



# THE EU'S THIRD COUNTRY REGIMES AND ALTERNATIVES TO PASSPORTING

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## The International Regulatory Strategy Group

The International Regulatory Strategy Group (IRSG) is a practitioner-led body comprising leading UK-based figures from the financial and related professional services industry. It is one of the leading cross-sectoral groups in Europe for the financial and related professional services industry to discuss and act upon regulatory developments.

Within an overall goal of sustainable economic growth, it seeks to identify opportunities for engagement with governments, regulators and European and international institutions to promote an international framework that will facilitate open and competitive capital markets globally. Its role includes identifying strategic level issues where a cross-sectoral position can add value to existing industry views.

TheCityUK and the City of London Corporation co-sponsor the IRSG.

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# FOREWORD

As the UK stands on the brink of a new era in its trading relationship with the EU and the rest of the world, the UK-based financial services industry is still assessing its current and future position.

In her recent speech on 17 January 2017, the Prime Minister outlined the UK Government's intention to secure a bespoke deal with the EU with the greatest possible access to EU markets. She recognised the important role the UK plays as Europe's financial centre and that the industry must be able to provide its services across national borders after Brexit. We hope that this report will help inform this debate.

The UK's intended direction of travel has now been outlined, but the complex political path to be navigated, and the demanding timescales involved, mean that it is increasingly urgent that financial services providers assess their priorities and develop their plans for Brexit.

We know that when the UK ceases to be a member of the EU, it will automatically lose the access rights which it currently has through its EU membership. The UK will become a 'third country' from the perspective of EU financial services legislation. However, the implications of being a third country have rarely been considered within the UK, and there has until now, been a lack of detailed analysis of the legal position.

The International Regulatory Strategy Group (IRSG) – co-sponsored by TheCityUK and The City of London Corporation – has established a working group, chaired by Hogan Lovells and with representatives from across the industry, to produce a clear and neutral analysis of the UK's position in relation to the cross-border provision of financial services, to and from the EU, after Brexit.

The aim is to produce an insightful analysis of the implications of the range of potential outcomes, in order to provide a practical, factual context to the industry and to assist policymakers in assessing their objectives and priorities and developing their future strategy.

We are pleased to contribute this thinking to the complex task of shaping a future relationship which works to the benefit of all those who rely on financial services in the UK and across the EU – including financial services providers themselves, their employees, and the consumers they serve.

There is currently a significant amount of cross-border business (in both directions) between the UK and the rest of the EU, and our analysis should be of benefit to financial services providers on both sides of a future UK/EU border.

We have not considered the concept of 'passporting' in detail, as the scope and availability of passporting is already well known to the industry and the UK Government has indicated that it does not intend to pursue an approach that relies on the continuation of passporting. Instead we have focused on identifying what the alternatives to passporting could be.

Under existing EU law, there are 'third country regimes' already in place, which allow financial services providers from outside the EU to have access to parts of the EU financial services market.

This report contains a factual matrix which provides details of:

- the scope of the existing third country regimes – i.e. which areas of financial services are covered by third country regimes and which are not;

- the conditions that both the UK and UK-based financial services providers would need to satisfy in order to make use of the third country regimes. In most cases, the availability of those regimes depend upon the UK's own regulatory regime being determined by the EU authorities to be 'equivalent' to the EU regime; and
- the processes for securing access under the third country regimes, both to understand the obligations that the UK and UK-based financial services providers would be subject to, and to give an indication of how quickly the necessary determinations could be obtained.

There are legitimate concerns that even if the UK's regime is actually equivalent at the date of Brexit, the question of whether the EU authorities will grant the necessary determinations – or will do so in time for the UK's exit from the EU – is unclear. That, and the narrower range of activities covered by the third country regimes, suggests that relying only on those regimes will not meet the objectives for 'maximum possible access' which have been outlined by the UK. But the Prime Minister has also stated that the if its objectives cannot be secured, then the UK may proceed on the basis of "no deal" which would, effectively, mean that the UK would be relying on the TCRs to secure on going access to the EU.

As a result, the report concludes that the UK should be looking to reach a bespoke agreement with the EU, allowing wider, mutual rights of market access, to reflect the unique position of the UK in relation to the EU and reflecting their integrated and interdependent markets. The report provides insights into some of the mechanisms which could be used to structure a relationship based on this new approach, if enhanced access across the UK/EU border can be agreed politically.

The report also provides a detailed analysis of what the position would be if the UK, after Brexit, does not secure a bespoke agreement and is not able – or not willing – to comply with the conditions of the third country regimes. This analysis includes input from a number of key EU jurisdictions regarding the extent to which a firm from a non-EU country can undertake business in those jurisdictions without obtaining a local licence – for example, by relying on reverse solicitation, and the extent to which it could outsource activities from to the UK from a subsidiary established in those EU jurisdictions.

Finally, the report considers the importance of agreeing transitional arrangements and suggests measures that the UK should be looking to agree with the EU, as soon as possible, to give reassurance to the financial services industry on both sides of the future UK/EU border.

By enhancing understanding of the additional access mechanisms which would need to be put in place at the time of Brexit to maintain continuity of provision for those who rely on financial services, in the UK and across the EU, we hope that this report will support the UK and EU in framing and transitioning to a successful new relationship for all.

We are extremely grateful for the support of all contributors to this report.

**Mark Hoban**  
Chair, IRSG Council

**IRSG**  
INTERNATIONAL  
REGULATORY  
STRATEGY GROUP

**Rachel Kent**  
Global Head of financial Institutions Sector, Hogan Lovells

**Hogan  
Lovells**

# EXECUTIVE SUMMARY

- 1 Brexit and the shape of a new relationship with the EU are critical issues for the UK-based financial and related professional services industry and for the wider economy it serves. To help the Government prepare its strategy effectively and to clearly define the industry's priorities for the forthcoming negotiations, TheCityUK has undertaken extensive work related to the decision by the UK to leave the EU. We are committed to ensuring we respond effectively to what is a fundamental change to the way that our industry has operated to date, but also a change that presents opportunities if managed in the right way.
- 2 As an industry that employs around 2.2 million people across the UK, generates more in tax revenue and attracts more foreign direct investment than any other, its continued strength is intrinsically linked to a strong and thriving economy and is a national and European asset. The UK benefits economically from having a strong financial and related professional services industry that serves the UK, Europe and the rest of the world. Meanwhile, Europe benefits from having London – one of only a handful of truly global financial centres – as its hub and entry point for companies based outside Europe wanting to access the Single Market. London and the wider UK therefore help to enable economic growth and jobs across the UK and Europe. Given how interconnected and interdependent the UK's and EU's financial markets and services have become, it will remain a political imperative to ensure that these markets continue to function in a coherent way post-Brexit.
- 3 In light of the industry's importance to the UK economy, we believe that financial and related professional services issues should be prioritised in the forthcoming negotiations. This must include securing a "mutual access" arrangement, which allows as much two-way access between the UK and EU as possible. Agreeing an approach which facilitates the access to skilled talent from both the EU and the rest of the world in order to continue and boost the UK's competitiveness will also be important.
- 4 *The EU's Third Country Regime and Alternatives to Passporting* was produced by the IRSG in collaboration with Hogan Lovells. Its aim is to look at what the alternatives are if the UK does not continue to have passporting rights after Brexit – and in particular it provides a comprehensive analysis of the EU's current third country regimes (TCRs) for financial services. The TCRs are provisions of existing EU law that provide certain rights and protections, subject to conditions, to countries outside the EU (so-called **third countries**) and to financial services firms from those countries (**third country firms**). These rights fall short of passporting but, when granted by the EU, include the ability to conduct certain regulated activities in the EU without obtaining authorisation from the regulators in the relevant Member States. It has been suggested by some commentators that a new UK-EU relationship in financial services could be based on TCRs.

**2.2**  
**MILLION**  
**PEOPLE**



**FINANCIAL AND RELATED  
PROFESSIONAL SERVICES  
REMAINS ONE OF THE MOST  
IMPORTANT INDUSTRIES,  
DIRECTLY EMPLOYING  
2.2 MILLION PEOPLE  
ACROSS THE UK**

- 5** Based on the analysis undertaken by the IRSG, the report draws the following conclusions:
- Given their limited coverage (compared to current rights of access), uncertainty of availability and the lack of key safeguards associated with them, the TCRs do not provide an acceptable long-term, sustainable solution for the UK-based industry as a whole to access EU markets.
  - Relying on the degree of access that is permitted under local laws in individual Member States does not provide a sufficient solution either. Indeed, since the UK's current regime for allowing access for overseas firms is materially more liberal than that in many individual Member States, we would be left with an asymmetric relationship.
  - The debate should thus focus on what a bespoke agreement between the UK and the EU allowing mutual market access should look like.
  - Transitional arrangements will have to be agreed as quickly as possible to ensure continuity of service provision until a new settlement can be implemented and to minimise unnecessary relocation or restructuring by financial firms.
- 6** Only a very small proportion of financial services which are currently covered by the passporting regime are the subject of TCRs:
- There are TCRs available for certain types of market infrastructure providers (e.g. CCPs and benchmark administrators).
  - There is no TCR giving cross-border access for a number of key financial services, including deposit taking, lending, payment services, mortgage lending, and activities relating to UCITS funds. There is only a very limited TCR for insurance.
  - TCRs are in the process of being introduced that may be useful to (i) firms undertaking investment business that wish to provide cross-border services (i.e. without establishing a branch in the EU) to wholesale customers in the EU (there is also a TCR for establishing branches, subject to the consent of the relevant Member State, and this could include the provision of services to retail clients); and (ii) non-EU alternative investment fund managers who wish to market funds to professional clients in the EU.
  - The TCRs only provide very limited rights of access in relation to retail clients.

In summary, the combination of a lack of a comprehensive framework of TCRs and concerns about the way in which they operate means that even if the UK were to achieve the best possible outcomes under the existing/proposed TCRs, UK firms would still not be able to offer the full range of financial products and services that they can offer today to customers and counterparties in the EU.

- 7** In general, in relation to the TCRs:
- Most TCRs depend on the third country regime being 'equivalent' to the relevant EU regime. In relation to this:
    - There is a lack of clarity over what 'equivalence' means in practice. The analysis is supposed to be outcomes-based, but that is not consistent with the experience



# £190BN

**FINANCIAL AND RELATED  
PROFESSIONAL SERVICES  
CONTRIBUTED £190BN TO  
THE UK ECONOMY IN 2014.  
THIS REPRESENTED 11.8%  
OF UK ECONOMIC OUTPUT**

of third country firms who have applied under the existing TCRs, where the analysis has been carried out 'line by line'. It appears that some divergence between the two regimes is permitted, but it is difficult to determine what level of divergence would mean that the regimes are non-equivalent.

- (ii) The requirement to be equivalent is ongoing. In order to maintain equivalence under the TCRs, the UK may end up being something of a 'rule taker' – i.e. having to implement changes in its own law to follow changes in EU law (and having less ability to influence those changes than it did as a member of the EU).
  - (b) The TCRs only apply if the EU authorities make a formal determination of equivalence. Although UK firms should in theory have an equivalent regime at the date of Brexit, it is not clear that the EU authorities will necessarily share that view or that they will make their formal determination before the date of Brexit.
  - (c) Some TCRs contain additional restrictions or limitations (e.g. requiring third country firms to submit to the jurisdiction of EU courts) – or permit Member States to impose additional restrictions or limitations of their own.
  - (d) Some TCRs are optional for Member States (i.e. they give the individual Member State the ability to opt out of allowing access to third country firms), so access is only available in relation to those Member States who decide to allow access.
  - (e) There are serious concerns regarding the processes around TCRs. In particular:
    - (i) the processes are unpredictable and very time consuming;
    - (ii) TCRs can be withdrawn or varied by the EU at little or no notice; and
    - (iii) there is little or no right of appeal against a determination of non-equivalence for a third country.
- 8** In addition, there are also numerous provisions of EU legislation which, although they do not directly deal with access rights, impose restrictions on EU firms dealing with third country firms where the third country is not equivalent. For example, a UCITS fund in the EU will be prevented from investing into UK investment funds if the UK's regime is not considered equivalent to that of the EU. There is also concern that EU data protection laws may present a practical barrier to UK firms when dealing with EU customers and counterparties. Provisions of this nature could have a significant impact on UK firms.

**9** If neither passporting nor the TCRs are available in relation to a regulated activity and no other alternative form of access arrangement is agreed with the EU:

- (a) For each Member State where it wished to conduct regulated business, a UK firm would have to consider whether national laws permitted it to carry on such business without a licence (or whether, for example, there might be an exemption available). Our analysis shows that the position differs between the different Member States, resulting in a complex patchwork of rules. There are no general exemptions across the EU.



**£1.1  
TRILLION**

**EU BANKS IN THE UK HOLD  
OVER £1.1 TRILLION IN  
ASSETS OR 17% OF TOTAL  
BANK ASSETS IN THE UK**

- (b) A UK firm could establish a subsidiary in the EU and apply for it to be authorised by the local regulator. The subsidiary would be able to use passporting rights around the rest of the EU. Our analysis shows that the subsidiary could outsource certain activities back to the UK, but it would have to satisfy ‘substance’ requirements in the EU Member State where it is authorised. This route to market is often inefficient (e.g. it may create new risks in the business).
- (c) A UK firm could itself apply directly to a local regulator for authorisation in that Member State (i.e. instead of establishing a local subsidiary and applying for that entity to be authorised). The UK firm would typically have to establish a branch office in the Member State in order to obtain authorisation in this way. Some Member States allow this, but others impose limitations or rarely use the approach, so again it is not a universal solution.

**11.0%**

**UK FINANCIAL SERVICES  
ARE A VITAL SOURCE OF TAX  
RECEIPTS, CONTRIBUTING  
£67BN IN TAX REVENUE  
IN 2014/15, OR 11.0% OF  
TOTAL UK TAX RECEIPTS**

- 10** Taking the above issues into account, the most favourable solution is likely to be for the UK and EU to enter into a bespoke agreement to allow mutual access to each other’s markets. This could be on the basis of mutual recognition, or on the basis that the two regimes are broadly consistent (rather than strictly ‘equivalent’, under the approach currently used in the TCRs).
- 11** Arrangements need to be put in place to protect customers who already have products in issue from the other side of the UK/EU border at the date of Brexit. This could take the form of some kind of ‘grandfathering’ arrangement, under which products that are already in issue at the date of Brexit will automatically be regarded as valid and can continued to be serviced across the UK/EU border for the lifetime of the product. This would also support stability and access to the full range of financial services products for businesses and consumers during the negotiation period by providing confidence that the products would not cease to be effective on Brexit.
- 12** It is essential for the UK and EU to agree transitional arrangements as quickly as possible in order to maintain continuity of service provision by UK and EU firms until a negotiated settlement can be achieved and a smooth and orderly transition to the longer term arrangements implemented. These transitional arrangements should ideally cover all the areas covered by the current passporting regime, so that existing businesses can continue to service their customers across the UK/EU border.
- 13** TheCityUK has been playing a central role in defining and delivering the industry’s priorities for the Brexit negotiations and beyond, to ensure the UK remains the world-leading centre for financial and related professional services. The cooperative relationship between the UK and the rest of Europe needs to be retained. This will mean avoiding the imposition of new barriers between the two markets when Brexit occurs.



# OVERVIEW

## Background and context

- 1 The UK Government has said that it wants to retain as much access to the ‘Single Market’ as possible.<sup>1</sup> UK firms currently use the passporting regime set out in EU laws to access the Single Market, but those laws will cease to apply to the UK on Brexit. The ability of EU firms to rely on passporting to access the UK will also lapse on Brexit. Unless a replacement arrangement is agreed, UK firms wishing to access the Single Market (and EU firms wishing to access the UK market) will need to find another route to provide those services after the UK leaves the EU.
- 2 The ‘Single Market’ covers the relationships within the EU itself and the relationships that the EU and its members have with the other members of the EEA. The UK will be considering how to maximise its post-Brexit access to all of this market.
- 3 It is in the interests of both the UK and the EU (and of consumers in each) to retain some degree of access to each other’s markets:
  - (a) For the UK, financial services remains one of its most important industries, directly employing 2.2 million people across the UK and generating an estimated £60-67 billion of taxes each year. It also supports a wider ecosystem of employment and tax contribution (e.g. from related professional services), as well as providing access to finance needed in daily life and across all other industries. The EU is the biggest market for UK exports of financial services, generating 41% of the UK’s total trade surplus in financial services in 2015.
  - (b) The UK is an important financial and related professional services centre for the rest of the EU. The extent of the UK’s trade surplus with the EU in relation to financial services demonstrates the demand in other EU Member States for the UK’s financial services and products. The strength of London as a financial centre attracts capital and investment into Europe, which flows through to the EU. The EU would therefore potentially stand to lose from a reduction in the UK’s position as a global financial hub.
  - (c) It appears unlikely that any of the other cities in the EU could, in the short or medium term at least, absorb the whole financial services ecosystem which exists in the UK. A number of factors contribute to that, including that the requisite capacity to do so does not currently exist in any one EU city in terms of scale of infrastructure (business or domestic) and resident talent pool.
  - (d) As a result, if Brexit means that firms need to relocate, this (as well as differing preferences of location) is likely to result in the fragmentation of financial services across the EU. Many commentators have noted that weakening London’s position as a global financial hub is likely to strengthen other global centres, such as New York or Singapore, rather than purely benefitting other cities in the EU.
  - (e) If the result of Brexit is that the costs of doing business in EU markets would increase (e.g. because UK firms need to establish separate EU subsidiaries to carry



**THE EU IS THE UK'S BIGGEST MARKET FOR EXPORTS OF FINANCIAL SERVICES, GENERATING A TRADE SURPLUS OF £19.9BILLION – OVER A THIRD OF THE UK'S TRADE SURPLUS IN FINANCIAL SERVICES IN 2013.**

<sup>1</sup> See the speech by the Prime Minister dated 17 January 2017: “An important part of the new strategic partnership we seek with the EU will be the pursuit of the greatest possible access to the Single Market, on a fully reciprocal basis, through a comprehensive free-trade agreement.”

on doing business with EU consumers), that may increase costs to consumers in those markets or lead firms to consider that it is no longer cost-effective to service smaller markets and withdraw.

- 4 There is scope for debate over exactly what ‘access’ means in this context. In this report, we use the term ‘access’ to refer to the ability of a financial services firm to rely on an authorisation provided by its regulator on one side of the EU/UK border in order to provide regulated financial services to customers or counterparties on the other side of that border, either directly from its home state or through a branch established on the other side of the border.
- 5 A loss of passporting would mean that if a UK firm wishes to perform a regulated activity in another country, it will usually need to be authorised in that country in accordance with local laws. If a regulated activity is performed in multiple countries, separate authorisations will be required. The Single Market Directives introduced passporting (and, to a lesser extent, third country regimes in order to avoid the need for multiple authorisations.
- 6 An issue also arises in relation to ‘products in issue’ by a UK firm with an EU customer at the date of Brexit. In relation to some regulated activities, such as ‘dealing in investments’, the activity is concluded as soon as a trade is completed. In such cases, if firms cease their trading activity they will not be continuing to do regulated activities in such a way as to require authorisation. In other cases, such as investment management agreements and insurance policies, the regulated activity takes place on a continuing basis. On a loss of passporting, it will be necessary to consider the ability of firms to continue providing such services and products to customers. This is likely to be a more significant issue for firms with a branch in the EU.
- 7 There are essentially four potential outcomes for the UK’s future relationship with the EU on access for financial services post-Brexit:
  - (a) having passporting rights, via EEA membership;
  - (b) agreeing a bespoke arrangement with the EU;
  - (c) relying on the existing TCRs; or
  - (d) not seeking to rely on existing TCRs (see paragraph 18(a) of this overview).

These possibilities are considered in more detail in sections 2, 3, 7 and 8 of the report.

- 8 This report analyses the TCRs and other options for providing access for financial services providers across a UK/EU border post-Brexit if passporting is no longer available. The report is focussed on how (and whether) potential alternatives to passporting would work. It does not analyse in detail the possibility of passporting under EEA membership nor the terms which may need to be accepted by the UK in order to become a member of the EEA.

## The TCRs

- 9 The TCRs are provisions of existing EU law that provide certain rights and protections, subject to conditions, to countries outside the EU (so-called “third countries”) and to

35%



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**AROUND 35% OF EU  
WHOLESALE FINANCIAL  
SERVICES ACTIVITY TAKES  
PLACE IN LONDON**

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financial services firms from those countries ('third country firms'). These rights fall short of passporting but include the ability to conduct certain regulated activities in the EU without obtaining authorisation from the regulators in the relevant Member States.

- 10** Usually, where a TCR is available, it is on the condition that the EU authorities must first make a determination that the legal and regulatory system in the relevant third country is equivalent to that in the EU. The issues relating to equivalence are considered below, in paragraph 13(c) of this overview.
- 11** Our review of the scope of the TCRs (sections 3 and 4 of the report) has shown that only a very small proportion of the areas of financial services which are currently covered by the passporting regime are the subject of TCRs.
- 10** Specifically:
- (a) The only areas where TCRs currently offer a level of access that is likely to be useful to UK firms is in relation to certain areas of market infrastructure – for example, allowing UK clearing houses and benchmark administrators to provide services to EU customers. These TCRs are only likely to be directly applicable to a relatively small number of UK financial services providers (although they have a broader role in supporting the UK's position as a global financial centre).
  - (b) A number of important areas of financial services currently covered by passporting have no TCR which allows for cross-border access. These areas include:
    - (i) banking (deposit taking);
    - (ii) lending;
    - (iii) payment services;
    - (iv) mortgage lending;
    - (v) insurance mediation and distribution; and
    - (vi) activities relating to UCITS funds.
  - (c) There is a very limited TCR in relation to the issuing of contracts of insurance. EU Member States have an absolute discretion about whether to grant direct authorisation to branches of third country insurance firms. If a Member State decides that it will grant direct authorisation to a third country insurance firm, the TCR sets minimum standards that the Member State must apply when doing so.<sup>2</sup> However, the TCR does not require EU Member States to allow such branches to be established in the first place. EU Member States could therefore effectively 'opt out' of allowing access to UK insurers, even if the UK regulatory system had the requisite degree of equivalence.
  - (d) There are TCRs which are still in the process of being introduced that may, following their introduction, be useful to the following types of firm:
    - (i) third country firms wishing to provide investment services to wholesale



**112 COMPANIES FROM  
EU MEMBER STATES ARE  
LISTED ON THE LONDON  
STOCK EXCHANGE**

<sup>2</sup> This is not the case in relation to pure reinsurers (i.e. insurers who only enter into reinsurance contracts and do not enter into primary contracts of insurance). For pure reinsurers, the relevant Directive (the Solvency II Directive) does not set any standards for the establishment of a branch; it simply requires that pure reinsurers from third countries should not be treated more favourably than a pure reinsurer from the EU that was relying on passport rights.

customers on a cross-border services basis (i.e. without establishing a branch) under MiFID II. However, there will be no right to provide such services to retail clients and the rights under this TCR are subject to limitations (including in particular an obligation on the third country firm to submit disputes to the jurisdiction of a court or arbitral tribunal in an EU Member State); and

- (ii) 'non-EU alternative investment fund managers' who wish to market to alternative investment funds to professional clients in the EU (although the introduction of this TCR, which is found in the AIFMD, has already been the subject of some delay).

Each of these TCRs is considered in the case studies in section 5 of the report.

- (e) The TCRs only provide for very limited rights of access in relation to retail clients. The proposed TCR for investment services under MiFID II allows for branches of third country firms to service retail clients, but there is no obligation on Member States to allow such branches to be established – i.e. Member States can opt out of it. Other than in this specific situation, there are no TCRs allowing rights of access in relation to retail clients.
- (f) UK investment firms and credit institutions will lose rights of access to EU trading venues, central counterparties and clearing and settlement systems after Brexit. There is no TCR which provides similar rights, so it will be up to individual EU Member States to determine whether UK firms will be able to have such access after Brexit.
- (g) Some of the TCRs contain additional restrictions which may prove to be an obstacle to access. For example, EU firms are normally restricted from relying on credit ratings issued by credit ratings agencies ('CRAs') from third countries. There is a TCR under which third country CRAs can apply to be certified, which would allow their credit ratings to be used by EU firms. However, certification is only available where the credit ratings are not of 'systemic importance'. If the credit rating is of systemic importance, the credit rating produced by the third country CRA could only be used by an EU firm if the credit rating had been endorsed by an EU CRA.

**13** Our review of the general nature of TCRs (see section 3 of the report) also shows that:

- (a) TCRs have arisen in a piecemeal manner over time and are contained in separate EU Directives, depending on the activity covered, with differing processes and requirements applying. Each TCR was influenced by different policy priorities at the time it was created.
- (b) Where they do exist, TCRs offer rights and protections that are much less extensive and less reliable than passporting. In particular:
  - (i) they are frequently subject to specific restrictions and limitations (e.g. regarding the type of customer that can be serviced);

- (ii) some are optional for Member States (i.e. individual Member States can opt out of allowing the third country firm to access their market); and
  - (iii) Member States are often able to impose additional restrictions on third country firms (i.e. above and beyond the requirements that would apply to a firm from within the EU).
- (c) There are considerable concerns regarding the determination of equivalence of a third country. In particular:
- (i) There is a lack of clarity over what 'equivalence' means in practice. The answer can differ as between different TCRs and different industry sectors. The assessment of 'equivalence' is meant to be outcome-based, so potentially it allows some scope for divergence between the respective regimes of the EU and the third country. In the absence of more detailed guidance from the EU authorities, however, it will be difficult for the UK law makers and regulators to know how far they can diverge from the EU standards without ceasing to be regarded as equivalent.
  - (ii) The experience of third countries who have applied for determinations of equivalence under existing TCRs shows that the processes followed by the EU authorities are unpredictable and time consuming. Even though equivalence assessments are supposed to be outcomes-based, the practical experience under the existing TCRs is that the process has involved comparing the respective regimes "line by line". There is no set timetable for equivalence decisions and most decisions have taken between two and four years to complete. Section 5 of the report contains case studies illustrating the actual experience of third countries seeking a determination of equivalence.
- (d) There is uncertainty regarding the ease with which the UK, as a third country post-Brexit, could obtain a determination that its legal and regulatory system is equivalent to that of the EU. Assuming that the UK effectively imports EU laws wholesale to take effect on Brexit (as is the UK Government's stated intention, via the Great Repeal Bill), its legal and regulatory system ought, in principle, to be equivalent with that of the EU at the date of Brexit. However, the UK's new legal framework will need to be available in adequate time for the assessment to be made and there is no assurance as to how quickly the EU authorities will consider any application for equivalence by the UK and whether they would complete their deliberations before the date of Brexit itself. The EU has indicated that the UK will be treated as a third country as soon as it serves notice to leave the EU, which should facilitate the commencement of any processes for determining equivalence.
- (e) Under the TCRs, the requirement to be equivalent is ongoing. In order to maintain equivalence (and subject to the point about some degree of divergence potentially being acceptable), the UK is likely to become something of a "rule taker" – i.e. it will have to:
- (i) follow developments in EU law on an ongoing basis and enact them into UK law; and

- (ii) refrain from making changes to the UK's own regulatory framework which would result in it ceasing to be equivalent.

It may be possible, however, for a third country to operate a "dual regime" (i.e. with separate parallel regimes or a tiered rule book), one of which has equivalent standards to the EU and one of which does not.

- (f) There is currently no forum through which the UK and EU could collaborate into relation to changes in regulation and maintaining equivalence (although there are relevant examples in other contexts).
- (g) Unlike passporting rights, TCRs are capable of being withdrawn or varied by the EU – either for:
  - (i) third countries as a whole (in respect of which there is no formal process for the withdrawal of equivalence); or
  - (ii) individual third country firms (where some of the TCRs have a formal process for the withdrawal of recognition, but most do not). Where there is a formal process for withdrawal, the notice period can be as little as 30 days.
- (h) There is also currently no mechanism through which a third country or third country firm can appeal against a determination relating to a third country as a whole. The possibility of an equivalence determination being withdrawn at little or no notice could affect the willingness of UK firms to rely on TCRs. To date, however, the EU has not withdrawn any determination of equivalence that it has made under the existing TCRs.
  - (i) In circumstances where a third country has been determined to be equivalent under an existing TCR, a third country firm that has its recognition withdrawn may have standing to challenge such a decision in the Court of Justice of the European Communities (but only if the decision affects it as an individual firm, as opposed to affecting a category of firms in which it belongs).

**14** If a bespoke agreement is being put in place, the UK may wish to consider whether it is possible to agree safeguards with the EU regarding equivalence determinations – e.g. so that a determination of equivalence cannot be withdrawn at little or no notice, or without the UK itself or UK firms having a formal opportunity to respond or remedy the situation before withdrawal occurs. There may also be scope for the UK and EU to agree that disputes regarding equivalence could be resolved by an arbitral or judicial body appointed for that purpose.

**15** Although the focus of this report is on the availability of TCRs as an alternative to passporting, it is important to note that there is also EU legislation which does not directly address the question of third country access, but which imposes restrictions on EU firms dealing with third country firms. In a number of cases, these restrictions do not apply in relation to third country firms who can demonstrate equivalence, and are thus another example of the importance of equivalence issues to third country firms. Although they only affect third country firms indirectly, these so-called "indirect TCRs" can have an adverse impact on firms from non-equivalent third countries. For example:

- (a) EU Member States are permitted to impose regulatory restrictions on the ability of EU insurers to reinsure with third country reinsurers in non-equivalent third countries. If the UK is not formally determined to be equivalent by the EU, this could affect the ability of UK reinsurers to do business with EU insurers; and
- (b) EU UCITS funds would be prevented from investing in UK investment funds unless the home Member State of the UCITS fund considers the UK investment fund to be subject to supervision equivalent to that laid down in EU law. If the UK is non-equivalent, this source of investment into UK funds will be cut off.

**16** There are a number of these provisions in EU law, which could also affect the willingness of EU firms to have exposures to UK firms post-Brexit, the way in which international groups have to organise themselves and the ability of UK firms to offer products and services into the EU. Appendix 3 sets out the main examples of these provisions. In the post-Brexit world, the UK will want to ensure that it has been determined to be equivalent in relation to these provisions.

**17** This report does not address all the ways in which the UK being a third country may affect the UK financial services industry. In addition to the issues relating to financial services, there are issues which may apply all industries. Any future inconsistency between the UK and EU in relation to data protection law may affect the ability of firms to transfer data across the UK/EU border and act as a practical impediment to cross-border business. Access to talent is also a concern for the UK financial services sector.

## Access options other than relying on the existing TCRs or entering into a bespoke agreement

**18** If neither passporting nor the TCRs are available in relation to a regulated activity, and no bespoke agreement can be secured, it is likely that UK-based financial services firms would have only limited access options available to them after Brexit. The main options would be as follows:

### (a) **Carry on such cross-border activities as are permitted under local laws**

In this situation, the UK firm would be seeking to provide cross-border services from an establishment in the UK to customers or counterparties based in EU Member States. The ability of the UK firm to do so will depend on whether local laws require them to obtain a licence to do so or whether there are any relevant exemptions that it can make use of.

In connection with this, we have considered whether it could be argued that certain forms of business carried on from the UK with EU counterparties or customers are being carried out only in the UK and not in the EU Member State, such that no need for a licence arises. Our conclusion is that there would be material risk associated with relying on such an argument, not least because many EU Member States take a different interpretation and it is the law in those Member States that is relevant.



There are no general exemptions that UK firms could use in order to secure access (such as the UK's 'overseas persons exemption' which the UK currently applies to non-EU firms). In some individual Member States, there are exemptions that might assist, but a UK firm would need to consider its position separately in each Member State. We have reviewed the law in several key EU Member States and concluded that UK firms would have limited scope to conduct regulated activities in those Member States without a local licence.

In relation to some of the Member States we reviewed, UK firms could accept business from EU customers or counterparties on a 'reverse solicitation' basis (i.e. where the business resulted from the EU customer approaching the UK firm, rather than through the UK firm soliciting the business). Even where reverse solicitation is permitted, however, it is often subject to limitations. In any event, UK firms are likely to find that an inability to actively solicit customers means that reverse solicitation of very limited practical use.

**(b) Establish a subsidiary in the EU**

Many UK firms who currently rely on passporting rights are considering establishing a subsidiary in the EU and applying to get it authorised by the local regulator. The subsidiary would be able to passport services from that Member State around the rest of the EU.

In relation to this approach:

- (i) A UK firm currently using passporting to conduct an activity in other Member States would need to transfer all or part of its business into a regulated EU subsidiary to continue conducting it. That is likely to involve considerable disruption to the UK firm's existing business.
- (ii) Establishing a new subsidiary would be significantly less efficient than the position that a UK-based financial services business which currently has a passport finds itself in (e.g. from a regulatory capital position, as well as operationally).
- (iii) In many of the key EU Member States, it would be possible for the new EU subsidiary to outsource critical functions back to its parent company in the UK. There has been speculation about whether a UK firm could use a so-called 'brass plate' approach – i.e. under which it puts the minimum resources into the EU subsidiary and outsources everything back to the UK. The answer is that there is a balance to be struck. The new EU subsidiary would have to be an entity of substance, with real decision making being undertaken within that entity itself (which may mean, amongst other things, having to find additional directors in the relevant Member State). Subject to those requirements, however, it would be possible for the new EU subsidiary to rely on the UK parent company to provide support on an outsourced basis to a significant degree. The exact extent of delegation possible may vary between the different types of regulated activity and as between the Member States in which the subsidiary could be based. See section 7 of the report.

Some firms may choose to curtail the business they conduct cross-border, reducing their offering to businesses and consumers across the EU or only provide the services to Member States which permit direct access.



### (c) Apply to individual EU Member States for direct authorisation of a branch

EU Member States sometimes permit third country firms to obtain authorisation directly from the local regulator – usually to establish a branch of the third country firm itself in that Member State. Our review of key jurisdictions showed that some Member States impose limitations or that the approach is rarely used in practice. In some instances, the relevant Directives expressly prohibit it, so it would not be a universal solution.

Even if this option is available, the UK firm would need to obtain direct authorisation separately in every jurisdiction in which it wished to operate.<sup>3</sup>

Each of the options discussed above is considered in more detail in section 7 of the report.

## Access options – with extension of access beyond the scope of the current TCRs (including through a bespoke agreement)

- 19** The UK should consider whether to engage with the EU on proposals to extend the scope of access beyond the TCRs, to give a wider coverage and/or to address ‘process’ issues (such as those highlighted in paragraph 13 of this overview) that could provide a smoother transition and greater predictability.
- 20** In doing this, a number of important political and strategic decisions will need to be made around priorities for a future EU trading relationship – such as:
- (a) whether the optimum route would be to make piecemeal changes for specific priority areas of financial services activity (which the UK Government would need to identify in advance of the negotiations) or seek to introduce a more comprehensive approach, as has been advocated by proponents of the so-called ‘omnibus’ approach;
  - (b) whether changes should be sought in areas that relate solely to the UK-EU relationship (at least in the first instance, given the timing constraints) – or whether an expanded TCR should be put in place that would improve access to the EU generally and apply to the benefit other third countries as well (the so-called ‘universal’ approach); and
  - (c) whether changes should be developed on a ‘top-down’ basis (i.e. with a high level principle of mutual access being established) or on a ‘bottom-up’ basis, using the existing rights of access under the TCRs as the starting point and seeking to expand those rights.
- 21** If the UK is looking for a top-down approach, it could consider a ‘mutual access’ arrangement, under which the UK and EU allow access to each other’s markets on the basis that their respective regimes are broadly consistent. If possible, the UK should try to avoid having rights of access tied to the existing concept of ‘equivalence’, as used in the TCRs.

<sup>3</sup> There is an exception to this principle for a firm that is doing wholesale business under the MiFID II TCR. In that situation, the branch itself would have passport-like rights: see paragraph 4.11(c) for further information.

- 22** The nature of the changes being sought by the UK will determine what steps need to be taken to implement the changes – and in particular whether changes will have to be made by changing EU legislation or whether they could be achieved through a bespoke agreement with the EU. The processes and timing considerations of each approach differ and are considered in section 8 of the report.
- 23** If a broad arrangement for mutual access cannot be agreed, the UK needs to decide what changes to the existing rights of access for third countries might be appropriate. Possible changes that might be appropriate (and which the UK could consider asking for) include:
- (a) removing conditions for access;
  - (b) introducing procedural protections; and/or
  - (c) mitigating the impact of establishing an EU subsidiary.

Further detail on each of these possibilities is set out in section 8 of the report.

## Allowing access to the UK market

- 24** Post-Brexit, EU Member States will no longer have the right to passport into the UK. The UK has an existing regime for non-EU countries to access the UK market cross border under the “overseas persons” exemption. The UK also allows non-EU firms to establish branches in the UK. The approach that the UK is willing to offer to EU firms should be taken into account when considering what arrangements to put in place with the EU. See section 10 of the report.

## Transitional arrangements

- 25** The relatively short timeframes under Article 50 of the Treaty on European Union (TEU), and the length of time it typically takes to activate TCRs or to establish subsidiaries within the EU and get them authorised, means that transitional arrangements will be essential for maintaining continuity of service provision by UK and EU firms to businesses and consumers in their respective territories until a negotiated settlement can be agreed.
- 26** To avoid the cost, distraction and disruption of UK and EU firms needing to implement contingency plans, potentially unnecessarily, before the new operating environment becomes clear, it would be beneficial if the UK and EU could agree a transitional arrangement under which the current status quo will be preserved while a longer term solution is being negotiated. More detailed transitional arrangements would be agreed during the withdrawal period if necessary.
- 27** The most desirable arrangement for the transition period would be if the UK and EU could agree that current passporting rights can continue (or similarly extensive rights of access be applied), in both directions, during the transition period. That way, existing businesses on both sides of the UK/EU border will be able to continue their current activities, until such time as the longer term arrangements have been agreed and fully implemented. It is acknowledged, however, that a complex matrix of rights and obligations would be involved in continuing such arrangements after Brexit, and that some additional questions would need to be addressed in relation to this.
- 28** We note that the Treasury Select committee is currently consulting on the transitional arrangements. The consultation closes on 31 January 2017.

# SUMMARY TABLE – SECTOR SPECIFIC ANALYSIS

Type of business	Passport available?	TCR for cross-border access without a branch?	TCR for branch access?
<b>Banking and related services</b>			
Deposit-taking	Yes	No	Potentially, but subject to the discretion of individual Member States. There is no right to establish a branch, but if a Member State permits a third country firm to establish a branch, CRD IV sets out the criteria it must apply.
Lending (non-consumer)	Yes, but only for credit institutions	No	No
Lending (consumer)	Yes, but only for credit institutions	No	No
Providing mortgages	Yes, but only for credit institutions	No	No
Foreign exchange services	Yes, but only for credit institutions	No	No
Payment services	Yes, but only for credit institutions	No	No
<b>E-commerce and issuing electronic money</b>			
E-commerce	No, but information society services can be provided freely from one Member State into others.	No	No
Issuing electronic money	Yes	No	No
<b>Investment Services</b>			
Retail investment services and activities (retail client and elective professional clients)	Yes	No	Potentially, but subject to the discretion of individual Member States. Member States may “opt in” to allowing a third country firm to establish a branch. If they do, access must be subject to the following conditions: <ul style="list-style-type: none"> <li>• the third country firm is authorised in the third country;</li> <li>• the third country firm fulfils conditions regarding capital, management and investor compensation;</li> <li>• the third country takes an acceptable approach to AML and financial crime; and</li> <li>• there is a cooperation agreement in place.</li> </ul> The branch could provide services to retail clients and elective professional clients. (TCR not yet in force)

Type of business	Passport available?	TCR for cross-border access without a branch?	TCR for branch access?
<b>Investment Services</b>			
<b>Wholesale investment services and activities (per se professional clients and eligible counterparties)</b>	Yes	<p>Yes, there is a right to provide cross-border services if the conditions are satisfied.</p> <p>The conditions are that:</p> <ul style="list-style-type: none"> <li>• there is an equivalent regulatory regime in the third country;</li> <li>• the third country firm is authorised and subject to effective supervision and enforcement;</li> <li>• there is a cooperation agreement in place; and</li> <li>• the third country firm agrees to submit to the jurisdiction of an EU court.</li> </ul> <p>(TCR not yet in force)</p>	<p>Potentially, but subject to the discretion of individual Member States.</p> <p>The relevant Member State will need to “opt in” to the branch regime, as described above.</p> <p>A third country firm providing services to retail clients via a branch (see above) will be able to provide wholesale services from the branch as well.</p> <p>A branch that undertakes wholesale activities will also be permitted to provide cross-border services from the branch into other Member States.</p> <p>(TCR not yet in force)</p>
<b>Data reporting services</b>	No. When MiFID II comes into effect, an authorised data reporting services provider will be able to provide services in any Member State of the EU.	No	No
<b>Portfolio managers</b>	Yes	<p>Yes, there is a right to provide cross-border services to per se professional clients and eligible counterparties if the conditions are satisfied.</p> <p>The conditions are that:</p> <ul style="list-style-type: none"> <li>• there is an equivalent regulatory regime in the third country;</li> <li>• the third country firm is authorised and subject to effective supervision and enforcement;</li> <li>• there is a cooperation agreement in place; and</li> <li>• the third country firm agrees to submit to the jurisdiction of an EU court.</li> </ul> <p>There is no TCR providing cross-border access without a branch in relation to retail clients.</p> <p>(TCR not yet in force)</p>	<p>Potentially, but subject to the discretion of individual Member States.</p> <p>Member States may ‘opt in’ to allowing a third country firm to establish a branch. If they do, access must be subject to the following conditions:</p> <ul style="list-style-type: none"> <li>• the third country firm is authorised in the third country;</li> <li>• the third country firm fulfils conditions regarding capital, management and investor compensation;</li> <li>• the third country takes an acceptable approach to AML and financial crime; and</li> <li>• there is a cooperation agreement in place.</li> </ul> <p>The branch could provide services to retail clients and elective professional clients.</p> <p>(TCR not yet in force)</p>

Type of business	Passport available?	TCR for cross-border access without a branch?	TCR for branch access?
<b>Funds and fund management</b>			
Acting as a fund (UCITS or ELTIFs)	Yes	No	No
Fund management (UCITS or ELTIFs)	Yes	No	No
Fund management and marketing of AIFs in the EU (AIFs and AIFMs)	Yes, but currently only for EU AIFMs of EU AIFs. Where there is no passport, the AIFMD provides common standards for private placement regimes, but Member States are not obliged to allow access.	Yes, if the third country AIFM obtains a “proper authorisation”. The conditions for proper authorisation include that: <ul style="list-style-type: none"> <li>• there is a cooperation agreement in place; and</li> <li>• the third country does not have in place laws or regulations that would prevent effective supervision.</li> </ul> (TCR not yet in force)	Yes, if the proper authorisation is obtained (see adjacent column). (TCR not yet in force)
<b>Insurance and reinsurance</b>			
Insurance and reinsurance undertakings	Yes	No	Potentially, but subject to the discretion of individual Member States. There is no right to establish a branch, but if a Member State permits a third country firm (other than a pure reinsurer) to establish a branch, Solvency II sets out the criteria it must apply. There is no TCR
Insurance mediation and distribution	Yes	No	No
<b>Credit ratings agencies</b>			
Issuing of credit ratings	No, but EU firms can generally only use a credit rating produced by an EU CRA (except where the TCR applies).	Yes, subject to either endorsement by EU CRA or certification (including requirement for equivalence decision).	N/A

Type of business	Passport available?	TCR for cross-border access without a branch?	TCR for branch access?
<b>Market infrastructure</b>			
<b>Trading platform activities</b>			
<b>Operating an MTF or OTF</b>	Yes	Yes – as for wholesale investment services (see above). (TCR not yet in force)	Yes – as for wholesale investment services (see above). (TCR not yet in force)
<b>Provision of trading platform services, other than via MTF or OTF, to EU firms</b>	Yes, “passport-like” rights are available. An EU regulated market in one Member State is permitted to operate in other Member States for the purposes of facilitating trading by members in those Member States. <sup>4</sup>	No <sup>5</sup>	No
<b>Access to EU CCPs</b>	No, but third country trading venues can request access to EU CCPs on a non-discriminatory basis.	Yes, subject to an equivalence decision and reciprocity.	N/A
<b>Access to EU benchmarks</b>	No, but MiFIR will require a person with proprietary interest in a benchmark to grant non-discriminatory access to EU trading venues.	Yes, subject to an equivalence decision and reciprocity.	N/A
<b>Provision of benchmarks by third country benchmark administrators</b>	No, but third country benchmarks already referenced in financial instruments, financial contracts, or used to measure the performance of investment funds, by or on 1 January 2020 can continue to be used after that date.	Yes, if the third country benchmark is registered with ESMA, recognised by the local regulator in the Member State of reference, or endorsed by an EU benchmark administrator by 1 January 2020.	N/A
<b>Central counterparty activities</b>			
<b>Provision of services to EU clearing members</b>	Yes	Yes. A third country CCP can apply for recognition in order to offer services to EU firms. The conditions are that: <ul style="list-style-type: none"> <li>• there is an equivalent regulatory regime in the third country (including AML systems);</li> <li>• the third country has reciprocal arrangements to allow foreign CCPs access;</li> <li>• the third country firm is authorised and subject to effective supervision and enforcement; and</li> <li>• there is a cooperation agreement in place.</li> </ul> Recognition will also allow the CCP to have access to EU trading venues.	N/A. A CCP would not set up a branch in the EU to carry out clearing services in the EU.

Type of business	Passport available?	TCR for cross-border access without a branch?	TCR for branch access?
<b>Central counterparty activities</b>			
<b>Access to EU benchmarks</b>	No, but MiFIR will require a person with proprietary interest in a benchmark to grant non-discriminatory access to EU trading venues.	Yes. The requirements and conditions are essentially the same as in the row above. (TCR not yet in force)	No
<b>Central securities depository activities</b>			
<b>Provision of CSD services to issuers and market participants and establishment of links with EU CSDs</b>	Yes	Yes The third country CSD must apply to ESMA for recognition, which is subject to the following conditions: <ul style="list-style-type: none"> <li>• the third country must have an equivalent regulatory system;</li> <li>• the third country firm must be subject to effective authorisation, supervision and oversight by home state;</li> <li>• there must be a cooperation arrangement in place; and</li> <li>• the CSD must allow users to comply with applicable national law.</li> </ul>	Yes, subject to an equivalence decision and reciprocity.
<b>Trade repository activities</b>			
<b>Acting as a trade repository</b>	No, but EMIR requires a trade repository operating in the EU to be registered with ESMA. The registration is then effective across the EU.	Yes. A third country repository must be recognised by ESMA. To be recognised, the third country firm must show that it is authorised and subject to effective supervision in a third country which has: <ul style="list-style-type: none"> <li>• an equivalent and enforceable regulatory and supervisory framework; and</li> <li>• cooperation and other agreements in place with the EU/ESMA.</li> </ul>	N/A

<sup>4</sup> There is no formal passporting regime for regulated markets in MiFID II. However, the UK provides regulated markets providing services into or out of the UK with passporting rights under sections 312A to 312D of the FSMA.

<sup>5</sup> It may be possible for exchanges based outside the EU to have members in the EU – but in the absence of authorisation under MiFID II as a “regulated market”, there is no obligation on Member States to allow such exchanges to facilitate trading for members based in their territory.

