
8-in-8 Recent Trends in European Law and Policy Alert Series: Update on Brexit and Financial Services

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This is the second issue of WilmerHale's 8-in-8 Recent Trends in European Law and Policy Alert Series. Our attorneys will share insights on current and emerging issues affecting companies doing business in Europe and across the Atlantic. Attorneys from across various practice groups at the firm will offer their take on issues ranging from Brexit to Big Data to EU energy market regulation.

WilmerHale has offices in key European capitals, including Brussels, Berlin, Frankfurt and London, as well as lawyers qualified in a range of European countries. With one of the leading European law and policy practices in the world, we follow and work on a broad range of EU legal and policy issues, including data protection and privacy, competition, trade, technology, intellectual property, financial services, and a range of other EU and transatlantic regulatory and policy challenges that our clients face. Read all [issues](#) in this series and our other recent publications.

The City of London financial district currently plays a central role in the provision of financial services in the European Union. It manages EUR 1.5 trillion in assets; it facilitates two-thirds of debt and equity capital raised by corporate entities; it handles 78% of foreign exchange trading and 74% of interest rate derivatives, and it is a significant provider of insurance.¹

In December 2017, the EU Council [declared](#) that "sufficient progress" had been achieved in the first phase of the Brexit negotiations. In March 2018, the EU and the UK published a [Draft Withdrawal Agreement](#) and the EU Council published its [Guidelines on the framework for the future EU-UK relationship](#). As a result, discussions on the future trading relationship between the EU and the UK began.

In this context, it is currently an open question to what extent the EU and the UK will have access to each other's markets in financial services after Brexit, and what the future role will be of the City of London, as well as that of other EU financial services centers such as Frankfurt, Paris, Dublin, Amsterdam, and Madrid.

These are critical issues, for both the UK and the remaining 27 EU Member States (EU-27), as well as for third countries (such as the U.S.), and of course for individual financial services companies or customers. EU-related business represents a substantial part of the financial services provided in

the City of London and third country financial services companies often use the City of London as their key European hub. By the same token though, access to the London market, either directly or indirectly, is often critical for customers for the financial system in the remaining EU-27, and many expect the City to continue to play a central role in the global financial system. Banks, hedge funds and pretty much all other participants in global financial services markets will be impacted by what the post-Brexit EU-UK financial services relationship looks like.

This update provides a high-level overview of (i) the rules that currently apply to the provision of financial services in the EU (“passporting”); (ii) how third country (i.e., non-EU) financial institutions can obtain access to EU markets without establishing separate EU-authorized entities (“equivalence”); and (iii) conceivable alternative approaches – what precedents there are in Free Trade Agreements (“FTAs”); the current EU and UK negotiation positions; and potential outcomes. The long and short of it is that much remains to be negotiated, and that now is as good a time as any for individual market participants to determine their preferred outcomes, monitor developments closely, and work with counsel or others to help shape the direction of the negotiations that are taking place.

Passporting

A significant aspect of EU financial services regulation is the passport provided for EU and EEA firms to do business throughout the EEA on the basis of their home country authorization. Over 5,000 UK-headquartered financial services firms use passports to provide services in the EU and 8,000 EU firms use passports to access the UK market (a significant overweight position for UK institutions, given that the UK accounts for only 16% of EU GDP).

An EU “passport” is based on a single authorization/registration in an institution’s home country. Passports are specific to the type of financial service at issue and may contain an enumerated list of services for which the institution has passport rights. On this basis the institution can provide those services throughout the EU/EEA’s Single Market - (i) solely supervised by its home authority and subject to home country rules; (ii) without the need to obtain a local authorization or to open a local branch in other EU Member States; (iii) with various mechanisms for resolving regulatory issues in case of disputes; and (iv) subject to the jurisdiction of the Court of Justice of the EU (CJEU). The basis for passports is an extensive and complex rule book for financial services that has been developed through EU law over decades.

Post-Brexit, since it has decided to leave the EU and not join the EEA, EU law will not apply in the UK and, unless otherwise agreed, it will not be possible to do business on the basis of a passport or the Single Rulebook since they will no longer apply in the UK.

Equivalence

The EU currently applies an “equivalence” test to regulatory authorities in third countries – i.e., those that cannot rely on “passporting” as described above. This means that under certain EU financial services regulatory measures, the EU will decide whether the rules and supervision in a particular third country are equivalent to the EU framework. This can allow non-EU firms to operate in the EU on the basis of their home country regulatory framework.

However, doing business based on an equivalence finding does not meet the UK's objectives and could leave wide swaths of financial services without access to the EU. First, the UK would have no direct say on the equivalence decision and would have to shape its regulatory framework to ensure that it stays close enough to the EU's to ensure a finding of equivalence. Second, equivalence decisions are taken on a case-by-case basis. Third, the EU can unilaterally modify or withdraw them on short notice. Fourth, they are only available in certain situations (e.g., for certain wholesale and retail commercial banking services provided by credit institutions, for the provision of insurance/re-insurance services or for access to EU trading venues; but not for payment services, UCITS funds, or the provision of investment services for retail markets and investors (see page 17 of the [EC's report on equivalence](#))). The EU is currently considering whether to enhance its equivalence procedure and to widen its scope but, as things stand, the above considerations mean that for individual financial services suppliers and users, an "equivalence" approach either comes with certain risks or may not even be available.

Alternative Approaches

Beyond "passporting" and "equivalence," certain alternative approaches may be pursued as well, but they would be subject to further negotiation and it is less clear-cut how they would be structured and work out for individual financial services sector participants in practice.

