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Client Alert Commentary

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Brexit: 10 Commonly Asked Questions

Q&As for UK Regulated Firms

Although the general election result has provided some certainty in relation to what happens next from a Brexit perspective, there are still many outstanding questions. In addition, a large part of the focus so far has been on no-deal preparations, rather than what will happen if there is a deal and a transitional period. Accordingly, this *Client Alert* seeks to address these questions, specifically for UK-regulated firms, through a series of questions and answers.

1. Now that the general election has taken place, what happens next — will the UK definitely avoid a no-deal exit?

In order to avoid a no-deal exit, both the UK and the EU need to approve and sign the Withdrawal Agreement by 31 January 2020. Otherwise, the default position is that the UK will leave the EU on a no-deal basis at the end of January.

Following the UK general election, the government's Withdrawal Agreement Bill passed its second reading in the House of Commons on 20 December 2019. The Bill must now complete its passage through the Commons and be approved by the House of Lords before 31 January 2020. The Withdrawal Agreement itself must also be approved by the European Parliament. It is unlikely in practice however that either the House of Lords or the European Parliament will block the agreement. The Salisbury Convention — under which the House of Lords does not vote down legislation that features in the government's manifesto — makes it very unlikely that the House of Lords vote will reject the Withdrawal Agreement Bill. In addition, the European Parliament is widely believed to be willing to agree the Withdrawal Agreement as soon as it passes the UK Parliament. Since there are no longer sufficient numbers of opposition MPs in the House of Commons to force another extension of the Brexit deadline, the general expectation is that the Withdrawal Agreement will be agreed by the 31 January 2020 deadline.

2. Even if the UK and the EU agree the Withdrawal Agreement by 31 January 2020, is a no-deal exit still possible?

If the UK leaves the EU on 31 January 2020 with a Withdrawal Agreement in place, under the terms of that agreement the UK will enter into a transitional arrangement until 31 December 2020. During this period, in summary, EU law will continue to apply in the UK, and UK firms will continue to benefit from EU rights such as passporting arrangements. During this period, the UK and the EU will need to negotiate and agree the terms of their future relationship after 31 December 2020. Failure to reach an agreement by the end of the transitional period would result in the UK exiting the EU on a no-deal basis unless the UK government requested (and the EU agreed to) an extension to the transitional arrangement. The deadline for the UK government to request an extension to the transitional arrangement is 1 July 2020. However, the government has written into law that the transitional period may not be extended, effectively ruling this option out — although the government could reverse this prohibition by passing an amendment to the Withdrawal Agreement Act.

It is therefore still possible that the UK could leave the EU on a no-deal basis at the end of December 2020 even if the Withdrawal Agreement is in place by the end of January 2020.

3. If we do have a no-deal exit when will this be confirmed, and how much notice will we get?

Two dates must be considered to determine whether and when there will be a no-deal exit. The first is 31 January 2020, by which date the Withdrawal Agreement needs to be agreed to prevent a no-deal exit at that point.

The Withdrawal Agreement Bill is currently expected to complete its passage through the House of Commons on 9 January 2020, with the House of Lords vote on 13 January 2020. European Parliament approval is then expected once the legislation has been approved in the UK. Accordingly, as with many of the other Brexit deadlines, it is unlikely there will be certainty significantly in advance of the relevant deadline. That said, both sides are now much closer to approving the Withdrawal Agreement than they ever have been.

It currently appears that the more significant risk of a no-deal exit is from a failure of the UK and the EU to reach a trade agreement covering financial services by 31 December 2020, when the transitional arrangement will expire. If neither an extension nor a trade deal is agreed, the transitional arrangement will end, and the UK will trade with the EU as a third country on World Trade Organization (WTO) terms — effectively a no-deal exit for financial services given the limited WTO treatment.

As noted above, the deadline for the UK government to request an extension to the transitional arrangement is 1 July 2020. Therefore, if after 1 July 2020 the government has not requested an extension, or the EU has refused that request, then a no-deal exit becomes more likely. In this scenario, to avoid no-deal, the UK and the EU would need to have negotiated a trade deal by 31 December 2020 (noting that currently the government is not required to seek parliamentary approval for any trade deal that it negotiates with the EU). The risk of no-deal may therefore emerge very suddenly, should trade talks break down at a late stage. Equally, it remains possible that a last-minute arrangement may be reached.

4. If a transitional arrangement is put in place under the terms of the Withdrawal Agreement, will there be any changes for UK-regulated firms during this period?

