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Client Alert
News Flash

Latham & Watkins Financial Regulatory Practice

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Brexit and Financial Services —Temporary Permissions

The UK's temporary permissions regime appears to be a helpful concession for inbound firms, but there are some hidden challenges.

Key Points:

- The UK regulators have set out further details of the rules they propose that inbound EEA firms will need to comply with when using the temporary permissions regime.
- In some instances the regulators intend to extend UK requirements to firms without a UK presence.
- This extension could raise practical difficulties both in terms of firms' ability to comply with, and the regulators' ability to supervise, these requirements.

Although the key details of the temporary permissions regime (TPR) were published in the summer (outlined in Latham's related *Client Alert*), the recent FCA and PRA consultations (CP18/29, CP18/36, and CP26/18) have set out more detail around which specific FCA and PRA rules inbound EEA firms will need to comply with whilst in the TPR.

The regulators are seeking to achieve a balance between what can be expected of firms, acknowledging the short timeframe and the temporary nature of the TPR, and what is required to ensure optimum stability and consumer protection. While inbound EEA firms operating via a UK branch legitimately may expect to have to comply with many of the rules applicable to third-country (*i.e.*, non-EEA) branches, the regulators are proposing to apply some of these requirements to EEA firms operating on a cross-border services basis too.

Under the current regime, EEA services firms doing business into the UK are subject to limited UK obligations. This is for two reasons: first, most matters are reserved to the home state regulator, which is supervising the firm against common standards under one of the EU financial services single market regimes; and second, there are obvious practical difficulties in supervising an entity without any UK presence. The imposition of UK regulatory requirements may prompt some EEA services firms to view the TPR as less of a panacea than it first appeared.

This *Client Alert* highlights particular areas in which, according to the proposals, services firms will need to comply with UK requirements. Firms have until 21 December 2018 to comment on the FCA's proposals in CP18/36, and until 2 January 2019 to comment on the PRA's proposals in CP26/18. Firms are urged to comment on these proposals if they foresee significant compliance challenges.

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Inbound EEA firms should note that the regulators have now also issued directions about how such firms should notify the relevant regulator that they wish to enter the TPR. The directions state that firms wishing to enter the TPR must complete the Temporary Permission Notification Form using the Connect system, and submit the form between 7 January 2019 and 28 March 2019. If an inbound EEA firm has not made a notification by the deadline, or otherwise submitted an application for authorisation or Variation of Permissions prior to exit day, that firm will not be able to take advantage of the TPR.

Approach to the SMCR

A key area in which the PRA is deviating from the expected approach is in relation to the Senior Managers and Certification Regime (SMCR). The PRA proposes to apply the SMCR for third-country branches to firms within the TPR — even those without a UK branch (EEA services firms currently are not subject to the SMCR at all). Under this proposal, all firms would need to have someone performing the Head of Overseas Branch Function. If relevant to the business, TPR firms would also need to have individuals performing other functions relevant to third-country branches approved (such as the Chief Risk, Chief Finance, and Head of Internal Audit Functions).

It is not clear how the PRA intends to supervise compliance with these rules by firms with no UK presence, nor what it would do were a conflict of laws to arise — for example, if appointing a "head" of the cross-border business was contrary to local law requirements.

The PRA plans to give firms up to 12 weeks from exit day to obtain deemed or full approval for individuals needing approval. During that period, individuals performing relevant functions would not be treated as performing a Senior Management Function. The deemed approval process allows the PRA to treat an individual as approved for up to three years during the TPR (mirroring the firm's deemed authorisation under the TPR). The PRA plans to allow firms to use an adapted version of the Short Form A and to submit only a short Statement of Responsibilities for an individual seeking deemed approval.

The PRA also proposes to apply the Certification Regime, Conduct Rules, and rules on regulatory references to EEA services firms who benefit from the TPR (UK branches of EEA firms are already subject to these requirements). It is unclear quite how such firms will distinguish individuals who have the requisite UK nexus to fall within the remit of these regimes from other individuals within the firm. The PRA is considering allowing transitional relief in relation to these requirements, so that they would not apply immediately from exit day.

