The Impact of Brexit on Cross-Border Business of UK Credit Institutions and Investment Firms with German Clients[*]

[Preliminary Draft – please do not circulate]

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Abstract

The passporting framework currently entitles UK institutions to conduct cross-border activities throughout the EEA without being required to obtain a license in each EEA country. This regime would no longer be available if the UK withdraws from the EU and the EEA. Instead, a UK institution that intends to offer its services in Germany, will, in principle, be required to establish a subsidiary in that country. This subsidiary would have to apply for an individual license and to meet the comprehensive requirements that apply to institutions in Germany under the sole supervision of BaFin and/or the ECB. Alternatively, UK institutions may opt for establishing a new 'EEA hub' in another EEA country which would be entitled to apply the European passport and set up a branch or offer cross-border services in Germany or other EEA countries. The UK institution could also apply for a German national exemption from the license requirement and, subject to certain conditions, provide services on a cross-border basis to German clients.

As third-country firms, UK institutions might be granted a more comprehensive access to EEA markets under the MiFID II/MiFIR framework applying as of 3 January 2018. This framework will enable the European Commission to adopt equivalence decisions allowing third-country firms to register with the ESMA and provide services to eligible counterparties and 'per se' professional clients. However, this regime is only applicable with respect to investment services and activities, but not to banking business. Moreover, the equivalence regime does not entitle third-country firms to provide investment services to retail clients and 'opt in' professional clients. Therefore, UK institutions will also have to find alternative options for accessing the EEA financial markets, such as providing services on the basis of reverse solicitation.

Keywords: Brexit, cross-border financial regulation, equivalence regime, European passport, freedom to provide services, freedom of establishment, MiFID II, MiFIR, reverse solicitation

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1. Introduction

On 23 June 2016, the majority of British citizens voted to leave the European Union ('EU'). The withdrawal mechanism set out in Article 50 of the Treaty on EU ('TEU') has become the focal point of the legal discussion. Pursuant to this provision, a Member State that decides to withdraw from the EU must notify the European Council of its intention to do so. The withdrawing Member State and the EU then have two years to negotiate the conditions of a potential withdrawal agreement. Otherwise, the EU Treaties will automatically cease to apply to the UK after the expiry of the two-year period.[1]

For credit institutions and investment firms the outcome of Brexit raises the question whether they will still be allowed to carry out banking business and provide financial services on a cross-border basis or establish branches throughout the European Economic Area[2] ('EEA'). Typically, groups of UK institutions[3], but also institutions from the US and other non-EEA countries, use credit institutions and investment firms in the City of London as their main hub to carry out banking business or offer investment services[4] throughout the EEA. This type of business with European clients, including German clients, is usually conducted on the basis of the European Passport.[5]

With 88 UK branches (17 branches of UK credit institutions and 76 of UK investment firms)[6], nearly half of 178 EEA branches registered in Germany were established by UK institutions.[7] Germany hosts more branches of UK institutions than any other EEA country. In comparison, 61 UK branches were established in Italy (15 UK credit institutions and 54 UK investment firms)[8], 54 in France (19 UK credit institutions and 47 UK investment firms)[9], 46 in the Netherlands (12

[1] See Article 50(3) of the TEU.
[2] The EEA comprises the EU, its 28 EU member states and the three EFTA States Iceland, Liechtenstein and Norway.
[3] UK credit institutions and investment firms are together hereinafter referred as to 'UK institutions'.
[4] Whenever reference is made to the provision of investment services this reference is to be understood as encompassing also the provision of investment activities with or without any ancillary services.
[5] See Charles Goodhart and Dirk Schoenmaker, The Global Investment Banks are now all Becoming American: Does that Matter for Europeans? *Goodhardt/Schoenmaker*, Journal of Financial Regulation 171 (2016).
[6] There are 5 UK institutions that have established branches both as credit institution and as investment firm, and are therefore listed in both databases of the EBA and the ESMA. These institutions are *J.P. Morgan International Bank Limited, J.P. Morgan Securities plc, Macquarie Bank International Limited, Standard Chartered Bank* and *The Royal Bank of Scotland plc*.
[7] The numbers are based on the information available in the EBA Credit institutions register (https://eportal.eba.europa.eu/cir/faces/publicDisclaimer.xhtml#no-back-button) and the ESMA MiFID Investment Firms register (https://registers.esma.europa.eu/publication/searchMifid) (last access on 16 January 2017).
[8] 8 UK institutions have established branches both as credit institution and as investment firm.
[9] 12 UK institutions have established branches both as credit institution and as investment firm.

UK credit institutions and 35 UK investment firms)[10] and 38 in Spain (10 UK credit institutions and 34 UK investment firms)[11].

Taking into account the importance of the German market for UK institutions and, in turn, the importance of the UK institutions for the German market, this paper analysis the impact of Brexit on cross-border activities of UK institutions in Germany and potential post-Brexit alternatives available to UK institutions. To understand the consequences of Brexit for cross-border activities of UK institutions, it is helpful to recall the general principles of the European Passport.[12] On this basis, this paper further discusses the direct impact of Brexit on cross-border activities of UK institutions in Germany[13], potential options for the negotiations of the withdrawal agreement between the UK and the EU[14] and alternative steps that might be considered by UK institutions to access the German market after Brexit[15]. Although the paper focuses on cross-border activities of UK institutions in Germany, many of the aspects discussed can also be applied to cross-border activities in all other EEA countries.

2. The European Passport

(a) Background

The European passport is a key element of cross-border regulation in the EEA. It sets up a pan-European framework under which credit institutions and investment firms are entitled to conduct cross-border activities throughout the EEA without being required to obtain a domestic license in each EEA country. The passport regime thereby implements the right of establishment[16] and the freedom to provide services[17], and it manifests the 'principle of mutual recognition' and the 'country of origin principle' in European financial regulation.[18] According to these principles, a domestic license granted by a home state supervisory authority of an EEA country is binding upon any other EEA country host state supervisory authority and has the effect of a transnational

[10] *Northern Trust Global Services Limited* has established its branch both as credit institution and as investment firm.
[11] 8 UK institutions have established branches both as credit institution and as investment firm.
[12] See 2. below.
[13] See 3. below.
[14] See 4. below.
[15] See 5. below.
[16] Articles 49-55 of the TFEU, Articles 31-35 of the EEA Agreement.
[17] Articles 56-62 of the TFEU, Articles 36-39 of the EEA Agreement.
[18] George Walker and Robert Purves, *European Financial Services*, in George Walker, Robert Purves and Michael Blair eds, *Financial Services Law* 83 at 91 (3rd ed; Oxford; Oxford University Press, 2014); Heinrich Nemeczek and Sebastian Pitz, *Die Auswirkungen des Brexit auf den Europäischen Pass für CRR-Kreditinstitute und Wertpapierhandelsunternehmen*, Wertpapier-Mitteilungen 120 at 121 (2017); Jörg Schwerdtfeger, *Europäischer Pass für Leasing und Factoring*, Zeitschrift für Bank- und Kapitalmarktrecht 53 at 55 (2010); Sara Konoe, *The Politics of Financial Markets and Regulation* 85-6 (Basingstoke; Palgrave Macmillan, 2014).

administrative act.[19] The supervisory authority of the host EEA country is, in principle, not allowed to second-guess the institution's home state license or other regulatory requirements applicable in the institution's home state, including, *inter alia*, the institution's capital structure, its management body or risk management. The host state authority may neither allege that the institution's home Member State has failed to correctly implement the EU regulatory standards set out in the CRD IV[20] regarding credit institutions, and the MiFID I[21] regarding investment firms. Rather, the European Commission is competent to investigate and sue an EU Member State before the ECJ[22] if such issues arise.

Compared to other jurisdictions outside the EEA that implemented the 'principle of mutual recognition' on the basis of bilateral agreements, the passport regime is characterized by a higher degree of harmonization in the European Single Market.[23] The license requirements and supervisory standards were harmonized by several European legal acts, including the CRD IV, the CRR[24] and the MiFID I. The CRD IV and the MiFID I also set out the requirements and procedures regarding the European passport.

The EEA-wide recognition of home state licenses is justified by its harmonized regulatory standards that the supervisory authorities, both national competent authorities and the ECB, must apply in the supervision of credit institutions and investment firms.[25] The 'principle of mutual recognition' and the 'country of origin principle' also determine which supervisory authority is responsible for the supervision of cross-border activities. Credit institutions and investment firms that exercise passport rights for their cross-border activities in the EEA remain primarily subject to the supervision of their home supervisory authority. The CRD IV and the MiFID I refer to this

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[19] Christoph Ohler in Peter Derleder, Kai-Oliver Knops and Heinz Georg Bamberger eds, *Handbuch zum deutschen und europäischen Bankrecht,* § 76 para. 33 (2nd ed.; Vienna; Springer, 2009); Mathias Hanten, *§ 53b*, in Heinz Beck, Carl-Theodor Samm and Axel Kokemoor eds,, *Kreditwesengesetz* para. 8 (127th suppl.; Heidelberg; C.F. Mueller, 2007).

[20] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (OJ L 176, 27.6.2013, p. 338) ('Capital Requirements Directive', 'CRD IV').

[21] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (OJ L 145, 30.4.2004, p. 1) ('Markets in Financial Instruments Directive I', MiFID I').

[22] Article 258(2) of the TFEU. Before an EU Member State brings an action against another Member State, Article 259(2) of the TFEU requires it to bring the matter before the European Commission.

