EXECUTIVE SUMMARY

of the Brexit reports
submitted to the HCJP

6th July 2018

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EXECUTIVE SUMMARY OF THE BREXIT REPORTS SUBMITTED TO THE HCJP ON 6th JULY 2018

At the beginning of 2018, the Legal High Committee for Financial Markets of Paris (Haut Comité Juridique de Place - HCJP) set up four working groups in charge of analyzing the legal issues arising from a possible 'Hard' Brexit - i.e. without an agreement on a transition regime - for:

1/ banks,
2/ investment services providers,
3/ asset management,
4/ insurance.

During the course of this analysis, it was decided that the two reports 'Brexit and Banks' and 'Brexit and Investment Services' would be combined into one, in order to avoid duplications.

Three draft reports were therefore submitted to the HCJP on 6th July 2018:

- Brexit, Banks and Investment Services,
- Brexit and Asset Management,
- Brexit and Insurance.

These reports, which still require a few drafting adjustments, will be published after the summer. They are follow up on earlier work, in particular work on the access of British[1] financial institutions to the French market[2] and on the continuity of banking and financial contracts established before Brexit, between a British financial institution and an entity or person situated in the European Economic Area (27 European Union Member States plus three European Free Trade Association countries)[3].

They do not challenge the conclusions of these earlier reports but rather detail the analysis of the legal risks implied by a 'hard' Brexit and, with the aim of limiting these risks, they offer recommendations deemed to be in the interests of both the EU and the Paris Financial Centre.

The financial centre of London currently hosts a large portion of the EU's banking, financial and insurance activities. This situation, in the case of a 'hard' Brexit, would give rise to legal difficulties

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[1] The definition of financial institution is here intended in the broad sense of the term, and includes institutions authorized for the provision of financial, investment, collective management or insurance services.

[2] HCJP report on the accessibility of the French market by banking and financial institutions in the post-Brexit environment, 7th November 2017.

[3] Status report by HCJP on the impact of Brexit on banking and financial contracts, and the stability of the financing of continental entities, 29th September 2017.

for financial institutions in the EU, as well as for their clients.

Primarily, the loss of the European passport, the effects of which are analyzed in the first part of the present report, would disallow British financial institutions from providing new services covered by a European monopoly. Additionally, British regulations may be led to diverge from that of the EU, which would cause increasing complications for financial institutions and legal insecurity for clients residing in the EU. Lastly, Brexit will free British courts from the jurisdiction of the European Court of Justice and will result in the UK leaving the system of international European legal cooperation.[4] Indubitably, disagreements will arise between European judges and British judges on the interpretation of texts which are key for financial activities (e.g. EMIR, MiFiD 2).

In this context, these reports distinguish between contracts agreed **before** Brexit and those relating to new **post-**Brexit activities.

1/ With regards to contracts agreed before Brexit, the main legal challenge is that of their continued validity when they remain in course of performance on the day of Brexit. The HCJP considers the risk of contracts not being honored as limited; however, uncertainties remain for certain contracts, and it is vital to lift these before Brexit. Operational difficulties may also arise, which texts of an adequate level could and should overcome.

2/ Concerning new activities after Brexit, the HCJP believes that the current European legal framework does not prohibit the location outside of the EU27 of the key functions of certain financial institutions. Beyond the risks that such a situation may present for the financial stability and the integrity of European markets, it may lead to intra-European regulatory arbitrage, which is contrary to the concept of a Single Market for financial services. To remedy this, the HCJP recommends working towards greater harmonization of the texts applicable in the EU and increased coherence in their implementation by the 27 Member States.

[4] *HCJP report on the implications of Brexit on commercial and civil legal cooperation, 30th January 2017.*

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1 - Most ongoing contracts could continue to be performed after a 'hard' Brexit. Some difficulties should, however, be resolved in advance

The work of the HCJP covers the legal impact of the loss of the European passport on ongoing contracts agreed by financial institutions located in the UK (legal entities subject to British law and branches of European companies located in the UK, hereafter referred to as 'British financial institutions') and persons located in France. Contracts agreed by European financial institutions (excluding British financial institutions) and clients or persons residing in the UK were not examined, as they are subject to British law.