Interestingly, the PRA's approach contrasts with that of the FCA, which plans to keep the status quo for firms in the TPR. Therefore, dual-regulated EEA branches in the TPR would continue to comply with the SMCR for EEA branches, until they become authorised as third-country branches and the SMCR for third-country branches applies. The FCA does not propose to apply the SMCR to EEA services firms in the TPR. The SMCR would begin to apply to them once they become authorised as a third-country branch (they will not be able to operate in the UK on a cross-border basis post-Brexit if seeking UK authorisation). This difference in approach by the regulators is bound to cause confusion for dual-regulated EEA services firms, as it will leave them operating under two different regimes.

Client Assets

Another area that will mark an important change for inbound EEA firms is in relation to client assets. Currently, client assets supervision is reserved to the home state regulator, so the FCA does not supervise inbound EEA firms in relation to client assets requirements.

The FCA is proposing that TPR firms (both firms with UK branches and cross-border services firms) that receive or hold client assets in connection with investment business or insurance mediation activities will need to comply with certain UK client assets rules.

First, TPR firms will become subject to any UK rules that implement EU requirements, although they will be able to use substituted compliance (*i.e.*, the FCA will accept compliance with home state rules that have equivalent effect). Second, TPR firms will need to comply with certain specific new requirements:

- From 1 April 2019, TPR firms will be required periodically to report their client assets arrangements to the FCA using a prescribed template. The frequency of reporting will match that for UK firms, and will depend on the firm's business type and size of client assets holdings.
- TPR firms subject to MiFID will need to provide an English translation of their client assets audit report to the FCA on request, or when the firm receives an opinion stating that the firm did not have adequate arrangements in place.
- TPR firms will need to disclose to clients the jurisdiction under which the firm's failure would be administered, and explain any possibility that under the firm's local law UK clients' assets may be treated differently to those of other customers in the event of the firm's failure.

It is difficult to see how this will provide the FCA with meaningful insight into or supervision over inbound EEA firms' client asset arrangements, yet the proposals will add a significant new burden for firms in terms of reporting to the FCA.

Consumer Protection

Both regulators plan to bring inbound EEA firms with UK branches within scope of the Financial Services Compensation Scheme (FSCS), meaning that such firms will need to contribute to FSCS levies for the first time. However, cross-border services firms will not need to become FSCS members (although the few already covered by the FSCS will remain so).

UK branches will need to prepare for being brought within the FSCS, and ensure that customers are aware of this change in coverage. The PRA proposes that UK branches of EEA banks will need to update their depositor protection customer disclosures from exit day, and will also need to provide updated information to existing depositors within two months following exit day. UK branches will also need to display updated posters and stickers in branch, and train staff to answer questions from customers about depositor protection post-exit. The PRA has indicated that there will not be any transitional relief for firms with UK branches in relation to FSCS protection, so firms will need to comply from exit day.

Notably, deposits held by EEA branches of UK firms will not benefit from FSCS protection post-exit. The PRA proposes that UK firms will need to notify affected customers of the change in protection within one month following exit day.

EEA firms with UK branches are already within scope of the Financial Ombudsman Service (FOS), but the FCA plans to include cross-border services firms within the FOS's compulsory jurisdiction for the first time — meaning they will be subject to the relevant fees. This raises practical questions as to how ombudsman awards might be enforced against firms with no physical UK presence, and whether this will achieve the desired outcome of ensuring protection for UK consumers doing business with EEA firms.

Next Steps

Inbound EEA firms intending to make use of the TPR will need to conduct a gap analysis comparing the rules they comply with today against those to which they will be subject during the TPR, noting that the regulators are still to consult further on the rules that will apply during the TPR. Inbound EEA firms should also note the regulators' statements that the regulators intend to use their powers to grant transitional relief broadly, and so even where standards are due to change it is possible that these will be phased in rather than applying in one go from exit day. These powers have not yet been granted to the regulators, and so they have not set out in detail at this stage exactly how they intend to use them.

Another key next step for firms wishing to enter the TPR is to prepare their notification, and ensure this is submitted prior to the 28 March 2019 deadline.

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