Fourth Quarter BREXIT ROADMAP and COMMENTARY

September – December 2020

Merlys

4th Quarter BREXIT Roadmap & Commentary (Sept-Dec 2020)

From the first mention of Brexit, Merlys has closely followed proceedings as it relates to the **Funds and Asset Management sectors.**

In producing this document and Roadmap, Merlys aims to provide a bird's-eye-view of this quarter's activities and to draw attention to the threats and opportunities creeping out of the woodwork.

In this document, Merlys poses and responds to, among others, such questions as:

- **Are WTO Rules the fall back?**
- **What can the smaller fund managers with no EU presence do to respond?**

…and importantly, Merlys shines a light on solutions and suggests actions the sector can and would be wise to take, sooner rather than later.

This briefing note is intended to act as general guidance and is not intended to offer specific legal advice. Merlys is very happy to assist you with any aspect of the content in this article, as it relates to your business. See contact details below.

Current State of Play on EU-UK Financial Services Access

While there is still uncertainty on EU-UK negotiations, one thing is clear – financial market access is sure to be marked by more friction.

As the end of the transition period approaches, the views of the EU and UK are diverging, which indicates that financial services trade across the Channel will be very different next year. If a trade agreement were to be concluded by the end of 2020, it is generally agreed that market access will be well below its historic and current levels.

The areas where equivalence decisions can be made are limited in scope, and many equivalence assessments await conclusion.

The ROADMAP

Before we get into the Commentary, the list on the following page is a brief round-up of the current state of play on UK, EU and International developments relating to funds as at October 2020.

2020	**September**		
Funds	1st	**EU**	Close of ESMA consultation on guidelines on Article 25 of AFMD
Funds	30th	**UK**	FCA rules on illiquid assets and open-ended funds enter into force. The rules are set out in Policy Statement 19/24 published in September 2019 – https://www.fca.org.uk/publication/policy/ps19-24.pdf
Funds	30th	**EU**	ESMA guideline on liquidity stress testing in UCTIS and AIFs apply (published September 2019) – see https://www.esma.europa.eu/sites/default/files/library/esma34-39-882_final_report_guidelines_on_lst_in_ucits_and_aifs.pdf
2020	**October**		
Funds	1st	**UK**	Close of FCA consultation (CP20/5) on ETF Listing: Premium to standard listing.
Funds	1st	**UK**	Close of FCA consultation (CP20/5) on OEICs and proposals for a more proportionate listing regime – https://www.fca.org.uk/publication/consultation/cp20-05.pdf
Funds	26th	**International**	Close of IOSCO consultation on draft guidance for regulating asset managers' and market intermediaries' use of artificial intelligence and machine learning – https://www.iosco.org/library/pubdocs/pdf/IOSCOPD658.pdf
2020	November 3rd	**UK**	Close of FCA consultation (CP20/15) on liquidity mismatch in authorised open-ended property funds.
2021	**August 1st**	**EU**	Most substantive new requirements under the REFIT initiative on cross-border distribution of funds apply
2021	**December 31st**	**EU**	End of transitional period for UCITS.

The COMMENTARY

What *are* the **possibilities** for EU-UK financial services trade in 2021?

Four different scenarios are possible in 2021

1. no agreement or World Trade Organisation (WTO) rules
2. equivalence decisions (limited scope)
3. Comprehensive Free Trade Agreement (CFTA)
4. CFTA and equivalence decisions

…OR a combination of the above – ***possibly an ideal outcome***

Serious disagreements continue on many elements of the future relationship. Currently it appears to us that a few equivalence agreements by the end of the year are still possible.

Yet, even with some equivalence agreements agreed upon and a CFTA in place, **the UK will be a long way from the single market framework it has today.**

There are also 4 possible scenarios for EU-UK financial market access

1. WTO rules (no Free Trade Agreement (FTA))
2. Equivalence decisions (and WTO rules)
3. CFTA
4. CFTA and equivalence decisions

Why does this all matter?

