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**Editor's Note: Looking Back, and Ahead**
Victoria Prussen Spears 427

**Long-Term Capital Management: A Retrospective—Part I**
Paul L. Lee 429

**Crapo Helps Community Banks**
Gregory J. Hudson and Joseph E. Silvia 456

**A Brave New World: Cryptocurrency, Blockchain, and the Complex and Ever-Changing Regulatory Framework**
David W. Adams, John C. Amabile, and Brian S. Cromwell 462

**Banking After Brexit—The Future for Financial Services in Europe**
Christian Tuddenham, Maximilian von Rom, and Benjamin Herz 471

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# Banking After Brexit—The Future for Financial Services in Europe

***Christian Tuddenham, Maximilian von Rom, and Benjamin Herz****

*This article discusses some of the key questions and challenges faced by market participants as Europe moves towards Brexit. In addition to discussing the positions of the banks, the authors compare and contrast the actions and commentary of the regulators, central banks, and legislators in each jurisdiction.*

London and Frankfurt have long been regarded as the leading centers for banking and financial services in Europe. Most financial institutions operating in Europe are headquartered in one of these two cities.

The impending departure of the UK from the EU represents potentially fundamental change for the financial services industry in Europe. Whilst the Brexit negotiation process is still far from complete, the relationships which financial institutions hold with their European regulators, their host countries, and indeed one another, are already evolving. Industry cannot afford to await the conclusion of an inherently unpredictable political process.

This article discusses some of the key questions and challenges faced by market participants as Europe moves towards Brexit. In addition to discussing the positions of the banks, the authors compare and contrast the actions and commentary of the regulators, central banks and legislators in each jurisdiction.

## TRANSITIONAL ARRANGEMENTS

On March 19, 2018 the UK announced a preliminary agreement with the EU's chief negotiator that is designed to avoid a sudden and disorderly termination of the UK's existing relationships with the EU on Brexit day, March 29, 2019, and instead provides for a 21 month transitional period from that date to the end of 2020. Essentially, the UK would still remain part of the single market during this transitional phase. The agreement as to transitional arrangements is, however, only part of the much larger draft agreement that

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remains under negotiation regarding all aspects of the UK's withdrawal from the EU, and as such is conditional upon the successful conclusion of those ongoing broader negotiations.

**Will the Recent Agreement on Transition Protect Existing Passporting Rights?**

EU (and European Economic Area ("EEA")) member states are entitled to access to a single market for financial services in principle. Among other benefits, this means that all EU member states recognize regulatory authorizations granted by other EU member states. This in turn means that once a financial institution has obtained the requisite authorization to conduct a specific form of business in one EU member state, it can conduct that same business throughout the EU without the need to obtain further authorizations or permissions in other EU member states. This is known as "passporting."

The current position of the EU27 is that when the UK leaves the EU, its access to the single market for financial services must end. This means that passporting rights will also end. However, there is currently uncertainty as to whether passporting rights will continue during the transitional period.

The Bank of England and the UK's Financial Conduct Authority (the "FCA") have indicated that they will treat the transitional deal as effective despite its conditional status and have urged other European regulators to work together to implement continuing passporting rights for firms undertaking regulated activities between the UK and EU. That, however, obviously falls well short of a guarantee that passporting rights will continue unaffected throughout the transitional period.

Nevertheless, following the deal, the Bank of England wrote to EU-headquartered firms with UK branches stating that they could plan on the basis that authorization would not be required before the end of the transitional period.

This position is at odds with that of other EU regulators. For example, the Bundesbank has stated that it would be premature for firms to assume that they will have the benefit of a transitional period, given the conditional nature of the deal. In a scenario where passporting rights derived from a UK authorization are lost, financial institutions wishing to provide services in continental Europe would need to establish an authorized entity or branch in one of the relevant EU countries instead. That EU presence and local authorization would then enable the institution to provide regulated services within the EU marketplace under the passporting regime.

