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BREXIT AND THE UK'S FINANCIAL SERVICES INFRASTRUCTURE

Time for a more detailed assessment?

INTRODUCTION

The last couple of weeks have been important for Brexit developments. The Prime Minister confirmed that the UK will not look to remain in the single market post-Brexit and will instead push for the 'freest possible trade' deal with European countries. Her speech on 17 January sets out the UK government's negotiating objectives for exiting the EU, but the Supreme Court decision may have just thrown a spanner in the works.

If the government's position remains unaltered, it has stated that it will aim for a 'phased process of implementation' for the UK's future legal and regulatory framework in relation to financial services. The government may also seek to take in elements of the current Single Market arrangements in certain areas, such as the freedom to provide financial services across national borders.

The UK wants a smooth, orderly Brexit and will seek an agreement about its future partnership with the EU by the time the two-year Article 50 process has concluded. From that point, the government would like to put in place a 'phased process of implementation', the aim of which would be to allow businesses to plan and prepare for any new arrangements agreed between the UK and the EU. The Prime Minister suggested that this process might apply to, among other things, the future legal and regulatory framework for financial services.

From a financial services perspective, much of the debate and lobbying position has focused on access to the single market and the loss of passporting rights. However, this draws the issues very narrowly and the UK government and the financial services industry is at risk of missing an opportunity to think creatively about how financial services can continue to be provided cross-border into and out of the UK, without using the language of "passporting".

In addition, more detailed consideration needs to be given to current gateways for business, both into and out of the UK by European firms, even if passporting is turned off as a result of Brexit. One area that needs to be thought through is access rights provided by the UK regime applicable to third country access arrangements. The UK regime will potentially provide routes for EU businesses to continue to access the UK market. It is this type of detail that could frame alternative negotiating positions that step away from the language of "passporting" and "equivalence".

This paper takes a closer look, in particular, at the UK's third country regime, although we also mention the rules relating to "information society services". Using these examples, we believe these areas could, with additional thought, provide alternative avenues for the UK government to explore in shaping the negotiations with the EU going forward.

FOCUS ON PASSPORTING

The EU single market enables financial services firms authorised in one Member State (their home state) to carry on business in any other Member State (a host state) without the need for a separate host state authorisation either by establishing a local branch or on a cross-border basis. This is referred to as the "passport".

Much of the Brexit debate has focussed on the impact on financial services firms authorised in the UK if the UK was to lose its passporting rights on leaving the EU. The assumption is also that, if the UK is forced in to a hard Brexit option and would consequently lose passporting rights, then the UK Government will simply have the ability to "turn off" EU member states' access to the UK in a similar way, by removing EU passporting rights here.

Of course, passporting rights are not universally shared by all participants in the market, nor are they available for all types of financial services activities. In the event of a hard Brexit, it would be anticipated that the Great Repeal Act would keep live all EU implemented legislation into the UK statute book. However, there is also plenty of UK legislation which derives from Acts of Parliament (including statutory instruments that themselves derive from primary legislative powers), rather than from the European Communities Act. The Financial Services and Markets Act 2000 (**FSMA**) and much of the secondary legislation are cases in point. A hard Brexit would be unlikely to have very significant legislative impacts on this body of legislation.

There are plenty of references within UK legislation, which provide rights (and duties) on "EEA firms" as defined within our legislation. Since the only country who would no longer be a member of the EEA, firms established within the EU would remain "EEA firms" and, without amendments being made immediately to the UK legislation, would retain all their rights as an EEA firm.

Thus, whilst passporting may well then be repealed, without a detailed analysis and package of amendments to the UK legislation, the door would remain open in any event to EEA firms.

It would be wrong, therefore, to assume that the turning off of passporting would be an automatic and two way consequence of Brexit – it would not. It would require detailed legislative drafting to achieve that outcome.

Even then, the UK regime applicable to third country access would give rise to more significant challenges.

UK FINANCIAL SERVICES INFRASTRUCTURE– DETAILED ASSESSMENT OF OTHER ACCESS ROUTES REQUIRED

So far, we have only seen high level legal analysis about UK access to the EU post Brexit, but in order to shape the negotiations with the EU, the UK government will need to undertake a far more detailed assessment of its current legislative infrastructure. Simply talking of removing passport rights is a simplification of the position and does not factor in more difficult nuances associated with the UK financial services regime and, in particular, the UK's treatment of other exemptions, but most notably, the overseas persons exemption.