# RECOMMENDATIONS

## The new arrangement

- 1 Securing access to the Single Market through membership of the EEA would allow UK-based financial services firms to maintain their current level of access to the Single Market after Brexit, as they would continue to be able to use the passporting regime. It is likely, however, that significant political compromises would need to be made by both the UK and EU for that outcome to be acceptable to both parties. The UK Government has already indicated that its proposals will not involve membership of the Single Market.<sup>6</sup> We have therefore not covered this option in detail in the report.
- 2 As the UK will become a third country on Brexit, it would be entitled to seek to secure access for UK firms under the EU's existing TCRs. However, given their limited coverage, uncertainty of availability (at least by any particular date) and the lack of key safeguards associated with them, the TCRs do not currently provide a sufficiently robust basis for the UK financial services sector to access the EU market in the longer term. The TCRs that exist have been helpful in relation to the discrete areas that they cover. They have not, though, been used, nor were they designed, to provide an access regime for an entire financial services industry the size of the UK's. Nor were they intended to provide transitional arrangements for an exiting Member State.
- 3 Wider rights of access for UK firms could be secured by extending and enhancing the existing TCRs (potentially for the benefit of all third countries). However, this would require legislative change which is unlikely to be achieved within a short period (such as the two year period triggered by the UK giving notice under Article 50). The UK may also find that by seeking to improve its position from the relatively unhelpful starting point under the existing TCRs, it is able to achieve less than it would do under a more general right of access which is not determined by reference to the existing TCRs.
- 4 The UK should instead seek to agree a bespoke agreement with the EU to allow for mutual rights of access to each other's markets.
- 5 In reaching any agreement with the EU, the following factors should be taken into account:
  - (a) **Basis for access**

Mutual access to each other's markets could be granted on the basis that the respective regimes of the UK and EU are broadly consistent with one another (in that they have consistent regulatory objectives and aim to deliver the same outcomes). At the date of Brexit, they should be almost entirely consistent.

If possible, the UK should try to avoid having rights of access tied to the existing concept of 'equivalence' as it is currently applied by the EU, since the history of the current TCRs shows that analysis of equivalence has been very granular and less focussed on 'outcomes' (as intended). This makes it time consuming to apply in the first place and makes unwieldy the introduction of new law.

<sup>6</sup> Speech by the Prime Minister: "Blueprint for Brexit" (17 January 2017).



A genuinely outcomes-based approach would be preferable. This would be consistent with the intention behind some of the current TCRs, although past experience with those TCRs shows that that has sometimes been overlooked. A renewed focus on outcomes would be welcome. The UK and the EU should also seek to be more collaborative and to focus on influencing and implementing the wider international regulatory agenda going forwards.

**(b) Scope of access**

The UK should seek to ensure that rights of access cover as broad a scope of activities as are currently covered under the passporting regime – including areas such as deposit taking, lending and payment services (which are not covered by the TCRs at all) and insurance (which is only covered by the TCRs to a very limited degree). The EU financial services market is an integrated market, and if the UK was only able to secure access to parts of that market it would potentially lose the benefits of accessing the integrated market as a whole.

The UK should also seek to secure rights of access to all categories of client. The current TCRs provide only very limited coverage in relation to retail clients. The protection of retail clients may be a particularly sensitive question in some Member States, and so the UK should be prepared to accommodate such concerns by incorporating appropriate consumer protections into any bespoke agreement.

**(c) A stable arrangement**

The arrangements that are put in place should include robust processes and procedures that provide legal certainty, such as:

- (i) clear criteria for securing rights of access (either at a national level or for individual firms);
- (ii) a clear, predictable process for termination of the arrangement (either at a national level or for individual firms), with objective criteria;
- (iii) an adequate notice period for withdrawal of the arrangement, so that affected firms have adequate opportunity to make alternative arrangements; and
- (iv) an independent tribunal to determine whether the criteria are satisfied.<sup>7</sup>

**(d) Uninterrupted access**

The transition into the new arrangements should allow for continuous and uninterrupted access to products and services for firms and customers.

When the criteria for mutual access have been agreed, the UK and EU should also seek immediate recognition that the other party meets the relevant criteria and implement efficient systems to migrate firms to the new structure. For example, any firm which currently has a passport between the UK and another Member State should automatically be granted rights of access under the new arrangements .

**(e) Rights of access for EU-regulated entities**

The arrangement should also be designed to preserve continuity of operation for UK-based entities regulated at an EU level, e.g. CRAs. Alternatives might include the EU

<sup>7</sup> In the EEA, it is the EFTA Surveillance Authority and the EFTA Court; a similar mechanism could be used for this arrangement as well. The EFTA Court decisions operate a principle of “homogeneity” with the CJEU, which has the advantage of giving the EU comfort on alignment of interpretation. It was also proposed by the EU to Switzerland as an option for their relationship.

recognising the UK's ability to regulate such entities directly or the UK and EU agreeing alternative ways of regulating such entities.

(f) **Regulatory collaboration**

An essential element of a successful arrangement will be cooperation between the respective regulatory authorities. That will be necessary to ensure day-to-day cooperation, but more generally it will also help ensure that the respective regimes remain broadly consistent and deal appropriately with the incorporation of international standards.

Both the UK and EU will be participating in and following developments at a global level (e.g. through IOSCO and the BCBS) and collaboration will help to ensure that they have a stronger voice and that they implement global changes in a consistent way.

Mechanisms available to members of the EEA, such as the EEA EFTA Experts engagement on legislative committees, could be considered. The UK could also consider asking for observer status in relation to EU decision making.

## Structure for relationships with other countries

- 6** A mutual access arrangement (such as that set out above) could be used by the UK as the basis for its relationships with other third countries going forwards. In a world where the UK will be increasingly looking to global trade, a mutual access arrangement may offer a better structure for access to the UK than the UK's current 'overseas persons exemption' regime.
- 7** A mutual access arrangement may also offer the EU a new way of dealing with other third countries – for example, to streamline the current processes the EU has in place with Switzerland, or to form the basis of new arrangements with third countries other than the UK.

## Issues prior to concluding a new arrangement

- 8** Prior to concluding a new arrangement, the UK should consider the following issues:

(a) **Demonstrating mutuality of interest**

The key to establishing a new relationship is to demonstrate that the UK and EU have integrated economies and that it is in the interests of the EU, as well as the UK (and consumers across Europe), for the EU and UK to have access to each other's markets.

Further economic analysis may be necessary to demonstrate the continuing value to the EU's existing and developing financial centres and capital markets of maintaining access to the UK market. Various studies are currently underway.

(b) **Agreeing transitional arrangements**

An immediate priority for both the UK and EU should be to agree a transitional arrangement to maintain continuity of service and enable a smooth and orderly transition to any new long-term arrangement. The UK and EU should aim to reach agreement on the transitional arrangements as soon as possible – either before the withdrawal notice is served or shortly thereafter.

The transitional arrangements would cover the period up to the date on which the new long term post-Brexit arrangements have been fully implemented. Those long term arrangements could take the form of a negotiated agreement or, in the absence of agreement, they could involve the UK having no additional rights of access beyond that of any other third country. Whatever the outcome, the transitional arrangements should be designed to allow firms sufficient time to adapt to that outcome.

Until the new long-term arrangement has been implemented, there should be continuation of access for all types of activities currently conducted cross-border until the relevant long-term arrangement has been implemented and there has been an opportunity for firms to adapt to the new arrangements.

Prior to the date of Brexit, continuation of access would be through the passporting rights that the UK has as a member of the EU. After the date of Brexit, the most beneficial arrangement would be that the current passporting arrangements continue (or similarly extensive rights of access be introduced), in both directions, on a temporary basis, while the Brexit arrangements are implemented. It is acknowledged, however, that a complex matrix of rights and obligations would be involved in continuing such arrangements after Brexit, and that some additional questions would need to be addressed in relation to this.

If a transitional arrangement is not agreed in the near future, firms which currently provide services using the passport – either from the UK to the rest of the EU, or vice versa – may find that (in view of the long lead times required to secure alternative routes to, or withdraw from, markets) they will need to take steps imminently to maintain continuity of service and to transfer their business out of the UK. It could even lead to business being moved out of Europe altogether, for example, if the challenges of transferring business into Europe outweigh the benefits of relocating.

Moving business out of the UK could prove to be unnecessary, depending on the scope of any new long term arrangements. Early agreement on transitional arrangements would help avoid unnecessary steps being taken or businesses being distracted by a concern that they may not have sufficient time to implement their contingency plans.

We note that the UK Government is currently consulting on the transitional arrangements.

### **(c) Agreeing appropriate arrangements for existing products and services**

The UK and EU should agree appropriate arrangements which ensure that products or services acquired by consumers prior to Brexit can continue to be serviced across an EU/UK border without interruption post-Brexit. This is necessary to avoid legal uncertainty.

This solution could take the form of some kind of ‘grandfathering’ arrangement, under which products which are already in issue at the date of Brexit will automatically be regarded as valid and can continued to be serviced across the UK/EU border for the lifetime of the product.

Appropriate arrangements should be agreed as a matter of priority, to reassure customers that they can continue to retain the benefits of products and services and to discourage any action which might negatively affect their financial position.

# 1.0 INTRODUCTION

## 1.1

### Terms of reference

## 1.2

The terms of reference for the IRSG workstream which produced this paper are:

- (a) building on existing industry positions and research, to provide a comprehensive analysis of the EU's TCRs looking at all pieces of relevant financial services legislation, setting out what the different equivalence provisions look like;
- (b) to analyse the impact of a new UK-EU relationship based on equivalence for the current business lines of UK-based financial services firms;
- (c) to consider why certain access rights currently don't exist, whether these could be expanded (for the UK) and whether the EU's TCRs could be reformed to allow easier access to the Single Market in financial services for the UK, recognising its special status;
- (d) to influence the thinking of the industry, regulators, HM Government and other stakeholders on what the terms of the UK's new relationship with the EU could look like;
- (e) to consider the UK's own future TCR and which terms would be most beneficial for financial and related professional services; and
- (f) to consider the availability of other alternatives to passporting and TCRs for provision of financial services between the UK/EU post-Brexit.

### 1.3

## Scope of the report

### 1.4

The scope of this report is limited to considering the law relating to the provision of financial services across a newly established EU/UK border. There may be other areas of the law which could have an impact on the ability or willingness of UK firms to do business in the EU post-Brexit (or vice versa), such as tax law and data protection law (the latter being particularly significant as the EU is in the process of overhauling its data protection laws creating increased risk of divergence on Brexit). As these issues are not related to cross-border access to financial services, they are not covered in in this report.

### 1.5

In this report, we have not attempted to identify all of the provisions of EU law that will be affected by the change of the UK from EU Member State to third country. We have, however, sought to identify the key provisions of EU law which involve an explicit consideration of the status of third country firms and where assessments based on equivalence (or a similar concept) are likely to be relevant.

### 1.6

We have focused the report on the position of third country firms. We have not considered the position in relation to central banks based in third countries.

### 1.7

## Interpretation

### 1.8

Appendix 1 contains interpretative provisions and an explanation of the terms and acronyms used in this report.

### 1.9

Appendix 2 contains a list of the scheduled review dates for key items of EU legislation relating to TCRs.

# 2.0 THE PROVISION OF FINANCIAL SERVICES ACROSS EU BORDERS – BACKGROUND AND GENERAL CHARACTERISTICS

## Key points

- Brexit will create a new regulatory border between the UK and the rest of the EU.
- Under EU law, passporting allows firms to establish branch offices in other Member States or provide services from its home state directly into other Member States without requiring local authorisation. Passporting will cease as at Brexit without an agreement to the contrary.
- On Brexit, firms who currently rely on passporting to enable them to provide services across a UK/EU border will either need to rely on a different access mechanism being in place to provide those services, establish an authorised operation on the other side of the border or cease providing such services on a cross-border basis altogether.
- The TCRs are a mechanism through which firms from outside the EU can access EU markets. The TCRs are part of existing EU law and already apply for the potential benefit of non-EU firms.
- There are four different potential outcomes for the UK/EU relationship after Brexit:
  - having passporting rights, via EEA membership;
  - entering into a bespoke agreement with the EU;
  - relying on the existing TCRs; or
  - not relying on the TCRs or any other rights of access.

## 2.1 Introduction and context

### 2.2

Brexit will create a new regulatory border between the UK and the rest of the EU. Whereas the operation of the EU's "passporting" rights currently enable UK firms to treat the EU as a Single Market, those passporting rights will cease after Brexit. Similarly, EU firms will lose their passporting rights to the UK market.

### 2.3

The loss of passporting rights has many implications at a commercial level for firms and consumers in both the UK and the rest of the EU. Being able to operate across borders improves the range and value of financial services on offer to citizens and businesses across the EU. It improves the flow of capital and operational efficiencies and reduces the costs (both for firms and regulators) associated with having to establish, capitalise and regulate another operation in each market in which services are being provided.

### 2.4

In terms of financial impact, reports by TheCityUK<sup>8</sup> and by Oliver Wyman for TheCityUK<sup>9</sup> note that:

<sup>8</sup> *Brexit and the Industry*: TheCityUK Member Briefing (September 2016)

<sup>9</sup> <https://www.thecityuk.com/assets/2016/Reports-PDF/The-impact-of-the-UKs-exit-from-the-EU-on-the-UK-based-financial-services-sector.pdf>

- (a) the UK-based financial services sector annually earns approximately £190-205 billion in revenues and, together with 2.2 million people working in financial services across the UK, it generates an estimated £60-67 billion of taxes each year;
- (b) the wider financial and related professional services sector employs over two million people in the UK, of whom two-thirds are outside of London;
- (c) the EU is the single biggest market for UK exports of financial services, generating a trade surplus of £22.8 billion, representing 41% of the UK's total trade surplus in financial services totalling £54.8 billion in 2015; and
- (d) the UK's financial services trade surplus with the EU more than doubled over the past decade (demonstrating the level of demand from businesses and consumers in the rest of the EU for UK financial services, as well as its value to the UK).

## 2.5

The Oliver Wyman report estimates that if, after Brexit, the UK is outside the EU but the new framework negotiated with the EU delivers access to the Single Market on terms similar to those that UK-based firms currently have, this will cause only a modest reduction in UK-based activity. In this scenario, revenues are predicted to decline by up to £2 billion (2% of total wholesale and international business), 4,000 jobs would be at risk and tax revenues would fall by less than £0.5 billion per annum. If the UK moves to a third country arrangement with the EU, but without any regulatory equivalence being secured,<sup>10</sup> up to 50% of EU-related activity (£20 billion in revenue) and an estimated 35,000 jobs could be at risk, along with £5 billion of tax revenues per annum.

## 2.6

It appears unlikely that any of the other cities in the EU could, in the short or medium term at least, absorb the whole financial services ecosystem which exists currently in the UK. A number of factors contribute to that, including that the requisite capacity to do so does not currently exist in any one EU city in terms of scale of infrastructure (business or domestic) and resident talent pool. As a result, if Brexit means that firms need to relocate, it is likely to result in the fragmentation of financial services across the EU. If the result is that the cost of doing business in EU markets increases, then it may increase costs to consumers in those markets or firms may consider that it is no longer cost-effective to service smaller markets and withdraw. Many commentators have noted that weakening London's place as a global financial hub is likely to strengthen other global financial centres, such as New York or Singapore, rather than another city or cities in the EU.

## 2.7

### The regulatory context for the provision of cross-border services

## 2.8

Broadly speaking, the regulatory regimes of EU Member States (including the UK) require that, if a person performs regulated activities in a Member State, that person will need to obtain regulatory authorisation from the regulators in that state.<sup>11</sup>

<sup>10</sup> i.e. operating solely on the WTO/GATS rules – see paragraph 2.21(d) below.

<sup>11</sup> In practice, the provisions of domestic law which require a firm to obtain authorisation for certain regulated activities are likely to be the result of the application of EU law.

### 2.9

To become authorised in a Member State, a person will have to satisfy the local regulatory requirements, which will typically include demonstrating sufficient substance and governance or oversight, holding a specified amount of capital and demonstrating the fitness and properness of the person concerned and the adequacy of the firm's systems and controls, and the suitability and effectiveness of its staff.

### 2.10

Before the advent of passporting, this led to considerable inefficiencies for firms wishing to do business in multiple jurisdictions. In order to satisfy the local regulatory requirements, such a firm might have to be authorised in and hold regulatory capital separately in each jurisdiction of operation; its staff and processes might need to be vetted in each jurisdiction separately; and since local regulators could impose their own requirements, it was likely that the firm might need to adapt its processes differentially in each jurisdiction and be unable to adopt a "one size fits all" approach across its business.

## *Passporting*

### 2.11

One of the purposes of the Single Market Directives was to remove the inefficiencies described above, as they were seen as an obstacle to cross-border trade. The Single Market Directives introduced the concept of passporting and this is the regime currently in place.

### 2.12

Although the exact details of the passports differ according to the Directive in question,<sup>12</sup> broadly speaking if a regulated firm satisfies the requirements for authorisation in one member state, it is deemed to have satisfied the requirements for all member states. On that basis, an individual member state cannot (save in exceptional circumstances) prevent a firm authorised in another member state doing business in its territory or require it to obtain a separate authorisation from the regulator in that member state.<sup>13</sup>

### 2.13

The passporting regimes usually include two possible rights for passporting firms:

- (a) freedom of establishment – the right to set up a branch office in that territory and to provide services from that branch office to customers in that territory; or
- (b) freedom of services – the right to provide services from an establishment in its home state directed to customers located in the other Member State, without establishing a branch in the other Member State.

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<sup>12</sup> Although the passporting regime has developed on a piecemeal basis and there are some differences between the passporting regimes under the Single Market Directives, those differences are generally not very substantial and there is certainly less variability between the passporting regimes than there is between the different TCRs.

<sup>13</sup> Passporting is available to all EU member states and also to those states that are members of the EEA without being members of the EU – namely Iceland, Liechtenstein and Norway.



## 2.14

In order to support this approach, and to prevent regulatory arbitrage between different jurisdictions, the Single Market Directives sought to harmonise the requirements for authorisation across all Member States. The logic is that, if the arrangements are required to be the same in each Member State, then, by definition, satisfying the requirements in any one Member State should suffice for all the others. The Single Market Directives usually stipulate that Member States must require firms to become authorised if they wish to carry on activities of the kind specified in the Directive, in order to ensure that all Member States are taking the same approach.<sup>14</sup>

## 2.15

The passporting regime covers a very broad range of services and products but it is not fully comprehensive and does not cover all aspects of financial services.<sup>15</sup>

## 2.16

Generally, the Single Market Directives require that a firm that wishes to passport must be incorporated in a Member State.<sup>16</sup> This means that third country firms which obtain “direct” authorisation for a branch in the EU (see paragraph 7.19 below) cannot passport into other Member States – i.e. they can neither establish a branch nor provide cross-border services in other Member States and must confine their EU activities to the Member State in which they are authorised.

## 2.17

As the passporting regimes derive from EU law, the UK’s passporting rights will lapse on the date of Brexit, when the EU’s laws cease to apply to the UK. Equally, any rights that EU firms have to access the UK will also cease to apply.

<sup>14</sup> There are exceptions to this. CRD IV (which contains the main passporting regime for credit institutions) provides that the activity of “lending” is capable of being passported, but does not require that the activity is one which must be regulated by the local regulator. As a result, a Member State can decide whether or not lending amounts to a regulated activity in its territory. In the UK, for example, lending to large corporate customers is not a regulated activity – so there is no need to be authorised in the UK in order to carry out this activity and there are no rules in the UK rulebook which apply to this kind of lending. By contrast, lending of this nature in France requires authorisation and is restricted so that only a credit institution (and not, for example, a money lending business) can carry it out. The UK has passed domestic legislation which states that, if a firm who has a passport can perform an activity legally in its home state, it can passport that activity as well – even if the activity is not a regulated activity in its home state (see regulation 19 of the FSMA (EEA Passport Rights) Regulations 2001). What is less clear is whether the host Member State could object to that argument. The protection for the host Member State in this situation is that it can apply its own conduct of business rules, with the result that the passporting firm will need to treat its customers in the host Member State in the same way as other, locally-regulated firms would in the same Member State. It is worth noting that passporting can happen even where there is a lack of equivalence between the authorisation regimes of the two Member States – which may be relevant when considering the extent to which TCRs must be equivalent to the relevant EU regimes, as discussed further below.

<sup>15</sup> For example, there is no passporting regime in relation to certain activities which are covered under CRD IV when those activities are carried out by a firm that is not a credit institution – such as lending (to commercial customers or to consumers) or providing regulated mortgages (although credit intermediation is passportable). The specific position for the different types of regulated firm is set out in section 4 and is summarised in the table at the start of this report.

<sup>16</sup> There will be an exception to this general approach in MiFID II, which will introduce a so-called “branch passport” for branches of third country firms, which will allow a branch established under the MiFID II TCR to provide cross-border services into other EU states. See paragraph 4.11(c) for further information.

## The concept of TCRs

### 2.18

The TCRs provide a mechanism through which a firm not established in an EU Member State can, if it satisfies certain conditions, benefit from access rights which are similar in nature to those for passporting (i.e. in that they avoid the need to obtain local authorisation).<sup>17</sup> The TCRs are part of existing EU law and some of them can already be used by third country firms to obtain access. The TCRs are considered in detail in sections 3, 4 and 5 below.

### 2.19

The conditions for being able to use a TCR, which are considered in more detail in section 3 below, usually include that the third country in question has a regulatory, legal and supervisory regime that is equivalent to that in the EU. For this reason, access based on TCRs is sometimes referred to as “equivalence” access.

### 2.20

## The potential outcomes for the UK after Brexit

### 2.21

Unless the UK and EU are able to agree a different arrangement (in relation to which, see section 8 below), there are essentially four potential outcomes for the UK’s future relationship with the EU on access to the Single Market for financial services post-Brexit:

#### (a) Having passporting rights via EEA membership

Countries which are in the EEA but not in the EU (the so-called “EEA-EFTA countries” – currently Iceland, Liechtenstein and Norway) are able to benefit from the passporting regimes in the same way as an EU Member State.<sup>18</sup> If, after Brexit, the UK was a member of the EEA, it would, in effect, be able to retain its passporting rights. It is acknowledged that, in view of the UK Government’s stated approach towards Brexit, this is an unlikely outcome, so we have only considered it briefly below.

Under the EEA Agreement, a party must be either a member of the EU or a member of EFTA. In order to be in the EEA post-Brexit, the UK would therefore have to rejoin the EFTA.<sup>19</sup>

The UK would also have to be a party to the EEA Agreement and be bound by its terms.<sup>20</sup>

<sup>17</sup> TCRs are not limited to third country firms that have already have authorisation in the EU (e.g. through obtaining direct authorisation from an EU Member State, in the manner described under paragraph 7.19 below). They can be used by third country firms that do not have any existing authorisation in the EU.

<sup>18</sup> The EEA-EFTA countries do not automatically incorporate Single Market Directives into their national legislation. After a Directive with EEA relevance has been adopted by the Council of the EU, it will be submitted to a joint committee of the EU states and EEA-EFTA countries, which will decide whether the legislation should be incorporated into the EEA Agreement. After the EU legislation has been incorporated in the EEA Agreement, it may then need to be transposed into each country’s national law. Only once the relevant measure has been implemented in the EEA-EFTA country does that country benefit from and become subject to the relevant passporting regime. Consequently, there may be significant delays in incorporating EU legislation into the national law of the EEA-EFTA country. For example, the following legislation (which is already in force in the EU) has not yet been formally adopted in the EEA Agreement: CRD IV, the UCITS V Directive (2014/91/EU), the ELTIF Regulation, the CSD Regulation and the MCD.

<sup>19</sup> This would require the agreement of the EFTA members, i.e. the EEA-EFTA countries plus Switzerland.

<sup>20</sup> It is unclear whether the UK could remain a party to the EEA Agreement by ensuring that it becomes an EFTA member at the moment it ceases to be an EU Member State, or whether it would require the unanimous agreement of all the existing EEA members (i.e. the EU Member States and the EEA-EFTA countries) for it to be a party to the EEA Agreement going forward. If the UK wishes to withdraw from the EEA Agreement, it is arguable that the UK may be obliged to serve a notice under Article 127 of the EEA Agreement. It has been reported that a court case is to be brought against the UK Government to require any decision to serve an Article 127 notice to be put before the UK Parliament.

The terms of the EEA Agreement require signatories to:<sup>21</sup>

- (i) allow freedom of movement;<sup>22</sup>
- (ii) incorporate EU laws into domestic law without having a vote on them (i.e. in effect, being a “rule taker”);<sup>23</sup>
- (iii) make a budgetary contribution;<sup>24</sup> and
- (iv) accept the supervisory authority of the EFTA Surveillance Authority in relation to observing its commitments under the EEA Agreement and have disputes referred under the jurisdiction of the EFTA Court.

In addition to the EEA Agreement, EEA-EFTA countries may also have bilateral agreements with the EU. For example, Switzerland has numerous bilateral agreements with the EU.<sup>25</sup>

If the UK sought to be a member of the EEA after Brexit, in order to retain the ability to use EEA passporting, this would require considerations of the compromises involved.

It may be possible for the UK to become a member of EFTA without being a party to the EEA Agreement. It would be for the current EFTA states (i.e. the EEA-EFTA countries plus Switzerland) to decide whether to admit the UK into EFTA and whether membership should be subject to any conditions. If the UK was a member of EFTA only:

- (i) Membership of EFTA would not offer access to the Single Market but it would offer other benefits, including access to EFTA’s 27 free trade agreements without the UK being constrained from entering into its own free trade agreements with the rest of the world.
- (ii) The UK could choose whether or not to opt in to any EFTA free trade agreements which are agreed.
- (iii) The UK would be a third country and would therefore be able to make use of any available TCRs.

Given that Switzerland also has a strong financial services sector, there may be some value to working together on EFTA free trade agreements.

#### (b) **Agreeing a bespoke arrangement with the EU**

The UK could seek to agree a new form of trading relationship with the EU under a bespoke agreement. This could either be a bilateral agreement or – if other countries outside the EU become involved – a multi-lateral agreement.

<sup>21</sup> There have been reports that the EEA-EFTA countries would be interested in reforming the EEA Agreement, for example, to improve the processes.

<sup>22</sup> There is, however, no concept of EU citizenship and there are slightly different provisions which relate to potential controls on the movement of people (principally applying to Liechtenstein).

<sup>23</sup> This only applies in the sectors which are covered by the EEA Agreement, so the UK would have control over laws in those areas which are not included (e.g. fisheries). Financial services is covered by the EEA Agreement, and this is an area where there may be impetus to remain “equivalent” after Brexit, reducing the scope for any divergence). Where a matter is within the scope of the EEA Agreement, there is a right for representatives of the EEA-EFTA countries to participate in the processes related to initiating and progressing draft legislation prior to the vote stage

<sup>24</sup> The budgetary contributions are paid to EFTA Secretariat and does not form part of the EU budget. Control over its application is retained by EFTA (which does not include the EU).

<sup>25</sup> See paragraph 8.5(a) below for further details.

The nature of the agreement could involve any form of access arrangements that meet the respective political objectives of the parties.

The possibility of a bespoke agreement is considered in more detail in section 8.

**(c) Relying on the existing TCRs**

UK firms could rely on the rights that third country firms have under the existing TCRs. One of the primary purposes of this report is to analyse the extent to which the existing TCRs provide coverage of the financial services sector.

The position under the TCRs is considered in detail in sections 3, 4 and 5.

**(d) Not relying on the existing TCRs**

Under this outcome, the UK would not have any passport-like access rights, either through passporting itself (via EEA membership), any access rights that might be agreed as part of a bespoke arrangement, or through the existing TCRs (e.g. if the UK is not willing to use the existing TCRs or where no TCR exists).

In such a situation, the UK's access to the EU would be limited to the access available to any third country which did not operate under the TCRs. A detailed analysis of the position is set out in section 7.

This situation equates to operating solely on the basis of the rules of the WTO and the GATS. In relation to these:

- (i) The WTO rules do not contain any relevant provisions relating to the provision of cross-border services (as opposed to goods). The WTO rules are therefore not applicable to financial services.
- (ii) The GATS prohibits individual WTO member states (including EU Member States) from imposing discriminatory restrictions on third country firms wishing to offer their services across borders. However, the GATS also contains a carve-out under which the prohibition can be disapplied when prudential controls are threatened. The existence of this carve-out may mean that third countries cannot rely on (or will not want to rely on) the GATS to obtain access to the financial markets in other states.

# 3.0 GENERAL OVERVIEW OF THE TCRS

## Key points

- The TCRs offer very limited coverage:
  - A number of important areas of financial services have no TCR at all, e.g. deposit taking, lending, payment services, mortgage lending, insurance mediation and distribution and activities relating to UCITS funds. Other activities (e.g. the issuing of insurance contracts) have very limited TCRs.
  - There are TCRs available for certain types of market infrastructure providers (e.g. CCPs and benchmark administrators).
  - TCRs are in the process of being introduced that may be useful to (i) third country firms wishing to provide investment services to wholesale customers on a cross-border basis (i.e. without establishing a branch in the EU) under MiFID; and (ii) “non-EU alternative investment fund managers” who wish to market alternative investment funds to professional clients in the EU.
  - The TCRs only provide very limited rights of access in relation to retail clients.
- Most TCRs depend on the third country regime being assessed by the EU as “equivalent” to the relevant EU regime. In relation to this:
  - There is a lack of clarity over what “equivalence” means in practice.
  - The TCRs only apply if the EU authorities make a formal determination of equivalence. Although UK firms should in theory have an equivalent regime at the date of Brexit, it is not clear that the EU authorities will necessarily:
    - share that view; or
    - complete the necessary formalities in order to make a determination before the date of Brexit.
  - The requirement to be equivalent is ongoing. In order to maintain equivalence, the UK may end up being something of a “rule taker” – i.e. having to implement changes in its own law to follow changes in EU law.
- Some TCRs contain additional restrictions or limitations (e.g. requiring third country firms to submit to the jurisdiction of EU courts) – or permit Member States to impose additional restrictions or limitations of their own.
- Some TCRs are optional for Member States (i.e. an individual Member State can still refuse to allow third country firms to access its market).
- There are serious concerns regarding the processes around TCRs (e.g. for determining equivalence). There are often no safeguards (such as processes giving third country firms the ability to object to the withdrawal of recognition already granted under the TCRs). Experience of current TCR processes shows that they are unpredictable and time consuming.
- There is also EU legislation which does not directly deal with access rights, but which imposes restrictions on EU firms dealing with third country firms where the third country is not equivalent. Provisions of this nature could have a significant impact on UK firms.

### 3.1

This section of the report provides a general overview of the TCRs.

### 3.2

In addition to the general overview in this section 3:

- (a) an analysis of how the TCRs apply to different specific sectors of the financial services industry is set out in section 4;
- (b) three case studies in relation to TCRs are set out in section 5; and
- (c) a full detailed analysis of the main TCR provisions that are relevant to third country access is contained in the “Summary of Legal Provisions” Annex.

### 3.3

## The background to, and rationale for, TCRs

### 3.4

TCRs could be considered to provide a “quasi-passport” for third country firms, in that they allow third country firms to have access to EU customers and counterparties without those third country firms needing to be authorised in each Member State. Where the TCRs apply, it is usually on the basis that the third country firm is regulated in its home country, where the laws have been determined by the EU authorities to be equivalent to those of the EU.

### 3.5

TCRs are by no means comprehensive, and historically they have tended to develop as part of a particular Single Market Directive, as an addition to the provisions relating to passporting. The TCRs have been developed relatively recently, with the first example of a third country being recognised occurring in 2008<sup>26</sup> and the vast majority of third country recognitions having been made since 2014.

### 3.6

While the rationale for the passporting regime is clear and is applied consistently, the philosophy behind the various TCRs is less clear. The TCRs have arisen on a piecemeal basis, as and when the legislating EU authorities have considered it appropriate in relation to an activity of a particular type, and often arise only in respect of particular customer types.

### 3.7

There are acknowledgements in some of the Directives that the development of TCRs is in accordance with the EU’s international obligations under the WTO rules, including the GATS, and that they follow regulatory goals and standards set by G20 (for example, in implementing the G20’s proposals in relation to derivatives).<sup>27</sup> In other contexts, the development of TCRs has been characterised as being for the benefit of consumers and enabling EU financial services providers to compete more effectively in overseas markets<sup>28</sup> or to invest in, or obtain funding from, third countries and third country investors.<sup>29</sup> In the case of credit ratings agencies, the existence of a

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<sup>26</sup> The first recognitions were for Japan and USA, under the Prospectus Directive and the Transparency Directive, in relation to the use of the accounting standards of the third country.

<sup>27</sup> See, for example, recitals 41 and 44 of MiFIR and recital 7(3) to the Prospectus Directive.

<sup>28</sup> See the EC press release relating to third country equivalence decisions under Solvency II (5 June 2015).

<sup>29</sup> See recital 41 of MiFIR.

TCR may have in part been driven by commercial practicalities, such as the necessity of allowing EU financial services providers to access the services of US credit ratings agencies.

### 3.8

There have been recent suggestions that the EU may reconsider its approach towards TCRs. In a recent Financial Times article<sup>30</sup>, it was reported that the EU was re-examining existing equivalence rules, with an eye to streamlining and strengthening the approval process so it is more rigorous for “systemically relevant jurisdictions” (which were not identified but which we assume would include the UK).

### 3.9

In some cases, the TCRs set out a regime that looks very similar to a passport, in that third country firms have the right to provide services in an EU Member State if they satisfy the conditions of the TCR.<sup>31</sup> In other cases, the effect of the TCR is to establish minimum standards that a Member State should apply when considering whether to grant a domestic authorisation to a third country firm.

### 3.10

## The position of third countries in relation to the EU

### 3.11

The main points to note about the position of a third country in relation to the EU are as follows:

#### (a) The fundamental freedoms

A third country is not subject to the four fundamental freedoms conferred on EU Member States under the EU Treaties, namely: the free movement of goods; the free movement of services and freedom of establishment; the free movement of persons (and citizenship); and the free movement of capital.

The only exception to this principle is that the rights relating to the free movement of capital would apply to a third country, as Article 63 of the TFEU prohibits “*all restrictions on the movement of capital between Member States and between Member States and third countries.*” However, the free movement of capital can be restricted by a discriminatory measure in respect of a third country where the measure existed before a certain date<sup>32</sup> or is justified by economic reasons.<sup>33</sup> In addition, the benefit of this freedom is further restricted due to the rights in relation to free movement of goods, services and persons having been held to take precedence over the rights relating to free movement of capital.<sup>34</sup>

<sup>30</sup> “EU reconsiders financial market access rules”, Financial Times, 6 November 2016.

<sup>31</sup> Unlike passporting, however, this is a right that can be withdrawn by the EU.

<sup>32</sup> Article 64 of the TFEU.

<sup>33</sup> Article 66 of the TFEU.

<sup>34</sup> In the case of *Fidium Finanz AG v Bundesanstalt für Finanzdienstleistungsaufsicht* (C-452/04), a legal challenge by a third country firm to a national measure on the grounds that it restricted free movement of capital was rejected by the CJEU on the grounds that the freedom to provide services was also affected. In relation to restrictions on the provision of credit on a commercial basis, it was held that, while free movement of capital was engaged, it was the principle of free movement of services that prevailed in the circumstances and, since the non-EU claimant could not rely on the latter, its challenge failed. A third country firm could not therefore seek to challenge a restrictive measure on the grounds of free movement of capital when the court considers another freedom to be the predominant consideration in the circumstances.

The corollary of not benefiting from the fundamental freedoms is that the third country is not bound by them either.

#### (b) **The possibility of discriminatory measures**

EU Member States are prevented from introducing discriminatory restrictions on the four fundamental freedoms in respect of other Member States. The four fundamental freedoms also prohibit non-discriminatory restrictions against other Member States unless they can be objectively justified. In relation to third countries, however, an EU Member State is only prevented from introducing restrictive measures to the extent that the measure conflicts with rights conferred under the TCRs or the free movement of capital under Article 63 of the TFEU.

### 3.12

The individual TCRs themselves do not require third countries to:

- (a) contribute to the EU budget as a pre-condition of accessing third country rights;
- (b) accept free movement of persons or any of the other fundamental freedoms of the Single Market;<sup>35</sup> or
- (c) adopt EU laws in their entirety but only insofar as is necessary to maintain equivalence in relation to the activity to which the TCR relates. The laws of the third country can diverge from EU law provided that they maintain equivalence of outcome (see paragraph 3.18(a) below).

### 3.13

The last of these points suggests that it is open to a third country to adopt a “dual regime” – i.e. with separate parallel regimes (or a tiered rule book), one of which has equivalent standards to the EU and one of which does not.

### 3.14

## Summary of sector specific analysis

### 3.15

In section 4, we consider the application of the TCRs in relation to specific sectors of the financial services industry. The overall conclusions on the range of regulated activities which are covered by the TCRs can be summarised as follows:

- (a) The only areas where TCRs currently offer a level of access that is likely to be useful to UK firms is in relation to certain areas of market infrastructure, for example allowing UK clearing houses and benchmark administrators to provide services to EU customers. These TCRs are only likely to be directly relevant to a relatively small number of UK financial services providers, but they may have a broader impact on the UK’s ability to retain its place as a global financial centre.<sup>36</sup>
- (b) A number of important areas of financial services which are currently covered by the passporting regime have no TCR at all. These include:

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<sup>35</sup> This is in contrast to the position under bespoke agreements, where the EU may require that the third country agrees to some of the fundamental freedoms. For example, there are numerous bilateral agreements between the EU and Switzerland, and in connection with these agreements the Swiss have agreed to the free movement of persons.

<sup>36</sup> Even within the area of market infrastructure, there may still be difficulties for UK financial institutions. For example, after Brexit, the UK regulated markets will lose their rights of access to participants in EU Member States, and no TCR is available to replace that right.



- (i) banking (deposit taking);
  - (ii) lending (both to consumers and non-consumers);
  - (iii) payment services;
  - (iv) mortgage lending;
  - (v) insurance mediation and distribution;
  - (vi) data reporting services; and
  - (vii) activities relating to UCITS funds.
- (c) There are limited TCRs in relation to insurance and reinsurance, which essentially establish minimum standards for the authorisation of branches of third country firms. EU Member States have an absolute discretion about whether to grant direct authorisation to branches of third country firms. If a Member State decides that it will grant direct authorisation to a third country firm to issue insurance contracts in its territory, the TCR sets minimum standards that the Member State must apply when doing so. However, the TCR does not require Member States to allow such branches to be established in the first place. This allows Member States to effectively “opt out” of deciding to allow access to UK insurers.
- (d) There are TCRs which are in the process of being introduced that may, following their introduction, be useful to the following types of firm:
- (i) third country firms wishing to provide investment services to wholesale customers on a cross-border basis (i.e. without establishing a branch) under MiFID II – but the rights under this TCR are subject to limitations, including in particular an obligation on the third country firm to submit disputes to the jurisdiction of a court or arbitral tribunal in an EU Member State (see paragraph 3.20(b) below); and
  - (ii) non-EU alternative investment fund managers who wish to market to professional clients in the EU (although the introduction of this TCR has already been the subject of some delay).
- (e) Neither of these TCRs will assist UK firms in providing services to retail clients. Under MiFID II, there will be a TCR for third country firms to establish branches which can provide investment services to retail clients, but there will be no obligation on Member States to allow such branches to be established. This means that Member States can opt out of the TCR under MiFID II.
- (f) UK investment firms and credit institutions will lose rights of access to trading venues, CCPs and clearing and settlement systems after Brexit. There is no TCR which provides similar rights, so it will be open to individual EU Member States to impose restrictions on the access available to such UK firms.
- (g) Some of the TCRs contain additional restrictions which may prove to be an obstacle to access. For example EU firms are normally restricted from relying on credit ratings issued by third country CRAs. There is a TCR under which third country CRAs can apply to be certified, which would allow their credit ratings to be used by EU firms. However, certification is only possible where the credit ratings are not of “systemic importance”. If the credit rating is of systemic importance, the third country CRA cannot rely on the certification regime and would instead have to have its credit ratings endorsed by an EU CRA before the credit rating could be used by EU firms.

### 3.16 Conditions common to the TCRs

#### 3.17

It is difficult to make generalisations which apply to all the TCRs, given the extent to which the terms of the individual TCRs differ. However, the following conditions are commonly found as part of a TCR:

- (a) **Equivalence:** The legal, regulatory and supervisory regime of the third country must be assessed by the EU authorities to be “equivalent” to those of the EU in relation to the activity in question.
- (b) **Local authorisation and effective supervision and enforcement for the third country firm:** The third country firm must be authorised in the jurisdiction in which its head office is established and it must be established that the third country firm is subject to effective supervision and enforcement in its own territory. This is a different test to equivalence.
- (c) **Cooperation agreements:** Typically, there must be a cooperation agreement in place between the third country and the relevant bodies in the EU.

#### 3.18

Each of the conditions is considered in more detail below.

##### (a) Equivalence

The meaning of equivalence differs between the different TCRs, in that:

- (i) the nature of what is being assessed as equivalent differs between the TCRs; and
- (ii) the question of what counts as equivalent can differ between the TCRs and industry sectors.

In relation to the question of what is being assessed, the answer is sometimes as broad as “equivalent legal and supervisory requirements” in relation to the matter which is the subject of the TCR.<sup>37</sup> In other contexts, it is a question of whether there are protections which are equivalent to specific provisions of the relevant EU legislation.<sup>38</sup> In some cases, the term “equivalent” is not used in relation to the assessment; for example, under the AIFMD, the key test is whether the third country has laws or regulations that would prevent effective supervision by the competent authorities (although in practice this is seen as being the same as an equivalence test).<sup>39</sup>

Many of the relevant TCRs provide further detail on what specifically should be considered as part of the equivalence assessment. For example, the TCR under MiFID II specifically

<sup>37</sup> For example, Article 5(6) of the CRA Regulation allows for the Commission to publish an equivalence decision that “the legal and supervisory framework of a third country ensures that credit rating agencies authorised or registered in that third country comply with legally binding requirements which are equivalent” to those in the CRA Regulation.

<sup>38</sup> For example, Article 13(2) of EMIR considers there to be equivalence where the third country legal, supervisory and enforcement arrangements are equivalent to Articles 4, 9, 10 and 11 of EMIR, as well as requiring there is protection of professional secrecy equivalent to EMIR.

<sup>39</sup> In the final advice on AIFMD that ESMA published in September 2016, it said: “while it would not be appropriate to require (for the purposes of giving positive advice on the extension of the passport) that there be a minimum degree of equivalence between the regulatory framework of the non-EU country and the AIFMD, it is nevertheless relevant and necessary to investigate the extent to which the regulatory framework of the non-EU country differs from the AIFMD.”

identifies the relevant requirements as including: capital, appropriate requirements for shareholders and the firm's managing body, organisational requirements (relating to internal control functions), conduct of business rules and market conduct. In practice, that is an extremely broad range of requirements and it would no doubt be a considerable undertaking to address all of those areas in any application for a determination of equivalence.

Even where the TCR identifies specific areas for review, the legislation often uses terms like "appropriate" and "adequate" without giving an explanation of what criteria would be applied. The EU authorities therefore have a considerable amount of discretion in determining whether or not a third country's position is equivalent.

There is little additional guidance from the EU authorities on what approach should be taken to equivalence, but it appears (based on such guidance as has been given and on the approach taken by the EU authorities in relation to equivalence decisions taken so far) that the position is as follows:

- (i) "Equivalent" does not mean "identical". Some degree of divergence between the third country's regime and the EU regime is permitted. It is unclear, however, exactly how far the two regimes can diverge before they are considered non-equivalent.
- (ii) It appears that it is not necessary that all aspects of the third country's system should be equivalent – only those aspects that are relevant to the area of activity of the third country from which it is seeking to rely on the TCR. This means that third countries do not need to align all aspects of its regulation with the EU and could potentially operate a "dual regime".
- (iii) The emphasis is on outcomes rather than processes, which means that the EU authorities should look at the substance of the third country's regulatory regime rather than its form.<sup>40</sup> (The experience in practice is somewhat different – see the case studies in section 5, below.)
- (iv) Where the regulatory regime of a third country is considered not to be equivalent, the EU authorities may suggest what changes would be necessary in order to become equivalent. For example, when Switzerland applied to be assessed under the AIFMD, it was told by ESMA in 2015 that certain provisions of Swiss law meant that it did not satisfy the requirements (see paragraph 4.14(d), below, for details). Switzerland amended those laws and applied again. In 2016, ESMA confirmed that Switzerland had satisfied the requirements.

The experience of third countries who have already been the subject of equivalence assessments is that the EU authorities look at a very broad range of factors and require a considerable amount of evidence. Please see the case studies in section 5 below for specific examples. Comments made by US representatives regarding the process for determining equivalence under the TCR for CCPs suggest that the idea that equivalence does not require identical rules does not accord with the actual practice of the EU authorities.

<sup>40</sup> For example, recital 41 to MIFIR states that the equivalence assessment under that Regulation "should be outcome-based; it should assess to what extent the respective third-country regulatory and supervisory framework achieves similar and adequate regulatory effects and to what extent it meets the same objectives as" EU law.

There are a number of questions that remain unclear about equivalence decisions:

- (i) How far does the concept of equivalence extend? For example, would the insolvency laws of the third country have to be equivalent? Would the third country have to have equivalent rules in relation to investor compensation schemes?<sup>41</sup>
- (ii) Where the relevant EU rules allow some interpretation (for example, where a rule requires that it should be applied proportionately),<sup>42</sup> will the regulatory authorities in the third country be allowed to make their own interpretation or will they be expected to follow interpretations of the EU authorities?

Without further, more granular, guidance from the EU authorities, it would be challenging to produce a concise analysis of what the EU authorities would require in order to make a determination of equivalence. This creates a lack of predictability about the scope and timing of the process.

It is also important to note that the fact that a third country believes itself to be equivalent does not, of itself, entitle the third country firm to benefit from the TCR. It is also necessary to obtain a determination from the EU authorities that it is considered to be equivalent. In that regard, although the ESAs (such as ESMA) provide a technical advisory role and are responsible for some of the elements of the TCR assessments, many of the assessments – particularly in relation to assessing the equivalence of third countries (as opposed to assessing whether there is effective supervision and enforcement) – involve the Commission itself.

#### (b) **Authorisation/effective supervision and enforcement**

Typically, it is a requirement of the TCRs that the third country firm must be:

- (i) authorised to provide the relevant services in the jurisdiction of its head office; and
- (ii) subject to effective supervision and enforcement in that jurisdiction.

Demonstrating the first of these requirements is unlikely to be a problem for UK financial services providers, as they generally need to be authorised by the UK regulators to carry on the activities for which they would be seeking to use the TCR.<sup>43</sup>

However, whether the UK would be assessed by the EU as meeting the second of these requirements is less predictable – in particular because of the level of discretion permitted to the relevant ESA in its assessment of whether the supervision and enforcement regime in a third country is “effective”.

<sup>41</sup> The MiFID II TCR for branches includes a requirement that the third country firm belongs to an investor compensation scheme which is authorised or recognised under the Investor Compensation Schemes Directive (which would presumably be the scheme in the country in which the branch was located). Other than in relation to this, none of the existing TCRs contain any references to investor compensation schemes. It is not clear, therefore, whether the existence of such schemes would ordinarily be part of an equivalence test.

<sup>42</sup> An example of this would be the remuneration codes.

<sup>43</sup> As considered in footnote 14 above, there are some activities which are not regulated in the UK but which are capable of being passported (e.g. lending to corporate customers, and foreign exchange). An entity that only performed activities of this nature would not need to be regulated in the UK, and would therefore not satisfy the requirement that it be authorised. Similarly, even a regulated entity in the UK might not be regarded as being subject to “effective supervision and enforcement” in relation to an activity that was not regulated in the UK. At present, the issue is academic, since none of the activities that are unregulated and yet passportable come within the scope of any of the current or proposed TCRs. If the UK sought an expanded TCR under which such activities were covered, however, it may want to ask that the requirements to be authorised and subject to effective supervision and enforcement be amended to allow for this.

