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The UK regulation of EEA firms and funds post-Brexit – clarity on how the FCA rule-set will apply to firms that avail themselves of the temporary permissions regimes

October 2018

Executive summary

On 10 October 2018, following the publication of the draft secondary legislation creating the temporary permissions regimes (**TPRs**) for 'inbound' EEA firms and investment funds which provide services in or are marketed into the UK, the Financial Conduct Authority (**FCA**) published its consultation paper (CP18/29) looking at how firms and funds can enter the TPR, how long each will operate for and the regulatory rule-set that will apply to firms and funds marketing activities during that time.

In designing the regime, the FCA has attempted to balance consumer protection with proportionality so that EEA firms and fund managers can reasonably comply with the regime from 29 March 2019. Whilst the approach is laudable, a review of the consultation paper demonstrates quite how complicated it will be to establish exactly which rules apply during the regime as well as highlighting quite how much work firms will need to undertake, particularly in relation to client disclosures, ahead of Brexit.

Whilst the consultation runs until 7 December 2018, with feedback expected in early 2019 and final rules due to be published shortly before 29 March 2019, the FCA is asking firms to flag where compliance with changes to regulatory requirements by exit day would be "particularly challenging".

On the same day, the FCA published another consultation paper, CP18/28, which is the first in a series which will consider the changes required to the Handbook and BTS in order to reflect the secondary legislation made under the EUWA as it is published. Firms and funds availing themselves of the TPR should have regard to the proposed changes being made under that paper.

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Background

In December 2017, the UK Government confirmed that it would bring forward legislation to set up a TPR for inbound passported EEA firms and investment funds to enable them to continue their activities in the UK for a limited period after Brexit. The aim of the TPR is to reduce the risk of harm associated with an abrupt loss of permissions by enabling firms that passport into the UK to undertake new business that falls within the scope of their existing permissions and to service existing business. It is also intended to allow relevant EEA-domiciled investment funds[i] to continue to be marketed in the UK to new and existing investors.

Once the EU (Withdrawal) Act 2018 (**EUWA**) received Royal Assent at the end of June 2018, HM Treasury commenced work on the secondary legislation required to ensure the UK continues to have a functioning financial services regulatory regime in the event of a ‘hard’ Brexit where no transitional period is ratified. This has included the publication of the statutory legislation creating the TPRs for the following types of firms:

– Treaty firms and EEA firms which passport (whether on an establishment or services basis) into the UK under the Financial Services and Markets Act 2000 (**FSMA**), including those types of firms who also have top-up permissions (**TP firms**) – the “EEA Passporting Rights (Amendment, etc., and Transitional Provisions) (EU Exit) Regulations 2018[ii]” statutory instrument (**SI**) was laid before Parliament in September;
– EEA electronic money institutions (**EMIs**), EEA payment institutions (**PIs**) and EEA registered account information service providers (**RAISPs**) – the “Payments and Electronic Money (Amendment) (EU Exit) Regulations” SI[iii] was laid in October; and
– Managers of EEA-domiciled UCITS and AIFs that market those funds in the UK (**TP marketing fund managers**) – the draft EU Exit SIs[iv] for investment funds and their managers (**TPR Fund Regulations**) were published by HM Treasury in October.

Whilst the TPR SIs include provisions to make the required changes to the UK’s legal and regulatory framework, the question of how the regulators’ rulebooks will apply to firms on the TPR has been left for the regulators to devise and articulate. It is for this reason that the publication of the CP18/29 is to be welcomed. With only five months until a possible ‘hard’ Brexit, clarity on how rule-set changes are to be dealt with during the regime is critical.

Temporary transitional tool

It is worth noting that on 8 October, HM Treasury confirmed it will bring forward legislation to allow regulators to grant some flexibility in applying new requirements under the EUWA. In the context of firms and investment funds availing themselves of the TPR, the FCA expects to use this power, where appropriate, for certain obligations in EU Regulations/ Binding Technical Standards (i.e. level 2 regulatory technical standards and implementing standards) (**BTS**) and in other legislation that is applied in the UK for the first time on exit day. The power will enable the FCA and PRA to amend the onshored EU legislative ruleset (such as the Capital Requirements Regulation and European Market Infrastructure Regulation). Firms will need to assess how the changes brought about by the onshoring and amendment of the EU legislative ruleset will affect them and may wish to approach the regulators where the changes are material.