In the UK, certain activities in relation to financial services are regulated. The vast majority of these are regulated under FSMA. However, there are some activities which are regulated under regimes set up outside of FSMA (such as e-money – under the E-Money Regulations, and payment services – under the Payment Services Regulations). For the purposes of this paper, we will focus on the regime covered by FSMA, since the regimes covering e-money and payment services are largely a copy out of the EU requirements and have less nuance.

REGULATION UNDER FSMA

FSMA sets up regulation effectively in 2 ways:

- it regulates certain activities performed in relation to certain products / services. It then requires firms performing those activities to be authorised (unless they are exempt); and

- it regulates the provision of "financial promotions" (loosely advertising or communications that induce a person to engage services which are themselves covered by the regulatory regime). Where a financial promotion is regulated, it can only be issued if it is approved by an authorised person or if it is exempt.

FSMA only regulates activities carried on "in the United Kingdom" and a financial promotion is only caught where it is capable of having effect "in the United Kingdom".

Section 418 of FSMA extends out what might otherwise be considered to be carrying on business in the UK in certain circumstances (some of these extensions cover EEA specific circumstances and some apply more broadly).

In relation to cross border activities, therefore, businesses wanting to perform activities which are regulated under FSMA, and which, in performing them, will mean they are carrying on those activities in the UK, will need to obtain UK authorisation. Similarly, if businesses want to send out communications /literature to customers in the UK, they can only do so if an authorised person is able to approve it or it is otherwise exempt.

Obviously, in relation to firms based in the EEA currently, they are treated specially under FSMA and enjoy rights to do business in the UK, often where they have obtained a passport to do so. There are however also specific exemptions or provisions that provide additional exemptions specifically for "EEA firms". Based on the Prime Minister's speech, the assumption underlying this paper is that as the Government will not negotiate to retain single market access, these rights currently enjoyed by EU / EEA firms will be lost post Brexit. As we indicated above, however, it will not work to simply leave the UK legislation as it is unamended as this would be likely to have the effect of continuing to enable significant rights to EU / EEA firms post Brexit, even in the event of an agreed hard Brexit position. Significant amendments will be needed to UK legislation to make the legislation make sense.

The question, however, which then arises is, even if an EU firm is no longer to benefit from the rights afforded to "EEA firms" (because we repeal such rights in totality, on the basis that, in the event of a hard Brexit, we are unable to secure free market

access for the UK to the EU single market), that leaves unconsidered what routes in to the UK would EU/EEA firms still have open to them due to other exemptions that the UK currently affords to anyone who can satisfy the relevant exemptions – whether they are located in the EU/EEA or outside the region.

ACCESS TO THE UK - ACTIVITY SPECIFIC EXEMPTIONS THAT APPLY TO ANYONE

There are a number of exemptions that apply to specific activities. For example, there is an exemption applicable to certain regulated activities which are carried on in connection with a firm's main business of selling goods or supplying services.[1] These exemptions will continue to be available to anyone, including EU firms post a hard Brexit, unless the Government decides to amend FSMA. This paper does not consider these types of exemptions in detail on the basis that they set out the perimeter for UK regulation generally; they are available now to all firms. The UK government will need to consider whether it wants to regulate those activities to prevent, for example, EU firms carrying out that business in the UK post-Brexit. In order to shape the Government's position, however, UK firms need to consider to what extent they are content for EU firms to be able to utilise these routes in if all routes to them are turned off into Europe.

REGULATED ACTIVITIES ORDER - OVERSEAS PERSONS' EXEMPTION

In relation to financial services, activities which are regulated or exempt are covered by the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (**RAO**).

There are a series of exemptions that apply to an "overseas person".[2] These are persons or businesses who do not carry on any specifically prescribed activities, or offer to do so, from a permanent place of business maintained by them in the UK.

Thus, these exemptions are available to any firm which does not have a permanent place of business in the UK, but instead are based in an EU/EEA or non EU/EEA country, such as the United States, for example. Unless the Government decides to amend the RAO, use of these exemptions would be open to EU firms post-Brexit, even if the EU passport and/or gateways open to EEA firms were expressly switched off or closed down.

This exemption is not wide reaching and so has significant limitations in its application.

The exemption is not available to an overseas firm who sets up a permanent physical presence in the UK, from which, for example, it then decides to market its products or services. It would also not apply to group entities who already have a permanent place of business in the UK (i.e. those who have established a branch in the UK) if the UK business was involved in the regulated activities. The exemption is targeted, therefore, at those based outside the UK, but whose activities touch the UK or UK customers.