In the political declaration of 12 November 2019, the stated intent is to develop a wide-ranging and balanced economic partnership. The relationship is meant to be one based on a 'level playing field', with comparable norms for environmental, social, tax and competition matters, and a dispute settlement system with a joint Committee and the European Court of Justice (ECJ) for EU legal matters.

In respect of financial services, there was supposed to have been **equivalence** assessments of both parties' regulatory frameworks in place before the end of **June 2020**.

Continues…

The UK has now circulated its draft CFTA

This is a 290-page document with a chapter on financial services. It proposes very open access to each other's market, with the intent of almost maintaining the free provision of services as we know them today in the EU.

The draft states that the treatment of financial services and cross-border financial service suppliers should be "no less favourable than the most favourable treatment accorded by that Government to its own like financial services and financial service suppliers" (Art 17.3.3), with no quantity or quality limitations (Art. 17.5).

The use of a prudential carve-out that exists at General Agreement on Trade in Services (GATS) level should be clearly delineated and not invoked unnecessarily (Art. 17.13). However, we have heard that the EU is not currently minded to agree to this without compromise on non-related financial services matters.

One development proposed is a **new financial services committee** which is intended to supervise the implementation of these provisions. This committee would also function as a first-level dispute settlement entity and be composed of competent persons from each side.

Interestingly, from an EU perspective, albeit unsurprising from the UK point of view, there is no reference to a role for the ECJ, or any ambition to create an independent judicial entity, but the agreement proposes a new overall dispute settlement system for the CFTA, along the lines of international arbitration panels.

So What Might It Look Like?

The applicable provisions of the draft CFTA in relation to financial services are similar to the EU-Canada Comprehensive Economic and Trade Agreement (CETA) but, importantly, without the discretionary provisions, such as for the prudential carve-out.

CETA's Article 13.16 states that "a party may require registration of a provider" or "prohibit a particular financial service", which does not appear in the draft CFTA. For the cross-border provision of services, the provisions are also similar. (The difference stems from the fact that the UK has substantial operations within the EU, and vice versa, under the free provision of services of the EU single market, which was obviously not the case for Canada.)

The CFTA discussions are advancing slowly.

Continues...

In general, despite newspaper headlines, the parties appear to be trying to present a quietly positive view. However, the end of June deadline did pass without much progress having been made, particularly on equivalence decisions. The 'level playing field' alone is one area causing considerable disagreement, mostly in the competition policy and state aid domain, but also for fisheries.

Even if a CFTA-style agreement is reached between the EU and the UK in the remaining time, it will need to be approved by the European Parliament, which is a further hurdle as that process is time-consuming let alone the time it may take to be approved in the UK.

Are WTO Rules the Fallback? **Not really…**

If there is no CFTA, there will not be a dispute resolution system either. The WTO appellate body has ceased to function following the US's refusal to nominate judges. It is still possible for the WTO quasi-legal panel process to still function to settle disputes.

Within the context of **equivalence** decisions, disputes could move to the EU Court, but the UK refuses to accept any role for this EU entity.

The UK has stated that it will offer transitional relief for EU operators in the UK market, meaning they can continue to operate during a given period after 2020.

The EU does not want to replicate this for the moment, apart from possible equivalence decisions, but some member states may do this on an individual basis. Again that is a limited option due to the way in which the EU processes work.

What about Equivalence?

Equivalence is an EU unilateral measure. From the UK perspective it therefore has several disadvantages.

- Equivalence is instigated by the EU and any decision is for a limited amount of time which can be revoked with one month's notice. Equivalence is obviously no substitute for the market access that exists today.
- The UK wants, essentially, **broad equivalence** as a process – almost mutual recognition of regulatory frameworks – and legal certainty.
- There is **no broad EU framework** for equivalence which is another challenge for the parties.

- Equivalence varies from none, to limited or very extensive provisions in the existing legal frameworks governing the free provision of services and financial products in the EU.