[23] IOSCO Task Force on Cross-Border Regulation, Final Report, FR23/2015, September 2015, 31; Douglas W. Arner, *Cross-Border Supervision of Financial Institutions*, in Niamh Moloney, Eilís Ferran and Jennifer Payne eds, *The Oxford Handbook of Financial Regulation* 487 at 492-7 (Oxford; Oxford University Press, 2015); see also John Armour, Dan Awrey, Paul Davies, Luca Enriques, Jeffrey N. Gordon, Colin Mayer and Jennifer Payne, *Principles of Financial Regulation* 616-643 (Oxford; Oxford University Press, 2016) on international regulatory coordination..

[24] Regulation (EU) No 575/2013 of the European Parliament and of the Council o 26 June 2013 on prudential requirements for credit institutions and investment firms (OJ L 176, 27.6.2013, p. 1) ('Capital Requirements Regulation', 'CRR').

[25] See Niamh Moloney, *Brexit: An Uncertain Future for the City?*, 17 German Law Journal 75 at 77 (2016).

aspect as the 'principle of home Member State (prudential) supervision'[26]. As the cross-border activities are primarily supervised by the home state authority and covered by the license of the home state, it is mostly the law of the home state that applies to the supervision of cross-border activities in the EEA.

Although the European passport allows an institution to offer its services across the EEA, it would not be correct to qualify the European passport itself as a single European license. This would require that the license would be granted with immediate effect for the entire EEA and would entitle the institution *eo ipso* to conduct cross-border activities in other EEA countries without taking any further actions. Unified administrative acts with EU-wide effect can be found in European trademark or design law where the European Union Intellectual Property Office (EUIPO) can grant an EU trade mark[27] or a registered Community design[28]. These acts are automatically granted for the entire EU. By contrast, the European passport in financial regulation does not immediately entitle credit institutions and investment firms to conduct cross-border activities. Before they can do so, they must initiate a notification procedure towards their home state authority which will communicate the necessary information to the supervisory authority of the host state where the intended cross-border activities shall be conducted.[29] Under certain circumstances, the home state authority may even prohibit the intended cross-border activities.[30]

(b) Scope of Application

The European passport is not available to all financial institutions that national laws define as a credit institution or investment firm, but only to 'credit institutions' within the meaning of Article 4(1) point 1 of CRR[31] and 'investment firms' as enshrined in Article 4(1) points 1 of MiFID I[32]. Institutions that solely grant credits for their own account without simultaneously taking deposits or other repayable funds, would be deemed as credit institutions in German financial regulation and must thereby obtain a license[33]. In European financial regulation, such

[26] Recital 15 of CRD IV and Recital 22 of MiFID I; see also Recital 46 of MiFID II.
[27] Article 45(1) of the Council Regulation (EC) No 207/2009 as amended by Regulation (EU) 2015/2424 of 16 December 2015 (OJ L 341, 24.12.2015, p. 21).
[28] Article 48 of the Council Regulation (EC) No 6/2002 of 12 December 2001 (OJ L 3, 51.1.2002, p. 3).
[29] See below at 2(d).
[30] See below at 2(d)(i).
[31] Article 4(1)(1) of CRR defines credit institution as '*an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account*'.
[32] Pursuant to Article 4(1)(1) of MiFID I, investment firm '*means any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis*'.
[33] Sections 1(1)(2) point 2 and 32(1) of the German Banking Act (*Kreditwesengesetz*).

institutions are, by contrast, not qualified as credit institutions and they are therefore not eligible for the European passport.

(c) Advantages of the European Passport

The European passport facilitates cross-border activities of EEA institutions in many respects. Under German law, a license is generally required as soon as the German market is targeted, even if the provider of the banking products or financial services has its legal seat and head office outside of Germany.[34] For credit institutions, this license is granted by the European Central Bank ('ECB'), irrespective of whether the institution is significant or less significant.[35] Licenses for investment firms are granted by the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht, 'BaFin'*). The license is, however, only permissible if the institution has its head office and legal seat in Germany.[36] One might suggest that the license requirements and other regulatory requirements may, at least partially, be avoided by establishing a branch instead of a subsidiary which, from a corporate law perspective, is deemed to be a legally dependent part of an institution.[37] From a regulatory perspective, branches of third-country institutions established in Germany will, however, be treated as legally separated

[34] Oberlandesgericht Dresden (Higher Regional Court Dresden), Judgment of 20 June 2007 – 8 U 328/07; Oberlandesgericht München (Higher Regional Court Munich), Judgment of 17 December 2008 – 20 U 3508/08; BaFin, Guidance Notice – Notes regarding the licensing requirements pursuant to section 32 (1) of the German Banking Act (Kreditwesengesetz – KWG) in conjunction with section 1 (1) and (1a) of the KWG for conducting cross-border banking business and/or providing cross-border financial services, 5 April 2005; see also Bundesverwaltungsgericht (German Federal Administrative Court), Judgment of 22 April 2009 – 8 C 2/09, 133 Entscheidungen des Bundesverwaltungsgerichts 358 para. 36; Bundesgerichtshof (German Federal Supreme Court), Judgment of 7 July 2015 – VI ZR 372/14, Neue Juristische Wochenschrift Rechtsprechungs-Report 1144 para. 23 (2015).

[35] See Article 4 (1) (a) and Article 14 Regulation (EU) No. 1024/2013 ('SSM Regulation') in conjunction with Article 78 Regulation (EU) No 468/2014 ('SSM Framework Regulation'); see also Klaus Lackhoff, *How will the Single Supervisory Mechanism (SSM) function? An overview*, Journal of International Banking Law and Regulation, 454 (2013); Brigitte Haar, *Organizing Regional Systems: The EU Example*, in Niam Moloney, Eilís Ferran and Jennifer Payne, *The Oxford Handbook of Financial Regulation* 157 at 180 (Oxford; Oxford University Press, 2015). The licensing procedure for credit institutions is a so-called common procedure under the Single Supervisory Mechanism ('SSM'). Within the SSM, the ECB is competent for the direct supervision of significant credit institutions as regards certain areas of the law. The national competent authorities ('NCA') remain responsible for the supervision regarding all areas of law which are not covered by the SSM and, in addition, for less significant credit institutions. The common procedures, including licensing, withdrawal of licenses and qualifying holding procedures, are an exception from this concept, since the ECB is also competent for the final decision in these procedures regarding less significant credit institutions.

[36] Section 33(1)(1) point 6 of the German Banking Act; see also Article 13(2) CRD IV and Article 5(4) MiFID I.

[37] Article 4(1) point 17 of CRR defines 'branch' as '*a place of business which forms a legally dependent part of an institution and which carries out directly all or some of the transactions inherent in the business of institutions*' (emphasis added); see also John Armour, Dan Awrey, Paul Daies, Luca Enriques, Jeffrey N. Gordon, Colin Mayer and Jennifer Payne, *Principles of Financial Regulation* 628 (Oxford; Oxford University Press, 2016).

institutions being obliged to obtain a license and all other regulatory requirements as if it was a subsidiary.[38]

The European passport provides for an exception from the licensing requirement. Institutions with head offices in the UK are allowed to access the German market for their cross-border business without being required to obtain a license in Germany if they are authorized for the relevant type of business and supervised through the Prudential Regulation Authority ('PRA') or the Financial Conduct Authority ('FCA') and have successfully completed the European passport notification procedure.[39] The passport notification thereby extends the license to the territory of the host Member State.[40] In contrast, the scope of the license, i.e. the services covered by the license, remains identical.[41] If, for example, the institution was solely authorized to provide investment advice, the European passport does not entitle the institution to provide any other investment services in the EEA country in which it established a branch or is allowed to provide cross-border services. It may do so only after having been granted the respective license by the PRA or FCA and, in addition, extended its branch or cross-border passport notification.

One material advantage of the European passport is that a UK institution does not have to establish a subsidiary in an EEA country in order to conduct banking business or provide investment services in that country. It is also not required to have its head office or its legal seat in Germany. This reduction of regulatory requirements under the European passport save time and cost[42] because the institution does not need to establish a newly licensed legal entity under German law – a jurisdiction which the institution might have no experience with and would therefore require enhanced external advice. As the branch is not treated as a separate legal entity, it is not required to have a certain amount of initial capital which, in case of a credit institution, would be EUR 5,0 million[43], whereas investment firms require between EUR 25.000 and EUR 730.000[44]. Moreover, establishing a branch does not require a separate management body,

[38] Section 53(1) of the German Banking Act; see Wolfgang Vahldiek, *§ 53*, in Karl-Heinz Boos, Reinfrid Fischer and Hermann Schulte-Mattler eds, *Kreditwesengesetz, VO (EU) Nr. 575/2013 (CRR)* para. 49 (5th ed.; Munich; C.H. Beck, 2016); Dirk Auerbach, *§ 53*, in Andreas Schwennicke and Dirk Auerbach eds, *Kreditwesengesetz* para. 49 (4th ed.; Munich; C.H. Beck, 2016).
[39] See Section 53b (1)(1) of the German Banking Act.
[40] Cf. Matthias Lehmann and Dirk Zetzsche, *Brexit and the Consequences for Commercial and Financial Relations between the EU and the UK*, European Business Law Review 999 at 1017 (2016).
[41] Cf. George Walker and Robert Purves, *Regulatory Processes – Authorisation, Supervision, and Enforcement*, in George Walker, Robert Purves and Michael Blair eds, *Financial Services Law* 245 (3rd ed; Oxford; Oxford University Press, 2014).
[42] Francisco de la Peña Fernández-Garnelo, *Gentle Brexit, a very British Exit: EEA Membership as the Most Favourable Model to Secure Financial Services Passports*, European Business Law Review 1057 at 1061 (2016).
[43] Section 33(1)(1) point 1(d) of the German Banking Act.
[44] Section 33(1)(1) point 1(a)-(c), (f), (g) of the German Banking Act.

including several board members that fulfill certain regulatory requirements[45], or separate governance arrangements[46]. Due to the principle of home Member State supervision the institution does not entirely[47] have to become familiar with a new, foreign regulator and its individual practises, but will continue its routine with the PRA or FCA.

