Brexit – implications for investment firms

We have previously written about the likely impact on fund managers of the UK's historic vote to leave the EU and here address some key concerns for investment firms subject to the EU Markets in Financial Instruments Directive ("**MiFID**"), such as investment advisers, broker-dealers, portfolio managers and investment banks.

Unless some sort of special status is negotiated, leaving the EU and EEA will inevitably mean that the UK's financial services firms are no longer able to access the MiFID "passport" – which enables firms authorised in one member state to provide services to clients in other member states, either on a cross-border basis or through the establishment of a branch, without needing to seek local authorisation in each jurisdiction.

The reverse is also true, and EU firms that currently provide services to clients in the UK or who have established UK branches will no longer be able to rely on the passport to do so, though as a matter of domestic regulation it would be possible for the UK to provide for some sort of quasi-passport and allow EU firms access as if it was still in the EU, should it choose to do so.

The more difficult questions will be for UK firms and UK offices of global firms, many of which may have been set up in the UK to access EU markets. Once these firms no longer have access to the passport, it is not clear how, if at all, they will be able to access EU markets and the extent to which they will be subject to the MiFID rules in so doing.

Unlike AIFMD (on which we have written previously), MiFID does not contain any concept of a third-country (i.e. non-EU country) passport. On its face this would suggest that UK firms will either need to seek local authorisation or establish an EU presence which itself can benefit from the passport. Clearly such an approach could result in significant additional costs and administrative and/or regulatory burdens for those firms who have historically chosen the UK as their EU base. Fortunately, however, the position is likely to be considerably less bleak than this due to certain provisions in the Second Markets in Financial Instruments Directive ("**MiFID2**"), due to be implemented across the EU in 2018 – around the same time the UK's formal exit from the EU is likely to take place.

Although it still doesn't contain a third-country passport as such, MiFID2 does have detailed provisions on third-country access, both in relation to cross-border business and business from a branch in the relevant jurisdiction, summarised below.

Cross-Border Business

The following provisions relate only to business conducted with eligible counterparties and "per-se" professional clients, the biggest and most sophisticated types of client. Retail clients and "elective" professional clients (e.g. high net worth or sophisticated individuals who have chosen to opt-up to

professional client status) are not subject to these rules and EU member states may impose additional requirements in respect of business with them, or require third-country firms to establish a local branch to do business with them (see below).

MiFID2 provides that, subject to certain conditions summarised below, third-country firms may provide investment services to EU clients on a cross-border basis upon registration with the European Securities and Markets Authority ("**ESMA**"). Upon such registration the relevant third-country firm will be given a right (similar to the "passport") to provide cross-border services to clients across the EU, with member states prohibited from adding additional requirements.

The conditions include the European Commission confirming that the third-country jurisdiction has equivalent regulation to MiFID2 and require ESMA to determine that that the third-country firm is subject to effective supervision and enforcement and that there are appropriate co-operation agreements in place with the relevant third-country regulator.

Since the UK currently has fully EU-compliant regulation in place it must be assumed that it will be able to meet these conditions though the relevant co-operation agreements will need to be entered into. Even if the UK chooses to put in place lighter-touch domestic regulation, as long as MiFID-equivalent regulation is maintained for business with EU clients the conditions should still be met.

Branch Establishment

MiFID2 also provides that member states may require third-country firms wishing to do business with retail clients or professional clients to establish a branch in the jurisdiction to do so. Member states do not have to do this and can maintain their existing domestic regimes if they wish, but if they choose to require establishment of a branch, then MiFID2 sets out the conditions that will apply.

The conditions for establishment are, broadly, that the third-country firm is authorised and subject to effective supervision and enforcement in its home state, that relevant co-operation agreements are in place between the EU regulator and the relevant third-country regulator, that the third-country has an OECD-compliant tax exchange agreement in place, that the third-country has joined an EU-recognised investor compensation scheme, and (in relation to the firm itself) that sufficient initial capital is available and that the management board complies with MiFID2 governance requirements.

Unlike cross-border services where the application is made to ESMA and carries rights similar to the passport, for branch business the application is made to the individual member state regulator and does not immediately carry any passporting rights. Subject to the equivalence decision from the European Commission referred to above, a branch of a third-country firm established in an EU jurisdiction may be able to benefit from certain passporting rights, but only in relation to eligible counterparties and per-se professional clients, not the retail clients and elective professional clients the branch will likely have been established to service – so effectively the passport rights available are cross-border passport rights rather than true branch passport rights.

All of the above is subject to the caveat that non-EU firms can continue to provide services to any EU clients provided the firm has been approached at the "exclusive own initiative" of the EU client – but whereas we have seen significant use of "reverse solicitation" in connection with AIFMD and professional investors, it is perhaps less likely that this will be used to any great extent in the broader investment services arena where retail clients may lack the necessary sophistication to make such enquiries at their own initiative.

Brexit will mean the end of the MiFID passport for UK firms and UK establishments of global firms, but there will still be scope to provide cross-border services to certain clients and to service other clients

through establishment of a local branch, in both cases in much the same way as if the passport was still available. This would require the UK to maintain "equivalent" regulation, which may be unpopular given the resentment of EU regulatory requirements in certain circles, but since there would appear to be nothing preventing the UK from implementing a dual-track form of regulation providing equivalence for those that need it and a lighter touch for those that do not, this is not too difficult to imagine.

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