There is little guidance in the Directives about exactly what counts as “effective” for these purposes. The ESAs themselves have not published any guidance.

The indications from TCR decisions that have already been made is that the ESAs are looking at the track record of third countries in relation to enforcement – e.g. for what they are prosecuting and what levels of fines have been imposed etc.

### (c) **Cooperation agreements**

The obligation to have a cooperation agreement is usually framed in terms of an agreement between the relevant ESA and the competent authority in the third country. Although there are some differences between the requirements of the different TCRs, the content requirements for such agreements are broadly similar and usually cover the scope of the cooperation, arrangements for the transfer of information and confidentiality. The UK authorities already have similar agreements in place with a number of non-EU countries.

Some TCRs require a third country to sign a cooperation agreement with Member State competent authorities as well as ESMA; such agreements will typically have been negotiated in advance by ESMA on behalf of the Member States. The UK currently has 49 cooperation agreements in place with third countries in respect of the AIFMD<sup>44</sup> alone, which suggests that entering into cooperation agreements in relation to TCRs should not present a conceptual challenge for the UK. Nevertheless, the UK will have to ensure that it has entered into the necessary cooperation agreements in sufficient time for UK firms to be able to rely on the TCRs.

## 3.19 **Additional requirements of TCRs**

### 3.20

In addition to the common conditions set out under paragraph 3.16 above, there may be specific requirements in relation to particular Directives. The most notable examples are as follows:

#### (a) **Reciprocity**

For some of the TCRs, the relevant Directive requires that the third country should have reciprocal arrangements for EU firms to have access to the third country.<sup>45</sup> For other TCRs, this is not a formal requirement.

We anticipate that the UK Government will want to allow EU firms to have access to the UK markets and that it will, therefore, be willing to allow reciprocity for EU firms.

#### (b) **Submission to local courts’ jurisdiction**

Under the MiFID II TCR, third country firms must, before providing any service or performing any activity in relation to a client established in the EU, “offer to submit any disputes relating to those services or activities to the jurisdiction of a court or arbitral tribunal in a Member State”.<sup>46</sup>

<sup>44</sup> <https://www.fca.org.uk/firms/nppr/supervisory-cooperation-arrangements-mous>.

<sup>45</sup> The relevant TCRs are those under MiFID II, EMIR (in relation to CCPs) and the CSD Regulations. The other TCRs do not specifically identify reciprocity as a requirement.

<sup>46</sup> Article 46(6) of MiFIR.

This appears to mean that a third country firm cannot have disputes resolved by the courts of its home state but must submit to the jurisdiction of the courts of an EU Member State. In practice, that is most likely to mean the home courts of the EU counterparty or customer with whom the third country firm is contracting. Please see paragraph 4.11(c) for a more detailed consideration of the MiFID II TCR.

As a matter of practice, contracts tend to specify that the courts that have jurisdiction to resolve disputes under the contract are the courts of the country whose governing law applies to the contract. If UK firms are required to submit to the jurisdiction of an EU Member State, that may mean that it is more likely that the contract would be governed by the law of that country as well.

The jurisdiction requirement may act as a potential inhibitor to UK investment firms and credit institutions wishing to rely on the MiFID II TCR.

Although the jurisdiction requirement does not appear in the other TCRs, it is noteworthy that the MiFID II regime is the most recent TCR to be developed and is arguably the one that is closest to providing access to the EU market in the style of a passport. If the EU has decided that the jurisdiction requirement is something that should apply to other TCRs in the future, this may reduce the attractiveness to third country firms of any expanded TCR arrangement.

#### 3.21

In relation to MiFID II, there are certain legislative provisions that appear to exclude third country firms, although it is unclear whether this is intentional or a drafting oversight. For example, Article 23 of MiFIR provides that an EU investment firm must ensure that the trades it undertakes in shares admitted to trading on a regulated market or traded on a trading venue must take place “on a regulated market, MTF or systematic internaliser, or a third-country trading venue assessed as equivalent in accordance with Article 25(4)(a) of [the MiFID II Directive]”.<sup>47</sup> Article 25(4)(a) of the MiFID II Directive, however, only refers to “third country markets” which are equivalent to regulated markets and does not appear to cover third country MTFs or OTFs. It is not clear whether this is a drafting oversight, but taken at face value the wording suggests that EU investment firms and credit institutions may not be permitted to trade equities on third country MTFs and OTFs unless those trades come within the relevant exceptions. Wording such as this could have serious consequences for those third country venues and possibly for EU investment firms and credit institutions that would seek to make use of those venues.<sup>48</sup>

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<sup>47</sup> This rule is subject to some exceptions, namely where the characteristics of the trades include that they: (a) are non-systematic, ad-hoc, irregular and infrequent; or (b) are carried out between eligible and/or professional counterparties and do not contribute to the price discovery process.

<sup>48</sup> Similarly, the provisions in Article 48(7) of the MiFID II Directive which require regulated markets and trading venues to allow direct electronic access to participants only apply for the benefit of EU-authorised credit institutions and investment firms. It is not clear whether third country firms have been excluded deliberately or through oversight.

## 3.22 “Indirect” TCRs

### 3.23

The analysis of TCRs above focusses primarily on their ability to act as a substitute for passporting, in the sense that they may provide a means for access to the EU market for UK firms post-Brexit.

### 3.24

There are also other provisions of the relevant Directives that relate specifically to third country firms that do not address the question of direct access to the EU market but can have an indirect impact on the ability of third country firms to do business in the EU (or on the cost of doing business with the EU) and which involve questions of equivalence. Please note that this report does not seek to consider all the consequences to UK firms of the UK leaving the EU and becoming a third country. Specifically, this section on “indirect” TCRs only addresses those areas of EU law where third countries and/or third country firms are treated differently to their EU counterparts but where an equivalence regime may allow them to be treated the same way.

### 3.25

Examples include the following:

#### (a) Provisions in EU law which limit the ability of EU entities to deal with third countries

There are numerous examples of situations where EU entities may be subject to limitations about whether or how they deal with firms from third countries which are not equivalent. For example:

- (i) Under MiFID II, EU investment firms and financial counterparties will be restricted in their ability to trade in derivative contracts on third country markets, unless the Commission has determined the third country market to be equivalent.<sup>49</sup> If the UK was not determined to be equivalent, this could lead to the loss of derivatives trading by EU financial services providers on UK trading venues.
- (ii) Under Solvency II, EU Member States can impose restrictions which would prevent insurers in their Member State from entering into reinsurance contracts with a third country reinsurer, unless the Commission has determined that the third country is equivalent.<sup>50</sup> If the UK is not determined to be equivalent for these purposes, this could have a serious impact on the business of UK reinsurers.
- (iii) Under the UCITS Directive, restrictions are imposed on the types of investments which UCITS funds can be invested in.<sup>51</sup> UCITS funds can only invest in other collective investment undertakings which are subject to supervision which is equivalent to that in the EU. If the UK is not equivalent, UCITS funds could not invest in UK funds. In addition, the decision about whether the supervision is equivalent rests with the competent authority of the Member State in which the UCITS is established, allowing

<sup>49</sup> Article 28 of MiFIR.

<sup>50</sup> Recital 89 and Article 172 of the Solvency II Directive.

<sup>51</sup> Article 50 of the UCITS Directive.

for variation of approaches between Member States and necessitating up to 27 separate determinations.

- (iv) Under the CRR, EU credit institutions and investment firms must, when calculating their capital requirements, apply a risk weighting to their assets, so that a riskier asset requires more capital to be held against it than a less risky one. Exposures that the EU firm has to another EU credit institution are given a lower risk weighting than an exposure that the EU firm has to a third country credit institution, unless the third country has been assessed as equivalent.<sup>52</sup> If the UK is not determined to be equivalent, this may make EU credit institutions less likely to lend to UK credit institutions and investment firms.

**(b) Provisions which affect the treatment of third country products and services**

Under the Prospectus Directive, for example, securities cannot be offered to the public within an EU Member State without prior publication of a prospectus. No prospectus may be published until it has been approved by the competent authority of a Member State. The Directive allows Member State regulators to approve the prospectuses from third countries only where the relevant requirements in those third countries are equivalent to those under the Directive.<sup>53</sup> If a UK issuer wished to offer securities in the EU, it would only be able to do so if the UK's regime was equivalent to that under the Prospectus Directive. In addition, even if the UK is determined to be equivalent, the UK issuer would still need to persuade the relevant regulator in an EU Member State to approve the prospectus; it would have no right to require that regulator to do so.

**(c) Provisions which affect the operation of cross-border groups**

There are several provisions which could affect the operation of cross-border groups. For example:

- (i) Under the CRR, EU credit institutions and investment firms are not permitted to incur an exposure to a client or group of connected clients the value of which exceeds 25% or more of its eligible capital. Member States are permitted to allow exceptions to this, and in particular can permit a firm to have an exposure in excess of the limit to clients who are group undertakings, insofar as those undertakings are covered by consolidated supervision of the group. Where the group undertaking is a third country firm, the exposure is only permitted if the third country has equivalent standards in force. If, for example, the UK was not determined to be equivalent and an EU credit institution had an exposure which was above the threshold to a UK group undertaking, the EU credit institution would be required to take steps to remove that exposure.
- (ii) Intra-group derivatives transactions are exempt from certain requirements in EMIR relating to the trading and clearing of derivatives. However, where one of the counterparties within the group is from a third country, the exemption only applies if the third country has been determined as equivalent. If the intra-group exemption does not apply, EU firms may have to provide additional margin when dealing with third country firms within its own group.

<sup>52</sup> If, for example, the UK was not determined to be equivalent, a French credit institution with a three month loan to an A-rated UK credit institution might have to hold five times as much capital against that asset as it would have done if it had had the same exposure to the same UK credit institution whilst the UK was in the EU.

<sup>53</sup> Article 20 of the Prospectus Directive.



### 3.26

Although the issues identified above do not deal with direct rights of access for the third country firm, they are capable of having considerable indirect impact on UK financial services firms and thus should be taken into account when the UK Government considers the UK's post-Brexit relationship with the EU. If the UK is not determined to be equivalent then, in some instances, UK firms' access to EU markets will, for practical purposes be restricted.<sup>54</sup>

### 3.27

A table summarising the effect of these "indirect" TCRs can be found at Appendix 3. The sector specific summaries in section 4 of this report also refer to these "indirect" TCRs where appropriate.

### 3.28

As a general comment, the processes for determining equivalence in the context of some of these "indirect" TCRs are not as clear as for some of the direct TCRs covered in this report. According to the Commission's website, for many of these indirect TCRs no determinations of equivalence have actually been made in respect of any third country. There is, therefore, no body of precedents for the UK and UK firms to assess whether or not they are likely to satisfy the requirements.

### 3.29

## The processes associated with the TCRs

### 3.30

As would be expected, given the piecemeal nature in which the TCRs have arisen, the procedures for making an application in respect of a TCR vary. Nevertheless, the following general observations can be made:

#### (a) Making an application in order to rely on a TCR

The processes, in effect, have two separate stages that must be completed before a third country firm will be able to rely on the TCRs:

##### (i) *Obtaining a determination at a national level*

Before a third country firm is even able to apply to the relevant ESA for recognition, the national authorities of that third country must satisfy certain conditions. In particular:

- (1) the relevant third country must have been accepted as equivalent (or satisfied a similar test); and
- (2) the third country must enter into a cooperation agreement with the EU authorities.

None of the TCRs specify any time frame for steps (1) and (2) to be taken (although there are time frames when the third country firm itself comes to make its own application – see paragraph (b) below). Although the relevant Directives usually indicate what factors

<sup>54</sup> It is difficult to draw a rigid distinction between a TCR that directly affects access and one that only indirectly affects access. There are some TCRs that could be regarded as either – such as the TCRs affecting the ability of third country market infrastructure providers to deal with EU counterparties. The key point is not to lose sight of the possibility that equivalence decisions can apply in the context even of the more indirect TCRs.

will be considered as part of the equivalence assessment under the TCR, it is less clear exactly what information a third country will need to provide to the EU authorities.

Anecdotal evidence from third countries which have made applications under TCRs suggests that the process for satisfying these conditions can be slow. The EU authorities typically ask for a considerable amount of information and then need a long time to process that. See the case studies in section 5 below for examples.

To give some examples of the timings of actual applications:

- (1) applications for equivalence decisions in relation to EMIR have taken between two and nearly four years (the longest application being that of the USA – see case study 1 in section 5 below regarding the USA's application for equivalence in relation to CCPs);<sup>55</sup> and
- (2) of the nine applications that were made by credit ratings agencies under the CRA Regulation, one (Japan) took just over six months, three (Australia, Canada and the USA) took between 18 months and two years and five (Argentina, Brazil, Hong Kong, Mexico and Singapore) took over four years.

The timing of the determination of equivalence is entirely open-ended and depends on the speed and willingness of the EU authorities to progress matters and to take a pragmatic view.

Although there is no prescribed timetable for entering into cooperation agreements, it is worth noting that ESMA negotiated 11 cooperation agreements in relation to access to third country CCPs under EMIR in approximately two years.

#### (ii) *The application by individual third country firms*

Once the conditions in paragraph (i) above are satisfied at a national level, each individual third country firm which wishes to provide services or products cross-border must make its own application for recognition.

The Directives are generally quite prescriptive in relation to these applications, both in terms of timeframes and the supporting information required.

The timings differ as between the different TCRs. The relevant ESA will typically have around six months in which to consider an application, although some of the time frames are shorter than this. Some of the TCRs count the deadlines from the day on which the EU authorities consider that they have received a complete application. This gives them some scope to delay the processing of the application on the basis that the application is incomplete.

The supporting information is often specified in the relevant legislation. In other cases, the legislation merely asks for “all information necessary”, so the applicant will need to find out what is required.

The process that applies to the firms themselves is generally more certain than that for satisfying the conditions at a national level and applicant firms ought to be able to anticipate with reasonable certainty how long their application will take to be processed.

<sup>55</sup> The way that EMIR is worded means that in practice it is likely to take a minimum of 18 months to make an equivalence assessment.

**(b) Withdrawal of a TCR**

As with applications for a TCR above, it is necessary to consider separately:

- (i) withdrawal of equivalence for the third country as a whole; and
- (ii) withdrawal of the recognition of a specific third country firm.

There are no set timeframes and few details of the processes regarding the withdrawal of equivalence for the country as a whole.

The Commission can act on its own initiative to remove equivalence for a third country. Some TCRs also require the Commission to act in response to certain circumstances: for example, under MIFIR, if ESMA withdraws a registration from a third country firm, the Commission is required to review that country's equivalence status.

There are very few procedural safeguards in place to challenge or delay a decision by the Commission to withdraw equivalence.<sup>56</sup> There is no right of appeal.

The Commission has not yet withdrawn an equivalence decision for a third country due to a divergence of regulation at a national level (although since the vast majority of equivalence decisions were only originally made in the last three years, this is not particularly surprising). We are not aware that the prospect of the withdrawal of an equivalence determination has been raised by the EU either.

The published decisions regarding equivalence contain little practical guidance on the extent to which the domestic regimes of third countries can diverge from EU regimes.

The decision to withdraw equivalence is likely, in part, to be a political one, with the degree of divergence which is accepted being up to the Commission to decide. See also section 6 below in relation to how the UK, as a third country, could continue to ensure that it is regarded as being equivalent.

In relation to withdrawal of recognition for a specific third country firm, most of the Directives do not prescribe a timeframe or process. The exception to this is the MiFID II TCR, which specifies that ESMA must first refer the matter to the third country firm's home regulator and, if the home regulator does not take appropriate measures (for which no time frame is specified), ESMA may give 30 days' notice to the home regulator that the recognition of the third country firm is being withdrawn. MiFID II also specifies the grounds on which recognition can be withdrawn.

### 3.31 Challenging equivalence determinations under the existing TCRs

### 3.32

There are no formal procedural safeguards available to third countries under the existing TCRs in the event that the Commission rejects an application by a third country to be determined equivalent or decides to withdraw an existing determination of equivalence in respect of a third

<sup>56</sup> Under MIFID II, the Commission is required to consult a committee on which every Member State is represented when deciding whether to withdraw equivalence. The committee votes on a qualified majority voting basis.

country. An equivalent third country does not have any special status under EU law by virtue of which it could challenge the Commission.

#### 3.33

Under Article 263 of the TFEU, the CJEU has jurisdiction to review the legality of acts of the Commission and other bodies, offices or agencies of the EU (such as ESMA) and, if appropriate, declare them void. A claim can be brought on the grounds of lack of competence, infringement of an essential procedural requirement, infringement of the Treaties, or misuse of powers. Claims under Article 263 can only be brought, however, by EU Member States, certain EU institutions or “any natural or legal person” to whom the act of the Commission under challenge is “expressly addressed” or of “direct and individual concern”. In relation to this:

- (a) Non-Member States do not have standing to bring an action under Article 263, and after Brexit the UK will have no direct legal recourse to challenge a decision by the Commission withdrawing equivalence. The decision of the Commission could, however, be challenged by an EU Member State on the UK’s behalf. The EU Member State challenging the decision would not be required to demonstrate any direct interest in bringing the action in order to have standing to bring the claim.
- (b) UK firms are “legal persons” within the meaning of Article 263 and could potentially bring actions. However, the requirement that the act under challenge must be of “direct and individual concern” to the complainant has been very narrowly defined by the EU courts. The legal person must be affected “by reason of certain attributes which are peculiar to them or by reason of circumstances in which they are differentiated from all other persons”.<sup>57</sup> A UK firm is unlikely to be successful in bringing an action under Article 263 in relation to decisions made by the Commission relating to the equivalence of the UK as a whole, as this determination would affect all UK firms and not just the firm seeking to make the complaint.
- (c) In circumstances where the UK is determined to be an equivalent third country in respect of a TCR but there is an additional requirement under the TCR for individual firms to be registered by ESMA (as is the case in respect of MiFID II), a firm would be able to bring an annulment action against a decision not to register it, as that decision would be expressly addressed to it.

#### 3.34

### Key issues regarding the TCRs

#### 3.35

The following general statements can be made about the TCRs:

##### (a) TCRs are not comprehensive

The TCRs do not cover all aspects of the financial services industry. They tend to be created under individual Single Market Directives which focus only on particular services or products (such as investment services). Even within the context of a specific Directive, the TCRs may only apply to some of the activities covered by that Directive.

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<sup>57</sup> Case 25/62 Plaumann v Commission

There are some TCRs that apply across multiple types of regulated firm – such as EMIR, which can apply to different types of firm that undertake activities in relation to derivatives.

**(b) TCRs are narrower in scope than passporting**

The passporting regime is considerably broader in scope than the TCRs.

The summary table in the overview at the start of this report illustrates the difference between the scope of the passporting regime and the current TCRs.

Generally, there are relatively few areas of financial services where there are TCRs or where TCRs will be introduced in the near future. In part, this may be because the EU does not want to lose additional control over access to its markets by firms which are based outside its territory and regulated by third country regulators, where the EU and the regulators of Member States may be concerned that they are unable to exert sufficient influence over the activities and the nature of such persons.

**(c) TCRs are less stable than passporting**

TCRs are less stable than passporting, as passporting is a right related to membership of the EU, which cannot be unilaterally varied or withdrawn from a Member State by the EU. However, it is open to the EU to withdraw or vary the operation of TCRs or change the guidance in relation to their operation as regards all third countries, as well as to change the “equivalence” status of a specific third country.

**(d) Additional restrictions and limitations**

In addition to TCRs applying only to specific services and/or products, the TCRs can also be limited in other ways – such as:

- (i) applying only to certain ways of providing cross-border services – e.g. allowing access for cross-border services but not allowing the third country firm to establish a branch; or
- (ii) applying only to certain types of customers – e.g. allowing services to be provided to non-retail clients only.

These restrictions and limitations are usually more restrictive than the corresponding passporting right that would exist for a firm from an EU Member State. There are also some restrictions that apply in order to get access through a specific TCR.<sup>58</sup> For example, the MiFID II TCR contains a requirement that the third country firm must submit to the jurisdiction of the courts or an arbitration tribunal of a Member State (see paragraph 4.11(c)). There is no equivalent to such a restriction under any of the passporting regimes.

**(e) Some TCRs are optional for member states**

Some of the TCRs are optional for Member States – i.e. they only apply if the Member State intentionally “opts in” and chooses to allow third country firms to have access to its market.

The nature of these TCRs is, in effect, to create a common minimum standard for Member States that wish to allow access to the TCRs, but not to create a right of access for third country firms.

<sup>58</sup> See, for example, paragraph 3.20(b) above in relation to the jurisdiction requirement under the MiFID II TCR.

For example, under Solvency II there is a TCR which applies where a Member State wishes to allow a third country insurer access to insurance business in that Member State.<sup>59</sup> Under the TCR, the Member State must require the insurer to establish a branch in the Member State. The same criteria for the establishment of a branch would apply to any Member State that is willing to consider such an application. However, there is nothing in Solvency II which requires the Member State to consider the request in the first place; the Member State can simply decide that it does not wish to allow any third country firms to access insurance business within its territory.

**(f) Differences in criteria**

In relation to the criteria that are to be applied when determining whether a third country firm can have access, the TCRs tend to have some common features (see under paragraph 3.16 above). However, there are many variations in relation to the criteria, with some TCRs featuring additional criteria beyond the normal factors (such as specific criteria in connection with protections against financial crime).<sup>60</sup> This means that even if a third country is equivalent in relation to one TCR, it may not be equivalent in relation to another. Each TCR could lead to different outcomes.

**(g) Differences in processes**

The processes under the different TCRs for determining whether a third country or third country firm meets the criteria are derived from separate Directives and Regulations and contain differences. See paragraph 3.29 above for examples.

**(h) Scope for additional national requirements**

As part of the broader policy objective of creating a Single Market, many of the Single Market Directives set out intentionally to harmonise the regulatory rules across the EU. Such Directives typically set out detailed requirements and then prohibit Member States from introducing additional rules on top of those requirements (so-called “gold plating”), other than in very limited circumstances.

Some of the TCRs contain provisions preventing a Member State from introducing additional requirements that would apply to third country firms.<sup>61</sup> Most of them, however, do not.

If Member States can “gold plate” the TCRs and impose additional requirements, a third country firm may find itself having to adapt its businesses to meet each of the differing local requirements. This would potentially undermine one of the principal benefits of trying to utilise the TCRs.

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<sup>59</sup> Article 162 of the Solvency II Directive.

<sup>60</sup> See paragraph 4.20 for an example.

<sup>61</sup> For example, the MiFID II TCR includes a rule which limits the ability of Member States to impose additional requirements on branches of third country firms (Article 41(2) of the MiFID II Directive). Likewise, Member States cannot impose additional requirements on recognised third country CCPs (see Recital 50 of EMIR).

# 4.0 SECTOR SPECIFIC ANALYSIS

## 4.1 Introduction

### 4.2

This section of the report contains a summary of the position in relation to each of the following sectors:

Sector	Paragraph
Banks/credit institutions	4.5
Lending	4.6
Mortgage providers and intermediaries	4.7
Foreign exchange	4.8
Payment services providers	4.9
E-commerce providers and e-money issuers	4.10
Investment services (wholesale business)	4.11
Investment services (retail business)	4.12
Data reporting services (APAs, ARMS, CTPs)	4.13
Investment funds and their managers	4.14
Portfolio managers	4.15
Insurers and reinsurers	4.16
Insurance and reinsurance intermediaries/distributors	4.17
Credit ratings agencies	4.18
Operators of trading venues	4.19
Central counterparties	4.20
Central securities depositories	4.21
Trade repositories	4.22
Benchmark administrators	4.23
Wealth managers	4.24
FinTech companies	4.25

### 4.3

The separate “Summary of Legal Provisions” Annex contains a detailed record of the legal requirements of the different TCRs, broken down by sector. It also includes details of the processes associated with each of the separate TCRs.

### 4.4

Appendix 3 contains details of other EU legislation which does not create an access regime as such but which does contain provisions regarding equivalence which will be relevant to the status of third country firms – the so-called “indirect TCRs” (see under paragraph 3.22 above).

## 4.5 Banks/credit institutions

### (a) What are the activities in this category?

Banks (or credit institutions, as they are described in the Single Market Directives) typically engage in the following activities:

- (i) deposit taking;
- (ii) lending (including consumer lending and mortgage lending);
- (iii) foreign exchange services;
- (iv) investment services (such as dealing in investments and advising on investments);
- (v) the provision of custody services;
- (vi) payment services;
- (vii) e-money services; and
- (viii) insurance intermediation and distribution.

### (b) Is passporting available in relation to these activities?

Under CRD IV, there is a long list of activities which credit institutions can passport into other Member States. The activities include:

- (i) deposit taking;
- (ii) lending (including consumer credit, mortgages, factoring and the financing of commercial transactions);
- (iii) foreign exchange services;
- (iv) payment services;
- (v) issuing and administering other means of payment (e.g. travellers' cheques and bankers' drafts); and
- (vi) custody services.

Most of the activities that are covered by CRD IV require a licence to be obtained if any solicitation is undertaken. However, some of the activities that are passportable under CRD IV do not always amount to regulated activities: for example, lending (other than to consumers) is not a regulated activity in the UK and a person does not need authorisation from the UK regulators in order to carry on that activity in the UK. Credit institutions are currently able to use passporting rights in relation to such activities under the principle discussed in footnote 14 above.

In addition to the services which are passportable under CRD IV:

- (i) Credit institutions can (and frequently do) engage in any of the investment services which are governed by MiFID. A credit institution can, therefore, passport any of the services identified in paragraph 4.11(a).
- (ii) A credit institution is also able to passport insurance mediation and distribution activities under the IMD – see paragraph 4.17.



**(c) Are the activities covered by TCR or is this a gap area?**

- (i) Most of the activities that credit institutions currently carry out will not be covered by the TCRs.
- (ii) There is no TCR under CRD IV. As a result there is no TCR for any of the following activities: deposit taking; lending (including consumer credit, mortgages, factoring and the financing of commercial transactions); foreign exchange services; payment services and the issuing and administering of other means of payment (e.g. travellers' cheques and bankers' drafts).
- (iii) Similarly, there is no TCR in relation to insurance mediation and distribution – see paragraph 4.17.
- (iv) There will be a limited TCR in relation to investment services provided by credit institutions (which will be governed by the MiFID II provisions – see paragraph 4.11). This may enable a third country credit institution to provide investment services to wholesale customers on a cross-border basis, but in practice is unlikely to assist in relation to the provision of investment services to retail clients. The TCR for investment services also provides a mechanism through which credit institutions and investment firms can establish branches in Member States, but Member States are not obliged to allow third country firms to open branches. If a Member State did allow a credit institution to establish a branch under the investment services TCR, it would only be able to carry out MiFID investment services from that branch and would not be able to carry out any of the services listed under CRD IV, as CRD IV does not contain a TCR.
- (v) There are equivalence provisions under EMIR that would be relevant to a credit institution that deals in derivatives. See paragraph 4.11(d)(iv) for further information.
- (vi) The provision of custody services is passportable under both CRD IV and MiFID. This raises the possibility that credit institutions could continue to have access to a TCR for custody services:
  - (1) In the context of MiFID, the custody service is an “ancillary activity”, which means that it can only be passported if the credit institution is also passporting a “core” investment service under MiFID (see paragraph 4.11(a)).
  - (2) As there is no TCR under CRD IV, the only way that a third country credit institution could carry on custody services would be if it was able to use the MiFID II TCR for investment services or activities, as described in paragraph 4.11(a).
  - (3) The MiFID II TCR is likely to operate in the same way as the MiFID passport – i.e. as long as the third country firm is carrying out a core investment service, it will also be able to use the TCR for ancillary services (including custody).
  - (4) A credit institution that did not provide investment services, however, would not be able to use the MiFID II TCR and would not be able to rely on that TCR to provide custody services.

(vii) The analysis described in paragraph (vi) above in relation to custody services would also apply to any other “ancillary service” under MiFID – i.e. the MiFID II TCR may be available for the ancillary service if the credit institution also undertakes a core investment service under MiFID. The list of other ancillary services includes the following, both of which would be within the scope of the MiFID II TCR:

- (1) granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm granting the credit or loan is involved in the transaction; and
- (2) foreign exchange services, where these are connected to the provision of investment services.

(d) **Other comments**

- (i) Under CRD IV, a Member State has discretion to allow third country credit institutions to establish branches in its territory, provided that the rules for third country branches are not more favourable than those applied to branches of firms from other EU Member States. This means that the competent authorities of Member States will at least apply the minimum standards which they apply to branches of EU credit institutions established in other Member States.
- (ii) In addition, CRD IV contains a provision which would, in principle, allow the EU to negotiate an agreement with a third country so that branches of credit institutions from that country will receive the same treatment throughout the EU.<sup>62</sup>
- (iii) In relation to recovery and resolution:
  - (1) When the UK leaves the EU, the Bank Recovery and Resolution Directive (“BRRD”) will cease to apply to UK credit institutions. In the absence of the BRRD (and any further agreement between the UK and EU), there will be no framework for the mutual recognition of bank resolution schemes between the UK and the EU.
  - (2) Pending the creation of an EU-UK agreement, individual Member States may enter into transitional bilateral agreements with the UK.<sup>63</sup> Unless and until such an international agreement is reached, if a UK credit institution fails, national regulators in the EU would have the choice as to whether to recognise or reject UK resolution proceedings. For example, regulators in the EU could reject UK resolution proceedings if they believed that a UK credit institution’s resolution would affect financial stability or that creditors (and in particular depositors) in the EU would not receive the same treatment as creditors and depositors with similar legal rights in the UK.<sup>64</sup>

## 4.6 Lending

(a) **What are the activities in this category?**

Lending (including lending to corporates and consumer lending).

<sup>62</sup> Article 47(3) of CRD IV.

<sup>63</sup> Article 93 of the BRRD.

<sup>64</sup> Article 95 of the BRRD.

**(b) Is passporting available in relation to these activities?**

Under CRD IV, a credit institution can passport all forms of lending, including consumer credit, mortgages, factoring and the financing of commercial transactions. See paragraph 4.5 above.

The position for firms which are not credit institutions is very much more limited.

Under MiFID, one of the “ancillary services” is “granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm granting the credit or loan is involved in the transaction”.<sup>65</sup> Ancillary services are passportable where the firm in question also passports one of the “core” investment services under MiFID (see paragraph 4.11 for further information). A firm that passports under MiFID (which would have to be either a credit institution or an investment firm) would therefore be able to passport lending activities – but only in the very limited context of loans which enable investors to carry out transactions that the firm is involved with.

Save for the (very limited) MiFID passport for lending that applies to investment firms, there is no passporting regime available for financial services providers other than credit institutions to carry on lending activities.

**(c) Are the activities covered by TCR or is this a gap area?**

There is no TCR under CRD IV for credit institutions.

If a credit institution or investment firm was carrying out investment services under MiFID (i.e. was carrying out a core investment service which enabled it also to passport ancillary services – see paragraph 4.11), it may be able to benefit from the MiFID II TCR in relation to lending in the very limited sense described above.

Other than as stated above, there is no TCR for lending.

## 4.7 Mortgage providers and intermediaries

**(a) What are the activities in this category?**

This category covers:

- (i) the provision of regulated mortgage contracts; and
- (ii) ancillary activities, including:
  - (1) credit intermediary activities (which include presenting or offering credit agreements to consumers, undertaking preparatory work and concluding credit agreements with consumers on behalf of the creditor); and
  - (2) advisory services (i.e. the provision of a personal recommendation to a consumer in respect of one or more transactions related to credit agreements).

**(b) Is passporting available in relation to these activities?**

Credit institutions may passport the provision of “lending” under CRD IV. The category of

<sup>65</sup> Annex I, Section B of the MiFID II Directive.

“lending” is sufficiently broad to cover the provision of regulated mortgage contracts (as well as other forms of lending, including consumer credit lending).<sup>66</sup>

Institutions other than credit institutions cannot passport under CRD IV. A money lending firm which was not a credit institution would not be able to passport.

The provision of regulated mortgage contracts is regulated by the Mortgage Credit Directive (MCD).

The MCD does not contain its own standalone passporting regime for the provision of regulated mortgage contracts. It does, however, have a passporting regime for “credit intermediaries” who wish to provide credit intermediary activities or advisory services. Credit intermediaries passporting under the MCD can either establish a branch in another Member State or provide services into another Member State on a cross-border basis.

(c) **Are the activities covered by TCR or is this a gap area?**

There is no TCR in relation to mortgage contracts, either under CRD IV or the MCD.

## 4.8 Foreign exchange

(a) **What are the activities in this category?**

This category covers the provision of foreign exchange services – i.e. services relating to “spot” foreign exchange transactions, rather than derivative contracts relating to currency, such as options and futures.<sup>67</sup>

(b) **Is passporting available in relation to these activities?**

Foreign exchange services relating to spot transactions are not regulated activities in the UK and a firm providing such services does not need to be authorised by the UK regulators. Other Member States, however, do require providers of foreign exchange to be authorised.

Notwithstanding that foreign exchange is not regulated in the UK, under CRD IV a UK credit institution is able to passport the provision of foreign exchange into other Member States using the principle outlined in footnote 14, above.

Under MiFID, one of the “ancillary services” is “foreign exchange services where these are connected to the provision of investment services”.<sup>68</sup> Ancillary services are passportable where the firm in question also passports one of the “core” investment services under MiFID (see paragraph 4.11 for further information). A firm that passports under MiFID (which would have to be either a credit institution or an investment firm) would therefore be able to passport foreign exchange services – but only in the very limited context of services that are connected with the core investment services.

Unless the MiFID passport applies, a financial services provider that was not a credit institution would not be able to passport

<sup>66</sup> Annex 1(2) of CRD IV.

<sup>67</sup> Activities related to derivatives contracts would be covered by MiFID – see paragraphs 4.11 and 4.12.

<sup>68</sup> Annex I, Section B of the MiFID II Directive.

**(c) Are the activities covered by TCR or is this a gap area?**

There is no TCR under CRD IV for credit institutions.

If a credit institution or investment firm was carrying out investment services under MiFID (i.e. was carrying out a core investment service which enabled it also to passport ancillary services – see paragraph 4.11), it may be able to benefit from the MiFID II TCR in relation to foreign exchange services, in the limited sense described above.

Other than as stated above, there is no TCR for foreign exchange services

**4.9****Payment services providers****(a) What are the activities in this category?**

“Payment services” means a range of services, including the execution of payment transactions, the issuing and acquisition of payment instruments, and money remittance services.

This section of the report does not apply to the provision of payment services by credit institutions; for the position in relation to credit institutions, see paragraph 4.5.

**(b) Is passporting available in relation to these activities?**

Payment service providers currently have access to a passporting regime under the Payment Services Directive (PSD), which enables them to provide payment services on a cross-border basis or through a branch.

This passporting regime does not apply to firms that are not subject to the Payment Services Directive, such as credit institutions or e-money institutions. Those institutions can derive similar passport rights under CRD IV (see paragraph 4.5) and second Electronic Money Directive respectively (see paragraph 4.10).

**(c) Are the activities covered by TCR or is this a gap area?**

There is no TCR for payment services.

The PSD does not contain a TCR. The PSD is due to be replaced by the Second Payment Services Directive (“PSD 2”) before the date on which the UK leaves the EU, but PSD 2 does not provide a framework for access for third country firms either.

Firms which would previously have passported under the PSD will be unable to continue using the passport and there is no TCR available in its place. The same is also true for credit institutions who passport their ability to provide payments services under CRD IV; see paragraph 4.5 for the analysis in relation to this.

**(d) Other comments**

PSD 2 specifies that authorisation to be a payment services provider can only be granted to a person who is established within the EU. As a result, EU Member States would be prevented from permitting UK payment services providers to have direct authorisation from the local regulators post-Brexit.

## 4.10 E-commerce providers and e-money issuers

### (a) What are the activities in this category?

This category covers:

- (i) the provision of “information society services” (as described in the E-Commerce Directive),<sup>69</sup> and
- (ii) the issuing of e-money (as described in the second Electronic Money Directive or 2EMD).

### (b) Is passporting available in relation to these activities?

In relation to information society services:

- (i) the E-Commerce Directive does not contain a passporting regime in the ordinary sense but Member States are prohibited from restricting the freedom to provide information society services from another Member State, except if specified conditions are met (such as for the protection of public policy or public health);<sup>70</sup> and
- (ii) under the so-called “country of origin” principle, it is sufficient for the providers of such services to comply with home state laws (even if they sell their products to customers in another Member State).<sup>71</sup>

In relation to the issuing of e-money under 2EMD, firms can passport either by establishing a branch in another Member State or providing services into another Member State on a cross-border basis.

### (c) Are the activities covered by TCR or is this a gap area?

There is no TCR in relation to e-commerce or e-money services.

### (d) Other comments

- (i) In relation to e-commerce, the E-Commerce Directive states that the Directive should not apply to services supplied by service providers established in a third country, but it says that:<sup>72</sup>

*“in view of the global dimension of electronic commerce, it is, however, appropriate to ensure that the Community rules are consistent with international rules; this Directive is without prejudice to the results of discussions within international organisations (amongst others WTO, OECD, Uncitral) on legal issues”*

If this means that the EU intends to follow the international rules in relation to e-commerce, it should assist the UK in arguing for the creation of TCR for e-commerce (provided the UK intends to follow the same international rules).

<sup>69</sup> In summary, this means any service normally provided for remuneration, at a distance, by means of electronic equipment for the processing (including the digital compression) and storage of data at the individual request of a service recipient. These services do not amount to regulated activities in their own right.

<sup>70</sup> Articles 3(2) and 3(4) of the E-Commerce Directive.

<sup>71</sup> Article 3 of the E-Commerce Directive.

<sup>72</sup> Recital 58 of the E-Commerce Directive.

- (ii) I2EMD prohibits persons who are not “electronic money issuers” from issuing electronic money.<sup>73</sup> The definition of electronic money issuer<sup>74</sup> includes (but is not limited to) “credit institutions” and “electronic money institutions”, which must have at least a branch located within the EU. This suggests that access from a third country on a cross-border services basis (i.e. without the establishment of a branch) would be prohibited.

## 4.11 Investment services (wholesale business)

### (a) What are the activities in this category?

This category covers investment services and activities, as defined in MiFID, that are provided by an investment firm or a credit institution.

Under MiFID, the “core” investment services and activities are any of the following involving the provision of a service in relation to a financial instrument:

- (i) reception and transmission of orders in relation to one or more financial instruments;
- (ii) execution of orders on behalf of clients;
- (iii) dealing on own account;
- (iv) portfolio management;\*
- (v) the making of a personal recommendation;
- (vi) underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis;
- (vii) placing of financial instruments without a firm commitment basis; and
- (viii) operation of multi-lateral trading facilities.

(\* There is a separate section in this report for portfolio management – see paragraph 4.15 below.)

MiFID also provides that certain ancillary services are within the scope of the Directive, but only if the firm in question provides a core investment service as well as the ancillary service. Those ancillary services include the provision of custody services.<sup>75</sup>

This section of the report applies to “wholesale” investment services – i.e. investment services provided to a client who has not been categorised as a “retail client” or an “elective professional client” under MiFID.<sup>76</sup> Typically, this would include where the investment firm or credit institution is providing services to or is dealing with another regulated firm or an institutional investor. It would not apply in any situation where the investment firm or credit institution was providing services to a natural person (i.e. an individual human being).

<sup>73</sup> Article 10 of 2EMD.

<sup>74</sup> Article 1(1) of 2EMD.

<sup>75</sup> The full list of ancillary services is: (a) safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management; (b) granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm granting the credit or loan is involved in the transaction; (c) advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings; (d) foreign exchange services where these are connected to the provision of investment services; (e) investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments; (f) services related to underwriting; and (g) investment services and activities as well as ancillary services within (a) to (f), above, related to the underlying of the certain derivatives specified in MiFID.

<sup>76</sup> See paragraph 4.12, below, for the position in relation to firms who wish to provide investment services in relation to retail clients and elective professional clients.

**(b) Is passporting available in relation to these activities?**

Yes. Investment firms and credit institutions can passport under MiFID to carry on these activities,<sup>77</sup> either by establishing a branch in another Member State or providing services into another Member State on a cross-border basis.

**(c) Are the activities covered by TCR or is this a gap area?**

There is currently no TCR under MiFID, but MiFID II will introduce a TCR for third country investment firms and credit institutions to carry on wholesale business.

The position under the TCR will depend on whether the third country firm wishes to provide services on a cross-border services basis or to establish a branch.

**(i) Cross-border services**

The MiFID II TCR will permit third country firms to provide investment services to wholesale customers in the EU without having to establish a branch in a Member State. This means that third country firms within the scope of the TCR will have a right to provide cross-border services into the EU.

In order to benefit from the TCR, the third country firm will have to be registered with ESMA. ESMA will include a third country firm on its register if all of the following conditions are satisfied:

**(1) *The Commission confirms that the third country has an equivalent legal and supervisory regime***

The requirements are that the third country:

- complies with legally binding equivalent prudential and conduct of business requirements (which according to MiFIR will be assessed on an “outcomes” basis); and
- has an effective equivalent system for the recognition of investment firms and credit institutions authorised in other countries – i.e. that there are reciprocal arrangements allowing access to the third country for EU investment firms and credit institutions.

**(2) *The firm is authorised to provide the relevant services in the jurisdiction of its head office and is subject to effective supervision and enforcement in that jurisdiction***

There is no further guidance on what would constitute “effective” supervision and enforcement in the third country.

It is unclear whether ESMA will be able to rely solely on the Commission’s determination (which will be made by the Commission as part of the equivalence decision) that third country firms from a particular jurisdiction are subject to effective supervision and enforcement, or whether ESMA must make a separate assessment in relation to the individual third country firm.

There is a similar concept in the TCR for CCPs, which is already in force (see

<sup>77</sup> The investment service can only passport an ancillary service if it is also passporting a core service. It cannot have a passport that only covers ancillary services.



paragraph 4.20, below). In that context, ESMA said that it considered factors such as the nature of the third country's legal framework for supervision, the supervisory objectives of the regulators involved, the process for a firm applying for authorisation, the role of ongoing monitoring of authorised firms and how rules are enforced under the third country's legal framework. It is likely that the assessment of the effectiveness of supervision and enforcement under the MiFID II TCR would involve looking at similar factors.

(3) *There is a cooperation agreement between ESMA and the firm's home regulatory authorities*

The cooperation agreement must meet the requirements in Article 47(2) of MiFIR.<sup>78</sup>

(4) *Jurisdiction of an EU court*

Although it does not express it to be a "condition" of registration, as such, Article 46(6) of MiFIR requires that a third country firm must offer to submit disputes to the jurisdiction of a court or arbitral tribunal in a Member State.

This is an unusual requirement and does not appear in any of the other TCRs. It appears to mean that a third country firm cannot have disputes resolved by the courts of its home state but must offer to submit to the jurisdiction of the courts in an EU Member State.<sup>79</sup> In practice, that is most likely to mean the home courts of the EU counterparty with whom the third country firm is contracting.

It is not clear exactly how this rule will apply. For example, will it only be necessary for the third country to offer to submit to the jurisdiction of the court, with the EU counterparty being able to waive that offer and agree to the jurisdiction of the courts of the third country? Or does it mean, in effect, that the third country will have to submit to the jurisdiction of an EU Member State, regardless of what the parties to the contract might prefer? Where the parties are both wholesale firms, it would be surprising if they were not given the freedom to choose the jurisdiction, but the position is unclear.

The requirement in Article 46(6) applies only to the question of where disputes are resolved; it does not require that the contract be governed by the law of any particular country. Legally, it is possible to have a contract which is governed by the law of one country and subject to dispute resolution in the courts of another country, but this is cumbersome and impractical. The effect of the Article 46(6) restriction may be that third country firms end up not only submitting the jurisdiction of a court in any EU Member State but also allowing the contract to be governed by the law of that state.

<sup>78</sup> Article 47(2) of MiFIR requires that the cooperation agreement must 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 non-EU firms authorised in third countries that is request 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 infringes the conditions of its authorisation or other law to which it is obliged to adhere; and
- (c) the procedures concerning the co-ordination of supervisory activities including, where appropriate, on-site inspections.

<sup>79</sup> The rule also applies to arbitral tribunals, as well to courts, so it is not possible to circumvent the rule by going to arbitration instead. (It is conceivable that firms could appoint an arbitral body in an EU Member State which then calls upon experts from the English legal system to act as arbitrators, but this would be a cumbersome way to avoid the application of the rule.)

This requirement may act as a potential inhibitor to UK investment firms and credit institutions wishing to do business with EU customers and counterparties.

(ii) *Establishing a branch*

Under the MiFID II TCR, a third country firm will not have a right to establish a branch in a Member State. Member States will have discretion whether to allow third country firms to establish branches. If a Member State does allow a third country firm to establish a branch, however, the MiFID II regime will apply and the Member State will have to follow the criteria laid down in MiFID II when considering the application.

The criteria under the MiFID II TCR are that:

- (1) the third country firm is authorised in its home jurisdiction;
- (2) the firm itself has sufficient initial capital, has responsible persons to manage the branch and belongs to an investor compensation scheme which is recognised under the Investor Compensation Directive;<sup>80</sup>
- (3) the regulator in the third country has regard to anti-money laundering and counter-terrorist financing requirements and the third country complies with international standards on the exchange of information; and
- (4) there is a cooperation agreement between the EU regulator (ESMA) and the firm's regulator.

(The term "equivalence" is not used in the legislation.)

The Member State regulator to whom the application is made must also ensure that the third country firm complies with certain specific rules under MiFID II. Those rules include the main obligations that would apply to firms passporting under MiFID II, such as those relating to order execution, suitability, transparency and conflicts of interest.

Where a UK investment firm or credit institution currently has a branch in another Member State, it is already likely to be in compliance with most of the requirements under the TCR. However, it will be necessary for the UK authorities to enter into appropriate cooperation agreements in order to make the TCR available to that firm.

*Passporting by the branch*

Where a third country firm has satisfied the relevant criteria and established a branch in a Member State, MiFID II will provide a mechanism for that branch to itself provide cross-border services within the EU. The branch will be able to provide investment services to wholesale clients in other Member States without the need to establish new branches in those Member States. In theory, therefore, a third country firm could (with the consent of the French regulator) establish a branch in France and then provide services to wholesale clients from that branch into Germany without the need to establish a separate German branch.

On that basis, if one Member State was willing to allow a UK firm to establish a branch, that Member State could be used as the basis to provide services across the whole of

<sup>80</sup> Directive 97/9/EC.

the EU, even if other Member States would not themselves have approved a branch. In practice, this may not make a significant difference, since the third country firm may be able to provide cross-border services from its home territory under the TCR for cross-border services anyway (see above). It may be operationally simpler for the firm, however, if its branches can provide cross-border services too.

(d) **Other comments**

(i) *Protection against additional restrictions*

MiFIR provides that where a third country firm is registered with ESMA, Member States must not impose any additional requirements on the third country firm in respect of matters covered by MiFIR or the MiFID II Directive.<sup>81</sup> This means that individual Member States will not be able to impose any additional restrictions in respect of third country firms.

This is potentially helpful for third country firms seeking to rely on the MiFID II TCR. A third country firm that has been registered under the TCR can expect to be treated consistently across the EU.

