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Y2K or Reverse Big Bang?

How Likely is a Brexit-Related Exodus of Financial Services Firms and Regulated Real Estate Businesses from London

As the Millennium approached, concerns about computer systems malfunctions, and the possible impact of what became known as Y2K, grew to the point that nearly all large organisations had Y2K task forces and contingency plans. The history is well known. 1 January 2000 came and went, and the Y2K fears failed to materialise.

The spectre of a possible exodus of London-based financial services firms and other regulated entities in the aftermath of the United Kingdom's Brexit referendum has received much coverage. In the face of uncertainty as to the timing (in all likelihood two years away at least) and terms of a UK exit from the European Union, many of these firms are understandably accelerating their own contingency planning in anticipation of a potential loss of "passporting" rights—the now well-documented rights of an entity authorised in one EU member state to provide regulated services either on a cross-border basis or through locally established branches in every other member state of the EU without needing to be separately authorised outside of the home member state.

The prospect of financial services firms relocating significant parts of their businesses to other cities in Europe has wide-ranging implications, from the effect on potentially thousands of employees and their families to the potential value of City of London real estate.

In this *Commentary*, we explore whether the loss of passporting rights would, in terms of regulatory and operational significance, be equivalent to the City of London's "Big Bang" of the 1980s, or would it be more a Y2K whimper.

The Current Framework and Best- and Worst-Case Scenarios

London dominates the EU's capital markets and is overwhelmingly the largest market for authorised financial services and regulated real estate businesses in the EU. Many authorised firms operating cross border from the UK to the EU currently do so on the basis of an EU "passport" under EU financial services-related directives.

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In the short term, and until Brexit is implemented, the current EU framework on financial services regulation will continue to apply. Accordingly, there is no immediate reason to assume that London will cease to be the European hub for financial services businesses. However, the uncertainty around the UK's future relationship with the EU causes concern. The best-case scenario is that the UK retains access to the EU Single Market (through admission to the EEA or otherwise). If that happens, it would very much be business as usual for authorised firms that operate from the UK. Not many commentators are predicting this form of soft landing, and certainly many businesses are planning for the scenario where the UK becomes a so-called "third country" (i.e. non-EU country) for the purposes of EU financial services regulation. It is this scenario that we explore in more detail below.

Central to the analysis below is the concept of "equivalence". Under the relevant EU directives (notably AIFMD and MiFID II—discussed in further detail below) non-EU businesses may have access to institutional clients in the EU, via a "third-country passport". This is available if the non-EU country's regulatory regime is regarded as *equivalent*.

We consider it to be highly likely that the European Commission would determine the UK's regulatory regime to be equivalent to EU standards, and therefore access to institutional investors would remain possible. This is because at the point of exit, the UK's financial services legislative framework would reflect, and in many cases be derived from, EU law. It would therefore be difficult for the European Commission to determine that the UK was not an equivalent jurisdiction.

Non-EU Entities with a UK Presence

Understandably, given London's dominant position, much of the current focus has been on how significant the fallout will be for non-UK entities with a UK presence if the UK exits the EU without access to the EU Single Market. This depends on whether such non-EU entities operate in the UK either as subsidiaries or branches and whether their businesses require access to institutional or retail clients.

Branches v Subsidiaries; Institutional v Retail Clients. Those non-EU companies currently operating in the UK through branches will not be affected by Brexit for regulatory reasons, as they do not currently enjoy passport rights under the Single Market directives anyway. These businesses tend to establish in the UK to serve the domestic market and/or to access the UK market infrastructure—i.e. LSE, LIFFE, Lloyds market, LME etc.—rather than to benefit from the EU passporting rights under the Single Market. There is therefore no regulatory reason for such banks and financial institutions to leave the UK as a result of Brexit. Of course, as third-country firms, they could still enjoy access to the institutional market, assuming the EU regards the relevant home country regulatory regime as equivalent.

For those authorised firms that operate in the UK through subsidiaries, which are licensed or regulated in the UK, the consequences of a UK exit are potentially more significant.

