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Brexit Law – your business, the EU and the way ahead

The UK regulation of EEA firms post-Brexit – contractual continuity and the financial services contracts regime

January 2019

Executive summary

EEA firms currently passporting into the UK are contingency planning for a "hard Brexit" on which their authorisation to continue to conduct regulated activities in the UK ends abruptly. Following publication of details around the temporary permissions regime (**TPR** see our separate bulletins on the FCA's approach to firms in the TPR and the PRA's approach to firms in the TPR), HM Treasury has now published the legislative framework to allow those EEA firms that do not enter the TPR or which exit the TPR without authorisation to continue to service existing contracts for a limited period to enable an orderly wind down of their UK business (the Financial Services Contracts (Transitional and Saving Provision) (EU Exit) Regulations 2019 or **FSC SI**[1]).

Understanding the availability and scope of the FSC SI is crucial for EEA firms that will not be authorised or deemed authorised to conduct regulated activities in the UK post Brexit. Performing regulated activities in the UK without such permission could be a criminal activity. The availability or otherwise of the FSC regime helps firms to determine the extent to which they may be able to continue to service existing business in the UK in the absence of authorisation or deemed authorisation. Equally, the existence of the FSC SI protects UK clients and counterparties of such firms from risks that might otherwise arise such as an EU insurance firm being unable to pay an insurance claim or an EU central counterparty or trade repository being unable to continue to provide services in the UK.

Assuming a hard Brexit goes ahead, EEA firms will need to decide in advance of 29 March whether to opt into the TPR, enter into the run-off regimes (the SRO and CRO, as discussed below) contemplated by the FSC SI or to cease to be regulated in the UK altogether. Each will present different benefits (in terms of ongoing access to the UK market) and costs (principally regulatory compliance obligations).

[1] The Financial Services Contracts (Transitional and Saving Provision) (EU Exit) (No.2) Regulations 2019 were also published in December and provide further transitional provisions relating to electronic money and payment services which are beyond the scope of this bulletin.

What does the FSC SI do?

The FSC SI delivers on the commitment[2] of the Government to provide transitional relief in respect of the so-called 'contractual continuity' issues associated with the loss of passporting rights by firms at the point of Brexit. This is the risk that, as EEA firms lose their passporting rights, performance of their contracts becomes unlawful, resulting in significant market disruption.

It supplements and amends the EEA Passport Rights (Amendments, etc., and Transitional Provisions) (EU Exit) Regulations 2018 (the **TPR SI**). It also modifies certain aspects of the application of the Financial Services and Markets Act 2000 (**FSMA**) to firms benefiting from the transitional relief it provides, and amends the Solvency 2 Regulations 2015 in relation to certain insurance-related activities.

Part 2 of the FSC SI amends the TPR by introducing a new Part 6 and Part 7 which provide for two interlinking regimes for permissions and exemptions. New Part 6 of the TPR SI provides for two sets of deemed temporary **permissions** for affected firms:

1. temporary limited permission (**TLP**) for a passported firm which remains authorised in its home state; and
2. temporary limited variation of permission (**TVP**) for a passported firm which remains authorised in its home state and has UK authorisation (a so-called **top-up permission**).

The TLP and TVP regimes are together referred to as Supervised Run-off or **SRO**.

New Part 7 of the TPR SI provides for temporary **exemption** (**TE**) for firms with no UK branches (**services firms**) which continue to carry on passported activities following Brexit. The TE regime is referred to as Contractual Run-off or **CRO**.

Part 3 of the FSC SI amends the Central Counterparties (Amendment, etc., and Transitional Provision) (EU Exit) Regulations 2018 to provide a contractual run-off regime of one year for central counterparties (**CCPs**) who do not enter the TPR or for a period determined by the Bank of England (being no longer than one year) for CCPs who exit the TPR without recognition. The Bank of England may subject CCPs exiting the TPR without recognition and which benefit from the run-off regime to such transitional arrangements as it considers necessary or expedient.

Similarly, Part 4 amends the Trade Repositories (Amendment, etc., and Transitional Provision) (EU Exit) Regulations 2018 to provide temporary registration for a run-off period of up to one year (as determined by the FCA) for trade repositories who exit the TPR without registration or trade repositories in respect of which the FCA has withdrawn registration. Trade repositories in the run-off regime may be subject to such requirements as the FCA deems necessary or expedient.