The institution may conduct cross-border activities by establishing a branch in Germany or provide services (without establishing a branch). Branches under the European passport will not be treated as legally separated institutions with the obligation to obtain a license, but as a legally dependent part of the UK institution.[48] The European passport is, however, limited to the individual licensed institution.[49] In principle, it does not apply to the entity's subsidiaries established in other EEA countries. Such subsidiaries must obtain a separate license if they intend to conduct banking business or provide investment services. Only under specific requirements, the European passport may extend to the activities[50] of subsidiaries of one or more credit institutions.[51] In this case, the subsidiary is not required to hold a license for the purposes of the European passport.[52] It is rather sufficient that the parent undertaking is authorized as a credit institution in the state in which the subsidiary has its head office and certain other criteria are met, for example, the parent CRR credit institution(s) hold(s) at least 90% of the voting rights in the subsidiary.[53]

(d) Institutional Impact of the European Passport

Turning the view towards the institutional impact of the European Passport in more detail, the 'principle of the home Member State supervision' comes into focus. Under this principle, institutions seated in the UK are primarily supervised by PRA or FCA as the competent home Member State supervisory authorities even if the UK institutions target the German market by establishing branches or providing cross-border services or in Germany. The PRA and FCA

[45] Cf. Section 25c of the German Banking Act.
[46] Cf. Section 25a(1) of the German Banking Act.
[47] But see below at 2(d) regarding national provisions in the interests of the general good.
[48] Section 53(1) of the German Banking Act which treats branches of foreign institutions as separate legal entities do not apply in the context of the European passport pursuant to Section 53b(1)(3) of the German Banking Act. relevant provision
[49] Simon Morris, *Financial Services in Practice*, para. 5.51 (Oxford; Oxford University Press, 2016).
[50] Section 53b(7)(1) of the German Banking Act captures banking businesses in terms of Section 1(1)(2) points 1-3, 5, 7-9 of the German Banking Act, financial services in terms of Section 1(1a)(2) points 7, 9 and 10 of the German Banking Act, payments services in terms of the German Payment Services Supervision Act (*Zahlungsdiensteaufsichtsgesetz*) as well as the financial undertakings in terms of Section 1(3) of the German Banking Act.
[51] See Section 53b(7) of the German Banking Act.
[52] National laws may though require that the subsidiary must hold a license. If they do not, the European passport would not be precluded only because the subsidiary has not obtained any license.
[53] See Section 53b(7)(1) point 5 of the German Banking Act.

cooperate closely with BaFin and, with respect to the SSM, the ECB[54] as competent host state supervisory authorities that still retain a 'residual competence' for the supervision of UK institutions under certain circumstances.[55] Prior to commencing cross-border activities, UK institutions therefore need to notify their intention to conduct cross-border activities in Germany towards the PRA or the FCA which will communicate the outward passporting notification to BaFin. The requirements and the procedures for passporting notifications differ between the establishment of branches and the provision of services which we will turn next.

(i) The Establishment of UK Branches in Germany (Outward Passporting)

Credit institutions and PRA-designated investment firms[56] must notify their intention to establish a branch to the PRA. Investment firms which are not 'PRA-designated' must notify the FCA as their competent home state supervisory authority.[57] The notification includes, *inter alia*, a program of operations, details on the structural organisation of the branch and on the professional experience of the persons responsible for the management of the branch, or a profit and loss forecast[58]. The branch notification form for credit institutions is provided by Commission Implementing Regulation (EU) No 926/2014[59], for PRA-regulated firms – other than credit institutions – by Appendix 1a of the passporting rules in the PRA Rulebook[60] and for FCA-regulated firms by SUP 13 Annex 1 R of the FCA Handbook.[61]

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[54] In this context, the ECB is competent for the supervision of branches of credit institutions established in non-participating Member States, i.e. EEA countries that do not fall within the scope of the SSM (Article 14(1) of the SSM Framework Regulation). Branches from the UK that qualify as significant do not exist in Germany. However, branches of Barclays Bank plc may serve as an example as they are supervised by the ECB in France and Italy.

[55] See Wolfgang Vahldiek, *§ 53b*, in Karl-Heinz Boos, Reinfried Fischer and Hermann Schulte-Mattler eds, *Kreditwesengesetz, VO (EU) Nr. 575/2013 (CRR)* para. 61 (5th ed.; Munich; C.H. Beck, 2016); 8 (127th suppl.; Heidelberg; C.F. Mueller, 2007); Christoph Ohler in Peter Derleder, Kai-Oliver Knops and Hermann Heinz Georg Bamberger eds, *Handbuch zum deutschen und europäischen Bankrecht*, § 76 para. 39 (2nd ed.; Vienna; Springer, 2009; Dirk Auerbach, *Banken- und Wertpapieraufsicht*, 21 (Munich; C.H. Beck, 2015).

[56] It concerns investment firms which are supervised by the PRA. The requirements are stipulated in Section 3(2) and (3) of the Financial Services Markets Act 2000 (PRA-regulated Activities) Order. Also see the Statement of Policy, Designation of investment firms for prudential supervision by the Prudential Regulation Authority, March 2013 (available on: http://www.bankofengland.co.uk/publications/Documents/other/pra/designationofinvestmentfirms.pdf, (last access on 16 January 2017).

[57] Schedule 3 para. 19(2) of the Financial Services and Markets Act 2000 ('FSMA') for the establishment of a branch and Schedule 3 para. 20(1) of the FSMA for the exercise to provide services.

[58] For credit institutions see Article 3 of the Commission Delegated Regulation (EU) No 1151/2014 of 4 June 2014 (OJ L 309, 30 October 2014, 1); the required information for PRA-regulated firms, other than credit institutions, are provided by the branch notification form in Appendix 1a of the passporting rules in the PRA Rulebook and for FCA-regulated firms by SUP 13 Annex 1 R of the FCA Handbook.

[59] Commission Implementing Regulation (EU) No 926/2014 of 27 August 2014 (OJ L 254, 28 August 2014, 2).

[60] Available on: http://www.bankofengland.co.uk/pra/Documents/authorisations/passporting/branchnotificationform.pdf (last access on 4 January 2017).

[61] Available on: https://www.handbook.fca.org.uk/form/sup/SUP_13_ann_01_20160101.pdf (last access on 4 January 2017).

After receipt of the notice of intention, the PRA or the FCA assess the adequacy of the administrative structure and the financial situation of the credit institution[62] or investment firm.[63] If the PRA or the FCA reach the necessary degree of comfort with regard to these conditions, they will, within three month after receipt of the passport notification from the institution, forward the relevant documentation together with the so-called 'consent notice' to BaFin[64] and inform the credit institution or investment firm accordingly.[65] As the responsible authority for the effective and consistent functioning of the SSM[66], the ECB will only get involved if a UK credit institution exercises its passporting right.[67] In such a case, BaFin will then notify the ECB of the receipt of the relevant documentation from the PRA.[68] If the branch of a UK credit institution is classified as significant, the ECB as competent supervisory authority within the SSM informs the UK institution about the national conditions[69] which are applicable to the branch in Germany in the interests of the general good.[70] They include, *inter alia*, the reporting of loans of at least EUR 1.0 million[71] or of financial information[72], each at branch level. In case of less significant branches of UK credit institutions[73] or branches of UK investment firms, BaFin informs the institution about the applicable national conditions in the interests of the general good.[74]

Since the PRA or the FCA are the national competent authorities of the home Member State, neither BaFin nor the ECB assess the adequacy of the administrative structure or the financial

[62] See Article 35(3) CRD IV, Schedule 3 para. 19(6) of the FSMA; the PRA or FCA may also question the reputation, qualifications or experience of the directors or managers of the firm or the person proposed as the branch's authorized agent for the purposes of those directives pursuant to Schedule 3 para. 19(7)(b) of the FSMA.

[63] See Article 35(3) of Directive (EU) No. 65/2014 ('Markets in Financial Instruments Directive II', 'MiFID II').

[64] The notification will be submitted to BaFin as NCA within the SSM as set out in Article 13(1) of the SSM Framework Regulation for CRR credit institutions and for investment firms pursuant to Article 35(3) of MiFID II (for UK institutions the national provision is stipulated in Schedule 3 para. 19(4) of the FSMA).

[65] Schedule 3 para. 19(7B) of the FSMA for investment firms and Schedule 3 para. 19(6) of the FSMA for credit institutions do not require that the notification ('notice of intention' pursuant Schedule 3 para. 19(2) of the FSMA) has, within three months of receipt of the information by the credit institution, to be communicated to the competent authorities of the host Member States, but this results from an interpretation in conformity with the directive pursuant Article 35(3)(1) of CRD IV (similar requirements are provided by Article 32(3) of MiFID I and Article 35(3) of MiFID II for investment firms).

[66] Article 6(1)(2) of the SSM Regulation.

[67] Klaus Lackhoff, *The Framework Regulation for the Single Supervisory Mechanism*, International Company and Commercial Law Review 18 at 25 (2015) refers to this as the '*out-in scenario*'.

[68] See Article 13(1) SSM Framework Regulation.

[69] Where the relevant Union law is composed of Directives, the ECB applies the national legislation transposing those Directives (Articl 4(3) of the SSM Regulation).

[70] Article 4(2) of the SSM Regulation and Article 13(2) of the SSM Framework Regulation.

[71] Section 22 and 23 of the German Banking Act.

[72] Section 25 of the German Banking Act.