## Why are Banks Continuing to Plan for a "No Transition" Scenario?

The conditional nature of the transitional agreement means that, although it represents a political consensus, it is not currently legally effective or enforceable. This has led some regulators, including the European Central Bank (the "ECB"), to regard the deal as vulnerable to change or cancellation. If there is no transitional period, the industry faces a sudden and complete exit from the EU on March 29, 2019.

Prior to the transitional agreement, the ECB (in its supervisory role, pursuant to the Single Supervisory Mechanism) requested financial institutions that are considering relocating (or otherwise expanding) out of the UK and into Frankfurt or other EU cities to file their licensing applications in summer 2018 at the latest. The ECB was anxious to ensure that all necessary licenses would be granted prior to Brexit. It was thought that the ECB might relax this timeline in light of the transitional agreement but it has not done so, on the basis that the agreement is conditional. Indeed, the ECB and other EU banking supervisory authorities have instructed firms to continuing planning for a hard Brexit on March 29, 2019.

The European Commission's Vice President for Jobs, Growth, Investment and Competitiveness, Jyrki Katainen, recently opined that banks should continue to prepare for a "cliff-edge" Brexit, pointing out that the free trade agreements currently being discussed do not provide for financial services.

## Current Views from Within the Industry

The Association for Financial Markets in Europe and the industry body TheCityUK both welcomed the transitional deal, whilst at the same time recognizing that regulators across the EU will now need to work together to reach consensus on issues such as contractual continuity, market access and the communication of data. A similarly cautious view has been taken by UK Finance, an umbrella organization representing approximately 300 financial institutions providing services in, or from, the UK. UK Finance responded to the announcement of the transitional agreement in the following terms:

> Without political direction from leaders in the EU to their financial regulators instructing them to develop cross-border models of supervision and solutions to these cliff-edge issues, financial institutions and their customers may not be able to rely on these measures.

## MARKET ACCESS

### Has there been Tangible Progress on the Topic of Market Access during the Course of 2018?

Yes, but not enough for the UK government. The EU had originally ruled out an agreement regarding market access, but has more recently indicated that the UK will be permitted "appropriate access" to the EU financial marketplace after the UK leaves. Precisely what that means is not yet clear, although we do know that it would allow the EU unilaterally to determine not only the terms of access, but also the right to access itself. The UK government, the FCA, and UK industry bodies, had been seeking a bilateral arrangement on access ("mutual recognition"), which would have been negotiated and agreed between the EU27 and the UK. However, those hopes appear to have been relinquished, and the UK government appears to have accepted that something lesser will have to be agreed.

It is also currently unclear whether "appropriate access" means the same thing as the type and level of access currently permitted to non-EU countries, for example the United States, which is based on the concept of "equivalence." In short, "equivalence" applies where the EU and relevant third country recognize their individual regulatory regimes to be sufficiently similar as to be equivalent, justifying the removal of some of the regulatory barriers to access. Critically, equivalence arrangements with the EU are only offered in relation to individual regulatory regimes as opposed to across the board. For instance, the Capital Requirements Directive IV ("CRD IV"), covering deposit taking and commercial lending is not currently part of any equivalence agreement. If the UK's access to EU financial markets post-Brexit is to proceed under the equivalence regime then the UK would undoubtedly want that access to extend to the banking services regulated under CRD IV.

A further issue with equivalence, which has been cited by critics, is that it is essentially unilateral: it is open to the EU to withdraw access at any time if it decides that a particular regulatory regime operated by the third country no longer qualifies as equivalent to the relevant EU regime. For this reason, the UK has proposed that it be afforded an expanded version of traditional equivalence, which would presumably involve a more comprehensive agreement covering more, or all, of the relevant regulatory regimes and possibly also involve a level of bi-lateral control.