There are about **40** areas where **equivalence decisions** could be possible but, with some exceptions, they do not offer the full freedoms comparable to today's position. The EU Commission recently raised questions on about 28 different areas to the UK but has only received limited responses.

Obstacles

- Within the financial services industry one obvious stumbling block for equivalence are **bonuses**. In the past, the UK raised concerns about bonus rules or pay restrictions in EU financial regulations. As a full member state, the UK was then able to vote against them for UK bank prudential regulation in the context of the Capital Requirements Directive (CRD) IV.
- Another obstacle is **money laundering**. The UK is in a more vulnerable situation outside the EU than inside, particularly with its dependent territories.

The UK has already indicated clearly that it wants to diverge from EU rules, a position which makes equivalence decisions even more difficult.

The UK position would impact, for example:

i) the Minimum Requirements for own funds and Eligible Liabilities (**MREL**) definition in the Bank Recovery and Resolution Directive (**BRRD**),

ii) the **prudential regime** for large investment firms under the 2019 investment firm regulation, and

iii) the settlement regime under the Central Securities Depositories Regulation (**CSDR**). Also, the **EU-27** is considering changing **MiFID II**, which was drafted very much from a UK market perspective.

So What Can We Expect?

While some of this may still be "crystal ball gazing" it seems that from 2021 onwards, EU-UK financial market access will be governed by:

- **A patchwork of time-limited equivalence decisions**, for example for Central Counterparties (**CCPs**), where the EU needs access, possibly for investment services under **MiFID** and asset management under the **AIFMD**.
- **Numerous bilateral Memoranda of Understanding** (**MoU**) between the UK Financial Conduct Authority (FCA) and EU national competent authorities for the delegation of asset management under Undertakings for the Collective Investment in Transferable Securities (**UCITS**)

- **Other bilateral deals** between the UK and selected EU member states for other financial services (difficult to achieve due to EU requirements on members states not to set up separate agreements with third party countries (e.g. the UK) outside of those negotiated by the EU on behalf of all the members)
- A **CFTA** but most likely not for a few years: this will be slowed down by EU-UK governments' processes particularly while dealing with the ongoing pandemic responses
- At least initially, **no 'dispute settlement system'** as the **WTO** body is not functioning
- And, at the very least, **a tense relationship**

This is clearly damaging for all involved. For fund managers, splitting portfolios between the UK and the EU already leads to a proliferation of legal documentation and is bad for efficient netting (some in the UK, others in the EU). Capital considerations will also drive up costs.

More positively…

The implementation of EMIR 2.2 may bring some relief to equivalence, as it allows for deference to third country rules. Even if a systemically important third country CCP, for example, is under the direct supervision of ESMA, it can request that the rules to which it is subject in its home country be comparable to EU standards.

A CFTA will facilitate the relationship, creating an overall framework, also for equivalence decisions, and it creates a structure for permanent dialogue and dispute settlement.

Failing that, for at least another year or so, UK-based financial services providers will need to have subsidiaries in the EU, or can work, for at least a few areas, with the equivalence frameworks that are of will be in place. In other areas, the possibility for equivalence is diminishing as both sides are moving in different directions.

In 2021, **cross-border financial services between the EU and the UK is likely to be significantly different**.

What can be done?

For Small Funds or Funds with no EU presence, there are 3 key things that the Fund and Asset Manager can do in readiness:

⇒ Consider getting an EU distributer
⇒ Look at EU Temporary Permission Regimes (TPR) if you haven't already
⇒ Tie-ups / Joint Ventures / sharing capabilities

We're here to help.

If you are unfamiliar with any of the above; If you need advice, support or introductions to appropriate service providers, call us: +44(0) 20 7821 5395 or email charles@merlys.uk

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This briefing note is intended to act as general guidance and is not intended to offer specific legal advice. Merlys is very happy to assist you with any aspect of the content in this article, as it relates to your business.

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