[73] BaFin is only competent for the supervision of UK branches which are less significant based on the criteria laid down in Article 6 of the SSM Regulation and Articles 39-72 of the SSM Framework Regulation (Article 13(2) of the SSM Framework Regulation).

[74] See Section 53b(2)(1) of the German Banking Act and Article 36(1) of CRD IV.

situation of the institution nor are they allowed to make objections to the exercise of the passporting rights.[75]

The branch of a credit institution may be established on receipt of a letter from the ECB or BaFin. This piece of communication also includes the German laws applicable to the branch in the interest of the general good. Alternatively, the branch can be set up two months after BaFin has received the branch notification by the PRA or FCA.[76] In case of an investment firm, BaFin is exclusively competent and the two-month period already starts to run after the transmission of the branch notification by the PRA or FCA to BaFin.[77]

(ii) The Freedom to Provide Services

Like in case of establishing a branch, UK institutions may exercise the freedom to provide services only after they have given the PRA or FCA specified notice of their intention to provide cross-border services.[78] This outward notification typically requires less information than the branch notification as they primarily only include the intended activities, whereas organizational information on the structure of a branch or the details of professional experience of the persons responsible for the management do not have to be submitted.[79] The cross-border services notification form for credit institutions is provided by Annex V of Commission Implementing Regulation (EU) No 926/2014, for PRA-regulated firms – other than credit institutions – by Appendix 1ab of the passporting rules in the PRA Rulebook[80] and for FCA-regulated firms by SUP 13 Annex 2 R of the FCA of SUP 13.[81]

The PRA or FCA will forward the cross-border services notification to BaFin within a one-month period.[82] If the notification is submitted by a credit institution, BaFin must immediately inform

[75] See above at 2(a).
[76] Section 53b(2)(2) of the German Banking Act, Article 36(2) of CRD IV.
[77] Section 53b(2)(2) of the German Banking Act does not differentiate between credit institutions and investment forms, but it has to be interpreted in accordance with Article 32(6) of MiFID I which refers to the 'transmission of the communication by the competent authority of the home Member State'.
[78] Simon Morris, *Financial Services in Practice*, para. 5.79 (Oxford; Oxford University Press, 2016).
[79] For credit institutions see Article.5 of the Commission Delegated Regulation (EU) No 1151/2014 of 4 June 2014 (OJ L 309, 30 October 2014, 1). In addition to a programme of operations, investment firms must notify if they intend to use tied agents in the territory of host Member State (Article 31(2)(b) of MiFID I). The required information for PRA-regulated firms, other than credit institutions, are provided by the branch notification form in Appendix 1b of the passporting rules in the PRA Rulebook and for FCA-regulated firms by SUP 13 Annex 2 R of the FCA Handbook.
[80] Available on: http://www.bankofengland.co.uk/pra/Documents/authorisations/passporting/crossborderservicesnotificationform.pdf (last access on 4 January 2017).
[81] Available on: https://www.handbook.fca.org.uk/form/sup/Sup13_Ann2_20130401.pdf (last access on 4 January 2017).
[82] Schedule 3 para. 20(3) of the FSMA; Article 15 SSM Framework Regulation in conjunction with Article 39(2) of CRD IV and Article 31(3)(1) of MiFID I.

the ECB as the competent host state authority[83] on the receipt of notification.[84] While credit institutions are allowed to commence their notified cross-border activities as soon as they have informed PRA or FCA about their intention,[85] investment firms must wait until the PRA or FCA have forwarded the notification to BaFin before they start to provide services.[86]

(iii) Residual Powers of BaFin and ECB

Due to 'principle of the home Member State supervision' BaFin and the ECB are not competent for supervisory measures against the UK institutions, because the PRA or the FCA remain the responsible supervisory authority and receive supervisory reports as well as other relevant information. Cross-border activities in the passported territory are treated basically as if they are conducted in the UK and are therefore supervised in the same way as domestic activities. For this reason, the PRA or FCA may, after having first notified BaFin or the ECB[87], verify the information required for the prudential supervision of the branch, on their own or through their representative agents.[88] At the same time, the PRA and FCA generally collaborate closely with BaFin and the ECB in order to supervise cross-border activities of UK institutions in Germany. For this reason, they supply each other with all information which is required for the purposes of complying with their supervisory duties.[89]

The CRD IV and MiFID I still confer certain residual powers on BaFin and the ECB as host state authorities. For example, they may, after consulting the PRA or FCA, carry out on-the-spot checks and inspections of the activities carried out by UK branches in Germany and require information from a branch about its activities and for supervisory purposes.[90] If BaFin or the

[83] The ECB is competent irrespective of the size of the UK credit institution and of the size of its activities in Germany (Article 4(2) of the SSM Regulation and Article 16(1) of the SSM Framework Regulation). See Klaus Lackhoff, *The Framework Regulation for the Single Supervisory Mechanism*, International Company and Commercial Law Review 18 at 26 (2015).

[84] Article 15(2) of the SSM Framework Regulation.

[85] See European Commission, Commission interpretative communication, Freedom to provide services and the interest of the general good in Second Banking of 20 June 1997 (OJ C 209, 10 July 1997, 13); Wolfgang Vahldiek, *§ 53*, in Karl-Heinz Boos, Reinfrid Fischer and Hermann Schulte-Mattler eds, *Kreditwesengesetz, VO (EU) Nr. 575/2013 (CRR)* para. 30 (5th ed.; Munich, 2016); Till Brocker, *§ 53b*, in Andreas Schwennicke and Dirk Auerbach eds, *Kreditwesengesetz* para. 30 (4th ed.; Munich, 2016); a provision similar to Article 31(3)(2) of MiFID I (respectively Article 34(3) of MiFID II) is not stipulated in the CRD IV. FSMA stipulates this requirement for a credit institution to commence with its business in Schedule 3 para. 20(1).

[86] See Article 31(3)(2) of MiFID I.

[87] The ECB is competent for significant branches of UK credit institutions (Article 14(1) of the SSM Framework Regulation).

[88] Section 53b(6) of the German Banking Act.

[89] Article 52(1)(2) of CRD IV and Article 58(1) of MiFID I; while cases of inward passporting to the UK is stipulated by Section 8(3)(7) of the German Banking Act, there is no express provision which requires BaFin to exchange information with the PRA or FCA in case of outward passporting.

[90] Section 53b(3)(1) point 8, (11) and Section 44(1) of the German Banking Act, Article 52(3) of CRD IV, Article 57(1) of MiFID I.

ECB ascertain that a UK institution does not fulfill its regulatory obligations under the national conditions in the interests of the general good[91] or the CRR, or that it is very likely that the institution will not fulfil its obligations, they first must inform the PRA or the FCA accordingly.[92] Only if the PRA or FCA fail to take any measures, if measures taken by them prove to be insufficient[93], or in urgent cases, BaFin or the ECB are allowed to take measures vis-á-vis the UK institution.[94] If the PRA or the FCA disagree about the procedure or content of actions taken by BaFin or the ECB, they may request the assistance of the European Banking Authority (EBA)[95] as regards credit institutions or the European Securities and Markets Authority (ESMA)[96] as regards investment firms in reaching an agreement.

3. Consequences of Brexit Concerning the European Passport

(a) Non-application of the EU Treaties

If an agreement between the UK and the EU cannot be reached, the EU Treaties will automatically cease to apply two years after the UK's notification of its intention to withdraw from the EU.[97] As secondary and tertiary EU acts will lose their legal basis in the EU Treaties, they will likewise no longer apply to the UK.[98] In terms of the passporting rights, this concerns the CRR[99], CRD IV and MiFID I on the one hand, the Commission Implementing Regulation (EU) No 926/2014 and Commission Delegated Regulation (EU) No 1151/2014 providing the required information and standard forms for passport notifications for credit institutions on the other hand. In contrast, national laws implementing the CRD IV and the MiFID I will remain unaffected by the withdrawal.[100] Only the effects of EU directives on implementing national laws will cease to apply.[101] If UK national laws remain unchanged, EEA institutions – other than UK

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[91] See supra at 2(d).
[92] Section 53b(4)(1) of the German Banking Act, Article 41(1)(1) of CRD IV, Article 62(1)(1) of MiFID I.
[93] Section 53b(4)(2) of the German Banking Act.
[94] Section 53b(5)(1) of the German Banking Act.
[95] Article 19(1) of Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 (OJ L 331, 15 December 2010, 12).
[96] Article 19(1) of Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 (OJ L 331, 15 December 2010, 84).
[97] Article 50(3) of the TEU.
[98] See Dierk Booß, *Art. 50 EUV*, in Carl-Otto Lenz and Klaus-Dieter Borchardt eds, *EU-Verträge* para. 3 (6th ed.; Cologne; Bundesanzeiger, 2013); Alexander Thiele, *Der Austritt aus der EU – Hintergründe und rechtliche Rahmenbedingungen eines „Brexit"*, Europarecht 281 at 301 (2016).
[99] Although ithe CRR does not directly stipulate the requirements and the procedure for the passporting regime, it is part of the harmonized supervisory law as basis for the 'principle of mutual recognition' and the 'country of origin principle' (see supra at 2(a)).
[100] See Alexander Thiele, *Der Austritt aus der EU – Hintergründe und rechtliche Rahmenbedingungen eines „Brexit"*, Europarecht 281 at 301-2 (2016).
[101] As far as national UK law which contradicts European law is currently not applied because of the primacy of European law, it will become applicable again after the Brexit. European directives will no longer have an impact on the UK. UK will no longer be required to implement requirements set forth in European directives. UK law will

institutions – may still have access to the UK market as long as the FMSA entitles them to apply passporting rights in the UK.[102] However, UK institutions will only continue to have privileged access to the Single Market as long as the UK remains part of the EEA – a question which, legally, appears to be difficult to answer.[103]

(b) Withdrawal From the EEA

Legal analyses of Brexit generally assume that the UK's EEA membership will be terminated *ipso iure*, should the UK decide to withdraw from the EU.[104] It must, however, be noted that, the EEA Agreement[105] was concluded as a 'mixed agreement'. On the 'EU side', it therefore neither comprises only the EU nor only its Member States as Contracting Parties, but rather the EU *and* each of its individual Member States including the UK as an individual Contracting Party.[106] The EEA membership will only be terminated if the UK government chooses to unilaterally withdraw from the EEA pursuant to Article 127(1) of the EEA Agreement.[107] A notification under Article 50 of the TEU, by contrast, cannot be interpreted as also resulting in a withdrawal from the EEA, *inter alia*, because it would prevent the three EFTA States within the EEA (Iceland, Liechtenstein and Norway) that are not parties to the TEU from trading with the UK – a result which would contravene the principle of '*pacta tertiis nec nocent nec prosunt*' as enshrined in Article 34 of the VCLT.[108]

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no longer have to be interpreted in conformity with European directives. If European directives were not fully implemented, a potential direct application of these directives will no longer have to be considered.

