ONSHORING EU FINANCIAL SERVICES LEGISLATION UNDER THE EUROPEAN UNION (WITHDRAWAL) ACT 2018

The European Union (Withdrawal) Act 2018 provides for domestication of EU legislation and grants powers to the Government to correct deficiencies arising from Brexit. HM Treasury and the UK financial services regulators have announced how they intend to use these powers. The announcements also discuss the UK’s approach to implementing a temporary permissions and recognition regime to cover the UK leaving the EU without a deal.

ONSHORING EU LEGISLATION

The European Union (Withdrawal) Act 2018 passed into UK law on 26 June 2018. It provides for the domestication of the huge volume of EU law that currently applies in the UK to ensure legal continuity at the point of the UK’s exit from the EU. The Act does this by:

• repealing the European Communities Act 1972;
• "onshoring" and preserving most EU and EU-derived law as it stands immediately before the UK’s departure; and
• giving the Government wide powers, exercisable for up to two years from exit day, to amend this retained EU law to correct deficiencies in retained EU law arising from the UK’s withdrawal from the EU.

Addressing these deficiencies will inevitably involve policy choices and will have technical and practical implications for financial services firms. It will be important for firms to monitor how the Government uses these powers over the coming weeks and months and to assess their impact on firms’ existing businesses, including their Brexit contingency plans.

On 27 June, HM Treasury published a document setting out its approach to exercising its powers under the Act. This will involve the Treasury laying before Parliament statutory instruments to correct deficiencies in retained EU law relating to financial services. The scale of this task should not be underestimated. Overall, we understand that the Government expects to publish around 800 statutory instruments (although not all of these will relate to financial services). As discussed below, the UK financial regulators will also be making extensive changes to EU technical standards and their own rulebooks.
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For further commentary on the Act, see our briefing "The European Union (Withdrawal) Act 2018: what it does, why and how".

DELEGATION OF POWERS TO REGULATORS

In its approach document, the Treasury indicated that one of its first steps will be to delegate powers to the UK financial services regulators in a way that is consistent with the responsibilities already conferred on them by Parliament. The regulators have also issued announcements setting out how they intend to use these delegated powers.

The Treasury published in April 2018 a draft version of the statutory instrument under which these powers will be delegated (the Financial Regulators’ Powers (Technical Standards) (Amendments etc) (EU Exit) Regulations 2018). It intends to lay the final statutory instrument before Parliament shortly.

Scope of delegated powers

The Treasury proposes to delegate powers to the regulators to issue 'EU exit instruments' to remedy deficiencies arising from Brexit in binding technical standards and in the EU-derived provisions of their own rules.

When exercising these powers, the regulators will not be obliged to comply with the requirements to consult and prepare cost benefit analyses that normally apply to rule changes. The regulators have, however, indicated that they intend to consult on proposed amendments to rulebooks and binding technical standards during autumn 2018.

The Treasury proposes that the UK regulators will also have ongoing powers to make binding technical standards via 'standards instruments'. The regulators would need to follow the usual consultation and other requirements for rule changes in respect of these ongoing powers.

In addition, the Treasury intends to transfer supervisory powers currently exercised at EU level to the Financial Conduct Authority in relation to credit ratings agencies and trade repositories and to the Bank of England in relation to non-UK CCPs and non-UK central securities depositories.

Treasury and Parliament oversight of delegated powers

Unlike under the normal rule-making process, the regulators will not be able to make EU exit instruments or standards instruments without the approval of the Treasury. The Treasury will be able to veto EU exit instruments if they don't comply with the requirements of the Act or with the changes that Parliament has approved in onshored legislation. It will be able to veto standards instruments if it considers that they have implications for public funds or would prejudice negotiations for an international agreement.

The regulators will also need to make an annual report to Parliament setting out how they have exercised the powers delegated to them under the Act.

Regulators’ approach to Level 3 materials

There is an outstanding question as to how the UK financial services regulators will approach existing EU Level 3 Q&A, guidelines, recommendations and other non-binding ‘soft law’. These Level 3 pronouncements do not form part of retained EU law and so they will not be onshored under the Act. Nevertheless, although not binding, they often provide valuable guidance and assistance to firms in understanding how to interpret relevant requirements.
The UK regulators take varied approaches to Level 3 materials. In some cases, the regulators have expressly confirmed their supervisory expectation that firms should follow relevant guidance. However, in other cases, they are silent or have even confirmed that they do not expect firms to follow relevant guidance. Therefore, it would be difficult to adopt a "one size fits all" approach to these Level 3 materials.