If the UK exit involves it becoming a third country, those subsidiaries would not be able to rely on EU passports (as the relevant directives would fall away). Whether this affects the ability of a financial services business to carry out its business will depend on the nature of its clients. If a business needs access to institutional clients (i.e. professional clients, such as pension funds, government development funds and significant corporates), such access may not be affected by Brexit. This is because of the principle of equivalence described above.

If a business operating from a third country needs access to retail clients (i.e. individuals, small companies and other clients which do not fit the institutional mould), then it can only do so on a reverse solicitation basis (i.e. the client would need to engage with the business on its own initiative and not have been solicited by the business). If the UK becomes a third country, then this limitation will present significant challenges to private wealth firms and similar businesses engaging with EU retails clients. However, the position as regards retail clients may be softened depending on the negotiations between the UK and the EU in relation to Brexit. We will therefore monitor these negotiations once they commence.

EU27 Entities with a UK Presence

If the UK becomes a third country, it is unlikely that branches of EU firms located in the remaining EU member states (the EU27) will have to close or convert to UK authorised subsidiaries. The more likely scenario is that they will be "grandfathered" by the UK regulators as directly authorised UK

branches of the EU firms. Those entities currently operate in the UK under an EU directive passport. Accordingly, they do not need to be authorised by the UK regulators. However, we need to wait for the unfolding of the post-Brexit model before we can be sure what will happen.

In the medium term, whether a business needs to consider relocating any of its operations will depend on the types of clients it wishes to access in the EU and the manner in which its business is currently structured. As demonstrated above, if such businesses have institutional clients, the landscape may not fundamentally change. Similarly, those non-EU entities which use branches to operate in the UK will be unaffected by Brexit. On the basis of the foregoing, we take the view that most businesses will continue to enjoy access to their EU client base, even if there is a complete “divorce” from Europe.

The Impact on Regulated Real Estate Businesses

There are a number of real estate sector businesses that are themselves regulated. Typically, they are regulated for insurance mediation services, investment advice or alternative fund management activities. To the extent that they engage with EU clients, the points above apply, and the real estate businesses’ approach will depend on whether they market to institutional or retail clients.

Third-Country Passporting—MiFID II. As real estate firms tend to engage with institutional clients, their access to the Single Market from the UK should not be materially affected. This is because the Markets in Financial Instruments Directive, known as MiFID II, comes into effect in January 2018 and introduces a passporting mechanism to third-country investment firms, allowing them access to institutional investors. It is therefore likely that a UK-authorised real estate firm providing advisory/arrangement services for these types of clients would be able to do so via the MiFID II third-country passport, even after Brexit.

Third-Country Passporting—AIFMD. Perhaps of more interest to the larger real estate firms, will be their ability to market real estate funds in Europe. Although the Alternative Investment Fund Managers Directive, or AIFMD, envisaged the extension of the EU passporting regime to include all full-scope managers (“AIFMs”) of alternative investment funds (“AIFs”), passporting is not yet available to non-EU firms because it has not yet been decided whether they are equivalent.

In its advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs published on 19 July 2016, the European Securities and Markets Authority (“ESMA”) concluded that there were no significant obstacles impeding the extension of the AIFMD passport to managers in Canada, Guernsey, Japan, Jersey and Switzerland. ESMA was more equivocal about the extension of the passport to managers in other jurisdictions, including the United States. The Parliament, the Council and the Commission are now considering ESMA’s advice.

Should the UK become a third country, as noted above, we consider it is likely that ESMA would conclude that it is an equivalent jurisdiction for the purposes of the AIFMD, and therefore UK-authorised AIFMs, like those in the Channel Islands for example, would be able to access institutional investors in the EU via a third-country passport.

Conclusion

Ultimately, this is not a Y2K situation, and it is appropriate that authorised firms give significant consideration to their contingency planning. But neither is it a reverse “Big Bang”. While it is undeniable that authorised businesses, and therefore real estate businesses which rely on such businesses as tenants, face a period of uncertainty, it is very likely that access to institutional clients in the EU will continue post-exit and regardless of the terms of that exit.

The UK will either maintain Single Market access and continue with business as usual, or it will be in a strong position to obtain the equivalence decisions required to allow its authorised firms access to EU institutional investors. As such, from a regulatory perspective, it is hard to see a compelling argument for an exodus.

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