the degree of market access in financial services is supplemented by schedules of commitments which set out what treatment each WTO member offers to others in terms of access or limitation. The GATS also allows members to take prudential measure where required, allowing national regulators to discriminate against foreign suppliers if it is deemed necessary for prudential security. National requirements to obtain authorisation before market access are widespread in the area of financial services and they are not prohibited by GATS. Reliance on the WTO framework would require some additional processes and procedures as the existing GATS Financial Services Schedule does not cover the UK as a country outside the EU.
29. Apart from the basic GATS protocols, there is also an initiative among a subset of WTO countries to increase liberalisation in the services sector, including financial services, which suggests the extra-EEA framework may not be as bleak

an option as it is frequently portrayed. The main aim of the draft Trade in Services Agreement (TiSA) is to boost liberalisation of the global services sector, beyond the current GATS provisions. Following the failure of the multilateral WTO Doha Round negotiations, an ad hoc coalition of 23 members (including the EU representing 28 countries), the so-called “Really Good Friends of Services”, decided to negotiate a separate agreement to deepen the extent of services commitments between them. Together the participating countries account for 70% of world trade in services.

30. TiSA is intended to be a forerunner of a multilateral agreement on services that will eventually be folded into the WTO once a critical mass of countries that support it is reached. In the area of market access for financial services, the draft annex as of 27 June 2016<sup>14</sup> provides for some direct cross-border and branch-based market access commitments. In particular, the EU and Norway have proposed provisions that would require any measures taken by contracting parties in relation to authorisation requirements (including fees, qualification requirements and procedures affecting trade in financial services) to be objective, transparent and independent. Procedures would need to be adequate to demonstrate to applicants whether they meet the requirements. In addition, the draft agreement provides for an independent panel for disputes on prudential issues and other financial matters with the necessary expertise relevant to the specific financial service under dispute.
31. Therefore, if no agreement were reached with the EU/EEA, the UK would still potentially be able to advance other global initiatives to improve reciprocal market access for the UK and third countries. On the other hand, if bilateral arrangements with the EU are envisaged, the TiSA provisions including the dispute settlement mechanism may also serve as a model in any bilateral arrangement with the EU.

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<sup>14</sup> Published by wikileaks at [https://wikileaks.org/tisa/document/20160627\\_TiSA\\_Annex-on-Financial-Services/20160627\\_TiSA\\_Annex-on-Financial-Services.pdf](https://wikileaks.org/tisa/document/20160627_TiSA_Annex-on-Financial-Services/20160627_TiSA_Annex-on-Financial-Services.pdf)



## **H. Recommendations in the event of a hard Brexit**

32. Regardless of which future framework is chosen, it is advisable for the UK government to consider the following so as to assist in maximising the chances of a smooth Brexit process and an optimal outcome for UK financial services industry:

- a. Given that negotiations are likely to take months or years, providing certainty early on in the process that a sufficient transitional period of continued reciprocal market access will apply such that UK businesses will have time to consider their options once the details of any deal reached between the UK and the EU and/or or any alternative approach chosen by the UK are known;
- b. The preservation of the banking services passport (the CRD IV passport) or the expansion of the third country equivalence regime to the banking sector to maintain London's status as a centre of international banking (see further, sub-paragraphs d and e below);
- c. An agreement with the EU that any proposed equivalence or mutual recognition process will take place prior to the end of negotiations such that the framework would take effect immediately upon withdrawal from the EU, i.e. day one of Brexit.
- d. Alternatively, a temporary equivalence agreement – along the lines of the provisional application of free trade agreements between the EU and third countries – which would enter into force from day one of Brexit, pending confirmation of equivalence from the EU;
- e. The maintenance by the UK of existing reciprocal market access arrangements for EU and third countries, (currently granted through EU equivalence). This would lead to the creation of a UK centric equivalence system;

- f. The clarification of the UK's position on financial services access and conditions within the WTO and GATS framework.

## **CHAPTER 2 - MiFID / MiFID II / MiFIR:**

### **(1) Effect of Brexit on Passporting & Equivalence Regimes**

### **(2) Effect of Brexit on FS Dispute Resolution in the UK**

#### **A. Preliminaries**

1. This first part of this Chapter deals with the effect of Brexit on the passporting regimes under MiFID,<sup>15</sup> MiFID II<sup>16</sup> and MiFIR<sup>17</sup> and is structured as follows:
  - a. An introduction to MiFID, MiFID II and MiFIR;
  - b. Passporting rights if the UK were to remain within the EEA;
  - c. Passporting rights if the UK were to leave the EEA;
  - d. Some issues arising for consideration.

The second part of this Chapter sets out some brief observations on the effect of Brexit on the resolution of financial services disputes in the UK relating to services that will be governed by MiFIR.

#### **B. An introduction to MiFID, MiFID II and MiFIR**

##### ***(1) High level introduction***

2. The following paragraphs are intended as a high-level introduction to MiFID - the corner stone of EU financial services regulation - and the legislation due to replace it (MiFID II and MiFIR). Readers familiar with the broad concepts might wish to read from paragraph 8 below.

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<sup>15</sup> Markets in Financial Instruments Directive (2004/39/EC).

<sup>16</sup> Markets in Financial Instruments Directive II (2014/65/EU).

<sup>17</sup> Markets in Financial Instruments Regulation Regulation No 600/2014 of 15 May 2014.

3. MiFID regulates firms who provide services to clients linked to financial instruments (shares, bonds, units in collective investment schemes and derivatives) and the venues where those instruments are traded.<sup>18</sup> MiFID was applied to the UK from 1 November 2007.
4. MiFID is one of several single market Directives currently in force that provide passporting rights for financial institutions. MiFID does not contain a mechanism allowing passport rights to an investment firm whose head office is located in third countries.
5. A significant part of the UK's financial services industry relies on the passport under MiFID to provide its services to other member states of the EEA. By way of illustration, as at 27 July 2016, 2250 firms had at least one outbound passport under MiFID and 988 had at least one inbound passport.<sup>19</sup> If Brexit led to the loss of the current passporting arrangement the impact could be wide-ranging.
6. From 3 January 2018, MiFID will be replaced by MiFID II and MiFIR. MiFID II is in the process of being implemented in the UK and the FCA is in the midst of a consultation exercise in respect of that implementation. A policy statement is due in the second half of 2017. MiFIR will take direct effect.
7. The FCA statement of 24 June 2016 in response to the result of the EU Referendum made clear that EU-derived financial regulation will remain applicable until any changes are made, which will be a matter for Government and Parliament. Subject to changes to the timetable for Brexit or MiFID II/ MiFIR, it seems highly likely that MiFID II and MiFIR will have come into effect before the UK formally leaves the UK.

## **(2) Background to MiFID and the EU-wide investment services passport**

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<sup>18</sup> [www.fca.org.uk/markets/mifid-ii](http://www.fca.org.uk/markets/mifid-ii).

<sup>19</sup> Figures given in a letter dated 17 August 2016 from the FCA to the Chairman of the Treasury Committee.

8. In 1985, the EU Commission proposed (by its White Paper entitled “Completing the Internal Market”) that banks and other investment firms based in each (“home”) Member State ought to be able to provide financial services in other (“host”) Member States. Member States would be required to recognise the home state authorisation of incoming firms to carry on activities falling within the scope of the home authorisation, and – importantly - precluded from imposing requirements with the purpose or effect of restricting the activity in the host state of the incoming firm. In this way and thereafter the Commission, further emboldened by the Single European Act of 1986 (which introduced qualified majority voting for most internal market measures) and the anticipated introduction of the single currency as part of ever closer economic and monetary union following the Maastricht Treaty of 1992, launched the Financial Services Action Plan (FSAP) in 1998 (COM (1998) 625). The FSAP sought to achieve a “single, deep and liquid capital market” in the EU, covering a wide range of financial services.
9. This included, crucially, the provision of wholesale and retail investment services in the securities markets. The EU had previously implemented the Investment Services Directive in 1993 (93/22/EEC) (ISD), which provided the platform for host state licenses in respect of certain investment services (listed in Section A of the Annex to the ISD), to apply across other Member States (and EEA states).<sup>20</sup> The ISD itself built upon (and to an extent overlapped with) various banking Directives (principally the Banking Consolidation Directive 2000/12/EC), which amongst other things sought to provide for a single market for banking activities, including investment related activity.
10. The ISD has provided a limited degree of harmonisation across the investment services sector. The ISD sets a minimum level of regulation for investment firms and at the same time establishes the passporting regime for those regulated firms, enabling an investment firm regulated in one Member State to establish a

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<sup>20</sup> See paragraph 21 below.

branch in, or provide certain of its investment services cross-border into, any other Member State – this was known as the ‘ISD passport’.

11. But the ISD has not been as effective as it might have been in establishing the framework for a single European market in investment services. There were perceived to be two principal problems. First, the scope of investment activities to which the ISD applies was narrow. Second, while Member States were required to permit investment firms to passport into the jurisdiction, they were not prohibited from imposing additional local rules regulating the manner in which those services were to be provided.
12. Also, implementation of the ISD across Member States was inconsistent, making for a lumpy single market in investment services. A good example of this is the view taken by Member States about the Member State “in which a service was provided”. This was important because the ISD required Member States to devise their own set of conduct of business rules, which varied from one state to another. Therefore, the opposing views taken by Member State as to the state “in which services were provided”, led to different rules being applied to investment firms. Another good example of the limits of the ISD was the absence of a definition of what constituted a professional investor. This was important because Article 11(1) ISD provided for a calibration of conduct rules applicable to investment services provided to professional investors, yet the absence of a safe and usable definition of an investor falling within Article 11(1) meant wholesale clients were afforded the same protections as less sophisticated retail clients.
13. One aim of the FSAP was to radically redraw, simplify and harmonise rules (particularly conduct of business rules) governing the provision of investment services across the EU, and thereby enhancing the existing ISD passport. The Commission announced in 1999 that the FSAP would seek to “prepare the ground for the effective cross-border provision of investment services” by

“urgently updating” the ISD.<sup>21</sup> In this way, the Markets in Financial Instruments Directive 2004/39/EC (MiFID) was anticipated to be, and subsequently became, the most ambitious pillar of the FSAP.

14. MiFID replaced the ISD in 2007.<sup>22</sup> It is central to the operation of the EU’s financial services regime, and of paramount importance to the role of London as a place for investment business.
15. MiFID provides for UK banks to conduct investment business across other EU Member States. More particularly, MiFID provides the principle regulatory architecture governing the conduct of investment services by banks in each Member States, for example the trading and execution on behalf of clients of securities and derivative transactions.
16. The central changes introduced by MiFID were as follows:
  - (1) An extended definition of investment services to include investment advice and commodity derivative business;
  - (2) Detailed rules for the harmonisation of conduct of business rules. Further, MiFID appears on its face (Article 19(10) MiFID) to provide for maximum

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<sup>21</sup> European Commission communication of 11 May 1999.

<sup>22</sup> MiFID has been developed using the Lamfalussy legislative process. Named after Baron Lamfalussy, the chairman of the so-called “Committee of Wise Men” that devised it, the process was proposed in 2001 as a means of accelerating the development of European financial services legislation and enabling market experts to participate in the legislative process. The Lamfalussy approach to law-making involves the preparation of a framework “Level 1” Directive which establishes guiding principles and requirements. Subordinate “Level 2” measures are subsequently prepared during the Level 1 implementation period. Level 2 measures build technical detail on to the Level 1 framework and are formulated by the European Commission with the assistance of advice provided by the European Securities Committee, itself a creation of the Lamfalussy process. In support of these legislative measures are the Level 3 and Level 4 processes. At Level 3, the Committee of European Securities Regulators (CESR) works to develop recommendations, interpretative guidelines and common standards which aim to ensure the consistent implementation and application of the Level 1 and Level 2 legislative measures across the EU. Level 4 is concerned with supervision and enforcement: in essence, the Commission checks the compliance of Member States with Level 1 and Level 2 legislation and, where necessary and appropriate, takes action to ensure that it is observed and properly implemented. MiFID is a Level 1 Directive.

harmonisation, by authorising the Commission to enact subsequent legislation to achieve 'uniform application' across Member States.

- (3) A definition of professional clients in Annex II MiFID (who are afforded less protection than retail clients). By introducing this definition, investment firms could apply levels of protection to investors proportionate to the sophistication of the client.
  - (4) A clarification of the responsibilities of home and host state regulators. In particular, MiFID allocated sole jurisdiction to the home state of the investment firm.
17. The second Markets in Financial Instruments Directive (MiFID II) will replace MiFID in 2018 (subject to any interference caused by the Brexit negotiations).<sup>23</sup> There are some significant differences between MiFID and MiFID II with regard to the treatment of third country entities. For example, MiFID II will establish two separate regimes for third countries doing business with certain categories of EU entities, introducing different provisions for retail clients and professional clients. Crucially, MiFID II introduces a harmonized regime making the MiFID passport available to non-EEA based financial institutions provided their home state regulation is deemed MiFID equivalent. As explained below, this provision may provide a workable answer to the question of how UK investment firms, as third country firms post-Brexit, might nevertheless enjoy unfettered (or limited fettering of) access to the EU single market in investment services.
18. Building on the foundations laid by the ISD and the BCD, MiFID gives investment firms the ability to carry on business and sell services of far broader

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<sup>23</sup> The MiFID II 'Level 1' framework was agreed in 2014 - this contains two linked pieces of legislation: a revised MiFID and the Markets in Financial Instruments Regulation (MiFIR). There is provision for Level 1 to be supplemented in many areas by various implementing measures (known as 'Level 2' legislation, referred to and explained in FN3, above). These measures take two forms: 'delegated acts', drafted by the Commission on the basis of advice by the European Securities and Markets Authority (ESMA), and 'technical standards', drafted by ESMA and approved by the Commission.



scope (delimited to the activities identified in Annex 1 MiFID), both in terms of the services provided and the markets and products affected, throughout Europe without obtaining a licence to provide services as a regulated firm in each and every individual Member State country.

19. In this way, UK investment firms can presently 'passport' into other Member State investment markets and compete with local firms for business. Given the muscularity of UK- and UK based- investment firms in the development and provision of sophisticated investment services, including in (expanded areas) of MiFID business i.e. commodity derivatives, London has been a major beneficiary of the enhanced MiFID regime.
20. A further important aspect of this is that non-EU, or third country, banks have tended to locate themselves in London (through a UK subsidiary), and used the MiFID "passport" regime to sell their investment service across the EU. The prospect of such third country banks locating themselves away from London following Brexit is a major commercial risk to London as a financial centre.

### **C. Passporting rights if the UK were to remain within the EEA**

21. The European Economic Area or EEA is constituted by all EU Member States along with Norway, Iceland and Liechtenstein, which are members of the separate European Free Trade Association, or EFTA. By operation of the EEA Agreement formed between the EU and the EFTA States and in force since 1994, most legislative measures passed by the EU are now automatically adopted by these 3 EFTA States. In this way, MiFID applies to EEA states. If the UK leaves the EU but remains within the EEA, UK financial institutions would continue to benefit from the same passporting rights in respect of financial services.<sup>24</sup>

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<sup>24</sup> See FN6 above.

#### D. Passporting rights if the UK were to leave the EEA

22. If the UK were to leave the EEA and did not secure an EEA-like arrangement or some other special status via a bilateral treaty, UK firms would lose the passporting rights arising from the UK's membership of the EU. However, the MiFID II/ MiFIR regime is set to introduce passporting rights for third country firms in the circumstances discussed below.
23. While MiFID II will improve consistency in the EU approach to third country firms, the new framework remains far from straightforward. As stated above, the position of third country firms under MiFID II will depend on whether they are seeking access to wholesale markets only (Article 46 MiFIR), or also to offer services to retail or "elective" (i.e., less sophisticated) professional clients (Article 39 MiFID 2).
24. Broadly speaking, there is no common third country regime under MiFID and each Member State has its own rules, so any third country firm wishing to provide services in a particular EU jurisdiction must either itself be established as an authorised entity in that Member State and authorised under MiFID or (as certain third country firms presently do in London) establish an authorised subsidiary in a Member State and rely on passporting rights across the EU.
25. An investment firm established in a third country will only be able to conduct regulated investment business with a *retail client* in a Member State if the bank has established a branch in that Member State. In order to establish a branch, the Member State's authorities would need to be satisfied that the third country has adequate regulation in certain key areas, such as anti-money laundering.
26. The UK should meet all these requirements on day 1 post-Brexit, in relation to Level 1 Directive measures. However in the absence of any bespoke domestic legislation effectively transposing what would otherwise be directly applicable Level 2 measures, e.g. MiFIR, there is a real risk that the EU would not regard the UK as having an equivalent regime. In any event, and prospectively, in order to maintain any such equivalent status, the UK would have to ensure that it

legislated to provide for new rules which corresponded to developments at an EU level.

27. An investment firm established in a third country seeking to do business with *professional clients* in a Member State will be able to do so under MiFID II without establishing a branch in that Member State as long as it is registered in a register maintained by the European Securities and Markets Authority (ESMA). This is only possible where the third country regulatory regime is considered equivalent and a decision to this effect has been adopted by the European Commission (the Commission), so the effect on the UK would depend on whether its regulatory environment was deemed to be equivalent and whether the Commission could be persuaded to grant an exiting EU member this status. In theory, the UK should be in a position to meet the equivalence requirements in respect of Level 1 Directive measures, assuming the UK implements MiFID II as anticipated prior to Brexit.

***(1) Eligible counterparties and professional clients***

28. Article 46 MiFIR states: “A third-country firm may provide investment services or perform investment activities with or without any ancillary services to eligible counterparties and to professional clients within the meaning of Section I of Annex II to Directive 2014/65/EU established throughout the Union without the establishment of a branch where it is registered in the register of third-country firms kept by ESMA in accordance with Article 47.”<sup>25</sup>

29. Article 47 of MiFIR states:

***“Equivalence decision***

1. The Commission may adopt a decision in accordance with the examination procedure referred to in Article 51(2) in relation to a third country stating that the legal and supervisory arrangements of that third country ensure that firms authorised

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<sup>25</sup> Section I of Annex II to Directive 2014/65/EU includes (for example) entities required to be authorised or regulated to operate in the financial markets, investment firms, institutional investors etc.