The overseas persons' exemption does not apply to all regulated activities. It is available in connection with the following activities:

- Dealing in investments as principal or agent;
- Arranging (bringing about) deals in investments;
- Making arrangements with a view to transactions in investments;
- Advising on investments;
- Operating a multilateral trading facility;

[1] Article 68 RAO
[2] Article 72 RAO

- Arranging, entering into and administering regulated mortgage contracts;
- Arranging entering into and administering regulated home reversion and home purchase plans, and sale and rent back agreements;
- Agreeing to carry on the following specified kinds of activity: arranging deals in investments, managing investments, assisting in the administration and performance of a contract of insurance, safeguarding and administering investments and sending dematerialised instructions.

Use of the overseas persons' exemption needs to be considered carefully because in addition, it does not apply in the same way to all of the activities for which it is available.

For example, in relation to mortgage related regulated activities, the overseas person can carry out the activity where the borrower / customer is not resident in the UK, or in the case of a variation to an existing agreement, where they were non-resident at the time the original agreement was entered into. This would enable an EU based firm to enter into regulated mortgage contracts with customers physically present in the UK, provided they were not a UK resident.

A further layer to the operation of the exemption in the RAO is that, in addition to the above, in seeking to rely on it, the overseas person must satisfy one of the following two conditions:

- The regulated activity requires the direct involvement of an authorised or exempt person (acting within the scope of their exemption). The example of an exempt person would be where the overseas person was dealing with an Appointed Representative. In effect, this route enables an overseas person to access the UK financial services infrastructure if it routes the business via a UK firm who has permission to carry on the activities; OR
- The regulated activity is carried on as a result of a "legitimate approach" – which is an approach to, or by or on behalf of an overseas person that does not breach the UK financial promotion regime (section 21 of FSMA). This means that the financial promotion would need to be approved by an authorised person or treated as exempt under the Financial Services and Markets Act 2000 (Financial Promotions) Order 2001 (**FPO**) which we consider in more detail below.

By way of summary, the exemption is therefore available:

- only to businesses that do not have a permanent place of business in the UK;
- in relation to certain types of regulated activities but does not apply in the same way to each regulated activity; and
- where the business can satisfy one of two conditions set out above. Different activities apply those conditions slightly differently:
  - for dealing in investments as principal or agent and operating a multilateral trading facility, an overseas person can rely on either condition;
  - where the activity is arranging deals in investments, the exclusion can only be relied on if the condition relating to the involvement of an authorised or exempt person is satisfied; and
  - where the activity is advising on investments or agreeing to carry on certain activities, the exclusion can only be relied on if the condition relating to a legitimate approach is satisfied.

FINANCIAL PROMOTIONS ORDER 2001 (FPO)

Where the condition relating to a legitimate approach is used, it is also necessary to consider what material an overseas person can issue under the exemptions found in the FPO.

The exemptions in Articles 30 to 33 of the FPO relate specifically to financial promotions provided into the UK by an overseas communicator who does not carry on certain regulated activities in the UK. These enable the following:

- Article 30: exempts any solicited real time financial promotion made by an overseas communicator from outside the UK in the course of, or for the purposes of, certain regulated activities which he carries on outside the UK. This allows an overseas communicator, for example, to respond to: (i) an unprompted telephone enquiry made by a person in the UK; or

(ii) an enquiry which follows a financial promotion made by the overseas communicator and which was approved by an authorised person.

- Article 31: exempts non-real time financial promotions made by an overseas communicator from outside the UK to 'previously overseas customers' subject to certain conditions. To satisfy this exemption, the communicator must be based overseas and must be communicating with a person who is, or was recently, a customer of his while that person too was overseas.

- Article 32: provides an exemption for unsolicited real time financial promotions made by an overseas communicator to persons who were previously overseas and were a customer of his at that time. This is subject to certain conditions, including that, in broad terms, the customer would reasonably expect to be contacted about the subject matter of the financial promotion.

- Article 33: broadly applies where the overseas communicator:

  - has reasonable grounds to believe that the recipient is knowledgeable enough to understand the risks associated with the controlled activity to which the financial promotion relates;

  - has informed the recipient that he will not gain the protections under the FSMA in respect of the activity or of the making of unsolicited real time financial promotions; and

  - has informed the recipient whether he will lose the benefit of dispute resolution and compensation schemes.

