BREXIT: Defending financial services in the SME sector

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Recommendations from the Genesis Initiative to protect UK small-to-medium sized Financial Services Firms after the withdrawal of the UK from the EU:

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The Genesis Initiative represents 117 organisations from the SME and self-employed sectors which are members of the Genesis Senate.

https://www.genesis-initiative.org/senate/senate-member-listing/.

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Introduction

Of 1.1 million financial service jobs in the UK, it is estimated that, conservatively, at least 350,000 are based in SMEs (small and medium sized enterprises), for instance amongst fund managers, where SMEs represents 45% of jobs. Overall exports of financial services to the EU were worth £27Bn to the UK economy in 2017, 44% of total financial service exports[i]. The sector contributes some 11% of tax receipts[ii]. SMEs make a significant contribution to these finance streams and the supporting firms and infrastructures.

Continuing access for UK SME-type financial services entities to the Single Market and EU-authorised financial services entities to the UK, after the UK leaves the European Union, is critical for these SMEs and their clients. By their very nature they lack the global structures and in-depth resource to find other means of access to markets or vary their business models or adapt to shocks. An abrupt raising of barriers will damage both SME financial service providers and their UK and EU clients, including members of the Genesis Senate trade bodies across the UK economy, Annex 1 sets out a range of regulatory consequences.

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[i] Financial Services Contribution to the UK Economy, House of Commons Library 2018
[ii] PWC 2017

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Recommendations

To avoid an unfavourable outcome in terms of continuing and unfettered access to the EU single market by UK-based financial services firms, a more comprehensive EU equivalence agreement needs to be quickly settled before the end of the transition period, i.e., December 2020, embracing all the various financial service regulations and directives. Equivalence would allow non-EU-based products and services providers to be marketed and sold within the EU if they fulfil the same regulatory and supervisory outcomes and principles, as recognized by the EC.

It is now clear that a "revised and improved EU Equivalence Mechanism" will not end up being part of a wider comprehensive free trade agreement (FTA) with the EU, the latter of which, in any event, takes time to negotiate. Further, existing FTA's with the EU are limited in their coverage and comprehensiveness of trade in financial services. The UK government has also been informed that a mutual recognition regime between UK and EU is not feasible. What is most important for SME financial service businesses is a regime that allows them to operate with certainty in the medium term to long term, which arrangements under an Equivalence Regime would do. Such Equivalence arrangements are a standard feature for other third non-EU countries, like the USA (the most significant financial services market worldwide) in seeking unfettered access to the Single Market for foreign banks, insurers and fund managers.

The Equivalence Regime would also ensure :

- Mitigation of highly disruptive flows of capital, transactions, payments and settlements between both parties (EU and the UK)

- Continued role for the City of London as a primary and critical financial transactional centre for hedging, borrowing, trading on behalf of much of the 27EU States, including EU SMEs

- Avoidance of a protracted development of a bilateral agreement regime, i.e., Switzerland, covering all EU regulations and directives

- Cultivation of closer and enhanced relations between the UK regulatory community and the EU Institutions (EC, ESA's and potentially, ECB) in (i) ensuring the closest possible alignment of regulatory frameworks and (ii) sharing of information.

Avoidance of "regulatory divergence" between the UK and the 27 EU should be a central ambition to preserve business and jobs.

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The importance of the UK financial services sector vis-à-vis the EU – Asset management, a case study.

Adding to the raw numbers on the size of the UK SME financial services sector and its business in Europe, a range of other trading figures and demographics add to that picture of significance for UK jobs and wealth. In asset management:

- Some 37% of the £8.1tn in assets under management in the UK relates to clients from outside the UK. In 2015, asset managers oversaw some £2.2tn for foreign clients (CityUK)

- Some £24bn of revenues are booked by UK asset managers, 25% of which are derived from EU-related business (LSE report, London)

- The total number of wealth and asset management staff in the UK involved in this subset stands at 15,000[ii].

