CLIFFORD CHANCE

MARKET ACCESS AND THE BREXIT LEGACY

– THOUGHT LEADERSHIP

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Financial institutions are focusing on market access in preparation for Brexit, but with the rise of deglobalisation, there is also a broader global trend towards limiting cross-border market access and tightening barriers. Our experts take a look at the issues around navigating market access, the impact of Brexit and the challenges ahead.

Current trends

Regulating market access is a way in which national policy makers and regulators seek to maintain oversight of, and manage risks associated with, the financial activity taking place in their jurisdiction. However, restrictive market access rules can have adverse consequences, such as reduced efficiency of cross-border investment, risk management and resource allocation.

Policy makers and regulators generally seek to balance an appropriate level of oversight of what is taking place in their markets against the risk of unduly restricting access to global financial markets. Although there are concerns at an international level around the adverse consequences of market fragmentation, there is currently a trend a towards tightening up existing frameworks and mechanisms for allowing cross-border market access. In the EU, this trend may be attributed, at least in part, to Brexit, as the EU assesses the impact of the UK leaving the single market, whilst the size of UK financial markets means that they are likely to remain of systemic importance to the EU.

Licensing requirements

Licensing requirements are the main legal tools that jurisdictions use to regulate market access, although they are by no means the only legal tools that can restrict or limit cross-border market access in practice.

Licensing requirements restrict market entry for firms providing banking and investment services, ensuring that, at the national level, only firms which satisfy certain minimum conditions and comply with ongoing requirements are able to operate in the jurisdiction concerned. Approval conditions could include local presence, capital requirements, organisational requirements (including fitness of management, systems and controls) and the capability of being supervised.

Firms need to consider differing tests that trigger licensing requirements in different jurisdictions and for different activities and services. In some jurisdictions, there is a strong territorial-scope analysis and "characteristic performance" test such that, if the economic activity of the relevant service is actually performed outside of the jurisdiction then no licensing requirement is triggered (even if the services are being provided to persons located in the jurisdiction).

In other jurisdictions, any nexus to the jurisdiction, including the location of the recipient of the service, would bring the provision of the service into scope. In still other cases, the trigger for licensing is the targeted marketing or solicitation of local service recipients, so no licence may be required if it is possible to evidence client-initiated requests (reverse solicitation).

Even if a firm falls with the jurisdictional scope of a particular regime, there may be exemptions to licensing requirements, such as for cross-border activities with institutional counterparties. This country-by-country analysis can be complicated and impacts the viability of cross-border operating models, often pushing firms to establish a locally licensed presence.

National approaches to market access are the norm in Asia, Africa and North America. The one regional exception is the European Union where firms established and licensed in one Member State may exercise "passporting" rights to provide cross-border services or establish a branch in another Member State without obtaining a local licence. However, even in the European Union, market access for non-EU firms is determined at the Member State (national) level – with certain exceptions, for example where there is an equivalence or recognition mechanism for the EU to determine that the rules of the relevant third country are equivalent.

Other limitations on market access

Product regulation acts as a significant limit on market access. This includes marketing restrictions such as national prospectus requirements for public offerings and cross-border marketing of investment funds.

Eligibility requirements can also act as limitations to market access. These include requirements for locally licensed entities to take on specific roles such as depositaries of alternative investment funds or local registrations for money market funds or benchmarks.

Mandatory requirements for locally authorised firms to trade certain shares on locally authorised trading venues restrict firms from trading dual-listed shares outside of their jurisdiction.

Existing free trade agreements (FTAs) do not address these barriers to market access for financial services. For example, even the Comprehensive Economic and Trade Agreement (CETA) between the EU and Canada includes only limited provisions on financial services and crucially does not address local licensing requirements.

Navigating market access in Asia

Hong Kong

While Hong Kong adopts an open capital market approach, the local banking and securities regulatory regimes apply to various regulated activities and restrict market access on a cross-border basis from outside Hong Kong. For example, under the Securities and Futures Ordinance, an overseas person cannot actively market services to the Hong Kong public if such services would be regarded as a regulated activity. The Banking Ordinance also regulates deposit advertisement and money broker operations with extra-territorial restriction. Additionally, the concept of "carrying on business" in Hong Kong is likely to be interpreted widely, and very little activity is required to be undertaken in Hong Kong before a company could be treated as "carrying on business" in Hong Kong.

Offering of financial products to persons located in Hong Kong could also trigger regulatory licensing and product authorisation regimes unless an exemption or private placement safe-harbour applies.

Singapore

Market access requirements depend on the relevant activity being carried on as certain financial regulatory regimes apply to activity carried out on a cross-border basis from outside Singapore, but with Singapore persons. For example, Singapore's Securities and Futures Act, which regulates financial services relating to capital markets products including securities, exchange traded and OTC derivatives contracts, funds and foreign exchange trading has express extra-territorial application and applies to activity carried out on a cross-border basis. Caution should be taken even in cases where the regulatory regime applies only to activity carried on within the jurisdiction, as prohibitions against solicitation can nevertheless apply, for example under the Payment Services Act which is expected to come into force at the end of 2019 or the start of 2020.