*in that third country comply with legally binding prudential and business conduct requirements which have equivalent effect to the requirements set out in this Regulation, in Directive 2013/36/EU and in Directive 2014/65/EU and in the implementing measures adopted under this Regulation and under those Directives and that the legal framework of that third country provides for an effective equivalent system for the recognition of investment firms authorised under third-country legal regimes...”*

*The prudential and business conduct framework of a third country may be considered to have equivalent effect where that framework fulfils all the following conditions:*

*(a) firms providing investment services and activities in that third country are subject to authorisation and to effective supervision and enforcement on an ongoing basis;*

*(b) firms providing investment services and activities in that third country are subject to sufficient capital requirements and appropriate requirements applicable to shareholders and members of their management body;*

*(c) firms providing investment services and activities are subject to adequate organisational requirements in the area of internal control functions;*

*(d) firms providing investment services and activities are subject to appropriate conduct of business rules;*

*(e) it ensures market transparency and integrity by preventing market abuse in the form of insider dealing and market manipulation*

*2. ESMA shall establish cooperation arrangements with the relevant competent authorities of third countries whose legal and supervisory frameworks have been recognised as effectively equivalent in accordance with paragraph 1. Such arrangements shall specify at least:*

*(a) the mechanism for the exchange of information between ESMA and the competent authorities of third countries concerned, including access to all information regarding the non-Union firms authorised in third countries that is requested by ESMA;*

*(b) the mechanism for prompt notification to ESMA where a third-country competent authority deems that a third-country firm that it is supervising and ESMA has registered in the register provided for in Article 48 infringes the conditions of its authorisation or other law to which it is obliged to adhere;*

*(c) the procedures concerning the coordination of supervisory activities including, where appropriate, on-site inspections.*

*3. A third-country firm established in a country whose legal and supervisory framework has been recognised to be effectively equivalent in accordance with paragraph 1 and is authorised in accordance with Article 39 of Directive 2014/65/EU shall be able to provide the services and activities covered under the authorisation to eligible counterparties and professional clients within the meaning of Section I of Annex II to Directive 2014/65/EU in other Member States of the Union without the establishment of new branches. For that purpose, it shall comply with the information requirements for the cross-border provision of services and activities in Article 34 of Directive 2014/65/EU.*

*The branch shall remain subject to the supervision of the Member State where the branch is established in accordance with Article 39 of Directive 2014/65/EU. However, and without prejudice to the obligations to cooperate laid down in Directive 2014/65/EU, the competent authority of the Member State where the branch is established and the competent authority of the host Member State may establish proportionate cooperation agreements in order to ensure that the branch of the third-country firm providing investment services within the Union delivers the appropriate level of investor protection.*

*4. A third-country firm may no longer use the rights under Article 46(1) where the Commission adopts a decision in accordance with the examination procedure referred to in Article 51(2) withdrawing its decision under paragraph 1 of this Article in relation to that third country.”*

30. Article 47(1) provides that the Commission “may” adopt an equivalence decision and that the prudential and business conduct framework of a third country “may” be considered to have equivalent effect where that framework fulfills all

of the conditions set out in Article 47(1). The Commission has a discretion, but is under no obligation to conclude the UK's prudential and business conduct framework had equivalent effect even if all the conditions were fulfilled.

31. Given that MiFID II will take effect before the UK leaves the EU it is perhaps unlikely that the UK's conduct of business rules would be sufficiently divergent from the EU's Level 1 Directive measures that, at the time of Brexit, there would be an issue with Article 47(1)(d). However, as stated above, the position is less certain in respect of what are presently or anticipated to be directly applicable rules, and in any event the need to retain equivalence might mean that any amendments to the rules in the future would have to mirror developments in the EU.
32. It is also worth noting that Article 46 MiFIR envisages a lengthy registration process for third country firms. Article 46(4) MiFIR states that within 30 working days of receipt of the application, ESMA shall assess whether the application is complete. Within 180 working days of the submission of a complete application, ESMA shall inform the applicant third-country firm whether the registration has been granted or refused. Put more simply, it could take almost 11 calendar months from submission of a complete application to registration.
33. Article 47(2) of MiFIR would also impose co-operation requirements upon the UK authorities with ESMA.
34. Article 47(3) of MiFIR provides that a third country firm established in a country whose legal and supervisory framework was equivalent and authorised in accordance with Article 39 of MiFID II shall be able to provide the services and activities covered under the authorization to eligible counterparties and professional clients (as defined). In other words, UK firms could offer services to eligible counterparties and professional clients through an authorised branch in an EU member state *if* the UK had received a favourable equivalence decision and the EU member state in which the branch was authorised had implemented Article 39 of MiFID II.

35. Article 39(1) of MiFID II states: “A Member State may require that a third-country firm intending to provide investment services or perform investment activities with or without any ancillary services to retail clients or to professional clients within the meaning of Section II of Annex II [clients who may be treated as professionals on request] in its territory establish a branch in that Member State.” Article 39(2) sets out the conditions for prior authorisation of the branch by the member state.

## ***(2) Retail clients and elective professional clients***

36. For services to retail clients or clients who may be treated as professionals on request, third country firms will (except in cases of reverse solicitation pursuant to Article 42 of MiFID II) need to seek authorisation to establish a branch in the member state pursuant to Article 39 of MiFID II (above) (or where Article 39 is not implemented, under national law).

## **E. Some MifID/MiFID II/MiFIR Passporting and Equivalence issues arising for consideration**

37. The UK Government will clearly be considering wider issues surrounding access to the single market and membership of the EU and EEA which are beyond the scope of this section of the paper. We do not discount the fact that a negotiated alternative to the choice of remaining in the EEA or leaving the EEA might be achievable but without a detailed proposal from the Government it seems – in this context – neither practicable or helpful to comment.<sup>26</sup> In respect of MiFID II and MiFIR, we respectfully raise **seven** broad issues for consideration.

38. **First**, UK based firms will likely have a period during which MiFID II and MiFIR are in place but before Brexit and so face the costs in ensuring compliance with the new regime as it is implemented in the UK during an transitional period.

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<sup>26</sup> For example, bilateral treaties between the UK and the EU might allow cross-border services to be provided. See, for example, the arrangements allowing general insurers in Switzerland (not part of the EEA) to set up an establishment in the EEA).

39. **Second**, if Brexit means that the UK leaves the EEA then consideration will no doubt be given to whether or not a negotiated alternative to third country status is desirable and can be achieved. A possible alternative is for the UK and the EU, or even certain key Member States each on a bilateral basis, to negotiate a bespoke deal on mutual access to investment markets. However, we regard that as a more complex, uncertain and politically precarious route to maintaining access to investment markets for UK firms. If third country status is unachievable, i.e. because the EU does not regard the UK regime as equivalent, it is difficult to envisage circumstances where a viable deal could be achieved by this alternative route.
40. **Third**, if the UK acquires third country status when Brexit takes effect, that will heavily impact the access that UK firms are likely to have to the EU (particularly in respect of retail and elective professional clients).
41. **Fourth**, the impact of the loss of a reciprocal passport arrangement would also affect firms in other EU member states and that might militate in favour of a negotiated alternative to third country status for the UK. By way of illustration, as noted above 988 firms had inbound passports under MiFID and, in relation to some other Directives, the number of inbound passports outnumbered the outbound (e.g. the Insurance Mediation Directive, the UCITS Directive, CRD IV and Solvency II Directive).
42. **Fifth**, if Brexit means that the UK has “third country” status then it is obviously desirable that a decision to seek a favourable equivalence decision from the Commission is communicated in sufficient time for UK firms to factor that into their plans. The importance of this is compounded by the fact that the mechanism by which third country firm can register for access under MiFID II/ MiFIR could – even if the application was complete – take almost 11 calendar months.
43. **Sixth**, depending on the arrangements made, there is arguably an opportunity to create a local lighter touch regulatory regime in relation to areas that have



proved controversial. A good example of this is the limit on the holding of net positions in commodity derivatives traded on trading venues and economically equivalent OTC contracts. This was a controversial element of MiFID II. The UK rejected the underlying rationale for the position limit framework but accepted that removal of position limits altogether was not viable. It therefore sought to minimise the harm position limits could do to the liquidity of the UK's commodity market. If regulation of MiFID activities were to be reassessed following Brexit, position limits would arguably be a candidate for removal from the UK rulebook. We say "arguably" because the UK Government might consider that the MiFID II/ MiFIR regime is one which it would wish to maintain, because the benefits of membership of the single market in investment services outstrips the costs of certain rules of membership. If equivalence is sought then as noted above it seems likely the rules for professional clients and eligible counter parties will continue to mirror developments in the EU.

44. **Seventh**, if a favourable equivalence decision is going to be sought, the UK Government, HM Treasury and the FCA will no doubt liaise with EU institutions and regulators in order to maximize the prospects of the MiFID II/ MiFIR regime being implemented in a way likely to satisfy the Commission. To date, the UK has enjoyed a strong position in the Council when negotiating EU legislative texts, including in respect of MiFID and MiFID II. If third country status is to work, and to work successfully, the UK will have to continue to negotiate and cooperate with the EU institutions in order to create and maintain a workable alternative to EU membership, in respect of the mutual access to investment markets.

#### **F. Brief observations on the effect of Brexit on the resolution of financial services disputes in the UK relating to services governed by MiFIR**

45. Article 46(6) of MiFIR provides that:

*“Third-country firms providing services or performing activities in accordance with this Article shall, before providing any service or performing any activity in relation to a client established in the Union, offer to submit any disputes relating to those services or activities to the jurisdiction of a court or arbitral tribunal in a Member State”.*

46. In our view, in the absence of special measures, the introduction of MiFIR, combined with Brexit, could well have a detrimental impact on litigation and arbitration in the UK.
47. In particular, firms established in the EU seeking services subject to MiFIR from third-party firms who are offered a choice might insist that any disputes be subject to the jurisdiction of a Member State, or be arbitrated in a seat of a Member State, rather than this jurisdiction, especially where such EU firms have no or little connection to this jurisdiction.
48. Article 46(6) might even lead third-country firms which routinely deal with firms within the EU to provide for jurisdictions or seats other than this jurisdiction in their contractual dispute resolution clauses as a matter of course in order to avoid the need to negotiate an English & Welsh seat or jurisdiction.
49. In our view, therefore, the Government should give consideration to seeing whether it could be agreed that the UK would not be treated as a “third country” for the purposes of MiFIR. However, we recognise that this issue would probably not be considered in isolation and would need to be assessed together with broader issues relating to financial services and in particular the question of passporting in general.
50. MiFID II<sup>27</sup>, which applies to retail clients, might also have an impact on English jurisdiction. Article 39(1) provides that:

*“A Member State may require that a third-country firm intending to provide investment services or perform investment activities with or without any ancillary*

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<sup>27</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0065>

*services to retail clients or to professional clients within the meaning of Section II of Annex II in its territory establish a branch in that Member State.”*

51. The existence of a branch in a Member State may found jurisdiction in that Member State according to its laws, and mean disputes that would be heard in this jurisdiction being heard elsewhere.

## CHAPTER 3 - BREXIT AND THE INSURANCE INDUSTRY

### A. Introduction

1. The domestic insurance industry faces real uncertainty as a consequence of Brexit. This Chapter seeks to capture a snapshot of the UK insurance market, summarise its regulatory framework, explain the opportunities and difficulties that a 'hard' Brexit will generate, from both regulatory and market perspectives, and present options to mitigate the problems.

### B. Nature of the Industry

2. The modern British insurance market is complex and diverse in terms of the entities that operate in the sector, the methodologies and mechanisms used to price and allocate risk, and the range of insurance products available to parties seeking to protect themselves against risks.
3. Insurance providers and products are classified in various ways by different bodies and authorities. Some general classifications, however, are commonly distinguished: between direct insurers and reinsurance,<sup>28</sup> between insurers/reinsurers and intermediaries, and between life and non-life insurance. These practical distinctions, explored below, inform the approach of regulators to the insurance market.
4. Many insurers sell insurance products to the end-user without the use of brokers or agents; rather, they typically sell online or by phone. Lloyd's identifies around 60 kinds of insurance product sold directly, from aviation to employer's liability, and from marine to professional indemnity insurance. An array of general insurance is made available to the retail market, including motor, home, and

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<sup>28</sup> The term "*direct insurance*" is sometimes used to refer to insurance concluded without the use of an intermediary, but we do not adopt that usage.

travel insurance. The relative simplicity of retail products makes them ideal for being sold directly.

5. Some forms of insurance are less likely to be sold directly, but are instead commonly sold by brokers or agents, known as insurance intermediaries.<sup>29</sup> Brokers ordinarily work for the purchaser, offering and advising upon alternative products provided by a range of insurers, whereas agents commonly represent the insurer in a transaction. Intermediaries, with a broad knowledge of the insurance market and an understanding of the needs of specific purchasers, can improve the functioning of the insurance market, lowering search costs and helping purchasers to make informed decisions.
6. Life insurance, a category of insurance contracts for which the benefit payment is based on the occurrence of death, disability, or critical illness of the insured within the specified coverage term, or on the life status of the insured at maturity, is a type of insurance often sold by intermediaries. Although the categorisation and classification of life insurance products falls outside the scope of this paper, term insurance, annuities and endowment policies are all properly considered forms of life insurance.<sup>30</sup>
7. Life insurance contracts are agreements to pay a sum of money when the event insured against occurs, whereas non-life insurance contracts are usually agreements to indemnify the insured against loss if it is suffered and to the amount of the loss suffered.<sup>31</sup>
8. Reinsurance is an insurance contract under which an insurer takes cover on its own risk.<sup>32</sup> It protects insurers against very large claims and may permit a single insurer to insure risks that would otherwise be too burdensome. Insurers spread

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<sup>29</sup> Insurance mediation is defined in IMD Art 2.3 as the process of introducing, proposing or carrying out other work preparatory to the conclusion of contracts of insurance, or of concluding such contracts, or of assisting in the administration and performance of such contracts, in particular in the event of a claim.<sup>29</sup>

<sup>30</sup> See, for example, Expert Group on European Insurance Contract Law, Discussion Paper 6

<sup>31</sup> See Birds' Modern Insurance Law, John Birds, 10th Ed. (2016), p. 5

<sup>32</sup> Colinvaux's Law of Insurance, 11<sup>th</sup> Ed. (2016), Merkin, [18-001]

the cost of paying out on large risks by reinsuring part of their coverage. For example, if a particular country is especially vulnerable to natural disasters, and an insurer is heavily exposed in that country, its insurance may be reinsured to obtain an international spread of risk.<sup>33</sup> Only a small proportion of life insurance is reinsured, as there is often a significant savings component associated with life insurance products, which obviates the need for risks to be spread amongst insurers.

9. Lloyd's, based in the City of London, is the world's leading insurance and reinsurance marketplace. Insurance and reinsurance business is underwritten by members joining together in syndicates to provide capital and accept insurance risks. In general, each underwriter has unlimited several liability on the insurance contracts they enter into.

### **C. Size and Importance**

10. The European insurance market is the largest in the world, making up around 33% of global gross premiums written in 2012. Total European gross written premiums amounted to more than €1.1tn in 2012. The insurance sector has the largest pool of investments in the EU with almost €8.4tn invested in the global economy in 2012.<sup>34</sup>
11. The UK insurance market plays an important role in the national economy. It is the third largest insurance market in the world and the largest in Europe. The gross written premiums of UK-based insurers and reinsurers, including retail and life insurance, exceed £200bn annually, generating revenues of £39-42bn and employing 310,000-335,000 staff.<sup>35</sup> UK insurers hold around £1.9tn of invested

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<sup>33</sup> *Swiss Re: The essential guide to reinsurance* (2013) p. 9

<sup>34</sup> Supplementing directive 2009/138/EU of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) – impact assessment for delegated acts.

<sup>35</sup> Oliver Wyman, *The impact of the UK's exit from the EU on the UK-based financial services sector*, pp. 4; 19-22.

assets.<sup>36</sup> The UK reinsurance market alone has revenues of between £2-4bn annually and employs around 5,000 of these staff.<sup>37</sup>

12. The retail insurance market is essential for consumers too. In 2013, 20.4m households in the UK had contents insurance, 20.1m had motor insurance, 5.7m had whole life insurance, and 1.9m had private medical insurance.<sup>38</sup>

#### **D. Current Position in the EU Single Market**

##### ***(1) Insurers and reinsurers***

13. Freedom of movement for both (primary) insurers and reinsurers is provided for by Directive 2009/138/EC, ("**Solvency II**"). The freedom of movement provisions of Solvency II were required to be given effect in national laws by 1 January 2016.
14. Following the same pattern as previous insurance Directives, Solvency II provides that:
  - a. the taking-up of the business of direct insurance or reinsurance covered by the directive is subject to prior authorisation (Article 14(1)); and
  - b. such authorisation "*shall be valid for the entire Community. It shall permit insurance and reinsurance undertakings to pursue business there, that authorisation covering also the right of establishment and the freedom to provide services*" (Article 15(1)).
15. Article 18 sets out the conditions of which a "*home Member State*" that authorises a insurance/reinsurance undertaking must be satisfied, including the undertaking having sufficient "*own funds*" to cover the Minimum Capital Requirement and Solvency Capital Requirement laid down by the Directive.

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<sup>36</sup> Association of British Insurers, Key facts (2015)

<sup>37</sup> Oliver Wyman, The impact of the UK's exit from the EU on the UK-based financial services sector, pp. 4; 19-22.

<sup>38</sup> Association of British Insurers, Key facts (2015), p. 8.

16. More detailed provisions for the exercise of the right of establishment and freedom to provide services are set out in Title I Chapter VIII. These require a direct insurance undertaking to notify and provide specific information to its home supervisory authorities, including details of the types of business it plans to carry out in the other Member State(s) and, in the case of a branch, its structural organisation (Articles 145 and 147). The ensuing procedure depends whether the firm seeks to establish a branch another Member State or to do business there under the freedom to provide services.
17. In the case of a branch (Article 146):
  - a. Unless the home regulator has reason to doubt the adequacy of the system of governance or the financial situation of the insurance undertaking (or the fitness and propriety of its authorised agent), it must within three months communicate to the regulator in the host Member State the information the firm has provided.
  - b. The home regulator must also attest that the insurance undertaking covers the Solvency Capital Requirement and the Minimum Capital Requirement.
  - c. The host state regulator must then within two months inform the home regulator and firm of any conditions under which, in the interests of the general good, the business must be pursued in the host Member State.
  - d. The insurer can then establish the branch and start doing business.
18. In the case of non-branch operations (Article 148):
  - a. the home regulator must within one month provide to the host Member State(s) specified information including a certificate attesting that the insurance undertaking covers the Solvency Capital Requirement and the Minimum Capital Requirement; then
  - b. the host regulator can require specified further information in relation to motor insurance; and



- c. The insurer can start doing business.