- The UCITS – the EU-wide framework for mutual funds – accounts for €9tn of assets in Europe, is an example of where such funds that can be regulated in Dublin, managed in London and sold in Italy. UK-based UCITS managers may no longer be able to sell their UK-based funds across the EU, post-Brexit

- UK fund houses are concerned that some £1.2tn funds being managed in the UK for institutional investors, such as pension funds and insurers, may be at risk, post-Brexit. This is due in large part to the uncertainty relating to the continuity of MiFID licences following the UK's departure from the EU.

- More than three-quarters of European alternative investment funds, such as hedge funds, are managed from the UK (AIMA)

- The UK enjoys the presence of the large pension fund sector, ranking the 3rd largest after the US and Japan in assets under management

- UK fund management expertise per se contributed to securing foreign clients, accounting for 40% of the assets Vs 18% EU, 21% other (FCA). The number of asset management firms currently authorised in the UK totals 1,840 in 2016 (FCA)

In the private equity space, close on a half of the funds are raised in the UK, with some 40% of managers located in the UK (Invest Europe/PEREP).

[ii] Financial Times

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Critical issues facing UK SME financial services post-Brexit

Over the coming years, a number of critical issues will emerge as the UK leaves the EU. Many of these would be resolved by equivalence, once the "revised and improved" regime is operational at EU regulatory level and takes account of a significant "high-velocity" financial centre based in the UK, and operating in a third-country jurisdiction upon leaving the EU.

1. The loss of the EU single market Passport for UK-licensed companies selling to both domestic and foreign clients, especially retail clients.

2. Recognition that the sole reliance on the EU Equivalence Regime as a basis for 3rd country access to the EU, covering a multi trillion pound sterling sector could be dangerous in seeking to build/invest in business going forward. Notable issues amongst the current concerns are the question of any Equivalence Regime being:

(a) Somewhat arbitrary/ill-defined

(b) Dependent on EU political goodwill

(c) The risk that there will over time be drift between the UK rules and EU ones which impacts the ability to prove/show equivalence and

(d) Subject to withdrawal at any time.

3. No 3rd country regime exists for insurance companies under Solvency II and the associated Insurance Distribution Directive (IDD), thus restricting market access for 3rd countries, aside from the freedom of establishment. This is expected to be addressed by the EC in its revised Equivalence Regime.

4. Potential restrictions on EU-investment firms, especially portfolio managers, in "delegating or outsourcing" certain functions and activities (i.e., staff) back to the UK, when the funds are registered in another EU State, i.e., Luxembourg. Further, there are possible restrictions on the use of "management companies" by UCITS managers in delegating functions to 3rd countries, i.e., it cannot delegate the totality of its functions to one or more 3rd parties. Although management companies are allowed to be based in a 3rd country other than that UCITS home state, under existing rules, appropriate measures are required to ensure that an EOI agreement exists between the home and host state supervisors.

5. Possible limitations on access to the UK markets by EU-registered and based investment firms.

6. In the absence of an EU equivalence decision by the EU authorities allowing 3rd country AIFM's (alternative investment fund managers) access to the EU, UK-based AIFMs will need to apply for local authorisation in an EU Member State to operate (national private placement schemes)

7. Access by UK-based MiFID investment service managers to the EU single market will require an equivalence assessment to serve eligible counterparties and professional clients. Retail clients can only be serviced via the establishment of a local branch in the host country.

8. Uncertainty for UK-based asset managers being able to distribute and provide client support from the UK to EU investors.

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Final points

The Genesis Initiative recognises the helpful attempts of certain MEPs to facilitate the development of a more transparent and holistic EU/UK Equivalence Regime, taking into account the specificities of the UK's prominent financial services sector.

The EC also acknowledges the shortcomings of the current Equivalence Regime and is reviewing how it could be improved and made more predictable.

An existing Equivalence agreements was reached with the USA and the EU in 2017 recognizing the regulation of US and European securities and derivatives markets as being equivalent.

Under EU rules, the European Commission would recognise US venues as equivalent to their own and the US regulator the Commodity Futures Trading Commission to also recognise European venues in the same manner.

In securing such recognition, the Equivalence agreement ensures that investment firms in both the EU and US can pursue cross-continental trading relationships or trading on platforms based in each other's jurisdiction.

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Conclusion - Definition

The European Commission describes equivalence as follows: 'in certain cases the EU may recognise that a foreign legal, regulatory or supervisory regime is... equivalent to the corresponding EU regime.'