(ii) *Access can be permitted outside the TCR*

MiFIR provides that a Member State may allow a third country firm to provide investment services and activities to eligible counterparties and professional clients in its territory even where no equivalence decision has been made, or such a decision is no longer in effect.<sup>82</sup> This means that it would be open to the UK to agree bilaterally with Member States that UK firms can still secure access to wholesale customers in those states.

This approach would potentially be helpful as the conditions of the TCR would not apply – and so it would not be necessary, for example, for the UK firm to submit to the jurisdiction of a foreign court. On the other hand, there would be nothing in that situation to prevent the other Member State imposing additional requirements of its own choosing as a condition of allowing UK firms access to its markets.

This approach would only work if the UK had not applied to ESMA for recognition or it had been rejected or had its status withdrawn. If it is not possible for the UK to achieve equivalence, the UK Government could seek to agree favourable terms with individual Member States instead. (Any terms that the UK may agree would be subject to the restriction that the Member State could not agree to treat UK firms more favourably than it would have to treat firms from elsewhere in the EU.)

(iii) *Access to EU regulated markets*

Article 36 of the MiFID II Directive states that Member States must provide in their local law that investment firms and credit institutions in other Member States with appropriate dealing authorisations have access to or the right to membership of regulated markets in their territory.<sup>83</sup> Similarly, Article 37 of the MiFID II Directive requires that such firms have the right of direct and indirect access to CCPs and clearing and settlement systems.

<sup>81</sup> Article 46 of MiFIR. The Member State cannot, however, treat the third country firm more favourably than an EU firm passporting under MiFID.

<sup>82</sup> Article 46 of MiFIR.

There is no provision requiring such access to be given to third country firms. This may mean that it will become more difficult for such firms to access/become members of EU regulated markets and to access CCPs and clearing and settlement systems.

Article 48(7) of the MiFID II Directive will require trading venues that permit direct electronic access to their systems to ensure that members or participants are only permitted to provide such services if they are investment firms or credit institutions authorised under MiFID II. If the UK was relying on TCRs, this would effectively prevent UK firms from having direct electronic access. (As discussed in paragraph 3.21, it is not clear whether this provision is excluding third country firms deliberately or whether this is a drafting oversight.)

(iv) *Equivalence under EMIR*

EMIR imposes obligations on investment firms and credit institutions that wish to enter into certain classes of derivatives contracts. Firms are required, for example, to clear certain OTC contracts on a CCP which has been authorised in a Member State or is from a third country and has been recognised by the Commission.<sup>84</sup> They are also required to report on transactions, comply with risk mitigation obligations and to observe position limits.

Article 13 of EMIR sets out a mechanism under which the Commission can determine that the legal, supervisory and enforcement arrangements of a third country:

- (1) are equivalent to the EMIR requirements mentioned above;
- (2) ensure protection of professional secrecy that is equivalent to that set out under EMIR; and
- (3) are being effectively applied and enforced in an equitable and non-distortive manner so as to ensure effective supervision and enforcement in that third country.

Firms from third countries that have been determined to be equivalent will be deemed to have satisfied the requirements under EMIR.

If the UK is not determined to be equivalent, UK investment firms and credit institutions could find themselves having to comply with EMIR requirements in addition to any requirements they may be subject to under the relevant regime in the UK.

Equivalence under Article 13 of EMIR can also be relevant to EU groups with UK group companies. For example, there are exemptions from some of the EMIR requirements for intra-group transactions, but where one of the counterparties is established in a third country the transaction will only be regarded as being intra-group if the third country in question has been the subject of an equivalence determination under Article 13. If the third country was not equivalent, the intra-group transactions would be subject to further requirements – such as an obligation to provide additional margin. This could

<sup>83</sup> Other forms of exchange, such as MTFs and OTFs, are likely to amount to investment firms and will have passporting rights. The exchanges would therefore be entitled under MiFID II to provide investment services to other EU firms.

<sup>84</sup> Recognition would take place under the procedure for recognising third country CCPs in Article 25 of EMIR; see paragraph 4.20 for further information.

potentially have a significant impact on liquidity for the EU group, as well as raising operational challenges.

We are not aware that any equivalence decisions have yet been undertaken under Article 13 of EMIR. In addition, the mechanism for determining equivalence is vague. Unlike the TCR under EMIR for CCPs, where the trigger for the equivalence process is the application being made by a CCP, there is no trigger under Article 13. It appears that the Commission has to act on its own initiative. If the UK requires a determination of equivalence under Article 13 to apply after Brexit, it will need to take steps to ensure that the process is put into operation.

(v) *Outsourcing of portfolio management*

EU firms within the scope of MiFID are subject to a limitation on their ability to outsource portfolio management to third country firms. See paragraph 4.15 below for details.

## 4.12

### Investment services (retail business)

(a) **What are the activities in this category?**

This category covers investment services under MiFID which are provided by an investment firm or credit institution. The list of services in paragraph 4.11 above also applies here.

This section of the report considers firms that deal with customers who are not eligible counterparties or per se professional clients. Into that category would come all retail clients and also any clients who would have qualified as retail clients but have been “opted up” to be treated as professional clients. Any client who is an individual person will be in this category.

(b) **Is passporting available in relation to these activities?**

Yes. Investment firms and credit institutions can passport under MiFID to carry on these activities<sup>85</sup> either by establishing a branch in another Member State or providing services into another Member State on a cross-border basis.

(c) **Are the activities covered by TCR or is this a gap area?**

There will be a TCR under MiFID II, but Member States have discretion whether to allow third country firms to have access. The position is different for firms wishing to establish branches and firms wishing to provide cross-border services without establishing a branch:

(i) *Establishing a branch*

There will be a TCR for the establishment of branches, which is considered in more detail in paragraph 4.11 above.

Member States will have the option of whether to allow third country firms to establish branches in their territory, but if they decide to permit the establishment of a branch, they will have to apply the MiFID II criteria in considering the application.

<sup>85</sup> A firm can only passport an ancillary service if it is also passporting a core service. It cannot have a passport that only covers ancillary services.

If a Member State does allow a branch to be established, that branch may be permitted to provide services to retail clients and elective professional clients (as well as to eligible counterparties and per se professional clients). The question of exactly which types of client could be serviced from the branch would be at the discretion of the individual Member State.

One way in which the MiFID II TCR for branches will differ between wholesale clients and retail clients is that the arrangement under which a third country firm's branch in one Member State can provide services into another Member State (see paragraph 4.11(c) above) does not apply in relation to retail clients. A third country firm seeking to use the MiFID II TCR in relation to retail clients would have to set up branches in each Member State separately.

(ii) *Providing services on a cross-border services basis only*

There will be no TCR under MiFID II in relation to cross-border services for retail clients.

There will be a TCR for cross-border services under MiFID II, but it will only apply to eligible counterparties and per se professional clients; it will not apply to retail clients or elective professional clients.

(MiFID II will permit Member States to allow access to third country firms outside the TCR, however, so it would be open to the UK to try and agree access with individual Member States; see paragraph 4.11(d)(ii) for the issues relating to this.)

## 4.13 Data reporting services (APAs, ARMs, CTPs)

(a) **What are the activities in this category?**

This category will cover the provision of a "data reporting service", as defined in the MiFID II Directive.

Under MiFID II, a data reporting service is provided where a firm operates:

- (i) an approved publications arrangement (APA);
- (ii) an approved reporting mechanism (ARM); or
- (iii) a consolidated tape provider (CTP).

Firms providing these services are collectively referred to as data reporting services providers (DRSPs).

The services in this category are not currently regulated in the UK. They will become regulated activities once MiFID II comes into effect (on 3 January 2018).

(b) **Is passporting available in relation to these activities?**

No. There is currently no passporting regime for these activities.

MiFID II will not provide a formal passporting regime for data reporting services when it comes into effect. However, it will allow a DRSP authorised in a Member State to provide services into any other Member State of the EU – which means, in effect, that it does not need to have a passport in order to be able to provide cross-border services within the EU.

**(c) Are the activities covered by TCR or is this a gap area?**

There is no TCR currently available.

The MiFID II TCR which will apply to firms providing investment services or performing investment activities (with either wholesale or retail clients) will not extend to DRSPs.

**4.14****Investment funds and their managers****(a) What are the activities in this category?**

This section covers:

- (i) the marketing of investment funds; and
- (ii) the provision of management services by fund management companies in relation to investment funds.

The service of providing segregated portfolio management to clients is considered separately in paragraph 4.15 below. This section considers only investment funds and their management companies.

**(b) Is passporting available in relation to these activities?**

There are two main categories of investment fund and the availability of passporting depends on their categorisation.

The two main categories of investment fund are:

**(i) UCITS funds**

UCITS funds are funds which comply with the requirements of the UCITS Directive. The UCITS Directive contains common standards for funds which are intended to be sold to retail clients – so that each UCITS fund is, for example, required to comply with certain investment restrictions and meet certain liquidity standards.

UCITS funds have extensive EU-wide passporting rights. Once a passport has been obtained, UCITS funds can be sold to investors (including retail investors) in any Member State.

In addition, the manager of a UCITS fund can obtain a passport to allow it to provide management services in relation to a UCITS fund established in any Member State.

**(ii) AIFs**

Almost all investment funds that are not UCITS funds are “alternative investment funds” or AIFs.<sup>86</sup>

The relevant EU legislation for AIFs and their managers (who are known as AIFMs) is the AIFMD.

<sup>86</sup> There is a relatively small additional category comprised of collective investment schemes that are not subject to either the UCITS Directive or AIFMD (e.g. where they are excluded from the scope of the AIFMD as a result of specific exemptions or transitional provisions). In the UK, such schemes are classified as “residual CISs”.

AIFMs whose aggregate AIF assets under management are below certain levels<sup>87</sup> (referred to as “sub-threshold” AIFMs) are not subject to AIFMD in full and the passports referred to below are not available to them. Marketing of sub-threshold AIFs is instead dependent on the availability of a national private placement regime (“NPPR”).<sup>88</sup>

In relation to AIFs, there is currently only a limited passport regime. An AIFM which has its registered office in a Member State (an “EU AIFM”) can obtain a passport which enables it to:

- (1) provide management services to an AIF in another Member State (e.g. a French AIFM could manage a Luxembourg AIF); or
- (2) to market an EU AIF<sup>89</sup> to “professional investors” based in another Member State.

There is, however, currently no passport when a non-EU element is involved (i.e. where AIFM is not an EU AIFM or where the fund is a not an EU AIF). Where there is a non-EU element, the fund can only be marketed under NPPRs and only in those Member States that have opted to make an NPPR available.

The AIFMD does include provisions relating to NPPRs, which set out the minimum criteria that must be applied for marketing to be permitted.<sup>90</sup> However, it is open to a Member State to apply more stringent criteria, or to prohibit marketing altogether.<sup>91</sup>

There is also a sub-category of AIF known as a European Long Term Investment Fund (“ELTIF”). ELTIFs are a category of investment vehicle intended to encourage long-term investment in infrastructure, but have received limited distribution to date. Only EU AIFs managed by EU AIFMs are eligible to become authorised ELTIFs. Authorised ELTIFs benefit from access to an EU-wide passport that includes marketing to retail investors.<sup>92</sup>

#### (c) **Are the activities covered by TCR or is this a gap area?**

The position depends on the type of fund:

##### (i) *UCITS funds*

There is no TCR in relation to UCITS funds.

<sup>87</sup> An AIFM is sub-threshold where it is the designated AIFM for one or more AIFs with combined assets of less than: €100 million or €500 million (where the AIFs are not leveraged and investors are “locked in” to their investment for a minimum of five years following their initial investment).

<sup>88</sup> There are exceptions for European venture capital funds (“EuVECA”) and European social enterprise funds (“EuSEFs”), which are special categories of fund focussing on certain sectors. Subject to compliance with certain rules, EuVECA and EuSEFs benefit from EU-wide marketing passports. Only the EU domiciled funds of EU domiciled managers are able to qualify as EuVECA or EuSEFs. TCRs are accordingly not relevant to them.

<sup>89</sup> An “EU AIF” is an AIF which is authorised or registered in a Member State under the applicable national law or (if it is not so authorised or registered) has its registered office and/or head office in a Member State.

<sup>90</sup> These conditions include, broadly, that the AIFM will comply with certain specific provisions of the AIFMD, that there are appropriate cooperation agreements in place with (amongst others) the Member State in which the AIFM wishes to market the fund, and that the third country is not listed as a non-cooperative country and territory by the FATF.

<sup>91</sup> The approach of Member States to NPPRs varies considerably. Some states, such as the UK, Ireland, the Netherlands and Luxembourg have adopted NPPRs that are close to the AIFMD minimum standards. Other Member States such as Germany and Denmark, have imposed requirements that go beyond the minimum required by AIFMD, for example by imposing a “depository-lite” requirement on non-EU AIFMs (i.e. requiring a non-EU AIFM to appoint an entity to perform custody and oversight functions in relation to each AIF marketed in the EU). Certain other Member States, such as France and Italy, apply NPPRs that are highly restrictive or prohibitive.

<sup>92</sup> Article 3(2) of the ELTIF Regulation.



The intention underlying the EU's legislation on UCITS was to create a class of open-ended investment funds that could benefit from authorisation in a single Member State to be marketed into all of the Member States. The UCITS fund was designed to be an EU-only concept, and as a result the UCITS fund itself, its management company (if any) and its depositary must be authorised in EU Member States.<sup>93</sup>

There is no TCR for UCITS managers, so UK UCITS funds would have to relocate (or cease being categorised as UCITS funds – see below) and UK UCITS managers would have to cease managing UCITS funds.

For relocation, the UCITS fund would need to be redomiciled in a Member State and self-managed or managed by an EU management company. Its depositary would also need to be changed to a depositary in the home Member State of the fund.<sup>94</sup>

If the UCITS fund failed to make these changes, it would no longer qualify as a UCITS and would lose its passport to market to retail investors in the EU. The fund would, therefore, by default be a non-EU AIF with a non-EU AIFM. Any marketing into the EU could only be carried out using any applicable NPPR under the local law of the relevant jurisdiction (at least, until the “non-EU AIFM passport” comes into effect, as considered in paragraph (ii) below). Private placement regimes significantly curtail the marketing of funds to retail clients and contain restrictions on marketing to non-retail investors. In addition, EU distributors may be hesitant to engage in the active promotion of funds which can only be sold on a private placement basis.

(ii) **AIFs**

There is currently no TCR for AIFs, but it is intended that one will come into effect in the future.

The AIFMD creates a framework for a “passport” for non-EU AIFMs (and for EU AIFMs when managing non-EU AIFs) to market their funds to professional investors in the EU.<sup>95</sup> This arrangement is known as the “non-EU AIFM passport” (although it is not really a passport and should be better understood as being a form of TCR). Although the framework for the non-EU AIFM passport is contained in the AIFMD, the necessary steps have not yet been taken to implement the passport.

When the non-EU AIFM passport comes into effect, the key elements will include the following:

- (1) It will be capable of being used to market the AIF to “professional investors” only.<sup>96</sup> It will not be available to firms seeking to market to retail clients. This is the same as for the passport that is currently available under the AIFMD.

<sup>93</sup> Article 5 of the UCITS Directive. The UCITS fund and its depositary must be authorised in the same Member State.

<sup>94</sup> Article 23(1) of the UCITS Directive.

<sup>95</sup> See Articles 35, 39 and 40 of the AIFMD.

<sup>96</sup> “Professional investor” is defined in Article 4(1)(ag) of the AIFMD as an investor which is considered to be a professional client or may, on request, be treated as a professional client within the meaning given in the MiFID Directive.

- (2) The AIFM will have to identify its “Member State of reference” (broadly, the location where its marketing activities will be focused).<sup>97</sup>
- (3) The AIFM will have to seek prior authorisation from the authorities in the Member State of reference. Authorisation will not be granted unless certain conditions are met (in addition to the requirements applicable for the authorisation of an AIFM generally). Amongst other things, the applicant AIFM will have to provide a proposed marketing strategy and appoint a legal representative in the Member State of reference, to act as the contact in that state and to fulfil the compliance function.
- (4) There are various requirements regarding the relationship between the third country and the Member State of reference and/or other EU authorities. In particular:
- there must be cooperation agreements in place between the authorities in the third country, the Member State of reference and the home Member State of the AIF (if applicable) and also an agreement between the third country and the Member State of reference for the exchange of tax information; and
  - the third country’s laws and regulations must not prevent effective supervision by the competent authorities.<sup>98</sup> This assessment is made by ESMA.

In summary, the steps that would need to be taken by a non-EU AIFM to be able to access the passport are quite onerous and involve full compliance with the AIFMD regime. Nevertheless, it may be that non-EU AIFMs will ultimately be compelled to do this, because it is the stated intention of the EU authorities to remove the ability of non-EU AIFMs to rely on the NPPRs in due course.<sup>99</sup> Once the “non-EU AIFM passport” regime has come into effect, the NPPRs will be phased out and non-EU AIFMs (or EU AIFMs in respect of non-EU AIFs) will only be able to access the EU markets via the passport.<sup>100</sup>

There is no TCR for ELTIFs, EuVECA or EuSEFs or the managers of any of these types of fund.

#### (d) Other comments

##### (i) Delegation

It is possible for the managers of both AIFs and UCITS funds to delegate certain functions to third parties, but this may be subject to restrictions.

AIFs and UCITS funds may delegate investment management responsibilities to a non-EU portfolio manager, provided that the AIFM or UCITS management company notifies its home state regulators in advance of the delegation and ensures that the delegate meets certain requirements, including that:

<sup>97</sup> The criteria for determining the Member State of reference are quite detailed and are set out in Article 37(4) of the AIFMD.

<sup>98</sup> Article 37(7) of the AIFMD.

<sup>99</sup> Article 68(6) of the AIFMD.

<sup>100</sup> The AIFMD anticipates the NPPRs being phased out 3 years after the non-EU passport is available (Article 68 of the AIFMD), but this is subject to further legislation which may or may not be forthcoming.

- (1) the delegate must be authorised or registered for the purposes of asset management and subject to supervision.<sup>101</sup> For AIFMs, where that condition cannot be met, the delegation may still be possible, but only with the prior approval of the AIFM's home state regulator; and
- (2) cooperation between the competent authorities of the home Member State of the AIFM or UCITS manager and the supervisory authority of the delegate must be ensured.<sup>102</sup> For AIFMs, this must be by a written agreement between the respective regulators that addresses a specified list of matters including access to information, documents and premises and communication and cooperation in relation to regulatory breaches and enforcement.<sup>103</sup>

The delegation must also not prevent the effectiveness of supervision of the manager or prevent it from acting in the best interests of investors,<sup>104</sup> and it must be possible to withdraw the delegation with immediate effect where this is in the interests of investors.

For both AIFs and UCITS, the ability of the manager to delegate is subject to an overarching requirement that the manager must not delegate to the extent that it becomes a "letter-box".<sup>105</sup>

#### (ii) *Investments by UCITS funds*

There is an indirect TCR in relation to UCITS funds.

A UCITS fund is also subject to restrictions regarding what it can be invested in.<sup>106</sup>

In particular:

- (1) in order for a UCITS fund to invest in a third country fund: (i) the third country fund must be subject to supervision considered by the competent authorities of the UCITS fund's home Member State to be equivalent to that laid down in EU law; and (ii) cooperation between authorities is sufficiently ensured;<sup>107</sup>
- (2) a UCITS fund can only invest in a security which is listed on an exchange or traded on a regulated market in a third country if the choice of exchange or market has been approved by the competent authorities in the EU or is provided for in law or the fund rules or the instruments of incorporation of the UCITS fund; and
- (3) a UCITS funds cannot invest more than 30% of its total assets into non-UCITS funds.

#### (iii) *Progress with the non-EU AIFM passport*

Although AIFMD was implemented in July 2013, the non-EU AIFM passport has not yet come into effect and the EU authorities have not yet confirmed which third country jurisdictions will be eligible.

<sup>101</sup> Article 13(1)(i) of the UCITS Directive and Article 20(1)(c) of the AIFMD.

<sup>102</sup> Article 13(1)(d) of the UCITS Directive and Article 20(1)(d) of the AIFMD.

<sup>103</sup> Article 78(3) of the AIFMD Level 2 Regulation.

<sup>104</sup> Article 13(1)(g) of the UCITS Directive and Article 20(1)(f) of the AIFMD.

<sup>105</sup> Article 13(2) of the UCITS Directive and Article 20(7) of the AIFMD.

<sup>106</sup> Article 50 of the UCITS Directive.

<sup>107</sup> In addition, the decision about whether the supervision is equivalent rests with the competent authority of the Member State in which the UCITS is established, allowing for variation of approaches between Member States.

ESMA is required to provide advice on the non-EU AIFM passport (including the marketing of non-EU AIFs by EU AIFMs). When ESMA considers that there are “no significant obstacles” regarding investor protection, market disruption, competition and the monitoring of systemic risk, it will issue positive advice regarding the extension of the passport to non-EU AIFMs and AIFs:

- (1) ESMA published its initial advice on the non-EU AIFM passport in July 2015. It carried out a country-by-country assessment in relation to six jurisdictions (Guernsey, Hong Kong, Jersey, Singapore, Switzerland and the USA) and found that there were no obstacles to extending the regime to Guernsey or Jersey. It also found that the regime could be extended to Switzerland once certain amendments had been made to the Swiss financial services law relating to cooperation between regulators.<sup>108</sup> ESMA did not reach a definitive view on the other three jurisdictions due to concerns related to competition, regulatory issues and a lack of sufficient evidence.
- (2) ESMA issued its second advice on the non-EU AIFM passport in September 2016 in relation to 12 jurisdictions: Australia, Bermuda, Canada, Cayman Islands, Guernsey, Hong Kong, Japan, Jersey, Isle of Man, Singapore, Switzerland and the USA. ESMA found that there were no significant obstacles impeding the application of the AIFMD passport to Canada, Guernsey, Japan, Jersey and Switzerland. In the case of Switzerland, this followed an amendment to Swiss law to address the issue raised by ESMA in its previous advice. ESMA was also generally positive with regard to Hong Kong and Singapore but found that these jurisdictions allowed retail investors to invest in UCITS from only five of the EU’s Member States. Although the access of professional investors to AIFs was unaffected, this was noted as a potential obstacle to competition.

See case study 2 in section 5 below, which relates to an application for a non-EU AIFM passport by Jersey.

ESMA’s advice is now being considered by the Commission, the European Parliament and the Council.

ESMA was required to provide its advice on the extension of the AIFMD passporting regime to non-EU AIFMs and AIFs by 22 July 2015 (which ESMA did achieve – see above).<sup>109</sup> The Commission is required to adopt the delegated act extending the passporting regime to non-EU jurisdictions within three months of having received positive advice from ESMA, together with an opinion on the application of the AIFMD passporting regime in relation to EU AIFMs and the functioning of national private placement regimes.<sup>110</sup>

However, despite ESMA’s positive advice in respect of certain third countries, the Commission has not yet adopted the delegated act that would activate the AIFMD in respect of non-EU AIFMs or AIFs. ESMA’s initial advice in July 2015 suggested that the Commission should consider waiting until ESMA had delivered positive advice on a

<sup>108</sup> In particular, ESMA was concerned that Swiss law allowed a client to challenge the right of the Swiss regulator to transfer client information to regulators outside Switzerland.

<sup>109</sup> Article 67(1) of the AIFMD.

<sup>110</sup> Article 67(6) of the AIFMD.

sufficient number of non-EU countries. The Commission concurred, saying in December 2015 that it would only take a decision on whether to adopt the delegated act after “sufficient numbers have been appropriately assessed” by ESMA. To date, there has been no indication of when the non-EU AIFM passport will become effective.

For the non-EU AIFM passport to become effective, the European Parliament, the Council and the Commission would have to agree to activate the relevant provision of the AIFMD through a delegated act.

In addition, ESMA has agreed a number of cooperation agreements with non-EU regulators. These are a pre-requisite for funds to be marketed under NPPRs (see paragraph 4.14(c)(ii)(4) above). ESMA has negotiated a total of 38 cooperation agreements in the form of MoUs with third country regulators. The MoUs are bilateral agreements that must be signed between each EU national competent authority and the relevant third country authority. The national competent authority may choose the third country authorities with which it will sign an MoU in the form negotiated by ESMA.

## 4.15 Portfolio managers

### (a) What are the activities in this category?

This section covers portfolio managers – i.e. firms which provide segregated portfolio management and associated services to clients (both retail and wholesale). In relation to investment funds and their management companies, please see paragraph 4.14 above.

The main activities that a portfolio manager is likely to be carrying out are as follows:

- (i) portfolio management;
- (ii) execution of orders on behalf of clients; and
- (iii) the making of a personal recommendation (which portfolio managers often provide to clients in addition to making discretionary portfolio management decisions on their behalf).

Each of the above activities is within the scope of MiFID (and will be within the scope of MiFID II). The analysis set out in paragraph 4.11 above therefore applies in relation to all of these activities.

MiFID also provides that certain ancillary services are within the scope of the Directive, but only if the firm in question provides a core investment service as well as the ancillary service. Those ancillary services include the provision of custody services. See paragraph 4.11 above for further information.

### (b) Is passporting available in relation to these activities?

Yes. Investment firms and credit institutions can passport under MiFID to carry on these activities<sup>111</sup> either by establishing a branch in another Member State or providing services into another Member State on a cross-border basis.

<sup>111</sup> The investment service can only passport an ancillary service if it is also passporting a core service. It cannot have a passport that only covers ancillary services.

**(c) Are the activities covered by TCR or is this a gap area?**

MiFID II introduces a TCR for investment firms and credit institutions, which will potentially be available to portfolio managers.

The full details of the TCR are set out in paragraphs 4.11 (for wholesale business) and 4.12 (for retail business), but in summary the position will be as follows:

- (i) If the third country firm wishes to provide portfolio management services to wholesale customers<sup>112</sup> in the EU on a cross-border basis (i.e. without establishing a branch), the TCR will permit it to do so if:
  - (1) the Commission confirms that the third country has an equivalent legal and supervisory regime;
  - (2) the third country firm is authorised to provide the relevant services in the jurisdiction of its head office and is subject to effective supervision and enforcement in that jurisdiction;
  - (3) there is a cooperation agreement between ESMA and the firm's home regulatory authorities; and
  - (4) the third country firm offers to submit disputes to the jurisdiction of a court or arbitral tribunal in a Member State.

These provisions will only apply in relation to wholesale business. There will be no right to provide services on a cross-border basis to retail clients.

- (ii) Under the MiFID II TCR, a third country firm will not have a right to establish a branch in a Member State. Member States will have discretion whether to allow third country firms to establish branches. If a Member State does allow a third country firm to establish a branch, however, the MiFID II regime will apply and so the Member State will have to follow the criteria laid down in MiFID II when considering the application. If the Member State allows a third country firm to establish a branch:
  - (1) that branch may be permitted to provide services to retail clients and elective professional clients (as well as to eligible counterparties and per se professional clients). The question of exactly which types of client could be serviced from the branch would be at the discretion of the individual Member State; and
  - (2) the branch itself will have passport-like rights which enable it to provide services into other Member States – but only for wholesale clients and not for retail clients. See paragraphs 4.11 and 4.12 above for further details.

**(d) Other comments****(i) Protection against additional restrictions**

MiFIR provides that where a third country firm is registered with ESMA, Member States must not impose any additional requirements on the third country firm in respect of matters covered by MiFIR or the MiFID II Directive.<sup>113</sup> This means that individual

<sup>112</sup> See paragraph 4.11 for an explanation of which customers are “wholesale customers” for these purposes.

<sup>113</sup> Article 46 of MiFIR.

Member States will not be able to impose any additional restrictions in respect of third country firms.

This is helpful for third country firms seeking to rely on the TCR. A third country firm that has been registered under the TCR can expect to be treated consistently across the EU.

(ii) ***Access can be permitted outside the TCR***

MiFIR provides that a Member State may allow a third country firm to provide investment services and activities to eligible counterparties and professional clients in its territory even where no equivalence decision has been made, or such a decision has been withdrawn. This means that it would be open to the UK to agree bilaterally with Member States that UK firms can still secure access to wholesale customers in those states.

This approach would potentially be helpful as the conditions of the TCR would not apply – and so it would not be necessary, for example, for the UK firm to submit to the jurisdiction of a foreign court. (On the other hand, there would be nothing in that situation to prevent the other Member State imposing other requirements of its own choosing as a condition of allowing UK firms access to its markets).

See paragraph 4.11 above for further information.

(iii) ***Outsourcing of portfolio management***

Portfolio managers within the scope of MiFID are currently subject to a limitation on their ability to outsource portfolio management to third country firms.<sup>114</sup> (This restriction will continue to apply under MiFID II).

The outsourcing of portfolio management to third country firms is only permitted where:

- (1) the third country firm is authorised in its home country to provide that service and is effectively supervised by a competent authority in that third country; and
- (2) there is a cooperation agreement between the EU firm's regulator and the regulator of the third country firm.

After Brexit, these requirements could affect any UK investment firms and credit institutions who currently provide portfolio management services on a delegated basis to investment firms and credit institutions in other Member States. If such firms are going to be able to provide such services after Brexit, the UK will need to comply with the above requirements.

## 4.16

### Insurers and reinsurers

(a) **What are the activities in this category?**

This category covers insurers and reinsurers. The same analysis applies to both general contracts of insurance and long term contracts of insurance.

For insurance intermediaries and distributors, see paragraph 4.17 below.

<sup>114</sup> Article 15 of the MiFID Implementing Directive (2006/73/EC).

**(b) Is passporting available in relation to these activities?**

EU insurers and reinsurers can passport under the Solvency II Directive, which entitles them to establish branches in other Member States or to enter into insurance contracts on a cross-border basis (i.e. without establishing a branch).

**(c) Are the activities covered by TCR or is this a gap area?**

Solvency II does not contain a general TCR giving rights of access to insurers. However, some provisions of Solvency II apply to third country firms seeking to do business in the EU.

Solvency II requires that an undertaking with a head office outside the EU must apply for authorisation if it wishes to carry on insurance business in the EU.<sup>115</sup> In this regard, there is a distinction between (i) carrying on insurance business in the EU and (ii) entering into contracts of insurance with EU policyholders and cedants from outside the EU. Solvency II requires authorisation for the former, but not the latter; for example, many UK groups currently have captive insurers based in Guernsey (i.e. outside the EU) which provide direct insurance to group members in the UK. This is on the basis that the third country insurer would not be regarded as carrying on insurance business in the EU Member State.

Solvency II requires that an insurer seeking authorisation to do insurance business in the EU must establish a branch in the territory of the Member State in which it is seeking authorisation.<sup>116</sup>

Where a third country insurer applies to a Member State to establish a branch, Solvency II sets out the minimum criteria that the Member State must apply. There is nothing in Solvency II that requires the Member State to grant authorisation to the third country insurer, or that prevents the Member State from imposing additional criteria.

The minimum requirements under the Solvency II regime are that the third country insurer:

- (i) is authorised in its home country for insurance business;
- (ii) establishes a branch in the territory of the Member State;
- (iii) sets up accounts and records in the place where the business is managed, designates a general representative for the branch and (where required) appoints a claims representative;
- (iv) meets Solvency II regulatory capital requirements in that Member State, calculated by reference to the business of the branch;
- (v) submits a scheme of operations (in relation to which there are detailed content requirements); and
- (vi) meets governance requirements from Chapter IV, Section 2 of Solvency II.<sup>117</sup>

In addition, Member States must require undertakings to establish adequate technical provisions to cover insurance and reinsurance obligations assumed in their territories

<sup>115</sup> This does not apply to firms who wish to do business which is exclusively reinsurance. However, Article 14 of the Solvency II Directive still requires authorisation for pure reinsurers where they carry on reinsurance business in the EU.

<sup>116</sup> Article 162(2)(b) of the Solvency II Directive.

<sup>117</sup> Article 162(2) of the Solvency II Directive.



(calculated in accordance with Solvency II) and value assets and liabilities and determine own funds in accordance with Solvency II.

The most noteworthy of these requirements is the requirement that the third country insurer meets the capital requirements in the relevant Member State. A third country insurer that wished to set up branches in more than one Member State would normally have to hold the full amount of capital (as required by Solvency II) in respect of the business of the branch in each Member State – although Solvency II does allow Member States to agree to the centralisation of capital requirements in a single Member State.<sup>118</sup> If the third country firm established a subsidiary in the EU and passported from the subsidiary, that subsidiary could hold the capital required for all EU business it undertook, including that undertaken via branches. This significantly reduces the attractiveness to third country firms of having a branch under the TCR regime.

#### *Pure reinsurers*

The Solvency II provisions on third country branches do not apply to pure reinsurers (i.e. reinsurers who only carry on reinsurance business and do not also carry on insurance business). This means that there is no TCR at all for pure reinsurers.

An EU Member State can allow a third country pure reinsurer to establish a branch (under the principles of direct authorisation) using a less onerous set of requirements than under the Solvency II TCR. However, Solvency II requires that a third country reinsurer is not given more favourable treatment than that given to EU reinsurers, so a third country pure reinsurer applying for direct authorisation of a branch can expect to be subject to at least the same criteria as an EU reinsurer.<sup>119</sup>

Member States are allowed to impose additional restrictions on a third country reinsurer. Reinsurance contracts with third country reinsurers must be treated in the same manner as reinsurance contracts concluded with EU reinsurers, provided that the third country's solvency regime is determined by the Commission to be "equivalent".<sup>120</sup> The criteria for determining equivalence are set out in Article 378 of the Solvency II Delegated Regulation.

This provision is treated differently in different Member States. For example, the German regulator recently announced that third country insurance and reinsurance undertakings must establish a German branch office if they wish to carry on insurance or reinsurance business in Germany. There is an exemption from this requirement, applying to undertakings that wish to carry on reinsurance business only in Germany: they may do so on a cross-border basis if they are based in a jurisdiction that the Commission has decided is equivalent.<sup>121</sup>

Other regulators in the EU have followed this approach and restrict cross-border reinsurance from non-equivalent jurisdictions. Others, such as the PRA in the UK, have not taken this approach and would allow reinsurers from non-equivalent third countries to reinsure UK-based undertakings on a cross-border basis.

<sup>118</sup> Article 167 of the Solvency II Directive.

<sup>119</sup> Article 174 of the Solvency II Directive.

<sup>120</sup> Article 172 of the Solvency II Directive.

<sup>121</sup> BaFin Conduct of reinsurance business in Germany by insurance undertakings situated in a third country (31 August 2016). In that regard, the list of equivalent regimes comprises only Bermuda, Switzerland and (temporarily) Japan.

**(d) Other issues**

While Solvency II does not contain a TCR in the sense of something that allows third country insurers and reinsurers to have guaranteed access to the EU market, it does contain provisions which relate to the treatment of third country firms and the corporate groups of which they are members.

In particular, Solvency II states that the Commission may deem the solvency regime of a third country to be equivalent for certain purposes, which may affect the position of third country firms. The relevant areas are:

**(i) *The treatment of reinsurance contracts***

Generally, the treatment of reinsurance contracts between an EU insurer and a third country reinsurer is a matter for the Member State in which the insurer is established. Under Solvency II, the EU insurer can also take regulatory credit when the reinsurer is a third country reinsurer and the Commission has assessed that the solvency regime of the third country is “equivalent” to that in the EU.<sup>122</sup>

If the Commission does not determine that the UK is equivalent after Brexit in accordance with the formal process laid down in the Solvency II Directive, Member States may place regulatory restrictions on the ability of insurers established in their jurisdiction to enter into reinsurance contracts with undertakings based in the UK.

**(ii) *The calculation of group solvency***

When calculating their solvency capital requirement, groups headquartered in the EU are required to consider the capital position for any subsidiary companies in the group. Where a subsidiary is itself subject to Solvency II, the Solvency II capital rules will apply. If the subsidiary is in a third country, generally Solvency II will require the group calculation to be done on the assumption that the Solvency II rules apply to the subsidiary.

If the subsidiary is in an “equivalent” jurisdiction, the group may apply to use the subsidiary’s local rules for their solvency capital requirements instead of having to apply the Solvency II standards.<sup>123</sup> In some cases, this might mean that the subsidiary has to hold less capital, but the main benefit is a practical one – namely that the subsidiary does not need to go to the trouble of recalculating its capital requirements using the Solvency II standards.

**(iii) *Group supervision***

Solvency II requires a group capital calculation at the level of the insurer’s top insurance holding company. Where the top insurance holding company is outside the EU, the general position is that the Solvency II rules have to be applied to the whole group.

However, where a Solvency II group is headquartered in an “equivalent” third country jurisdiction, EU regulators must rely on the assessment of prudential supervision

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<sup>122</sup> Recital 89 and Article 172 of the Solvency II Directive.

<sup>123</sup> Article 227 of the Solvency II Directive.

arrangements by the third country regulator.<sup>124</sup> This is particularly helpful for such groups, as it avoids them having to recalculate the capital for the whole group using the Solvency II standards.

## 4.17

### Insurance and reinsurance intermediaries/distributors

#### (a) What are the activities in this category?

This category covers “insurance distribution activities” that will be within the scope of the Insurance Distribution Directive (IDD). Specifically that will cover the activities of:

- (i) advising on contracts of insurance;
- (ii) proposing contracts of insurance;
- (iii) carrying out other work preparatory to the conclusion of contracts of insurance, of concluding such contracts; and/or
- (iv) assisting in the administration and performance of such contracts, in particular in the event of a claim.

These activities include “the provision of information concerning one or more insurance contracts in accordance with criteria selected by customers through a website or other media and the compilation of an insurance product ranking list, including price and product comparison, or a discount on the price of an insurance contract, when the customer is able to directly or indirectly conclude an insurance contract using a website or other media.”

The IDD is due to come into effect in February 2018. It will be a recast and amended version of Insurance Mediation Directive (IMD). The IMD currently allows passporting of “insurance mediation activities” (which has a similar scope to the “insurance distribution activities” referred to above) either through a branch or on a cross-border basis.

The same regime applies to reinsurance distribution activities, which covers the same scope of activities but in relation to reinsurance contracts.

#### (b) Is passporting available in relation to these activities?

The IMD currently allows passporting of “insurance mediation activities” (which has a similar scope to the “insurance distribution activities” referred to above) either through a branch or on a cross-border basis. The IMD will be replaced by the IDD in February 2018.

The IMD regime also contains an additional provision which allows EU insurance intermediaries to appoint tied agents in other Member States. Tied agents are separate legal entities in the relevant Member States who do not need to seek local authorisation because the insurance intermediary has agreed to accept responsibility for their actions. The tied agent is regarded as a branch of the insurance intermediary. The tied agent regime will continue to apply under the IDD.

<sup>124</sup> Article 260 of the Solvency II Directive.

**(c) Are the activities covered by TCR or is this a gap area?**

There is no TCR under either the current IMD or the new IDD.

The IDD states that it does not apply to third country firms except to the extent that equal treatment must be guaranteed to all persons engaged in insurance and reinsurance distribution in the EU. This means that if a third country firm did ask an individual Member State to allow it to provide insurance intermediation services in its jurisdiction, and the Member State was minded to do so, that Member State could not treat the third country firm more favourably than a firm passporting from another Member State under the IDD.

Tied agents of UK insurance intermediaries who operate in other Member States may also need to consider their position.

**4.18****Credit ratings agencies****(a) What are the activities in this category?**

This applies to the issuing of credit ratings by credit ratings agencies (CRAs).

**(b) Is passporting available in relation to these activities?**

Unlike most forms of regulated activity, acting as a CRA is not regulated at a Member State level but is regulated by ESMA, which acts as a central European regulator.

As a result, there is no formal passporting regime, but a CRA which has been established in the EU and registered by ESMA is permitted to issue credit ratings that may be used by financial services providers elsewhere in the EU.

EU financial services providers can only use credit ratings originating from outside the EU in limited circumstances (see below).

**(c) Are the activities covered by TCR or is this a gap area?**

There is no formal TCR, but there is a regime based on equivalence which applies in relation to credit ratings issued by third country CRAs and which is currently in force.

EU financial services providers cannot use credit ratings originating from a third country CRA unless one of two situations applies:

**(i) Endorsement**

EU registered CRAs may endorse a credit rating issued by a third country CRA. The EU CRA will be responsible for the production of the credit ratings.

The EU CRA may only endorse the credit rating from the third country CRA if certain conditions are fulfilled – including that:

- (1) the EU CRA has verified and is able to demonstrate on an ongoing basis to ESMA that the conduct of the credit rating activities by the third country CRA fulfils requirements which are “at least as stringent” as for EU CRAs;

- (2) there is an objective reason for the credit rating to be elaborated in a third country; and
- (3) the home country of the third country CRA must have a cooperation agreement in place with ESMA.

The EU CRA must also have approached ESMA in relation to its ability to endorse third country CRAs.

(ii) **Certification**

Credit ratings that are related to entities established or financial instruments issued in third countries and that are issued by a CRA established in a third country may be used in the EU without being “endorsed” by an EU CRA where certain conditions are satisfied. Instead, the third country CRA has to directly apply to ESMA for certification that it meets the conditions.

The conditions are as follows:

- (1) the CRA is authorised and supervised in the third country;
- (2) there has been an equivalence decision in relation to the third country;
- (3) a cooperation agreement must be in place; and
- (4) the credit ratings issued by the CRA and its credit rating activities must not be of “systemic importance” to the financial stability or integrity of the financial markets of one or more Member States.

As a result of these requirements, any third country CRA whose credit ratings activities might be of systemic importance would not be able to obtain certification. It would instead have to find an EU CRA that would be willing to endorse it under the procedure in (i) above.

It is likely that a UK CRA will need to make very significant adjustments when the UK leaves the EU. The CRA will immediately become a third country CRA and it would have to apply for certification and/or find an EU CRA that would be willing to endorse its credit ratings. In the latter case, this may mean in practice that the UK CRA will have to set up an affiliate in an EU Member State and apply for that affiliate to become a registered UK CRA.

(d) **Other comments**

(i) *The need to replace ESMA as the regulator for UK CRAs*

A UK CRA will face a practical challenge after Brexit, in that it will not immediately satisfy the requirement under the certification regime that it is authorised and supervised in its home country – because UK CRAs are currently regulated by ESMA at a European level and there is no direct regulation of these activities in the UK.

The jurisdiction of the PRA or FCA will need to be expanded to include credit rating activities (assuming that the UK Government would prefer not to leave CRAs unregulated).

(ii) *Experience of equivalence assessments made to date*

The Commission and ESMA have already assessed a number of third countries for equivalence under the CRA regime:

- (1) For the purposes of “certification”, the Commission has made equivalence decisions in respect of the following jurisdictions: Japan, Australia, Canada, the USA, Argentina, Brazil, Hong Kong, Mexico and Singapore.
- (2) For the purposes of “endorsement”, ESMA has assessed that all of those countries, together with South Africa, have a TCR that is “as stringent as” the EU regime.

In its advice in respect of Japan in 2010,<sup>125</sup> CESR (ESMA’s predecessor body) stated that its approach to assessing equivalence was “not to expect the EU regime to be adopted in an identical manner”. In CESR’s view, this was “clearly unrealistic and [did] not reflect the principle that the same outcome may be achieved through different means”. The advice also stated that “the priority should lie in assuring that users of ratings in the EU would benefit from equivalent protections in terms of CRA’s integrity, transparency, good governance and reliability of the credit rating agencies.” The question to be answered in assessing the equivalence of a TCR was whether its legal and supervisory framework achieved this objective.

Although this is apparently helpful, the application of Japan was one of the first to be considered and it took a little over six months to complete. Every subsequent application, however, has taken considerably longer (typically about three years) and so it is possible that ESMA is no longer taking such a broad approach.

**4.19****Operators of trading venues****(a) What are the activities in this category?**

This section covers firms that operate an exchange or provide trading platform services to customers. Operators of trading venues can be divided into two categories:

- (i) operators of regulated markets (such as the London Stock Exchange, the London Metal Exchange, ICAP and ICE Futures); and
- (ii) operators of multi-lateral trading facilities (“MTFs”) or organised trading facilities (“OTFs”). MTFs and OTFs are relatively new types of trading venue, which were created under MiFID I and MiFID II respectively.<sup>126</sup>

**(b) Is passporting available in relation to these activities?**

The position is slightly different for the two types of trading venue:

<sup>125</sup> [https://www.esma.europa.eu/sites/default/files/library/2015/11/10\\_333.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/10_333.pdf)

<sup>126</sup> Examples of MTFs include separate platforms operated by BATS and ICAP and Liquidnet Europe, as well as the Turquoise trading platform. OTFs will only be regulated once MiFID II comes into effect in January 2018, and so no OTF operator has yet been formally registered. It is anticipated that OTFs will provide services in relation to bonds, structured finance products, emission allowances and derivatives.

(i) *Regulated markets*

Regulated markets are regulated under MiFID and are authorised by their home state regulator. Regulated markets will also be regulated under MiFID II when it comes into force.

Regulated markets are subject to a “passport-like” regime. MiFID provides that Member States are required to allow regulated markets from other Member States to provide “appropriate arrangements on their territory” to facilitate access to and trading on the regulated market by remote members or participants established in their territory.<sup>127</sup> This means that regulated markets are entitled to expect that firms from anywhere in the EU will be able to access the regulated market. Although this is not a formal passporting regime for the purposes of MiFID, the UK has given regulated markets providing services into or out of the UK passporting rights under sections 312A to 312D of the FSMA.

(ii) *Operators of OTFs/MTFs*

The operator of an MTF is regarded as an investment firm under MiFID and it is able to passport under MiFID.

The same will be true of OTFs once MiFID II comes into effect.

(c) **Are the activities covered by TCR or is this a gap area?**

The position is different for the two types of trading venue:

(i) *Regulated markets*

There is no TCR for regulated markets generally.

Although regulated markets are authorised under MiFID, the TCR under the MiFID II Directive will only apply to firms which are credit institutions or investment firms and a regulated market is neither of those things.

Once the UK leaves the EU, any exchanges which are currently “regulated markets” will cease to have that status and will therefore lose the right of access to participants in EU Member States that they currently have. It would be possible after Brexit for individual Member States to create barriers which would prevent firms in those states from accessing the exchange in question. (See below, however, in relation to derivatives trading.)

(ii) *Operators of OTFs/MTFs*

Firms which operate MTFs or OTFs would potentially be able to rely on the TCR for wholesale firms under MiFID II – see paragraph 4.11. MTF and OTF operators are included within the definition of “investment firms” for the purposes of MiFID II and would in principle be able to access the EU as third country “investment firms”.<sup>128</sup>

***Restrictions on trading certain financial instruments outside the EU***

MiFIR will create obligations on EU firms to trade certain financial instruments only on particular types of trading venue. In each case, there is a TCR under which a third country trading venue can be recognised as one of the prescribed types of trading venue. In particular:

<sup>127</sup> This provision will be found in Article 53 of the MiFID II Directive, when it comes into effect.

<sup>128</sup> Article 4(1) of the MiFID II Directive.

(i) *Trading obligation in relation to shares*

Under Article 23 of MiFIR, an investment firm will be required to ensure the trades it undertakes in shares admitted to trading on a regulated market or traded on a trading venue take place on a regulated market, MTF or systematic internaliser, or a third country trading venue assessed as equivalent in accordance with Article 25(4)(a) of the MiFID II Directive.

(ii) *Derivatives which are subject to a clearing obligation*

Under Article 28 of MiFIR, undertakings which are established in the EU<sup>129</sup> will be required to conclude transactions in relation to certain classes of derivative<sup>130</sup> on one of the following: a regulated market, MTF, OTF or a third country trading venue which has been recognised as equivalent by the Commission under the procedure set out in Article 28(4).