## **(2) Intermediaries**

### **(a) Insurance Mediation Directive (Directive 2002/92/EC)**

19. The Insurance Mediation Directive (“IMD”)<sup>39</sup> was adopted to address a perceived lack of transparency and poor sales practices by insurance and reinsurance intermediaries. The Commission was concerned that purchasers did not understand the features, risks and costs of insurance products, and that intermediaries were subject to serious conflicts of interests, receiving undisclosed inducements for selling certain products. The Commission, in proposing the legislation, also hoped to help develop a single market for insurance, so that providers would offer – and consumers and businesses would be confident enough to purchase – insurance products cross-border.<sup>40</sup>
20. IMD now regulates the taking-up and pursuit of the activities of insurance and reinsurance mediation by those persons who are established in a Member State or hope to become so, subject to some limited exceptions (Article 1), but IMD does not apply to the provision of insurance and reinsurance mediation services provided in relation to risks located outside the EU (Article 1(3)).
21. The Directive distinguishes between an intermediary’s ‘home’ Member State and the ‘host’ Member State. Article 3 prescribes that insurance and reinsurance intermediaries are to be registered with a competent authority in their home Member State. Article 3(5) permits registered insurance and reinsurance intermediaries to take up and pursue the activities of insurance and reinsurance mediation in host Member States, under the freedom to provide services or the freedom of establishment. Article 6 provides that they may do so without the need for specific authorisation in host Member States, provided they have notified the competent authorities of their home Member State in advance. Combined, these provisions create the IMD passport.

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<sup>39</sup> IMD was to be transposed by Member States by 15 January 2005.

<sup>40</sup> IMD1 recitals 5 and 7.

22. The sales requirements under Article 4 require certain intermediaries to possess the appropriate knowledge and ability to sell insurance products, and Articles 12 and 13 seek to ensure that intermediaries provide certain information in a clear and accurate manner to the customer before concluding the insurance contract.
23. This Directive has been criticised from several perspectives. Conceptually, IMD fails to recognise the diversity of national insurance markets, with some insurance products common in some Member States, and virtually unknown in others, and misjudges the scope for confusion for intermediaries and customers who seek to buy or sell insurance cross-border. Equally, in attempting to develop a single market for insurance mediation, IMD arguably overestimates the desire of, for example, Spanish intermediaries to sell life insurance to Croatian customers.<sup>41</sup> Implementation of IMD has also been uneven across Member States, linked to both the inaccurate drafting of the Directive itself, the minimum harmonisation nature of the Directive and the pre-existing fragmentation of national markets.<sup>42</sup>

**(b) Insurance Distribution Directive (Directive 2016/97/EC) from February 2018)**

24. Having regard to the limitations of IMD, the EU adopted a new legislative proposal, known as the Insurance Distribution Directive (“IDD”) or IMD2, which will supersede IMD when it is transposed by Member States.<sup>43</sup>
25. IDD makes a renewed attempt to improve sales standards and expand opportunities for cross-border insurance business. Its scope is broader than IMD, regulating the activities of direct insurers and ancillary insurance intermediaries, in an attempt to ensure equal levels of consumer protection across different distribution channels.<sup>44</sup> The UK, however, in transposing IMD, gold-plated key

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<sup>41</sup> NB the speech by Sharon Bowles MEP dated 10 December 2010.

<sup>42</sup> Commission Staff Working Paper: Consultation document on the Review of the Insurance Mediation Directive (IMD), pp. 5-8.

<sup>43</sup> IDD is to be transposed by Member States by 23 February 2018.

<sup>44</sup> IDD recitals 6 and 7.

provisions by adopting a wide definition of “insurance intermediary”, so that transposition of IDD will have a relatively limited impact on direct insurance in the UK.

26. With perhaps more relevance to the UK market, the new regime requires insurance distributors to act honestly, fairly and professionally in accordance with the best interests of their customers, and to give customers objective information about products (Article 17). The Insurance Product Information Document – a form of document taken from other financial services directives<sup>45</sup> – will give customers basic information about non-life insurance products in a standardised format to improve comparability, particularly cross-border (Article 20). Article 19 of IDD further specifies enhanced disclosure obligations on distributors in relation to inducements and other fees, and to be explicit about conflicts of interest. Finally, reflecting common themes of recent EU consumer policy, IDD discourages tying/bundling practices in Article 24.
27. To improve the functioning of the passporting system for insurance intermediaries, Articles 3-8 of IDD make some relatively technical adjustments to the notification procedure where an insurance intermediary (not direct insurers and reinsurers, to avoid duplicating the passporting regime under Solvency II) intends to exercise the freedom of establishment, and clarifies the division of competence between home and host Member States. Article 6, developing substantially the provisions under IMD, requires an insurance intermediary to communicate to the competent authority of its home Member State information including where it intends to establish a branch or permanent presence, the classes of insurance it intends to sell, and details about the individuals involved in management of the branch. Article 8 generally requires host Member States to refer the breach of an obligation under IDD by an insurance intermediary to the competent authority of the home Member State.

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<sup>45</sup> Such as the PRIPs Regulation, Solvency II and the Payment Accounts Directive.

28. Under Article 9, and in respect of all insurance distribution, host Member States reserve the power to introduce ‘general good’ provisions, so that the competent authority of that host Member State can take steps to prevent an insurance distributor established in another Member State from providing services in the host Member State to preserve the proper functioning of insurance and reinsurance markets.

**(3) *Extent of current use of passporting***

29. The passporting regimes available under IMD and Solvency II (as well as under MiFID and other financial services legislation) have proven extremely popular. Firms can hold multiple passports under one Directive, and may hold passports under several Directives, enabling them to offer linked services in other Member States. For example, a UK firm may use its passport under IMD1 to offer its overseas clients life insurance products, and its MiFID passport to give clients advice on related investment products.

30. The FCA’s letter of 17 August 2016 to the House of Commons Treasury Committee indicates that there are 220 firms with at least one ‘outbound’ passport under Solvency II and 726 firms with at least one ‘inbound’ passport under the Directive. 2,758 firms have outbound IMD1 passports and 5,727 firms have inbound IMD1 passports.

**E. Position in a “Hard” BREXIT**

**(1) *Direct (primary) insurance***

31. Following a ‘hard’ Brexit in which the UK does not join the EEA, it will be regarded as a “*third country*” for Solvency II purposes.

32. An authorisation under Article 14 of Solvency II to do business throughout the EU can be granted only to an undertaking with its head office in a Member State.

33. Branches within the EU of firms with head offices outside the EU are covered by Title I Chapter IX of Solvency II. Article 162 requires Member States to make

access to “the business referred to in the first subparagraph of Article 2(1)”<sup>46</sup> by any undertaking with a head office outside the Community subject to an authorisation. It provides that a Member State may grant such an authorisation where the undertaking fulfils at least certain specified conditions, including that:

- a. it establishes a branch in the Member State in question i.e. a “*permanent presence ... which receives authorisation in that Member State and which pursues insurance business*”;
  - b. it undertakes to set up at the place of management of the branch accounts specific to the business which it pursues there, and to keep there all the records relating to the business transacted;
  - c. it possesses in the Member State in which authorisation is sought assets of an amount equal to at least one half of the absolute floor prescribed in Article 129(1)(d) in respect of the Minimum Capital Requirement and deposits one fourth of that absolute floor as security;
  - d. it undertakes to cover the Solvency Capital Requirement and the Minimum Capital Requirement in accordance with the requirements referred to in Articles 100 and 128;
  - e. it submits a scheme of operations in accordance with the provisions in Article 163; and
  - f. it fulfils the governance requirements laid down in Chapter IV, Section 2.
34. These are stated to be minimum requirements, and any grant of authorisation is at the discretion of the Member State in question.

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<sup>46</sup> Article 2(1) 1<sup>st</sup> paragraph reads: “This Directive shall apply to direct life and non-life insurance undertakings which are established in the territory of a Member State or which wish to become established there”.

35. Even if granted, an authorisation does not entitle the firm to do business in other Member States: a separate branch and separate authorisation is required for each.
36. Article 167 provides that such a firm with authorisation for branches in more than one Member State can apply for certain “*advantages*”:
- a. the Solvency Capital Requirement being calculated in relation to the entire business which it pursues within the EU;
  - b. the required deposit having to be lodged in only one of the Member States in which the business pursues its activities; and
  - c. the assets representing the Minimum Capital Requirement being localised in any one of those Member States.
37. However, this is entirely discretionary: these “*advantages*” “*may be granted only where the supervisory authorities of all Member States in which an application has been made agree to them*” (Article 167(3), and “*At the request of one or more of the Member States concerned, the advantages ... shall be withdrawn simultaneously by all Member States concerned*” (Article 167(4)).
38. Article 171 provides that:-
- “The Community may, by means of agreements concluded pursuant to the Treaty with one or more third countries, agree to the application of provisions different to those provided for in this Section, for the purpose of ensuring, under conditions of reciprocity, adequate protection for policy holders and insured persons in the Member States.”*
39. It seems inevitable that such an agreement would be needed in order to make it practicable for UK headquartered firms to continue carrying on direct insurance business within the EU, at least via branches. We are not aware of any precedent for such an agreement being concluded, nor any guidance as to when and on what terms any such agreement might be made.

40. As noted earlier, Article 162 applies to “*the business referred to in the first subparagraph of Article 2(1)*”, which in turn refers to “*direct life and non-life insurance undertakings which are established in the territory of a Member State or which wish to become established there*”. It has been argued that Solvency II does not prevent an insurer or reinsurer from carrying on business in the EU without establishing a branch. We understand that the UK, for example, has taken the view that third country insurers require authorisation only if they are effecting or carrying out contracts of insurance in the UK, with the firm or its agent having some kind of presence in the UK.
41. However, it appears that this approach may well not assist firms following a hard Brexit, for two reasons.
42. First, the EU Commission’s view appears to be that Article 162 means “*a third-country insurance undertaking may insure risks located in a Member State through a branch authorised by the competent supervisory authority of that Member State*”.<sup>47</sup> That statement may go too far. For example, Article 172 relating to equivalence of reinsurance (discussed below) presupposes that reinsurance may be provided by a third country reinsurer to an EU insurer, without imposing any requirement that the reinsurer establish a branch in the Member State in question.
43. Secondly, however, even if (contrary to the Commission’s view) Solvency II is silent on the issue, that does not mean a third country insurer/reinsurer has a right to provide services in the EU. Instead, it means that its ability to do so depends on the laws of the relevant Member State. We understand that the laws of many EEA states provide (in contrast to UK law) that a local risk may be underwritten only by an EEA authorised insurer or an insurer with the benefit of an EU passport.<sup>48</sup>

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<sup>47</sup> See the minutes at [http://ec.europa.eu/finance/general-policy/docs/expert-group/150714-minutes\\_en.pdf](http://ec.europa.eu/finance/general-policy/docs/expert-group/150714-minutes_en.pdf), p2 section 4.

<sup>48</sup> This is stated for example in the Clifford Chance Briefing note at [https://www.cliffordchance.com/briefings/2016/03/brexit\\_-\\_insurancesectoranalysis.html](https://www.cliffordchance.com/briefings/2016/03/brexit_-_insurancesectoranalysis.html). This may not be the position in Germany: other commentators suggest that Germany and some other Member States permit “home-foreign insurance” on the basis of reverse solicitation i.e. where the EEA

## (2) Reinsurance

44. The position for pure reinsurers is slightly better than for direct insurers because certain provision is made for equivalence assessments. However, it is important to note that, unlike in other internal market legislation, these equivalence provisions do not equate to a passport entitling reinsurers to carry on business in the EU.

45. Article 172(1) and (2) provide that:

*“(1) The Commission shall adopt delegated acts in accordance with Article 301a specifying the criteria for assessing whether the solvency regime of a third country that applies to reinsurance activities of undertakings with their head office in that third country is equivalent to that laid down in Title I.*

*“(2) If the criteria adopted in accordance with paragraph 1 have been fulfilled by a third country, the Commission may, in accordance with Article 301a, and assisted by EIOPA in accordance with Article 33(2) of Regulation (EU) No 1094/2010, adopt delegated acts determining that the solvency regime of that third country that applies to reinsurance activities of undertakings with the head office in that third country is equivalent to that laid down in Title I of this Directive.”<sup>49</sup>*

46. Any such delegated acts require the non-opposition of the European Parliament and Council and can be withdrawn by either at any time (Article 301a(3) and (5)).

47. These types of delegated act do not provide for access to the single market as such: they have the effect that *“reinsurance contracts concluded with undertakings having their head office in that third country shall be treated in the same manner as reinsurance contracts concluded with undertakings authorised in accordance with this*

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person takes the initiative in seeking insurance from a third country insurer: which may be a viable business model for wholesale, as opposed to retail, insurance business (see <http://www.shearman.com/~media/Files/NewsInsights/Publications/2016/07/Brexit-Implications-for-the-Insurance-and-Reinsurance-Industry-INS-071916.pdf> at p4).

In addition, it has been suggested that in the case of reinsurance, it may be easier under local laws for firms to avoid the regulatory net by keeping activities offshore: see <http://www.sidley.com/~media/publications/reactions-member-dannheisser.pdf>.

<sup>49</sup> There is also provision in Article 172(4)-(6) for grants of temporary equivalence.



*Directive*". Member States may not then require pledging of assets to cover unearned premiums and outstanding claims provisions in relation to such reinsurance contracts.

48. This type of equivalence can facilitate reliance by an EEA insurance company on reinsurance provided by a third country reinsurer when that insurer is seeking to satisfy the Solvency Capital Requirement. That in turn may make it more attractive to EEA insurers to place reinsurance with reinsurers based in countries whose regimes have been recognised as equivalent under Article 172.
49. The Commission has made Article 172 equivalence determinations in relation to Switzerland, Bermuda<sup>50</sup> and (on a temporary basis until 2020) Japan.
50. In order for third country reinsurers to be able actually to carry on reinsurance business in the EU, it is necessary for a specific agreement to be made. Article 175 ("*agreements with third countries*") provides that:

*"(1) The Commission may submit proposals to the Council for the negotiation of agreements with one or more third countries regarding the means of exercising supervision over the following:*

*(a) third-country reinsurance undertakings which conduct reinsurance business in the Community;*

*(b) Community reinsurance undertakings which conduct reinsurance business in the territory of a third country.*

*(2) The agreements referred to in paragraph 1 shall in particular seek to ensure, under conditions of equivalence of prudential regulation, effective market access for reinsurance undertakings in the territory of each contracting party and provide for mutual recognition of supervisory rules and practices on reinsurance. They shall also seek to ensure the following:*

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<sup>50</sup> Except in relation to captive and special purpose reinsurers.

*(a) that the supervisory authorities of the Member States are able to obtain the information necessary for the supervision of reinsurance undertakings which have their head offices situated in the Community and conduct business in the territory of third countries concerned;*

*(b) that the supervisory authorities of third countries are able to obtain the information necessary for the supervision of reinsurance undertakings which have their head offices situated within their territories and conduct business in the Community. ..."*

51. As with Article 171 in relation to direct insurance, we are aware of no specific guidance as to the operation of this provision. It may be noted that recital 89 to Solvency II states:

*"In order to take account of the international aspects of reinsurance, provision should be made to enable the conclusion of international agreements with a third country aimed at defining the means of supervision over reinsurance entities which conduct business in the territory of each contracting party. Moreover, a flexible procedure should be provided for to make it possible to assess prudential equivalence with third countries on a Community basis, so as to improve liberalisation of reinsurance services in third countries, be it through establishment or cross-border provision of services."*

52. It may be inferred that Article 175 aims to facilitate reciprocal agreements under which EEA reinsurers can do business in significant markets outside the EEA.

### **(3) Group solvency**

53. Article 227(1) provides:

*"When calculating the group solvency of an insurance or reinsurance undertaking which is a participating undertaking in a third-country insurance or reinsurance undertaking, in accordance with Article 233, the third-country insurance or reinsurance undertaking shall, solely for the purposes of that calculation, be treated as a related insurance or reinsurance undertaking."*

*However, where the third country in which that undertaking has its head office makes it subject to authorisation and imposes on it a solvency regime at least equivalent to that laid down in Title I, Chapter VI, Member States may provide that the calculation take into account, as regards that undertaking, the Solvency Capital Requirement and the own funds eligible to satisfy that requirement as laid down by the third country concerned."*

54. Thus, a finding of equivalence for the solvency regime means that calculation of group solvency may take into account the Solvency Capital Requirement and own funds of the third country insurer. This applies if group solvency is being calculated in accordance with "method 2", the deduction and aggregation method, rather than "method 1", which is the default method.
55. Article 227 provides for such equivalence to be determined by the group supervisor in the EU, subject to any decisions the Commission may take on this topic. Even where equivalence is found, Article 227 does not expressly compel the EU Member State to take into account the third country rules: that appears to be a matter of discretion.
56. The Commission has made group solvency equivalence determinations in relation to Switzerland, Bermuda and (on a 10-year provisional basis) for the US, Australia, Brazil, Canada, Mexico and Japan.

#### **(4) Group supervision**

57. Article 213 provides for supervision at group level of insurance and reinsurance undertakings, including *"insurance or reinsurance undertakings, the parent undertaking of which is an insurance holding company or a mixed financial holding company which has its head office in a third country or a third-country insurance or reinsurance undertaking ..."* (Article 213(2)(c)).
58. Article 260 provides that in such a case:

*"... the supervisory authorities concerned shall verify whether the insurance and reinsurance undertakings, the parent undertaking of which has its head office outside*

*the Union, are subject to supervision, by a third-country supervisory authority, which is equivalent to that provided for by this Title on the supervision at the level of the group of insurance and reinsurance undertakings referred to in Article 213(2)(a) and (b)."*<sup>51</sup>

59. Article 261(1) provides:

*"In the event of equivalent supervision referred to in Article 260, Member States shall rely on the equivalent group supervision exercised by the third-country supervisory authorities ..."*

60. These provisions mean that if equivalence is granted, EU Member States will rely on the group supervision exercised by the third country supervisor. They apply where the EU insurers have a parent undertaking in the third country. Member States supervisors form a 'college' led by the third country group supervisor.