Offering of products to persons in Singapore would typically trigger licensing and prospectus requirements unless exemptions or safe-harbours apply; capital markets product issuers (including those outside Singapore) are required to carry out classification of products and to notify relevant distributors unless restricted to certain offerees only.

Japan

Japan has similar licensing restrictions on market access. Activities including deposit-taking, lending, securities-dealing, derivatives, asset/fund management and insurance fall within the scope of Japanese financial services regulation. Entities conducting such activities in Japan or from outside Japan towards Japan residents are generally subject to the Japanese licensing requirements (and disclosure requirements in case of a securities offering). Certain exemptions may be available, such as for "cross-border activities with institutional counterparties," subject to case-by-case analysis.

Following the Japanese government's recent focus on opening the Japanese market to foreign institutions, the Japanese Financial Services Agency (FSA) has established a Financial Market Entry Consultation Desk, which welcomes inquiries from foreign institutions regarding registration procedures and provides a fast-entry route to doing business in the Japanese market.

The view from Europe – the European Commission's approach to equivalence

In the EU, equivalence mechanisms are used to reduce overlaps in regulatory and supervisory compliance and, in some cases, to facilitate market access. For example, equivalence is a prerequisite for recognition of non-EU central counterparties (CCPs) for the derivatives trading obligation and regulatory capital purposes; and the Markets in Financial Instruments Regulation (MiFIR) introduced an equivalence regime for cross-border provision of investment services to professional clients and eligible counterparties.

Nevertheless, the level of third country market access made possible via equivalence is relatively limited. It is no substitute for passporting rights enjoyed by EEA firms. For example, there is no equivalence mechanism in EU legislation allowing market access in respect of core banking services such as deposit taking and lending. In addition, the EU has recently agreed changes to the recognition regime for third country CCPs and the equivalence regime under MiFIR, which will grant EU supervisors greater powers to supervise or impose requirements on these non-EU CCPs and investment firms, even where the third country regime is deemed equivalent.

The European Commission's recent communication on its equivalence policy also indicates a tightening approach to equivalence and third country market access. For example, the Commission highlights that equivalence assessments involve a risk-management exercise and that it "*will expect stronger safeguards against risks when that third country's impact on the EU markets is high.*" The Commission also notes that equivalence empowerments in EU legislation are unilateral and discretionary, meaning that third countries do not have a right for their framework to be assessed or to receive a positive equivalence determination, even if the framework does, in fact, fulfil relevant criteria.

Finally, the Commission makes clear that it has the discretion to adopt, suspend or withdraw equivalence decisions as necessary, and the flexibility to grant time-limited or partial equivalence decisions. Alongside the communication, the Commission announced the withdrawal of some existing equivalence decisions under the Credit Ratings Agencies Regulation, where the local frameworks have not kept up with subsequent changes to the EU regime.

This policy may, therefore, give the Commission leeway to use the equivalence process as leverage to achieve unrelated political goals, such as in the case of the recognition of Swiss exchanges in the context of the negotiations with Switzerland on a new framework agreement for EU-Swiss trade. The Commission does not mention, in its communication, the GATS constraints on derogations from most-favoured nation treatment but these are, in any event, relatively weak.

The impact of Brexit

While the final outcome (even at this late stage) remains far from certain, at the time of writing, the policy of the UK Government is to leave the European Union and the single market on 31 October 2019. By withdrawing from the EU single market (leaving aside the possibility of some sort of future and/or transitional arrangement between the UK and the EU on market access), UK-based financial firms will lose the benefit of passporting rights to access EU markets and investors.

EEA firms will also be restricted in their access to UK financial markets, although the UK Government has introduced various temporary permissions and recognition regimes which seek to mitigate cliff-edge impacts of a no-deal Brexit and allow EEA firms to continue their current UK activities for up to three years after exit day. The loss of passporting rights will impact the provision of banking, broker/dealer and asset management services from the UK into the EU (and from the EU into the UK) as well as cross-border capital raisings and marketing by issuers and fund vehicles and trading on UK/EU trading venues.

The European Commission has made time-limited equivalence decisions in respect of central counterparties (CCPs) and central securities depositories (CSDs) to address contract continuity and financial stability risks in a no-deal Brexit scenario. However, the Commission has so far declined to make an equivalence decision in relation to UK trading venues, and the UK is similarly delaying a decision on equivalence of EU trading venues until there is reciprocity – despite calls from the financial services industry for these decisions to be made in time for Brexit. There is a risk that, if relations were to continue on an acrimonious path following a no-deal Brexit, both sides may be tempted to use unilateral measures such as withholding of equivalence as leverage for post-Brexit negotiations. As highlighted above, the Commission's policy on equivalence indicates that it may also require a more stringent assessment of UK regimes before granting equivalence, in light of the high impact on EU markets.