[102] Heinrich Nemeczek and Sebastian Pitz, *Die Auswirkungen des Brexit auf den Europäischen Pass für CRR-Kreditinstitute und Wertpapierhandelsunternehmen*, Wertpapier-Mitteilungen 120 at 126-7 (2017).

[103] See also John Armour, *Brexit to the EEA: What Would it Mean?*, Oxford Business Law Blog, July 2016.

[104] See, *inter alia*, House of Commons Library, Research Paper 13/42, 19; Marc-Philippe Weller, Chris Thomale and Nina Benz, *Englische Gesellschaften und Unternehmensinsolvenzen in der Post-Brexit-EU*, Neue Juristische Wochenschrift 2380 (2016); The Law Society of England and Wales, *The EU and the Legal Sector* 6 (October 2015); Alexander Wolff, *Europäische Betriebsräte nach dem Brexit*, Betriebs-Berater 1784 (2016); Christoph Bode, Jan Bron, Barbara Fleckstein-Weiland, Marcus Mick and Manfred Reich, *Brexit – Tax it?*, Betriebs-Berater 1367 (2016); Sarah Garvey, Karen Birch and Maeve Hanna, *Brexit – legal consequences for commercial parties*, May 2016, 3; Jean-Claude Piris, *If the UK votes to leave*, Centre for European Reform, January 2016, 4.

[105] Agreement on the European Economic Area (OJ L 1, 3 January 1994, 3) ('EEA Agreement').

[106] See the Preamble and Article 2(c) of the EEA Agreement.

[107] Ulrich G. Schroeter and Heinrich Nemeczek, The (Uncertain) *Impact of Brexit on the United Kingdom's Membership in the European Economic Area*, European Business Law Review 921 at 926-8 (2016); but see John Armour, Holger Fleischer, Vanessa Knapp and Martin Winner, *Brexit and Corporate Citizenship*, working paper, January 2017, 12.

[108] Article 34 of the VCLT is a rule of customary law; see ECJ, Judgment of 25 February 2010, Case C-386/08 [2010] ECR I-1289, paras 42, 44 – *Brita*; Alexander Proelss, *Article 34*, in Oliver Dörr and Kirsten Schmalenbach eds; *Vienna Convention on the Law of Treaties: A Commentary* para. 4 (Berlin, Heidelberg; Springer 2012); Villiger, Commentary on the 1969 Vienna Convention on the Law of Treaties 472 (Leiden, Boston; Martinus Nijhoff, 2009); see also ECJ, Judgment of 23 January 2014, Case C-537/11, para. 44 – *Manzi and Compagnia Naviera Orchestra*.

Passporting rights require institutions to have their place of business, at least, in the EEA, but not necessarily in the EU.[109] If the post-Brexit UK remained in the EEA, UK institutions would therefore continue to have passporting rights in other EEA countries, and institutions from other EEA countries would *vice versa* still have privileged access to the UK financial market (inward passporting).[110]

Difficulties could nevertheless arise in this context because passporting rights implicitly presuppose that (minimum) harmonized standards of financial regulation apply to all institutions concerned.[111] Domestic laws therefore make a passport dependent on the foreign financial institution e.g. being '*supervised by the competent authorities of the home State in accordance with the directives issued by the European Union*'.[112] Whether the latter requirement is fulfilled in the UK may be doubted once Brexit has taken place: Although CRR, CRD IV and MiFID I are all EU legal acts with EEA relevance[113], only the MiFID I has yet been incorporated into Annex IX of the EEA Agreement, where EU secondary law on financial services applicable in the EEA is listed.[114] In contrast, the Annex mentions neither CRR nor CRD IV as being part of EEA law, and supervisory authorities of the EEA's 'non-EU pillar' accordingly do not have to act in accordance with these directives. However, it may be assumed that the CRR and CRD IV will have been included in Annex IX of the EEA Agreement at the time of Brexit.[115] As far as the CRD IV is concerned, its rules have already been implemented into UK domestic law. As long as the UK legislator would leave the implementing provisions in force after Brexit, with UK law accordingly exceeding the requirements of the then applicable EEA law, no difficulties should arise. The situation would be somewhat more complex as far as CRR would be concerned,

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[109] See e.g. Section 53b(1) first sentence of the German Banking Act; Schedule 3 point 12(1) of the FSMA. According to the EBA, the term 'Member States' in the CRR and the CRD IV generally includes the EEA countries 'as a mtter of principle' (EBA, Single Rulebook Q&A, Article 4 of CRR, Question ID 2013_233). As a text with EEA relevance, the same must apply *mutatis mutandis* to the MiFID I.

[110] This is based on that assumption that Schedule 3 Part II of the FSMA setting out the requirements for the exercise of passporting rights in the UK remains in force without any changes; see also Matthias Lehmann and Dirk Zetzsche, *Brexit and the Consequences for Commercial and Financial Relations between the EU and the UK*, European Business Law Review 999 at 1017 (2016); Francisco de la Peña Fernández-Garnelo, *Gentle Brexit, a very British Exit: EEA Membership as the Most Favourable Model to Secure Financial Services Passports*, European Business Law Review 1057 at 1082 (2016).

[111] Cf. Markus Möstl, *Preconditions and Limits of Mutual Recognition*, 47 Common Market Law Review 413–8 (2010); Christine Janssens, *The Principle of Mutual Recognition* 88 (Oxford; Oxford University Press 2013).

[112] Section 53b(1)(1) of the German Banking Act (translation by the authors).

[113] See Francesco A. Schurr and Johannes Gasser, *Financial Services Law*, in Carl Baudenbacher ed, *The Handbook of EEA Law* 667–8 (Cham, Heidelberg, New York, Dordrecht, London; Springer, 2016) on MiFID I; see also Georges Baur, *Decision-Making Procedure and Implementation of New Law*, in *The Handbook of EEA Law* 45 at 53-6 (Carl Baudenbacher ed.; Cham, Heidelberg, New York, Dordrecht, London; Springer, 2016) on the notion of EEA relevance.

[114] Point 31ba of Annex IX of the EEA Agreement.

[115] Heinrich Nemeczek and Sebastian Pitz, *Die Auswirkungen des Brexit auf den Europäischen Pass für CRR-Kreditinstitute und Wertpapierhandelsunternehmen*, Wertpapier-Mitteilungen 120 at 125-6 (2017).

because its provisions would simply cease to apply in the UK at the moment Brexit takes effect, given that it is a directly applicable EU regulation (Article 288(2) of the TFEU) that has never been transposed into UK law. The UK legislator would therefore need to make the CRR's rules a part of post-Brexit UK domestic law in order to guarantee an EU-equivalent standard of supervision. It could do so, for example, by declaring the CRR applicable to institutions who wish to use passporting rights (possibly offering a second 'lighter touch' regime for institutions not interested in a passport), provided that such a declaration is sufficiently clear and precise.[116]

(c) Loss of the Privilege of the European Passport due to the Withdrawal from the EU and the EEA

If the UK withdrew from both the EU and the EEA, it would become a third country.[117] UK institutions would no longer be allowed to apply the European passport.[118] Cross-border activities of UK institutions would therefore become subject to the licensing requirement in Germany. Branches of UK institutions would be regarded as third-country branches and would be required to apply for a separate German license.[119]

The situation would be similar to the expiry of a license and should thus be treated by analogy with Sections 35 and 38 of the German Banking Act.[120] Once the European passport is no longer

[116] For the correct transposition of a directive into domestic law see ECJ, Judgment of 28 February 1991, Case C-131/88 [1991] ECR I-865, para. 6 – *Commission v. Germany*; ECJ, Judgment 30 May 1991, Case C-361/88 [1991] ECR I-2596, para. 15 – *Commission v. Germany*; ECJ, Judgment of 13 December 2007, Case C-418/04 [2007] ECR I-10997, para. 158 – *Commission v. Ireland*.

[117] Eilís Ferran, *The UK as a Third Country Actor in EU Financial Services Regulation*, University of Cambridge Faculty of Law Working Paper No 47/2016, September 2016, 3. Though the CRR, CRD IV and MiFID I do not expressly define the term 'third country', it is generally recognised that it includes states that are not Member States of the EU or the EEA, while the term 'Member States' include EU and EEA countries (see EBA, Single Rulebook Q&A, Article 4 of CRR, Question ID 2013_233). Article 4(1)(57) of MiFID II accordingly defines 'third-country firm' as '*a firm that would be a credit institution providing investment services or performing investment activities or an investment firm if its head office or registered office were located within the Union*'. As a text with EEA relevance, the MiFID II will also be included in Annex IX of the EEA Agreement, where EU secondary law on financial services applicable in the EEA is listed, thereby obliging the EFTA States of the EEA to implement the MiFID II. 'Union' as referred to in Article 4(1)(57) of MiFID II will thereby include all EEA countries, i.e. the three EFTA States Iceland, Liechtenstein and Norway alongside the EU and its Member States.