61. Here, it appears the EU regulatory authorities are required to allow home supervision by the third country regulator, if equivalence exists. However, verification of whether equivalence does exist is a matter for the EU supervisory authority, subject (as for Article 227 on group solvency) to any Commission determination on that topic.

62. Absent equivalence, Member States can either apply the directive's group supervision provisions, or other methods to ensure appropriate supervision of the insurers in a group.

63. The Commission has made group supervision equivalence determinations in relation to Switzerland and Bermuda.

#### ***(5) Existing contracts of insurance and reinsurance***

64. It is unclear to what extent UK insurers and reinsurers will be permitted, under EU law, to continue to service existing policies following a hard Brexit. Solvency II makes no specific provision for this.

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<sup>51</sup> Articles 213(2)(a) and (b)

65. Solvency II contains rules governing both the “taking up” and “pursuit” of insurance and re-insurance.<sup>52</sup> Consistent with the existing Directives (and their predecessors), Solvency II appears to require authorisation for both activities.<sup>53</sup>
66. It is arguable that an undertaking which is merely servicing its existing contracts, and not writing new business in the EU, is neither taking up nor pursuing insurance business within the meaning of the directive. The concepts of “taking up” and “pursuit”, given their natural meaning, arguably refer to the commencement and development of a business, rather than extending to circumstances in which a company has ceased to pursue new business in the EU and is simply engaged in settling its outstanding financial commitments.
67. However, an alternative view is that such a firm is pursuing the activities of an insurance undertaking within the scope of Solvency II, at least insofar as it is taking additional premia, but arguably also insofar as it is managing its existing book e.g. by paying claims. The substantive provisions of Solvency II go beyond the starting of a business and the writing of new contracts, extending to matters occurring during the currency of contracts – for example, claims management<sup>54</sup> and the mandatory provision of information to policyholders.<sup>55</sup> While these examples are not conclusive, they may suggest that all of these aspects are part of the process of pursuit of insurance business. The Commission might not accept that, for instance, a life insurance company with a large number of policyholders paying annual premia, potentially for decades into the future, is not pursuing the business of insurance.
68. If the latter view is correct, then there is an urgent problem to address in order to permit firms to carry on servicing their existing policies.

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<sup>52</sup> Solvency II, Article 1(1).

<sup>53</sup> See e.g. Solvency II, Article 15(1), which provides that authorisation shall ‘permit insurance and reinsurance undertakings to pursue business’ throughout the EU, and similarly Article 73(1).

<sup>54</sup> E.g. Solvency II, Article 200, regarding legal expenses insurance.

<sup>55</sup> E.g. Solvency II, Article 185(5) regarding life insurance.

## **(6) Intermediaries**

69. There is no equivalence regime under IMD or IDD that third-country insurance intermediaries can use to passport into the Single Market.

## **(7) MiFID/MiFID II activities**

70. Insurance businesses may need passports to provide their other, non-insurance activities cross-border. See the Chapters on MiFID and MiFID II/MiFIR (from January 2018) (Chapter 2) and Capital Requirements (CRD IV) (Chapter 6) for more information on passporting under those regimes.

## **(8) Generally**

71. It should be apparent from the foregoing that even if all available equivalence recognitions were granted, UK insurers and reinsurers would still not be legally entitled to carry on business in the EU as they are at present pursuant to the Article 14 “passport”. Accordingly, to the extent that EU business is significant for these industry sectors, and unless effective “work-arounds” can be found, the industry is likely to be seriously damaged by a hard Brexit unless a deal can be struck to preserve access to the relevant EU markets.

## **F. Commentary**

72. Stakeholders in the insurance market have publicly deliberated upon the consequences of Brexit for the UK insurance industry.
73. Before the 23 June 2016 referendum, Lloyd’s explained that access to the Single Market is: “critical to the success of the London insurance market and its position as the world’s largest specialist insurance and reinsurance centre.”<sup>56</sup>
74. The Lloyd’s chairman warned on 5 September 2016 that: “if we are not able to access the single market, either through passporting rights or other means, the inevitable consequences for Lloyds – and indeed other insurance organisations – will be that we will

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<sup>56</sup> Sean McGovern, Lloyd’s chief risk officer, speech on 10.02.16.

*transact the business onshore in the EU – and that obviously will have an impact on London.”<sup>57</sup> Inga Beale, the Lloyd’s chief executive, developed the theme: “We are making very robust plans. We could open a subsidiary in one of the remaining EU countries that will enable us to passport.”<sup>58</sup>*

75. In our judgment, these warnings are credible and realistic. Despite Lloyd’s precautions, global insurers may still shift business to subsidiaries elsewhere within the Single Market, bypassing the Lloyd’s market altogether. One news source quotes the general counsel of a FTSE 100 insurance company: *“For now, people in insurance should be looking at their cross-border arrangements. You’re in a good place if you have subsidiaries in the right places and passporting isn’t an issue – others don’t have that luxury. Does your business need to establish subsidiaries elsewhere? Who are your suppliers? People should get a feel for where they think problems will arise.”<sup>59</sup>*
76. More generally, multinational insurers with their European headquarters in the UK are considering moving operations to other Single Market countries. AIG’s chief executive for the UK and Europe recently noted: *“At a certain point in time you’ve got to pull the trigger, absent of any clarity on where negotiations are going in the transition period”.*<sup>60</sup>

## **G. Possible Mitigations**

77. Commentators and policymakers have presented various options to mitigate the challenges posed by Brexit and, specifically, the risks to the UK insurance industry of losing passporting rights into the Single Market.
78. For firms, it has been suggested that an insurer may use a “*pass through*” vehicle established in the EU which reinsures all its risk back to a UK entity within the

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<sup>57</sup> John Nelson, Lloyd’s chairman, speech on 05.09.16.

<sup>58</sup> 22.09.16, *The Guardian*, “Lloyd’s considers opening EU subsidiary to be ready for Brexit”.

<sup>59</sup> <http://www.inhouselawyer.co.uk/index.php/mag-feature/the-new-order/>

<sup>60</sup> Anthony Baldwin, AIG’s chief executive for the UK and EU, speech on 22.11.16 to the ABI.

same group. However, such arrangements are likely to be workable only in the event of suitable equivalence determinations being made, and in any event could not assist intermediaries.

79. Failing that, or some other governmental solution of the kind discussed below, an insurer or intermediary seeking to continue to do business in the EU, and not wishing to re-domicile itself, will need either:
  - a. to set up an EU subsidiary, seek authorisation from the relevant EU Member State for it, and then exercise passporting rights through that subsidiary; or
  - b. to establish branches in EU Member States and seek authorisation for them on a country by country basis.
  
80. The options for the UK government include:
  - a. Joining the EEA. Membership of the EEA (and, by implication, EFTA) would maintain passporting rights under IMD/IDD and Solvency II into the EU and EEA for the UK insurance industry.
  - b. Entering a free trade agreement with the EU: known as “the Canada option”.
    - (1) Any bilateral trade agreement between the UK and EU may contain “most-favoured nation treatment” provisions, such as those under Article 13.7 of CETA<sup>61</sup>, whereby direct insurers, reinsurers and insurance mediators can sell into the EU.<sup>62</sup> Any trade deal could reserve a prudential carve-out to the UK, as contained in Article 13.16 of CETA, retaining greater regulatory independence for the UK competent authorities than at present. Given the two-way flow of passports, as seen above, and the access EU insurers, reinsurers and intermediaries have to the UK market, there is likely to be

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<sup>61</sup> The Comprehensive Economic and Trade Agreement between the EU and Canada.

<sup>62</sup> NB the definition of financial services under CETA, which includes insurance, reinsurance and insurance intermediation.



enthusiasm amongst them for the conclusion of a free trade agreement, so that this access can be retained unchanged.

- (2) If the UK government is to negotiate a free trade deal with the EU, or otherwise seeks a bespoke agreement for passporting rights, that agreement must be concluded before Brexit day, or before the expiry of a transitional period, while the insurance industry retains passporting rights, to ensure continuity in the provision of insurance services thereafter, without the need for the establishment of subsidiaries or pass-through vehicles.
- c. Third-country status: equivalence determinations of the kind discussed above, though markedly inferior to full access to the internal market, would mitigate the effects on the industry of a hard Brexit. Given the opacity of the equivalence process, and the quasi-political nature of equivalence determinations, where there is an equivalence regime built into EU legislation (such as under Solvency II) the UK should work to obtain equivalence determinations during the 2-year period after notification is giving under TEU Article 50, rather than waiting until Brexit day to begin the process. Such determinations can be sought on a provisional basis under Solvency II, and this should be regarded as an urgent priority with a view to avoiding any significant gap following the end of the Article 50 notice period. At the same time, a more comprehensive deal will be need to be negotiated in the mutual interests of insurers in both the UK and the EU.
  - d. Since there are no equivalence regimes under IMD/IDD, in the absence of a free trade agreement or a transitional agreement, insurance and reinsurance intermediaries will be deprived of their right to sell into the EU without specific authorisation in each Member State, unless they establish appropriate subsidiaries or pass-through vehicles in advance of Brexit day.



## **CHAPTER 4 - THE IMPACT OF BREXIT ON SCHEMES FOR THE TRANSFER OF FINANCIAL SERVICES BUSINESS UNDER THE FINANCIAL SERVICES AND MARKETS ACT 2000, PART VII**

### **A. Introduction**

1. The Financial Services and Markets Act 2000 ('FSMA 2000'), Part VII (Control of business transfers) establishes a statutory framework under which the High Court (or the Court of Session in Scotland) may sanction the transfer of specified types of financial services business, on the terms of a transfer scheme. In its present form, the Part VII framework covers (a) insurance business transfer schemes; (b) banking business transfer schemes; (c) reclaim fund business transfer schemes<sup>63</sup>; and (d) ring-fencing transfer schemes<sup>64</sup>.
2. The insurance business transfer scheme has its origin in EU legislation, specifically the First Non-Life Insurance Directive (73/239/EEC). That Directive required Member States (a) to make it possible for an insurance undertaking established in that state *"to assign all or part of its portfolio of policies if the assignee possessed the necessary solvency margin"*; and (b) to establish a related regime for the transfer of portfolios of insurance contracts effected by insurance agencies or branches operating in its territory. Successive Directives extended the portfolio transfer regime to cover long-term insurance business and, much later, reinsurance business.

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<sup>63</sup> A "reclaim fund" is a company established pursuant to the Dormant Bank and Building Society Accounts Act 2008. Reclaim funds are intended to enable the distribution of money in dormant bank and building society accounts for the benefit of the community, whilst ensuring the right of owners to reclaim their money is protected. Under FSMA 2000, s. 106A(1) a scheme is a reclaim fund business transfer scheme if, under the scheme, the whole or part of the business carried on by a reclaim fund is to be transferred to one or more other reclaim funds.

<sup>64</sup> In response to the 2008 to 2009 financial crisis the Financial Services (Banking Reform) Act 2013 established a bank ring-fencing regime. In broad outline, the regime requires UK banking groups that have retail banking operations above a specified size to ensure that retail banking operations are carried on only through 'ring-fenced bodies': group legal entities that are (a) separate from group legal entities undertaking wholesale and investment banking activities; and (b) required to operate in compliance with the ring-fencing regime. Under FSMA 2000, s. 106B, a scheme is a ring fencing transfer scheme if, amongst other conditions, it is to be made for a specified purpose connected with the implementation of the ring-fencing regime.

3. When FSMA 2000 came into force on 1 December 2001, Part VII replaced the insurance business transfer regime under the Insurance Companies Act 1982, ss. 49 to 52B and introduced two innovations. First, general insurance business transfer schemes, which had previously been sanctioned at the discretion of the relevant Secretary of State, were brought into line with long-term insurance business transfer schemes and made subject to sanction by the Court. Second, the Part VII framework was extended to provide for banking business transfer schemes, which had previously required either the consent of the customers affected, or a private Act of Parliament.<sup>65</sup>
4. However, both (a) the extension of the Part VII framework to cover banking business transfer schemes; and (b) its subsequent extension to cover reclaim fund business transfer schemes and ring-fencing transfer schemes, are UK domestic initiatives. They are neither the UK implementation of EU requirements, nor the product of directly effective EU measures.

### **B. Key features of the Part VII Framework**

5. The essential features of the Part VII framework are as follows. Except as noted, these features are common to all types of business transfer scheme:
  - a. Once the relevant pre-conditions<sup>66</sup> are met, the Court may sanction a transfer scheme if it is satisfied that in all the circumstances of the case, it is

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<sup>65</sup> See, for example, Proctor, 'Bank Restructuring under the Financial Services and Markets Act', [2003] JIBRL, p. 471.

<sup>66</sup> There are four basic pre-conditions. First, the scheme must fall within the definition of a scheme for that type of business, set out FSMA 2000, ss.105 to 106B. Footnotes 63 and 64 above touch on the definition of reclaim fund transfer schemes and ring-fencing transfer schemes. A more prosaic example is FSMA 2000, s. 105(3), which provides that a scheme is not an insurance business transfer scheme if, amongst other possibilities, the transferor concerned is a friendly society. Second, under FSMA 2000, s. 108(2) the Court may not determine an application for the sanction of a scheme unless the applicant has complied with any 'requirements on applicants' imposed by way of subordinate legislation. In the main, these requirements relate to publicity for the scheme. Third, the Court must be satisfied that the appropriate certificates have been obtained, as set out in FSMA 2000, s. 111(2)(a) to (ab), read with FSMA 2000, Schedule 12. For example, in relation to a banking business transfer scheme the relevant financial regulator must have certified that, taking the proposed transfer into account, the transferee has, or will have before the scheme takes effect, adequate financial resources. Fourth, under FSMA 2000, s. 111(2)(c), the Court must be satisfied that transferee has, or will have before the scheme takes

appropriate to do so.<sup>67</sup> The Court has affirmed<sup>68</sup> that its discretion to sanction (or not sanction) a transfer scheme is “*of real importance, not to be exercised in any sense by way of rubber stamp*”.

- b. On sanction of a transfer scheme, the Court may, under FSMA 2000, s. 112(1)(a), order “*the transfer to the transferee of the whole or any part of the undertaking concerned and of any property<sup>69</sup> or liabilities<sup>70</sup> of the transferor*”. Pursuant to FSMA 2000, ss. 112(2)(a) and (3), the effect of that order is to transfer to and vest in the transferee, such of the affected property and liabilities as are governed by the law of part of the UK.<sup>71</sup> That transfer is effective even if the relevant property or liabilities are otherwise non-transferable at common law,<sup>72</sup> or by virtue of express contractual provisions.<sup>73</sup>
- c. On sanction of a transfer scheme, the Court may also make provision for a range related outcomes.<sup>74</sup> In particular, under FSMA 2000, s. 112(1)(d), the Court may make provision “*with respect to such incidental, consequential and supplementary matters as are, in its opinion, necessary to secure that the scheme is fully and effectively carried out*”. The Court has adopted a liberal

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effect, the authorisation required (if any), to enable the transferring business to be lawfully carried on in the place to which it is to be transferred.

<sup>67</sup> FSMA 2000, s. 111(3).

<sup>68</sup> *In re Pearl Assurance* [2006] EWHC 2291 (Ch), per Briggs J, at [6].

<sup>69</sup> Defined in FSMA 2000, s. 112(12) to include ‘property, rights and powers of any description’.

<sup>70</sup> Defined in FSMA 2000, s. 112(3), to include ‘duties’.

<sup>71</sup> FSMA 2000, s. 112(4): ‘if any property or liability included in the order is governed by the law of any country or territory outside the United Kingdom, the order may require the transferor concerned ... if the transferee so requires, to take all necessary steps for securing that the transfer to the transferee of the property or liability is fully effective under the law of that country or territory.’ A somewhat different regime applies in relation to insurance business transfers.

<sup>72</sup> For example, because at common law the novation of a liability requires the consent of the creditor.

<sup>73</sup> See *Re Carter Allen* (unreported 30 April 2002), per Laddie J (banking business transfer scheme); and *WASA International (UK) Insurance Co v WASA International Insurance Co Ltd* [2002] EWCA 2698 (Ch) (insurance business transfer scheme), holding that FSMA 2000, s. 112(2)(a) (‘an order under subsection (1)(a) may ... transfer property or liabilities whether or not the transferor concerned otherwise has the capacity to effect the transfer’) has a wide ambit, not confined to limitations of corporate capacity. FSMA 2000, ss. 112(2A) and (2B) now make clear the scope of the Court’s power under FSMA 2000, s. 112.

<sup>74</sup> FSMA 2000, s. 112(1)(b) to (d).

construction, under which “*necessary*” lies “*somewhere ... between ‘vital’ on the one hand and ‘desirable’ on the other*”.<sup>75</sup> At least in the context of insurance business transfer schemes, the Court has held<sup>76</sup> that as long as the predominant purpose of the scheme is to effect one or more transfers, there is no statutory requirement that the scheme should do nothing but effect a transfer. In addition, FSMA 2000, s. 112(8) enables a Court that sanctions an insurance business transfer scheme to provide for insurance-specific outcomes, including the reduction of benefits payable under transferring policies.<sup>77</sup>

- d. To ensure that the Court makes the decision whether or not to sanction a transfer scheme with a full appreciation of the potential impact of that scheme, FSMA 2000, s. 110 provides that both (a) the relevant UK financial regulator<sup>78</sup>; and (b) any person (including an employee of the transferor or the transferee) who alleges that he would be adversely affected by the carrying out of the scheme, has the right to be heard at the hearing for the sanction of the scheme. Except in the case of ring-fencing transfer schemes, where representations must be in writing and served on the relevant financial regulator<sup>79</sup>, no particular formality attends the exercise of the right to be heard. The regulators’ current practice<sup>80</sup> is to make written reports to the Court, explaining the basis on which they do not object<sup>81</sup> to the transfer

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<sup>75</sup> *Re Norwich Union Linked Life Assurance Ltd* [2004] EWHC 2802 (Ch), per Lindsay J. at [9], following *Re Hill Samuel Life Assurance Ltd*, (unreported, 10 July 1995) per Knox J.