The recipient must also have signified clearly that he/she accepts the position after having been given a proper opportunity to consider the information. There is no definition of a proper opportunity for this purpose. Historic regulatory opinion is that it was likely to require the recipient to have a reasonable time to reflect on the matter and, if appropriate, seek other advice. What is a reasonable time depended upon the circumstances of the recipient but it was unlikely that a time of less than 24 hours would be enough.

The above exemptions apply in addition to any other generally available exemptions which may apply to any particular financial promotion by an overseas communicator.

In summary, the above provisions provide various, albeit complex, routes to enable overseas businesses to access UK financial services infrastructure and therefore, UK customers. Clearly, access is far more limited than a current EU passport, which enables an EU firm to establish and trade fully on the same basis as UK firms. However, unless amendments are made to existing UK legislation, EU firms will continue to have these gateways to the UK following a hard Brexit.

From a policy perspective, the UK financial industry and government may not consider this to be particularly problematic given the limited nature of the access provided to overseas persons. However, similar rights for UK businesses to access EU financial services markets and customers, which replicate the framework in FSMA, the RAO and the FPO, may not exist[3]. This would mean that, following a hard Brexit, without changes to these legislative instruments, EU firms could potentially have more rights to access the UK than UK firms will have to access EU markets and customers.

One option would be for the UK to exclude EEA firms from the definition of an "overseas person" – placing UK firms on a similar footing to the UK's position in the EU/EEA. However, doing so would be politically very damaging since the UK would then be positively favouring firms based in other nations over those located in the EU/EEA. This may also be in breach of World Trade Organisation (**WTO**) requirements.

Alternatively, the UK could choose to maintain parity for all overseas persons, but restrict the current overseas persons' exemption for all access to the UK. However, this is equally unlikely to be politically palatable since that would impact the UK's accessibility for more than just firms located in the EU/EEA.

What this does do, however, is to provide an alternative starting point for negotiations, focused on achieving parity for UK firms with a third country access regime similar to that which will automatically be available to EU countries. The industry should be evaluating this position and the extent to which it might go some way to answering some of the needs industry might have. It may also be that the UK Government may be open to considering widening the existing third country rights in order to secure a slightly broader similar position for UK firms in the EU. Again, this is the opportunity for the financial services industry to be creatively flexing a regime that exists and will remain post Brexit.

[3] Certainly, the industry ought to be gathering information from across EU jurisdictions as to their equivalent overseas persons exemptions to the extent that any exist.

INFORMATION SOCIETY SERVICES – ANOTHER GATEWAY INTO THE UK FOR EEA FIRMS

Another gateway of entry for EEA firms which will potentially exist post-Brexit, unless it is expressly turned off, and which the Government needs to think carefully about is the legislative framework arising out of the EU E-Commerce Directive. All requirements on persons providing electronic commerce activities into the UK from the EEA are lifted, where these fall within the "co-ordinated field" and would restrict the freedom of such a firm to provide services.[4] The co-ordinated field includes any requirement of a general or specific nature concerning the taking up, or pursuit, of electronic commerce activities. Authorisation requirements fall within the co-ordinated field[5].

The exemption in Article 72A of the RAO is the mechanism by which financial services have implemented these requirements and it applies to regulated activities that consist of the provision of an information society service (ISS) from an EEA state other than the UK. The exclusion applies to all regulated activities except for effecting or carrying out a contract of insurance when carried on by an EEA authorised insurer.

This exemption relates to the provision of online products and services. An ISS is a service that is normally provided for remuneration at a distance, by means of electronic equipment. The definition is potentially broad enough to cover, not only online businesses, but also products and services provided by solicited email and interactive digital television. Unless there are changes to UK law, EEA businesses who operate an ISS will be able to continue offering their goods and services to UK customers.

However, more interesting in our view is whether the E-Commerce regime, which does not use the language of passporting or or equivalence, might be the starting point for a regime that could operate between the UK and the EU. There are aspects which might need to be tweaked to make it work well and with greater certainty, but taking such positions that move away from using the controversial language of "the single market", "passporting" or "equivalence" and a regime based upon a recognised, but less politically charged mechanism, might well find more favour around the negotiating table.

What all this demonstrates, in our view, is the importance for the industry in moving away from the high level sound bites, to a more detailed legal analysis of the legislation and the threats that will need to be dealt with, but also new opportunities the detail might reveal to find a more acceptable route through Brexit for everyone.

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[4] Referred to as the "country of origin" principle
[5] PERG 2.9.18G

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