1.1 - The immediate consequences of a 'hard' Brexit: loss of passports by British financial institutions located in the UK

From the moment of Brexit, financial institutions under British law will become 'third country entities'. Consequently, these entities will lose their 'European passport'. More precisely, these entities will no longer benefit from the mutual recognition of authorization set out by different sectorial texts which allow for a financial institution authorized in an EU or EEA Member State to exercise its activities on the territory of another, or several other, Member States, whether that be as per freedom of services or freedom of establishment, subject to a simple notification from the home authority to the relevant host authority.

British players intending to provide new banking, financial or insurance services on EU territory will therefore have two options. The first consists of applying for the benefit of the equivalence or mutual recognition regimes applicable to third countries, to the extent allowed by these regimes and in compliance with their requirements. The second, and more durable option, consists of transferring part of the activity previously carried out from the UK to an entity located within the EU, and therefore regulated by European law, using, subject to the relevant applicable conditions, delegation or outsourcing mechanisms allowing for certain functions to remain in the UK.

As concerns ongoing situations, no European text specifies the legal consequences of a loss of the European passport on contracts validly agreed before this loss. The loss of the passports for British financial institutions is therefore an unprecedented situation, the consequences of which the work of the HCJP has attempted to highlight.

1.2 - There would be no uncertainty for most ongoing contracts:

The HCJP working groups first considered that a loss of the passports would not, according to French law, result in the *ab initio* voiding of the contracts validly established before Brexit.

The sensitive subject is that of the effect of Brexit on the execution of ongoing contracts, whether they be instant contracts, whose effects have not been fully released before the day of Brexit, or contracts of successive performance. In fact, two questions need to be considered. The first relates to the fate of the contract: is the loss of the passport in itself a reason for the contract to lapse, be cancelled or terminated? The second concerns the activity of the service provider: can the service provider continue to honor the contract, or would the continued execution of the contract expose the service provider to penal sanctions for violation of the monopoly reserved to authorized financial professionals?

It appears certain that post-Brexit the loss of the European passports will bar financial institutions from renewing contracts before their expiry and from modifying essential contractual obligations for one of the parties agreed before Brexit, as this implies the provision of a new service. For example, in the field of insurance, this restriction could cover new engagements such as the addition of new guarantees to those which had been agreed before Brexit, or a raise in prices, or any other modification resulting in the increase of the insurer's liability.

This having been said, the continuity of contracts agreed before Brexit by British institutions located in the UK, with French clients in the EU, will not be under threat, as these contracts do not imply the provision of new services after Brexit.

In the field of banking, because the essential obligation will most often be fulfilled at the moment of their agreement, most banking contracts agreed before Brexit will be able to be validly executed after a 'hard' Brexit, despite the change of regulatory status of the relevant British entity. This is the case, in particular as regards financing activities, of revolving credit contracts, so-called 'committed' contracts - as they may be validated by signature - documentary credit contracts (including contracts whereby the line of credit provides for an issuing obligation post-Brexit) agreed before Brexit. However, syndicated loan agreements, which include prerequisite conditions which will not all be satisfied at the moment of Brexit, or uncommitted facilities will not be unable to continue post-Brexit. Similarly, if certain life cycle events which are included in a contract agreed before Brexit and which are considered as a service provision - such as a modification of the maturity or the amount of financing or the addition of a new French borrower - occur post-Brexit, the contract cannot continue.

As concerns investment services, the same line of reasoning applies. The loss of the European passports will have little impact on contracts ongoing at the moment of Brexit between a British entity losing its European passport and a French client, except in certain specific cases.

For instance, in case of a post Brexit modification initiated by a British financial institution of an essential obligation to a market transaction (derivative, securities loans or repurchase agreements transactions) agreed before Brexit, this transaction should not be able to continue.[5]

With regards to asset management, Brexit will not call into question the holding of units or shares of British UCITS or of AIFs by EU investors. In the same way, capital calls made by a British asset management company post-Brexit on behalf a British AIF for units or shares not yet entirely paid up on the day of Brexit will not be considered as new distribution activities, and will therefore remain legally valid.

This line of reasoning also applies to **insurance contracts**. At the end of their term, the tacit renewal of these contracts with British entities will be legally impossible. At that time, it will be the responsibility of insurers, under the control of both the EU and UK competent authorities, to inform their clients and the responsibility of the insured persons to undertake the necessary steps to establish cover from an EU-authorized entity.