If the UK leaves the EU on 31 January 2020 with a Withdrawal Agreement in place, it will enter a transitional arrangement, or “implementation period”, in which the UK and the EU will negotiate their future relationship. This is distinct from any further transitional arrangement that may form part of a future agreement. The transitional arrangement will preserve the existing trading relationship between the UK and the EU until 31 December 2020, and keep the UK within the Single Market and European Customs Union. In addition, all EU supervisory, judicial, and enforcement mechanisms will continue to apply. Thus, the UK (and UK firms) will continue to be subject to all existing EU legislation and regulation, as interpreted and implemented by European institutions such as the European Court of Justice and ESMA during this time. In particular, regulated firms will continue to benefit from passporting between the EU and the UK during the transitional period, and therefore will not need to take action to implement their Brexit contingency plans during this time.

Similarly, under the terms of the Withdrawal Agreement, should the EU and the UK enter into a transitional arrangement, the UK will continue to be obliged to implement new EU law for the duration of that period as if it were still a Member State. The European Commission has identified a number of focus areas for new European legislation that is likely to emerge during the transitional period, including completing Europe's Economic and Monetary Union, completing Europe's Banking Union, and environmental, social, and governance (ESG) legislation.

The key point to note, however, is that during the transitional period, the UK government and the UK regulators will no longer have the same ability to participate in discussions at the European level unless they are invited to do so, meaning that changes made to the European regulatory regime during the transitional period may not take into account the views or interests of UK firms or institutions. This will include bodies such as the ESMA Board of Supervisors, which makes policy decisions on behalf of ESMA, and is a key forum through which the FCA is currently able to participate in and influence European policy-making.

5. What will happen at the end of the transitional period?

At the end of the transitional period, the Withdrawal Agreement will no longer govern the trading relationship between the UK and the EU. If a trade agreement has been agreed, then it will form the new relationship; in the absence of an agreement or extension, the UK will trade with the EU on WTO terms.

6. If there is a no-deal exit, what will happen on Day 1, what will the key impacts be for UK-regulated firms, and what can be done to prepare?

The UK Parliament has passed nearly 700 statutory instruments that will become law on exit day in a no-deal scenario. These statutory instruments aim to prepare for a no-deal exit by preserving the vast majority of existing EU legislation that does not already form part of the UK statute book by "onshoring" this into UK law. In order to avoid a cliff-edge scenario, not all of these onshored requirements will take effect on exit day. Rather, the PRA and the FCA have been given temporary transitional powers, meaning they can phase in these requirements over time to allow flexibility for firms to transition to a fully domestic regulatory framework.

Notably however, transitional relief has not been granted in some areas, and therefore firms will be expected to comply with certain requirements from Day 1 if there is a no-deal exit. For example, the UK's transaction reporting regime will change as a result of Brexit, including connected obligations such as the requirement to submit financial reference data. On exit day, the ESMA Financial Instruments Reference Data System (FIRDS) will be replaced in the UK by a new FCA FIRDS system, and the FCA will switch off its feeds to ESMA FIRDS. Firms will therefore need to ensure that they have identified where they have a UK transaction reporting obligation, and that they are connected to FCA FIRDS where this is the case. In addition, firms may also have an EU transaction reporting obligation, in addition to their UK reporting obligation, and will therefore need to be mindful of the potential need to comply with two parallel regimes.

In light of this staggered approach to the implementation of a fully domestic regulatory framework in the UK, firms will need to identify the onshored obligations relevant to them and map the implementation timeline for each of these obligations, with Day 1 obligations taking priority. It is important to note that the relevant onshoring statutory instruments do not set out all of the transitional provisions applicable to each piece of legislation, as there are separate statutory instruments that deal with the transitional positions. Therefore, these need to be viewed as a whole to understand the relevant transitional timelines.

In the event that the UK leaves the EU on a no-deal basis after the transitional arrangement has expired, the regulators' temporary transitional powers are likely to be updated to allow them to phase in the onshored requirements in the same way, meaning that firms will still have a staggered implementation period. However, for those areas in which the regulators have already made clear that compliance is required from Day 1 in a no-deal exit scenario, it is likely that there will be less flexibility than may have been given previously, and therefore these should be the key focus areas for firms' ongoing contingency planning.

7. What happens to the FCA and PRA's temporary transitional powers if there is an exit deal at the end of the transitional period?

As noted above, in a no-deal exit scenario, the PRA and FCA can use their temporary transitional powers to phase in the onshored requirements, to help firms transition to a fully domestic regulatory framework. However, the regulators will only have the ability to make these transitional provisions if the UK leaves the EU without an agreement in place. Therefore, to the extent that there is an exit deal at the end of the transitional period, these temporary transitional powers will not be relevant.