<sup>76</sup> *Re Norwich Union Linked Life Assurance*, above, at [9] to [12].

<sup>77</sup> FSMA 2000, s. 112(8)(c).

<sup>78</sup> That is, the Financial Conduct Authority in all cases; and, in addition, if the transferor or the transferee is a ‘PRA-authorized person’ (i.e. a firm authorized under FSMA 2000 with permission to carry on insurance business or banking business and therefore ‘dual regulated’), the Prudential Regulation Authority.

<sup>79</sup> FSMA 2000, s. 110(3) to (5)/

<sup>80</sup> Following the ‘invitation’ extended by the Chancellor in *Re Alba Life Limited* [2006] EWHC 3507 (Ch), at [78].

<sup>81</sup> This is not to suggest that it is the policy of the regulators never to object to a transfer scheme. It simply reflects the reality that, as indicated in *Re Axa* [2001] 1AER (Comm.), per Evans-Lombe J, ‘the ... [regulators] by reason of ... [their] regulatory powers can also be expected to have the necessary material and expertise to express an informed opinion on whether policyholders are likely to be adversely affected. ... [and therefore] the court will pay close attention to any views expressed by the

scheme in question. To ensure that the right to be heard is fully exercised, the pre-conditions for the Court's sanction of a transfer scheme include requirements<sup>82</sup> that, with one exception, notice of an application for the sanction of a transfer scheme must be publicised in the Gazettes and in UK national newspapers.<sup>83</sup> More extensive notification requirements apply to an insurance business transfer scheme.<sup>84</sup> An application for the sanction of (a) an insurance business transfer scheme; and (b) a ring-fencing transfer scheme, must be accompanied by 'scheme report'<sup>85</sup> prepared by an appropriately qualified expert, whose duty is to assist the Court in the evaluation of the Scheme and, in the case of a ring-fencing transfer scheme, to express a view on specified issues in relation to the scheme.

### **C. The commercial and regulatory utility of FSMA 2000, Part VII**

6. The essential features of the Part VII framework, outlined above, provide a good indication of the utility of that framework beyond its obvious function as a mechanism to facilitate the purchase and sale of books of financial services business:
  - a. It enables the consolidation and reorganisation of insurance and banking business. For example, (1) in the banking arena, the regime has been applied to subsidiarise the deposit-taking business of UK branches of

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... [regulators]'. Accordingly, a transfer scheme to which either regulator objects is unlikely to proceed as far as a sanction hearing.

<sup>82</sup> See footnote 66, above.

<sup>83</sup> See the Financial Services and Markets Act 2000 (Control of Business Transfers) (Requirements on Applicants) Regulations 2001 (SI 2001/3625), Reg. 3(2)(a) (insurance business transfers); and Reg. 5(2) (banking business transfers and reclaim fund business transfers). The exception is ring-fencing transfer schemes in relation to which (oddly) there is no formal requirement for publication. However, a minimum level of publicity must be a necessary pre-condition for the effective exercise of the right to be heard.

<sup>84</sup> For example, under the Financial Services and Markets Act 2000 (Control of Business Transfers) (Requirements on Applicants) Regulations 2001 (SI 2001/3625), Reg. 3(2)(b), all policyholders of the transferor and the transferee must receive individual notice of an insurance business transfer scheme, unless the Court waives that requirement, under Reg. 4.

<sup>85</sup> See FSMA 2000, ss. 109 (insurance business transfer schemes); and s. 109A (ring-fencing transfer schemes).

Greek and Cypriot banks in the face of the Eurozone crisis; and (2) in the insurance arena, the regime has been applied to achieve the demutualisation of mutual insurers and to consolidate books of unique or dormant insurance business into specialist entities best able to unlock economies of scale in the runoff of that business. Perhaps the most striking example of the latter type of scheme was the transfer in 2009 of the 1992 and prior year long-tail insurance business done at Lloyd's of London to a UK subsidiary of the Berkshire Hathaway group.<sup>86</sup>

- b. It enables intra-group reorganisation, including to simplify group structure and optimise capital structure. For example, in anticipation of the enhanced regulatory capital regime for insurers under the 'Solvency II' Directive<sup>87</sup> (which came into force on 1 January 2016), a number of insurance groups have consolidated the insurance business of group subsidiaries in a single insurer, to access diversification benefits and consequent reductions in regulatory capital;
- c. It facilitates compliance with prudential and other regulatory requirements. For example (1) an insurance business transfer that effects an intra-group re-organisation may also engage the Court's power to modify the terms of the transferring insurance contracts, so as to remove or limit unduly onerous or uncertain policy guarantees, thereby enhancing the security of existing business and enabling compliance with regulatory capital requirements; and (2) a banking group may utilise a ring-fencing transfer scheme to transfer relevant deposit taking business to a ring-fenced body, in compliance with the bank ring-fencing regime.

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<sup>86</sup> *Re Names at Lloyd's for 1992 and prior years of account represented by Equitas* [2009] EWHC 1595 (Ch).

<sup>87</sup> Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast).



#### **D. Automatic recognition of insurance business transfer schemes authorised in EEA states**

7. The EU regime for insurance portfolio transfers currently appears in the Solvency II Directive. Solvency II, Art. 39 makes provision for the “*transfer of portfolios*” of insurance and reinsurance contracts by (re)insurance undertakings established within the territory of a Member State. Solvency II, Art. 164 makes parallel provision for the transfer of insurance portfolios by branches of undertakings set up in the territory of a Member State.
8. The Solvency II regime for portfolio transfers provides for procedural formalities,<sup>88</sup> including the certification of the solvency of the accepting undertaking, taking the proposed transfer into account. Most significantly, if a transfer initiated in a home State relates to contracts concluded in or connected with a host State, the consent of the relevant authority in the host State is required before the transfer is authorised in the home State.<sup>89</sup> However, a host State is deemed to consent if it fails to respond within three months of receiving a request for consultation.<sup>90</sup>
9. Solvency II, Articles 39(6) and 164(6) provide that portfolio transfers authorised in accordance with the applicable Directive provisions “*shall automatically be valid against policy holders, the insured persons and any other person having rights or obligations arising out of the contracts transferred*”. These requirements are implemented in the UK by way of FSMA 2000, s. 116, which provides for the recognition in the UK of insurance business transfers authorised in other EEA States.
10. The UK recognition regime applies:

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<sup>88</sup> Which formalities underlie the certification requirements forming part of the pre-conditions for the sanction of an insurance business transfer scheme, set out in footnote 66 above.

<sup>89</sup> Solvency II, Arts 39(4) and 164(4).

<sup>90</sup> Solvency II, Arts 39(5) and 164(5).

- a. Under FSMA 2000, s. 116(1), if as a result of transfer authorised in an EEA State,<sup>91</sup> in accordance with Solvency II, Art 39, an EEA insurer or reinsurer with its head office in that State, transfers to another body all its rights and obligations under a 'UK policy'<sup>92</sup>;
  - b. Under FSMA 2000, s. 116(2)(a), if as a result of a transfer authorised in an EEA State, in accordance with Solvency II, Art. 164, the EEA authorised branch of a third country insurer transfers to another body all its rights and obligations under a UK policy; or
  - c. Under FSMA 2000, s. 116(2)(b), if as a result of a transfer authorised in an EEA State, in accordance with the provisions in the law of that State which provide for the authorisation of transfers of all or part of a portfolio of contracts of a third country undertaking authorised to carry out reinsurance activities in its territory (as mentioned in Article 174 of the Solvency 2 Directive), an EEA pure reinsurer transfers to another body all its rights and obligations under a UK policy.
11. In summary, the first two categories of recognised transfer are straightforward: the recognition regime applies to transfers of UK policies (1) by an insurer or reinsurer established in an EEA State; and (2) by the EEA-authorized branch of a third country insurer (but not a reinsurer).
  12. The third category is more opaque. Its complexity stems from the way in which Solvency II deals with reinsurance business carried on by a pure reinsurer established in a third country. In principle, the reinsurer could carry on that business in the EU on either an establishment basis or a services basis. However,

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<sup>91</sup> The switch from the Directive language of "Member State" to the FSMA 2000 language of "EEA State" reflects the impact of the EEA Agreement (OJ No. L 1, 31 March 1993, p. 3 (as amended)) under which Solvency II is adopted as a relevant instrument (under Annex IX) and to which the provisions of Protocol 1 (on horizontal adaptation) apply, including paragraph 7: "Rights conferred and obligations imposed upon the EC Member States or their public entities, undertakings or individuals in relation to each other, shall be understood to be conferred or imposed upon Contracting Parties, the latter also being understood, as the case may be, as their competent authorities, public entities, undertakings or individuals".

<sup>92</sup> FSMA 2000, s. 116(6): any contract of insurance or reinsurance to which the applicable law is the law of part of the UK.

subject to (a) Solvency II, Art 174, which provides that a third country reinsurer must not receive more favourable treatment than an EEA reinsurer; and (b) the possibility of a bilateral agreement, under Solvency II, Art. 175, between the EU and the relevant third country regarding the supervision of third country reinsurers:

- a. Solvency II is silent (and it is therefore an open question) as to whether a third country pure reinsurer may simply conduct business on a services only (i.e. 'non-admitted') basis without a permanent presence or establishment in the EU; and
  - b. Solvency II is silent as to the conditions that Member States should impose on incoming branches of third country pure reinsurers. In principle, that leaves each Member State free to decide for itself what the relevant conditions should be.
13. Read against that background, FSMA 2000, s. 116(2)(b) deals with the situation in which (a) a third country pure reinsurer has in fact obtained some form of authorisation in an EEA State; and (b) the transfer of a portfolio of UK pure reinsurance policies has been authorised under the law of that state.
14. As to the recognition of an approved business transfer scheme in the UK FSMA 2000, s. 116 provides in part that:

*“(3) If appropriate notice<sup>93</sup> of the execution of an instrument giving effect to the transfer is published, the instrument has the effect in law –*

*(a) of transferring to the transferee all the transferor's rights and obligations under the UK policies to which the instrument applies, and*

*(b) if the instrument so provides, of securing the continuation by or against the transferee of any legal proceedings by or against the transferor which relate to those rights and obligations.*

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<sup>93</sup> Defined in FSMA 2000, s. 116(7).

(4) No agreement or consent is required before subsection (3) has the effects mentioned.”

### **E. Post-Brexit business transfer schemes that include assets and liabilities subject to a foreign law**

15. The obvious consequence of a “hard Brexit”, (under which the UK firms do not immediately gain either (a) EEA rights; or (b) equivalent rights under a bespoke agreement with the EU, whether under Solvency II or otherwise), is that EEA States will no longer be compelled to recognise the effect of insurance business transfer schemes sanctioned by the UK courts. As David Richards J put it<sup>94</sup>, an order of the Court sanctioning a transfer “*will not be directly effective in those States under the terms of the relevant EU insurance directive*”. That will be the case whether or not the UK maintains its recognition regime under FSMA 2000, s. 116.
16. A hard Brexit is likely to be less significant for banking business transfer schemes; reclaim fund business transfer schemes and ring-fencing transfer schemes, which do not currently benefit from an EU recognition regime. Indeed, insofar as those schemes include assets or liabilities that are governed by the law of any country or territory outside the UK, the Part VII framework does not assume that the sanction of the scheme by the Court will necessarily have any effect in relation to those assets. That is the obvious implication of FSMA 2000, s. 112(4), which provides that in relation to such assets, the order sanctioning the scheme “*may require the transferor concerned ... if the transferee so requires, to take all necessary steps for securing that the transfer to the transferee of the property or liability is fully effective under the law of that country or territory.*”
17. The implications of including foreign law assets and liabilities in a business transfer scheme post-Brexit are neatly illustrated by the decision of David Richards J in *Sompo Insurance. v Transfercom*.<sup>95</sup> As its title suggests, this case

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<sup>94</sup> In *Sompo Japan Insurance Inc. v Transfercom Ltd* [2007] EWHC 146 (Ch), at [23].

<sup>95</sup> *Sompo Japan Insurance Inc. v Transfercom Ltd* [2007] EWHC 146 (Ch).

concerned the sanction of an insurance business transfer scheme. However, the contracts to be transferred were primarily contracts of reinsurance. When the scheme came before the Court, EU insurance Directives did not yet require Member States (a) to provide for portfolio transfers in respect of reinsurance business; or (b) automatically to recognise transfers of reinsurance business sanctioned in other Member States.

18. Only about 27% of the affected policies (by number and by value of reserves) were governed by English law.<sup>96</sup> Accordingly, the Court had to consider whether it was nevertheless appropriate to exercise its discretion to sanction the transfer scheme in light of the principle in *Re Ratners Group plc* [1988] BCLC 685, that the court will not act in vain, by making an order with no real purpose. The Court concluded<sup>97</sup> on the evidence that it was reasonable to suppose that the transfer scheme would be effective in any relevant jurisdiction, at least as regards the contracts of insurance governed by English law. Accordingly, the scheme would achieve a substantial purpose. The fact that the scheme also extended to a larger class of business, not governed by English law, was not a good reason to refuse sanction.
19. The principle established in *Sompo Insurance. v Transfercom* has been considered and applied in later cases.<sup>98</sup> It seems likely that this principle will be unaffected by Brexit. However, if Brexit or its sequelae make it more difficult to obtain recognition of a UK judgement by an EU Member State, then that is likely to make it harder to satisfy a UK Court as to the utility and purpose of a business transfer scheme that includes assets and liabilities governed by the law of that state.

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<sup>96</sup> *Ibid.*, at [22].

<sup>97</sup> *Ibid.*, at [26].

<sup>98</sup> See, for example, *Re The Copenhagen Reinsurance Company Ltd* [2016] EWHC 944 (Ch), per Snowden J at [45] and ff. and the authorities cited there.

## **F. Conclusions**

20. The essential conclusions of this Chapter are as follows:

- a. The commercial and regulatory utility of the Part VII framework suggests that it is likely to remain an essential feature of the domestic financial services landscape, whatever form Brexit may ultimately take.
- b. Banking business transfer schemes, reclaim fund business transfer schemes and ring-fencing transfer schemes that include assets and liabilities that are subject to the law of an EEA state do not currently benefit from automatic recognition in those states. Accordingly, a hard Brexit is unlikely to affect those transfers, unless the fallout from Brexit makes it generally more difficult to obtain recognition of a UK judgement in an EEA state.
- c. Insurance business transfer schemes that include assets and liabilities that are subject to the law of an EEA state will be more severely affected by a hard Brexit because such schemes will no longer benefit from automatic recognition in those states.
- d. It seems unavoidable, therefore, that by removing automatic recognition, a hard Brexit will make the UK a far less attractive jurisdiction in which to promote and pursue an insurance business transfer scheme that includes a significant volume of insurance business that is subject to the law of an EEA Member State.

## CHAPTER 5 - AIFMs AND UCITS FUNDS

### A. Introduction

1. This Chapter considers the impact of Brexit on the authorisation and supervision of Alternative Investment Fund Managers (“AIFMs”) and on collective investment funds holding UCITS status<sup>99</sup> within the EU.
2. AIFMs act as managers of alternative investment funds (“AIFS”) such as hedge funds, private equity funds, and other non-UCITS investment vehicles. Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (“AIFMD”) regulates the position of AIFMs within the EU. UK AIFMs are authorised and regulated by the FCA, and must comply with the provisions of AIFMD as implemented in English law.
3. The rules currently applying to UCITS Funds are set out in Directive 2009/65 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities as regards depositary functions, remuneration policies and sanctions (as amended) (“**the UCITS Directive**”).
4. The likely impact of Brexit on AIFMs and on UCITS funds will obviously largely depend on the form that Brexit ultimately takes. If the UK remains as a member of the EEA, it will retain its access to the single market, including the financial services markets. In that case, the regulation of AIFMs and UCITS funds is likely to remain unchanged. This note considers the likely position if Brexit involves a withdrawal by the UK from the single market. However, it will be recognised

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<sup>99</sup> Undertakings for Collective Investment in Transferable Securities (“UCITS”) funds are mutual investment funds regulated by the harmonised EU UCITS framework (discussed in further detail in this section). UCITS funds are very popular investments, particularly with small investors seeking a diversified investment. According to the European Commission, as at April 2014, UCITS funds managed almost €6 trillion in assets and accounted for around 75% of all collective investments by small investors in Europe: [http://europa.eu/rapid/press-release\\_STATEMENT-14-121\\_en.htm](http://europa.eu/rapid/press-release_STATEMENT-14-121_en.htm)

that these two scenarios exist at opposite ends of a spectrum of possible outcomes, with a number of possibilities in between.

5. Fund management under Directive 2004/39 on Markets in Financial Instruments (“**MiFID**”) is dealt with in Chapter 2 of this Report. However, it should be noted that changes to the MiFID regime following Brexit will also apply to UK investment firms providing investment advisory and management services to UCITS funds and AIFMs in EU Member States under a MiFID permission.

## **B. Brexit and AIFMs**

6. Under AIFMD, EU authorised AIFMs (“**EU AIFMS**”) can sell EU-domiciled alternative investments funds (“**EU AIFs**”) to professional investors<sup>100</sup> across the EU. This “passporting” regime applies only to EU AIFMs and to EU-domiciled AIFs. A third country AIFM or an EU AIFM seeking to sell a non-EU AIF within the EU must do so under the national private placement regimes (“**NPPRs**”) in place in the relevant EU member states.
7. Passporting under AIFMD confers significant benefits on AIFMs. From an investor perspective, AIFMD provides for a standardised and transparent governance regime, which should increase investor protection and provide for transparency as to how such funds hold and manage their assets. From the perspective of the funds themselves, the main benefit of AIFMD is the access that it provides to investors throughout Europe as a result of passporting. The NPPRs impose more onerous burdens in terms of regulatory compliance and coordination as compared to the “one stop shop” provided for under AIFMD. Further, the NPPRs in place in certain EU Member States (such as France and Italy) are very limited, such that those jurisdictions are effectively closed to AIFs that cannot bring themselves within the passporting regime.