In effect, EU authorities can rely on the compliance of foreign entities with the equivalent foreign framework. According to the Commission, there are three main benefits from this approach:

1. Overlaps in compliance are reduced or completely eliminated;
2. Selected services, products and activities of third-countries' entities are acceptable for European regulatory purposes;
3. It reduces the burden for EU financial institutions exposed to an equivalent Third-country prudential regime.

Annexe 1

Regulatory consequences of BREXIT for financial service providers from the SME sector

On 8th February 2018, the European Commission issued a series of Notice to Stakeholders, aimed at UK and EU financial institutions on the regulatory consequences of Brexit.

Scope of the Commission's Notice to Stakeholders

The geographical scope covers regulatory consequences for UK-authorised firms in terms of continuing access to the single EU financial services market, and for EU-authorised firms with assets, and trading and clearing transactions in the UK.

The sectoral scope covers the implications of the UK no longer being in the European Union across seven fields:

- markets in financial instruments
- banking and payment services
- post-trade financial services
- asset management
- credit ratings
- insurance and reinsurance
- statutory audit.

Rationale

The EC state that the deliberations in these Notices are without prejudice to the UK securing a transition period, or the possibility of UK-based entities securing access to the EU market under an "equivalence" or "third-country" regime. But "considerable uncertainties" prevail at present, warranting the EC to remind the above stakeholders of the "legal repercussions which need to be considered".

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Summary of key clarifications

Sector	Key requirements under existing EU law
Banking	• UK-banks providing banking, payment services (via subsidiary, branches), e-money transactions to EU need to apply for a new licence. • EU-authorised banks with presence in the UK (branches) continue to be subject to the EU State supervisory oversight, with powers to restrict divestment and risk concentration. • EU supervisors to reassess whether EU-authorised banks are allowed to continue outsourcing, supervisory arrangements, and exemptions from form application of large exposures involving counterparties in the UK. • Prudential treatment of exposures to 3rd parties in the UK will need to be reassessed, including the resolution framework.
Asset Management	• UK UCITs funds cease to carry the EU UCITS label and become non-EU AIFs, which are subject to restrictions vis-à-vis EU retail investors. • UK-based UCITs and AIFMs will no longer have access to the EU single market, albeit allowed if EU **subsidiaries** of such funds continue to operate in the Single Market. • EU **branches** of UK-based funds will no longer benefit from the EU access rules, but are transformed into non-EU branches of AIFMs, subject to different national rules across the EU. • Asset managers to review disclosures and eligible investments sold to retail investors based in the EU. • UK UCITS management companies + UK AIFMs need to be registered in the EU to manage/market funds to retail and professional investors across the EU. • National Private Placement Schemes (NPPR) apply for non-EU AIFMs selling EU AIFs and non-EU AIFs. • UCITs management companies + AIFMs structured as subsidiaries in any EU State can continue to operate as EU-accredited UCITs manco's. Branches become non-EU AIFMs and subject to NPPRs. • Delegation of activities to the UK – in particular portfolio management or risk management –

	cooperation agreement will be subject to cooperation agreement between the home and host country, but with prior approval of the EC. • The use of non-EU branches for the purpose of performing functions/services vis-à-vis EU clients should not result in material functions or services being handled.
Credit Rating Agencies (CRAs)	• CRAs established in the United Kingdom will no longer be considered established in the EU, requiring ESMA to withdraw their registrations with effect on the UK withdrawal date. • As a result of UK established CRAs' deregistration, credit institutions, investment firms, insurance undertakings, reinsurance undertakings, institutions for occupational retirement provision, management companies, investment companies, alternative investment fund managers and central counterparties in the EU-27 will no longer be able to use ratings issued by these CRAs for regulatory purposes, i.e., Solvency II for insurance firms, CRD for banks and investment firms. • Ratings issued by a CRA est. in a 3rd country which is part of a EU CRA entity, registered by ESMA, will need to be "endorsed", subject to certain conditions being met, i.e., credit ratings activities by CRA in a 3rd country with at least as stringent rules as the EU specific framework, has an objective reason for the rating to be elaborated in the 3rd country and the existence of an appropriate cooperation arrangement between ESMA and the NCA. • Use of a CR in prospectuses issued by a UK-based CRA will need to include clear and prominent information stating that those credit ratings are not issued by a credit rating agency established in the EU and registered under the CRA Regulation.
MiFID/MiFIR	