However, the volume of Level 3 materials means that it is likely to be impractical for the regulators to identify individually those guidelines, Q&A and other pronouncements that they will continue to apply after the UK leaves the EU. However, it may be sufficient for the regulators to confirm publicly that they will continue to give as much weight to EU Level 3 materials after the UK leaves the EU as they do today.

Implications for legislative 'sclerosis' risk

This delegation of powers to the regulators, including ongoing maintenance of rulebooks, may go some way to address the risk of 'UK legislative sclerosis' i.e. the risk that after Brexit it would not be possible to update large parts of retained EU law, no matter how technical, without new primary legislation. The Treasury may be able to deal with the Commission's other 'Level 2' powers in a similar way, by transferring to ministers the powers to make or amend other delegated or implementing acts under EU legislation.

However, it will not be so easy to update 'Level 1' regulations such as CRR, EMIR and SFTR. For most purposes, the Act treats these regulations, however technical, as if they were primary legislation. It also treats statutory instruments adopted under the European Communities Act 1972 that implement Level 1 directives (such as the statutory instruments implementing the payment services or financial collateral directives) in a similar way. The hope must be that Parliament will find time after Brexit to create a more appropriate framework for financial services legislation which gives appropriate powers to regulators to deal with all the technical aspects of retained EU law.

CONTINGENCY PLANNING FOR A NO DEAL BREXIT

In its approach document, the Treasury says that the Government is confident that the transition (or implementation) period agreed in principle between the UK and EU earlier this year will be in place until 31 December 2020. During the transition period, the UK would retain access to the EU single market on its current terms. UK firms would also need to comply with any new EU legislation that becomes applicable during this period.

However, as both the UK and EU have indicated on several occasions, "nothing is agreed until everything is agreed". Any transition period will be part of the wider withdrawal agreement and will not therefore come into effect unless the withdrawal agreement is agreed and ratified before exit day. Although the Treasury and regulators do not expressly say so, it seems that the statutory instruments and the EU exit instruments to be published over the coming weeks and months will be drafted on the basis of a no deal scenario. This is to ensure that the UK will have a functioning legislative and regulatory framework in all scenarios.

Effect of a transition period

If a withdrawal agreement is agreed and the transition period comes into effect, EU law would not need to be onshored until the end of the transition period. In this case, most of the statutory instruments made under the Act will
likely not come into effect on 29 March 2019. Instead, many of them may only come into effect from the end of the transition period. The Government and regulators may also need to adjust these instruments to reflect any trade deal or other longer term agreement reached between the UK and EU during the transition period in respect of financial services.

‘Third country’ treatment in a no deal scenario

The European Commission has stated on several occasions that in a no deal scenario, the UK would be treated as a third country for the purposes of the EU financial services framework. The Treasury states that the UK will take the same approach and will generally treat EU Member States in the same way as other third countries, subject to providing for a smooth transition.

This has implications for the way in which the Treasury will seek to address deficiencies in retained EU law, particularly those relating to market access or recognition. Where there are existing regimes for third country firms under the UK financial services framework, it seems that these regimes will also apply to EU27 firms in a no deal scenario. However, where there is no third country regime and EU firms currently receive more favourable treatment than other third country, special provision may be made to smooth the transition.

Temporary permissions and recognition regimes

In December 2017, the Government committed to legislate, if necessary, to put in place temporary permissions and recognition regimes. These regimes would allow EU27 financial services firms and non-UK financial market infrastructures, such as central counterparties, to continue their activities in the UK for a time-limited period after the UK has left the EU, even if there is no transition period. This forms a key aspect of the Government’s contingency planning to provide for a smooth transition in a no deal Brexit.

The Treasury has confirmed that it intends to lay statutory instruments before Parliament relating to the temporary permissions and recognition regimes "soon". The Treasury also intends to introduce further specific transitional regimes for entities operating on a cross-border basis and outside of the passporting framework.

The Prudential Regulation Authority has already issued guidance on its approach to the authorisation and supervision of UK branches of EEA banks and insurers in the context of Brexit, as set out in supervisory statements published in March 2018. The FCA has also indicated that it intends to consult shortly on rules that would apply to firms under the temporary permissions regime.