1.3 - Legal uncertainties would primarily arise for two categories of contracts, requiring as a matter of priority contract transfers before Brexit

Three situations whereby legal uncertainty arises have been identified, in the fields of insurance, investment services and asset management.

In the area of insurance, a certain number of insurance contracts cover long-term risks, notably in relation to general third-party liability in medical and construction sectors, or short-term liability, in particular in the health sector. The aforementioned analysis, concerning the disallowance of the provision of new services, applies to these contracts; however, there are two contradicting views on the qualification of how these contracts are to be managed after Brexit.

The first relies on the qualification of insurance activity. Supported by the opinion of EIOPA[6] and a notice from the European Commission[7] interpreting the Solvency II directive, this position considers that a British insurer executing its engagements post-Brexit would be engaging in the illegal exercise of insurance activity[8]. This implies that the obligations of British insurers towards their European clients ought to be transferred to authorized entities in Europe.

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[5] *See paragraph 1.4 below on difficulties.*

[6] *Opinion on services continuity in insurance in light of the withdrawal of the UK from EU, 21st December 2017.*

[7] *Notice to stakeholders, Withdrawal of the United Kingdom and EU rules in the field of Insurance/Reinsurance, 8th February 2018.*

[8] *Article L. 310-27 of the French insurance code: 'Practicing on French territory one of the operations mentioned in the 1st, 2nd and 3rd sections of article L.310-1 without conforming to the requirements of articles L.310-2 and L.310-6 is punishable by a prison sentence of 3 years and a fine of €75,000'.*

The second analysis considers that the management of an insurance contract does not consist of taking on new engagements, but solely of managing the consequences of an already established engagement[9]. As a result, a British insurer executing its obligations subsequent to a contract established before Brexit, notably by ensuring the payment of damages, would not violate any provisions, and the transfer of portfolios to the EU would not be necessary. The Luxembourg regulator supports this interpretation.

The coexistence of competing theories constitutes in itself a source of insecurity and a British insurer might consider it preferable to transfer its portfolios to entities authorized in the EU, particularly considering the opinion expressed by EIOPA. It is however important that the relevant authorities quell this uncertainty before a possible 'hard' Brexit.

A solution could consist of treating the loss of the European passport by British insurers in the same way as the lapsing of authorization for French insurers, whereby ongoing contracts are allowed to run their course until the agreed term, in the context of "extinctive management", in order to avoid any legal risks for the parties. The acknowledgment of the loss of the European passport by the national competent authorities would thus imply the supervision of the entities concerned by the French Prudential Supervision and Resolution Authority (ACPR) for the liquidation of the obligations of the contracts agreed through the passport, in particular for the implementation of a programmed liquidation of the engagements. The constraint on British insurers to subject themselves to such supervision and to implement such a programme ought to be exercised by the French competent authorities, in collaboration with the relevant British authority.

In the area of investment services, in relation to market transactions (on derivatives, securities lending or borrowing or repurchases), financial institutions agree in the first instance with counterparts (financial or non-financial institutions) framework agreements[10] drawn up by professional associations (in particular American, English or French, such as the ISDA, ICMA, ISLA or FBF) which preside over the general obligations of the parties.

These parties then execute transactions under these framework agreements. The conclusion of each transaction in accordance with a master agreement is materialized through a 'confirmation'[11] containing the specific characteristics of the transaction.

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[9] Article L. 310-1 of the French Insurance code effectively states that 'The control of the state is exercised in the interests of the insured, subscribers and beneficiaries of insurance and capitalization contracts. Those subject to control: 1 the entities which contract their obligations in the form of direct insurance, the execution of which depends on the duration of the human life, engage in paying capital in cases of marriage or childbirth, requiring savings for the purposes of capitalization and as such contract determined obligations.

[10] The 'Terms' to a certain extent.

[11] The 'Conditions' to a certain extent.

A market transaction concluded before Brexit between a British financial institution and a person located in France could be legitimately executed after Brexit, unless the British institution takes the initiative to modify an obligation essential to this transaction, such as the modification of its nominal or notional amount, the modification of the expiry date (in particular in the context of a 'roll' or 'rollover') and more generally any modification which may be considered as a novation to the transaction. According to the analyses of the aforementioned professional associations, a British institution should be authorized in order to be allowed to make such modifications.