A third country venue may be recognised if the legal and supervisory framework of the third country ensures that the trading venue complies with legally binding requirements which are equivalent to the requirements for the trading venues covered by MiFID II, and which are subject to effective supervision and enforcement in that third country.<sup>131</sup> The third country must also provide for an effective equivalent system for the recognition of trading venues authorised under MiFID II to admit to trading or trade derivatives declared subject to a trading obligation in that third country on a non-exclusive basis (i.e. there must be reciprocal rights of access).

Under Article 28(2) of MiFIR, the trading obligation also applies to classes of derivatives that have been declared subject to the trading obligation with third country financial institutions or other third country entities that would be subject to the trading obligation if they were established in the EU.

(There is currently a process under EMIR, under which trading venues in third countries may be recognised as being equivalent to an EU regulated market.)<sup>132</sup>

A UK trading venue will only be able to conclude transactions with EU counterparties in the financial instruments specified above if it can satisfy the relevant equivalence requirements. If it cannot, it will effectively be excluded from that market.

***Access to EU CCPs and EU benchmarks***

Under MiFID II, the operator of a regulated market, MTF or OTF from a third country will be entitled to request:

- (i) access to an EU CCP. In order to have access, the Commission would have to confirm that the regulatory framework for trading venues in that third country is equivalent to the EU's regime and includes reciprocal access to trading venues in that third country;<sup>133</sup> and

<sup>129</sup> This rule applies to non-regulated EU entities (so-called "non-financial counterparties") as well as regulated EU entities.

<sup>130</sup> The classes of derivative are those which have been declared under Article 32 of MiFIR to be subject to the trading obligation.

<sup>131</sup> Article 28(4) of MiFIR contains detailed provisions regarding when the legal and supervisory framework of a third country is considered to have equivalent effect. Please see the Summary of Legal Provisions Annex for details.

<sup>132</sup> On 16 December 2016, the Commission determined that trading venues in Australia, Canada, Japan and Singapore were considered equivalent for these purposes.

<sup>133</sup> Article 38(1) of MiFIR.



- (ii) a licence and access rights to EU benchmarks, provided that the Commission agrees that the third country offers reciprocal rights for access to licences and benchmarks in that third country.<sup>134</sup>

## 4.20

### Central counterparties

#### (a) What are the activities in this category?

This category covers firms that act as central counterparties (CCPs) in connection with the clearing of financial instruments traded on financial markets. A CCP interposes itself between the counterparties to the contracts traded on the financial markets, becoming the buyer to every seller and the seller to every buyer.

#### (b) Is passporting available in relation to these activities?

Where a CCP is authorised under EMIR, it is effective for the entire territory of the EU.<sup>135</sup> Consequently, a formal passporting regime is not necessary.

#### (c) Are the activities covered by TCR or is this a gap area?

There are two TCRs that are potentially relevant in relation to CCPs:

##### (i) *The EMIR TCR*

EMIR provides a TCR for third country CCPs. A third country CCP can apply for recognition under EMIR in order to offer services to clearing members in the EU.

For a third country CCP to be recognised, it must submit an application for recognition in accordance with Article 25(4) of EMIR and the relevant RTS. The third country CCP must satisfy the following requirements:

- (1) the Commission has determined that the CCP's jurisdiction has an equivalent regulatory regime and that it allows reciprocal arrangements to provide access for foreign CCPs;
- (2) the CCP is authorised in the third country and is subject to effective supervision and enforcement in that jurisdiction;
- (3) ESMA has entered into a cooperation agreement with the third country firm's regulator; and
- (4) the third country is considered as having equivalent anti-money laundering systems.<sup>136</sup>

The requirement to have equivalent anti-money laundering systems is unique to the TCR for CCPs (although it is likely that most equivalence-based assessments of the regulatory systems of third countries under other TCRs would, in practice, involve the consideration of this issue).

<sup>134</sup> Article 38(2) of MiFIR.

<sup>135</sup> Article 148 of EMIR.

<sup>136</sup> Article 25 of EMIR.

EU firms can use CCPs that have been recognised by ESMA to clear standardised OTC derivative trades, as required by EMIR. The CCPs remain subject to the regulation and supervision of their home jurisdictions.

Unlike the TCRs under AIFMD or MiFID II, the TCR for CCPs is already operational. Several jurisdictions have been determined to have equivalent regulatory regimes for CCPs under EMIR – namely Australia, Brazil, Canada, the Dubai International Financial Centre, Hong Kong, India, Japan, Japan Commodities, Mexico, Singapore, South Africa, South Korea, Switzerland and the USA.<sup>137</sup>

See section 5 below for a case study relating to the recognition process for third country CCPs.

(ii) **MiFID II TCR**

The TCR under EMIR is currently in effect. In addition, under MiFID II (which is due to come into effect in January 2018) the following provisions will apply:

(1) *Access to trading venues*

Under Article 38(1) of MiFIR, a CCP established in a third country may request access to a trading venue in the EU subject to that CCP being recognised under Article 25 of EMIR.

CCPs established in third countries will only be permitted to make use of the access rights in Article 36 of MiFIR if the Commission has adopted a decision in accordance with Article 38(3) that the legal and supervisory framework of the third country is considered to provide for an effective equivalent system for permitting CCPs and trading venues authorised under foreign regimes access to CCPs and trading venues established in that third country.<sup>138</sup>

(2) *Access to trade feeds*

Under Article 36 of MiFIR, EU CCPs will be allowed to have non-discriminatory access to trade feeds from trading venues. This access will also be granted to any third country CCPs that have been recognised by ESMA under EMIR. In that situation, the third country CCP would be required to make an application to the trading venue itself, and MiFIR contains provisions regarding the process and the bases on which the trading venue can deny access to the third country CCP.<sup>139</sup>

(3) *Access to EU benchmarks*

Under Article 37 of MiFIR, benchmark administrators will be required to grant non-discriminatory access to EU CCPs to their benchmarks. MiFIR also contains provisions granting access to any third country CCPs that have been recognised by ESMA under EMIR. Access can be granted if the third country CCP satisfies certain equivalence requirements under MiFIR, is subject to effective supervision and enforcement and

<sup>137</sup> <https://www.esma.europa.eu/regulation/post-trading/central-counterparties-ccps>

<sup>138</sup> Article 38(3) contains detailed provisions regarding when the legal and supervisory framework of a third country is considered to have an effective equivalent system. Please see the Summary of Legal Provisions Annex for details.

<sup>139</sup> Article 38(1) of MiFIR.

there are arrangements for reciprocal access.<sup>140</sup> These requirements are similar to those under EMIR (see further above), but the tests are different. In addition, the third country CCP would need to apply to the benchmark administrator itself for a licence to use the benchmark.

(d) **Other comments**

- (i) In determining the equivalence of the respective regulatory regimes for CCPs, the Commission specified in its mandate that ESMA should consider whether the legal, supervisory and enforcement arrangements of the third country were equivalent to the respective requirements in EMIR, ensured an equivalent protection of professional secrecy and were being applied in an equitable and non-distortive manner so as to ensure effective supervision and enforcement in that third country.
- (ii) An assessment of equivalence is required to be outcomes-based, meaning that the Commission's primary concern must be whether the outcomes achieved by the relevant supervisory regime match those under EMIR, rather than what procedures are followed.
- (iii) A further benefit of recognition under the EMIR TCR is that a third country CCP that has been recognised under EMIR will obtain qualifying CCP status across the EU under the Capital Requirements Regulation. This means that the exposures of EU credit institutions to the CCPs will be subject to a lower risk weighting in calculating their regulatory capital.
- (iv) There is a lack of clarity as to the situations in which third country CCPs can be sure that EU firms will have access to them. Article 8 of EMIR indicates that trading venues must provide non-discriminatory access to CCPs that are "authorised to clear OTC derivative contracts". While the TCR regime in EMIR permits third country CCPs that are "recognised" to provide services in the EU in relation to OTC derivative contracts (as set out above), it is not clear that CCPs that are "recognised" in this way would have this right in the same way as CCPs that are actually authorised under EMIR.
- (v) Article 35 of EMIR contains a restriction on outsourcing functions a third country where the data protection standards of that country are not equivalent to those in the EU. It is, however, open to the parties to agree in the terms of the outsourcing contract to apply EU standards.

## 4.21

### Central securities depositories

(a) **What are the activities in this category?**

This applies to services provided by central securities depositories (CSDs) – i.e. the operators of securities settlement systems.

Under the CSD Regulation, CSDs are able to perform a range of activities, including the operation of the securities settlement system itself and a range of associated and ancillary services. Some of these services (e.g. arranging for the settlement of securities) amount to regulated activities in the UK, whereas others (e.g. providing regulatory reporting) do not.

<sup>140</sup> Article 38(2) of MiFIR.

**(b) Is passporting available in relation to these activities?**

Yes. A CSD authorised in a Member State is able to provide services in other Member States, whether on a cross-border basis without a branch or by establishing a branch, provided that the services are covered by its authorisation.<sup>141</sup>

**(c) Are the activities covered by TCR or is this a gap area?**

Article 25 of the CSD Regulation will permit a third country CSD to provide CSD services into the EU – but the TCR is not yet in effect.<sup>142</sup>

Under the TCR, a third country CSD will need to be recognised by ESMA if it intends to provide certain specified services in relation to products constituted in the EU (in particular, initial recording of securities in a book-entry system and providing and maintaining accounts at the top tier level).

A third country CSD will need to apply to ESMA for recognition. In order to be granted recognition, the third country CSD will have to demonstrate that the following conditions have been satisfied:

- (i) the Commission has adopted an implementing act which determines that the third country's regulatory system is equivalent in certain key respects;
- (ii) the CSD is subject to effective authorisation, supervision and oversight (or if the system is operated by a central bank, oversight ensuring full compliance with applicable prudential requirements);
- (iii) there are cooperation arrangements between ESMA and the responsible authorities in the third country;<sup>143</sup> and
- (iv) if relevant, the CSD has taken necessary measures to allow users to comply with any applicable national law of a Member State in which it is providing CSD services.

In considering whether the conditions have been met, ESMA must consult the competent authorities of the Member States in which the third country CSD intends to provide CSD services, the relevant authorities<sup>144</sup> and the third country authorities responsible for supervising CSDs.

The Commission may adopt an equivalence decision to determine that:

- (i) the CSDs authorised in a third country are subject to legally binding requirements that are equivalent to the requirements in EMIR;
- (ii) those CSDs are subject effective supervision, oversight and enforcement; and
- (iii) the third country allows reciprocal access.

The Commission has not yet adopted any equivalence decisions in respect of third country CSDs since the CSD Regulation was implemented in September 2014.

<sup>141</sup> Article 23(1) of the CSD Regulation.

<sup>142</sup> The CSD Regulation became effective on 17 September 2014, but third country CSDs will only be able to apply for recognition within six months from the later of: (i) the date of entry into force of certain regulatory technical standards (which remain outstanding); and (ii) the adoption by the Commission of its equivalence decision. (Article 69(3) of the CSD Regulation.)

<sup>143</sup> Recital 34 and Article 25 of the CSD Regulation.

<sup>144</sup> As defined under Article 12, of the CSD Regulation. The definition includes central banks.

## 4.22

### Trade repositories

(a) **What are the activities in this category?**

This category covers trade repositories – i.e. firms that centrally collect and maintain the records of all derivatives transactions (whether OTC or exchange-traded).

Counterparties to a derivatives transaction are required to report the transaction to a trade repository that is recognised by ESMA.

(b) **Is passporting available in relation to these activities?**

No, but trade repositories have passport-like rights.

Under Article 55 of EMIR, where a trade repository is registered under EMIR, it is effective for the entire territory of the EU. Registration is with ESMA, rather than a national regulator in a Member State. Consequently, a formal passporting regime is not necessary.

(c) **Are the activities covered by TCR or is this a gap area?**

There is a TCR for trade repositories. Article 77 of EMIR provides that a third country repository can provide services in the EU if it is recognised by ESMA.

To be recognised, a third country trade repository needs to apply for recognition under Article 77 of EMIR. The third country trade repository must show that it is authorised and subject to effective supervision in a third country which has:

- (i) been recognised by the Commission as having an equivalent and enforceable regulatory and supervisory framework;
- (ii) entered into an international agreement with the EU regarding mutual access to, and exchange of information on, derivative contracts; and
- (iii) entered into cooperation arrangements to ensure that EU authorities, including ESMA, have immediate and continuous access to all necessary information.

There are also provisions of the Securities Financing Transactions Regulation that will potentially be relevant to third country trade repositories – see below.

(d) **Other comments**

(i) *The EMIR TCR*

The TCR for trade repositories has been in place since the implementation of EMIR in August 2012.

In 2012, the Commission gave a mandate to ESMA to provide technical advice in relation to the equivalence of various specified jurisdictions under EMIR.

ESMA provided technical advice on the equivalence of trade repositories in Australia, Singapore and the USA but it advised that only the Australian trade repositories were equivalent. ESMA acknowledged that the trade repositories authorised in Singapore and the USA are subject to effective supervision and enforcement but it said that there

were several areas where the rules applying in those jurisdictions are not equivalent. ESMA advised that only specific trade repositories that have adopted procedures and are subject to binding rules in these areas should be considered to be subject to equivalent requirements. In addition, ESMA found that US reporting requirements are not equivalent to the reporting obligation in Article 9 of EMIR.

At the date of this report, no third country repositories have been recognised by ESMA. Our understanding is that no third country repository has actually applied for recognition.

(ii) *Securities financing transactions*

Under the Securities Financing Transactions Regulation (**SFT Regulation**),<sup>145</sup> firms which engage in securities financing will be subject to obligations to report transactions to trade repositories. These obligations will commence in 2018.

The SFT Regulation provides that third country repositories will only be able to provide services to EU firms for the disclosure of transactions where the third country repository has been recognised by ESMA.<sup>146</sup> However, there remain some ambiguities about exactly what the criteria are (and in particular whether the operating organisation has to have a registered office in an EU Member State).

(iii) *The need to replace ESMA as the regulator for UK trade repositories*

A UK trade repository will face a practical challenge after Brexit, in that it will not immediately satisfy the requirement that it be subject to an equivalent and enforceable regulatory and supervisory framework – because UK trade repositories are currently regulated by ESMA at a European level and there is no direct regulation of these activities in the UK. The jurisdiction of the PRA or FCA will need to be expanded to include credit rating activities.

## 4.23

### Benchmark administrators

(a) **What are the activities in this category?**

This section applies to the activity of providing financial benchmarks.<sup>147</sup>

(b) **Is passporting available in relation to these activities?**

There is currently no formal passporting regime for entities that administer financial benchmarks.

Under the Benchmarks Regulation (which is due to come into effect on 1 January 2018), EU financial institutions will generally only be able to use a benchmark which has been produced by an administrator authorised in the EU and registered by ESMA.<sup>148</sup>

<sup>145</sup> Regulation (EU) 2015/2365

<sup>146</sup> Details of the criteria are included in Appendix 3.

<sup>147</sup> In the UK, it is a regulated activity to either (a) provide information in relation to a specified benchmark; or (b) administer a specified benchmark (Article 63O of the FSMA (Regulated Activities) Order 2001). This is a UK-only regime, and will be superseded by the EU-wide Benchmarks Regulation, which comes into effect on 1 January 2018. The UK regulators also currently expect that UK benchmark administrators will follow the relevant IOSCO principles. This approach is consistent with that taken by the US regulators.

**(c) Are the activities covered by TCR or is this a gap area?**

Once the Benchmarks Regulation comes into effect, benchmarks will only be able to be used in the EU if they are produced by an administrator authorised under the Benchmarks Regulation. However, the Benchmarks Regulation will permit benchmarks of a third country benchmark administrator to be used in certain circumstances.

A supervised EU entity will not be able to use a financial benchmark from a third country benchmark administrator unless:

- (i) the benchmark itself and the third country benchmark administrator have been registered by ESMA (**Registration**). There is a detailed set of conditions which will have to be fulfilled, including that the Commission has adopted an equivalence decision in relation to the third country;
- (ii) if the Commission has not yet reached an equivalence decision, the third country benchmark administrator has undergone a separate procedure to become recognised by the local regulator in its Member State of reference (**Recognition**). There is a detailed set of conditions which will have to be fulfilled;
- (iii) the benchmark has been endorsed by an EU benchmark administrator (**Endorsement**). This would mean that the EU benchmark administrator would be responsible for the production of the benchmark. Again, the third country benchmark administrator will have to make an application, and there is a detailed set of conditions that will apply to the EU benchmark administrator in order for it to endorse a third country benchmark. These include that the provision of the benchmark fulfils requirements which are at least as stringent as the requirements of the Benchmarks Regulation; or
- (iv) the benchmark has already been referenced in a financial instrument, financial contract or to measure the performance of an investment fund on 1 January 2020, in which case it may continue to be used beyond this date. It will not be possible for a benchmark to be added to a financial instrument, financial contract or used to measure the performance of an investment fund after this date.

**(d) Other comments**

The exact scope of the Benchmark Regulation has not yet been determined, although ESMA has published its final report with technical advice for the Benchmark Regulation.<sup>149</sup> The criteria for deciding whether third country benchmarks can be endorsed in the EU covers:

- (i) objective reasons for the provision of a benchmark in a third country, such as:
  - (1) geographical proximity (e.g. where a benchmark measures a market geographically limited to a certain region and the benchmark provider is closely linked to that market); and

<sup>148</sup> Although the Benchmarks Regulation is due to become effective on 1 January 2018, in relation to benchmarks issued before January 2018 benchmark administrators (including those from third countries) will have until January 2020 to make the appropriate arrangements to be included on the ESMA register before the restrictions apply.

<sup>149</sup> [https://www.esma.europa.eu/sites/default/files/library/2016-1560\\_final\\_report\\_on\\_technical\\_advice\\_on\\_benchmarks\\_regulation.pdf](https://www.esma.europa.eu/sites/default/files/library/2016-1560_final_report_on_technical_advice_on_benchmarks_regulation.pdf)

- (2) the benchmark relies on skills and expertise based in a third country, and reliance on their skills would lead to an advantageous cost reduction; and
- (ii) objective reasons for the endorsement of the benchmark's use in the EU, such as:
  - (1) the benchmark is already used to a material extent in the EU and discontinuation would have adverse consequences in the EU; and
  - (2) the benchmark is likely to be used to a material extent in the EU and non-endorsement in the future could have an adverse and material effect on the financial stability or market integrity of the EU, consumers, or the financing of households and businesses in the EU.

ESMA has also provided guidance on when a benchmark will be considered to be made available to the public. This is an essential aspect of the definition, as it determines the scope of the legislation. ESMA has advised that "making available to the public" should mean that the index value, as a figure, is available to a potentially indeterminate number of persons outside the provider's legal entity. The provision of the figure may be direct or indirect and may or may not require the payment of a fee.

#### 4.24

### Wealth managers

#### (a) What are the activities in this category?

The range of activities that a wealth manager can cover is extremely broad. Wealth managers could offer a combination of the following services:

- (i) deposit taking (if the wealth manager is a credit institution);
- (ii) lending services – such as consumer lending and the provision of mortgages;
- (iii) foreign exchange services;
- (iv) investment services, which could include:
  - (1) portfolio management;
  - (2) advisory services;
  - (3) brokerage services (i.e. dealing in investments);
  - (4) financial planning; and
  - (5) automated advice and online transaction arrangements;
- (v) certain types of product intermediation;
- (vi) custody services; and
- (vii) insurance intermediation and distribution.

The nature of the clients served by wealth managers is likely to include retail clients. The clients of wealth managers may also include professional clients; individual persons can only rarely be categorised as professional clients (and they cannot be categorised as "per se professional



clients”) but it is possible that corporate customers of wealth managers could be categorised as professional clients (and, if they satisfy the requirements, as per se professional clients).

**(b) Is passporting available in relation to these activities?**

Passporting is available in relation to most of the activities outlined above.

The deposit taking, lending services and foreign exchange services are passportable under CRD IV where the wealth manager is a credit institution, but would not otherwise be passportable – see paragraph 4.5. (This is subject to a minor exception under which certain lending services and foreign exchange services can be passported as ancillary activities under MiFID – see paragraphs 4.5 and 4.11.)

Investment services are passportable under MiFID – see paragraph 4.11.

Custody services are potentially passportable under CRD IV (for a credit institution) and MiFID – see paragraphs 4.5 and 4.11.

Insurance intermediation services are passportable under the IMD – see paragraph 4.17.

Across the entire range of products and services that a wealth manager would offer, the scope of passporting is patchy (particularly if the wealth manager is not a credit institution).

**(c) Are the activities covered by TCR or is this a gap area?**

There will be a limited TCR available for investment services to be provided via a branch, but it will be dependent on the relevant Member State opting in to the regime. If the Member State is agreeable, this could potentially allow a mechanism for a wealth manager to provide services from an EU branch to retail clients. This TCR arises under MiFID II and so would only cover the “investment services” referred to in paragraph (a) above.

There is no TCR for cross-border services in relation to retail clients or elective professional clients. Wealth managers may be able to access the TCR for cross-border wholesale services if their clients are per se professional clients or eligible counterparties, but it is likely that the vast majority of wealth management clients will not come into this category. See paragraph 4.12 for further information.

Insofar as the wealth manager is able to bring itself within the MiFID II TCR, it could potentially provide custody services, as long as it also undertakes core investment services under MiFID II. See paragraph 4.11 for further information.

There is no TCR for any of the following services:

- (i) deposit taking;
- (ii) the lending services outlined above – see paragraph 4.6;\*
- (iii) foreign exchange services – see paragraph 4.8;\* or
- (iv) insurance intermediation or distribution services - see paragraph 4.17.

(\* This is subject to a minor exception under which the lending services and foreign exchange services that can be passported as ancillary activities under MiFID could be covered by the MiFID II TCR – see paragraphs 4.5 and 4.11.)

## 4.25 FinTech companies

### (a) What are the activities in this category?

Financial technology (FinTech) is a broad category that refers to companies developing or providing technology designed to enable financial services firms to provide financial services, or which use such technology themselves in the provision of regulated activities.

To the extent that the FinTech firm itself performs the regulated activity, the provisions which relate to the activity set out above would apply.

Examples of the areas in which FinTech companies operate include:

- (i) lending services – such as consumer lending and the provision of mortgages;
- (ii) payment services;
- (iii) foreign exchange services;
- (iv) “investment services”, such as:
  - (1) investment advice;
  - (2) portfolio management;
  - (3) dealing in investments
  - (4) certain types of product intermediation (in relation to financial instruments); and
- (v) insurance intermediation and distribution services.

FinTech companies which undertake regulated activities tend by their nature to operate online rather than through physical presence and are therefore more likely to be interested in cross-border services than establishing branches.

Although there is no reason why FinTech companies cannot provide services to institutional investors (and some FinTech companies do provide such services), their regulated services tend to be provided to clients who would be categorised as retail clients. FinTech companies can provide services to many different types of retail client, from relatively sophisticated wealth management clients seeking complex services (such as robo-advice or robo-management) to mass market clients seeking more efficient payment services on their personal devices.

(b) **Is passporting available in relation to these activities?**

A number of passports are potentially available, depending on the precise activities undertaken.

Lending services, payment services and foreign exchange services would be passportable under CRD IV if the FinTech firm was a credit institution, but they would not otherwise be passportable – see paragraph 4.5.<sup>150</sup>

The investment services are passportable under MiFID – see paragraph 4.11 and 4.12.

Insurance intermediation and distribution services are passportable under the IMD and will be passportable under the IDD when it comes into effect – see paragraph 4.17.

(c) **Are the activities covered by TCR or is this a gap area?**

If the FinTech firm was providing investment services on a cross-border basis to wholesale clients, it would be able to use the TCR under MiFID II.

Otherwise, none of the activities of a FinTech firm are likely to be covered by a TCR.\*

The lack of ability to provide FinTech services on a cross-border basis could act as an impediment to the UK's ambition to be a leading hub for the FinTech industry.

(\* This is subject to a minor exception under which the lending services and foreign exchange services that can be passported as ancillary activities under MiFID could be covered by the MiFID II TCR – see paragraphs 4.5 and 4.11.)

<sup>150</sup> This is subject to a minor exception under which certain lending services and foreign exchange services can be passported as ancillary activities under MiFID – see paragraphs 4.5 and 4.11.

# 5.0 CASE STUDIES REGARDING TCRS

## 5.1

5.1 In order to illustrate the types of issue that arise, or are likely to arise, in relation to an application by a third country under the TCRs, we have set out three case studies below. The case studies consider the following TCRs:

- (a) the TCR for CCPs under EMIR;
- (b) the TCR in the AIFMD for marketing non-EU alternative investment funds; and
- (c) the TCR for MiFID II.

## 5.2

### Case study 1:

#### The application by the USA under the EMIR TCR for CCPs

##### Key points

- The application by the USA for equivalence for CCPs under EMIR took nearly three and a half years from the original application to the date of recognition. The EU conducted a highly detailed, line by line comparison of the respective regulatory regimes, rather than following an outcomes-based approach.
- The speed and the ease of the application process appeared to be seriously affected by political considerations.
- The compromise solution included a scenario in which a US CCP could be regarded as equivalent if the CCP's own rules and internal policies and procedures contained certain provisions replicating the EU regime. Since market infrastructure bodies typically have their own rules and membership criteria, this is a mechanism through which the same position could be introduced for all the CCP members. This approach is less likely to help when the third country firm does not have a rulebook of its own.
- In one specific area, the EU implemented legislative change to make its own requirements consistent with that of the USA.

## 5.3

Under Article 25 of EMIR, EU clearing members or trading venues can use third country CCPs to clear standardised OTC derivatives, provided that the legal and supervisory arrangements of the relevant third country ensure that its CCPs comply with requirements that are equivalent to those of the EU under EMIR (see paragraph 4.20 above).

## 5.4

In October 2012, the Commission asked ESMA to provide technical advice on the equivalence of the regulatory regimes of several third countries in relation to CCPs. The third countries included the USA, Japan, Switzerland, Australia, Dubai, India, Singapore and Hong Kong.

## 5.5

ESMA's technical advice regarding the USA was published on 1 September 2013.<sup>151</sup>

## 5.6

The technical advice covered CCPs registered in the USA with the CFTC and/or the SEC.<sup>152</sup> In its technical advice, ESMA found that:

- (a) CCPs were subject to effective supervision and enforcement in the USA;
- (b) the legal framework of the USA allowed for reciprocal treatment of foreign CCPs, but in practice the US authorities had required non-US CCPs to be subject to the direct jurisdiction of the SEC and the CFTC; and
- (c) there were areas where the legally binding requirements were not broadly equivalent to those in Title IV of EMIR.

## 5.7

In its assessment of equivalence, ESMA provided a “line-by-line” analysis of the differences and similarities between the third country requirements and those of Title IV of EMIR. The analysis was set out in table format and ran to over 120 pages of text. According to ESMA, it took an “objective-based approach” to the actual determination of whether there was equivalence. Nevertheless, a senior official at the CFTC later criticised the process, claiming that:

*“both the European Commission and CFTC essentially held each other’s regulatory text up to the ceiling light to determine if the words and font size were identical. This line-by-line analysis is contrary to the OTC Derivatives Regulators Group approach, which states that a flexible, outcomes-based approach, based on a broad category-by-category analysis, should form the basis of equivalence or substituted compliance.”<sup>153</sup>*

## 5.8

5.8 According to ESMA, the most important areas of difference in relation to derivatives clearing organisations (DCOs) regulated by the CFTC comprised the following:<sup>154</sup>

- (a) risk committee requirements;
- (b) business continuity arrangements;
- (c) margin requirements;
- (d) requirements for a default fund and other financial resources;
- (e) liquidity risk control requirements;
- (f) default waterfall requirements;
- (g) collateral requirements;
- (h) investment policy requirements; and
- (i) review of models, stress testing and back testing requirements.

<sup>151</sup> The technical advice regarding the USA was published along with technical advice in respect of Australia, Hong Kong, Japan, Singapore and Switzerland. This was followed on 1 October 2013 by technical advice in respect of Canada, India and Republic of Korea, together with further advice on Australia, Hong Kong and Singapore.

<sup>152</sup> The CFTC is responsible for supervision of CCPs that provide clearing services with respect to futures, options on futures contracts and swaps. The SEC supervises a number of CCPs that clear transactions in securities and options.

<sup>153</sup> Statement of Commissioner J. Christopher Giancarlo on European Union Determination of U.S. Central Counterparty Clearinghouse Equivalence (10 February 2016).

<sup>154</sup> The decision did not apply to CCPs registered with the SEC; see paragraph 5.18 below.

## 5.9

Nevertheless, ESMA stated that if an individual US CCP adopted rules in these areas that were broadly equivalent to the EU requirements, that CCP should be regarded as being subject to equivalent requirements for the purposes of EMIR.

## 5.10

In terms of technical differences between the EU and US regulatory regimes, the most contentious issue related to margin requirements for futures contracts. EMIR requires firms to provide CCPs with initial margin sufficient to cover exposure arising from market movements and assumes a minimum period of two business days to liquidate positions. In contrast, the CFTC requires DCOs to hold initial margin based on the assumption that positions may be liquidated within one day.<sup>155</sup> The EU regulators stated that this meant that the US regime was not equivalent.

## 5.11

Beyond the technical details, media coverage suggested that political differences between the Commission and US regulators were a significant factor in the delay. The application for equivalence occurred in the wider context of a discussion in relation to the cross-border application of the US Dodd-Frank swaps rules. EU regulators expressed concern about the extraterritorial reach of the Dodd-Frank rules, potentially leading to an overlap with EU rules.<sup>156</sup>

## 5.12

In addition, US CCPs were concerned that a failure by the Commission to provide an equivalence decision would mean that US CCPs would not be treated as “qualifying CCPs”, with the result that EU credit institutions and investment firms would be required to apply higher levels of regulatory capital when dealing with US CCPs. This could have had a significant impact on the market share of US CCPs.

## 5.13

Ultimately, the EU and the US authorities came to a compromise, which was enacted in the Commission’s equivalence decision.<sup>157</sup> The compromise meant that US CCPs are not required to adopt equivalent rules in respect of all of the areas of difference identified in ESMA’s technical advice (see above). The equivalence decision was limited to two kinds of CCP:

- (a) Systemically important DCOs; – i.e. DCOs that had been designated as “systemically important” by the US authorities; and
- (b) other DCOs authorised and supervised by the CFTC that had opted in to specified CFTC requirements.

## 5.14

The Commission’s decision stated that a DCO will be regarded as equivalent if its rules and internal policies and procedures contain:

- (a) initial margin requirements that assume a period of two days for the liquidation of positions in derivatives on regulated markets or designated contract markets;<sup>158</sup>

<sup>155</sup> ESMA, Final Report: Technical advice on third country regulatory equivalence under EMIR – US (ESMA/2013/1157) (1 September 2013).

<sup>156</sup> See, for example, Michel Barnier: “Why global markets require global rules” (15 February 2013).

<sup>157</sup> Commission Implementing Decision (EU) 2016/377 of 15 March 2016.

<sup>158</sup> See also paragraph 5.16 below in relation to the two day period.

- (b) measures designed to mitigate the risk of procyclicality; and
- (c) requirements on the DCO to maintain financial resources sufficient to withstand the default of at least the two clearing members to which it has the largest exposures.

### 5.15

The US authorities secured an exemption so that the EU requirements do not apply to US agricultural commodity derivatives.

### 5.16

As part of the arrangements, the EU also changed its own law. It introduced a regulation which allowed CCPs authorised under EMIR to apply a one-day liquidation period for financial instruments other than OTC derivatives.<sup>159</sup> This brought the EU regime into line with that of the US regime for its CCPs.

### 5.17

The Commission's equivalence decision also confirmed that the regime for DCOs registered with the CFTC will provide reciprocity for foreign CCPs seeking access to the US market. It was agreed that the CFTC would provide access to non-US CCPs under a system of "substituted compliance", where the CFTC provided a determination of "comparability" between CFTC rules and the rules of the relevant non-US jurisdiction.<sup>160</sup>

### 5.18

The Commission's equivalence decision did not cover US CCPs registered with the SEC. SEC-registered CCPs were excluded because the SEC had not finalised new rules for CCPs that were originally proposed in March 2014, several months after ESMA's technical advice on the US regime. Consequently, the Commission was not able to assess the equivalence of the new SEC rules.

### 5.19

In September 2016, the SEC adopted new standards for CCPs.<sup>161</sup> Media commentary highlighted the possibility that this would lead to an equivalence decision by the Commission in respect of SEC-registered CCPs in the near future.<sup>162</sup> In its commentary on the final rules, the SEC noted that it was aware of "recent public attention on the availability of QCCP status under EU capital requirements for certain covered clearing agencies that operate in the United States and have bank clearing members affiliated with [an EU] entity". The SEC specifically addressed its experience of dealing with CCPs authorised under EMIR and highlighted the potential compatibility of the new rules with EMIR requirements.

### 5.20

Of all of the countries that applied for equivalence under the TCR for CCPs, the USA experienced the longest delay in being recognised as equivalent – nearly three and a half years after the Commission's initial request for advice (and even now, some US CCPs are not

<sup>159</sup> Commission Delegated Regulation (EU) 2016/822.

<sup>160</sup> CFTC publication: "CFTC Approves Substituted Compliance Framework in Follow-up to the Recent Equivalence Agreement between the US and the EU" (16 March 2016).

<sup>161</sup> SEC publication: "SEC adopts rules for enhanced regulatory framework for securities clearing agencies" (28 September 2016).

<sup>162</sup> Philip Stafford, "New SEC standards may level playing field for European banks", *Financial Times* (28 September 2016); Silla Brush and Benjamin Bain, "EU Banks Closer to \$5 Billion Respite With SEC Clearing Rule" (28 September 2016).

covered).<sup>163</sup> Most of this delay occurred between the publication of ESMA's technical advice and the adoption by the Commission of its implementing decision.

### 5.21

This case study demonstrates the following:<sup>164</sup>

- (a) the EU may choose to conduct a highly detailed analysis, even where an assessment is intended to be “outcomes-based”, before reaching an opinion on the equivalence of a third country regime;
- (b) extensive delays can arise before such a regime is recognised as being equivalent; and
- (c) the speed and ease of the application process can be seriously affected by political considerations.

### 5.22

## Case study 2:

### The application by Jersey for a “non-EU AIFM passport” under the AIFMD

#### Key points

- The TCR in the AIFMD is not yet in force and there is no date set for its implementation. The history of this TCR demonstrates the susceptibility of the TCRs to political influences.
- The application by Jersey for recognition was subject to significant delays, notwithstanding that Jersey has EU-style legislation, cooperates with the EU regulators and had positive feedback from ESMA.
- The process that Jersey went through was detailed and exhaustive and was not carried out efficiently.

### 5.23

Under the AIFMD, it is proposed that non-EU AIFMs will be able to obtain a “passport” (known as the “non-EU AIFM passport”) which allows them to market alternative investment funds to professional investors in the EU without obtaining licences from the local regulators. The requirements of the proposed TCR are set out in paragraph 4.14 above.

### 5.24

The TCR in the AIFMD is not yet in force. It will not come into force unless the Commission adopts an implementing act to extend the AIFMD passporting regime to third country jurisdictions.

<sup>163</sup> In contrast, the earliest decisions on equivalence were provided by the Commission to other jurisdictions on 30 October 2014, just over a year after the request for advice.

<sup>164</sup> The fact that the US CCPs were able, in effect, to create equivalent rules through their own rule books is also potentially interesting, as it raises the possibility of individual firms being able to secure equivalence by virtue of the contractual arrangements they put in place with third parties. However, the nature of CCPs is that they have their own rule books which their members are obliged to agree to comply with in order to get access to the CCP. It is therefore relatively straightforward to introduce a uniform rule which mirrors the EU requirements. This may not be an easy approach to replicate with other kinds of financial institution who do not have their own rulebook.



### 5.25

Before the Commission can adopt the implementing act, ESMA is required to provide advice on the non-EU AIFM passport (including the marketing of non-EU AIFs by EU AIFMs). When ESMA considers that there are “no significant obstacles” regarding investor protection, market disruption, competition and the monitoring of systemic risk,<sup>165</sup> it will issue positive advice regarding the extension of the passport to non-EU AIFMs and AIFs.

### 5.26

In November 2014, ESMA issued a general call for evidence on the non-EU AIFMD passport, in which it stated that it intended to assess the extension of the passport on a country-by-country basis. (This country-by-country approach was not envisaged in AIFMD itself and has arguably introduced legal uncertainty into the process. The AIFMD did not contemplate that ESMA’s advice could be provided on this basis, or that the Commission could issue multiple delegated acts in respect of different non-EU jurisdictions).

### 5.27

This case study considers the application under the TCR by Jersey. Jersey is a particularly useful case study because it has financial services legislation which is closely related to and, in some areas, modelled upon, EU legislation. The legal system in Jersey also bears similarity to that of England and Wales.

### 5.28

Jersey implemented AIFMD-style rules in its domestic legislation in the form of the Alternative Investment Funds (Jersey) Regulations 2012. The Regulations took effect on 22 July 2013 (the same date that AIFMD became effective in the EU).

### 5.29

The Jersey Financial Services Commission (JFSC) agreed a cooperation agreement with ESMA in May 2013 in the form of a memorandum of understanding (“MoU”).<sup>166</sup> The MoU is a bilateral agreement that may be signed between the JFSC and each EU or EEA national regulator in the form negotiated with ESMA. The JFSC has since signed the MoU with 27 EU or EEA states.<sup>167</sup>

### 5.30

In relation to the TCR application, the JFSC engaged closely with ESMA in response to its call for evidence, submitting thousands of pages which covered topics including the legislative framework, information-sharing powers, cooperation between regulators, staffing at the regulator and arrangements for reciprocity with non-Jersey fund managers.

### 5.31

ESMA published its advice on the extension of the AIFMD passporting regime to Jersey, as well as other jurisdictions, on 30 July 2015.<sup>168</sup> The advice in relation to Jersey extended to five pages of text. As regards investor protection, ESMA noted that:

<sup>165</sup> Article 67(4) of the AIFMD.

<sup>166</sup> [http://www.jerseyfsc.org/the\\_commission/general\\_information/press\\_releases/release297.asp](http://www.jerseyfsc.org/the_commission/general_information/press_releases/release297.asp).

<sup>167</sup> [http://www.jerseyfsc.org/the\\_commission/general\\_information/press\\_releases/release303.asp](http://www.jerseyfsc.org/the_commission/general_information/press_releases/release303.asp).

<sup>168</sup> ESMA, Advice: ESMA’s advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs (ESMA/2015/1236) (30 July 2015).

- (a) the existing cooperation between EU national regulators and the JFSC was regarded as positive;
- (b) the Channel Islands Financial Ombudsman would shortly be operational and would provide a complaints process for small businesses and individual investors;
- (c) Jersey has an “AIFMD-like regime”, but there are differences with the AIFMD, especially regarding requirements on custody and remuneration; and
- (d) the most recent assessment of Jersey’s financial services sector, which included assessment of compliance with the IOSCO Principles on securities regulation, dated back to 2009, but Jersey received positive outcomes at the time.

### 5.32

ESMA also found that:

- (a) the granting of the passport to Jersey would probably result in more Jersey AIFs being marketed in the EU, but that it would be “difficult to predict the impact” on investor choice or increased fund availability;
- (b) there were no competition issues in terms of EU AIFMs wishing to market into Jersey; and
- (c) Jersey had frameworks in place to address systemic risk.

### 5.33

Consequently ESMA advised that there were no significant obstacles impeding the application of the AIFMD passport to Jersey.

### 5.34

Subsequently, however, on 17 December 2015, the Commission requested that ESMA provide further information in relation to Jersey and other jurisdictions.<sup>169</sup> The Commission asked for a more detailed assessment of the capacity of supervisory authorities and their track record in ensuring effective enforcement, together with a preliminary assessment of the expected inflow of funds by type and size into the EU from relevant third countries.

### 5.35

The Commission also stated that it would only take a decision on whether to adopt the implementing act to extend the AIFMD passporting regime to non-EU jurisdictions after “sufficient numbers have been appropriately assessed” by ESMA. (This approach is not contemplated in the AIFMD, which does not provide a mechanism for the Commission to delay the adoption of its implementing act after ESMA has given positive advice).

### 5.36

On 19 July 2016, ESMA responded with its final advice on Jersey and certain other third countries. This was an updated version of ESMA’s previous advice with some minor changes. In particular:

- (a) ESMA had required the JFSC to carry out a self-assessment based on the IOSCO Principles between February and May 2016. ESMA found that the Jersey legal framework appeared to be consistent with the IOSCO Principles; and

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<sup>169</sup> <https://www.esma.europa.eu/press-news/esma-news/esma-publishes-letter-european-commission-aifmd-passport>

- (b) ESMA provided data on the scale of the funds industry in Jersey based on information from the JFSC. ESMA noted that, given its population, the investor base in Jersey is limited as compared to the investor base in the EU.

### 5.37

ESMA found that there were no significant obstacles impeding the application of the AIFMD passport to Jersey and repeated its previous recommendation that Jersey should be granted an AIFMD passport.<sup>170</sup>

### 5.38

To date, the Commission has not yet adopted legislation to extend the AIFMD passporting regime to Jersey or to any other non-EU jurisdiction. The Commission has stated previously that it would only take a decision on whether to adopt the delegated act after “sufficient numbers have been appropriately assessed” by ESMA, but it is not clear whether this threshold has been reached. Media commentary has suggested that EU Member States with large fund management sectors have expressed concerns about the opening-up of EU markets to external competition.<sup>171</sup>

### 5.39

This case study demonstrates the following:

- (a) a third country which has EU-style legislation, cooperation arrangements with EU regulators and positive feedback from ESMA may still face significant delays in securing access to EU markets – even after ESMA has given a positive recommendation;
- (b) the process that Jersey went through was detailed and exhaustive – and not carried out in an efficient manner. The fact that ESMA asked for further information after it had initially made a positive finding in respect of Jersey suggests that the criteria which ESMA is to apply when making an initial assessment are not clear;
- (c) while the main test under TCRs is normally whether the regime is equivalent, the fact that the Commission asked separately for information about Jersey’s supervision and enforcement regime shows that the Commission regards that as a discrete test. This implies that a third country could be regarded as having an equivalent regime but still fail to secure access under a TCR because the EU authorities do not agree with its approach towards supervision and enforcement; and
- (d) the speed and ease of the process can be affected by political issues.

<sup>170</sup> ESMA, Press release: ESMA advises on extension of funds passport to 12 non-EU countries (ESMA/2016/1138) (19 July 2016). The advice was subsequently reissued on 12 September 2016 (with amendments in relation to the Isle of Man): see ESMA, Advice: ESMA’s advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs (ESMA/2016/1140) (12 September 2016).

<sup>171</sup> Attracta Mooney, “Offshore hedge funds fear being frozen out of the EU” (20 November 2016).

## 5.40

## Case study 3: The TCR for MiFID II

### Key points

- The MiFID II TCR is not yet in force. There would be two stages before a UK firm could rely on the TCR:
  - a national equivalence determination (i.e. that the UK is an equivalent country); and
  - a registration process, under which the UK firm itself applied for recognition.
- Many of the issues identified in section 3 above could potentially present obstacles to the successful reliance by a UK firm on the TCR.

## 5.41

MiFID II will come into effect on 3 January 2018. MiFID II contains two different equivalence measures, neither of which were contained in MiFID I.

## 5.42

The first relates to the establishment of branches and grants a passport to branches of non-EU firms who want to undertake business on a cross-border basis. However, this route requires a Member State to opt-in to this arrangement. To date, no Member States have done so. In addition, this route requires the establishment of a branch in the EU.

## 5.43

This case study therefore focuses on the second type of equivalence, which relates to the carrying on of business on a cross-border basis (which is more likely to be relevant once Brexit takes effect).

#### (a) National equivalence determination

Article 46 of MiFIR permits non-EU firms to provide investment services and activities freely within the EU provided that certain requirements are met. In summary, these requirements are:

- (i) the Commission must have taken the (political) decision to grant equivalence status to the third country where the firm is established; and
- (ii) the Commission must have undertaken research to ensure that the third country has (in summary): an effective authorisation, supervision and enforcement regime; efficient capital and governance requirements; adequate organisational requirements; appropriate conduct of business rules; and an anti-market abuse regime.

In addition, the third country must also provide equivalent access for EU firms to do cross-border business into that country and a cooperation agreement between the relevant regulators must be in place.

**(b) Registration process**

If a third country has been granted equivalence status by the Commission, a firm has to do the following before providing services in to the EU:

- (i) submit an application to ESMA (and ESMA has 180 working days to consider the information that must be provided);
- (ii) make clear to EU clients that the firm is only allowed to provide services to eligible counterparties and professional clients (as this equivalence provision cannot be used to provide services to retail clients);
- (iii) agree to submit disputes relating to these services to the jurisdiction of the courts or arbitral tribunal in an EU Member State.

**5.44**

The above regime will produce a harmonised EU approach to business being undertaken from any third country that has been determined to be equivalent. In the absence of any equivalence determination, each Member State may continue to take their own approach, to either permit or (as generally happens) prohibit any MiFID business being undertaken by unauthorised firms, otherwise than on an extremely limited reversed solicitation basis.

**5.45**

There are considerable advantages for firms based in third countries that can pass equivalence assessments. However, the regime is subject to the following disadvantages:

- (a) the granting of an equivalence decision is a political one which can be granted (or not) by the Commission as it sees fit;
- (b) it is likely that a lengthy process would be undertaken to determine whether or not a third country was or was not equivalent. For instance, it took two years to undertake equivalence assessments in relation to the narrower category of CCPs under EMIR, where there was considerable political good will to findings of equivalence. It is conceivable that, as a departing EU member already compliant with MiFID's requirements, the Commission could agree to "deem" the UK to be equivalent already, although there is no mechanism in the MiFID regime for it to do so;
- (c) equivalence decisions can be reversed, so it is a somewhat uncertain basis upon which to undertake business (although, in practice, there would be considerable pressure on the Commission not to reverse an equivalence decision unnecessarily or without giving prior notice so that alternative arrangements could be undertaken);
- (d) the regime does not permit any business to be undertaken with retail clients; and
- (e) the regime, in effect, requires reciprocal access by that third party (which may not be problematic in the case of the UK which already permits third country access to the UK market on even more generous grounds than those contained in MiFID II).

**5.46**

The MiFID II TCR has not yet been implemented, so it remains untested.

**5.47**

For further information on the MiFID II TCR, see paragraph 4.11 above.

## 6.0 THE UK'S POSITION IN RELATION TO THE TCR CONDITIONS

### Key points

- The existing TCRs were not designed with an exiting Member State in mind, and therefore do not have specific processes for transitioning an EU Member State into a third country.
- Although the UK's regulatory regime should in theory be equivalent on the day that it leaves the EU, there is still the potential for the UK to fail to satisfy the TCR conditions on that date.
- The experience of firms who have been through existing TCR processes suggest that there is a risk that an application by the UK might not be finalised in time for the UK's exit from the EU.
- The UK would have to demonstrate continuing satisfaction of the TCR conditions (including equivalence). This means that when the EU changes its regulatory regime, the UK may have to make equivalent changes to its own regime. In addition, when the UK wishes to make changes to its own regime, it may need to consider whether those changes would be compatible with the EU regime.
- The attitude of the EU towards equivalence may itself change over time. There is some evidence of a possible hardening of EU attitudes towards third country access.
- There may be some scope for the UK to influence EU regulation through its membership of global bodies which set international standards.

### 6.1

The UK will cease to be a Member State of the EU on the day that Brexit takes effect and will become a third country.