[118] Niamh Moloney, *Brexit: An Uncertain Future for the City?*, 17 German Law Journal 75 at 77 (2016).

[119] See Section 53(1) of the German Banking Act. An authorization procedure for a branch of a non-EEA institution also falls within the exclusive remit of BaFin. The SSM Regulation does not apply to branches from non-EEA banks as they are not qualified as credit institutions. Even though third-country firms are not explicitly excluded from the wording of Article 4(1) of CRR, in light of the general scheme of the regulation and, in particular Article 23 of CRR, the term credit institutions is to be understood as encompassing only EEA institutions. See Klaus Lackhoff, *The Framework Regulation for the Single Supervisory Mechanism*, International Company and Commercial Law Review 18 at 26 (2015); Bernd Geier, *Der Einheitliche Aufsichtsmechanismus*, in Uwe Jahn, Christian Schmitt, Bernd Geier, *Handbuch Bankensanierung und -abwicklung* A.II. para. 99 (1st ed.; Munich; C.H. Beck, 2016).

[120] Heinrich Nemeczek and Sebastian Pitz, *Die Auswirkungen des Brexit auf den Europäischen Pass für CRR-Kreditinstitute und Wertpapierhandelsunternehmen*, Wertpapier-Mitteilungen 120 at 126 (2017).

available, only ongoing services may be processed, while the provision of new services will not be allowed without taking alternative steps, such as applying for a license or exemption.[121]

4. Withdrawal Agreement

The impact of the withdrawal of the UK from the EU and the EEA on cross-border business of UK institutions would largely depend on the outcome of the negotiations between the EU and the UK. It is difficult to predict the content of the withdrawal agreement between the UK and the EU, because no precedents exist and the wording of Article 50 TEU remains vague.

We would expect that the UK would be interested in maintaining the framework regarding the European passport. However, not only will EU politicians keep insisting that the European passport will only remain available in exchange for the free movement of persons and workers, but cross-border activities of UK institutions should also be supervised in accordance with the relevant European regulations and directives as key element of the European passport – a requirement which, though, may become problematic if the UK withdraws from the EU and thereby loses its influence on EU legislation.

5. Potential Alternatives

UK institutions, including US and other non-EEA groups that currently use UK institutions as their main EEA hub[122], must rethink their approach to access the EEA markets. They consider existing alternative forms of market access, but also observe upcoming changes in EU financial regulation. UK institutions and non-EEA groups intend to be prepared – well before the outcome of Brexit negotiations becomes clear – for a scenario in which the continuance of the European Passport for institutions from the UK cannot be agreed upon. This scenario is commonly referred to as the 'hard Brexit' describing that the UK will give up its access to the European Single Market.[123]

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[121] See below at 5.

[122] Charles Goodhart and Dirk Schoenmaker, *The Global Investment Banks are now all Becoming American: Does that Matter for Europeans?,* Journal of Financial Regulation 171 (2016).

[123] One might even argue that such forecasts and scenario planning is required from a risk management perspective. See in more detail on the impact of Brexit on the UK economy John Armour, *Brexit and Financial Services*, working paper, January 2017.

(a) Establishment of a New EEA Hub

In order to establish a new EEA hub, UK institutions, in principle, have to use existing German or other EEA subsidiaries, or establish a new licensed subsidiary either in Germany[124] or in another EEA country in accordance with the relevant national laws. Such a new EEA hub is eligible for the European passport and can engage in cross-border activities across the EEA. The business of EEA branches of UK institutions would have to be transferred to the new EEA hub. The principal methods for the transfer of business comprise the statutory court transfer mechanism for banking business under Part VII of the FSMA, the conclusion of an intra-group transfer agreement, a novation of contracts, the establishment of a Societas Europaea (SE) in the UK[125] with a subsequent move of its seat[126], a cross-border merger of a UK institution into an EU institution[127], or an asset deal. The specific transfer mechanism to be chosen (or a combination of them) depends, *inter alia*, on the amount and type of business and client relationships to be transferred.

The rules for the European passport apply *mutatis mutandis* to the new EEA hub. In this context, it is often mentioned that it is expensive to move and that banking staff is reluctant to leave London. Therefore, one main questions is to which extent it would be required to move the management and operations to Germany in order to meet the requirements for a head office.[128] The term 'head office' is commonly understood as the place from where an institution is effectively managed.[129] This interpretation is in line with the interpretation of the term 'administrative

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[124] Investment firms must apply for a license with BaFin. After receipt of the application, BaFin assesses whether or not to grant a license. Credit institutions must also apply for a license with BaFin. However, BaFin forwards the application to the ECB. While BaFin assesses whether the application complies with all the requirements set up by national law it is up to the ECB to assess the compliance with EU law. A license will in effect only be granted if both the NCA and the ECB come to the conclusion that all relevant provisions are adhered to.

[125] The SE is an attractive legal form for Anglo-Saxon institutions as it allows to mitigate workers' participation and can be established with a one-tier board. Typically, a German stock company (*Aktiengesellschaft*) has a two-tier board. A precedent for an investment firm set up as a one-tier board SE is Schnigge Wertpapierhandelsbank SE, see https://www.schnigge.de/investor-relations/corporate-governance.html (last access on 16 January 2017).

[126] A move of seat for an institution established as an SE from UK to Germany is an unprecedented act. However, the necessary steps for such a transfer, e.g. obtaining a new authorization in Germany, similarly arise in the context of a move of seat of an (re-)insurance undertaking. An undertaking of Munich RE group, Great Lakes Insurance SE moved its seat from London to Munich (Germany) in December 2016, see https://www.munichre.com/site/corporate/get/documents_E3265923/mr/assetpool.shared/Documents/7_Great%20Lakes%20UK/About%20Us/Letter-relocation-of-Great-Lakes.pdf (last access on 16 January 2017).

[127] A recent example for such a transaction is the cross-border SE merger of a Luxembourg, Italian, Spanish and Dutch credit institution into UBS Deutschland AG that was renamed into UBS Europe SE in December 2016, see http://www.reuters.com/article/ubs-group-eu-wealth-idUSL8N1DW4BQ (last access on 16 January 2017).

[128] See Section 33(1) point 6 of the German Banking Act, Article 13(2)(a) of CRD IV, Article 5(4) of MiFID I.

[129] See Sven Müller-Grune, *§ 33*, in Heinz Beck, Carl Theodor Samm and Axel Kokemoor eds, *Kreditwesengesetz* para. 80 (Heidelberg; C.F. Mueller, December 2015).

headquarters' (*Verwaltungssitz*) in German corporate law.[130] If management takes place from different locations, the head office is typically the place where most of the management activities take place and/or the place where the legal representatives of the institution, i.e. its executive directors, have their (main) office.[131] In the words of BaFin, the head office shall be the place where the institution's executive directors have their office and where the firm's main business is carried on and its main decisions on risk policies are taken.[132] The main reason for requiring that a credit institution or investment firm has its head office and its registered office in the same EEA country is to ensure that the institution's home state prudential regulator has easy and direct access to the institution's senior management, books and records.[133] In practice, BaFin expects that the heads on the main business areas and also the heads of legal, compliance, AML and internal audit[134] have their main offices in Germany. Therefore, senior decision-makers and control functions should be located in Germany. However, significant parts of the front office personnel and commercial activities, especially sales and trading, investment banking, wealth management and private clients are allowed to remain located in London.

Another frequently raised question is to which degree the new German EEA hub may rely on services provided by the UK institution as outsourcing provider. Under German law, the admissible amount of outsourcing must be determined on a case-by-case basis.[135] However, it should at any time be assured that the members of the managing board are able to fulfil their managerial duties[136], for example, by retaining responsibility for outsourced functions and a sufficient minimum number of employees.

[130] See Sven Müller-Grune, *§ 33*, in Heinz Beck, Carl Theodor Samm and Axel Kokemoor eds, *Kreditwesengesetz* para. 80 (Heidelberg; C.F. Mueller, December 2015). Under German company law, the administrative headquarters are deemed to be located where the management body of an undertaking takes its fundamental business decisions and develops implementation strategies for these decisions, see Bundesgerichtshof (German Federal Supreme Court), Judgment of 10 March 2009 – VIII ZB 105/07, Neue Juristische Wochenschrift 1610 (2009); Bundesgerichtshof (German Federal Supreme Court), Judgment of 21 March 1986 – V ZR 10/85, Neue Juristische Wochenschrift 2194 (1986).

[131] See Sven Müller-Grune, *§ 33*, in Heinz Beck, Carl Theodor Samm and Axel Kokemoor eds, *Kreditwesengesetz* paras. 79-82 (Heidelberg; C.F. Mueller, December 2015); Reinfrid Fischer and Christian Müller, *§ 33*, in Karl-Heinz Boos, Reinfrid Fischer and Hermann Schulte-Mattler eds, *Kreditwesengesetz, VO (EU) Nr. 575/2013 (CRR)* para. 23 (5th ed.; Munich, 2016); Andreas Schwennicke, *§ 33*, in Andreas Schwennicke and Dirk Auerbach eds, *Kreditwesengesetz* para. 56 (4th ed.; Munich, 2016); Herbert Zerwas and Mathias Hanten, *Zulassung zum Geschäftsbetrieb für Kredit- und Finanzdienstleistungsinstitute*, Betriebs-Berater 2481 at 2486 (1998).