EEA credit institutions and EEA insurers

In relation to incoming EEA credit institutions (that are intending to continue to accept deposits in the UK after exit day) and incoming EEA insurers, the PRA confirmed its approach to branch authorisation and supervision back in March 2018 and requested that firms contact the regulator - please refer to our bulletin for more detail. However, given these firms are dual regulated, they will also need to have regard to CP 18/29 to the extent the provisions relate to matters for which the FCA is responsible.

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Overview of how the TPR will operate

CP18/29 builds on the information that the FCA first released on its webpage back in July 2018 in relation to the notification process. Namely:

- firms will need to notify the FCA that they intend to use the TPR via the online process using the Connect system which will open in early 2019. The FCA will publish information on how to complete the process and will also provide email confirmation once a notification is received;
- the notification window will close prior to exit day. Once the notification window has closed, firms that have not submitted a notification will not be able to use the TPR and fund managers who have not submitted a notification for a fund will not be able to market it in the UK after exit day via the TPR. Details of firms with temporary permission and details of EU domiciled UCITs funds with temporary permissions to be marketed in the UK will be shown on the FS Register;
- firms will be allocated a three-month application period (a 'landing slot') within which they will need to submit their application for UK authorisation. Landing slots will be allocated based on the type of business undertaken and will be confirmed by the FCA after exit day. The first landing slot is expected to be October to December 2019 and the last to be January to March 2021. Firms cannot request changes to their 'landing slot' although chapter 6 of CP18/29 implies that in relation TP marketing fund managers, there could be "exceptional circumstances" which would allow a change (it is not clear what those circumstances would be);
- firms with top-up permissions will need to submit a Variation of Permissions (VoP) application rather than an authorisation application; and
- if firms no longer wish to continue business in the UK they will be able to apply to cancel their temporary permission once they have ceased all UK business.

It is interesting to note that CP18/29 suggests that firms that fail to apply for authorisation (or recognition) within their landing slot or are unsuccessful may have action taken against them. This approach appears far more threatening than suggested by previous communications from both the Government and the regulator. Arguably the sheer volume of likely applications may be driving the robust approach.

The FCA's general approach in applying the rule-set to TP firms

As articulated above, the FCA has considered a number of factors when determining what rules should apply to TP firms, including consumer protection, the ability for TP firms to comply with the rules from exit day, the nature of the regime as well as how they intend to supervise TP firms and the time and resources available ahead of 29 March 2019.

A number of alternative approaches were considered, including either applying all rules to TP firms which apply to current third-country firms or applying no additional rules to TP firms other than those which currently apply to incoming passporting or Treaty firms. On balance, however, the FCA has confirmed that their proposed approach is to require firms that are in the TPR to comply, in respect of their UK business, with:

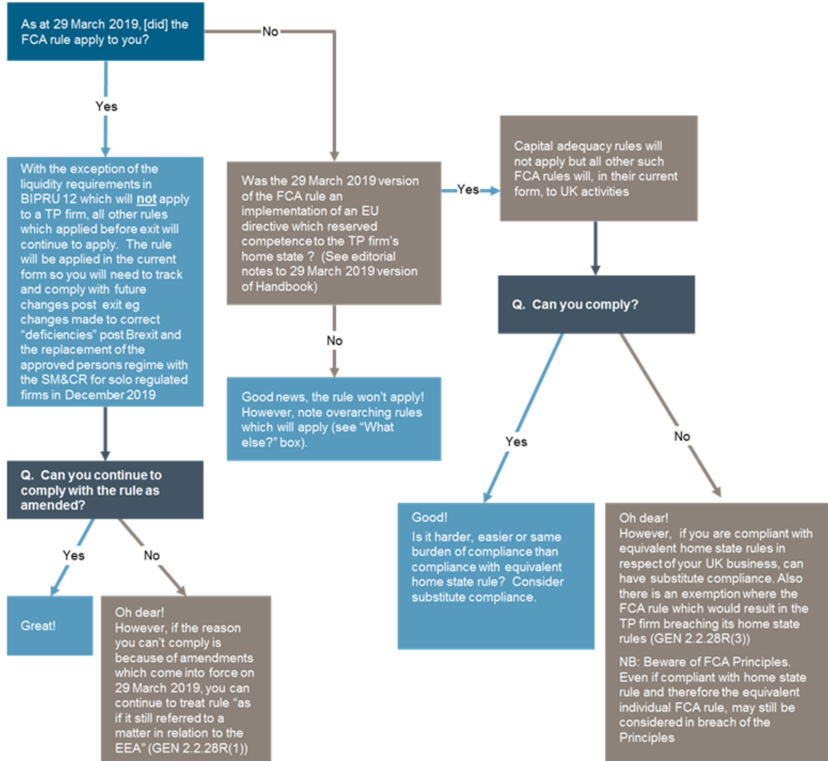
- all FCA rules which currently apply to them;
- all FCA rules which implement a requirement of an EU directive which are currently reserved to the TP firm's home state and which therefore the FCA do not currently apply to EEA firms (i.e. home state rules) – it is particularly welcome to note that the FCA intends to accept 'substituted compliance' in respect of these rules. If firms can demonstrate they continue to comply with the equivalent home state rules in respect of their UK business (including where this is on a voluntary basis if the relevant rules cease to cover UK business) they will be deemed to comply with the FCA rules;