For the purposes of avoiding uncertainty and therefore legal insecurity, it is therefore necessary to clarify in an exhaustive manner which modifications constitute essential obligations for the parties.

Portfolio management, defined as 'managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments'[12] is an investment service whose provision operates on a continual basis throughout the duration of the mandate, as it implies making recurring decisions to purchase or sell financial instruments throughout the duration of the mandate. Post Brexit, a British entity acting as an agent would find itself to be in violation of the monopoly of investment services providers and would no longer be in a position to legally continue the provision of such service. Here again, a transfer of contracts in advance of Brexit appears to be the most secure solution.

It appears essential that competent authorities plan ahead, before a 'hard' Brexit, the implementation of a regime similar to that applicable to the withdrawal of authorization, which would lead, under French law, to the setting up of a period of extinctive management devoid of legal risks, during which service providers would only carry out the operations strictly necessary to honor the obligations of the contract (article L.532-6 and 10 of the Monetary and Financial Code) in order to settle existing obligations in the best interests of the client-investors established in the EU in the following situations[13]:

- a British asset manager which, as a result of Brexit, loses the benefits of the management passport allowing it to manage a UCITS or AIF in the EU;
- an AIF or UCITS feeder in the EU invests in a British AIF or UCITS master; and
- a management mandate agreed between a British manager and an EU client and which is intended to continue beyond Brexit.

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[12] Article 4(1)(8) of the Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

[13] Such a period of extinctive management might also be organized for investment advice contracts when the advice continue after Brexit.

1.4 -The transfer of certain categories of contracts to the EU27 could give rise to operational difficulties; the adoption of new texts could contribute to their resolution.

The issue here relates to measures allowing British financial institutions to relocate their activities in the EU and facilitating the transfer of their activities in the EU to an entity (part of the institution's group) set up beforehand in the EU (subsidiary or branch of a third country) (hereafter referred to as an 'Entity').

It is worth remembering that the transfer of contracts to an Entity is a solution already available under current laws. However, there is no unified European regime when it comes to the handover of contracts (not mentioning issues relating to the taxation of such transfers) and the applicable mechanisms under domestic law are often unwieldy.

The transfer of contracts may be achieved via national contractual mechanisms, such as the transfer or novation of contracts. These modifications must include, at least[14], a change of contracting party and must necessarily take the form of a tripartite contract, including the British transferor, the transferee located in the EU27 (the Entity) and the client. The agreement of the three parties to the contract transfer or novation must be reached for the transfer to be valid. Clients must also be informed of this transfer.

Yet, there are on average more than 7 contracts[15] to document the relationship between a client and an institution established in the EU. Recent examples of repapering in the context of simple regulatory modifications (MiFID2 in particular) demonstrate the operational burden implied by this type of exercise, not only for the institutions, but also for their clients.

In the absence of provisions to facilitate the transfer of some of these contracts, in particular market transactions, clients located in the EU could suffer from situations whereby the continuity of the relationship with the British financial institution, via the intermediary of its Entity, cannot be ensured.

Therefore, as concerns **'market' contracts and transactions**, measures could be taken to facilitate the transfer of activities to the new Entities.

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[14] The adaptation of contract law and the relevant jurisdiction ought to be considered also.

[15] Contracts relating to the provision of services and market framework agreement confused.

For market master agreements[16], the conclusion of a new master agreement will have to be facilitated (the '**New Master Agreement**') between the Entity and a person located in the EU, the latter having already agreed a master agreement (concerning the same transactions) with a British financial institution which is the parent of the Entity.

In practice, this will involve replicating the terms of the existing master agreement (agreed between the British institution and an entity or person located in the EU) in a New Master Agreement.

It is therefore recommended that a European text sets out simplified and structured methods for Entities to set up New Master Agreements, including sufficient information of the clients concerned by the agreement. It would therefore be appropriate to set down simplified means for a client to consent to this New Master Agreement. This mechanism would thus allow for the replication of Master Agreements agreed between British financial institutions and persons located in the EU, for the benefit of Entities established in the EU.