[132] BaFin, Interpretation Aid on Article 2 of the German Bank Separation Act, 14 December 2016, para. 53.

[133] More generally, this requirement is intended to ensure an efficient supervision through the home state regulator, see Gunnar Schuster and Jens-Hinrich Binder, *Die Sitzverlagerung von Finanzdienstleistern in der EU*, Wertpapier-Mitteilungen 1665 at 1668-9 (2004).

[134] And potentially other risk and compliance functions.

[135] Section 25b of the German Banking Act, AT 9 of the BaFin Minimum Supervisory Requirements to Risk Management (*MaRisk*).

[136] See CEBS, Guidelines on Outsourcing, 14 December 2006, Guideline 4.2.(a) and AT 9.4 of the BaFin Minimum Supervisory Requirements to Risk Management.

Only the establishment of a new EEA hub allows UK institutions, including US and other non-EEA groups that currently use UK institutions as their main EEA hub, to carry out business in a similar way as they have done before Brexit. This solution, though, leads to an additional regulatory burden and triggers costs that may only be acceptable for UK institutions with a substantial book of EEA business. For UK institutions that are only engaged with EEA clients to a limited extent, other alternatives set out below may be more suitable.

(b) Establishment of a Third-country Branch

Alternatively, UK institutions could opt for the establishment of a third-country branch in Germany which would, however, be treated as a separate legal entity for banking regulatory purposes and require its own separate authorization.[137] A third-country branch established in Germany is subject to similar regulatory requirements as a subsidiary. At the same time, third-country branches cannot be used as EEA hubs as they are not eligible for the European passport.[138] This means that establishing a third-country branch is the less attractive option compared to setting up a new EEA hub.

(c) German National Exemption

Another option is to apply for an exemption from the licensing requirement for cross-border services.[139] This presupposes that BaFin comes to the conclusion that the non-EEA institution does not have to be supervised in Germany.[140] Broadly speaking, a BaFin exemption is available if the institution is subject to effective supervision in accordance with international standards, and the collaboration between BaFin and the home state supervisory authority is ensured.[141] An institution from a non-EEA country applying for an exemption must provide a certificate issued by its home state supervisory authority that sets out that the institution holds a valid license for the banking and investment services which it intends to provide on a cross-border basis and that no prudential concerns against the provision of these services in Germany exist. Should such

[137] Section 53 of the German Banking Act.

[138] Wolfgang Vahldiek, *§ 53*, in Karl-Heinz Boos, Reinfrid Fischer and Hermann Schulte-Mattler eds, *Kreditwesengesetz, VO (EU) Nr. 575/2013 (CRR)* para. 42 (5th ed.; Munich, 2016).

[139] Section 2(4) of the German Banking Act.

[140] See Section 2(4) of the German Banking Act and BaFin, Guidance Notice – Notes regarding the licensing requirements pursuant to section 32 (1) of the German Banking Act (Kreditwesengesetz – KWG) in conjunction with section 1 (1) and (1a) of the KWG for conducting cross-border banking business and/or providing cross-border financial services, 5 April 2005.

[141] Up to now, exemptions under Section 2(4) of the German Banking Act have been granted to institutions from the following countries: USA, Switzerland, Singapore, Canada and Australia. See https://portal.mvp.bafin.de/database/InstInfo/ for a list of institutions that have received an exemption under this provision (last access on 17 January 2017).

concerns arise at a later point in time, the home state supervisory authority is required to notify BaFin accordingly.

An exemption can generally be granted with regard to all banking and investment services that require a license. Services provided to retail clients, though, are only eligible for an exemption if a German credit institution or a comparable EEA institution that applies the European passport for providing services in Germany acts as an intermediary institution (*Anbahnungsinstitut*).[142] Swiss Banks can also be exempted from the requirement to use an intermediary institution and may offer services directly to retail clients in Germany if they use the mechanism of the 'simplified exemption procedure' provided for in the MoU concluded between the Swiss Confederation and the Federal Republic of Germany.[143]

The exemption is limited to the provision of cross-border banking business and investment services in Germany. Therefore, it does not provide for a harmonized access to the entire European market as the European passport. UK institutions are required to obtain different exemptions for each EEA country whose financial markets they intend to cover. In some countries such exemptions are not available as they require a physical presence in the form of a subsidiary or a branch. Moreover, non-EEA institutions operating under an exemption are not entitled to establish branches in Germany. This limits the amount of operations that can be located in Germany and also the scope of business which can actually conducted with German clients.

(d) Alternatives Under MiFID II and MiFIR

The MiFID I framework does not provide for a harmonized third-country regime. The market access for non-EEA institutions is solely determined by national laws. For example, non-EEA institutions that currently intend to actively carry out business with clients in Germany must either set up (i) a licensed subsidiary in Germany (or another EEA country[144]), (ii) a licensed third-country branch[145] or (iii) apply for an exemption[146]. Only a German subsidiary would be allowed to conduct passported cross-border activities as an EEA hub. Banking business and

[142] After the initiation of the relationship between the third-country firm and the retail client through a German credit institution or EEA institution, future (individual) transactions by the third-country firm can be conducted directly with the client as part of the existing business relationship.
[143] See in detail below at 5(e).
[144] Following the establishment, the subsidiary may apply the European passport to conduct cross-border activities in Germany (and other EEA countries).
[145] Section 53 of the German Banking Act.
[146] Section 2(4) of the German Banking Act.

financial services provided through a third-country branch in Germany or under a German license exemption must, in contrast, be limited to the domestic German market.

This will change under the MiFID II/MiFIR[147] framework for investment firms. Under the MiFID II/MiFIR regime which will presumably apply as of 3 January 2018 and therefore be in place at the time of Brexit, the conditions upon which a third-country institution will be allowed to provide cross-border investment services to European clients will depend on the type of client. However, with respect to banking business, European lawmakers do not intend to amend the CRD regime in a similar way.

(i) EU-Wide Exemption for Eligible Counterparties and 'Per Se' Professional Clients

Articles 46-49 of MiFIR primarily set out the prerequisites under which investment services or activities, with or without any ancillary services,[148] may be provided to EU eligible counterparties or 'per se' professional clients[149]. Pursuant to Article 46(1) of MiFIR, third-country firms, which intend to provide investment services to this type of clients are allowed to access the entire EU market after having registered in the register of third-country of the European Securities Markets Authority ('ESMA'). In such a case, UK and other non-EU institutions can operate as a European hub. The registration with the ESMA is only possible once the European Commission has adopted an equivalence decision regarding the regulatory framework of the home state of the third-country firm.[150] As long as such decision is not adopted, cross-border investment services and activities into EU countries may only be provided under the conditions set out by each individual Member State's national law. This means that in Germany, third-country firms would have to apply for an exemption.[151]

Third-country firms which intend to provide cross-border investment services and activities to eligible counterparties and 'per se' professional clients must register with the ESMA within a transitional period of three years after an equivalence decision has been adopted by the European

[147] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (Official Journal of the EU. 2014 L 173 p. 84) ('Markets in Financial Instruments Regulation', 'MiFIR').
[148] 'Investment services and activities' means any of the services and activities listed in Section A of Annex I of MiFID II relating to any of the instruments listed in Section C of Annex I of MiFID II (Article 4(1) point 2 of MiFID II). 'Ancillary services' means any of the services listed in Section B of Annex I of MiFID II (Article 4(1) point 3 of MiFID II).
[149] Professional clients within the meaning of Section I of Annex II of MiFID II.
[150] Article 46(2)(a) of MiFIR.
[151] Recital 41 of MiFIR; Niamh Moloney, *EU Securities and Financial Markets Regulation*, 407 (3rd ed.; Oxford University Press, 2014). Exemptions will be available under the newly introduced Section 2(5) of the German Banking Act that is likely to apply as of 3 January 2018 and will replace Section 2(4) of the German Banking Act.

Commission.[152] After the expiry of this transitional period, non-registered third-country firms are prohibited from providing cross-border services and activities to European eligible counterparties and 'per se' professional clients without the establishment of a licensed branch or subsidiary for as long as the equivalence decision remains in force.[153]

The equivalence regime provides access to the entire EU market and is not limited to the domestic market in Germany or other EU countries. However, this harmonized EU market access only includes the provision of investment services and activities to eligible counterparties and 'per se' professional clients.[154] The scope of access rights under the equivalence regime are therefore narrower than the passporting rights for institutions in the EEA. It will be impossible for a non-EEA firm to provide integrated banking and investment services to clients within the EU without establishing a licensed subsidiary.[155] Moreover, the equivalence regime under the MiFIR will initially be implemented in the EU and will only be extended to EFTA States of the EEA, i.e. Iceland, Liechtenstein and Norway, as soon as the MiFIR has been included in Annex IX of the EEA Agreement.[156]

Granting equivalence is a decision that can unilaterally be revoked at any time if divergences between the regulatory frameworks become visible. In principle, such revocation is not possible with respect to the European passport.[157] It can be expected that the MiFIR equivalence regime will primarily be appealing to smaller, specialized investment firms that intend to provide investment services to eligible counterparties and 'per se' professional clients. Larger investment firms and credit institutions that intend to offer banking services alongside investment services to all type of clients, including retail and 'opt-in' professional clients, may rather relocate their EEA hub as the main building block of their Brexit strategy.[158]

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[152] Article 54 of MiFIR. Within the transitional period of three years they may continue to provide services in accordance with the national regime.