### Why was the UK Unable to Secure "Mutual Recognition"?

The UK's Chancellor of the Exchequer, Phillip Hammond, argued for mutual recognition in early March 2018 in a speech given at HSBC's London headquarters when he said:

> . . . [the equivalence] regime would be wholly inadequate for the scale and complexity of UK-EU financial services trade . . . But the principle of mutual recognition and reciprocal regulatory equivalence, provided it is objectively assessed, with proper governance structures, dispute resolution mechanisms, and sensible notice periods to market participants clearly could provide an effective basis for such a partnership.

This position is supported by most UK industry bodies, including the International Regulatory Strategy Group and UK Finance.

There are a number of reasons why the EU has refused to countenance a deal that goes beyond the arrangements that are already in place for other non-EU countries. First, there is a general concern on the part of the EU27 that if the UK is seen to receive anything in the nature of a special deal then that risks diluting the very nature and rationale of EU membership. EU member states might question more closely the benefits of membership and third party countries with established but limited market access, such as the United States, might well ask why they cannot enjoy the same rights as the UK. Other reasons, more specific to the financial services sector, include the worry that a bilateral arrangement would have made it easier for UK operations to seek to insulate themselves from the EU in the event of another financial crisis, for example by channeling capital and liquidity back into London. It was also the case that there was little incentive for the EU27 to agree to a regime which would reduce the impetus for financial institutions to move parts of their operations out of London and into Frankfurt, Paris, Luxembourg, Dublin, and other competing financial centers.

**What would be the Benefits of Continued Cooperation—And for Whom?**

Different EU member states have articulated different views on the benefits of allowing the UK continued market access, and more generally on the topic of maintaining cooperation. Unsurprisingly, the UK's position is that access and cooperation should continue essentially unaffected by the UK's departure from the EU. The UK government argues that this would be for the benefit not only of the UK's financial services sector (being the UK's leading source of exports and a key revenue generator) but also benefit the sector and market participants throughout Europe, by helping ensure continuity and market stability.

There appears to be a divergence of opinion on this question as between different EU27 member states. Germany, for example, has highlighted the potential benefits of continued access and cooperation. Both the German financial regulator, BaFin, and the Bundesbank, have made it clear that they do not regard themselves as marketing agencies for Frankfurt. Together with certain other European regulatory authorities they have instead emphasized

their role as supervisory bodies with responsibility for highlighting the risks to market participants of being unprepared for the UK's departure from the EU.

By contrast, France has suggested that the financial sector will not find it difficult to adapt to a change in the existing arrangements, and appears to believe that reducing both the size of the London sector and its share of the EU marketplace, could in fact help the sector to develop in other European states.

## REGULATORY AND LEGAL IMPLICATIONS

### Cooperation between EU and UK Regulators

The regulatory authorities of the EU member states, the ECB and the European Securities and Markets Authority ("ESMA") are cooperating closely to ensure that there is a common understanding of the regulatory framework applicable for banks, financial services institutions and asset management companies intending to relocate parts of their business from the UK to continental Europe in the context of Brexit. Inter alia, the cooperation affects the regulatory outsourcing requirements under European financial supervisory law. Such outsourcing requirements can limit the possibility of supervised EU/EEA subsidiaries to obtain services from UK (group) companies to some extent. In particular, supervised EU/EEA subsidiaries must have sufficient on-site resources including parts of certain control functions to ensure a proper business organization. This is highly relevant, since large parts of the industry would like to keep as many resources as possible in the UK. The EU regulatory authorities aim to iron out potential differences regarding the interpretation of outsourcing requirements under European financial supervisory law in order to ensure a level playing field.

In March this year, the UK's Prudential Regulation Authority (the "PRA") published a policy statement regarding supervisory arrangements that will apply post-Brexit to EEA firms currently branching into the UK under passporting arrangements. Among other issues, the policy statement addressed how the PRA would assess equivalence. Essentially, the approach outlined by the PRA will be guided in each case by the nature of the firm's UK activities and its systemic importance to the UK economy.

The level of necessary cooperation between the PRA and EU regulators will depend in part on these matters, and mechanisms for cooperation may include memoranda of understanding, bilateral or supervisory college meetings, and the clear and prompt exchange of information. Mr. Dombret of the Bundesbank has indicated support for this approach, which he has described as "solution-orientated, pragmatic, yet stability-oriented."