The Treasury has stated that for firms wishing to maintain their UK business on a permanent basis, the temporary permission regime would provide sufficient time to apply for full authorisation from UK regulators.

The FCA has reiterated this and has asked FCA-only regulated firms to notify the FCA of their intention to rely on the temporary permissions regime by 29 March 2019. Conversely, the PRA previously indicated that EEA banks with UK branches should apply for authorisation by 30 March 2018.
Timing and key milestones

**13 July 2017**
- EU (Withdrawal) Bill introduced into House of Commons

**26 June 2018**
- EU (Withdrawal) Act 2018 received Royal Assent and became law

**Summer 2018**
- Treasury expected to publish first statutory instruments covering:
  - sub-delegation of powers to financial services regulators to fix deficiencies in binding technical standards and rulebooks
  - temporary permissions and recognition regimes (as a backstop in case of no transitional period)
- Treasury expected to publish draft statutory instruments on significant files relating to prudential regulation and capital markets to allow for stakeholder engagement

**Autumn 2018**
- Treasury expected to publish statutory instruments on significant files relating to prudential regulation and capital markets
- Regulators expected to consult on proposed rule changes and changes to binding technical standards

**Late 2018 – early 2019**
- Treasury expected to publish in groups remaining statutory instruments into early 2019

**29 March 2019 (exit day)**
- UK ceases to be an EU member state at 11pm UK time (unless otherwise agreed between the UK and EU)

**IMPLICATIONS FOR FIRMS' BREXIT PLANNING**

In its recent announcement, the Treasury indicated that firms should continue to plan on the assumption that a transition period will be in place until the end of 2020. This is consistent with the message from the financial services regulators. For example, the PRA stated in its March 2018 Dear CEO Letter that that ";...firms may plan on the assumption that PRA authorisation will only be needed by the end of the implementation period". It explained that this was on the basis of the political agreement reached on a transition period as well as the back-stop provided by the temporary permissions and recognition regimes.

The Treasury goes further and states that its proposed transitional measures mean that "firms do not need to prepare now to implement onshoring changes in the event no deal is reached with the EU" and that financial market infrastructures with existing EU authorisation or recognition will continue to be able to provide services to the UK, enabling access to financial market infrastructures "without disruption".

However, transitional provisions may not resolve every practical issue. Firms will need to scrutinise the changes being made as part of the onshoring process to see whether they need to give regulators notice of their intention to take advantage of transitional regimes, to make changes to internal systems...
and controls or to change client documentation to reflect the new status of the UK outside the EU and the changed framework of rules. In particular, in some cases, client or other documentation may need updating to refer to onshored rules in their new form or to make clear that references to EU legislation are references to the law applying in the EU itself. The provisions of the Act dealing with the interpretation of legislation and other 'documents' does not appear to provide a helpful solution to the question of how to read contractual cross-references to legislation after Brexit.

In addition, actions by the UK authorities cannot unilaterally resolve the issues that UK-based businesses face in relation to their 'outbound' business into other member states or the issues that EU-based business may face under EU rules when dealing with the UK. In contrast to the UK's approach, the EU authorities have not publicly committed to any plans to address market access, contract continuity or other cliff-edge risks arising from a no deal scenario (although there have been indications that such plans may be being considered privately). The EU authorities have consistently indicated that the effect of Brexit is that the UK will become a third country for EU purposes and that it is incumbent on the private sector to prepare for the consequences, taking account of every eventuality, including a no deal Brexit with no transition, without relying on public sector solutions.

For example, the European Insurance and Occupational Pensions Authority Opinion published in May called upon national supervisory authorities to ensure that the risks for the solvency position of insurers arising from the UK becoming a third country are properly "identified, measured, monitored, managed and reported" but without explicitly addressing how EU-based insurers should address the potential impact of changes to the treatment of exposures in the UK under Solvency II when the UK becomes a third country. EU-based firms will need to address these kinds of issues with their EU regulators.

As European Banking Authority Chair Andrea Enria stated last month "firms cannot take for granted that they continue to operate as at present nor can they rely on as yet unrealised political agreements or public policy interventions".

To conclude, in the next coming months, the financial services industry will need to monitor how the Government is proposing to retain EU law through the publication of the statutory instruments, both to understand what the instruments will do and to ensure that the law will work after exit day.
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