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<sup>100</sup> The restriction on the sale of AIFs to professional investors is to be found at AIFMD, Article 32(9) (EU AIFs)



## *(1) Marketing*

8. Following a Hard Brexit, UK authorised AIFMs will no longer be EU AIFMs. As a result, they will be unable to avail themselves of the passporting arrangements conferred by AIFMD,<sup>101</sup> and will have to comply with the NPPRs of each Member State for marketing into EU jurisdictions. Similarly, UK-domiciled AIFs will no longer count as EU AIFs and will also fall outside the AIFMD passporting arrangements. AIFMs and AIFs from other EU Member States will no longer be able to passport into the UK market, but instead will have to rely on the UK NPPR.
9. The sale of non-EU AIFs by UK AIFMs to professional investors within the EU will no longer take place pursuant to the passporting procedure set out in AIFMD Article 35. Instead, UK AIFMs, as third country firms, would need to comply with requirements imposed by Article 42<sup>102</sup> of the AIFMD in addition to the requirements imposed by any relevant NPPRs. In this regard, it is anticipated that the FCA will seek to enter into regulator cooperation agreements with each of its EU counterparties in order to satisfy the requirements of Article 42(1). The AIFMD makes provision for the passport, which is currently reserved to EU AIFMs and AIFs, to be potentially extended in future. However, for the reasons explained in paragraph 19(b) below, this is, from the perspective of any non-EU country seeking to acquire passport rights, likely to prove a detailed and time-consuming process that suffers from a number of significant shortcomings.

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<sup>101</sup> See AIFMD, Article 32.

<sup>102</sup> Article 42 requires that:

- (1) The non-EU AIFM complies with Articles 22, 23 and 24 in respect of each AIF marketed by it pursuant to this Article and with Articles 26 to 30 where an AIF marketed by it pursuant to this Article falls within the scope of Article 26(1);
- (2) Appropriate cooperation arrangements are in place between the regulatory authorities of the Member States where the AIFs are marketed and the authorities of the third country where the non-EU AIFM is established;
- (3) The third country where the non-EU AIFM or the non-EU AIF is established is not listed as a Non-Cooperative Country and Territory by the Financial Action Task Force (on Money Laundering) ("FATF").

10. Non-EU AIFs sold by UK AIFMs will no longer be subject to the regime imposed by Article 36 of AIFMD, which sets out the conditions under which a non-EU AIF managed by an EU AIFM may be marketed in Member States without a passport,<sup>103</sup> and will also be governed by the Article 42 regime following Brexit.

### *(2) Management*

11. Article 33 of AIFMD provides that EU AIFMs may, directly or by establishing a branch, manage EU AIFs established in another Member State. Following Brexit, UK AIFMs will no longer have an automatic entitlement to manage AIFs established in other EU Member States under Article 33.<sup>104</sup> However, Article 20 of AIFMD permits delegation of management activities to non-EU managers, provided certain minimal conditions are satisfied, which may permit UK managers to continue to market such AIFs within the EU where those conditions are met.

### *(3) Depositories*

12. EU AIFs are required to appoint a depository having the same domicile as the AIF.<sup>105</sup> If the UK ceases to be part of the single market, a UK depository will not meet the domicile requirements under AIFM. As a result, EU AIFs would not be able to use UK banks as depositories and UK AIFs would not be able to use EU banks as depositories. Non-EU domiciled AIFs marketed within the EU are

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<sup>103</sup> These conditions are as follows:

- (1) That the AIFM complies with all the requirements established by AIFMD (other than Article 21, which sets out the depository requirements of EU AIFs);
- (2) That appropriate cooperation arrangements are in place between the regulatory authorities of the Member States where the AIFs are marketed and the authorities of the third country where the non-EU AIFM is established;
- (3) That the third country where the non-EU AIFM or the non-EU AIF is established is not listed as a Non-Cooperative Country and Territory by the FATF.

<sup>104</sup> Instead, the procedure provided for in Articles 37 and 41 of AIFMD will apply.

<sup>105</sup> AIFMD, Article 21(1) and (5).

required to comply with the 'depository-lite' regime, which does require the depository to be EU-domiciled.<sup>106</sup>

## **C. Brexit and UCITS**

### ***(1) Marketing***

13. Brexit will also affect the ability of UCITS funds to be marketed in EU Member States.<sup>107</sup> In order to avail itself of the passporting provisions of the UCITS Directive, a UCITS fund must be domiciled in the EU and managed by an EU management company.<sup>108</sup> Following Brexit, UK established UCITS funds will no longer be EU domiciled and UK management companies will not constitute an authorised management company. Therefore, such funds will fall outside the scope of the applicable passporting provisions. Such funds would fall to be categorised as an AIF, and could only be marketed to professional investors in the EU pursuant to the Article 42 regime under AIFMD. Similarly, an EU established and managed UCITS would no longer have automatic access to the UK market and would have to comply with the UK NPPR.
14. It will therefore be seen that loss of the marketing passport under the UCITS Directive will cause the market available to UK UCITS funds to contract, as they will no longer be able to market to retail investors. This, added to the difficulties in accessing other EU markets' under their NPPRs, will mean that many UK UCITS funds are likely to look to redomicile in other EU member states, particularly if it appears that any settlement negotiated with the UK will involve the loss of passporting rights for financial services. Similarly, UK management

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<sup>106</sup> For non EU AIFs, the depository may be domiciled in the third country in which the AIF is established, the home Member State of the AIFM, or the Member State of reference of the AIFM managing the AIF: AIFMD, Article 21(5)(b). However, certain Member State require compliance with the full depository regime for non EU AIFs.

<sup>107</sup> See UCITS Directive, Articles 7 and 27.

<sup>108</sup> See UCITS Directive, Chapter XI.

companies may decide to redomicile in an EU Member State, or establish a new management company in the EU.

#### **D. Conclusions**

15. The marketing of these financial products within the EU is now heavily dependent on passporting. The loss of management and marketing passport rights following Brexit will be the most significant consequence of Brexit from the perspective of AIFMD and the UCITS Directive.
16. This is likely to have significant repercussions for the UK, in view of the importance of cross border marketing of these products. In order to give a sense of the scale of the problem, recent European Commission calculations indicate that the UCITS market has €8 trillion assets under management. Around 80% of UCITS funds are marketed cross-border. The commission also estimates that there are currently about €5 trillion of assets under management by AIFs, with 40% of such funds marketed across border. Overall, the Commission estimates that 57% of the funds (UCITS and AIFs) are marketed on a cross-border basis.<sup>109</sup>
17. A Brexit solution that would allow the UK to continue to access the EU single market for financial services would cause the least disruption to AIFMD and UCITS activities currently taking place in the UK. The UK could seek to retain this access as a full member of the member of the EEA or by way of a more limited alternative that would allow the UK to retain access to the single market in respect of certain industries and sectors, but not others.
18. If the UK does not retain access to the EU single market, it will have to seek to rely on “third country” regimes, which allow non-EU entities to access the single market, provided that: (1) the entity is authorised in a third country that has in place a regulatory regime in place that is equivalent to that operating within

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<sup>109</sup> EC Consultation Document, CMU Action on Cross-Border Distribution of Funds (Ucits, AIF, ELTIF, EUVECA and EUSEF) Across the EU (2016): [http://ec.europa.eu/finance/consultations/2016/cross-borders-investment-funds/docs/consultation-document\\_en.pdf](http://ec.europa.eu/finance/consultations/2016/cross-borders-investment-funds/docs/consultation-document_en.pdf)

the EU, (2) the third country offers reciprocal access to its market to EU domiciled firms, and (3) the regulator in that third country has entered into a regulator cooperation agreement with the EU.<sup>110</sup>

19. Because the UK currently implements the EU's regulatory regime for financial services, it is in theory well placed to avail itself of such third country regimes. In order to do so, it is anticipated that the FCA will have to retain many of the existing regulatory provisions applying to AIFMs and UCITS funds following Brexit.<sup>111</sup> However, even if this is done, the efficacy of third country regimes is undermined by a number of significant shortcomings:
  - a. First, the third country regimes that are presently available are not comprehensive. For example, the equivalence concept does not apply to the UCITS Directive, with the result that UCITS compliant funds from third states cannot rely on passporting rights. Although AIFMD contemplates that passporting will be available to non-EU AIFMs,<sup>112</sup> the relevant provisions have yet to be commenced.
  - b. Second, the detailed assessment procedures adopted by the European Securities and Markets Authority ("ESMA") for the purposes of determining whether it should recommend access to third state AIFMs is a detailed and time-consuming process. ESMA has only just completed its assessment for the first tranche of countries under consideration (Australia, Bermuda, Canada, Cayman Islands, Guernsey, Hong Kong, Japan, Jersey, Isle of Man, Singapore, Switzerland, and the United States) in July 2016.<sup>113</sup> Its advice is currently under consideration by the European Commission,

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<sup>110</sup> See generally, AIFMD, recital 69 and Article 67.

<sup>111</sup> The relevant provisions are set out in the Alternative Investment Fund Managers Regulations (2013/1773) and the Undertakings for Collective Investment in Transferable Securities Regulations (2011/161) (as amended) respectively.

<sup>112</sup> Directive 2014/65/EU on markets in financial instruments, Chapter IV. It is intended that this harmonised regime will ultimately replace existing NPPRs in Member States: AIFMD, recital 4; Article 68.

<sup>113</sup> <https://www.esma.europa.eu/press-news/esma-news/esma-advises-extension-funds-passport-12-non-eu-countries>

Parliament and Council. If the UK was to exit the EU and the EEA, it is unclear whether its assessment by the EMSA would be fast-tracked or whether it would have to join the back of the queue of third states awaiting assessment by the EMSA, following Brexit.

- c. It would be extremely important for the UK to seek to agree with the EU transitional arrangements for reciprocal market access, and for the EU to expedite the third country assessment process for the UK.
  - d. Finally, the UK will only be entitled to avail itself of such regimes while its regulatory regime is equivalent to that prevailing in the EU. Although the UK regulatory regime is likely to be equivalent as at the date that it leaves the EU, there is a risk of “creeping deharmonisation” as divergences between the EU and UK regimes appear over time. As a result, third country regimes would no longer be available to the UK unless it was to maintain its regulatory regime in line with that prevailing in the EU.
20. Given that there is likely to be a period of uncertainty before these issues are resolved, this will affect the decisions of many firms seeking to establish themselves or an investment fund within the EU in the near future. Third State funds seeking to establish a European AIFM are unlikely to choose the UK as its jurisdiction of domicile, or to choose a UK depository for its investments going forward. Similarly, many UK AIFMs may decide to establish an entity based in the EU to act as AIFM going forward. The result of this is that the UK financial services market is likely to be at a significant competitive disadvantage as compared to other EU jurisdictions. There is therefore a real premium on achieving certainty, or at least a desired end point, at the earliest possible time.

## CHAPTER 6 - CAPITAL REQUIREMENTS FOR BANKS, BUILDING SOCIETIES AND INVESTMENT FIRMS: THE CAPITAL REQUIREMENTS DIRECTIVE IV ("CRD IV")

### A. CRD IV and Passporting

1. The Capital Requirements Directive IV ("CRD IV") is an EU legislative package covering prudential rules for banks, building societies and investment firms. It consists of two separate pieces of legislation:
  - a. Capital Requirements Directive (2013/36/EU) ("CRD"), which must be (and in the UK has been) implemented through national law; and
  - b. Capital Requirements Regulation (575/2013) ("CRR"), which is directly applicable to firms across the EU.
2. CRD IV is intended to implement the Basel III agreement in the EU.<sup>114</sup> This includes enhanced requirements for, inter alia, the quality and quantity of capital, a basis for new liquidity and leverage requirements, new rules for counterparty risk, and new macro-prudential standards.
3. Annex I to the CRD sets out 15 types of activity which can be passported throughout the EU. Examples include deposit taking and lending (which includes consumer credit). This Chapter considers the CRD regime as it impacts upon the ability of firms to make use of passporting arrangements.
4. The provisions of the CRD which specifically address the ability to passport are as follows:<sup>115</sup>
  - a. Title III, '*Requirements For Access To The Activity Of Credit Institutions*';<sup>116</sup>

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<sup>114</sup> Which the UK will be obliged to comply with, even upon an exit from the EU.

<sup>115</sup> For the sake of completeness it should be noted that credit institutions also have passporting rights under MiFID to provide investment services – addressed in Chapter 2 of this Report. This section is concerned solely with banking activities that are authorised under CRD IV.

<sup>116</sup> Articles 8 – 21. Credit institutions are essentially banks and building societies.

- b. Title IV: *'Provisions Concerning The Freedom Of Establishment And The Freedom To Provide Services.'*<sup>117</sup>

We address each in turn.

(1) ***Title III: Access Requirements***

5. At the core of the access requirements is Article 8, which specifies that credit institutions need to be authorised by a Member State before commencing the activity specified in Annex I.
6. Article 17 provides that:

*"Host Member States shall not require authorisation or endowment capital for branches of credit institutions authorised in other Member States."*

7. Hence Article 17 provides a dispensation from the need to obtain authorisation in other Member States, when authorisation has already been given under article 8 by the home Member State. From a purely commercial perspective, the fact that the branch does not have to be separately capitalised is also a significant advantage.

(2) ***Title IV: Freedom Of Establishment And Freedom To Provide Services***

8. Article 33 provides:

*"Member States shall provide that the activities listed in Annex I may be carried out within their territories...either by establishing a branch or by providing services, by any credit institution authorised and supervised by the competent authorities of another Member State, provided that such activities are covered by the authorisation."*

9. The effect of article 33 is that if a credit institution is authorised in one member state, it has the freedom to establish a branch in, or to provide services to, any other EEA member state without prior approval. All that the credit institution

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<sup>117</sup> Articles 33 – 39.



has to do, if it wishes to exercise this freedom, is to notify the host country supervisor.<sup>118</sup>

10. The ability to establish a branch is important from a commercial perspective as it enables banks to avoid the costly and burdensome route of having to set up a separately capitalised subsidiary. Subsidiaries are separate legal entities subject to host country licensing and supervision that have to meet capital requirements on a solo basis. Using passporting rights to operate branches across the EU is therefore more time and cost effective.

### **B. Third Country Access**

11. On Brexit, UK banks would (subject to arrangements which preserve the existing position) lose their passporting rights. However, the CRD does not provide any framework for third country access to the single market, even for wholesale banking. This is hugely problematic.
12. Paragraph 23 of the recital to the CRD, provides as follows:

*“...The Union should be able to conclude agreements with third countries providing for the application of rules which accord such branches the same treatment throughout its territory. **Branches of credit institutions authorised in third countries should not enjoy the freedom to provide services or the freedom of establishment in Member States other than those in which they are established.**” (Emphasis added).*

13. It follows from this that, whilst the EU can theoretically enter into arrangements with third countries under CRD, those arrangements will not create any passporting rights, with the effect that a third country credit institution would therefore need to be separately authorised in each of the Member States in which it wished to do business.

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<sup>118</sup> The requirements of notification are contained in articles 35 and 39.

14. Other than the requirement that a Member State cannot treat a branch of an institution that has its head office in a third country more favourably than a branch of an institution that has its head office in the EU (article 47(1) CRD) the CRD does not provide any specific requirements as to the treatment of credit institutions of third country. Nor does the CRD specify the conditions that a third country credit institution would have to meet in order to offer cross-border services into the EU. As such, member states are, in principle, free to determine themselves how to apply authorisation and other regulatory requirements to non-EU credit institutions that want to provide services to the EU, either through cross-border activity or by establishing a subsidiary.
15. At present therefore, if, post-Brexit, a bank with its head office in the UK wanted to offer cross-border services, it would have to comply with the local law of each Member State into which it intended to offer its products or services. National laws may vary as to what kind of licensing is required to provide cross-border services, what capital requirements are applicable and whether the licence would be available in relation to services provided to all categories of client.
16. Article 47(3) of Title VI ('Relations With Third Countries') provides as material:

*"The Union may, through agreements concluded with one or more third countries, agree to apply provisions which accord to branches of a credit institution having its head office in a third country identical treatment throughout the territory of the Union".*
17. Accordingly article 47(3) at least conceives of the possibility that the EU and the third country could agree requirements as regards the establishment of branches that would apply uniformly across the EU. Hence, this may be one means by which the UK and the EU could reach agreement to preserve – in some form – passporting rights for banks located in the UK. However, beyond this generic statement, there is no guidance in the CRD either as to how the agreement should be reached or the substance of the requirements.

### C. Equivalence

18. The equivalence provisions under CRD IV are extremely limited, dealing essentially with prudential requirements. This is of no relevance to the critical issue of whether or not, post-Brexit, a UK-authorized credit institution will be able to offer cross-border services to the whole of the EU, and/or establish a branch there without seeking authorisation in each Member State. The effect of this is that, based on the current drafting of CRD IV, there is no fallback position in the event of a loss of passporting rights.
19. For the sake of completeness, it is as well to note the equivalence provisions that do exist in the CRD and the CRR, and the impact on UK institutions if no equivalence determination is forthcoming in this area.
20. In the CRD, article 127(1) specifies that where the parent undertaking of an institution in the Member State is outside the EU, the authorities must assess the third country supervisory authorities to decide whether they carry out consolidated supervision equivalent to that of the CRD and CRR. If no equivalence determination is forthcoming, article 127(3) provides that an EU bank, which has a UK parent which is a financial holding company or mixed financial holding company, would either be subject to the full requirements of CRD IV, or alternatively, the EU authority can apply “*other appropriate supervisory techniques*” which also achieve the objectives of consolidated supervision, as determined by the national laws of the Member State where the EU bank is established, which may include requiring the establishment of a holding company in the EU. The latter requirement would be an additional burden for non-EU banks.
21. The CRR equivalence provisions are limited to the prudential treatment of certain types of credit risk exposures to entities located in non-EU countries. The effect of article 107(3) of the CRR is that if the prudential supervisory and regulatory requirements in third countries are deemed at least equivalent to those applied in the EU, then certain categories of exposure to third country

banks can benefit from the same (often more favourable) treatment applied to materially identical exposures from EU institutions, meaning lower risk weights would be applicable.<sup>119</sup> The effect of no equivalence determination under the CRR would mean that third country institutions would be subject to higher capital requirements.