– certain additional FCA rules which the FCA believes are necessary to provide appropriate consumer protection or relate to funding requirements; and
– all guidance on the rules set out above must be considered.

How to determine which FCA Handbook provisions will apply

If references have been removed, how will firms know which rules apply during the TPR? The FCA has confirmed that the approach outlined above will be included as an overarching rule in the General Provisions of the Handbook (**GEN**). Individual sourcebooks will not be amended; instead, firms will need to apply the overarching rule in GEN to each one of the sourcebooks in order to determine the rules that apply during the TPR. Firms are advised to use the time travel optionality embedded within the regulator's Handbook in order to see the version that existed and applied prior to exit day, although the FCA notes that firms will also be required to take account of the changes made to the Handbook and BTS to reflect Brexit and beyond – for example, as set out in CP18/28. When seeking to identify which rules implement an EU directive and are "home state" rules, the regulator suggests that TP firms can use the editorial notes that the FCA includes in the Handbook. Given home state rules are subject to substituted compliance, however, TP firms can start from the position that they should follow the same rules as those that they presently need to comply with in their home state in respect of UK business.

We thought it might be helpful to capture the FCA's approach in a flow chart to help firms process which provisions of the Handbook will apply:



What else?

- PRIN will apply to TP firms (except Principle 4 which will only apply to the extent the TP firm is subject to any capital adequacy requirements).
- TP firms must disclose their status as a TP firm
- TP firms that hold or receive client assets must:
  - report client asset arrangements periodically from 1 April 2019
  - provide an English translation of a client assets audit report if the report finds that the firm doesn't have adequate arrangements or if the FCA requests
  - disclose the UK clients certain information about treatment of client assets on insolvency (in English)
- TP firms subject to MIFID II cannot use a tied agent or appointed representative to hold client assets.
- TP firms will be required to contribute to the SFGB costs
- EEA branch firms in the TPR will be required to contribute to the FSCS. EEA services firms in the TPR should make customers aware that they are not covered by the FSCS.
- TP consumer credit firms will be required to contribute to the IML levy
- The activities of all TP firms will be within the Compulsory Jurisdiction of the FOS. TP firms will be required to pay annual fees and any case or administrative costs.

How will application of the rule-set differ as between branch and services firms?

After exit day, the ruleset applicable to TP firms will change to that applicable to third-country firms, subject to certain modifications and as amended by the overarching rule in GEN mentioned above. TP firms that operate in the UK on a cross border basis (services firms) will see the biggest change, as a number of requirements will apply to TP firms in the

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same way whether they operate in the UK through a branch or cross border. The table below sets out the main ruleset changes for TP firms and whether substituted compliance will be available.

FCA Handbook / obligation	Branch impact	Services firm impact[1]	Substituted compliance?
FCA Principles for Business	Apply in full to TP firms (except for Principle 4[2])		No
Prudential sourcebooks	Same rules as currently apply to UK branches (except that liquidity requirements of BIPRU 12 will not apply)	Not applicable	No
SMCR / APR	No change during TPR (except for the transition from APR to SMCR when the latter becomes applicable to solo-regulated firms)	Not applicable	No
SYSC	UK rules apply in addition to home state rules		Yes
CASS	UK rules apply when holding or controlling client money or safe custody assets New CASS 14 for TP firms CASS reporting from 1 April 2019 required for TP firms Client asset audit reports to be made available to FCA on request/upon receipt of a negative audit opinion Additional insolvency disclosures for TP firms		Yes
FSCS membership	Transition from home state Depositor / Investor Protection Scheme to FSCS	Not in scope of FSCS Need to make customers aware of lack of FSCS coverage	No
FOS	In scope of the Compulsory Jurisdiction of the FOS, including additional levy		No
Supervisory fees and other levies	Subject to FCA fees, SFGB levy[3], IML[4] levy, FOS levy	Subject to UK fees for the first time, including FCA fees, SFGB levy, IML levy, FOS levy	No
SUP	UK reporting and notification requirements apply in full (e.g. close links and controllers, remuneration, CASS reporting, COMP notifications, other reporting obligations in SUP)		Potentially

[1] Note that a services firm will most likely need to become a branch or a subsidiary once TPR ceases to apply.
[2] Which will only apply if a firm is already subject to capital adequacy requirements in the UK.
[3] Single Financial Guidance Body, which will bring together the existing Money Advice Service, the Pensions Advisory Service and Pension Wise from January 2019.
[4] Illegal money lending (**IML**).