### 6.2

For the reasons described under paragraph 3.34 above, achieving equivalence under the existing TCRs would be only a partial solution to the loss of coverage as a result of the UK leaving the EU. The UK and UK firms may wish to consider approaches other than relying on the TCRs – as discussed in sections 7 and 8 of this report.

### 6.3

Insofar as the UK and UK firms wish to take advantage of the TCRs, they will need to be assessed by the EU as satisfying the TCR conditions, including in particular the equivalence requirements.

### 6.4

#### How can the UK satisfy the TCR conditions?

### 6.5

The UK could simply apply to the European authorities for a determination that it has satisfied the relevant conditions, in the same way as any other third country would. Such an approach, however, does not take account of the fact that the UK's regulations have been developed in

accordance with EU rules. The UK is currently a member of the EU and its domestic regulatory and supervisory regime should be capable of being regarded as equivalent with the relevant EU regimes as at the date of Brexit.

## 6.6

The existing TCRs were not designed with an exiting Member State of the EU in mind and therefore do not have specific processes for transitioning a country from being an EU Member State with a fully integrated regime to being a third country recognised under the TCRs, with a regulatory system which is legally distinct but which mirrors the EU's regulatory system. If the UK can persuade the EU to recognise the uniqueness of the UK's position, that may assist the UK in reaching a sensible accommodation with the EU about satisfying the TCR conditions.

## 6.7

There are two particular points of concern for the UK in considering the TCR conditions:

### (a) **Are the conditions satisfied as a matter of substance?**

On the day that the UK leaves the EU, it ought to, in theory, have a regulatory and supervisory regime that is equivalent to that of the EU. All of the relevant EU Directives should already have been incorporated into UK domestic law at that date. Insofar as there are EU Regulations that would apply directly to Member States, the UK Government has indicated that it intends to pass the Great Repeal Bill to incorporate any such regulations into UK law, in order to ensure continuity.

There is, however, the potential for the UK to fail to satisfy the TCR conditions even on the day that it leaves the EU. In particular:

- (i) Some EU Regulations give authority to EU institutions such as the ESAs – for example, to issue guidance in relation to the rules. If the UK intends to incorporate EU regulations into UK law, it may also follow the ESAs' guidance. However, it is also possible that the UK may want to formulate its own guidance in these areas, or may wish not to follow new guidance issued after the date of Brexit – in which case, it might not be equivalent as a matter of substance.
- (ii) One of the TCR conditions is that the third country must have effective supervision and enforcement. It is possible that, if the UK is perceived as taking a different approach to the EU on those matters, it could fail to satisfy the requirements.<sup>172</sup> The experience of third countries applying for a non-EU AIFM passport (see case study 2 in section 5, above) was that the Commission, having already received positive advice in relation to applicants, asked them to be assessed separately in relation to supervision and enforcement.

It is not, therefore, guaranteed that the UK will be regarded as substantively equivalent. However, it will almost certainly be more equivalent than any other third country and so the UK should make the argument that it should automatically be regarded as equivalent – see below.

<sup>172</sup> Most of the TCRs have a condition that the third country regulatory authority must enter into a cooperation arrangement with the competent authorities in Member States to facilitate the exchange of information and to allow the authorities to carry out their duties. It is likely that, given the current level of institutionalised cooperation between the FCA and other supervisory authorities in respect of financial services regulation, such an agreement would be desirable in respect of all activities covered by the existing TCRs. This agreement could be augmented with additional measures to facilitate the effective functioning of UK-EU trade in financial services and could also form part of the withdrawal negotiations.

(b) **Will equivalence determinations be made in time?**

As discussed in section 3, the experience of other third countries is that TCR determinations at a national level are drawn-out processes that take a very long time – typically between two and four years. In addition, where the TCRs also require the recognition of an individual firm, that will add an additional step to the process and take further time.

Given that the timetable for the UK leaving the EU is likely to be approximately two years after the UK serves its Article 50 notice, the UK and UK firms will be concerned that, if they have to go through the normal TCR processes, they will not receive the necessary status before Brexit takes effect.

## 6.8 Continuing satisfaction of the TCR conditions

### 6.9

Over the longer term, the UK should consider to what extent the ability to drive its own regulatory agenda would risk prejudicing its ability to demonstrate that it is equivalent. If the UK chooses to adopt an approach which requires it to maintain “equivalence”, it may find itself, in practice, having to follow the EU regulatory agenda in order to do so.<sup>173</sup> The UK would be something of a “rule taker” – i.e. it has to follow rules which are developed under a process in which it does not participate and has a limited ability to influence.

### 6.10

Maintaining equivalence is likely to mean that:

- (a) when the EU changes its regulatory regime, the UK may have to make equivalent changes to its own regime;<sup>174</sup> and
- (b) when the UK wishes to make changes to its own regulatory regime, it may need to consider whether those changes would be compatible with remaining equivalent with the EU regime – and refrain from making them if they are not.

### 6.11

Given that equivalence does not require the respective regimes to be identical, one of the challenges facing a third country that sought to rely on access through the TCRs would be to determine exactly how much freedom it has to set its own regulatory regime without putting its satisfaction of the TCR conditions at risk. The level of divergence permitted by a regime based on “equivalence of outcomes” will define the degree to which this is an issue. For example, if implementing a regulation which follows international standards is considered adequate for maintaining equivalence and the UK participates in the process of setting those international standards, this may mitigate the “rule taker” issue.

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<sup>173</sup> Members of the EEA are subject to a formal obligation to implement EU laws, which creates the “rule taker” issue. Under any “equivalence” based arrangement the issue may also arise, albeit to a potentially lesser degree, due to the need to maintain alignment of regulatory regimes.

<sup>174</sup> Many of the Single Market Directives are scheduled to undergo formal reviews on a periodic basis, so there would be obvious opportunities for the EU to reconsider the operation and scope of the TCRs. See Appendix 2.



**6.12**

In relation to new laws being made in the UK, the UK could establish a similar mechanism to that in place under the Human Rights Act 1998, where each piece of legislation is required to be assessed for its effect on human rights law and a declaration of incompatibility may be made if necessary. The UK Parliament could pass legislation that provides for an “equivalence assessment” for all new legislation that could affect the UK’s regulatory alignment with the EU, so that any possible impacts are identified and flagged at an early stage.

**6.13****How can the UK maintain influence as a third country?****6.14**

EU financial services legislation establishes a framework of cooperation and information sharing between the EU authorities (such as the European Central Bank and the ESAs) and the financial regulators of Member States. Once outside the EU, the UK would be seeking to find similar means of co-operating with the EU and its Member States – and ideally seeking to find means by which it can influence or contribute to the development of regulation in the EU that may come to indirectly influence the UK’s own regime.

**6.15**

Within the framework of the TCRs, the solution may lie in the cooperation agreements between third country regulators and either the relevant national regulators of EU Member States or with the relevant ESA, depending on the particular regime. Whether the cooperation agreements can be used for this purpose is a matter for negotiation as part of the withdrawal arrangements. The cooperation agreements negotiated with third countries to date are generally more comprehensive in respect of major financial markets such as the USA, and the UK could seek to establish similarly extensive arrangements. (This might be at the risk of lengthening the process through which the UK satisfies the TCR conditions, however.)

**6.16**

It is also important to remember that, as a major global financial services centre, the UK will retain the ability to influence and drive regulatory standards at a global level. Much of EU financial regulation is developed on the basis of standards set at a global level by bodies such as the BCBS, IOSCO and the Financial Stability Board (“FSB”). For example, CRD IV was based on the BCBS’s Basel III accord, which, in turn, sought to implement the recommendations of the FSB. The UK currently has significant influence via these global standard setting bodies. By way of illustration, the FSB is currently chaired by Mark Carney, the Chairman of the Bank of England.

**6.17**

The UK could focus on increasing the effectiveness of its influence in these global standard setting bodies. It may be possible to seek to focus an international agenda on extending the remit of these global standard-setting bodies to increase regulatory alignment at a global level – which would affect the development of law within the EU and thus potentially increase the alignment of the EU and third countries which are subject to the same global standards. There may be a particular opportunity to do this in relation to new developments in the law, such as dealing with emerging technologies like mobile banking and blockchain, where being able to

drive forward globally-recognised standards is likely to help ensure that there is equivalence between the various regulatory regimes (including those of the UK and the EU).

### 6.18

International recommendations are currently set at a high level and a significant amount of work on developing the legislative response occurs at the EU level. For “equivalence” to work effectively with a structure which relies on engagement with global standard setting bodies rather than the EU legislative process, it will be necessary for the assessment of equivalence to be based on whether the respective legislative frameworks of the EU and the third country both meet the outcomes required by the global standard setting bodies. At present, however, the EU assesses equivalence at a more granular level, taking account of the regulatory, legal and supervisory framework involved and it does not appear that there is any imminent prospect of moving towards a more high level assessment of equivalence.

### 6.19

## The EU approach towards TCRs

### 6.20

In considering the issue of ongoing equivalence, it is also important to recognise that the UK cannot assume that the attitude of the EU towards third countries and equivalence will remain unchanged. Whether or not a TCR exists, and what level of access it allows, is a matter for the EU and could be changed. The UK would not have any say in relation to changes of that nature. Even if the UK can demonstrate equivalence, and is willing to take steps to secure equivalence on an ongoing basis, there remains a residual uncertainty about the continuing availability of the TCRs for UK firms.

### 6.21

There have been recent indications that the EU may be changing its approach towards third country access. In particular, under a proposed amendment to CRD IV published on 23 November 2016, the Commission will require third country credit institutions to establish holding companies in the EU and to hold capital in that company where two or more institutions established in the EU have the same ultimate parent in a third country.<sup>175</sup> If this proposal is implemented, it may mean that the capital benefits to a third country credit institution of obtaining direct authorisation of a branch are considerably reduced. The proposal itself states that the change is proposed in order to facilitate the implementation of the internationally agreed standards on internal loss-absorbing capacity for non-EU globally systemically important institutions in EU law and, more broadly, to simplify and strengthen the resolution process of third country groups with significant activities in the EU, but it may also represent something of a hardening of an approach on the part of the Commission towards third country access generally.

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<sup>175</sup> This requirement will only apply where the third country group is either a third country systemically important institutions, or the group EU entities have total assets of at least €30 billion (taking into account the assets of EU subsidiaries and branches of the third country group). A summary published by the Commission in relation to the proposed changes is available online at [http://europa.eu/rapid/press-release\\_MEMO-16-3840\\_en.htm](http://europa.eu/rapid/press-release_MEMO-16-3840_en.htm)

# 7.0 OPTIONS WHERE NO ACCESS REGIME IS AVAILABLE

## Key points

If the UK does not agree any new arrangements with the EU and is unable to use the existing TCRs, the options for UK firms will be:

- Carrying on such cross-border activities as are permitted under local laws. In relation to that:
  - UK firms are unlikely to wish to rely on arguments that they are only performing services in their home state when they deal with EU customers or counterparties (such that they do not require local authorisation), as regulators in other Member States do not agree with this argument.
  - UK firms would have only a very limited ability to provide services into the EU.
  - Access would be determined by the laws of the individual Member States and the relevant laws differ between the Member States. There are no general exemptions.
- Establishing a subsidiary in the EU and applying for it to be authorised by the local regulator. The subsidiary would be able to use passporting rights around the rest of the EU. Our analysis shows that the subsidiary could outsource certain activities back to the UK, but it would have to satisfy local requirement that it has sufficient substance in the EU Member State where it is authorised.
- Applying for authorisation directly from the local regulator without establishing a subsidiary – usually by establishing a branch. Some Member States allow this, but others impose limitations or rarely use the approach, so it is not a universal solution.

## 7.1

In this section, we consider what alternatives would be available to UK firms, instead of relying on the existing TCRs – and assuming that the UK and EU had not agreed any changes to the existing arrangements. (In section 8, we consider what the alternatives could be for UK firms if the UK Government sought to agree changes with the EU).

## 7.2

Such a scenario might arise if the UK was unable to agree any new arrangements with the EU and was not able to use the existing TCRs – for example, because:

- (a) the UK did not satisfy the TCR conditions;
- (b) the determination that the UK had satisfied the TCR conditions was not given in time;
- (c) a TCR was withdrawn or reduced in scope; or
- (d) the UK decided that it did not want to follow the TCRs – for example, because it was not willing to be a “rule taker” in order to maintain equivalence with the EU.

## 7.3

This scenario would also arise in relation to any areas of financial services law where there is no TCR available – of which, as stated in paragraph 3.35(b) above, there are many.

### 7.4

The options considered in this section are for UK firms to:

- (a) rely on existing rights of access under the local laws of EU Member States to provide services on a cross-border basis;
- (b) apply for direct authorisation in other EU Member States; and
- (c) establish an EU subsidiary.

### 7.5

## Carrying on such cross-border activities as are permitted by local laws

### 7.6

In this situation, the UK firm would be seeking to provide cross-border services from an establishment in the UK to customers or counterparties based in EU Member States. (The situation in which the UK would seek to establish a branch in another Member State is considered under paragraph 7.19 below.)

### 7.7

The ability of the UK firm to provide cross-border services will depend on whether local laws require them to obtain a licence in order to do so. If the local law in the relevant Member State had an equivalent of the UK's "overseas persons exemption", for example, it may be possible for a UK firm to provide such services.

### 7.8

The key issues to consider under the default position are:

- (a) **Does the place where regulated activities are being carried on make a difference?**

There has been some debate about whether the fact that a firm is carrying out a regulated activity with a counterparty or customer from another country necessarily means that the firm is carrying on the regulated activity in that other country in such a way as to require local authorisation. If the firm is only regarded as performing the activity in its home state and not in the other country, it would not need to be authorised in that other country and therefore would not need either a passport or a TCR to carry on the activity in question. It is, therefore, worth considering this question to determine whether any of the activities that UK firms carry on in the EU can effectively be taken out of the debate regarding access to the EU.

The requirement to obtain authorisation from a regulator typically arises in the jurisdiction in which the activity is "carried on". The Commission has published an Interpretative Communication<sup>176</sup> containing guidance on where regulated activities are regarded as being carried on. The Commission indicated that only activities carried on "within the territory of another Member State" would require a passport, and that in order to determine where an activity was carried on, the place of provision of the "characteristic performance" of the service (i.e. the "essential supply for which payment is due") must be determined.

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<sup>176</sup> Commission Interpretative Communication: Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive (20 June 1997). There is also an Interpretative Communication in relation to insurance.

The types of regulated activity which it is most commonly argued do not comprise an activity which UK firms conduct outside the UK are as follows:

(i) ***Deposit taking***

Although the Interpretative Communication relates to banking activities, it does not provide guidance specifically on how the characteristic performance test is applied to deposit taking. It suggests that if representatives of the credit institution were to physically go into another Member State, other than on a temporary visit, this could mean that the credit institution was conducting regulated activities in that other Member State. However, the guidance also states that a credit institution may have customers domiciled in another Member State without necessarily being regarded as pursuing banking activities within that other Member State.

Besides the Interpretative Communication, there is a limited amount of additional guidance on what the “characteristic performance” is for deposit taking. The guidance of the PRA and FCA acknowledges the Interpretative Communication and says that, in their view, this requires consideration of where the service is carried out in practice,<sup>177</sup> but the guidance says little more than that.<sup>178</sup> We are not aware of any relevant UK case law. We have seen differing views expressed by commentators (some suggest that it depends on where the credit institution’s books and records are held, while others maintain that it depends on where the obligation to repay arises). There is, therefore, a lack of clarity on this point, even in the UK. The Interpretative Communication itself acknowledged that the matters had not been tested in the courts (which was true in 1997, when the guidance was issued, and, as far as we are aware, remains the case) and so the Commission suggested that credit institutions might want to protect themselves by applying for passports even if they might consider that they did not need one.

There is also a significant practical obstacle to the argument that deposit taking is only carried on in the deposit taker’s home state – namely that the regulators in certain other Member States do not agree with it. Notwithstanding the Interpretative Communication, certain Member States maintain that a credit institution from another Member State will be undertaking the activity of deposit taking in their territory if the credit institution solicits customers in their territory. On that basis, even providing deposit accounts on a cross-border basis could put a credit institution from another country in breach of the requirements of local law in those Member States if it did not have a local licence.

There would, therefore, be a significant risk to a UK credit institution in relying on an argument that it did not need a passport or TCR for taking deposits from a customer based in the EU on the basis that the activity had been conducted in the UK.

(ii) ***Portfolio management***

This activity consists of making discretionary investment decisions in relation to a client’s

<sup>177</sup> SUP App 3.6.7G from the FCA Handbook.

<sup>178</sup> Similar arguments could be made for payment services – such as placing cash on payment accounts located in the UK and the issuing of payment instructions. The Commission’s guidance does not specifically address those services either.

assets – most commonly by having control over a portfolio. The act of managing is essentially one of decision making, and so the argument is that the place of characteristic performance must be the place where the person making that decision is physically located – i.e. a UK based portfolio manager must, by definition, only be carrying on the activity of portfolio management in the UK (if that is where his decisions are taken), even if his customer is based in another country.

The logic in this argument is clear. However, the fact that MiFID allows the activity of portfolio management to be passported on a cross-border services basis suggests that the Commission does not agree with it (i.e. if the argument were true, no “freedom of services” passport would be necessary – only a passport for a branch would be necessary).<sup>179</sup> It is also apparent that regulators in other jurisdictions take a different view.<sup>180</sup> For the same reasons as given above for deposit taking, therefore, there would be a significant risk in relying on this argument.

Clients of UK financial services providers will themselves wish to avoid any possibility that the financial services provider could be acting unlawfully.

Regardless of the legal merits of the arguments, UK firms seeking to argue that they are not providing cross-border services are likely to meet with opposition from at least some of the EU Member States in which their customers or counterparties are based. In addition, the question as to the jurisdiction in which a regulated activity is taking place is likely to be a matter for the courts in the country in question and not the UK courts.

In the light of the above conclusions, we have assumed in this report that any regulated activities that are within the scope of the passporting regimes under the Single Market Directives would require local authorisation if provided on a cross-border basis.

### (b) **What do the other EU Member States allow?**

In order to get a sense of what the position is likely to be for a third country firm in this scenario, we have undertaken a review of the law in eight key Member States: France, Germany, Hungary, Italy, Luxembourg, the Netherlands, Poland and Spain.

The key points to note from our review are as follows:

#### (i) **Overview**

The local regulatory regimes vary significantly between Member States, with different approaches taken in relation to how financial services are regulated generally and whether any exemptions may be available.

Generally speaking, there are significant limitations on the ability of third country firms to do business in EU Member States without being separately authorised in those jurisdictions. While the UK generally has a liberal approach to allowing access from

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<sup>179</sup> The Interpretative Communication of 20 June 1997 does strictly apply to portfolio management services since the guidance applies to any activities passported under the relevant Single Market Directive (which is now CRD IV), and the list of passportable activities includes portfolio management. However, the discussion in the Interpretative Communication does not expressly refer to portfolio management.

<sup>180</sup> See paragraph 7.8(b) below for more details.

non-EU firms (in particular, through the use of an exemption for overseas persons),<sup>181</sup> the same is not true of other Member States.

In some Member States (e.g. Poland) there is relatively little guidance or clarity regarding the availability of exemptions that would benefit a third country firm, and it would be advisable in those Member States to approach the regulator on a case by case basis. In relation to such Member States, it is difficult for the third country firm to anticipate what level of access will be available.

(ii) *Location of performance*

In relation to the argument that a regulated activity is not carried on in the state in which the firm's customer or counterparty is based (see paragraph 7.8(a) above), there is little support for that position in the Member States we reviewed.

In France and Spain, the regulated activity would be regarded as being performed in that state if clients are being targeted or solicited in that state.

In some cases, the mere fact that the customer is based in a Member State is sufficient to mean that the activity is regarded as taking place in that Member State: this is the position for deposit taking in Netherlands (although the Netherlands applies different tests for other forms of regulated activity) and for deposit taking, payment services and portfolio management in Italy.

In other Member States, such as Poland and Hungary, the position is less clear. Of the Member States reviewed, only Luxembourg provided any support for the contention that the activities of a UK firm (for example, deposit taking) could be regarded as being performed in the UK only.

(iii) *Availability of exemptions generally*

There is no exemption that is generally available in the Member States we reviewed.

In some jurisdictions, there are exemptions which may be available for individual third country firms based on equivalence-like concepts. For example:

- (1) In the Netherlands, a third country firm can avoid the need for a licence if it is established in a jurisdiction which the Netherlands considers to have a regulatory framework of at least equal standing.<sup>182</sup>
- (2) The German regulators may allow a credit institution from a third country to provide services into Germany on a cross-border basis if they determine that the credit institution is subject to effective supervision in its home state and if there is sufficient cooperation between the German regulators and the credit institution's home state regulator.<sup>183</sup>
- (3) Hungary has an exemption under which a financial institution which has its registered seat in an OECD Member State can apply to provide certain financial

<sup>181</sup> See paragraph 10.12 for more details on the UK's "overseas persons" exemption

<sup>182</sup> The Dutch authorities consider the USA, Switzerland and Australia to be equivalent in relation to licences for investment firms, and the USA, Guernsey and Jersey to be equivalent in relation to investment management.

<sup>183</sup> This exemption has been used to allow Swiss and US banks to provide services to German customers.

services in Hungary without having a licence. In practice, however, this exemption appears to be used only rarely.

The other Member States that we reviewed have no exemptions of this nature.

In some Member States, exemptions may be available in relation to particular activities. For example, France has a “pre-marketing of funds exemption” under which a third country firm without a French licence can engage in certain activities relating to collective investment schemes.

Some Member States have exemptions in their insurance laws, permitting non-authorised insurers in third countries to underwrite some classes of insurance, predominately marine, aviation and transport. These provisions can be restricted: for example, use of a local insurance intermediary may be prohibited, or the carrying on of business may be limited to reverse solicitation.

(iv) *Marketing and the availability of exemptions for reverse solicitation*

One of the key factors in determining whether a third country firm would need a licence is whether that firm engages in marketing activity or solicitation in the relevant EU Member State. This is the case, for example, in Germany and Spain.

Similarly, some Member States would allow a third country firm to undertake business on the basis of reverse solicitation – i.e. where a person or institution from the relevant Member State approaches the third country firm of their own volition and asks the third country firm to provide services to them. In relation to this:

- (1) Reverse solicitation is already a feature of some of the Single Market Directives.<sup>184</sup> Where the Directives themselves do not provide for third country firms to have access on the basis of reverse solicitation, the question of whether reverse solicitation is permitted is a matter of domestic law in the individual Member State.
- (2) Our review of the approach in the key Member States shows a mixed picture. Some Member States (e.g. Germany) do allow third country firms to do cross-border business on the basis of reverse solicitation, but others are more restrictive. For example, Italy allows reverse solicitation in relation to investments but not for banking or insurance; France allows reverse solicitation but only in relation to investment funds (and even then takes a very restrictive approach as to what is permitted); the Dutch authorities allow reverse solicitation for portfolio management. In some Member States, such as Luxembourg, there is no formal exemption or guidance relating to reverse solicitation.

<sup>184</sup> For example:

- (a) Under MiFID II, where a retail client or professional client established or situated in the EU initiates the provision of an investment service or activity by a third country firm “at its own exclusive initiative”, the third country firm will not be required to seek authorisation under Article 39 to establish a branch.
- (b) The recitals to the AIFMD say that the Directive shall not affect existing arrangements whereby a professional investor established in the EU may invest in alternative investment funds on its own initiative, irrespective of where the alternative investment fund manager is established. In addition, the definition of “marketing” in the AIFMD only applies to marketing at the initiative of the AIFM, meaning that the marketing restrictions in the AIFMD do not apply when investors apply for funds at their own initiative.



- (3) Where reverse solicitation is allowed, it is usually on the basis that there has been no solicitation of the customer. How far a third country firm can go in dealing with a customer without being regarded as breaching that requirement also differs as between Member States.

Overall, reverse solicitation only offers patchy coverage (both geographically and in terms of activities covered) and for a third country firm to rely on reverse solicitation would require clear and robust systems and controls to manage and/or mitigate the risks. Even if the risks can be managed, the limitations on the ability to solicit means that reverse solicitation is unlikely to be a viable business model for a third country firm except in a few specific situations.

In the light of the above, any UK firm wishing to provide cross-border services to EU customers and counterparties without obtaining a local licence will have to consider the position separately for each Member State where those customers and counterparties will be based. Some Member States will be more accommodating than others and in some Member States it will be very difficult to conduct any regulated activities at all. A UK firm will certainly not be able to adopt a uniform approach to doing business in the EU.

A further point to bear in mind is that the position of a third country firm under the rules of an individual Member State is dynamic. The individual Member State may decide to change its approach and cease allowing access that it has allowed previously. Similarly, the Commission could decide to harmonise the rules at an EU level and remove the ability of the individual Member States to take its own approach towards third country firms. This means that a UK firm wishing to rely on the rules under local regimes must be mindful that whatever rights it currently has may not last indefinitely.

## 7.9

### Establishing a subsidiary in the EU

#### 7.10

Many UK firms who currently rely on passporting rights are considering establishing a subsidiary in an EU Member State and applying to get the subsidiary authorised by the local regulator.

#### 7.11

One of the main benefits of doing this is that the new authorised subsidiary, being established in an EU Member State, will be able to passport around the rest of the EU. This would avoid the firm in question having to consider its position separately in up to 27 different Member States.

#### 7.12

The disadvantages of establishing an EU subsidiary include:

- (a) the inefficiencies described in paragraph 2.10 above regarding regulatory capital and the vetting and approval of staff and systems and controls. The result for firms would be a significantly less efficient system than is currently available under passporting;
- (b) the UK firm will need to consider moving staff and resources out of the UK and into the new EU subsidiary (or finding new staff and resources in the Member State in question);

- (c) the new EU subsidiary will be subject to a new regulatory supervision regime that the UK firm may not be accustomed to; and
- (d) the process of applying for authorisation is likely to be expensive and time-consuming. UK firms may also be concerned that, given the possibility of the UK serving its notice to leave the EU in the next few months, they may not have sufficient time to choose a location for the new EU subsidiary and complete the application process.

### 7.13

The impact of the challenges relating to establishing and operating a subsidiary in the EU may be sufficient to cause UK firms to curtail the business they conduct cross-border. This would result in firms reducing their offerings to businesses and consumers across the EU.

### 7.14

Although establishing a subsidiary in the EU would enable a UK financial services provider to avoid many of the problems arising from the UK leaving the EU, there may be some issues which arise regardless. For example, some of the exemptions under EMIR in relation to intra-group transactions do not apply if one of the parties to the transaction is established in a third country which the Commission has not recognised as equivalent.<sup>185</sup> Thus even if the group contains an EU subsidiary with local authorisation, the existence of third country firms in the group can mean that the EU subsidiary is treated differently.

## *Outsourcing/delegation from an EU subsidiary to the UK*

### 7.15

One particular question which is exercising the minds of the UK financial services industry is the extent to which a new subsidiary that is authorised in an EU Member State would be able to outsource or delegate critical functions back to the UK. This would potentially enable the UK firm to leave some resources and expertise in the UK, while still taking advantages of the regulated status (and associated passporting rights) that the authorised EU subsidiary would have.

### 7.16

The approach to outsourcing and/or delegation, and therefore the ability of the new EU subsidiary to use such an approach, is different under each of the Single Market Directives.<sup>186</sup> It is also dependent on the local law of, and the approach of the local regulators in, the jurisdiction in which the new EU subsidiary becomes authorised.

### 7.17

As a general rule, a significant proportion of an operational business can be outsourced or delegated to a group entity, subject to certain conditions. However, there are limits on how far the delegation can extend. In particular:

#### (a) **Scope of activities that can be delegated**

There has been some speculation about whether it is possible to use a so-called “brass plating” approach – i.e. one under which the EU subsidiary maintains a minimum presence and level of resource in the EU Member State and outsources as much as it can to the UK.

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<sup>185</sup> See Articles 3 and 13 of EMIR.

<sup>186</sup> For example, MiFID contains a definition of outsourcing but the AIFMD does not contain a definition of delegation.

The answer is that it is a question of degree and that there is a balance to be struck. All of the relevant Directives provide that a firm may not delegate to such an extent that it becomes a “letter-box” entity (or similar concept) but, rather, must maintain an effective operation that has the capability to supervise and oversee the functions that it outsources.<sup>187</sup> This means that the EU authorised entity would need to retain at least a sufficient board level and senior management function operating in that EU jurisdiction.<sup>188</sup>

In practice, determining whether an outsourcing meets the relevant requirements is likely to be a question of fact in the circumstances (i.e. on a case by case basis) and it is difficult to make a general assessment or produce a rule of thumb in advance.

The position also differs as between jurisdictions. For example, under French law a firm wishing to outsource financial services must maintain its head office in France, and the head office is defined as the place of “effective management” or “main administrative services” – making a large-scale outsourcing impractical. Luxembourg’s only limiting requirement, however, is that the outsourcing firm must not become a “letter-box” entity.

UK businesses that are already established in other EU Member States may be able to restructure relatively easily in order to meet the requirements. However, for businesses located mainly in the UK, such a restructure of staff and operations to move the mind and management of a business to within the EU may present a significant challenge. The question of staff is likely to be a particular challenge; the EU subsidiary will need to have individual staff based in its home Member State and those individuals may need to be subject to local approvals (e.g. like under the approved persons and senior managers regimes in the UK).

In addition to this general principle, there are certain specific functions that cannot be delegated under the different Directives<sup>189</sup>.

<sup>187</sup> Article 20(3) of the AIFMD; Article 13(2) of the UCITS Directive; Article 49(1) of the Solvency II Directive; Article 13(5) of MiFID (and Article 16(5) of the MiFID II Directive); ESMA guidelines on Article 6 and 14 of MiFID (outsourcing of compliance functions) and Guideline 2 of the “Guidelines on Outsourcing” by the Committee of European Banking Supervisors dated 14 December 2006.

<sup>188</sup> By way of example, the limitations on delegation are most clearly expressed in relation to managers of alternative investment funds. The manager must make sure its outsourcing is not so extensive that the manager:

- (a) no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation;
- (b) no longer has the power to take decisions in key areas which fall under the responsibility of the senior management or no longer has the power to perform senior management functions, in particular in relation to the implementation of the general investment policy and investment strategies;
- (c) loses its contractual rights to inquire, inspect, have access or give instructions to its delegates, or the exercise of such rights becomes impossible in practice; and
- (d) delegates the performance of investment management functions to an extent that exceeds by a substantial margin the investment management functions performed by the AIF manager itself.

<sup>189</sup> For example:

- (a) Article 35 of EMIR sets out that a CCP can only outsource major activities linked to risk management where the competent EU authority has approved the outsourcing.
- (b) Article 20 of the AIFMD prevents the delegation of portfolio management to the depository, a delegate of the depository or any other entity whose interests may conflict with those of the AIFM or the investors of the AIF, unless such entity has functionally and hierarchically separated the performance of its portfolio management or risk management tasks from its other potentially conflicting tasks, and the potential conflicts of interests are properly identified, managed, monitored and disclosed to the investors of the AIF.

**(b) Location of service firm**

Subject to some specific exceptions, the relevant Directives generally do not place restrictions on the location of the service firm under an outsourcing. In theory, therefore, it is possible to delegate to a third country.

The specific exceptions to that approach are as follows:

- (i) When delegating portfolio management for retail clients<sup>190</sup> (and soon also for all clients).<sup>191</sup> AIFs<sup>192</sup> and UCITS<sup>193</sup> funds, the delegate must be authorised in its jurisdiction and subject to prudential supervision and there must be a cooperation agreement between the supervisory authorities of the relevant EU Member State and the third country. EU firms can ask for a waiver of this requirement from their regulator.
- (ii) There are additional requirements if UCITAIFMDS depository functions are delegated.<sup>194</sup>
- (iii) The delegation of risk management by an AIFM requires a written cooperation agreement between regulators of the EU state and the third country.
- (iv) In relation to insurance, the Commission has the power to implement detailed rules specifying the conditions for outsourcing, in particular to service providers located in third countries.<sup>195</sup> While the Commission has specified general conditions applicable to outsourcing<sup>196</sup> (see paragraph (c) below), these conditions do not distinguish service providers in third countries specifically, which suggests that third country providers are subject to the same conditions.

**(c) Outsourcing requirements**

Outsourcing, even on an intra-group basis, is subject to particular oversight and control requirements. Although these vary slightly between Directives, they are fairly similar and would require an EU authorised firm delegating to a service firm to, amongst other things:<sup>197</sup>

- (i) have a written agreement in place;
- (ii) assure itself that the delegate has suitably skilled and appropriate personnel;
- (iii) have systems and controls in place to manage its delegated activities;
- (iv) give access to and co-operate with the EU firm's regulator;
- (v) have business continuity and security measures in place;
- (vi) be able to take action to correct poor service performance; and
- (vii) have the ability to terminate the outsourcing relationship

<sup>190</sup> Article 15 of the MiFID I Implementing Directive.

<sup>191</sup> Article 32 of the MiFID II Delegated Regulation.

<sup>192</sup> Articles 20(1)(c) and (d) of the AIFMD and Articles 78(2) and (3) of the AIFMD Level 2 Regulation (231/2013/EU).

<sup>193</sup> Articles 13(c) and (d) of the UCITS Directive.

<sup>194</sup> Article 22a of the UCITS Directive.

<sup>195</sup> Article 50(2) of the Solvency II Directive.

<sup>196</sup> Article 274 of the Solvency II Delegated Regulation. See also the EIOPA Guidelines for Systems of Governance.

<sup>197</sup> Article 274 of the Solvency II Delegated Regulation; Article 13 of the UCITS Directive; Article 20 of the AIFMD; Article 13 of MiFID and Article 14 of the MiFID Implementing Directive.

These requirements should all be capable of being met relatively easily through a detailed intra-group services agreement, clear reporting lines and group policies. They are measures that any authorised business would be expected to have in place in any event.

One of the effects of the outsourcing requirements is that the EU local regulator would have indirect control over the operation of the business in the third country (e.g. through its access rights).

#### (d) **Jurisdiction-specific issues**

There are also restrictions under local law in the relevant EU Member States. For example:

- (i) Some Member States impose additional restrictions on the permitted scope of outsourcings.<sup>198</sup> These restrictions would need to be mapped out on a jurisdiction by jurisdiction basis.
- (ii) Local national laws may dictate specific corporate governance requirements which affect how the EU regulated entity is set up (and indeed which jurisdiction the UK firm decides to set the subsidiary up in).<sup>199</sup>
- (iii) Other EU and national laws will need to be considered – for example, in relation to data protection and tax.

### 7.18

The extent to which delegation will be practical is likely to vary as between different business types (as well as between different jurisdictions). It is thought, for example, that outsourcing of portfolio management is likely to be easier than the outsourcing of other activities such as banking; portfolio management does not create on-balance sheet risk and day-to-day contact with clients is not essential, which makes it easier for services to be carried out by a delegate. For more complex activities, greater monitoring and operational control is likely to be required in the EU subsidiary itself.

### 7.19

## Direct authorisation

### 7.20

If the UK firm cannot provide services on a cross-border basis without a licence and would prefer not to establish a new EU subsidiary, a further alternative would be for the UK firm itself to apply to be directly authorised by the local regulator in an EU Member State.

### 7.21

Some EU Member States permit firms from third countries to obtain local authorisation, notwithstanding that they are not established in that country. The UK itself (currently being an EU Member State) grants authorisation to a number of financial services providers from outside the EU (see section 10 for further details.)

<sup>198</sup> For example: generally in Italy, only ancillary, non-regulated and back office activities can be delegated to a third country.

<sup>199</sup> For example: in Luxembourg it is necessary to have at least three board members, one of whom is permanently resident in Luxembourg, and two “conducting officers” resident in Luxembourg.

### 7.22

In a post-Brexit environment, it would be open to UK financial services providers to ask the local regulators in Member States for direct authorisation of branches in the same way. In relation to this:

- (a) Insofar as there is a TCR which covers the proposed activity (as discussed elsewhere in this report), the local regulator would be required to follow that regime and the TCR may prohibit the local regulator from allowing direct authorisation.<sup>200</sup>
- (b) Generally speaking, however, where there is no formal TCR in place, it is open to the Member State to allow access – but that is entirely at the discretion of the Member State in question.
- (c) There are some areas of financial services regulation where Member States do not have the freedom to grant authorisation directly to branches of third country firms – for example, because the relevant Directive states that the activity can only be carried on in the EU by an entity established in the EU. Examples of this include payment services and the management of UCITS and ELTIFs. UK firms would therefore need to seek an alternative approach in relation to such activities.

### 7.23

Direct authorisation is generally only given where the third country firm wishes to open an establishment (i.e. branch) in a Member State.<sup>201</sup>

### 7.24

Where a third country firm obtains direct authorisation for a branch in an EU Member State, it needs to comply with all the conditions of authorisation and all the relevant regulatory rules in that Member State.

### 7.25

The main benefit to the third country firm of obtaining direct authorisation of its branch is that it may be able to use capital which it holds in its home jurisdiction to satisfy local capital requirements and, therefore, not have to hold that capital separately in the relevant EU Member State (or, at least, not hold as much capital as a separate subsidiary would have to do).<sup>202</sup> It may also be able to benefit from operational efficiencies, such as being able to utilise key support functions from its head office rather than having to put additional resources into the branch office.<sup>203</sup>

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<sup>200</sup> Article 77(1) of EMIR specifies that a third country trade repository may only provide its services and activities in the EU after it has been recognised by ESMA. Although not yet in force, the TCR for CSDs requires that any third country CSD is recognised by ESMA before providing services in the EU. (Article 25(11) of the CSD Regulation).

<sup>201</sup> In the EU Member States we have reviewed, only Spain allows portfolio managers to obtain authorisation without establishing a local branch.

<sup>202</sup> Under a proposed amendment to CRD IV (published on 23 November 2016), the Commission will require third country credit institutions to establish holding companies in the EU and to hold capital in that company where two or more institutions established in the EU have the same ultimate parent in a third country. This requirement will only apply where the third country group is either a third country systemically important institutions, or the group EU entities have total assets of at least €30 billion (taking into account the assets of EU subsidiaries and branches of the third country group). If this proposal is implemented, it may mean that the capital benefits of obtaining direct authorisation of a branch are considerably reduced. A summary published by the Commission in relation to the proposed changes is available online at [http://europa.eu/rapid/press-release\\_MEMO-16-3840\\_en.htm](http://europa.eu/rapid/press-release_MEMO-16-3840_en.htm).

<sup>203</sup> This would not be an outsourcing, since an outsourcing involves the provision of services by a separate legal entity. With branch offices, the branch is part of the same legal entity as the head office. The host state regulator for the branch is unlikely to apply any rules relating to outsourcings, but in considering whether to grant authorisation to the branch the host state regulator may ask for assurances that the head office will be able to provide the appropriate level of support to the branch.

## 7.26

The main disadvantage is that the third country firm would need to undertake the same exercise in relation to each Member State in which it wishes to seek a licence, since firms that are not incorporated in an EU Member State cannot passport<sup>204</sup> (even if they actually have authorisation from a regulator in a Member State).<sup>205</sup>

### ***What do other EU member states allow?***

## 7.27

As part of our review of the key EU Member States, we considered whether the local regulator would be willing to grant direct authorisation to a third country firm.

## 7.28

All of the EU Member States we reviewed would, in theory, consider such an application. However, there are considerable differences in approach between the different Member States. For example, in France the regulations allow for the direct authorisation of a branch for deposit taking but not for payment services. Italy prohibits the establishment of branches for insurance and reinsurance intermediaries but allows it for other types of firm. Spain prohibits the direct authorisation of credit institutions from outside the EU but may permit direct authorisation of other kinds of firm. In Hungary, the law allows for the direct authorisation of branches but no third country firm has actually been authorised in this way.

## 7.29

In some Member States, third country firms are expressly prohibited from carrying out regulated activities unless they have established a branch. This is a particularly common position in relation to insurance business.

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<sup>204</sup> Notwithstanding this limitation, there are numerous instances of third country firms seeking direct authorisation: in the UK, for example, a substantial number of US, Chinese and Swiss financial institutions which have obtained direct authorisation from the PRA or FCA and use that authorisation to carry on domestic business in the UK. See section 10 below for details.

<sup>205</sup> Under the proposed MiFID II TCR, there will be an exception to this general principle. See paragraph 4.11(c) for details.

# 8.0 NEW ARRANGEMENTS FOR ACCESS

## Key points

- The UK needs to consider a number of key questions in relation to seeking new arrangements for access, such as whether:
  - any changes to rights of access with the EU should be sought on terms that are:
    - universal – i.e. where any third country can avail itself of those rights; or
    - specifically for the UK;
  - any changes should be:
    - made on a piecemeal basis (e.g. targeting activities which are a particular priority or where it is felt that the deal is more likely to be achieved); or
    - comprehensive – i.e. covering all areas of financial services;
  - changes should be developed using a “top-down” or “bottom-up” approach.
- If the UK is looking for a top-down approach, it could consider an arrangement under which the UK and EU to allow mutual rights of access to each other’s markets on the basis that the respective regimes are broadly consistent.
- If possible, the UK should try to avoid having rights of access tied to the EU’s existing concept of “equivalence”, as used in the TCRs.
- In terms of effecting legislative change:
  - Legislative change would be necessary where the EU is seeking to grant additional rights to third countries by reference to existing directives. The timescales for enacting legislation can be very protracted.
  - The alternative to legislative change is through bespoke agreements. These may, depending on the content, require approval at both EU parliament and national parliament levels – and thus be subject to delay. Nevertheless, it is felt that change could be achieved more easily through a bespoke agreement than through new legislation.
- If a broad agreement cannot be reached, the UK needs to decide what changes (if any) to the existing rights of access for third country firms might be appropriate.

## 8.1

In this section, we consider what alternatives would be available to UK firms, instead of relying on the existing TCRs, where the EU and UK agree a new framework that involves changes to the existing arrangements.

## 8.2

While the existing system of TCRs offers a base to build on, it may be in the interests of all parties to explore the options for a more stable and more comprehensive platform for third country access. This section considers:

- (a) questions of overall approach to change;
- (b) how change might be effected; and



(c) what changes the UK could ask for.

### 8.3

Each of these questions is considered in further detail below.

### 8.4

## Questions of overall approach to change

### 8.5

There are several key questions of overall approach:

#### (a) **Universal approach or UK-specific approach?**

Rights of access to the EU could be sought on terms that are:

- (i) universal – i.e. where the EU agrees to enhance third country rights generally and any country that is assessed as having a regulatory framework that is equivalent to, or consistent with, that of the EU (and meeting any other conditions) is able to participate; or
- (ii) specific to the UK.

Each of these is considered further below.

#### (i) *The universal approach*

The existing TCRs use the universal model; they allow access to any third country that is determined to be equivalent. The Commission acknowledges that TCRs bring “*benefits to both the EU and third-country financial markets*”.<sup>206</sup> Therefore, it is arguable that the continued universal expansion of third country rights will benefit the EU. To date, TCRs have been developed in an inconsistent manner and there is, therefore, an opportunity to extend the TCRs generally with a more coherent approach in mind.

A universal approach would probably have to be introduced by legislative change. The Commission has the exclusive right to initiate new legislation, so the Commission would need to conclude that it is in the EU’s interests to extend third country rights in this way.<sup>207</sup> (See under paragraph 8.6 below regarding the processes and timing for legislative change.)

#### (ii) *A UK-specific approach*

A bespoke UK-specific arrangement could potentially be made via a free trade agreement, which would be negotiated and concluded in accordance with the process set out in Articles 207 and 218 of the TFEU.

A bespoke agreement between the UK and EU relating to financial services could be based on recognition of the UK’s unique position as a former Member State and its ability to maintain a high degree of regulatory integration with the EU post-Brexit.

<sup>206</sup> [http://ec.europa.eu/finance/general-policy/global/equivalence/index\\_en.htm#maincontentSec4](http://ec.europa.eu/finance/general-policy/global/equivalence/index_en.htm#maincontentSec4)

<sup>207</sup> Until Brexit occurs, the UK will continue to be a member of the EU and can vote on any such proposals in the Parliament and the Council. However, it may be politically contentious for a Member State that is withdrawing from the EU to drive a programme of legislative reform within the EU. In particular, the UK may be seen to have a conflict of interest as it will be seeking to benefit from the introduction of the regimes that it advocates. As noted in paragraph 9.24, it is permissible for the UK to be treated as a third country for the purposes of applying for equivalence, and the UK might find it difficult to maintain that it can be in both camps at once.

There are precedents for an agreement of this nature:

(1) *Norway*

Norway (which is a member of the EEA) has over 100 bilateral trade agreements with the EU.

(2) *Switzerland*

Switzerland (which is not a member of the EEA) has over 120 bilateral trade agreements with the EU. Most of these do not relate to financial services and they are subject to a laborious management process. One of the consequences of having these bilateral trade agreements is that the Swiss have had to agree to the four fundamental freedoms (see paragraph 3.11(a) above). In a referendum in 2014, the Swiss voted against freedom of movement of people and as a result Switzerland is having to review the nature of its relationship with the EU.<sup>208</sup>

The bilateral trade arrangements between the EU and Switzerland generally do not cover financial services. The one exception to this is the arrangement in relation to branches of general insurance undertakings – see paragraph 8.5(b)(i) below for further information.

(3) *Ukraine*

In respect of financial services, the UK could aim to replicate the approach taken by the EU-Ukraine agreement, which establishes the Deep and Comprehensive Free Trade Area (“DCFTA”).

Unlike other EU trade agreements, the Ukraine agreement provides for freedom of establishment (rather than just commercial presence) in several key service sectors, including financial services.

The DCFTA requires “legislative approximation” in financial services, an approach that is similar to the equivalence requirements under TCRs. However, the DCFTA is, in many respects, tailored to a unique political and economic situation and is seen by many as a precursor to Ukraine’s full membership of the EU.

As with equivalence determinations under the TCRs, any bilateral agreement providing for mutual access to trade in financial services would need to provide stability and certainty for businesses, so that access could not be taken away at short notice. If the bilateral agreement itself depends on there being equivalence, it may be necessary to include provisions which are aimed at preventing the respective regimes from diverging – such as those referred to in paragraph 8.5(d) below.

*A multi-lateral approach?*

The UK could also consider a multi-lateral approach, with allies outside the EU who have similar interests and who are able to offer similar benefits to the EU. Such an approach would not necessarily require a different approach to implementation but could present an alternative option for extension, in the form of a multi-lateral agreement between the

<sup>208</sup> See <https://www.ft.com/content/05ec46f0-c394-11e6-81c2-f57d90f6741a> (“Swiss move to drop quotas plan on inflows”, 16 December 2016.)

EU and an alliance of countries that are home to major financial centres, including the UK, USA, Japan, Singapore and others. There may be considerable economic benefits for the EU, arising from the liberalisation of financial services provision and enhanced cooperation with these states. This approach is also consistent with recent EU initiatives to enhance financial regulatory cooperation with the USA and Japan.<sup>209</sup>

EU is currently negotiating a multi-lateral trade agreement, the Trade in Services Agreement (“TiSA”), with 23 members of the WTO (including the USA and Japan). The exact contents of TiSA have not been disclosed but the EU has made clear that it covers a broad range of services, including financial services. The UK, once it becomes a third country, could seek to become a party to TiSA and benefit from the reduced barriers to trade in services which it may bring about.

However, a multi-lateral treaty is more likely to be ratified in all the Member States within an acceptable period of time if it is much narrower in scope. A free trade agreement that is specific to the financial services sector and agreed with a small number of countries that have developed financial markets may be a more effective solution.

