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PM May's Tough Talk On Brexit Dims Banks' Passport Hopes

By **Melissa Lipman**

Law360, London (October 4, 2016, 1:30 AM BST) -- British Prime Minister Theresa May's tough talk on immigration and sovereignty in a much-heralded speech Sunday means that banks should be steeling themselves for a possible future without coveted passporting rights, attorneys say.

May revealed at the Conservative Party Conference that the government would kick off the formal negotiating process to leave the European Union by the end of March, nine months after British citizens voted in favor of the exit, and promised to transpose all EU legislation into U.K. law for the time being.

But May didn't clarify the apparent conflict between the U.K.'s aim of retaining access to the EU's single market and the EU requirement that members allow workers from other nations to live and work freely within their borders. Instead, she promised to seek free trade in goods and services while emphasizing that the U.K. was not going through the process of leaving the EU only to wind up relinquishing control over immigration again.

On the whole, experts said, May's remarks left banks, clearinghouses and other firms with little more certainty than they had the week before as to what the regulatory framework will look like. But the hard-line stance the government appears to favor on immigration means that the financial services sector needs to prepare to lose the passporting rights that make it easier for U.K.-based firms to do business across the EU will little additional red tape.

"She's setting out a negotiating position that seemed harder than softer, which in my view makes it more difficult to get to the passporting that all the financial services firms have said they desperately want," said Covington & Burling LLP's Carlo Kostka. "The bottom line is that passporting seems further away rather than closer."

Ever since the June 23 referendum, the U.K.'s massive financial services sector has been jostling to deliver its wish list for the Brexit negotiations to the British government — and to try to divine what kind of arrangement the country would strike with the remaining 27 EU members.

Perhaps the trickiest balance U.K. negotiators will have to strike when it comes to financial services is securing access to the EU's free trade market for goods and services while still regaining control over immigration. The campaign for the U.K. to leave the EU made concerns about an influx of citizens from elsewhere in the bloc a centerpiece of its efforts, and May said Sunday that the talks were "not about negotiating all our sovereignty away again" whether it be about immigration or abiding by the decisions of EU courts and institutions.

A refusal to allow free movement, however, could make it impossible for the U.K. to continue to gain single-market access, as EU leaders have repeatedly said in recent months that the two were inextricably linked.

Single-market access is particularly important for many financial services companies, which benefit from several so-called passporting systems under EU law that allow them to use their U.K. regulatory clearance to do business across the region without having to seek approval in each jurisdiction.

No nation outside the EU has full single-market access with complete passporting rights, although Norway and Switzerland have fairly close trading relationships with the bloc. But May emphasized Sunday that the U.K. would not seek such a deal.

Even though the prime minister didn't explicitly rule out joining the European Economic Area, the zone that extends single-market access to Norway and others, May's speech seems to point to a so-called hard Brexit in which the U.K. has more limited ties to the EU, according to Davis Polk & Wardwell LLP's Michael Sholem.

"Firms can now take off the table the idea of continued EEA membership. That hasn't been explicit, but I think that has to be the takeaway from the tone of her speech and what's been said by the government in the last week," Sholem said. "You have to plan around what looks like the most likely outcome now, which is the U.K. will be a third country for financial services."

The fact that several major EU financial services regulations — notably the revised Markets in Financial Instruments Directive, or MiFID, and the European Market Infrastructure Regulation — include specific provisions for how to deal with non-EU nations known as third countries means that it could prove difficult for the EU to cut the U.K. a special deal for its financial services firms, according to Sholem.

But May's plan to pass legislation she dubbed the Great Repeal Bill to revoke the U.K.'s EU membership and then automatically transpose the EU's rules into British law may mean that financial services firms looking to use MiFID's passporting regime will at least get the benefit of equivalence, according toSquire Patton Boggs LLP partner Paul Anderson.

"By saying we'll automatically be transposing EU law into the U.K., where that might give some security is … equivalence in a relevant test for a third-country regime of passporting," Anderson said. "Under MiFID II there is a sort of equivalence test, and I've got to think if we implemented MiFID II, which it looks like we will … there's a third-country possibility."

On the other hand, attorneys said that importing EU law wouldn't be as simple as clicking a button. For starters, depending on what counts as EU legislation, there could be in the neighborhood of 20,000 acts that have to be moved while also taking into account any customized arrangements that the U.K. negotiates, according to Allen & Overy LLP counsel Karen Birch.

"You can't simply have a two-line act that says, 'All EU law is transposed into English law,'" Birch said. "It's sensible from a logistical perspective, but where it's less clear how it will operate is if there's a negotiated deal that would result in the continuation of some aspects of European law."

Likewise, much EU law references specific European institutions that are in charge of overseeing or enforcing it, whether that be the European Securities and Markets Authority, the European Banking

Authority or the European Central Bank.

"That's where a straight transposition of existing EU legislation won't be enough, because it may be that there are bespoke arrangements with the EU that you need to reflect in the legislation or, for example, that you need to address the status of supranational organizations going forward," said Allen & Overy counsel Sarah Garvey.

And the fix may not be as simple as replacing references to EU institutions with their U.K. counterparts, attorneys said.

"Rational lawyers could agree this is a principled approach to solving a very complex problem … But will it solve the passporting issue? No. Will it solve the equivalence issue automatically? No. Will there not be mistakes? No," Kostka said. "There's no silver bullets here."

All of which leaves financial institutions with little more certainty than they had before May's speech. The one thing banks can more or less plan on at this point is that the two-year clock for the U.K. to negotiate its exit from the EU will most likely start ticking in March. And that means that financial institutions should be preparing now, particularly those that rely heavily on London as a base to passport across the EU and may need more than two years to transition operations.

"I don't think it's too soon to be looking at contingency plans and to really start looking in detail at how third-country passporting might work for them or not work for them," Sholem said. "For all the major international financial groups, there would be a material impact if passporting were no longer available, and the third-country passporting certification under MiFID … does not provide a panacea for those concerns."

--Editing by Mark Lebetkin and Jill Coffey.