This bulletin focuses on the TLV, TLP and TE regimes available to incoming EEA firms.

Which regime do firms fall into?

We have mapped the interaction of the TPR, SRO and CRO regimes and the options available to firms in a flow chart at the end of this bulletin. Understanding the interaction of the regimes is challenging. However, it will be necessary to identify which regime a firm is in to ascertain what requirements apply.

Broadly speaking, for EEA firms with UK branches which are not in the TPR, it seems that they would be expected to avail themselves of the SRO regime to wind down their existing book of business. By contrast, the CRO regime is for EEA services firms (either immediately on Brexit or on exiting the TPR if their TLV or TLP (as appropriate) is cancelled).

It is also important to note that firms can be moved between the SRO on the one hand and the CRO on the other by the regulators at their discretion. Firms will need to be given a clear understanding of when, and how, these discretions will be exercised – particularly in relation to migration from the CRO to SRO given the significant compliance costs and

[2] https://www.gov.uk/government/publications/banking-insurance-and-other-financial-services-if-theres-no-brexit-deal/banking-insurance-and-other-financial-services-if-theres-no-brexit-deal

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resources associated with authorisation. Guidance on the run-off regime published by HM Treasury considers the example of a firm with significant UK exposure which enters the CRO (ie a services firm which seeks to avail itself of the TE), if the regulators feel that their statutory objectives would be served better if this firm was supervised in the UK, they can move it to the SRO. This does little to indicate how the regulators may exercise their discretion.

Similarly, clients and counterparties will need to be able to understand the status of the firms they deal with during transition. The FCA have confirmed that details of SRO firms will be shown on the Financial Services Register[3]. But what about CRO firms? We do not know.

What activities will firms be able to undertake?

The permission (in the case of the SRO) or exemption (in the case of the CRO) covers only those activities which are:

a) necessary for the performance of a pre-existing contract and which the firm was permitted to carry on beforehand; or

b) necessary for the purpose of reducing the financial risk of a party to, or affected by, a pre-existing contract; or

c) necessary in order to transfer property, rights or liabilities under a pre-existing contract to an authorised person; or

d) necessary in order to comply with a requirement imposed by or under an "enactment"

and only insofar as the relevant activity is necessary for that purpose[4]. A corresponding restriction applies to financial promotions: a firm with a TLP, TVP or TE[5] may only issue financial promotions necessary to the performance of a pre-existing contract.

The published draft FSC SI appears to seek to clarify that where a pre-existing contract includes the performance of an obligation which is contingent or conditional, this would satisfy the conditions for "necessary". However, uncertainty remains where performance is cancellable or discretionary. For example, where a firm has a cancellable commitment under a consumer credit loan, extending credit is not strictly necessary as the commitment to lend can be cancelled. Should consumer credit providers falling under the regime therefore cancel all commitments in order to avoid being called to perform in circumstances that could be characterised as unnecessary? Similar questions will arise under all arrangements which are terminable by the firm.

Similarly, the taking of discretionary action contemplated by a contract may not be "necessary", even though it may be expected and may be important to meeting the expectation of a client. Wholesale investment business terms typically permit, but do not oblige, a provider to provide services. Does entry into the regime effectively prohibit the provider from continuing to provide services which are not "necessary", on a literal interpretation of the word? This also raises questions around the permissibility of executing pending orders whose life-span straddles exit day – would firms with a TLP, TLV or TE be able to complete such orders after exit day without the relevant TPR or Part 4A permission?

How long will the regime last?

The regime is intended to be available to firms for fifteen years in relation to the performance of a contact of insurance, and five years for all other activities. HM Treasury may extend the period by up to five years based on a joint assessment by the FCA and the PRA. That period will commence at Brexit for firms which do not utilise the TPR, and at the point that the TPR ceases to apply otherwise.

[3] FCA consultation on Brexit and contractual continuity, CP 19/2
[4] Regulations 33, 40 and 53.
[5] Regulations 42, 59. (Note that Regulation 59 is technically redundant as section 21 does not permit exempt persons to communicate or approve financial promotions in any event.)

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Do firms have to do anything to enter and remain within the regime?

The FSC regime will automatically apply to EEA passporting firms that do not notify the FCA/PRA that they wish to enter the TPR, but have pre-existing contracts in the UK which would need a permission to service. A services firm relying on the CRO at exit date must notify the FCA that it is carrying on regulated activities in the UK.