**Regulatory Arbitrage Widely Excluded**

Regulatory arbitrage is the practice of circumventing unfavorable regulatory requirements or regimes by locating or structuring relevant entities, businesses or transactions in jurisdictions selected specifically for that purpose. European regulatory authorities cooperate to prevent regulatory arbitrage. There are also restrictions under national laws that ensure that certain regulatory requirements cannot be circumvented by choosing another location within the EU/EEA.

One regulatory requirement of particular relevance to firms that plan to relocate in the wake of Brexit is the limitation imposed on the outsourcing of front office activities to other group entities or branches. BaFin is of the view that the core of regulated services must be provided by the supervised EU/EEA entity itself, or its EU/EEA branch that is deemed authorized under the EU/EEA passport regime. The core of the regulated activities cannot be transferred to another group entity or a branch in a third country, since such a third country entity or branch would need a separate German license to be allowed to conduct regulated business in Germany (and such a license cannot be granted to an entity or branch that is located in a third country). Therefore, it is only possible to delegate preparatory or associated front office activities to a third country entity or branch in principle. For instance, in case of investment advice the direct advice to the client must be provided by the supervised EU/EEA entity or its EU/EEA branch that is authorized under the EU/EEA passport regime. A UK branch of the supervised EU/EEA entity can only be involved in the activities that are ancillary to the advice.

BaFin recently clarified that this applies not only for supervised entities that are located in Germany, but also for regulated entities in other EU/EEA member states. This means that even if another EU/EEA regulatory authority might permit a supervised entity located in the respective EU/EEA member state to outsource the core of a regulated service to a branch in the UK, this would not be binding on BaFin to the extent that the UK branch sought to provide services to German clients. In this scenario, the regulated services conducted by the UK branch would trigger a licensing requirement for the UK branch under German financial supervisory law. BaFin is also of the view that the EU/EEA passporting regime does not provide an exemption from the German licensing requirement in such cases.

**Additional Responsibilities and Powers to be Undertaken by the FCA and Bank of England**

The ESMA oversees individual EU regulators and is also the body which supervises trade repositories and credit rating agencies operating in the EU. It appears from the existing draft of the UK's EU Withdrawal Bill that the FCA

will assume these supervisory responsibilities after the UK leaves the EU. Separately, the Bank of England is likely to take on oversight of clearing houses and securities depositories.

**UK and German Data Protection Regimes Post-Brexit**

Post-Brexit, the UK will be a "third country" in terms of EU data protection laws in principle. Transferring personal data of customers or employees from the EU to a parent company or headquarters in the UK will therefore be subject to the same restrictions that apply to transferring data to other third countries in principle, which aim to ensure that personal information concerning European citizens enjoys the same level of protection abroad as it does within the EU. The UK Data Protection Act, which commenced on May 25, 2018, incorporates the EU General Data Protection Regulation into national law. As long as the UK adheres to this framework, after Brexit it ought to be recognized by the EU Commission as a country that ensures an adequate level of data protection. This would make businesses in the UK eligible to receive personal data from the EU under the same conditions as apply to data transfers within the EU. However, if the UK legislature decides to drop EU data protection legislation (or the UK regulator fails to enforce these laws in line with EU Court of Justice precedent) it is unlikely that the UK would continue to qualify as having an adequate data protection regime for the purpose of allowing receipt of personal data from the EU. In that case, UK banks would have to apply "appropriate safeguards" for personal data in order to be able to continue transferring data between the EEA and UK. This could be accomplished, for instance, by entering into intra-group data protection agreements based on standard contractual clauses which are published by the EU Commission.