8. Will a purely UK-based firm with no EU passports or entities be impacted in a no-deal exit scenario?

The UK government's onshoring process uses statutory instruments to implement EU legislation into UK law in the event of a no-deal exit. While the majority of requirements derived from EU law to which UK firms are currently subject will remain unchanged, the nature of the process is such that there are a number of differences between the European and onshored legislation which may impact even UK only firms.

For example, under the UK onshored version of PRIIPs KID, changes will be made to the content requirements for UK KIDs. In particular, the obligation to include information about the competent authority of the PRIIP manufacturer will be removed in relation to UK KIDs. Accordingly, this will lead to divergence in the approach to preparing UK-compliant KIDs and EU-compliant KIDs, meaning that firms will need to be clear which regime(s) they are subject to, since the KID templates will not be identical. Notably, this change also eliminates one of the arguments that some corporate issuers have made as to why they should not fall within scope of the PRIIPs Regulation. Issuers that do not have a competent authority have argued that they cannot be within the scope of the PRIIPs Regulation since, by not being able to include a competent authority, they would produce a non-compliant KID. However, this argument will fall away in the UK.

By way of contrast, the onshored version of MAR will retain the same scope as the current EU MAR, however this will not be reciprocal. This is because UK MAR will apply to financial instruments that are traded or tradeable on both UK and EU trading venues, whereas EU MAR applies only to EU (not also UK) venues. Therefore, following a no-deal exit scenario, if a financial instrument is within scope of EU MAR, it will also be in scope of UK MAR. However, because on Day 1 UK trading venues will no longer be EU trading venues, the reverse does not apply, *i.e.*, being within scope of UK MAR does not automatically mean that an instrument is within scope of EU MAR. UK entities will therefore need to be aware that instruments can be within scope of one or both of UK MAR and EU MAR and implement a process that identifies whether one or the other, or both, regimes apply.

As noted above, UK MAR purposefully applies to financial instruments that are traded or tradeable on both EU and UK trading venues. The explanatory memorandum to UK MAR states that this is so the FCA can ensure that it maintains the ability to prohibit, investigate, and pursue cases of market abuse related to financial instruments that affect UK markets and the FCA's reputation, thereby maintaining the integrity of UK markets. The example provided in the explanatory memorandum is that the FCA could take action against abuse of a UK firm's debt instruments that are admitted to trading on an EU trading venue. A key watch point will be the extent to which the FCA looks to take action in relation to conduct on EU trading venues (and the extent to which that conduct will require any UK nexus).

9. What will happen to the onshoring legislation if there is a Brexit deal?

The onshoring exercise is designed to ensure that there is no gap in the UK's legislative framework in the event of a no-deal exit (either at the end of January 2020 or at the end of the transitional arrangement in December 2020). If a free-trade agreement covering financial services is agreed to take effect at the end of the transitional period, then the nature and extent of the onshoring legislation will depend on what is agreed in that deal. The degree to which there is political appetite for the UK to retain significant amounts of EU law under a free-trade agreement is likely to emerge during the course of negotiations in 2020.

10. What might a future deal with the EU look like?

The financial services industry is likely to put pressure on both the UK government and the EU to agree to close regulatory alignment in a future free-trade agreement. The extent to which this ambition may be realised will depend on a number of factors, including the extent to which the UK government wishes to focus on agreements with other countries, such as the United States; the extent of the political pressure from within the Conservative Party for a "harder" exit deal; the outcome from HM Treasury's Financial Services Future Regulatory Framework Review; and the political appetite in the EU to allow what may be perceived as "cherry-picking" of EU legislation by a former Member State.

Should the UK and the EU fail to agree a closely aligned regulatory regime, there may be significant disruption to financial institutions. For example, UK institutions may lose access to the EU passporting system without any fallback, the UK and the EU may cease to recognise respective regulatory equivalence, and there may be a reduction in cooperation between UK and EU regulators.

Agreements between the EU and other third countries may provide insight into what could emerge from negotiations between the UK and the EU. However, the unique nature of the UK's relationship with the EU (*e.g.*, the close regulatory alignment on Day 1 of any exit scenario) means that none will provide a perfect comparison. The EU-Singapore Free Trade Agreement allows EU financial institutions to provide investment advice and limited portfolio management services in Singapore. Similarly, the EU-Canada agreement includes commitments on cross-border provision of portfolio management services. This agreement also allows for extensive consultation between Canadian and European regulators before the implementation of any new "laws, regulations, procedures, and administrative rulings of general application" related to financial services. However, neither the Singapore nor the Canadian agreement (nor any others) permit anything similar to the existing passporting agreements. This also sits against a background of the EU's tightening approach to third-country access (see Third-Country Firms Operating Cross-Border Into the EU — Upcoming Reform).

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