#### **D. Conclusions**

22. In short, once the UK ceases to be a member of the EU, absent an agreement to retain passporting rights or some other tailored solution, a credit institution that wants to offer services such as deposit taking and lending will be required to obtain authorisation from each of the EU member states in which it wishes to do business. There is no equivalence regime in this respect.
23. Where institutions wish to have a physical presence in the EU, they may have to set up costly separately capitalised subsidiaries. This has the potential to undermine the UK's status (and particularly that of London) as a global financial centre.<sup>120</sup>
24. Accordingly, absent a specific UK solution, or unless CRD IV is amended so as to expressly incorporate a third country regime or the existing equivalence regime is extended, there is a real concern that institutions currently authorised by the PRA/FCA may seek to relocate some of their operations to an EU Member State in order to benefit from the passporting provisions under CRD IV.
25. Finally, it is also important to ensure that any agreement which takes effect upon the UK's exit also sets out coherent transitional arrangements. Ideally,

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<sup>119</sup> There is a similar provision as regards to exposure to central governments, central banks, regional governments, local authorities and public sector entities (arts 114 - 116 of the CRR).

<sup>120</sup> A memorandum on Brexit published by the Japanese Government in September 2016, stated as material "...If Japanese financial institutions are unable to maintain the single passport obtained in the UK, they would face difficulties in their business operations in the EU and might have to acquire corporate status within the EU anew and obtain the passport again, or to relocate their operations from the UK to existing establishments in the EU..."

institutions ought to be able to continue operating under their existing passports until a replacement arrangement is implemented or until they are fully authorised in another EU Member State.

## **CHAPTER 7 - CENTRAL COUNTERPARTIES AND TRADE REPOSITORIES UNDER THE EUROPEAN MARKET INFRASTRUCTURE REGULATION**

### **A. What Is The European Market Infrastructure Regulation?**

1. The European Market Infrastructure Regulation on OTC derivatives, central counterparties and trade repositories<sup>121</sup> ('EMIR') imposes requirements to improve transparency and reduce the risks associated with the derivatives market. As it is a Regulation, it is directly applicable in all Member States.
2. Pursuant to Article 14, once a Central Counterparty ('CCP') is authorised by a Member State, that authorisation is effective for the entire EU. As such, once the UK exits the EU, it will have the status of a "third country"; consequently, a CCP authorised by the UK regulator will not be recognised by the rest of the EU.
3. However, Chapter 4 of EMIR contains equivalence provisions for third countries, with the effect that if equivalence is granted, there are passport-like rights for CCPs.

### **B. Equivalence Provisions - Central Counterparties**

4. Article 25 of EMIR, entitled '*Recognition of a third-country CCP*' provides that a third country CCP may provide clearing services to clearing members or trading venues established in the EU if that CCP is recognised by ESMA (article 25(1)).
5. As material, recognition by EMSA requires the following conditions to be satisfied:
  - a. The Commission has determined that CCPs authorised in a third country must comply with legally binding requirements which are equivalent to the requirements laid down in EMIR;

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<sup>121</sup> Regulation No 648/2012.

- b. the legal and supervisory arrangements in respect of CCPs established in the third Country provide for effective supervision and enforcement of CCPs;
  - c. the legal framework of that third country provides for an effective equivalent system for the recognition of CCPs authorised under third-country legal regimes;
  - d. ESMA has consulted the various national regulators in the EU member states where the counterparties or trading venues planning to use the services of the CCP are based;
  - e. Co-operation arrangements have been established between ESMA and the relevant third country authority; and
  - f. the third country has equivalent systems for anti-money laundering and combating the financing of terrorism to those of the EU.
6. The difficulties of obtaining and maintaining equivalence have been noted earlier in this Report. An illustration of these difficulties specifically under EMIR is reflected in the US example, where it took nearly four years for the Commission to assess the equivalence regime of US CCPs, before issuing an equivalence decision in March 2016. Indeed, the decision in respect of the US specifically noted that:

“ ...

*(23) The regular review of the legal and supervisory arrangements applicable...in the USA is without prejudice to the possibility of the Commission to undertake a specific review at any time, where relevant developments...make it necessary for the Commission to re-assess the equivalence granted by this Decision. Such re-assessment could lead to the repeal of this Decision.”*

7. In the US example, some commentators have expressed the view that some of the opposition from the EU was based on political, as opposed to technical,

reasons. The potential for political issues to influence whether or not an equivalence determination is given is therefore a very real concern.

### **C. Other Equivalence Requirements**

#### ***(1) Reporting, Margin and Clearing Requirements***

8. Article 13 of EMIR provides that the Commission may declare that the legal, supervisory and enforcement arrangements of a Third Country are equivalent to the reporting, clearing and margin requirements under EMIR and are being effectively applied and enforced so as to ensure effective supervision and enforcement in that Third Country.
9. Where such an equivalence decision is made, counterparties to derivative transactions will be deemed to have fulfilled the clearing requirements where at least one of the counterparties is established in that equivalent Third Country.
10. If the UK were to become a third country for EMIR purposes, an equivalence decision would be required in order to prevent counterparties to OTC derivative transactions from having to comply with two (possibly conflicting) sets of reporting, clearing and margin rules.

#### ***(2) Trade Repositories***

11. A trade repository established in a third country may provide its services and activities to entities established in the EU for the purposes of Article 9 only after its recognition by ESMA (art 77(1)). This requires that:
  - a. the European Commission has determined that the regime for the supervision of third-country CCPs is equivalent to EMIR, including in relation to the protection of business secrets;
  - b. the trade repository is authorized and subject to effective supervision and enforcement in the relevant third country;



- c. the third-country has entered into an international agreement with the EU regarding mutual access and exchange of information on derivatives contracts held in trade repositories;
  - d. the third-country has entered into cooperation agreements to ensure that EU authorities, including ESMA, have immediate and continuous access to all the necessary information held by trade repositories in that jurisdiction.
12. There is currently no equivalence determination in respect of trade repositories. Accordingly there is no precedent to establish how easy or difficult it would be to obtain such a determination.
13. Without an equivalence determination, a UK trade repository would not be able to provide such services to EU counterparties subject to EMIR. Currently there are six trade repositories approved by ESMA for collecting EMIR reports, of which four are headquartered in London. The need for an equivalence determination in this area (absent tailored UK arrangements post-Brexit) is therefore self-evident.

#### **D. Transitional Arrangements**

14. In respect of the application by a third country CCP for recognition, under art 25(4) of EMIR, once an application is received, ESMA has a 30 period to confirm that the application is complete, followed by a further 180 working days to determine the application. The application process therefore has the potential to be lengthy and protracted.
15. In light of this, and given the importance of CCPs to the smooth functioning of the markets, it is imperative that any transitional arrangements enable CCPs to continue in operation pending the outcome of a recognition application.

#### **E. Conclusions**

16. The UK is currently the most popular location in the EU in which to trade derivatives. To protect this position of strength it is important that either negotiations are concluded such that current passporting arrangements are continued or, at a minimum:
  - a. there is certainty – in as much as there can be in the present circumstances – that the UK will be declared equivalent by the Commission; and
  - b. transitional arrangements should be in place such that UK CCPs and trade depositories should continue to be recognised under EMIR until an equivalence determination is forthcoming.

## CHAPTER 8 - THE PAYMENT SERVICES DIRECTIVE

### A. Introduction to the PSD

1. The Payment Services Directive (2007/64/EC) (“**PSD**”)<sup>122</sup> is a minimum harmonising measure which lays down a regime designed to foster a single market in retail payment services across the EU Member States and the EEA. It develops the Single Euro Payments Area (“**SEPA**”), an integrated market for payment services in which there is no distinction between cross-border and national payments, by removing technical, legal and commercial barriers between national payment markets of different countries.
2. Payment services cover nearly all methods of making payments other than cheques and cash including, for example, the following:
  - a. services enabling cash to be placed on, or to be withdrawn from, a payment account and all of the operations required for operating a payment account;
  - b. the execution of direct debits and credit transfers (including standing orders) and payment transactions executed through a payment card or similar device;
  - c. issuing payment instruments or acquiring payment transactions; and
  - d. money remittance.
3. The PSD aims to make cross-border payments as easy, efficient and secure as ‘internal’ payments within a country, whilst also increasing competition and reducing costs by:

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<sup>122</sup> Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC and repealing Directive 97/5/EC. Full text version at: <http://data.europa.eu/eli/dir/2007/64/oj>

- a. removing barriers to entry and ensuring fair market access to enhance competition in payment services; and
  - b. establishing the same set of rules across the EEA on information requirements and other rights and obligations that will be applicable to many payment services transactions in the EEA.
4. Pursuant to Article 10 once a Payment Service Provider (“PSP”) is authorised by a Member State to provide payment services, that authorisation is effective for the entire EU. It is this ‘passport’ which enables the PSP to provide its services to other Member States without the need for a separate licence from that Member State. As per Article 25, any firm authorised by a Member State may exercise both the freedom to provide services, and also the freedom of establishment, throughout the EU.
  5. Once the UK exits the EU, it will have the status of a “third country” and consequently, authorisation by the UK regulator to provide payment services will not be recognised by the rest of the EU.
  6. When reviewing the PSD in 2012/2013, the European Commission found the legislation had:<sup>123</sup>
    - a. increased competition and choice by facilitating market entrance for regulated non-bank firms (i.e. payment institutions);
    - b. improved economies of scale whilst providing the foundation of the operational implementation of SEPA; and
    - c. enhanced transparency, in particular given the information requirements and rights/obligations linked to payment services such as execution times, refund rights and the liability regime.

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<sup>123</sup> [http://europa.eu/rapid/press-release\\_MEMO-15-5793\\_en.htm?locale=en](http://europa.eu/rapid/press-release_MEMO-15-5793_en.htm?locale=en)

## **B. UK Implementation**

7. The PSD was implemented in the UK by the Payment Services Regulations 2009;<sup>124</sup> the Payment Services (Amendment) Regulations 2009;<sup>125</sup> and the Payment Services Regulations 2012 (known collectively as “the PSRs”).<sup>126</sup> As material, the PSRs provide as follows:
  - a. PSPs that are not banks, building societies or e-money issuers (and so already authorised or certificated by the FCA) are required to comply with an authorisation and prudential regime, in order to become authorised payment institutions (“authorised PIs”) and be able to passport their services to other EEA States.<sup>127</sup> For example, these include e-money issuers, money remitters, (non-bank) credit card issuers and (non-bank) merchant acquirers.
  - b. Small payment institutions (“SPI”) are unable to passport but are exempt from authorisation and prudential requirements under the PSD<sup>128</sup> and instead simply need to be registered with the FCA.<sup>129</sup>
8. The Payment Services Regulations 2009, which were made on 9 February 2009 and generally came into force on 15 May 2009. Under the Regulations:
  - a. Part 2 deals with the registration of payment service providers as authorised payment institutions or small payment institutions;

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<sup>124</sup> <http://www.legislation.gov.uk/ukxi/2009/209/contents/made>

<sup>125</sup> <http://www.legislation.gov.uk/ukxi/2009/2475/contents/made>

<sup>126</sup> <http://www.legislation.gov.uk/ukxi/2012/1791/contents/made>

<sup>127</sup> See in particular Chapter 3 – Authorisation and registration, Chapter 6 – Passporting and Chapter 9 – Capital resources and requirements within the document on “The FCA’s role under the Payment Services Regulations 2009” available at: <https://www.fca.org.uk/publication/archive/payment-services-approach.pdf>

<sup>128</sup> SPI are exempt if they have an average monthly payment value of no more than €3 million and do not intend to provide payment services on a cross-border basis.

<sup>129</sup> See in particular Chapter 3 – Authorisation and registration of document on “The FCA’s role under the Payment Services Regulations 2009” available at: <https://www.fca.org.uk/publication/archive/payment-services-approach.pdf>

- b. Part 3 sets out rules for authorised payment institutions;
  - c. Part 4 sets out rules for both authorised payment institutions and small payment institutions;
  - d. Part 5 sets out requirements for information to be provided by payment service providers to payment system users before and after payments are made,
  - e. Part 6 sets out rights and obligations in relation to the provision of payment services, and in particular sets out rules that protect the payer from losses caused by unauthorised transactions unless caused by fraud or a negligent failure to keep security details confidential, put on the payment system provider the burden of showing that an unauthorised payment was caused by failing to keep such security details confidential, limit the circumstances under which payment service providers can levy fees, and protect payment service providers where payment is made to a “unique identifier” (such as an account number) even if the unique identifier does not belong to the intended recipient of the payment;
  - f. Part 7 confers powers on the FCA to regulate payment system providers;
  - g. Part 8 requires payment system providers to offer access to payment systems on a non-discriminatory basis (and confers powers on the CMA to enforce this); and
  - h. Part 9 creates criminal offences in relation to payment services.
9. This section generally considers the position under parts 5 and 6 (since they concern the relationship of banker and customer), rather than the regulatory aspects of the other parts.

### **C. No Equivalence Provisions in the PSD**

10. There are no “equivalence provisions” within the PSD that allow recognition of a third country PSP to provide payment services within the EU/EEA. As such, if the UK were to exit the EU and becomes a third country without specific arrangements to retain passporting or similar tailored arrangements, there is currently no mechanism within the PSD to enable a firm authorised by the UK regulator to provide payment services across the rest of the EU/EEA.
11. The practical and commercial consequences of the UK being a third country without tailored arrangements would be significant for all types of PSPs. The UK is the largest user of PSD passporting permission<sup>130</sup> and many providers from outside the EEA have likely set up in the UK precisely so they could take advantage of passporting.
12. An inability to passport their services across the EU might well cause PSPs currently based in the UK to relocate to an EU Member State, where passporting is available. The higher the level of dependence a firm’s model has on pan European payment services, the higher the probability a firm will chose to relocate.
13. At the very least, even without full relocation, PSPs may need to establish another payment institution within the EU in the event that UK based firms lose their passporting rights. This would mean that a separate legal entity would have to be created, not simply a branch of a UK legal person. That entity would then have to be authorised under the PSD in the relevant Member State, which will likely have a significant cost impact on business.
14. The process of obtaining a separate authorisation in an EU Member State is likely to be time-consuming and costly. Costs of relocation are higher still and for instance, could include moving people and infrastructure to the new site, legal

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<sup>130</sup> In a letter from Mr Andrew Bailey, head of the FCA to Mr Andrew Tyrie, head of the Treasury Committee it was revealed that 284 UK firms currently hold at least one passport under the PSD to trade elsewhere in EU, compared with 115 companies in other EEA states using at least one passport to trade in the UK. See: <https://www.parliament.uk/documents/commons-committees/treasury/Correspondence/AJB-to-Andrew-Tyrie-Passporting.PDF>.

and compliance expenses in setting up a separate legal entity, as well as an increase in the amount of capital needed to support the operations within the EU going forward.

#### **D. Single Euro Payments Area**

15. The Single Euro Payments Area (SEPA) is a payment-integration initiative of the EU that simplifies payments in Euro, and has been realised through numerous Directives and Regulations. The aim is to allow payment processing across Europe and comparable to a domestic clearing system; it covers key retail payment instruments, such as credit transfers, direct debits, and payment cards. We say no more about it in this Report because full details about the history and content of the SEPA framework are covered in COMBAR's Banking Brexit Report.

#### **E. Visa/Mastercard networks**

16. Visa Europe is headquartered in the UK whilst Mastercard is headquartered in Belgium, so there is a risk that Visa could choose to relocate to an EU Member State; indeed, there have been suggestions that Visa may be required to relocate as a condition of the agreement in connection with its recent takeover, which is said to stipulate that data from Visa card transactions should be held within the EU.<sup>131</sup> More widely, in the short-term (and before implementation of PSD II, discussed below) cards issued in EEA countries which are used in transactions with the UK and UK may attract inter-regional interchange fees rather than intra-regional, which are generally higher.<sup>132</sup>

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<sup>131</sup> <http://news.sky.com/story/brexit-jobs-threat-at-credit-card-giant-visa-10327664> (accessed 20 December 2016).

<sup>132</sup> [http://ec.europa.eu/competition/publications/cpn/2002\\_3\\_33.pdf](http://ec.europa.eu/competition/publications/cpn/2002_3_33.pdf)



## **F. PSD II**

17. The implementation deadline for PSD II is January 2018. Many financial service providers may have already invested heavily in anticipation of PSD II. The Bank of England is continuing to implement the current regulatory framework, which includes PSD II, until any new arrangements with the EU take effect.<sup>133</sup>
  
18. The key changes introduced by PSD II can be categorised into four (overlapping) themes, namely: 1) extending the scope of PSD; 2) competition; 3) security and 4) consumer protection.<sup>134</sup>

### ***(1) Extending the scope of the PSD***

19. Whilst the PSD is concerned only with intra-EU cross border payments (i.e. where both the payer's PSP and the recipient's PSP are located in the EU), the remit of PSD II is triggered where either the payer's or the recipient's PSP is located in the EU, irrespective of the location of the other PSP. This may therefore benefit UK consumers/businesses in the event of Brexit, as it means that any transactions UK customers/business have with EEA Member States will still fall within the remit of the legislation. However, UK-UK payments would still fall outside the scope of the Regulations even as revised to implement the second Directive.
  
20. Another way in which the PSD's scope has been extended by PSD II is to apply the regulations to Non-EEA currency payments between EEA-domiciled PSPs. Therefore, it would be more advantageous for UK PSPs to remain party to PSD II and/or impose similar obligations to provide information on the charges and conditions relating to national and international payments in order to compete with their EU counterparts.

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<sup>133</sup> <http://www.bankofengland.co.uk/publications/Documents/fsr/2016/fsrjul16.pdf>

<sup>134</sup> A helpful summary is available at:  
<http://www.paymentsuk.org.uk/sites/default/files/PSD2%20report%20June%202016.pdf>

## *(2) Competition*

21. Under the PSD II, new service providers will be able to enter into this market as it permits third party providers with customer consent, to access customers' accounts. For instance, this could allow payments using third party payment initiation service providers as an alternative to card payments, by moving money from payer accounts to merchants directly.
  
22. Both UK customers and UK based third party providers will benefit from the increased level of competition/market access under the PSD II. This should be preserved, or regulations with a similar effect should be introduced in the UK. These changes in the regulations reflect technological developments which have unfolded within the payments and banking industry since 2009.

## *(3) Security*

23. A corollary of increased accessibility of customer accounts is the need for a more secure authentication mechanism. PSD II therefore introduces 'Strong Customer Authentication.'. Once again, it would be more advantageous for UK PSPs and UK based customers to remain party to PSD II and/or impose similar duties to ensure UK PSPS remain competitive, and to offer the same level of consumer protection as their EU counterparts.