The FSC SI provides that TE firms will have to keep authorisation in their home state and must notify their regulator, the FCA or PRA, if their home state authorisation is cancelled or varied or is to be varied. They must also inform the FCA or PRA if they are the subject of a criminal investigation or proceeding or the subject of an insolvency event. Firms in SRO will also be expected to maintain authorisation and supervision in their home state.

The regulators can impose such requirements as they consider appropriate on firms that go straight into the SRO regime at exit date (and which do not enter the TPR).

What rules will apply to SRO firms?

SRO firms will remain authorised and subject to the FCA and, if applicable, PRA rules. The FCA and PRA will be updating their rulebooks to reflect the changes introduced through the FSC SI (among others), and to address any deficiencies as a result of the UK leaving the EU. The PRA is consulting on its proposed approach in CP32/18 – UK Withdrawal from the EU: Further changes to – PRA Rulebook and Binding Technical Standards – Resolution Binding Technical Standards. The FCA issued its consultation, CP19/2 on Brexit and contractual continuity, on the 8th January 2019.

The FSC SI provides that that Financial Services Compensation Scheme (**FSCS**) will not apply to SRO services firms with TLV or TLP but will apply to SRO branches which are credit institutions, insurance intermediaries, investment firms, mortgage intermediaries, UCITs management companies or certain AIFMs.

The FSC SI also provides for product intervention rules and any prohibition or restriction imposed under either Article 42 of MiFIR[6] or Article 17 of the Regulation on key information documents for PRIIPS[7] to apply to TE firms.

There is also provision for the regulators to give deemed approval to persons performing controlled functions within TLP and TLV firms.

PRA's proposed approach to SRO firms

In broad terms, the PRA propose to treat firms in the SRO as third country firms and to subject them to the same obligations and supervisory framework (including the Fundamental Rules) as other Part 4A authorised firms, with some amendments to ensure that the rules are effective and operable.

Branches

Firms in SRO which operate through UK branches will be required to comply with all of the requirements to which third country firms are subject, subject to possible transitional relief. Transitional relief is currently under consideration in respect of PRA remuneration rules where they go beyond minimum CRD IV requirements and certain reporting obligations where they involve the segregation of branch reporting data and the reporting and review of this data where this is not already required.

[6] Regulation 600/2014
[7] Regulation 1286/2014

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Services firms

Services firms in SRO will be subject to a more limited set of rules that could apply to a third country firm without a UK branch. In contract to the position for branches, the CP does not propose transitional relief other than in relation to the SMCR requirements.

The PRA's approach in CP 32/18 replicates the approach it proposes to take with respect to UK branches and service firms in the TPR (please see our bulletin on the PRA's approach to firms in the TPR including for analysis of how application of the PRA rule-set differs as between branch and services firm).

SM&CR

The PRA proposes to apply "a streamlined version" of the SM&CR to firms in the SRO. All firms (branches and services firms) will be required to appoint an SMF 19 to oversee the orderly run-off of the firm's UK regulated activities. Firms will have a 12 week window from their entry into the SRO to obtain deemed (or full) approval for the relevant personnel. An adapted version of Short Form A will be available for applications. If deemed approval is given, the relevant individual must then undergo a full fit and proper assessment and obtain PRA approval and FCA consent to that assessment as an SMF within 12 months.

In contrast to the PRA's October 2018 proposals for TPR firms, the usual Prescribed Responsibilities for third country branches will not apply to firms in SRO and the PRA propose that the Certification Regime only continue to apply to firms in SRO to the extent that it currently does pursuant to FCA Rules (ie to branches, not to services firms).

Depositor protection

The PRA's approach to firms in the SRO and CRO mirrors its approach to firms in the TPR. In summary, FSCS protection will cover eligible depositors with accounts with UK branches of firms in the SRO. All associated depositor protection rules will apply immediately on entry into the SRO with no transitional relief (e.g UK Single Customer View reporting and consumer disclosure requirements and FSCS levies. Please see our bulletin on the PRA's approach to firms in the TPR for further discussion of these requirements).

Disclosure and run-off plan

The PRA propose to require firms in SRO to include specific status disclosure wording in their communications with retail clients to indicate that they are in the regime and to provide the PRA with a run-off plan on entry into the SRO. Firms will then be required to provide regular (at least annual) updates on progress and any unexpected divergence from the plan.