Structural solutions

In order to continue providing the range of services to their EEA client base (without looking at country-by-country or product-by-product solutions), UK-based firms will need structural solutions, such as establishing or expanding an EEA presence in order to access EEA clients. Likewise, EEA-based firms would likely need to establish or expand UK-based operations to continue to provide services to their UK clients. As a result, firms are moving businesses and people from the UK to locally licensed entities which can benefit from a single passport, creating new infrastructure and operations and splitting liquidity. As firms have different location choices, no single EEA jurisdiction has benefited at the UK's expense.

Maintaining legacy books

In certain limited circumstances, firms may be comfortable with retaining existing business on UK based entities, but activities in relation to maintaining the legacy book will be significantly impacted in order to ensure that what was being done does not trigger licensing requirements in EEA countries. For example, in general terms, performance of obligations under a derivative contract should not trigger national licensing requirements in the EEA countries if the single passport is lost, but material amendments to the contract terms and certain lifecycle events might do so. Provision of ongoing services, such as a bank account, may also require an ongoing licence if the account holder is in a particular EEA country. Accordingly, such business may need to be transferred to a locally licensed entity.

New business outside territorial scope

Some firms may wish to apply country-by-country or product-by-product solutions to continue using a UK based entity when facing EEA clients in certain circumstances. However, navigating national market access rules will result in patchwork, highly bespoke solutions which will limit marketing and service provision and, therefore, any UK platform seeking to grow EEA business. Some EEA jurisdictions have introduced new laws or regulations to mitigate cliff-edge impacts of a no-deal Brexit, such as rules allowing for contract continuity, transitional exemptions or licensing regimes. In other cases, firms will need to argue that their activities do not trigger local licensing requirements, or that an existing exemption is available on a country-by-country or product-by-product basis.

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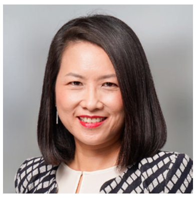

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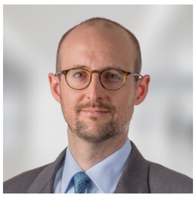

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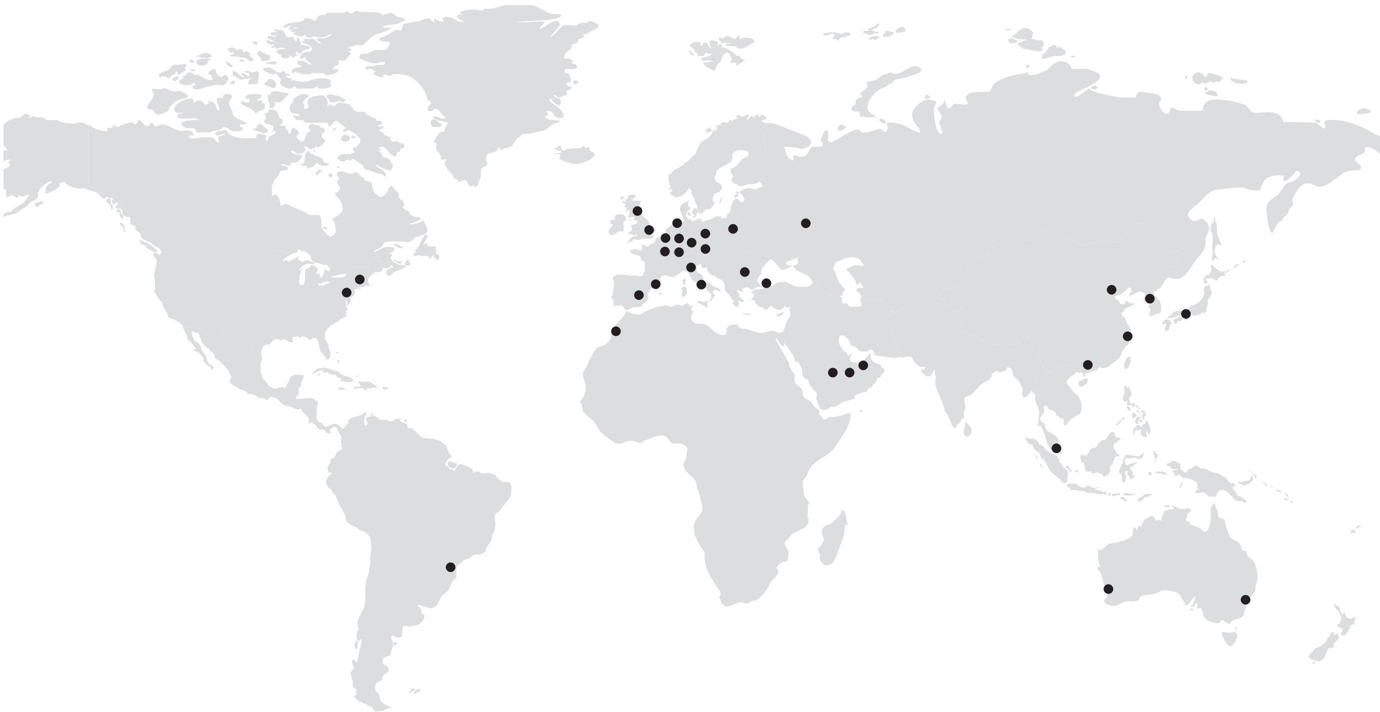

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