**Planned Relaxation of German Employment Laws to Benefit the Banking Sector**

Similar to the situation in France, German employment laws have for a long time been regarded as more protective of employees than those in most other EU member states. The new German government has however announced plans to amend German employment laws to attract banks and financial services institutions from the UK in the context of Brexit. Under these plans, it will in the future be much easier to terminate the employment of more highly-paid staff and executives who qualify as "risk takers," meaning those who occupy certain senior positions or who might otherwise expose their institution to material risk because of their role in the business. Under the new legislation, banks and financial services institutions will be able to apply for a court ruling allowing for the payment of compensation to "risk takers" in exchange for the termination of their employment.

## THE CHANGING MARKETPLACE

### Regulation of FinTech—Will London or Frankfurt Lead?

Some commentators predict that the UK's departure from the EU, and the associated changes to the regulatory landscape, will provide opportunities for the UK, Germany, and possibly other EU member states to seek a greater regulatory influence and importance in certain areas. One such area is FinTech.

The Bank of England has said that it is time to regulate cryptocurrencies and is seeking to take the lead in developing an appropriate framework for that purpose. Separately, the Chancellor of the English High Court, Sir Geoffrey Vos, noted in a speech earlier this year that Berlin, Paris, and London are competing for prominence as the European FinTech hub. The Chancellor went on to suggest that the UK's departure from the EU would provide an opportunity for English law to be established as the global standard for FinTech.

Brexit could indeed represent an opportunity for the UK to reform its existing FinTech regulatory regime, which is currently and necessarily allied to continental Europe. Exemptions from, or amendments to, the existing EU requirements might result in a significantly changed—and possibly improved—environment for FinTech business operating in the UK. That said, existing EU rules would of course continue to apply to UK FinTech businesses seeking to operate or offer services in the EU post-Brexit.

As regards the legal framework for the FinTech industry under European law, there is currently an intense debate within the EU legislature regarding potential reform and development of relevant law and regulation. Therefore, specific rules and guidelines for FinTech businesses operating within the EU are to be expected.

### Frankfurt as a Hub for Banks and Competition with Other Locations

Frankfurt is traditionally the hub for banks and financial services companies in continental Europe. For this reason, it is in many cases the most attractive location for banks and financial services companies that intend to relocate parts of their business to continental Europe. However, there is also competition with other locations, in particular with respect to fund managers, payment services providers, rating agencies and insurance companies which can be expected to consider Dublin, Luxembourg, Munich, Paris, and others as potential alternative locations. In order to avoid any kind of regulatory arbitrage, ESMA recently published an official opinion on Brexit according to which UK companies intending to relocate to continental Europe must be able to demonstrate objective reasons that were decisive for their choice of location.

Such objective reasons can concern, inter alia, the existing financial marketplace, existing and targeted clients, and the infrastructure available at the location.

## CONCLUSION: WHAT DOES BREXIT MEAN FOR FINANCIAL SERVICES?

The British Prime Minister, Theresa May, famously once said "Brexit means Brexit." The meaning of Brexit has not become a great deal clearer since that statement was made, because the consequences of Brexit for the financial services industry in Europe largely depends on the result of the ongoing and uncertain political negotiations.

Since there is not yet a final agreement, European regulatory authorities have been forced to emphasize, in unusually stark terms, that the financial industry must expect that UK entities will no longer have access to continental European markets as from March 29, 2019. Accordingly, market participants have been instructed to apply for all necessary regulatory authorizations in an EU/EEA member state as soon as possible, to ensure that requisite licenses are in place prior to Brexit. This approach should allow the continuation of normal business activities in continental Europe irrespective of the outcome of the political process. Banks and other institutions must remember that their choice of location must be based on reasons that can be justified from a regulating standpoint and, therefore, entities intending to relocate parts of their business to continental Europe must assess carefully any possible moves into new locations.

Beyond these protective considerations, it is difficult to provide much more in the way of general guidance at this stage. What is clear, however, is that a commercial and constructive dialogue between regulators, central banks and firms will offer the best hope of an outcome which is beneficial for the sector as a whole throughout Europe. The EU may be losing a member state, but never has there been a greater need for collaboration and cooperation towards a common objective.