## *(4) Consumer protection*

24. PSD II enhances consumer protection through, for instance, changes to security requirements such as strong customer authentication for electronic payments. In addition, applying surcharges to domestic and cross-border card payments will be banned under PSD II. The European Commission's estimates suggest that this ban will apply to approximately 95% of all card payments in the EEA, saving consumers an estimated €730 million per year. For instance, this includes surcharges applied when booking flights online and when purchasing small value items in a newsagent.

## **G. Conclusions**

25. The absence of any equivalence provisions in the PSD is problematic; in an ideal scenario, the PSD would be amended to include such provisions.
26. Once the UK exits the EU, to protect the ability of UK customers and businesses to make and receive intra EU/EEA payments, it is important that (if current passporting arrangements are not to be retained) transitional arrangements should be in place such that UK PSPs should continue to be recognised under the PSD until a new regime is in place.
27. Moreover, it is important to ensure that the UK government should also try to ensure that the Visa/Mastercard networks do not treat cross border transactions between the UK and EEA countries as inter-regional, rather than intra-regional, to avoid increases in card transaction fees.
28. Post Brexit, in order to ensure that the UK has a payments regime that is as competitive and consumer friendly as that within the EU, it would be advisable to adopt in substance the framework currently contained within the PSD/PSD II.

## CHAPTER 9 - MORTGAGE BROKERS UNDER THE MORTGAGE CREDIT DIRECTIVE

### A. Introduction

1. As explained in Chapter 4 (“**PERG 4**”) of the Perimeter Guidance Manual (“**PERG**”), there are six regulated mortgage activities requiring authorisation or exemption if they are carried on in the United Kingdom (“**UK**”). These are set out in the Financial Services and Markets Act (Regulated Activities) Order 2001 (“**Regulated Activities Order**”). They are:
  - a. arranging (bringing about) regulated mortgage contracts (“**RMCs**”);<sup>135</sup>
  - b. making arrangements with a view to RMCs;<sup>136</sup>
  - c. advising on RMCs;<sup>137</sup>
  - d. entering into a regulated mortgage contract (“**RMC**”) as lender;<sup>138</sup>
  - e. administering an RMC where that contract is entered into by way of business on or after 31 October 2004 or the contract was entered into by way of business before that date and is a legacy CCA mortgage contract;<sup>139</sup>
  - f. agreeing to carry on any of the above.<sup>140</sup>
2. Section 10A (“**PERG 4.10A**”) of Chapter 4 is entitled “*Activities regulated under the Mortgage Credit Directive*”.<sup>141</sup> It observes that certain exclusions in the Regulated Activities Order do not apply in cases covered by the Mortgage Credit Directive (“**MCD**”)<sup>142</sup> and explains the situations in which this applies.

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<sup>135</sup> Articles 25A(1) and (2A) (Arranging regulated mortgage contracts).

<sup>136</sup> Article 25A(2) (Arranging regulated mortgage contracts).

<sup>137</sup> Article 53A (Advising on regulated mortgage contracts).

<sup>138</sup> Article 61(1) (Regulated mortgage contracts).

<sup>139</sup> Article 61(2) (Regulated mortgage contracts).

<sup>140</sup> Article 64 (Agreeing to carry on specific kinds of activity).

<sup>141</sup> Strictly, activities are regulated not by the Mortgage Credit Directive itself but by the national law into which its provisions have been transposed.

<sup>142</sup> Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property.

3. Five preliminary observations might usefully be made:
- a. Whilst this Chapter of the Report is concerned with activities carried on by a type of intermediary (i.e. mortgage brokers), there is no such regulated activity as “mortgage broking”<sup>143</sup> (although the Regulated Activities Order does make reference to credit intermediaries<sup>144</sup> and providers of advisory services<sup>145</sup> as mortgage intermediaries).<sup>146</sup>
  - b. The activities undertaken by mortgage brokers will not necessarily be limited to those connected with RMCs. The contents of this Chapter of the Report will, though, largely relate (not least in the interests of comprehensibility) to activities connected with RMCs.
  - c. The regulated activities likely to be of most relevance to mortgage brokers are (i) arranging (bringing about) or making arrangements with a view to RMCs<sup>147</sup> and (ii) advising on RMCs.<sup>148</sup>
  - d. Whilst some regulatory provisions may solely or primarily relate to activities of a type carried by lenders or administrators rather than by mortgage brokers, there is nevertheless, of necessity, a considerable degree of overlap in the way in which the regulatory scheme operates.
  - e. The relative complexity of the way in which the regulatory regime interacts in practice with the structure of the market is illustrated by Section 15 of PERG (“*Mortgage activities carried on by 'packagers'*”). The term “*packagers*” is used variously to describe a range of intermediaries and their different activities in the mortgage process.<sup>149</sup> Of particular relevance for present

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<sup>143</sup> The regulated activity of credit broking is specified in article 36A of the Regulated Activities Order although broking activities in relation to RMCs will generally be excluded from article 36A by article 36E(2)-(4).

<sup>144</sup> PERG 4.10A.2G (1)(b).

<sup>145</sup> PERG 4.10A.2G (1)(c).

<sup>146</sup> PERG 4.10A.3. The meaning of “credit intermediary” is defined in article 5 of The Mortgage Credit Directive Order 2015 (SI 2015/910).

<sup>147</sup> Described in more detail at PERG 4.5.

<sup>148</sup> Described in more detail at PERG 4.6.

<sup>149</sup> PERG 4.15.1 G.

purposes is the guidance entitled “*Broker packagers (sometimes called ‘intermediary brokers’)*”:<sup>150</sup>

*“The term ‘broker packagers’ is typically used to describe intermediaries who either market their services directly to borrowers or who offer other intermediaries a complete mortgage outsourcing service. They are often involved in the sales and advice process, including helping the borrower complete application forms. In the FCA’s view, broker packagers carrying on these types of activity in direct contact with the borrower are likely to be carrying on the regulated activities of arranging (bringing about) and making arrangements with a view to regulated mortgage contracts. They may also be advising on regulated mortgage contracts depending on the circumstances.”*

#### **B. Existing mortgage regulation in the UK as at February 2014**

4. As at February 2014, activities connected with mortgages were regulated under two separate and distinct regimes.
5. Regulated mortgage activities requiring authorisation or exemption were limited to those connected with first charge residential mortgages. After 1<sup>st</sup> April 2013, the conduct regulator was the FCA, with the primary source of the regulatory regime being FSMA.
6. The definition of an RMC was set out in article 61(3)(a) of the Regulated Activities Order. In broad terms, it involved lending on the security of a first legal mortgage over owner-occupied residential property situated in the UK. Rules and guidance were (and still are) set out in the FCA’s Mortgages and Home Finance: Conduct of Business sourcebook (“**MCOB**”).

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<sup>150</sup> PERG 4.15.4 G.

7. In contrast, regulation of much other credit business, including second charge mortgages, was set out in consumer credit legislation and superintended and enforced by the Office of Fair Trading (“OFT”).
8. However, on 1<sup>st</sup> April 2014, the FCA took over from the OFT as the regulator for the consumer credit industry. Rules and guidance in relation to agreements secured on land which were not RMCs were thereafter set out in Chapter 15 of the FCA’s Consumer Credit sourcebook (“CONC”).
9. In general, buy-to-let mortgages did not fall within the definition of an RMC and were not, therefore, regulated by the FCA. Nor had they fallen within the scope of the OFT’s regulation of consumer credit (as transferred to the FCA on 1<sup>st</sup> April 2014). However, the broking of buy-to-let mortgages did usually require a firm to be FCA authorised. This was because the broking of buy-to-let mortgages was included in the scope of consumer credit broking.

### **C. The Mortgage Credit Directive**

10. It was against this background that the MCD was adopted on 4<sup>th</sup> February 2014. The European Commission (“EC”) had proposed the MCD on 31<sup>st</sup> March 2011 for adoption through the co-decision procedure with a first reading agreement on 22<sup>nd</sup> April 2013.
11. The aim of the MCD is to promote an efficient and competitive single mortgage credit market with a high level of consumer protection. It seeks to allow lenders to provide services throughout the single market, encouraging cross-border activity.
12. Most of the provisions of the MCD are concerned with setting the minimum regulatory requirements which member states are required to meet in order to protect consumers taking out credit agreements relating to residential property. It also imposes maximum standards on member states in a few areas, in

particular in the provision of pre-contractual information in a standardised format.

13. So as to meet its treaty obligations, the UK was required to transpose the provisions of the MCD into its national law by 21<sup>st</sup> March 2016.

#### **D. The UK's approach to negotiations on the MCD**

14. As was explained in a consultation ("**MCD Consultation**") published by HM Treasury on 5<sup>th</sup> September 2014,<sup>151</sup> the UK government took a sceptical view of the necessity for, and potential benefits of the MCD:

*"The UK government does not believe that the MCD offers many benefits to UK consumers beyond those already provided by the high level of protection offered by the existing FCA regime for mortgages. However, it does add a number of costs to UK industry.*

*A further aim of the MCD is to facilitate a better internal market in mortgage lending across Europe. The government does not believe that it offers much benefit in this area in practice because it does not address the primary obstacles for such a market. From a lender's perspective, these include the relative difficulty in understanding credit risk in unfamiliar markets and the complexity in enforcing loans under foreign legal systems. For consumers, the scale and nature of a mortgage commitment drives a preference for dealing with well established, or local, brands.*

*The UK has therefore been sceptical about the value of the MCD. Throughout the negotiation of the MCD, the UK focused on aligning the directive requirements as far as possible with the existing UK regulations, with a view to minimising the impact on UK industry and consumers."<sup>152</sup>*

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<sup>151</sup> "Implementation of the EU Mortgage Credit Directive".

<sup>152</sup> MCD Consultation, section 1.5.



## E. The Mortgage Credit Directive Order and MCOB

15. The provisions of the MCD were transposed into national law by The Mortgage Credit Directive Order 2015 (SI 2015/910) (“**MCD Order**”).
16. In addition, the FCA made changes to its Handbook, principally to MCOB but also to Training and Competence (“**TC**”) and the Prudential Sourcebook for Mortgages (“**MIPRU**”).
17. The two most significant changes brought about by the MCD Order involved (i) bringing second charge mortgage lending within the wider mortgage regime rather than the consumer credit regime formerly superintended and enforced by the OFT and (ii) meeting the MCD’s requirements for member states to put in place an appropriate framework for buy-to-let mortgage lending to consumers.
18. In the case of the former, this did no more than to implement what was already government policy. As was explained in the MCD Consultation:<sup>153</sup>

*“...the government has an existing policy commitment to move second charge mortgage lending into the regulatory regime for mortgage lending rather than the regime for consumer credit. This is on the basis that it is more appropriate to regulate lending secured on the borrower’s home consistently regardless of whether it is a first or subsequent charge. Moreover, a single regime would make the regulatory landscape simpler for those firms engaged in both the first and second charge markets.*

*The government originally announced its intention to make this change in 2011. However, in light of the MCD, the decision was made to postpone this transfer until the wider implementation of the directive. The MCD applies to all loans secured against residential property and so its provisions apply equally to first and second charge mortgages. The government wanted to avoid the disruption and additional cost to second charge firms of imposing two sets of regulatory changes in quick succession.”*

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<sup>153</sup> MCD Consultation, section 2.2.

19. This first change was achieved through an amendment to the definition of an RMC in article 61(3)(a) of the Regulated Activities Order. There was, though, a further amendment to that provision which was, for present purposes, of perhaps greater potential significance. This involved a change in the requirements as to the location of the property given as security so as to include the whole of the EEA. The reasoning behind this was explained in the MCD Consultation:<sup>154</sup>

*“The existing scope of FCA regulation is limited to mortgages secured on property located in the UK. While the MCD is not specific about the location of the property, this approach does not seem consistent with a number of the directive’s provisions, for example setting out how mortgage intermediaries ‘passporting’ to other jurisdictions should be regulated. For that reason the government is proposing some changes to the scope of FCA regulations so that it is aligned more closely with the mechanics of the MCD provisions. We do not, however, expect this to have a significant impact on UK firms, as it is relatively rare for a UK lender to provide mortgages on properties located outside the UK.”*

20. As to the second significant change, Part 3 of the MCD Order, including Schedule 2, sets out a framework for regulating buy-to-let-mortgage lending to consumers. It makes provision for a register of the firms involved in such lending, for the requirements with which such firms must comply, and for the FCA to monitor and enforce those requirements.
21. This was a change which the UK government made with some reluctance, doing the minimum necessary to comply with its treaty obligations. Again, the reasoning was explained in the MCD Consultation:<sup>155</sup>

*“When mortgage regulation was introduced in 2004 the government drew a distinction between mortgage lending to owner-occupiers and to buy-to-let landlords, and decided not to bring buy-to-let mortgage lending within the scope of FCA regulation. This reflects the different characteristics of buy-to-let customers, most of*

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<sup>154</sup> MCD Consultation, section 4.4.

<sup>155</sup> MCD Consultation, section 1.7.

*whom are carrying out a business activity and so do not require the same protections, as well as the fact that the borrower's own home is not at risk.*

*The MCD recognises the different characteristics of buy-to-let mortgage lending and provides member states with the option to exempt it from the detailed requirements of the directive. However, it also requires that member states using this option put in place an alternative appropriate framework to protect consumers engaged in buy-to-let borrowing. The government remains persuaded that it is right to treat buy-to-let mortgage lending differently, and so is proposing to use this option. This consultation sets out the government's plans for an appropriate framework for buy-to-let mortgages, seeking to put in place the minimum requirements in order to comply with the MCD."*

22. Three other changes arising from the MCD have a specifically European dimension. First, there were amendments to the provisions for cross-border activities within the EEA, i.e. "passporting". Secondly, the Key Facts Illustration ("KFI") provided to customers is to be replaced by a mandatory product disclosure document called the European Standardised Information Sheet ("ESIS") (albeit that use of the ESIS does not become fully compulsory in the UK until 21<sup>st</sup> March 2019).<sup>156</sup> Thirdly, the MCD contains assumptions for the calculation of the annual percentage rate of charge ("APRC"). The EC has made available a simulator (described as useful by the FCA) based on these assumptions to help users (including regulators, consumers and creditors) calculate the APRC of a given credit.
23. There were also changes to the Handbook (principally to MCOB) of varying degrees of significance which, although instigated by the MCD, had no particular European dimension. As a result, firms providing regulated mortgage advice:

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<sup>156</sup> MCOB 5A.4. The transitional provisions covering the period from 21<sup>st</sup> March 2016 to 21<sup>st</sup> March 2019 are to be found at MCOB TP 1.1, provision 45.

- a. need to provide a binding mortgage offer and a seven day (minimum) reflection period;
- b. need to give an adequate explanation of a product's essential features;
- c. are subject to new disclosure requirements.

## **F. Discussion**

24. The impact of Brexit in this area will (as elsewhere) obviously depend upon the form which it takes. The thoughts and conclusions set out below are clearly subject to those post-Brexit arrangements, but may also be of relevance in informing the best way forward.
25. First, unless expressly amended or revoked, the MCD Order will (like other delegated legislation) presumably remain in force post-Brexit regardless of any difficulties there might be in the workability of its provisions.
26. There is a clear distinction between domestic subordinate legislation merely introduced at the instigation of EU institutions and that which depends (or might depend) on continued membership of the EU for its workability.
27. Significant parts of the MCD Order fall within the former category. The most obvious examples of such provisions are those (i) extending the definition of an RMC to include second charges and (ii) introducing a system of regulation for buy-to-let mortgages. The government could have introduced such provisions of its own volition (and indeed, in the case of second charges, would have done so). Whilst these changes were, in fact, introduced at the instigation of EU institutions, there is no obvious reason to suppose that the government would now wish to reverse changes which (i) many would see as increasing consumer protection or (ii) in the case of non-buy-to-let mortgages, brought different parts of the domestic market under a single regulatory regime.

28. Perhaps the most striking conclusion is that a cessation of membership of the EEA in the absence of an amendment of the definition of an RMC would result in the (perhaps inadvertent) de-regulation of most mortgage related activities carried on in the UK. Similarly, any ambiguity about the status of the UK as a member of the EEA would lead to uncertainty and the potential for litigation. Subject to this, the current requirements as to the location of the security would not be inherently objectionable post-Brexit (although they might be thought illogical). There is no reason why regulated activities (e.g. advising) carried on in the UK should not relate to property (moveable or immovable) located elsewhere.
29. However, if the UK were no longer a member of the EEA, the geographical scope of the current definition of an RMC would appear somewhat arbitrary. For domestic regulatory purposes, why should the status of a mortgage contract depend upon whether the security is located within the territory of a body of which the UK is not a member? Should the geographical scope of the definition be widened to include security located elsewhere? Or should it be narrowed (thereby removing some lending from regulation altogether and thus arguably reducing consumer protection)?
30. The nature of land makes it more than usually likely that if (i) an activity involving advising is carried out in the UK but relates to property elsewhere, then (ii) any related activity involving arranging finance will not take place exclusively in the UK. It could plainly be inconvenient if, for example, a mortgage broker advising a UK customer in the UK in relation to borrowing from a French bank on the security of property in France were to be unable to use that bank's online application system.
31. This leads on to the wider issue of the potential effects of any loss of "passporting" rights. Much of what has been put forward in this Report in the context of other regulated activities will apply equally to mortgage brokers. In the MCD Consultation, the UK government expressed a degree of scepticism about the development of an EU-wide mortgage market. The provision of cross-

border mortgage advice (e.g. in relation to second or holiday homes) may be a specialist market, but any loss of “passporting” rights would be likely to be of considerable significance to those participating (or seeking to participate) in it.

32. The MCD resulted in the introduction of few rules relating to the conduct of mortgage business which are specifically European in nature. The most obvious is the requirement for an ESIS (this, though, not yet being mandatory). Will this requirement remain? If it does, how might the UK respond to any changes in the form or substance of the ESIS post-Brexit? If it does not, how might this affect access to the single market on the part of those carrying on regulated mortgage activities in the UK? It is beyond the scope of this Report to offer detailed proposals, but this is clearly an issue which will require careful strategic consideration at an early stage.