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The general approach for supervising fund marketing

In line with the general approach, operators, depositaries and trustees of EEA-domiciled investment funds will be required to comply with all the FCA rules that applied immediately before exit day in relation to the marketing of the relevant fund in the UK. The FCA will not take on responsibility for supervising rules that apply to the fund or its manager in their home states, because that would, in the regulators view, go beyond the aim of maintaining existing arrangements to avoid disruption to firms and investors. However, the TPR Funds Regulations would have the effect of applying current EU directive obligations that apply to the fund operator or the management company of the fund in their home state and which require them to fulfil certain obligations in the state where they are marketing the fund (the host state) and certain EU directive obligations that apply to the national competent authority of the fund or its management company, which require it to provide specified information to the national competent authority of the host state, in this case the UK.

References to a 'UCITS qualifier' or an 'AIFM qualifier' will be removed from the Handbook and the general approach for TP firms outlined above will be extended to fund marketing activities in the TPR.

Additional information for EMIs, PIs and RAISPs

Chapter 5 of CP18/29 confirms that the FCA's proposals in relation to contributions to the Single Financial Guidance Body (**SFGB**), the planned proposal to extend the compulsory jurisdiction of the Financial Ombudsman Service (**FOS**) and the approach to funding the TPR will all be applicable to EMIs, PIs and RAISPs. The FCA has also taken the opportunity to clarify how the approach to the use of agents, safeguarding and the transition to authorisation/registration will work for PIs, EMIs and RAISPs within the TPR, although these are not being consulted on as they do not require changes to the Handbook. The process for leaving the regime will be different for PIs and most EMIs due to the different authorisation and registration conditions that apply to those types of firms as compared to a TP firm.

Practical comments

Whilst the FCA's approach is to be welcomed, particularly in relation to the reliance on substituted compliance for areas such as client assets, determining which Handbook rules apply and how firms are meeting their obligations is not always going to be clear cut, as demonstrated above.

Even before firms and investment funds enter the TPR, a lot of work will need to be undertaken, possibly as part of the large scale re-papering exercises, in relation to disclosures. For example, TP firms that receive or hold clients assets will be required to disclose to UK clients the following information at the point of entry into the TPR:

- the jurisdiction under which the firm's failure would be administered, and
- if there is a possibility that any client assets may be treated differently to money or assets belonging to other customers of the firm in the event of the firm's failure, a statement that explains that this is the case – this element is unlikely to be straightforward particularly given any such disclosure will need to be cognisant of the 'treating customers fairly' obligations.

Other elements, for example funding of the illegal money lending levy and falling within the compulsory jurisdiction of the FOS for the first time, will come as unwelcome surprises for services firms and may require the design of systems to track, for example, consumer credit income in the UK.

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If you would like to discuss the issues raised in this paper in more detail, please contact any of the experts above or your usual Allen & Overy contact.

[i] These investment funds can use the regime:
- EEA-domiciled UCITS funds that have been recognised under FSMA s.264 to market to all investors in the UK
- EEA-domiciled AIFs which are entitled to be marketed to professional investors in the UK under regulations 49 or 50 of the Alternative Investment Fund Managers Regulations 201332, following receipt by the FCA of a regulator's notice or following approval by the FCA, where required
- EuVECA and EuSEF which immediately before exit day have been notified to the FCA for marketing in the UK in line with article 16(1) of the EuVECA Regulation or article 17(1) of the EuSEF Regulation
- ELTIF which are entitled to be marketed to all investors, or to professional investors only, in line with the notification procedures for AIFs described above

[ii] The EEA Passport Rights (Amendment, etc., and Transitional Provisions) (EU Exit) Regulations 2018
[iii] The Electronic Money, Payment Services and Payment Systems (Amendment and Transitional Provisions) (EU Exit) Regulations 2018
[iv] Draft EU Exit SIs for investment funds and their managers

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