FCA's proposed approach to SRO firms

The FCA also propose, at least in the short term, to apply the same approach to SRO firms that they propose for TPR firms, subject to any necessary modifications. The FCA has confirmed that firms in SRO will be required to comply, in respect of their UK business, with:

- all FCA rules which apply to them before they enter the SRO (whether on Brexit or on exit from the TPR);

- 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; and

- certain additional FCA rules which the FCA believes are necessary to provide appropriate consumer protection or relate to funding requirements.

This approach is included as an overarching rule in the General Provisions of the Handbook (the **general approach**). Individual sourcebooks will not be amended; instead, firms will need to apply the general approach to each one of the sourcebooks in order to determine the rules that apply whilst in SRO. Please see our bulletin on the FCA's approach to firms in the TPR which includes a flow chart to help firms process which provisions of the Handbook will apply and a table which sets out the main ruleset changes for branch and services firms and whether substituted compliance will be available.

The FCA propose to include additional guidance on the general approach as to how it applies to firms which enter SRO after exit day on leaving the TPR. They are also proposing different status disclosure wording for SRO firms to the wording it has proposed for TPR firms.

The FCA state that they may review the rules which apply to SRO firms in the medium term, once we have a better idea of how the regime is operating and how many firms are in it.

What rules will apply to CRO firms?

CRO firms will be exempt persons which are generally outside the scope of the regulators' rules, subject to the following exceptions provided for in the FSC SI:

– the FSCS will apply to CRO firms which are carrying out insurance contracts or are AIFMs or UCITS manager;

– the FCA's product intervention rules and any prohibition or restriction imposed under either Article 42 of MiFIR or Article 17 of the Regulation on key information documents for PRIIPS will also apply to CRO firms.

The regulators' approach to applying the FSCS to firms in the CRO mirrors their approach to firms in the TPR. It is expected that deposits taken by firms in the CRO will continue to benefit from the relevant Home State depositor protection regime.

Practical issues

A time-limited transitional period is inconsistent with the Government's commitment to minimise disruption. It will leave uncertainty over contracts with a duration that exceeds the duration of the regime. A party to a contract whose legality has a finite end is likely to feel obliged to take action sooner rather than later to mitigate that risk, meaning that there may be market disruption resulting from this uncertainty. It is also unclear from a policy perspective why an arbitrary limit on the regime is justified – whilst we appreciate that there are good arguments for insurance contracts to be provided a 15 year window, it seems to us that other contracts (which are currently within the five-year bucket) should benefit from a longer regime, particularly with respect to long dated derivative contracts (which are likely to be high-value transactions) and regulated mortgage contracts (which, similar to insurance, could have significant consumer impact).

As already noted, there are questions around the scope of "necessary" activity. Similar questions arise around the concept of activity "*necessary…for the purpose of reducing the financial risk*". Is the concept that only a step without which the financial risk under a pre-existing contract cannot be reduced is "necessary", and therefore permitted? If a provider is party to an option, its exercise may not reduce financial risk, particularly when viewed against the overall book of the firm. How are firms expected to demonstrate the reduction of risk? Also, it is not clear what risks are meant to be captured by "financial risk". We consider that a narrow approach to the interpretation of what is "necessary" could result in significant consumer detriment.

The PRA have invited feedback on any particular obligations it proposes to apply to firms in SRO which would be challenging to comply with from exit day. Given the limited time available to firms, it will be important to feedback early on the proposals, seek clarity and understand the PRA's approach to transitional relief particularly for those firms that do not intend to enter the TPR but also for firms who will enter the TPR given that we do not yet know which firms will be given an early "landing slot" for their authorisation application in the TPR or how quickly the regulators may process those applications.

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Whilst the FCA's approach to the application of the rules 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. Additionally, firms that will enter SRO directly on the UK's exit from the EU, will have a lot of work to do even before they enter SRO, possibly as part of a large scale repapering exercise, in relation to disclosures.

Elements of both the PRA's and the FCA's proposals 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.

Equally, understanding when and how the FCA or PRA may exercise its discretion with respect to a firm's reliance on a TLP, TLV or TE is critical.

What do firms need to do?