(b) **Piecemeal or comprehensive?**

Any proposed extension of third country access rights could proceed on either a piecemeal basis (i.e. Directive by Directive, or even activity by activity) or as a comprehensive or wide ranging introduction of consistent third country rights across the various sectors of the financial services industry currently covered by passporting rights. In relation to these options:

(i) *Piecemeal approach*

To date, EU legislative change in relation to financial services and the introduction of TCRs has been largely piecemeal. The extension of rights of access could also operate in this manner. (See also paragraph 8.5(c) regarding the question of the “top-down” versus “bottom-up” approach to extending access.)

There is a risk that if the UK is over-ambitious in its demands, it may not achieve its objectives and may lose the opportunity to achieve more realistic aims. The UK could therefore prioritise the areas of EU market access that are most important for it and tailor its negotiating strategy accordingly.

The UK should also consider whether there are areas where it anticipates that the EU may be less willing to reach agreement. For example, the existing TCRs are usually limited so that they apply only to institutional investors or to professional clients.<sup>210</sup> The UK could ask that rights of access be extended to cover retail clients as well (which would be consistent with the Commission’s stated intention to improve the extent to which retail clients benefit from the provision of cross-border services), but extending rights to third country firms in relation to retail clients may involve a step that the Commission or Member States are not yet willing to take.

<sup>209</sup> [http://ec.europa.eu/finance/general-policy/docs/global/160120-japan-eu-joint-statement\\_en.pdf](http://ec.europa.eu/finance/general-policy/docs/global/160120-japan-eu-joint-statement_en.pdf) and [http://ec.europa.eu/finance/general-policy/docs/global/160212-us-eu-joint-statement\\_en.pdf](http://ec.europa.eu/finance/general-policy/docs/global/160212-us-eu-joint-statement_en.pdf).

<sup>210</sup> The only TCR which allows the provision of services to retail clients is the MiFID II branch TCR, and even that is optional for Member States to implement.

If that was the case, the UK could instead ask for a more thorough and secure regime to be introduced in order to protect wholesale business.<sup>211</sup> A “professionals” exemption would remove any doubt about whether UK persons could deal with EU financial services providers or whether EU persons could deal with UK financial services providers.

#### *Legislative approach*

There are a different number of ways that the piecemeal changes could be approached made through legislation. For example:

- (1) entirely new legislation could be introduced – such as a CRD V or Solvency III;
- (2) certain aspects of existing TCRs could be extended by delegated legislation, such as Technical Standards Regulations, adopted in accordance with Article 290 of the TFEU. Article 290 permits EU legislation to delegate to the Commission the power to adopt non-legislative acts of general application to supplement or amend certain non-essential elements of the legislative act. The objectives, content, scope and duration of a delegated power must explicitly be defined in EU legislation; and
- (3) where powers to extend third country rights by delegated legislation currently exist in a Regulation or Directive, the scope of the coverage offered by existing TCRs could be extended.<sup>212</sup>

The EU legislative process is protracted and, unless multiple separate pieces of legislation are negotiated in parallel, a series of laws relating to each particular activity will have to be adopted to introduce new third country rights.

#### *Bilateral agreements*

A piecemeal approach could also involve bilateral agreements focussed on individual sectors or regulated activities subject to complying with WTO rules. By using this approach, the UK could focus on securing access in the areas where UK firms rely on it most.

There is some precedent for agreements of this nature in relation to financial services. A bilateral agreement was entered into between the EU and Switzerland in relation to direct insurance other than life insurance. It allows Swiss companies to open branches in EU Member States, and those branches must be granted equal access and conditions once they have been authorised by the host state’s national supervisory body. The Swiss agreement does not apply to cross-border services that are not provided through branches (although it does not prevent the writing of insurance on a cross-border

<sup>211</sup> A change in relation to professionals/institutions could, for example, be achieved by agreeing that persons on one side of the UK/EU border would be able to solicit business and/or enter into transactions with “professionals” on the other side of the border. In that context, “professionals” could include credit institutions, investment firms, fund managers, insurance companies, sovereign entities and supra-national bodies – most of whom would be regulated entities in their own right and should be capable of protecting their own position adequately when dealing with persons from the other side of the UK/EU border. An exemption of this nature could operate in addition to any existing equivalence under the TCRs. The UK already takes a similar approach with its “overseas persons” exemption (see paragraph 10.12 for further details), in that it allows overseas persons to enter into transactions in the UK “with or through” UK-authorised persons. A new exemption for professionals might, for example, allow transactions to be entered into by third country firms “with” professional clients and institutional investors in the EU (and vice versa). Some EU jurisdictions already have similar exemptions themselves, so it would not require a conceptual leap on either side to consider such an approach.

<sup>212</sup> For example, the AIFMD allows the Commission, on taking advice from ESMA, to adopt a delegated act applying the EU marketing passport to non-EU AIFMs and AIFs. It is likely, however, that there will only be very limited areas in which delegated legislation can be used to fill gaps in coverage.

basis). The agreement came into effect on 1 January 1993. Since then, there has been no extension of the arrangement into other areas of financial services law.

(ii) ***Comprehensive or “omnibus” approach***

There are proponents of a comprehensive or “omnibus” approach of introducing a single, cross-sector piece of legislation on third country rights. This would prevent TCRs from moving in different directions and ensure harmonisation between the approaches taken for each financial services activity.

Such an approach would present a way for the third countries to get comprehensive access to the Single Market without having to deal with numerous different laws and approaches and without having to make multiple applications for recognition. UK MEP Kay Swinburne has, in particular, been an advocate of introducing cross-sectoral financial services legislation to iron out the inconsistencies in the TCRs.

As stated above, the Commission is responsible for initiating legislation and therefore the EU’s interest in proposals for either piecemeal or omnibus expansion of the TCRs depends partly on the policy approach taken by the new EU Commissioner for Financial Stability, Financial Services and the Capital Markets Union, Valdis Dombrovskis.

(c) **Top-down or bottom-up?**

A key question for the UK to consider is whether the question of mutual access should be approached:

- (i) on a “top-down” basis, with a high level principle of mutual access established (and with exceptions to that being negotiated to reflect any particular areas of concern); or
- (ii) on a “bottom-up” basis, using the existing rights of access under the TCRs as the starting point and seeking to expand those rights.

There are concerns about taking a “bottom-up” approach. In particular:

- (i) As identified above, the existing TCRs contain significant differences. Any process of extending the TCRs will either mean that those differences will be perpetuated (leaving a patchwork regulatory landscape for third country firms) or that it is necessary to renegotiate existing TCRs in order to remove inconsistencies between them.
- (ii) Substantial areas of financial services law are not covered by the TCRs at all. If the UK wishes to try and agree access rights in relation to those areas:
  - (1) consideration of access issues would have to begin anew, either against a backdrop of the issue not having been considered before or (possibly, depending on what happened in the legislative process previously) having been considered and the consensus having been not to have a TCR giving rights of access;
  - (2) multiple negotiations would need to commence in parallel in different contexts. This is likely to represent a significant demand on resources (both for the UK and the EU) and having multiple negotiations in different contexts may mean that the negotiations go in different directions and lead again to a patchwork approach.
- (iii) Negotiating at a high level of granularity is likely to take a considerable amount of time. A broader approach is more likely to be agreed within a shorter timescale, and

it is likely that both the UK and EU will want to reach a long-term agreement sooner rather than later.

A “top-down” approach would potentially avoid some of these concerns. One possibility could be for the UK and EU to allow mutual access to each others markets on the basis that the respective regimes are “broadly consistent” with one another (in that they have similar regulatory objectives and aim to deliver the same outcomes).

If possible, the UK should try to avoid having rights of access tied to the existing concept of “equivalence”. As considered in sections 3 and 5 above, the history of the current TCRs shows that analysis of equivalence has been very granular. This makes it time consuming to apply in the first place and it makes unwieldy the introduction of new law. A genuinely outcomes-based approach would be preferable (and would be consistent with the stated intention behind some of the current TCRs – albeit that past experience with those TCRs shows that that has sometimes been overlooked). A broader concept than equivalence might also enable new approaches to be taken in relation to matters such as the jurisdiction of the CJEU and the role of the ESAs.

If it is necessary to devise another formulation to frame the relationship, one possibility would be a concept like “regulatory consistency”. This would be consistent with concepts used at the level of global standard setting – such as the “Regulatory Consistency Assessment Programme” which is used by the BCBS to monitor the implementation of Basel standards and to compare the approach taken in different jurisdictions.

In practice, we expect that, even if a top-down approach is taken, there may be certain specific areas where agreement on access cannot be reached and so exceptions to the general approach would need to be made. For example, the EU may be more reluctant to allow a third country firm to deal with retail clients than professional or institutional clients, as discussed above. Nevertheless, it may be easier to agree these elements as exceptions to a general right of access rather than building the rights of access incrementally.

#### (d) **Maintaining equivalence or consistency**

The nature of the basis for any agreement is likely to depend on the comparability of the respective UK and EU regimes – whether that be a broad test based on the respective regimes being consistent with one another or something more like the equivalence tests we have seen under the existing TCRs. Any rights of access which are based on equivalence or consistency run the risk of the two regimes diverging and ceasing to satisfy the necessary test. That is a risk that cannot be avoided entirely but the UK and EU could agree on processes which reduce the risk of serious divergence occurring.

Possible approaches include:

- (i) The creation of a joint forum (perhaps based on similar structures which exist for EEA members) to consider new legislation changes and to address questions of potential divergence.<sup>213</sup>

<sup>213</sup> The EU has also entered into similar arrangements with non-EEA countries. The EU and the USA recently established a Joint EU-US Financial Regulatory Forum to “discuss, as early and often as possible, respective rules and policies to improve transparency, reduce uncertainty, and generally promote better compatibility of each others rules in consistency with international standards”. The EU has also established similar links with Japan. These arrangements could provide a model for a joint forum with the UK, although it is likely that any joint forum with the UK would need to have more far-reaching terms of reference.

- (ii) The UK agreeing not to introduce divergent financial regulation without first giving adequate notice or consulting with the Commission.<sup>214</sup>

## 8.6 The processes for effecting change

### 8.7

Depending on the approach taken, the changes could be enacted through legislative change or by entering into a negotiated agreement.

#### *Legislative change*

### 8.8

Extending rights of access by relying on legislative reform would be appropriate where the EU is seeking to grant additional rights to third countries by reference to the existing Directives – for example, by removing TCR conditions already contained in a Directive or extending the rights of third countries under a particular Directive.

### 8.9

The process of amending legislation would involve what is known as the codecision or ordinary legislative procedure.

### 8.10

Under the ordinary legislative procedure, the Commission proposes legislation and the Council (comprising the heads of state from each Member State) and the European Parliament can make amendments to it. See the diagram in Appendix 4 for more details of the process. The Council votes by qualified majority, unless Member States consider the matter to be sensitive; financial regulation does not normally require unanimity on the Council. The European Parliament votes by simple majority.

### 8.11

The timescales for enacting legislation can be very protracted. For example:

- (a) The consultation on what became CRD IV began in July 2009, with different consultation periods running until March 2011. The Commission's proposal was tabled in July 2011, with CRD IV not being adopted until 26 June 2013. The new rules then didn't apply until 1 January 2014 – almost five years after the first consultation began.
- (b) Consultation for MiFID II began in mid-2010 and the Commission adopted its first proposal in October 2011. Though the MiFID II Directive and MiFIR were adopted in July 2014, the deadline for full implementation has been extended to the start of 2018.
- (c) The project for what was to become Solvency II was launched in 2004, with an initial proposal published in July 2007. The Solvency II Directive was adopted in April 2009, but repeated delays culminated in a major overhaul carried out through amendments made by another Directive, "Omnibus II". Eventually, Solvency II became fully effective in January 2016, nearly 12 years after the initial project started.

<sup>214</sup> Under the UK's constitutional principle of parliamentary sovereignty, Government cannot bind Parliament and Parliament cannot bind its successors, so any commitment would be subject to repeal by Parliament.

### 8.12

Each of those items of legislation was very wide ranging (even if, in the case of MiFID II, the intention was only to supplement an existing item of legislation). Conceivably the timeframes for an extension of the TCRs could be shorter, particularly if the scope of the change being sought is narrow. Even then, however, it is likely to take years, rather than months, for legislative change to be effected.

#### *Bespoke agreements*

### 8.13

Bespoke agreements are more likely to be used for broader arrangements which do not depend on merely extending the TCRs by reference to existing EU legislation.

### 8.14

In relation to the process for entering into a bespoke agreement:

- (a) the voting procedure which must be used in the Council depends on what the agreement covers (see diagram below);
- (b) any detailed agreement is likely to need unanimity among the 27 European Council members under Article 218(8) of the TFEU and approval of the finalised text by a simple majority in the European Parliament; and
- (c) any agreement between the UK and EU is likely to be a “mixed” free trade agreement, which falls under both Member State and EU competence, would also require approval by the national parliaments of each Member State and, in the case of Belgium, by regional parliaments.<sup>215</sup>

### 8.15

The UK and EU could also consider opting for an Association Agreement under the process set out in Article 217 of the TFEU. As well as providing for the liberalisation of trade between the parties, an Association Agreement contains provisions on establishing close economic and political cooperation and the respect of human rights and democratic principles. The EU has entered into a number of Association Agreements. The content of an Association Agreement varies depending on the partner country. However, under the Article 218 procedure, a mixed association agreement would always require unanimous approval in the Council, simple majority consent in the European Parliament and ratification by the Member States’ national parliaments. It is likely, therefore, that the ratification of an Association Agreement between the UK and EU would face the same challenges as any other type of bespoke agreement.

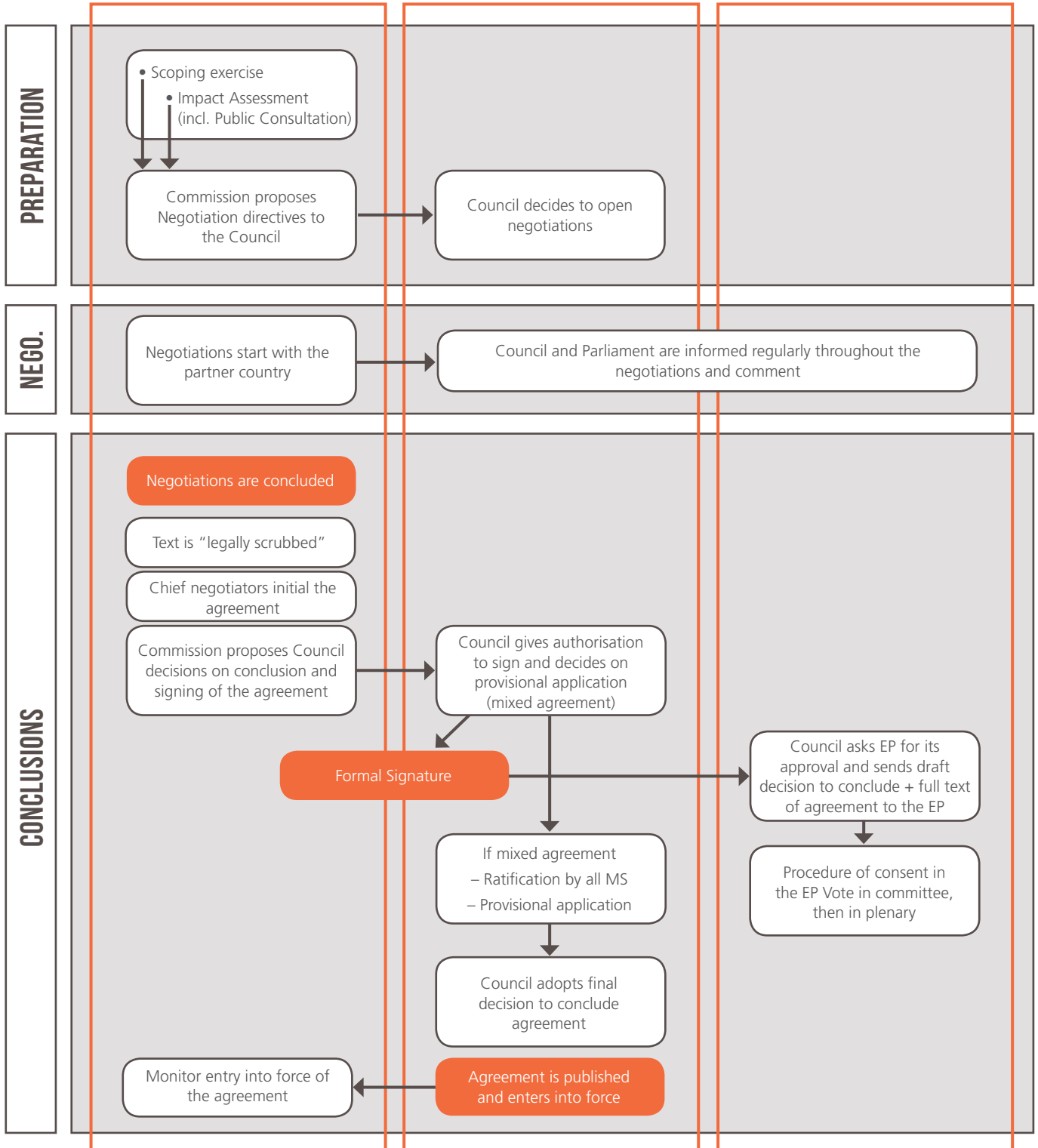
### 8.16

Any bespoke agreement between the UK and the EU would need to comply with WTO Most-favoured Nation (MFN) principles:

- (a) The MFN principles provide that WTO members must grant to goods and services of all other WTO members treatment no less favourable than that accorded to like services or goods of any other WTO member. However, this does not prevent free trade agreements, provided

<sup>215</sup> In this regard, it is worth noting the protracted nature of the negotiation of the EU-Canadian Comprehensive Economic and Trade Agreement (“CETA”) and the hurdles that agreement faced as a result of Belgian regional parliaments exercising a veto over their government’s power to sign the agreement.





Source: The Directorate General for Trade of the European Commission

that these eliminate substantially all duties and other restrictions on the trade between the parties to such an agreement.

- (b) WTO members are permitted to schedule exemptions from the MFN treatment in relation to services (but not goods), including financial services. For example, an exemption exists in relation to the agreement between the EU and Switzerland on insurance. However, new exemptions from MFN treatment must be agreed to by 75% of WTO members.
- (c) A sectoral agreement that provides for the liberalisation of cross-border trade in financial services on the basis of regulatory consistency or equivalence would be permitted, without having to rely on an exemption, since recognising regulatory equivalence is not a breach of MFN principles. The GATS permits WTO members to mutually recognise regulatory standards, such as licensing granted in a particular country, not just in relation to financial services.<sup>216</sup> The Annex on Financial Services to GATS contains provisions specific to the financial services sectors, including that a WTO member may recognize the prudential measures of another country when determining how their measures relating to financial services will be applied.

### 8.17

A model which is not currently used for third country access for financial services but is used for goods and which could be explored is a “mutual recognition model”. Some of the Single Market Directives aim to harmonise the regulatory regimes of different industry sectors across Member States. Where the regime is not subject to EU harmonisation, however, it is still possible for a firm from a Member State to provide goods into other Member States based on the principle of “mutual recognition”. It means that any product lawfully sold in one Member State can be sold in another, even if the product does not fully comply with the technical rules of the other country.

### 8.18

Related to this concept is the “mutual recognition agreement” (MRA), which is a form of bilateral agreement which relates to mutual recognition between the EU and a third country. The EU has entered into a number of MRAs with third countries (including Australia, Canada, Japan, New Zealand, the USA, Israel and Switzerland), although so far these MRAs only relate to trade in goods and it is not clear that they would be extended to the provision of services.<sup>217</sup>

<sup>216</sup> Article VII of the GATS.

<sup>217</sup> Under the MRA model, the MRA specifies conditions under which the third country will accept conformity assessment results (e.g. testing or certification) performed by conformity assessment bodies (CABs) designated by the EU to show compliance with the third country's requirements and vice versa. Although the MRA procedure is used exclusively for goods, a version of this approach could be used as a model for the future relationship between the UK and the EU. For example, a CAB could be appointed to provide a streamlined way of approving products and services for sale in the EU and could set out clear assessment criteria which could make the access approval process more objective and less political as well as introduce procedural certainty. There are, however, some potential drawbacks to this approach:

- (i) An MRA model may not be that different to the TCRs. The CAB's role, in determining whether a product meets the EU requirements, may not be that different in practice to the equivalence assessments that the ESAs make under the TCRs. The MRA may simply be another model for considering equivalence (but if it relates to mutual access, there may be more scope for a process which relies on clear criteria and a less politicised approach).
- (ii) The MRA regime was designed with manufactured goods in mind. For such products, it may be easier to set criteria or make minor changes to ensure conformity (e.g. to change the colour of a component), whereas making changes to financial services products and services may not be so straightforward.
- (iii) The MRA regime applies at the level of individual products. The TCRs apply more broadly and look at the equivalence of regulatory regimes, rather than looking at the terms of specific products. The use of MRAs to consider particular products and services would probably represent a significant administrative burden on the body appointed to be the CAB.

### 8.19

In relation to any bespoke agreement, there will be specific issues which need to be covered, such as:

- (a) how to entrench a withdrawal process from the agreement;
- (b) how to maintain “consistent” or “equivalent” regulatory standards (or other criterion, as applicable) – see also paragraph 8.5(d) above;
- (c) dealing with disputes. Unlike with EU legislation, there would not be a presumption that the CJEU would be the arbiter of disputes – and there is precedent for the EU having arrangements with third countries which use concepts of consistency or equivalence and where the CJEU does not act as arbiter. It would be open to the UK and the EU to agree a new arrangement, possibly with a new body being created as an independent arbiter.<sup>218</sup> The EFTA Court, which deals (in part) with infringement actions against EEA members who fail to implement EU rules, provides a useful analogy as to how such a body could operate; and
- (d) areas of opportunity for enhancing ways of working together, such as reporting mechanisms, regulatory cooperation or establishing joint drafting committees for developing a legislative response to a new international obligation (which could draw on the UK’s strength in financial services and share the resource burden of developing a regulatory response then assessing equivalence with varying third country responses).

### 8.20

In relation to timing:

- (a) Timescales for the negotiation of trade agreements vary greatly. For example:
  - (i) In relation to the bilateral agreements with Switzerland, the negotiation and approval period is typically at least four years, although some (e.g. the cooperation agreement in respect of the European Asylum Support Office) have taken as little as 18 months to negotiate and apply.
  - (ii) The EU-Canadian CETA agreement faced considerable hurdles, taking seven years (between 2009 and 2016) to negotiate, and it now needs to be ratified by the parliaments of each Member State; and
  - (iii) the wide-ranging EU-South Korea Free Trade Agreement took just two years to negotiate and sign (2007-2009) but it only formally entered into force on 13 December 2015 after ratification by Member States.
- (b) It seems likely therefore that a more focussed trade deal – addressing the financial services sector alone – could be agreed in shorter order than these broader agreements if there is political will within the UK and EU to achieve that. However, any trade agreement between the EU and UK after Brexit, including one that is financial services specific, would be highly politicised and complex and its negotiation could therefore be more drawn out than the agreements referred to above.

<sup>218</sup> In the context of aviation, for example, the EU has entered into agreements with third countries which involve equivalence-like concepts and where the CJEU is not the arbiter of disputes (and which, in at least one instance, involved a separate joint body being created for consideration of disputes and an appeal to an independent tribunal).

### **8.21**

It has been suggested by the UK Government that trade terms should be incorporated into the Withdrawal Agreement.<sup>219</sup> Article 50 provides for ratification of the Withdrawal Agreement by the Council acting by a qualified majority – though this still needs to be achieved within the two year notice period, or the UK’s membership lapses without the Withdrawal Agreement in place. However, there are indications that the EU may adopt a narrower interpretation which would not extend the text of Article 50 (which envisages that the Withdrawal Agreement will “take account of the framework” of the “future relationship” between the UK and the EU) to cover future trading arrangements.

### **8.22**

It is currently unclear whether the negotiation of any bespoke agreement between the UK and the EU could proceed in parallel with negotiation of the Withdrawal Agreement (although it is clear that bilateral agreements can only be concluded after the UK becomes a third country). Nevertheless, it may be in the interests of both the UK and the EU to adopt this approach in order to establish their future trading relationship as quickly as possible. It is therefore conceivable that broad agreement over financial services, such as the sectors or activities that will be included in any future bespoke agreement, could be included in the Withdrawal Agreement.

#### *Bilateral agreements with EU Member States?*

### **8.23**

In the paragraphs above, we considered the ability of the UK to enter into a bespoke agreement (e.g. a Free Trade Agreement) with the EU as a whole. In addition, it would be possible for the UK to negotiate bilateral agreements with individual EU Member States in order to secure exemptions which allow UK firms to service customers in those jurisdictions (potentially on the basis that the relevant Member State recognises that the UK’s standards are compatible with its own prudential requirements).

### **8.24**

The internal market is a shared competence between the EU and Member States.<sup>220</sup> Member States may exercise a shared competence to the extent that the EU has not exercised its competence.<sup>221</sup> Member States can only act using a shared competence where the EU has chosen not to. This would preclude an individual Member State agreeing a bilateral agreement with the UK in an area in which the EU has already legislated

### **8.25**

As discussed above, there is no overarching “omnibus” EU legislation in relation to recognition of equivalence in financial services; however, where there is existing EU legislation which deals with the recognition of equivalence, Member States cannot make similar bilateral agreements.

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<sup>219</sup> See Liam Fox’s comments to the House of Commons European Scrutiny Committee meeting, 26 October 2016.

<sup>220</sup> Article 4(2) of the TFEU.

<sup>221</sup> Article 2(2) of the TFEU.

## 8.26

Notwithstanding the restrictions set out above, there are examples of informal arrangements being made between EU Member States and third countries. For example, the UK and China have entered into a “strategic partnership”, which is not a binding agreement but a joint statement of intent to co-operate in certain areas. The list of areas is extensive and it specifically includes a partnership on financial services, covering the UK’s renminbi offshore market; the issuance of a sovereign renminbi bond in the UK and potential connections between the Shanghai and London Stock Exchanges. As a Member State, the UK is permitted to enter into these trade initiatives but is not able to conclude a binding free trade agreement with China.

## 8.27

### What changes might be appropriate for the existing access arrangements for third countries?

## 8.28

If the UK is unable to agree a broad right of access with the EU, in the manner described above, it may nevertheless wish to try and agree changes to the existing access arrangements for third countries. In particular, it could consider:

#### (a) Removing conditions to access

Where the TCRs involve the imposition of conditions on the third country, the UK may wish to ask for those conditions to be improved or modified. For example, the UK might ask that the condition in the MiFID II TCR for the third country to submit to the jurisdiction of an EU Member State be removed or relaxed.

#### (b) Introducing procedural protections

The UK could ask for additional procedural protections to be put in place – such as:

- (i) fixed time limits and clear criteria for the EU authorities to determine whether a third country is equivalent;
- (ii) in relation to the withdrawal of a determination of equivalence, a formal procedure under which a third country or third country firm is given sufficient notice of a possible withdrawal (e.g. a two year notice) and the right to be consulted and to make representations; and
- (iii) appointing a body which could act as an independent arbiter of any disputes regarding whether the conditions were satisfied for the third country firm to have access to the EU market.<sup>222</sup>

If the UK intends to enter into a bespoke agreement with the EU that goes wider than the current TCRs, it would want to ensure that any procedures introduced under the new arrangements would contain similar provisions and safeguards.

<sup>222</sup> It is reported that the Council has stated repeatedly that any further improvement of market access would require efficient mechanisms for adopting secondary law, a court system and surveillance of implementation. See <http://www.publications.parliament.uk/pa/ld201617/ldselect/lddeucom/72/72.pdf>.

**(c) Mitigating the impact of establishing an EU subsidiary**

If a UK firm wishing to do business in the EU considers that it has no alternative but to establish a subsidiary in the EU and for that subsidiary to apply for authorisation, the UK could ask for the TCRs to be extended in ways which would mitigate the negative impact of such a step. For example:

- (i) In relation to outsourcings, the UK could ask for recognition to be given that where the service firm is regulated in the UK, the EU firm and relevant EU regulator can assume that the outsource provider will be properly supervised and will have been required to have adequate systems and controls. Any changes of this nature could perhaps itself form the basis of a new TCR, with an assessment being made of whether the UK is equivalent for the purposes of all the key considerations that apply to an EU regulated entity when entering into an outsourcing. Having clarity and consistency of approach would help firms to plan.
- (ii) It may be possible to agree a basis on which the regulatory capital requirements for the EU subsidiary are relaxed and allow greater reliance on capital available from third country firms in the wider group. For example:
  - (1) Under Solvency II, an insurer is permitted to have meet up to 50% of its capital requirements using “ancillary own funds” – i.e. capital which has not yet been paid in but is available from a third party on demand and without conditions. This enables insurers to, in effect, cover the capital position of a regulated subsidiary using the promise to pay capital from a parent company. This approach is currently only available under Solvency II, for insurers and reinsurers, but if the concept could be extended to other types of regulated entity it would help relieve the capital burden associated with setting up an EU subsidiary.
  - (2) The regulatory capital requirements require firms to consider their exposures to third parties (including to other members of the same group). It may be beneficial if these rules could be relaxed in relation to exposures that the EU subsidiary has to third country firms in its group.<sup>223</sup>

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<sup>223</sup> An example of such a concession can be found in Article 107(3) of the CRR, which provides that exposures to third country firms shall be treated as exposures to an institution (and thereby receive more favourable capital treatment) only if the third country applies prudential and supervisory requirements to that entity that are at least equivalent to those applied in the EU.

# 9.0 TRANSITIONAL ARRANGEMENTS

## Key points

- It is strongly advisable that the UK and EU agree transitional arrangements as early as possible in the process.
- The nature of the transitional arrangements would have to be negotiated, but ideally it would involve a continuation of passporting rights (or similarly extensive rights of access) until such time as the new long-term arrangements have been fully implemented and firms have had time to adapt to them.
- If a continuation of the passporting regime (or similar rights) cannot be agreed as a transitional arrangement for the post-Brexit period, the UK may wish to seek protections to ensure that the TCRs are available for UK firms after Brexit.
- The Withdrawal Agreement could be a suitable tool for introducing transitional arrangements (although an interim agreement for the transitional arrangements may need to be reached more swiftly than that). For the purposes of negotiating the Withdrawal Agreement, the Commission considers the withdrawing state to be a third country once it is given notice after Article 50. After giving notice, therefore, the UK can engage in negotiations regarding its future status as a third country.

## 9.1

It is strongly advisable that the UK and the EU agree transitional arrangements in relation to any changes to cross-border access rights as soon as possible. In particular:

- (a) The UK's exit from the EU will take effect automatically two years after the UK serves notice under Article 50 of the TEU.<sup>224</sup> It is doubtful whether any significant changes to rights of access for third countries (whether through passing further EU legislation or through any mutual access agreement between the UK and EU) can realistically be enacted during that period.
- (b) Firms whose current authorisation or passporting arrangements will be affected by Brexit<sup>225</sup> need to make plans for how they will conduct their business after Brexit. If they do not put alternative arrangements in place before the date of the Brexit, they risk going over the "cliff edge" of their cross-border business becoming illegal after that date. The most likely solution for most UK firms will be to establish a subsidiary in an EU Member State, apply for that subsidiary to be authorised and transfer its existing cross-border business in that subsidiary (see under paragraph 7.9 for details). It is expected that such a process might in itself take one to two years. Many UK financial services providers already have plans in place, under which they will start this process very shortly after the Article 50 notice is served, in order to avoid the "cliff edge". If transitional arrangements can be agreed sufficiently swiftly, UK firms may be able to hold off commencing these processes. If not, UK firms may have no choice but to start their transfer processes imminently. From a UK perspective, this could lead to business leaving the UK unnecessarily. At a broader level, across the EU, it will

<sup>224</sup> This period could be extended with the unanimous agreement of EU Member States.

<sup>225</sup> This would include UK firms that passport into other Member States and firms from other Member States that passport into UK. It would also cover market infrastructure (both in the UK and the rest of the EU) that is currently authorised to provide services in the EU.

be extremely disruptive and inefficient for firms to have to commence these steps simply as a contingency against the “cliff edge” scenario. A transitional arrangement which removed the threat of the “cliff edge” scenario would enable firms not to act with unnecessary haste.

- (c) Consumers in the UK and EU will be affected. At one level, there will be numerous UK consumers who have purchased long term products such as life insurance from a firm based in another EU Member State. Those consumers will need reassurance that the products they have already purchased will not become invalid after Brexit. More broadly, citizens throughout the EU rely on a broad range of financial services, and they have a vested interest in the sector operating efficiently. The EU is also keen that EU citizens should have the benefit of cross-border access, as shown by the Commission’s Green Paper on Retail Financial Services.<sup>226</sup> It will be important to reassure individuals across the EU at an early stage that the financial products which they have in place (or which they purchase between now and the date of Brexit) will not be withdrawn due to Brexit.
- (d) If UK firms need to establish new subsidiaries in EU Member States and apply for local authorisation, it is likely that regulators in certain Member States will find themselves inundated with applications for authorisation. They may not be able to cope with the volume of applications or may need to invest in additional resources, and the demands on their resources may have implications for their ability to discharge their other regulatory functions effectively.

### 9.2

In view of these concerns, the immediate priority of the UK Government should be to agree transitional arrangements with the EU. The UK Government should also acknowledge publicly that that is the case, in order to give UK firms comfort that they may not need to implement their contingency plans immediately.

### 9.3

## The nature of the transitional arrangements

### 9.4

The nature of the transitional arrangements is something that will have to be agreed between the UK and EU.

#### *Continuation of current passporting rights*

### 9.5

Until the new long-term arrangement has been implemented, there should be continuation of access for all types of activities currently conducted cross-border.

### 9.6

The optimal solution would be for the UK and EU to agree to a continuation of the current passporting regime for a definite or (if linked to a trigger event, such as agreement on the future framework), indefinite period after Brexit – i.e. so that firms could continue to use existing passports across the UK/EU border.

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<sup>226</sup> [http://ec.europa.eu/finance/consultations/2015/retail-financial-services/docs/green-paper\\_en.pdf](http://ec.europa.eu/finance/consultations/2015/retail-financial-services/docs/green-paper_en.pdf)



Continuation of passporting would involve the least disruption to UK and EU institutions, since it would effectively be preserving the status quo.<sup>227</sup> It would also remove any concerns around the effectiveness of products that were already in issue (at least, until the transitional period ended).

### 9.7

There are precedents for transitional arrangements of this nature. When the Transparency Directive was introduced, the Commission was given a five year period to determine whether the accounting standards that the third country issuer was subject to in its home state were equivalent to those under EU law. The Transparency Directive provided that if the Commission decided that the accounting standards of a third country are not equivalent, it may allow the issuers concerned to continue using such accounting standards during an appropriate transitional period.

#### *Equivalence under the TCRs*

### 9.8

If the continuation of the passporting regime (or similar arrangement) cannot be agreed, and no long term post-Brexit arrangement has been put in place, UK firms may need to rely on the TCRs in the period after Brexit. This would not be a desirable fall back option and could potentially pre-judge the successful negotiation of longer-term market access arrangements. Given TCRs limited coverage, uncertainty of availability and the lack of key safeguards, this approach would leave significant issues unaddressed and UK firms would not be able to offer the current level and range of financial products and services to the EU. If that was the case, the UK could seek protections to ensure that the TCRs will be available to those firms at the date on which Brexit takes effect. In particular:

- (a) The UK, at a country level, will have to comply with the TCR conditions – which usually involves demonstrating that its legal and regulatory regime is equivalent to that of the EU. In order to avoid the possibility that the equivalence determination for the UK cannot be concluded prior to the date of Brexit, the UK could ask that it automatically be deemed to have satisfied all the TCR conditions for all the TCRs.<sup>228</sup> That could be agreed on the basis that the UK's status could subsequently be revoked if, on further analysis, the EU authorities concluded that the UK did not in fact satisfy the conditions.
- (b) UK firms who already have passports could be “grandfathered” into the TCR arrangements, so that their passports are automatically replaced by formal recognition under the relevant TCRs.

#### *Protection for existing products*

### 9.9

Consumers who have, prior to the date of Brexit, purchased a product from a regulated firm on the other side of the UK/EU border (e.g. a policy of long term insurance) may be concerned about whether that product will remain valid after the date of Brexit.

<sup>227</sup> Although this is referred to as continuing the existing passports, it would in fact require a separate mechanism to be put in place to enshrine that access. It would be necessary to cover the elements of the “passporting” arrangements which are currently dealt with by EU membership – such as mechanisms for withdrawal of access and maintaining a matching legal framework or to bring a non-EU member within the legislative framework of the EU.

<sup>228</sup> In relation to the condition that the UK has entered into a cooperation agreement, we expect that the UK would still be required to do this – or that the terms of cooperation are built into the agreement under which the UK is deemed to comply with the other TCR conditions.

### 9.10

In order to avoid this, in addition to any broader transitional arrangement, the UK and EU could agree to a “grandfathering” arrangement, under which any such product that is already in issue will automatically remain valid and that any firm that continues to service such a product across the UK/EU border will not be in breach of local licensing requirements by doing so.

### 9.11

## The duration of the transitional arrangements

### 9.12

The duration of the transitional arrangements would need to be considered carefully. The duration should be sufficient for the UK and EU to both agree and fully implement a long term solution to the question of cross-border access.

### 9.13

Ideally, the transition period would cover the period up to the date on which the new long-term arrangements have been fully implemented. Different approaches to the transition period are being considered; the BBA, for example, favours two separate periods, with a “bridging period” between the date of Brexit and the date on which the new arrangements are formally agreed, and an “adaptation period” between the end of the bridging period and the date on which the new arrangements come fully into effect.<sup>229</sup> The exact nature of the transitional arrangements could be different for different periods, but the key issue is that transitional arrangements should be in place and provide continued access for firms and their customers until the new long-term arrangements have been fully implemented. The UK Government itself has indicated that it would look to conclude the terms of any agreement prior to the date of Brexit itself, but that there may then be a period of phased implementation after Brexit.<sup>230</sup>

### 9.14

It is possible that the UK and EU may be unable to agree a long-term arrangement for reciprocal rights of access. The UK may end in a situation where it has no additional rights of access beyond that of any other third country. The transitional arrangements should be designed to cater for that eventuality – and to allow firms sufficient time to implement any contingency plans before the transitional arrangements come to an end.

### 9.15

If transitional arrangements of this nature could be agreed, financial services providers affected by Brexit would not need to start implementing their contingency plans now, as they know that they will always have time in the future to implement their contingency plans.

### 9.16

During the withdrawal negotiations, more detailed transitional arrangements could be agreed to reflect any changes to nature of the future trading relationship which is agreed.

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<sup>229</sup> BBA publication: “Time to adapt: achieving an orderly transition for banking” (November 2016).

<sup>230</sup> Speech by the Prime Minister: “Blueprint for Brexit” (17 January 2017).

**9.17**

With the benefit of a transitional arrangement in place, regulators and policy-makers across the UK and EU will be able to concentrate on designing the optimum way of working together for the long-term benefit of all – instead of monitoring and reacting before knowing what that long-term solution will look like.

**9.18****Introducing the transitional arrangements****9.19**

The extent to which the Withdrawal Agreement will deal with the future relationship between the UK and the EU is unclear, but that Agreement appears to be the most logical tool for introducing transitional arrangements.

**9.20**

Article 50(2) of the TEU states that *“the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union”*.

**9.21**

While it may be difficult to argue that detailed provisions on the long-term relationship between the UK and EU can be incorporated into the Withdrawal Agreement, that Agreement should at least be capable of covering the transitional arrangements which provide for the continuation of cross-border services prior to the agreement of a definitive solution.

**9.22**

It may, however, be necessary for the UK and EU to reach an earlier agreement (i.e. outside the confines of the Withdrawal Agreement) regarding transitional arrangements whilst the wider negotiations are progressed. If the transitional arrangements are not determined until the Withdrawal Agreement has been agreed, it is likely to be too late for firms to take any action to avoid the “cliff edge”. The transitional arrangements should be agreed as early as possible, and may need to take the form of a separate agreement. Those arrangements could then be enshrined in the Withdrawal Agreement as well. It is also possible that an interim agreement could be reached in order to address the question of the “cliff edge” and that that a different form of transitional arrangement is concluded during the negotiation of the Withdrawal Agreement.

**9.23**

For the purposes of the negotiation of the Withdrawal Agreement, the Commission considers the withdrawing state to be a third country rather than a Member State once it has given notice under Article 50 of the TEU.<sup>231</sup> Discussions relating to equivalence under the TCRs (whether as part of the negotiation of the Withdrawal Agreement or under the existing TCR determination mechanisms) could therefore proceed on the basis of the UK already being a third country for the purposes of seeking a determination.

<sup>231</sup> European Commission Note to the File, dated 28 June 2016. The Director General of the Legal Services Directorate confirmed the Commission’s view that “Article 50 TEU treats the withdrawing Member State as if it were already a third State”.

### 9.24

The EU has previously made pre-emptive equivalence decisions in respect of TCRs not yet in force; for example, equivalence determinations under Solvency II were made prior to the Directive coming into force. This establishes a helpful precedent if access under the TCRs is to be sought by UK firms.

### 9.25

The Council will conclude the Withdrawal Agreement on behalf of the EU, voting by qualified majority voting, under Article 50 of the TEU. This reduces the likelihood of smaller EU Member States being able to prevent the arrangements taking effect.

### 9.26

Transitional arrangements negotiated as part of the Withdrawal Agreement would need to comply with WTO rules on preferential treatment, in particular:

- (a) Article V of the GATS, which deals with agreements liberalising trade in services; and
- (b) Article XXIV of the General Agreement on Tariffs & Trade (GATT), which provides for the adoption of a transitional agreement prior to the formation of a free-trade agreement.

### 9.27

In order to be consistent with these provisions, the Withdrawal Agreement would have to time limit any transitional arrangements and include “a plan and schedule” for the establishment of a bilateral free trade area within a “reasonable length of time”. The WTO states that this “reasonable length of time” would exceed 10 years only in exceptional cases.<sup>232</sup>

### 9.28

If the transitional arrangements would be based on mutual recognition of consistency or equivalence, the UK and EU could argue that they would not be in breach of the GATS, as a result of the exception in Section 3(a) of the Annex on Financial Services to GATS which allows the recognition of prudential measures.

### 9.29

It is not anticipated that the transitional arrangements would require any changes to existing Treaties, as the arrangements would be concluded between the EU and a third country. The relationship between EU Member States is not affected.

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<sup>232</sup> [https://www.wto.org/english/tratop\\_e/region\\_e/regatt\\_e.htm](https://www.wto.org/english/tratop_e/region_e/regatt_e.htm)

# 10.0 THE UK'S OWN REGIME FOR DEALING WITH FIRMS FROM OUTSIDE THE UK

## Key points

- The UK needs to consider its own position towards overseas firms (i.e. firms from both EU Member States and third countries).
- The UK already has a liberal regime towards direct authorisation of branches of non-EU firms and towards allowing access to the UK market for non-EU firms who do not establish branches.
- The UK Government needs to consider whether, as a matter of policy, it wishes to maintain its existing approach and whether that should apply for the benefit of firms from EU Member States as well.

### 10.1

The UK needs to consider its own position towards overseas firms in a post-Brexit world – including in relation to firms from EU Member States (who will have lost their ability to passport into the UK), as well as other countries.

### 10.2

In this section of the report, we use the term “non-EU firm” to describe a firm from outside the EU rather than “third country firm” (even though, while the UK is still in the EU, such firms are third country firms vis-à-vis the UK), in order to avoid potential confusion with the post-Brexit situation, in which the UK will be a third country vis-à-vis the EU. The current UK approach to non-EU firms, as set out below, would potentially apply to EU firms after Brexit has occurred.

### 10.3

A non-EU firm that wishes to conduct regulated activities in the UK usually has three options:

- rely on an exemption under the UK regulatory regime to avoid the need for authorisation. There is an exemption for “overseas persons” under the UK regime, which is considered in more detail in paragraph 10.12 below. This option would not be available, however, to any person who wished to establish a physical presence in the UK (e.g. a branch office) or to continue operating from a branch established in the UK under the existing passporting arrangements;
- establish a subsidiary in the UK and apply for authorisation from the PRA or FCA; or
- establish a branch office in the UK and apply for direct authorisation of the branch from the PRA or FCA.

We have considered options (a) and (c) in more detail below.

### 10.4

## The UK's approach to direct authorisation of branches of non-EU firms

### 10.5

As explained under paragraph 7.19 above, it is open to regulators in EU Member States to allow direct authorisation of non-EU firms in relation to most aspects of financial services. Typically,

that takes the form of granting authorisation to a non-EU firm in respect of a branch established in an EU Member State.

### 10.6

The rules that the UK applies to non-EU firms differ depending on the type of business the firm is proposing to undertake in the UK. In the paragraphs below, we have focussed on the position applying to third country credit institutions and insurers, as the UK regulators have developed detailed and specific regimes applicable to these entities.

### 10.7

An application for direct authorisation technically covers the non-EU firm as a whole, so all the conditions for authorisation must be met by the firm as a whole and not just by the UK branch of the firm. Section 55D of the FSMA indicates that in determining whether a third country firm would satisfy the conditions, the UK regulator may have regard to any opinion notified to it by the relevant overseas regulatory authority. The FSMA therefore already has the framework for a process under which the UK regulators will co-operate with and seek input from non-EU regulators.

### 10.8

Non-EU firms that obtain direct authorisation are required to comply with relevant parts of the FCA Handbook and the PRA Rulebook. In some cases, the rules have been developed specifically with non-EU firms in mind: for example, parts of the PRA Rulebook apply specifically to branches of non-EU firms and contain requirements such as governance and capital requirements.

### 10.9

The position in the UK is currently as follows.

#### (a) **Non-EU credit institutions**

The PRA has allowed a number of non-EU credit institutions to become authorised in the UK and establish branches.<sup>233</sup>

In relation to credit institutions, the relevant Single Market Directive (CRD IV) does not prevent Member States granting access to non-EU firms under local laws – and indeed makes it clear that a Member State may allow non-EU credit institutions to establish branches in their territory, provided that the rules for third country branches are not more favourable than those applied to branches of firms from other Member States.<sup>234</sup> (This provision also means that there would be no legal obstacle to EU Member States granting direct authorisation to branches of UK credit institutions after Brexit.)

The PRA has produced a supervisory statement indicating how it will review authorisation applications from third country credit institutions and how it will supervise branches of such credit institutions.<sup>235</sup> The PRA takes a “risk approach” to authorising branches of non-EU credit institutions. In summary, the PRA will consider the following questions:

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<sup>233</sup> See the list of credit institutions, which includes a list of non-EU credit institutions with branches, at: <http://www.bankofengland.co.uk/pradocuments/authorisations/banklist/banklist1610.pdf>

<sup>234</sup> Article 47 of CRD IV.

<sup>235</sup> See <http://www.bankofengland.co.uk/pradocuments/publications/ss/2014/ss1014.pdf>

**(i) *Is the home state supervisor sufficiently equivalent?***

The PRA must assess whether the FSMA threshold conditions are met for the whole firm and not just the branch. The PRA has indicated that its equivalence assessment will involve looking at the following types of points: the home state jurisdiction's rules, powers, consolidated supervision, information sharing, confidentiality, the competence and independence of supervision, and capital, liquidity and resolution regimes (where the PRA will assess if the regime is consistent with international standards). After Brexit, an EU credit institution ought to be able to satisfy the PRA's requirements relatively easily.

