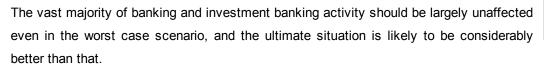
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## Brexit: Continuity of current arrangements for banks and investment banks

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Much of the analysis offered in the media and other publications to date as to the implications of Brexit for the bulk of business carried on in the City has been misleading and has overlooked or omitted key points.





In other words, by default, institutions conducting wholesale investment services — that is, broadly, principal and agency broking/dealing, custody services, fund management outside the scope of the Alternative Investment Fund Managers Directive (AIFMD), and investment advice with professional and sophisticated investors — into EU member states will be able to do so without the need for regulation other than in the UK.

Any negotiated exit is likely to contain additional facilities for and recognition of Europe-wide business.

## Current position for Pan-EU business conducted out of London

Historically, the standard model for institutions headquartered outside Europe that wish to offer financial services cross-border within the EU has been by way of an EU incorporated subsidiary-with-passport (normally based in London) conducting largely investment business cross-border within the EU and in some instances through a branch located in other European countries.

In addition, in the case of larger institutions, groups have often located a bank branch in one member state (normally the UK) so as to provide an entity with a strong credit rating to EU depositors. That entity does not benefit from a passport.

Banks (credit institutions) incorporated in the EU obtain their passport under the Capital Requirements Directive (CRDIV), including for investment business activities. Investment firms currently obtain their passport under the Markets in Financial Instruments Directive (MiFID). An institution incorporated within an EU jurisdiction obtains its licence in that member state and then notifies its regulators of an intention to passport.

The question of when activities (such as short flying visits, phone calls, emails and so on) are, as a matter of local member state law and regulation, conducted cross-border has been scarcely considered by many.

The point is legalistic and subtle. The market and many advisers have jumped over that question and have made passport notifications for all activities, on the basis the process is so easy that the issue need not be examined.

In fact, many key activities do not take place cross-border at all. For instance, deposit-taking has been generally regarded as taking place where the bank's books and records are located. Non-EU booking vehicles are often used for EU business without any cross-border issues arising.

Further, given the location of representatives of EU businesses in London many of the activities take place between people located entirely within the City. For those activities which could genuinely be cross-border a more rigorous legal analysis would be advisable going forward in instances where no passport is available. However, in many instances this will be unnecessary due to forthcoming changes in EU passporting law which echo G20 and FSB initiatives to ensure greater mutual reliance between regulators.

## The MiFID II passport extension for UK banks and investment banks

Under the arrangements known as MiFID II (incorporating an updated MiFID and a newly produced Markets in Financial Instruments Regulation, MiFIR), which will come into effect from January 2018 before any Brexit termination notice takes effect, two new passports are introduced for cross-border investment business conducted with professional clients and eligible counterparties.

These passports will be available to banks in their investment business activities (MiFID2 amends CRDIV), and to investment firms.

The first passport requires the firm to register with the European Securities and Markets Authority (ESMA) in its list of permitted third country firms. The second permits a firm to establish a retail branch in those EU member states which require a branch presence for that business (paradoxically, due to the breadth of the current overseas persons' exclusion, the UK opted out of implementing this aspect of MiFID II) with the result that the firm is then granted a passport across Europe for wholesale investment business.

The term "wholesale" means investment business with, broadly speaking, corporates (except when below tiny capital thresholds), financial institutions, insurers, funds (including pension funds), fund managers and governments.

Many cross-border dealings, including multiple and extensive on-the-ground visits, can be conducted without a branch being established. This requires of course a thorough consideration of local law and regulation including tax laws, in the way that lawyers assessed the situation under the first incarnation of what is now MiFID, the Investment Services Directive.

To make use of the new passporting processes outlined above, the European Commission must make a determination that the laws of a third country — in this case, the UK — are "broadly equivalent" to those in the EU in prudential and conduct of business requirements. It is almost inconceivable that an equivalence determination will not be automatic given that the UK's laws will be identical to those of the EU in these respects.

There is also a requirement for those laws to be properly enforced. Again, it is hard to conceive of any non-automatic assessment on that front given that the UK regulators are currently EU regulators.

Information-sharing mechanisms will need to be established between the UK regulators and ESMA or the EU member state's regulators where the retail branch is established. In the case of the retail branch there will need to be tax cooperation arrangements.

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There are already other equivalency regimes in place, such as for central counterparties and other market participants under EMIR. In this context there have been equivalence determinations for jurisdictional regimes which are considerably different from the EU's regime, on the basis that they give rise to similar outcomes.

Thus, under EMIR, equivalence has been declared for the regimes in the United States, Hong Kong, Singapore, Canada, Mexico and others.

There are some limited aspects that are not covered by the MiFID2 passport and other equivalence arrangements, such as lending by credit institutions under the passport in CRDIV. However, sophisticated arrangements have been developed for hedge funds that enable the provision of credit throughout Europe, which could cover much such activity.

This is, of course, a summary of the situation that presumes the UK does not negotiate a special deal with the EU, which is highly unlikely. In particular, banks and investment banks based in the continuing EU which wish to do business in the UK cross-border or through a branch will need a new relationship with the UK. The current approach of the Prudential Regulation Authority to non-EU institutions operating through a branch in London is to permit this so long as they are not conducting significant or systemically risky activities.

Thus U.S. institutions have been required to subsidiarise many of their UK operations. Banks and investment banks based in EU member states have not had to subsidiarise to date, due to their entitlements to passport into the UK without restriction under CRDIV and MiFID. There are therefore systemically important branches located in London, established from bases in other EU member states, primarily operating under the oversight of regulators based abroad.

In the post credit-crisis world this brings with it considerable risk that UK and other regulators have been clamping down on in order to ensure adequate prudential oversight and satisfactory recovery and resolution plans.

There will need to be new arrangements put in place to the satisfaction of UK regulators to deal with these points which ensure mutually beneficial recognition is in operation between the UK and continuing EU member states.

The G20 and Financial Stability Board (FSB) have been leading the way on a global level in working through the detailed aspects of equivalence regimes and deference to home state regimes and authorities.

This work at a global level paves the way for any post-Brexit arrangement.

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