It is noteworthy that, in this case, the master agreements and transactions concluded before Brexit between British financial institutions and entities located in the EU will continue to apply after Brexit. Questions remain as to the fate of ongoing transactions agreed under these master agreements.

For ongoing market transactions, after Brexit, it will be necessary to facilitate the transfer of a derivative products operation (agreed before Brexit and before the application of EMIR, between a British financial institution and a person located in the EU) to an Entity (of this institution) situated in the EU. The change of one of the parties to a derivative products operation could trigger the application of compensation or collateralization for transactions which were not subject to it, as they were agreed before these obligations came into effect. Indeed, the change of counterpart to a derivative products operation is seen by ESMA[17] as a novation, and the transaction is therefore considered as a new transaction for which these obligations are applicable. Due to this 'novation' [18], the institution would also be subject to obligations imposed by the MiFID2 directive, notably the requirement for pre-negotiation transparency. A European text could usefully exclude transactions affected by the application of these obligations under certain conditions.

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[16] It is necessary to observe that operators established in the EU and operating in the UK in the form of branches will not impact each other in this transfer difficulty, as the framework agreements agreed by branches will be considered to have been agreed with the European entity.

[17] ESMA, Q&A EMIR OTC Question 20.

[18] The notion of 'novation' ought to be clarified (see 1.3 above, under 'In the area of investment services' - the request for clarity of 'which modifications constitute the essential obligations of the parties').

2 - For future activities, broader harmonization of European texts appears indispensable to ensure the location of certain key functions within the EEA

2.1 - The ‘standard’ channels of execution of new activities

Current European texts offer two options allowing a third country entity to access European clients and markets:

2.1.1 - The creation of an authorized legal entity

Establishing entities in the EEA will still be possible, in the form of subsidiaries subject to national law or in the form of a European Company (EC). One of the advantages of the latter corporate structure is that it is not attached to the Member State in which it is headquartered. The headquarters can thus be easily transferred within the EU without being hindered by a nationality change or a wind up. It would therefore be possible for a British entity to change its structure to EC in the UK before Brexit, and then transfer its headquarters to the EU. Regardless of the legal structure adopted, these new legal entities ought to be authorized in compliance with the conditions provided in European texts transposed into the legislations of EEA States.

The authorization of a subsidiary in the EU will therefore provide the third country entity with the benefits of the European passport in the other EU Member States.

2.1.2 - The system of equivalence and its risks

Certain European texts[19] provide for mechanisms which allow a third country entity to serve European clients, either by setting up a branch, or directly, that is, without the obligation to set up a branch, provided that the third country regime is recognized as equivalent to the sectorial regulatory requirements of the MiFID2, MiFIR and the AIFM Directive.

These mechanisms of equivalence will not be applicable until the UK becomes a third country, that is, after Brexit. In addition, they only give access to European clients that are professional clients. Finally, the current texts do not provide for any periodic reexamination of the conditions for equivalence. Yet, it seems quite likely that the British regime will be led to diverge from the European regime in the coming years. Particular attention should therefore be paid to the assessment of the continuation of equivalence and the creation of an appropriate regime covering its withdrawal.

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[19] *AIFM Directive, MiFID 2 Directive and MiFIR regulation.*

2.2 - Solutions implying some degree of risk

Substantive European law contains exemption clauses for the regimes discussed above and which do not prohibit a third country entity from accessing European clients even though they have no physical presence in the EU (that is, in the form of a subsidiary or branch) or the equivalence of the regime of the third country is not assessed. The extensive use of these mechanisms could turn out to be against EU interests, allowing for a sort of *status quo* to be maintained, in particular in the case of delegation and reverse solicitation.[20]

Relevant European texts include mechanisms which allow entities or institutions authorized in the EU to delegate or outsource certain functions to countries other than that in which they are authorized, including to third countries. This mechanism of delegation could lead to situations whereby delegate entities are mere letter boxes.

Outsourcing could, in this regard, present similar risks of circumvention. Although these mechanisms are regulated by recent notices of ESMA and EIOPA[21], they deserve to be further defined in some regards and rendered more effective, to ensure that their implementation is harmonized throughout the different Member States. The HCJP also examined the American practice of 'chaperoning' - which authorizes the solicitation or performance of financial operations in the US through the intervention of a service provider possessing all the required authorizations. This mechanism only exists for brokers-dealers in the US. It has been discussed by ESMA over the past few months; however, it has not been decided yet to regulate this practice in Europe.