**(ii) *Has the home state supervisor accepted responsibility for the branch?***

Where the PRA has determined that the home state supervisor is sufficiently equivalent, it will rely where possible on the home state supervisor to supervise the branch. As part of this, the home state supervisor must accept responsibility for the branch and confirm that the PRA threshold requirements are met in relation to it. The PRA will also require the existence of a firm-specific agreement on the split of responsibilities for prudential supervision of the branch and an appropriate level of information sharing.<sup>236</sup>

**(iii) *What are the arrangements for resolution?***

As part of this, the PRA would assess the resolution arrangements of the home state (i.e. the arrangements for the orderly resolution of the credit institution in the event that it becomes insolvent).

**(iv) *What activities will the branch be undertaking?***

The PRA would consider whether the firm would be performing any "critical economic functions" which would have a significant impact on the UK market. The PRA has indicated that firms should not be providing retail services above a "de minimis" level and should focus on wholesale activities. In general, the greater the level of critical economic functions that the firm is undertaking, the greater assurance the PRA would require in relation to the arrangements in place for resolution of the firm.

If the PRA continues to apply this de facto restriction (i.e. restricting business to wholesale activities) to EU credit institutions after Brexit, it is likely that the EU Member States will take a similar approach to any request by UK credit institutions to obtain direct authorisation in the Member State and restrict them to wholesale business as well. The UK may therefore wish to consider whether to relax its restriction and allow EU credit institutions to provide retail services as well. This is permitted under CRD IV, so the question for the UK regulators is really whether it is comfortable allowing non-EU firms to have access to retail customers in the UK and whether their current arrangements allow them to supervise this adequately.

<sup>236</sup> The PRA has indicated that it will expect the split of responsibilities with the home state regulator to focus on the following issues:

- business risks (i.e. risks identified by the PRA as applying to the whole firm);
- liquidity (i.e. the extent to which the branch itself must have liquidity or can depend on liquidity from its home state);
- capital (which is a matter for the home state regulator);
- risk management and systems and controls (compliance with some UK rules is still required); and
- management and governance (which is primarily a home state matter, save that the UK's senior managers and certification regime does apply to UK branches of third country credit institutions).

**(b) Non-EU insurers**

The PRA allows non-EU insurers to become authorised in the UK and establish branches.

The relevant Single Market Directive (Solvency II) does not prevent Member States from permitting access via the establishment of branches. It does not contain a TCR, but it gives Member States some flexibility to permit non-EU insurers access under national rules.

Article 162 contains a series of requirements that must be met before a Member State can permit a non-EU firm to set up a branch.<sup>238</sup> Article 174 makes clear that, in the context of pure reinsurers, Member States must not apply rules to non-EU firms which result in more favourable treatment than the rules applied to reinsurers based in that Member State.<sup>238</sup>

The PRA has provided guidance on the factors it considers when authorising non-EU insurers.<sup>239</sup> These are similar to the regime applicable to third country credit institutions. The relevant factors include:

**(i) Adequacy of the home state regulator**

The PRA will judge the adequacy of the home state regulator (at the point of authorisation and then on an on-going basis). As part of this, it will assess whether the home state regulator is applying a regime which is “broadly equivalent” to that of the UK.

**(ii) Cooperation with home state regulator**

Where the PRA has satisfied itself that the non-EU country’s regulatory framework is equivalent, it will rely where possible on the non-EU country regulator’s prudential supervision in relation to the whole firm. The PRA will agree with the non-EU country’s regulator on how the responsibilities for supervision will be allocated as between that regulator and the PRA.<sup>240</sup>

The PRA rulebook contains a number of rules which are applicable to branches of non-EU insurers and reinsurers.<sup>241</sup> In particular, there are specific rules setting out how the senior insurance managers’ regime applies to such branches.

**(c) Other regulated firms**

It appears that other types of non-EU firm (i.e. other than credit institutions and insurers) have been able to obtain authorisation from the FCA for their branches. A review of the FCA register reveals a number of non-EU firms who are listed on the register as having been authorised to carry out activities including dealing in investments as principal, activities relating to regulated credit agreements (that is, consumer credit activities), activities relating to high cost short term credit and credit broking.

<sup>237</sup> This provision does not apply to pure reinsurers.

<sup>238</sup> These provisions support the idea that it should be possible for UK insurers to obtain direct authorisation in EU Member States after Brexit.

<sup>239</sup> <http://www.bankofengland.co.uk/publications/Documents/prapproach/insuranceappr1406.pdf>

<sup>240</sup> The PRA has indicated that it will tend to exercise additional supervision over activities of the branch, be concerned about what would happen in the event of failure (in particular the assets available to pay branch policyholders) and would ensure that there are senior individuals in the UK who are responsible for the management of the UK operations and business booked in the UK.

<sup>241</sup> <http://www.bankofengland.co.uk/pr/Documents/publications/ss/2015/ss4415.pdf>



Unlike the PRA, the FCA has not published any detailed policy statements on its approach to such applications. We do not expect that its approach would be materially different from that of the PRA. The FCA does note on its website that, under MiFID, non-EU firms have to operate under similar rules to UK investment firms and credit institutions when they provide MiFID investment services and activities.<sup>242</sup>

If the UK wishes to open its doors to EU firms to apply for direct authorisation, the FCA may wish to consider publishing guidance on its approach to such applications.

## 10.10

### The UK's approach to non-EU firms who do not establish branches

#### 10.11

The UK generally has a more liberal approach than other EU jurisdictions towards allowing access to non-EU firms who do not wish to establish branches (and seek direct authorisation) in the manner described above.

#### 10.12

The central feature of the UK's approach to non-EU firms is the so-called "overseas persons" exemption, which is contained in Article 72 of the FSMA (Regulated Activities) Order 2001. The main features of the exemption are as follows:

- (a) It can be used by an "overseas person", which is defined as a person who carries on certain regulated activities<sup>243</sup> but does not carry on any such activities, or offer to do so, from a permanent place of business maintained by him in the UK.
- (b) The exemption applies differently depending on exactly which regulated activity the overseas person wishes to carry on, but for most activities it is a requirement that the business is carried on by the overseas person either:
  - (i) with or through an authorised person (i.e. a person authorised by the PRA or FCA)<sup>244</sup> in the UK or an exempt person<sup>245</sup> in the UK; or
  - (ii) as a result of a "legitimate approach" – i.e. that the overseas person is undertaking that activity without having breached the UK's restrictions on financial promotions.
- (c) In practice, this means that an overseas person can deal with UK persons in the following situations:
  - (i) where the UK person is an authorised or exempt person, or (for the activity of dealing) the transaction is arranged by an authorised or exempt person;

<sup>242</sup> <https://www.fca.org.uk/mifid-ii/9-passporting-and-branches-non-european-economic-area-eea-firms>.

<sup>243</sup> The list of regulated activities covered by the exemption is contained in Article 3(1) of the FSMA (Regulated Activities) Order 2001. Most of the regulated activities under the FSMA are covered, but there are a number which are not, including deposit taking and entering into or carrying out contracts of insurance.

<sup>244</sup> The definition of "authorised person" currently includes EU firms passporting into the UK (i.e. EU firms with UK branches). Unless the UK wishes to exclude such firms from the scope of the overseas persons exemption after Brexit, it will need to update the relevant UK legislation to allow overseas persons to continue to communicate with such firms.

<sup>245</sup> An "exempt person" is a defined term in the FSMA and it covers a separate category of person who are not authorised by the UK regulators but who have been granted exempt status under the FSMA. The category includes appointed representatives (unregulated firms who operate through the support of an authorised person who takes responsibility for their actions), certain regulated exchanges and clearing houses and various non-governmental bodies.

- (ii) where the overseas person did not actually solicit the business of the UK person (i.e. where there is reverse solicitation);
  - (iii) where the overseas person is able to use one of the exemptions to the UK's financial promotion regime. There are exemptions available for communications to investment professionals (i.e. firms that are authorised in the UK) and certain other categories of sophisticated or high net worth investor; or
  - (iv) in the case of written communications only, the overseas person can comply with the financial promotion restriction by having the content of the communication formally approved by an authorised person. This could potentially allow communications to be sent to customers who are not professional investors. (The need to find an authorised person to approve the communication tends, in practice, to mean that this approach is only used by overseas persons who have a UK authorised person in the same group.)
- (d) There are some regulated activities in respect of which the overseas persons exemption is more restrictive. For example, in relation to the regulated activity of "arranging deals" in investments, the activities of the overseas person will only be exempt if the UK person it is dealing with is either an authorised person or an exempt person.

### 10.13

The overseas persons exemption means that the UK's approach towards non-EU firms is considerably more open than that of many other EU jurisdictions.

### 10.14

If the protagonists on each side of the UK/EU border maintain their current approaches towards access for non-EU firms after Brexit, this could result in an asymmetric approach to access as between the UK and EU. The UK Government needs to consider whether, as a matter of policy, it wishes to maintain its existing approach – and whether it intends that, post-Brexit, the overseas regime should apply for the benefit of EU firms as well.

# APPENDIX 1

## INTERPRETATION AND GLOSSARY

### 1.0 INTERPRETATION

#### 1.1

For simplicity, we refer throughout the report to the EU rather than the EEA. However, access to, from and between EU Member States generally includes access to, from and between the members of the EEA who are not also members of the EU (i.e. Iceland, Liechtenstein and Norway) – who we refer to in this report as “**EEA-EFTA countries**”. As a result, any arrangement with the EU regarding access for UK firms would also secure the same degree of access to the EEA-EFTA countries. Separate agreements may, however, be needed with the EEA-EFTA countries. Where in this report we refer to the EEA, we mean the whole EEA (i.e. including the EEA-EFTA countries), as distinct from the EU.

#### 1.2

When referring to EU legislation, we sometimes refer to an item in generic terms rather than specifically identifying all the relevant legislation. For example, when we use the term generic term “**MiFID II**”, we may – as the context requires – be referring to the MiFID II Directive (Directive 2014/65/EU), the Markets in Financial Instruments Regulation (Regulation (EU) No 600/2014) and/or the MiFID II Delegated Regulation (the Commission Delegated Regulation of 25 April 2016), as well as other delegated acts and any underlying regulatory or implementing technical standards and guidelines. Where we refer to specific provisions of legislation, however, we do identify the specific legislative instrument as well.

### 2.0 ASSUMPTIONS

#### 2.1

We have assumed that Brexit will not take effect before March 2019 at the earliest. On that basis, a number of items of EU legislation which have not yet been implemented – most notably MiFID II and the Insurance Distribution Directive – are expected to have been implemented in the UK and become part of UK law before the UK leaves the EU.

## 3.0 DEFINED TERMS

### 3.1

In this report, the following terms shall have the meaning set out below.

Term	Meaning
2EMD	the Electronic Money Directive (2009/110/EC)
ABI	the Association of British Insurers
AIF	an Alternative Investment Fund (within the meaning given in the AIFMD)
AIFM	an Alternative Investment Fund Manager (within the meaning given in the AIFMD)
AIFMD	the Alternative Investment Fund Managers Directive (2011/61/EU)
AIFMD Delegated Regulation	the Alternative Investment Fund Managers Directive Delegated Regulation (231/2013/EU)
APA	an Approved Publication Arrangement (as defined under MiFID II)
ARM	an Approved Reporting Mechanism (as defined under MiFID II)
BBA	the British Bankers' Association
BCBS	the Basel Committee on Banking Supervision
Benchmarks Regulation	the Benchmarks Regulation ((EU) 2016/1011), which comes into effect on 1 January 2018
CCP	a central counterparty
the Commission	the European Commission
CFTC	the Commodity Futures Trading Commission, a US regulatory authority
CJEU	the Court of Justice of the European Union
CRA	a Credit Ratings Agency
CRA Regulation	the Credit Rating Agencies Regulation ((EC) 1060/2009 (as amended by (EU) 513/2011 and (EU) 462/2013)
CRD IV	the Capital Requirements Directive (2013/36/EU)
CRR	the Capital Requirements Regulation ((EU) 575/2013)
CSD Regulation	the Central Securities Depository Regulation ((EU) 909/2014)
CTP	a Consolidated Tape Provider (as defined under MiFID II)
DCO	a Derivatives Clearing Organisation
DRSP	a Data Reporting Services Provider (as defined under MiFID II)
EBA	the European Banking Authority, which is the European Supervisory Authority with responsibility for effective and consistent prudential regulation and supervision across the EU banking sector
EEA	the European Economic Area, an area in which the EEA Agreement provides for the free movement of persons, goods, services and capital within the European Single Market. The members of the EEA are all the member of the EU, plus Iceland, Liechtenstein and Norway
EEA Agreement	the Agreement on the European Economic Area, which entered into force on 1 January 1994, as amended

Term	Meaning
EFTA	the European Free Trade Association, an intergovernmental organisation set up for the promotion of free trade and economic integration to the benefit of its four member states, who are Iceland, Liechtenstein, Norway and Switzerland
EIOPA	the European Insurance and Occupational Pensions Authority, which is the European Supervisory Authority with responsibility for the EU insurance and occupational pensions sector
elective professional client	<p>a client of a firm who has been categorised as an elective professional client by the firm. A firm may treat a client as an elective professional client if it complies with the following:</p> <ol style="list-style-type: none"> <li>(1) the firm undertakes an adequate assessment of the expertise, experience and knowledge of the client that gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved;</li> <li>(2) at least two of the following criteria are satisfied: <ol style="list-style-type: none"> <li>(a) the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters;</li> <li>(b) the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds €500,000;</li> <li>(c) the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged; and</li> </ol> </li> <li>(3) the following procedure is followed: <ol style="list-style-type: none"> <li>(a) the client must state in writing to the firm that it wishes to be treated as a professional client either generally or in respect of a particular service or transaction or type of transaction or product;</li> <li>(b) the firm must give the client a clear written warning of the protections and investor compensation rights the client may lose; and</li> <li>(c) the client must state in writing, in a separate document from the contract, that it is aware of the consequences of losing such protections.</li> </ol> </li> </ol> <p>(See Annex II of the MiFID II Directive)</p>
eligible counterparty	<p>a client of a firm who has been categorised as an eligible counterparty by the firm.</p> <p>A firm may treat any of the following as an eligible counterparty: investment firms, credit institutions, insurance companies, UCITS and their management companies, pension funds and their management companies, other financial institutions authorised or regulated under EU law or under the national law of a Member State, national governments and their corresponding offices including public bodies that deal with public debt at national level, central banks and supranational organisations.</p> <p>Member States may also recognise as eligible counterparties other undertakings meeting pre-determined proportionate requirements, including quantitative thresholds.</p> <p>(See Article 30(2) and (3) of the MiFID II Directive)</p>
ELTIF	a European Long-Term Investment Fund
ELTIF Regulation	the European Long-Term Investment Fund Regulation ((EU) 2015/760)
EMIR	the European Market Infrastructure Regulation ((EU) 648/2012)
ESA	a European Supervisory Authority (of which there are three: the EBA, ESMA and EIOPA). The ESAs are responsible for supervisory oversight at an EU level
ESMA	the European Securities and Market Authority, which is the ESA with responsibility for safeguarding the stability of the EU's financial system by enhancing the protection of investors and promoting stable and orderly financial markets
EU	the European Union
EU Regulation	EU legislation which has direct effect in all Member States, with no requirement for implementing legislation in Member States

Term	Meaning
FATF	the Financial Action Task Force
FCA	the Financial Conduct Authority
FSMA	the Financial Services and Markets Act 2000
GATS	the General Agreement on Trade in Services
Great Repeal Bill	the parliamentary bill that the UK government has announced its intention to introduce, which will govern the UK's departure from the EU and as a result of which the UK will cease to be bound by EU law. One of the proposed provisions of the bill will enact into UK law certain provisions of EU law, in order to ensure continuity of the law
IDD	the Insurance Distribution Directive ((EU) 2016/97/EU), which comes into effect in February 2018
IMD	the Insurance Mediation Directive (2002/92/EC)
investment services	investment services and activities under MiFID, as described in paragraph 4.11(a)
IOSCO	the International Organization of Securities Commissions, which is an international body consisting of securities regulators and which sets global standards for the securities sector
MCD	the Mortgage Credit Directive (Directive 2014/17/EU)
Member State	a member state of the EU
MiFID	the Markets in Financial Instruments Directive (Directive 2004/39/EC)
MiFID Implementing Directive	the MiFID Implementing Directive (2006/73/EC)
MiFID II	the package of changes relating to MiFID that is due to come into effect on 3 January 2018, including the changes being implemented under the MiFID II Directive and MiFIR
MiFID II Delegated Regulation	the Commission Delegated Regulation of 25 April 2016 supplementing the MiFID II Directive as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, which is due to come into effect on 3 January 2018
MiFID II Directive	the Markets in Financial Instruments Directive II (2014/65/EU), which is due to come into effect on 3 January 2018
MiFIR	the Markets in Financial Instruments Regulation (Regulation (EU) No 600/2014), which is due to come into effect on 3 January 2018
MoU	memorandum of understanding
MTF	a Multi-lateral Trading Facility, which is a multi-lateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with requirements under MiFID II
OTF	an Organised Trading Facility, which is a multi-lateral system which is not a regulated market or an MTF and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system in a way that results in a contract in accordance with requirements under MiFID II. The concept of an OTF will not form part of UK or EU law until MiFID II is implemented, on 3 January 2018
PRA	the Prudential Regulation Authority
PSD 2	the Second Payment Services Directive (EU/2015/2366), the relevant provisions of which are due to come into effect on 13 January 2018

Term	Meaning
per se professional client	<p>each of the following is a per se professional client unless and to the extent it is an eligible counterparty:</p> <p>(1) an entity required to be authorised or regulated to operate in the financial markets. The following list includes all authorised entities carrying out the characteristic activities of the entities mentioned, entities authorised by a Member State under a Directive, entities authorised or regulated by a Member State without reference to a Directive, and entities authorised or regulated by a third country: credit institutions; investment firms; other authorised or regulated financial institutions; insurance companies; collective investment schemes or the management companies of such schemes; pension funds or the management companies of such funds; commodity or commodity derivatives dealers; locals; and other institutional investors;</p> <p>(2) large undertakings meeting two of the following size requirements on a company basis:</p> <p>(a) balance sheet total of €20 million;</p> <p>(b) net turnover of €40 million;</p> <p>(c) own funds of €2 million;</p> <p>(3) national and regional governments, including public bodies that manage public debt at national or regional level, central banks, international and supranational institutions such as the World Bank, the IMF, the ECB, the EIB and other similar international organisations; and</p> <p>(4) other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financing transactions.</p> <p>(Annex II of the MiFID II Directive)</p>
Prospectus Directive	the Prospectus Directive (Directive 2003/71/EC)
retail client	a client of a firm who has not been categorised as either a professional client or an eligible counterparty by the firm (Article 4(1)(11) of the MiFID II Directive)
SEC	Securities and Exchange Commission, a US regulatory authority
Single Market Directives	<p>the EU legislation implemented with a view to promoting a Single Market in relation to financial services. The relevant Single Market Directives are:</p> <p>(a) the Banking Consolidation Directive (to the extent it applies to certain types of investment firm only);</p> <p>(b) CRD IV;</p> <p>(c) the Solvency II Directive;</p> <p>(d) MiFID;</p> <p>(e) the IMD/IDD;</p> <p>(f) the MCD;</p> <p>(g) the UCITS Directive; and</p> <p>(h) the AIFMD.</p>
the Solvency II Directive	the Solvency II Directive (2009/138/EC)
the Solvency II Delegated Regulation	the Solvency II Commission Delegated Regulation (EU/2015/35)
TCR	a Third Country Regime, meaning a regime established under EU legislation which relates to the treatment of third countries and third country firms
TEU	the Treaty on European Union (2012/C 326/01), which established the European Union, as amended.
TFEU	the Treaty on the Functioning of the European Union (2012/C 326/01), which is the main treaty governing the organisation of the EU
third country	any country that is not a member of the EU or the EEA. After Brexit, the UK will be a third country
third country firm	a firm that is established in a third country
UCITS fund	an Undertaking for Collective Investment in Transferable Securities, a type of fund regulated under the UCITS Directive
the UCITS Directive	the Undertaking for Collective Investment in Transferable Securities (UCITS) IV Directive (2009/65/EC) (as amended by the UCITS V Directive (2014/91/EU))
Withdrawal Agreement	the agreement between the UK and EU which governs the withdrawal of the UK from the EU
WTO	the World Trade Organization

## APPENDIX 2

### TABLE OF REVIEW DATES FOR LEGISLATION RELATING TO TCRs

This table contains the dates specified in the relevant legislation for the review of legislation relating to the TCRs. This will be important where the UK is required to maintain an “equivalent” regulatory framework after Brexit in order to access the EU via a TCR.

The table only shows:

- (a) legislation that requires a decision on equivalence or similar determination by the EU; and
- (b) review dates that will occur after the earliest expected implementation date for Brexit.

Legislation	Content of review/report	Date
MiFID II (Article 90)	Report on MiFID II regimes for trading venues, algorithmic trading, product intervention, sanctions, commodity derivatives, transparency and disclosure	Commission must report to Parliament and Council by 3 March 2020 <sup>246</sup>
AIFMD (Article 69)	General survey of the AIFMD	Commission must start review by 22 July 2017
MiFIR (Article 52)	Reports on transparency, transaction reporting, solutions to reduce information asymmetries between market participants, moving standardised OTC derivatives to exchanges	Commission must report to Parliament and Council by 3 March 2020
CSD Regulation (Article 75)	General report on CSD Regulation	Commission must report to Parliament and Council by 18 September 2019
Benchmarks Regulation (Article 54)	Report on Benchmarks Regulation	Commission must report to Parliament and Council by 1 January 2020
	Report on the evolution of international principles applicable to benchmarks and of legal frameworks and supervisory practices in third countries concerning the provision of benchmarks	Commission must report to Parliament and Council every five years after 1 January 2018

<sup>246</sup> Review dates in the MiFID II Directive and MiFIR have been delayed by 12 months following a delay to the legislative package as a whole.



## APPENDIX 3

# LIST OF EU LEGISLATIVE PROVISIONS WITH “INDIRECT” IMPACT

This Appendix contains some of the main examples of the so-called “indirect” TCRs considered at paragraph 3.22. This is not a comprehensive review of all the relevant equivalence provision in the EU legislation.<sup>247</sup>

We have not included any provisions of EU legislation which have a direct impact on third country firms by virtue only of the provisions being extra-territorial in their application (such as the obligation in EMIR for all firms trading in certain OTC derivative contracts to clear those trades on a CCP).

Ref	Provision	Impact on the UK as a third country
AIFMD		
1	Article 9(6) which allows a member state to require an AIFM to hold half the own funds normally required, if they benefit from a guarantee from an EU bank or insurer, or a third country bank or insurer where that third country firm is subject to prudential rules considered equivalent to the competent member state as being equivalent to EU law.	If an EU AIF held a guarantee from a UK credit institution or insurer, and the UK was not considered equivalent, the EU AIF would not receive the benefit of the guarantee when calculating its capital requirements and may have to end up holding more capital. This may reduce the willingness of EU AIFs to seek guarantees from UK firms.
2	Article 20(1)(d) sets out requirements for the delegation of AIFM functions, in relation to portfolio management or risk management, to third country firm. Such delegation requires that there is cooperation between the AIFM’s home Member State authorities and the authorities of the third country. <sup>248</sup>	The ability of an EU AIFM to delegate functions in relation to portfolio management or risk to a UK firm would depend on there being a cooperation agreement between the relevant EU Member State and the UK.
3	A depositary for a third country AIF needs to be established in either the third country where the AIF is established, or the home Member State of the AIFM which is managing the AIF, or the Member State of reference of the AIFM managing the AIF. <sup>249</sup> In order to appoint a third country depositary, the following requirements must be met: <sup>250</sup> <ul style="list-style-type: none"> <li>(a) the competent authorities of the Member States in which the units of shares of the third country AIF are intended to be marketed (and the home Member State of the AIFM, to the extent it differs) have signed cooperation and exchange of information arrangements with the competent authorities of the state in which the depositary are established;</li> <li>(b) the depositary is subject to effective prudential regulation (including minimum capital requirements) and supervision which have the same effect as EU law and are effectively enforced;</li> <li>(c) the third country where the depositary is established is not listed as a Non-Cooperative Country and Territory by FATF;</li> <li>(d) the Member States in which the units or shares of the third country AIF are intended to be marketed (and the home state of the AIFM, to the extent it differs) have signed an agreement with the third country where the depositary is established which fully complies with the standards laid down in the OECD Model Tax Convention on Income and on Capital, and ensures an effective exchange of information in tax matters including any multi-lateral tax agreements; and</li> <li>(e) the depositary shall by contract be liable to the AIF or to the investors of the AIF, consistently with the AIFMD.</li> </ul>	If the UK was not equivalent, there would be limitations on the ability of a UK depositary to act in that situation.

<sup>247</sup> There are, for example, equivalence-related provisions in other EU legislation, such as the Market Abuse Regulation (Regulation 596/2014) Article 26(3).

<sup>248</sup> Further detail on the process for meeting this requirement is detailed in Article 78 of the level 2 Regulation.

<sup>249</sup> Article 21(5) of the AIFMD

<sup>250</sup> Article 21(6) of the AIFMD

Ref	Provision	Impact on the UK as a third country
4	<p>In order for an EU AIFM to manage a third country AIF which is not marketed in the EU, the EU AIFM is subject to certain requirements. Broadly, these require that:</p> <p>(a) the AIFM complies with all requirements, excluding depositary and annual reporting requirements, in the AIFMD; and</p> <p>(b) appropriate cooperation arrangements are in place between the competent authority of the AIFM and the competent authority of the third country where the AIF is established.</p>	<p>A UK fund which was managed by an EU AIFM may not be able to use such a manager unless there are appropriate cooperation agreements in place.</p>
<b>CRR (Regulation 575/2013)</b>		
1	<p>The CRR determines how EU credit institutions and EU investment firms should calculate (a) their capital requirements and (b) what resources they have which count towards satisfying their capital requirements. In relation to the latter, firms are required to apply a risk weighting to their assets, so that a firm has to hold more capital against a riskier asset than it would against a less risky one.</p> <p>In this regard, there are areas where an exposure<sup>251</sup> to a third country firm can potentially be treated differently (and where equivalence provisions may apply in order to ensure that the third country firm can be treated the same as an EU firm). In particular:</p> <p><b>a) Exposures to institutions</b></p> <p>An exposure to an “institution” (i.e. a credit institution or investment firm) is given a relatively low risk weighting because institutions are considered to be financially stable.</p> <p>Article 107 of the CRR provides that exposures to third country investment firms, credit institutions or clearing houses and exchanges shall be treated as exposures to an “institution”<sup>252</sup> only if the third country applies prudential and supervisory requirements to that entity that are at least equivalent to those applied in the EU.</p> <p>If the third country is not regarded as equivalent, the exposure to the third country firm would be regarded as that for a corporate entity and would have a higher risk weighting.</p> <p><b>b) Exposures to collective investment undertakings</b></p> <p>The risk weighting applied to investments in collective investment undertakings (CIU) is higher for a third country CIU than for an EU CIU, unless the following conditions are met:</p> <p>(i) the CIU is managed by a company which is subject to supervision that is considered equivalent to that under EU law; and</p> <p>(ii) cooperation between competent authorities is sufficiently ensured.</p>	<p>Unless the UK was considered to be equivalent, an EU firm would have to hold additional capital to cover the higher risk weighting that would apply to the UK exposure.</p> <p>As an example, a 3 month loan from a French credit institution to a UK credit institution with an A rating would be regarded as a loan to a corporate entity rather than to an “institution”. The risk weighting for a loan to an A-rated corporate is five times that for a loan to an A-rated EU credit institution. The French credit institution would therefore have to hold five times as much capital against the loan if the UK was not considered equivalent.</p>
2	<p>A life policy issued by a third party insurer will only be eligible to count as collateral if it is subject to supervision by a competent authority of a third country which applies supervisory and regulatory arrangements at least equivalent to those applied in the EU.<sup>253</sup></p>	<p>This provision may indirectly affect demand for life policies in the UK if the UK is non-equivalent.</p>

<sup>251</sup> An exposure for these purposes would, in effect, cover any exposure that the relevant EU credit institution or EU investment firm might have to lose in the event that a counterparty became insolvent. Loans would amount to an exposure for these purposes, as would participation agreements.

<sup>252</sup> An “institution” means a credit institution or an investment firm.

<sup>253</sup> Article 212 of the CRR.

Ref	Provision	Impact on the UK as a third country
3	<p>For the purpose of calculating net positions and own funds requirements on a consolidated basis, institutions may – if the competent authorities in the relevant Member State permit it – use positions in one institution or undertaking to offset positions in another institution or undertaking.</p> <p>Where there are undertakings located in third countries, there are additional conditions which have to be met, namely that:</p> <ul style="list-style-type: none"> <li>(a) such undertakings have been authorised in a third country and either satisfy the definition of a credit institution or are recognised third country investment firms;</li> <li>(b) such undertakings comply, on an individual basis, with own funds requirements equivalent to those laid down in the CRR; and</li> <li>(c) no regulations exist in the third countries in question which might significantly affect the transfer of funds within the group.</li> </ul>	<p>If the UK is non-equivalent, the group cannot net off positions from the UK entity against positions of the group members who are established in the EU.</p> <p>For example, consider a group headed by a French credit institution, with a UK credit institution as its subsidiary. The French credit institution has a loan to a large client; the UK holds a substantial amount on deposit from the same client. While the UK and France are in the EU, the two can be offset and reduce the group's capital requirements overall.</p> <p>Once the UK leaves the EU, if the UK was non-equivalent, these positions could not be offset. The group as a whole would therefore have to hold more capital, as it would need to hold capital against the loan but could not offset the deposit that it is held in the UK.</p> <p>This may indirectly diminish the attractiveness for EU groups of having UK subsidiaries.</p>
4	<p>Under the CRR, an institution is not permitted to incur an exposure to a client or group of connected clients the value of which exceeds 25% of its eligible capital.<sup>254</sup></p> <p>There are exceptions to this rule, including where the exposure is to group companies, insofar as those group companies are covered by consolidated supervision under EU law or with equivalent standards in force in a third country.<sup>255</sup></p>	<p>If the exposure is to a group company in a non-equivalent third country, the exception does not apply.</p> <p>If a group headed by an EU credit institution had an exposure of more than 25% to a UK subsidiary, and the UK was non-equivalent, the group would have to either remove the exposure or find additional capital to ensure that the exposure was brought below the 25% limit. If any EU group had such an exposure, that could cause considerable disruption to the group.</p>
<b>EMIR</b>		
1	<p>Article 35 sets out requirements for EU CCPs to outsource certain types of operational activities to other firms. These requirements apply to outsourcing to both EU and third country firms.</p> <p>There is a specific requirement that the service provider protects any confidential information relating to the CCP and its clearing members and clients. For outsourcing to third country firms, the service provider is required to ensure that the third country data protection standards are equivalent to those in the EU, or that such provisions are added to the agreement.</p> <p>A CCP must not outsource major activities linked to risk management unless such outsourcing is approved by the competent EU authority.</p>	<p>An EU CCP could be prevented from outsourcing operational functions, services or activities to a UK firm unless the data protection standards in the UK were comparable to those in the EU or would be required to insert such provisions into the agreement.</p> <p>The relevant EU regulator would also have to approve any major outsourcing activities linked to risk management, which may be more difficult if the UK was not broadly deemed to be equivalent.</p>
2	<p>Article 13 sets out requirements to avoid conflicting or duplicative rules applying where an EU firm deals with a third country counterparty. Where the Commission adopts an implementing act which recognises the third country as equivalent, the counterparty will be deemed to have met certain EMIR requirements.</p> <p>Unlike for recognition of CCPs as equivalent (Article 25 of EMIR), there is no trigger for the Commission to adopt an implementing act which recognises a third country as equivalent for Article 13.</p>	<p>If the UK is not deemed equivalent, it could become subject to duplication of rules under the UK and EU regimes.</p> <p>Achieving equivalence under Article 13 is likely to be important for UK firms in a number of respects – see paragraph 4.11(d)(iv).</p>
3	<p>Under Article 30 of EMIR, the competent authority must refuse authorisation of a CCP where the laws, regulations or administrative provisions of a third country governing one or more natural or legal persons with which the CCP has close links, or difficulties involved in their enforcement, prevent the effective exercise of the supervisory functions of the competent authority.</p>	<p>If the UK was a third country and was considered to come within this section, UK firms would be prevented from having close links with a CCP authorised in the EU. This would potentially prevent EU CCPs from being owned by UK firms. (It is unlikely, however, in practice that the UK's regime would be regarded as preventing the effective exercise of the supervisory functions of the competent authority.)</p>

<sup>254</sup> Article 395 of the CRR.

<sup>255</sup> Article 400(2)(c) of the CRR.

Ref	Provision	Impact on the UK as a third country
<b>MiFID II</b>		
1	<p>Investment firms within the scope of MiFID are subject to limitations on their ability to outsource critical or important operational functions. Detailed requirements are contained in Article 31 of the MiFID II Delegated Regulation.</p> <p>Article 32 imposes additional requirements where the investment firm outsources functions related to the investment service of portfolio management provided to clients to a service provider located in a third country.</p> <p>Such an outsourcing is only permissible if the investment firm ensures that the following conditions are satisfied:</p> <ul style="list-style-type: none"> <li>(a) the service provider is authorised or registered in its home country to provide that service and is effectively supervised by a competent authority in that third country; and</li> <li>(b) there is an appropriate cooperation agreement between the competent authority of the investment firm and the supervisory authority of the service provider.</li> </ul>	<p>An EU investment firm will not be permitted to delegate portfolio management to a UK firm unless the UK has entered into the appropriate agreements.</p>
<b>Prospectus Directive (Directive 2003/71/EC)</b>		
1	<p>The Prospectus Directive provides that securities cannot be offered to the public within an EU Member State without prior publication of a prospectus. The prospectus must also be approved by the competent authorities in the relevant Member State before the offer to the public is made.</p> <p>Where the issuer of a security is incorporated in a third country, the competent authority of the home Member State<sup>256</sup> may approve a prospectus which has been drawn up in accordance with the legislation of a third country, provided that:</p> <ul style="list-style-type: none"> <li>(a) the prospectus has been drawn up in accordance with international standards set by international securities commission organisations, including the IOSCO disclosure standards; and</li> <li>(b) the information requirements, including information of a financial nature, are equivalent to the requirements under the Prospectus Directive.</li> </ul>	<p>UK issuers who wished to offer a security to the public in an EU state or who wish to apply for admission to trading on a regulated market will need to seek the approval of a local regulator in the EU.</p>
<b>Securities Financing Transactions Regulation (Regulation (EU) 2015/2365)</b>		
1	<p>The Securities Financing Transactions ("SFT") Regulation was introduced to address concerns about use of collateral to access financing and the impact on indebtedness across the EU. The lack of transparency in this area made it difficult for regulators to ensure there was sufficient market stability.</p> <p>The SFT Regulation introduced a requirement for EU firms to disclose SFTs to trade repositories.</p> <p>Article 19 sets out provisions limiting the ability of third country firms to provide services to EU firms for the required disclosure of SFTs. Article 19(3) provides that a trade repository established in a third country may only provide such services where it has been recognised by ESMA.</p> <p>For a third country firm to be recognised by ESMA, there needs to be a Commission determination of equivalence for the third country and an appropriate cooperation arrangement between ESMA, relevant EU authorities and the relevant third country authorities.</p> <p>The Commission may deem a third country to be equivalent where:</p>	<p>A UK trade repository would be unable to offer services to EU firms to meet the SFT Regulation reporting requirements unless recognised. This requires the UK to be deemed equivalent by the Commission and there be cooperation arrangements.</p>

<sup>256</sup> As the issuer is not from an EU Member State, it does not have a "home" Member State, as such. Instead, the "competent authority of the home Member State" is defined as the competent authority of the EU Member State where the securities are intended to be offered to the public or where the application for admission to trading on a regulated market is made.

Ref	Provision	Impact on the UK as a third country
	<ul style="list-style-type: none"> <li>(a) trade repositories authorised in the third country comply with legally binding requirements which are equivalent to those in the SFT Regulation;</li> <li>(b) effective supervision of trade repositories and effective enforcement of their obligations takes place in that third country on an ongoing basis;</li> <li>(c) guarantees of professional secrecy exist, including the protection of business secrets shared with third parties by the authorities and those guarantees are at least equivalent to those in the SFT Regulation; and</li> <li>(d) trade repositories authorised in that third country are subject to a legally binding and enforceable obligation to give direct and immediate access to the data to the required entities.</li> </ul>	
2	<p>Article 21 allows for an EU firm which transacts with a third country counterparty to be deemed to have met the disclosure requirements where the reporting requirements are equivalent to those in the SFT Regulation and the counterparties have complied with the requirements of that third party.</p> <p>The Commission may adopt an implementing act that the legal, supervisory and enforcement arrangements of a third country are equivalent where:</p> <ul style="list-style-type: none"> <li>(a) the requirements are equivalent to those in the SFT Regulation for disclosure;</li> <li>(b) they ensure the protection of professional secrecy equivalent to those in the SFT Regulation;</li> <li>(c) the requirements are effectively applied and enforced in an equitable and non-distortive manner in order to ensure effective supervision and enforcement in that third country; and</li> <li>(d) they ensure that the relevant entities have either direct access to the details on SFT data or indirect access, as set out in Articles 19 and 20 respectively.</li> </ul>	<p>An EU firm which deals with a UK counterparty would only be excluded from reporting requirements where the reporting requirements of the UK firm were deemed to be equivalent.</p>
<b>Short Selling Regulation (Regulation 236/2012)</b>		
1	<p>The Regulation imposes disclosure requirements on persons engaged in the "short selling" of the following types of instrument:</p> <ul style="list-style-type: none"> <li>(a) financial instruments which are admitted to trading on a EU trading venue (including such instruments when traded outside a trading venue);</li> <li>(b) derivatives which relate to a financial instrument referred to above or to an issuer of such a financial instrument (including such derivatives when traded outside a trading venue); and</li> <li>(c) debt instruments issued by a Member State or the EU and derivatives as set out above which relate or are referenced to debt instruments issued by a Member State or the EU.</li> </ul> <p>The requirements of the Regulation are extra-territorial – i.e. they apply to persons in third countries as well as to the EU.</p> <p>Article 17 creates an exemption for EU market makers. Article 17(2) extends the exemption to third country market makers which are considered equivalent are also within the scope of this exemption.</p> <p>The third country's legal and supervisory framework can be considered equivalent if:</p> <ul style="list-style-type: none"> <li>(a) markets are subject to authorisation and to effective supervision and enforcement on an ongoing basis;</li> <li>(b) markets have clear and transparent rules regarding admission of securities to trading so that securities are capable of being traded in a fair, orderly and efficient manner, and are freely negotiable;</li> <li>(c) security issuers are subject to periodic and ongoing information requirements ensuring a high level of investor protection; and</li> <li>(d) market transparency and integrity are ensured by preventing market abuse in the form of insider dealing and market manipulation.</li> </ul>	<p>A UK market maker would be prevented from short selling a financial instrument traded on an EU regulated trading venue, unless the UK is deemed equivalent by the Commission.</p>

Ref	Provision	Impact on the UK as a third country
<b>Single Euro Payments Area Regulation (Regulation 248/2014)</b>		
1	<p>Single Euro Payments Area (SEPA) Regulation provides a mechanism for payments to be made across EU borders quickly and cheaply.</p> <p>The European Payments Council (EPC) published rules (first issued 1 April 2014, revised 12 August 2015) on the criteria for communities of credit institutions or financial institutions outside the EEA to participate in the SEPA scheme. Access to the SEPA scheme may be granted to third country firms in accordance with these criteria.</p>	<p>A UK firm would lose its access to the SEPA Scheme unless the EPC recognised the UK as being an equivalent country and resolved to allow the third country firm access to SEPA.</p>
<b>Solvency II</b>		
1	<p>Under Article 172, an EU insurer can take regulatory credit when the reinsurer is a third country reinsurer and the Commission has assessed that the solvency regime of the third country is “equivalent” to that in the EU.</p> <p>See paragraph 4.16 for further details.</p>	<p>If the Commission does not determine that the UK is equivalent after Brexit in accordance with the formal process laid down in the Solvency II Directive, then Member States may place regulatory restrictions on the ability of insurers established in their jurisdiction to enter into reinsurance contracts with undertakings based in the UK.</p>
2	<p>Under Article 227, if a third country subsidiary is in an “equivalent” jurisdiction, the group may apply to use the subsidiary’s local rules for their solvency capital requirements instead of having to apply the Solvency II standards.</p> <p>See paragraph 4.16 for further details.</p>	<p>In some cases, this might mean that the subsidiary has to hold less capital, but the main benefit is a practical one – namely that the subsidiary does not need to go to the trouble of recalculating its capital requirements using the Solvency II standards.</p>
3	<p>Under Article 260, where a Solvency II group is headquartered in an “equivalent” third country jurisdiction, EU regulators must rely on the assessment of prudential supervision arrangements by the third country regulator.</p> <p>See paragraph 4.16 for further details.</p>	<p>This would be helpful for groups headquartered in the UK and with EU subsidiaries, as it avoids them having to recalculate the capital for the whole group using the Solvency II standards.</p>
<b>Statutory Audit Directive (Directive 2006/43/EC, as amended)</b>		
1	<p>The Accounting Directive (2013/34) applies requirements for financial reporting of firms in the EU, including audit requirements. This applies to EU subsidiaries of third country firms, as well as EU firms. Member States have some discretion about the application of audit requirements in their jurisdiction.</p> <p>Article 45 provides that audits carried out by third country auditors (whether a natural person or an entity) will not be recognised in the EU unless the auditor has been registered in the Member State. The third country auditor can only be registered if:</p> <ul style="list-style-type: none"> <li>(a) the third country auditor carrying out the audit on behalf of the third country audit entity meets equivalent requirements;</li> <li>(b) the audits of the annual or consolidated financial statements are carried out in accordance with IFRS in line with the Directive requirements, or with equivalent standards and requirements; and</li> <li>(c) the auditor publishes online an annual transparency report which includes the information required in Article 13 of Regulation (EU) 537/2014 or complies with equivalent disclosure requirements.</li> </ul> <p>For entities, there is an additional requirement that the majority of the members of the administrative or management body of the third country audit entity meet equivalent requirements.</p>	<p>An EU subsidiary of a UK group would be required to undergo an audit according to the audit requirements of the EU Member State, regardless of whether it had been audited as part of the UK group requirements, unless the UK auditor had been registered in the relevant EU Member State. This requires the UK auditor being recognised as equivalent.</p>

Ref	Provision	Impact on the UK as a third country
<b>Transparency Directive (Directive 2004/109/EC)</b>		
1	<p>Amongst other things, the Transparency Directive imposes requirements on the issuers of securities which are listed on a regulated market in an EU Member State. These requirements include obligations to:</p> <ul style="list-style-type: none"> <li>(a) publish information to shareholders (e.g. annual and half-yearly reports and interim management statements); and</li> <li>(b) ensure that shareholders are subject to equal treatment in relation to the exercise of their rights in relation to their securities.</li> </ul> <p>Where the registered office of the issuer is in a third country, the competent authority of the home Member State<sup>257</sup> may exempt the issuer from certain requirements under the Directive, provided that the law of the third country in question lays down equivalent requirements or such an issuer complies with requirements of the law of a third country that the competent authority of the home Member State considers as equivalent.</p>	<p>If any UK issuers have their securities listed on an EU exchange, they will have to comply with the EU requirements in addition to any requirements they have in the UK, unless the UK is considered equivalent.</p>
<b>The UCITS Directive</b>		
1	<p>Article 13 of the UCITS Directive allows management companies to delegate their functions to third parties, subject to the preconditions in Article 13 being complied with.</p> <p>Where the mandate concerns investment management and is given to a third country undertaking, cooperation between the supervisory authorities concerned must be ensured.</p>	<p>If an EU management company wished to delegate investment management of a UCITS fund to a UK company, it will not be able to do so unless "cooperation" between the supervisory authorities in its home state and those in the UK have been ensured – i.e. a cooperation agreement must be entered into.</p>
2	<p>Article 7(1) of the UCITS Directive requires management companies to satisfy capital requirements.</p> <p>Member States may authorise management companies not to provide up to 50% of the additional amount required if instead they have a guarantee from a credit institution or an insurance undertaking which has its registered office in the EU. A guarantee from a credit institution or insurance undertaking in a third country is only permissible where that firm is subject to prudential rules equivalent to those under EU law.</p>	<p>An EU management company cannot rely on guarantee from UK institutions unless the UK is considered equivalent.</p>
3	<p>Article 50 of the UCITS Directive imposes restrictions on the kinds of investments that a UCITS can be invested in.</p> <p>Among the restrictions are some particular restrictions on investment from third countries. In particular, the UCITS can be invested in:</p> <ul style="list-style-type: none"> <li>(a) transferable securities and money market instruments listed on a stock exchange in a third country or dealt in on another regulated market in a third country – but provided that the stock exchange or market has been approved by the competent authorities or is provided for in law or the fund rules or the instruments of incorporation of the investment company; or</li> <li>(b) other collective investment undertakings, whether or not established in a Member State, subject to certain conditions – including that such other collective investment undertakings are authorised under laws which provide that they are subject to supervision considered by the competent authorities to be equivalent to that under EU law, and that cooperation between authorities is sufficiently ensured; and</li> <li>(c) certain deposits with credit institutions, provided that if the credit institution has its registered office in a third country, it is subject to prudential rules equivalent to those under EU law.</li> </ul>	<p>Unless the UK is considered to be equivalent (in terms of prudential rules and/or supervision), UCITS funds from the EU will not be able to:</p> <ul style="list-style-type: none"> <li>(a) invest in transferable securities which are dealt on UK markets;</li> <li>(b) invest in collective investment undertakings authorised under UK law; or</li> <li>(c) place money on deposit with UK credit institutions.</li> </ul>

<sup>257</sup> In the case of a third country issuer of debt securities with a denomination per unit of less than €1,000 or a third country issuer of shares, the "competent authority of the home Member State" will be the Member State in which the issuer is required to file the annual information with the competent authority in accordance with the Prospectus Directive. In other situations, the competent authority of the home Member State can be chosen by the issuer, and must be either the Member State in which the issuer has its registered office (if applicable) or a Member State which has admitted its securities to trading on a regulated market on its territory.

Ref	Provision	Impact on the UK as a third country
4	<p>Investment companies and management companies are required under Article 22 of the UCITS Directive to appoint a single depository to carry on certain functions on behalf of the UCITS fund.</p> <p>Where the depository will be providing a safekeeping service, the investment company or management company must satisfy certain conditions, including undertaking due diligence on the depository.</p> <p>Under Article 22A, if the proposed depository is a third country firm, there are additional conditions that must be satisfied. In particular, the third country must be subject to effective prudential regulation, including minimum capital requirements and supervision in the jurisdiction concerned.</p> <p>(The provision of services by securities settlement systems – including third country securities settlement systems – are not considered to be a delegation of custody functions.)</p>	<p>This could affect the ability of UK depositories to provide services to UCITS funds and UCITS managers.</p>



# APPENDIX 4

## LEGISLATIVE PROCESS



The IRSG wishes to thank the members of the workstream which has overseen the production of the report:

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In uncharted waters, you need advisors who are not afraid to innovate.

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For further information about this report, please contact:

**Gary Campkin**, Director, Policy & Strategy, TheCityUK  
[gary.campkin@thecityuk.com](mailto:gary.campkin@thecityuk.com)

**Kerstin Mathias**, Head of Policy, TheCityUK  
[kerstin.mathias@thecityuk.com](mailto:kerstin.mathias@thecityuk.com)

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