Assuming a hard Brexit goes ahead, EEA firms will need to decide in advance of 29 March whether to opt into the TPR, enter into the SRO or CRO or to cease to be regulated in the UK altogether. Each will present different benefits (in terms of ongoing access to the UK market) and costs (principally regulatory compliance obligations). Firms will need to understand the business they provide in the UK and undertake the cost-benefit analysis in order to decide what their longer term plans for any UK business will be. Depending on that decision they may need to opt into the TPR or fall into the run-off regime, and make changes to any UK business (whether by winding down existing activities or establishing a new presence).

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Choose your own adventure: The road ahead for passporting firms

Key:

TPR means the Temporary Permissions Regime under The EEA Passports Rights (Amendment, etc., and Transitions Provisions) (EU Exit) Regulations 2018

TLP means the Temporary Limited Permission under the Financial Services Contracts (Transitional and Saving Provision) (EU Exit) Regulations 2019 (draft)

TLV means the Temporary Limited Variation under the Financial Services Contracts (Transitional and Saving Provision) (EU Exit) Regulations 2019 (draft)

START: Are you currently relying on a passport to conduct regulated activities in the UK?

No → The TPR, TLV and TLP are not applicable to you.

Yes → Do you currently have a Part 4a top up permission?

Yes → Do you want to enter the TPR for deemed authorisation for activities you currently rely on passport for authorisation to perform?

Yes → Notify FCA/PRA for deemed variation of permission under Regulation 11

TPR → Variation of permission granted?

No → Seek to rely on TLV under Regulation 34 (via Reg 38)* to service contracts existing before exit TPR. If TLV ceases to apply, services firms may hope for a direction by FCA/PRA that Reg.47 exemption applies (Reg 52)

Yes → Are there any activities not captured by expanded Part 4a authorisation that had been captured by Regulation 11 deemed permission and which need to continue to service existing book of business?

No → Great!

Yes → Seek to rely on TLV under Regulation 34* (via Reg 38). If TLV ceases to apply services firms may hope for a direction by FCA/PRA that Reg.47 exemption applies (Reg 52)

No → Do you have legacy contracts that will continue to require performance post Brexit which will require you to perform regulated activities in the UK for which no other exemption applies ?

No → Okay, your authorisation will be restricted to that under Part 4a on exit day

Yes → Seek to rely on TLV via Reg 36. If TLV ceases to apply services firms may hope for a direction by FCA/PRA that Reg 47 exemption applies (Reg 52)

No → Do you want to enter the TPR for deemed authorisation for activities you currently rely on passport to perform?

Yes → Notify FCA/PRA for deemed authorisation under Reg 8

TPR → Authorisation granted?

No → Regulation 8 ceases to apply. For existing contracts, seek to rely on Reg 28 TLP (via Reg 31) *. If Reg 28 ceases to apply...

Either → Services firms may hope for a direction by FCA/PRA that Reg 47 exemption applies (via Reg 51)

Or → [Seek to rely on TLV (via Reg 39) *. If TLV ceases to apply, services firms may hope for a direction by FCA/PRA that Reg.47 exemption applies (Reg 52)]

Yes → Are there any activities not captured by Part 4A authorisation but which need to continue to serve legacy contracts?

No → Good!

Yes → Seek to rely on Reg 34 TLV (Via Regulation 37)*. [If TLV ceases to apply, services firms may hope for a direction by FCA/PRA that Reg.47 exemption applies (Reg 52)

No → Do you have legacy contracts that will continue to require you to perform regulated activation in he UK for which no other exemption (e.g. Overseas Person) applies post Brexit?

No → Ok, you will no longer be authorised to perform regulated activities in the UK after 29 March 2019. Beware S.19 FSMA.

Yes →

Either → Notify FCA to rely on Exemption under Reg 47 (via Reg 49) → If exemption ends hope for a direction by PRA/FCA that Reg 28 TLP applies (Reg 32) → If TLP ceases to apply

Either → Services firms may rely on exemption under Reg 47 (via Reg 51)

Or → [Seek to rely on Reg 34 TLV (via Reg 39) *]

Or → Branch firms can rely on Reg 28 TLP (via Reg 30). If TLP ceases to apply... → [Seek to rely on Reg 34 TLV (via Reg 39) *]

*At regulator's discretion

The regulators maintain discretion in the proposed regime to allow firms to rely on the TLP/TLV or to move firms between the TLP/TLV and exemption regimes. As such, the end of each strand of this flow chart may not be the end of the story and it is possible that firms may find themselves re-entering the TLP (via Reg 32) and continuing their regulatory journey. ...

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