Therefore, by allowing the performance of key functions to be carried out from outside the EU27, these mechanisms raise issues in terms of legality and sovereignty: difficulties for European regulators to fully exercise control, most contracts remaining within the jurisdiction of British law and British courts.

Besides, other mechanisms which are not harmonized at the European level could kindle competition among Member States and encourage a pre-Brexit *status quo*. The absence of harmonization - which would naturally encourage British entities to perform forum shopping - that is, operators that intend to set up an authorized entity in the EU would set against each other the national legal and regulatory regimes of different Member States - which would be detrimental to the interests of the EU. The bonus thus granted to the lowest bidder would weaken the solidity of the regimes, in

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[20] *Article 42 of the MiFID 2 Directive (transposed into article L. 532-51 of the Monetary and Financial Code) states that a third country entity is not required to have authorization from the Prudential Supervision and Resolution Authority (ACPR) or an EU passport, provided that a client established in France, whether professional or not, initiates on his own initiative, the provision of an investment or associated service.*

[21] *Opinion on supervisory convergence in light of the United Kingdom withdrawing from the European Union, EIOPA, 11th July 2017.*

particular prudential regimes, which were put in place in the interests of the insured, investors and other clients of the organizations concerned, as well as of the fairness of competition. Such a forum shopping could in particular happen in the context of MiFIR[22] which includes the possibility for Member States to have their own national regime allowing third country entities to offer investment and associated services to professional clients in their country. Even if the MiFIR Regulation does not grant the European passport to these entities, the multiplication of national regimes could in the end harm the collective interests of the 27 EU Member States. After an overseas exemption was introduced several years ago in the UK, many Member States followed suit and added a similar regime in their national law.

2.3 - Recommandations

• In order to avoid forum shopping within the EU, better harmonization of the approaches of the national authorities could be achieved through a strengthening of the powers of each of the European Supervisory Authorities[23] (ESAs) regarding the interpretation and implementation of European texts.

• European texts containing a third country regime do not all include the same conditions and implementing measures. This inconsistency among regimes, in particular in the field of asset management, does not allow for a uniform application of the principles. It would be beneficial to harmonize these regimes and make them more robust, in particular with regards to the conditions of equivalence, in order for the most relevant rules to apply to third country players.

• The special case of delegations by an EU entity to a third country entity should be paid particular attention, as it is true that certain European directives currently allow companies in the EU to perform such delegation in all areas of their activity, including 'key functions'. It would be appropriate, therefore, to firstly require that these key functions be located on EU territory, and secondly, determine precisely the means necessary for their execution, to be located in the EU. As for it, the question of reverse solicitation could lead the European authorities to rapidly take a stance to avoid abuse, like ESMA was able to do for investment services.[24]

[22] *Article 46(4) of the MiFIR Regulation.*

[23] *ESMA, EBA, EIOPA.*

[24] *See Q&A ESMA Investor protection in the version issued ofn12th July 2018 (ESMA 35-43, pages 95 to 98).*

IN CONCLUSION:

The HCJP notes that a situation of 'hard' Brexit would lead to few legal difficulties, such as the continuity of contracts in progress, and that these difficulties would be, in theory, limited.

BEFORE Brexit, the HCJP considers it vital that, in the fields of finance, banking and insurance, the competent authorities prepare a solution for the contracts in progress, which would spark uncertainty for the contractors, aiming at the same objectives as that for institutions which lose their authorization. Such solution would consist, in French law, of creating a regime allowing for the extinctive management of ongoing contracts, exempt from legal risk, whereby the service provider performs its engagements and only carries out the necessary operations, in the best interests of its clients.

The position of the European authorities on certain risky commercial practices, such as reverse solicitation, also ought to be specified, in order to avoid abuse.

Finally, an improvement of the regime on transfer procedures to the EU27 applicable to certain contracts would be appropriate.

AFTER Brexit, the HCJP recommends to urgently launch reflections on broader harmonization of certain European texts, in order to ensure that certain key functions are located in the EU and to limit the possibilities of regulatory arbitrage among countries in the EU27.