	• UK investment firms will no longer benefit from the MiFID authorisation6 to provide MiFID investment services and activities in the EU (loss EU passport) • EU-27 subsidiaries (legally independent companies est. in EU-27 and controlled by or affiliated to investment firms established in the UK) can continue to operate as EU investment firms if they have a MiFID authorisation in one of the EU Member States. Need to comply with MiFID rules, i.e., governance, outsourcing or the use of branches in a third-country to provide services back in the EU. • UK Branches in the EU-27 become 3rd country investment firms and will need to comply with national requirements applicable in the Member State where the branch is established. • UK market operators/investment firms operating a trading venue or execution venue will no longer benefit from the MiFID authorisation/licence, i.e., regulated markets, multilateral trading facilities or systematic internalisers will thus cease to be eligible venues for trading shares (under MiFIR share trading obligation) • EU counterparts can no longer undertake trades in shares subject to the trading obligation on the above UK platforms • UK based trading venues and CCPs13 will no longer benefit from the open and non-discriminatory access to EU trading venues and EU central counterparties (CCPs) and to EU benchmarks respectively. • Clients can no longer have direct electronic access to EU established trading venues via UK established firms
INSURANCE / REINSURANCE	• UK insurance firms will no longer benefit from the Solvency II authorisation to provide services in the EU (loss of EU passport) and will transformed into a 3rd country insurance firm, i.e., no longer allowed to provide services in the EU, including through online sales. • Branches of UK insurance firms in the EU will become branches of 3rd country insurance firms, and need an

	authorisation in the Member State of their activity to continue operating • The authorisation of a branch, however, does not grant the right to conduct business across the EU Member States, but only in the Member States that has granted that authorisation. • EU-27 subsidiaries (legally independent companies est. in the UK) can continue to operate as an insurance firm on the basis of their authorisation in the EU Member State of their establishment. • Member States are free to require the pledging of assets or the establishment of a branch by the 3rd country reinsurer. • Group supervision: Insurance/reinsurance firms operating in the EU but part of a group with the parent undertaking registered in the UK will be subject, in the absence of equivalence supervision, to the Solvency II provisions empowering EU supervisory authorities to require a worldwide group solvency or to apply other methods aiming to ensure appropriate group level supervision including the establishment of a holding company with head office in the Union. • Any group-level internal model covering a UK group operating in the EU, will no longer be recognised in the EU as of the withdrawal date, and will require a new application and approval by an EU-27 supervisor.
POST-TRADE FINANCIAL SERVICES	• Derivatives traded on a UK regulated market will no longer fulfil the definition of exchange traded derivatives (**ETDs**) under EU law, thus as of the withdrawal date, ETDs traded on a UK regulated market will be over-the-counter (**OTC**) derivative contracts. • An OTC ETD will thus become subject to all EMIR requirements applicable to OTC derivatives transactions, i.e., certain risk mitigation techniques (notably the exchange of margins) will apply.

	• OTC derivatives that are subject to the clearing obligation must be cleared by a CCP which is authorised and established in the EU or a CCP established in a 3rd country and which is recognised by ESMA. • As of the withdrawal date, UK CCPs will become 3rd country CCPs and need to be recognised under EMIR before they could be used to fulfil the clearing obligation. • The clearing obligation via an authorised CCP est. in the EU or a recognised CCP established in a 3rd country also applies to counterparties established in 3rd countries, where the contract has a direct, substantial and foreseeable effect within the EU or where such an obligation is necessary or appropriate to prevent the evasion of any provisions of EMIR. • Higher capital charge apply to exposures resulting from positions in derivatives held by credit institutions and investment firms established in the EU and their subsidiaries in non-recognised CCPs established in the EU. • Systems will no longer be able to be designated by the UK under the Settlement Finality Directive.

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Adapted summary from the EC Notices to Stakeholders, EC/DG FISMA, 8 February 2018

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Contributors

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