Exemptions (e.g., granted by the UK or the Netherlands): Third-country firms are exempted from some authorization/branch requirements in specific cases. However, they can only operate locally (e.g., on the domestic market of the UK or the Netherlands), without EU passporting rights. Outside the EU, similar examples exist in Japan and Switzerland.

National treatment: Foreign providers may not be treated less favorably than domestic ones. For instance, an EU-based bank can set up a banking subsidiary in the US, but the full US regulatory regime (including capital requirements) will generally apply to its activities. Depending on the wording in any particular FTA or other trade agreement, "foreign" can mean a variety of things including services provided cross-border, through establishment in-country or through temporary entry of service providers/employees.

International agreements (e.g., the Asia Region Funds Passport initiative): Passport rights are provided to firms on the basis of an international treaty. Also, mutual assistance agreements could be available on regulatory/supervisory cooperation (e.g., the EU-US Covered Agreement on Insurance and Re-insurance).

Free Trade Agreements ("FTAs"): Due to concerns over sovereignty, financial stability and prudential operation, financial services-related provisions have traditionally not been part of most EU FTAs. When included, such provisions have typically been in the form of guaranteed national treatment and prohibitions on quantitative limits on market access, i.e., far from the wishes of the UK on mutual recognition of regulation. However, certain precedents show that improved access to EU financial markets can be negotiated under an FTA, if both sides agree.

- [The EU-Ukraine Deep and Comprehensive FTA \("DCFTA"\)](#), which is part of a wider

Association Agreement with the Ukraine, grants Ukrainian firms access to EU financial markets when the EU determines that the Ukraine has implemented EU regulation. The agreement gives the CJEU the final word on interpreting its rules.

- [The Canada-EU Comprehensive Economic and Trade Agreement \("CETA"\)](#) grants Canadian firms limited access to EU financial markets. They are required to establish a presence in the EU and to comply with EU rules to benefit from the EU financial services passport.
- The draft [EU-US Transatlantic Trade and Investment Partnership \("TTIP"\)](#), which has been on ice since the end of the Obama Administration, provides an example where the EU pursued integrated cooperation and put forward to the US the concept of mutual recognition of financial services regulation.

The UK for its part has indicated an interest in negotiating FTAs with a range of other countries and financial services centers worldwide, which will crest an additional interesting dynamic in terms of both negotiations, and market access.

EU and UK negotiating positions

The **EU** has started the negotiations on a future relationship with the UK in financial services with a tough stance. Michel Barnier, EU Chief Negotiator for Brexit, [declared](#) that "[t]here is no place [for financial services]" in an FTA. The [EU Council Guidelines on the framework for the future EU-UK relationship](#) do not mention financial services, but only services. The aim is

"allowing market access to provide services under host state rules, including as regards rights of establishment for providers, to an extent consistent with [UK third country status] and [the fact that] the Union and the UK will no longer share a common regulatory, supervisory, enforcement and judiciary framework."

The **UK** is seeking the broadest possible access to EU financial markets. Philip Hammond, the UK's Chancellor of the Exchequer, has [challenged](#) the assertion that financial services cannot be included in an FTA. He argues that the EU should negotiate an agreement on mutual access to financial services with the UK, given the importance for the EU of the UK financial services sector; the fact that UK taxpayers stand behind the risks presented by the UK financial sector; and the consequence that the absence of an FTA between the UK and the EU would benefit non-EU rivals in financial services (e.g., Singapore or the US). Given the fact that the UK and the EU will have the same rules in place on regulation of financial services at the moment when Brexit occurs, the UK's negotiating objectives are (i) mutual recognition of the regime of the home country regulator and reciprocal regulatory equivalence; (ii) continued supervisory cooperation; and (iii) predictability in case of future divergence of financial services regulation.

The EU has refuted the argument that it needs the financial services provided by the City of London in order to be competitive in financial services and have efficient access to world capital markets. Michel Barnier has [responded](#) that "[t]his is not what we hear from market participants, and it is not the analysis that we have made ourselves" and asked "[w]hy would the equivalence system, which works well for the US industry, not work for the City?"

Potential Outcomes and Conclusions

In the words of Michel Barnier, “market participants [...] should hope for the best, but prepare for the worst.” This is practical advice, but does not indicate much about the direction in which negotiations are headed.

While it continues to be very hard to predict what will ultimately be agreed, the current outlook is that UK firms will almost certainly lose “passport” rights as they currently exist. Even if financial services are included in an EU-UK FTA, access for UK firms under more relaxed mutual recognition will likely be limited to those areas in which the EU truly needs services provided out of the UK and sees no alternatives, or where the UK has been able to get the EU to compromise in exchange for other commitments. However, negotiating objectives on both sides show that broader access for the UK to EU financial markets under an FTA than is currently often assumed could be possible and might be an acceptable (compromise) outcome for both sides.

If financial services are not part of an EU-UK FTA, UK-based firms or third-country service providers relying on a UK presence should consider whether an equivalence regime is or could be available, and whether an EU-UK bilateral agreement could be negotiated to broaden this regime, amend the procedural requirements for equivalence and come closer to approximating mutual recognition. The devil, however, will be in the detail. And the coming months will be key in setting the direction for what any post-Brexit EU-UK financial services relationship will look like. Other players, such as the US – home to many of the financial services firms doing business in London and the remaining EU-27 – will likely play a key role in this respect as well and will have a real stake in what the eventual outcome looks like.

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1. “Chancellor's HSBC speech: financial services,” published 7 March 2018. Available [here](#).
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