[153] See Simon Lovegrove, *Third country regime*, in Jonathan Herbst ed, A Practitioner's Guide to MiFID II, 412 at 414 (2nd ed; London; Sweet & Maxwell, 2015); Lennart Dahmen and Jochen Kindermann, *Zwischen Passport und Niederlassungszwang: Erbringung von Wertpapierdienstleistung aus einem Drittstaat*, in Hanno Teuber and Ulrich Schröer eds, *MiFID II/MiFIR Umsetzung in der Bankpraxis* para. 539 at 587 (Heidelberg; Finanz Colloquium, 2015).

[154] See Articlea 46(1) and 47(3) of MiFIR; Eilís Ferran, *The UK as a Third Country Actor in EU Financial Services Regulation*, University of Cambridge Faculty of Law Working Paper No 47/2016, September 2016, 9-10.

[155] See Rolf Sethe, *Das Drittstaatenregime von MiFIR und MiFID II*, Schweizerische Zeitschrift für Wirtschafts- und Finanzmarktrecht 615 at 630 (2014) with regard to Switzerland's prospects of being granted equivalence.

[156] See above at 3(b).

[157] See BBA Brexit Quick Brief # 4, *What is 'equivalence' and how does it work?*, available on: https://www.bba.org.uk/wp-content/uploads/2016/11/webversion-BQB-4.pdf (last access on 14 January 2017).

[158] Lennart Dahmen and Jochen Kindermann, *Zwischen Passport und Niederlassungszwang: Erbringung von Wertpapierdienstleistung aus einem Drittstaat*, in Hanno Teuber and Ulrich Schröer eds, *MiFID II/MiFIR Umsetzung in der Bankpraxis* para. 539 at 618 (Heidelberg; Finanz Colloquium, 2015).

(A) Equivalence Decision by the European Commission

Equivalence decisions are a well-known feature of EU financial regulation.[159] They are, *inter alia*, also relevant in the context of the treatment of exposures to foreign banks[160], CCPs[161] and with respect to third-country reinsurers[162].

An equivalence assessment process can be divided in two main steps of decision making: First, the decision to start the equivalence assessment. This decision could serve as an instrument of economic policy.[163] Secondly, the decision whether the third country's regulatory regime is deemed to be equivalent. This decision is to be based on a legal comparison of the EU regulatory framework and the third-country framework.

The equivalence framework under the MiFIR provides for an economic policy instrument that has the purpose to support EU financial markets, firms and customers in their activities in the EU and in third countries. Third countries will in particular be considered as potentially providing an equivalent regime if their investment firms are important for the EU financial markets. The European Commission will consider already existing supervisory and cooperation agreements between third countries and EU Member States as well as effective equivalent systems for the recognition of EU investment firms (*principle of reciprocity*).[164] The purpose of this regulatory '*do ut des*' is to promote and develop the mutual approximation of regulatory standards between the EU and certain third countries. Not only EU firms that will be allowed to access 'equivalent' third-country markets more easily will benefit from the equivalence framework as a political instrument, but also clients located in the EU are intended to benefit from a higher variety of financial products offered through firms from equivalent third-countries. Therefore, the

[159] Matthias Lehmann and Dirk Zetzsche, *Brexit and the Consequences for Commercial and Financial Relations between the EU and the UK*, European Business Law Review 999 at 1017 (2016); Dirk Zetzsche, *Competitiveness of Financial Centers in Light of Financial and Tax Law Equivalence Requirements*, in Ross P. Buckley, Emilios Avgouleas and Douglas W. Arner eds, *Reconceptualising Global Finance and its Regulation* 390 (Cambridge; Cambridge University Press, 2016); Danny Busch and Marije Louisse, *MiFID II/MiFIR's Regime for Third-Country Firms*, in Danny Busch and Guido Ferrarini eds, *Regulation of the EU Financial Markets: MiFID II and MiFIR* paras. 10.23-6 (Oxford; Oxford University Press, 2017).

[160] Articles 107(4), 114 et seq. of CRR

[161] Article 25(6) of Regulation (EU) No 648/2012 of 4 July 2012 (OJ L, 27.7.2012, p. 1) ('European Market Infrastructure Regulation', 'EMIR').

[162] Article 172 of Directive (EU) No 138/2009 of 25 November 2009 (OJ L 335, 17.12.2009, p. 1) ('Solvency II ').

[163] See Rolf Sethe, *Das Drittstaatenregime von MiFIR und MiFID II*, Schweizerische Zeitschrift für Wirtschafts- und Finanzmarktrecht 615 at 630 (2014), who fears that the equivalence decision will be used to exercise political pressure on third countries.

[164] Recital 41 of MiFIR.

European Commission will primarily assess the equivalence of countries that are considered to be important for firms and clients in the EU.[165]

To what extent the EU financial markets are relevant for third countries and third-country firms should be irrelevant for the decision whether equivalence of a third country is to be assessed. Although an equivalence decision may be crucial for cross-border activities of third-country firms, they or the third countries they are located in have no right to demand an equivalence assessment. It is at the European Commission's sole discretion to decide about the assessment of the equivalence of a third-country's regulatory framework.[166] Though recital 41 of MiFIR expressly allows EU Member States to request the assessment of specific third countries, it also declares such requests as legally non-binding. To this end, the European Commission is in principle free to decide if it starts to assess certain third countries and can therefore not be forced to do so. However, the European Commission may be bound by the principle of equal treatment requiring that '*similar situations should not be treated differently and different situations should not be treated identically unless such a differentiation is objectively justified*'.[167]

While the provisions of MiFIR do not explicitly set out requirements for the European Commission's decision to start the assessment, Article 47(2) of MiFIR provides for several criteria under which a third country may be considered to have equivalent effect. In general, an equivalence decision will consider two aspects: on the one hand, the regulation of third-country firms by its home legislation (*principle of equivalent regulatory standards*) and, on the other hand, the recognition of investment firms authorised under foreign legal regimes (*principle of reciprocity*).[168]

The equivalent regulatory standards of a third-country framework are assessed upon its prudential and business conduct requirements.[169] The MiFIR, MiFID II and CRD IV as well as its accompanying implementing measures serve as a benchmark for the equivalence assessment. This does not mean that the third-country regulatory standards have to be identical to those of EU supervisory law. It may also suffice if the core principles of EU supervisory law can be

[165] Recital 41 of MiFIR; Rolf Sethe, *Das Drittstaatenregime von MiFIR und MiFID II*, Schweizerische Zeitschrift für Wirtschafts- und Finanzmarktrecht 615 at 624 (2014).
[166] See Recital 41 of MiFIR: 'The Commission should initiate the equivalence assessment on its own initiative.'
[167] ECJ, Judgment of 7 July 1993, Case C-217/91 [1993] ECR I-3923 para. 37 – *Spain v. Commission*; ECJ, Judgment of 13 December 1994, Case C-306/93 [1994] ECR I-555 para. 50 – *SMW Winzersekt*; ECJ, Judgment of 22 June 2006, Joined Cases C-18/03 and C-217/03 [2006] ECR I-5479 para. 170 – *Belgium v. Commission*; EGC, Judgment of 5 April 2006, Case T-351/02 [2006] ECR II-1047 para. 137 – *Deutsche Bahn AG*.
[168] See Article 47(1)(1) of MiFIR.
[169] See Recital 41 of MiFIR.

identified in the third-country legislation[170]. This assessment process involves a gap analysis. This means that it is to be determined to which extent differences between the EU and the third-country legal framework exist. If and where such differences exist, it must be evaluated whether the third-country regime reaches similar and adequate regulatory effects with respect to the objectives of the relevant EU provisions.[171]

Article 47(1) of MiFIR lists the aspects which the European Commission must assess for its equivalence decision. The European Commission will assess whether authorisation requirements exist for firms that provide investment services and activities in the third country.[172] The competent third-country home state authority must effectively supervise the authorized entities and enforce adherence to the relevant provisions on an ongoing basis.[173] Appropriate conduct of business rules must apply to supervised entities and adequate organizational requirements must be in place with regards to internal control functions including compliance, risk control management and the management of conflicts of interest.[174] Investment firms must be subject to sufficient capital requirements.[175] There must furthermore be mechanisms in place to ensure the reliability of shareholders and members of the management body.[176] The third-country's legal framework must ensure market transparency and integrity by preventing market abuse in form of insider trading and market manipulation.[177]

Only if these minimum requirements are fulfilled a declaration of equivalence may be granted. Due to the large variety of international standards in this area of law (e.g. Basel Committee on Banking Supervision, IOSCO[178], Financial Stability Board etc.)[179] a high level of harmonization is already in place and in many cases the requirements set forth in Article 47(2) of MiFIR might already be fulfilled.[180] As the UK's financial regulation is currently largely based on EU rules, it

[170] Rolf Sethe, *Das Drittstaatenregime von MiFIR und MiFID II*, Schweizerische Zeitschrift für Wirtschafts- und Finanzmarktrecht 615 at 625 (2014).
[171] See Recital 41 of MiFIR.
[172] Article 47(1)(2)(a) of MiFIR.
[173] Article 47(1)(2)(a) of MiFIR.
[174] Article 47(1)(2)(c) and (d) of MiFIR; see also Rolf Sethe, *Das Drittstaatenregime von MiFIR und MiFID II*, Schweizerische Zeitschrift für Wirtschafts- und Finanzmarktrecht 615 at 625 (2014).
[175] Article 47(1)(2)(b) of MiFIR.
[176] Article 47(1)(2)(b) of MiFIR.
[177] Article 47(1)(2)(e) of MiFIR.
[178] Recital 41 MiFIR explicitly states that the Commission should have particular regard to the IOSCO objectives when assessing equivalence.
[179] See also John Armour, Dan Awrey, Paul Daies, Luca Enriques, Jeffrey N. Gordon, Colin Mayer and Jennifer Payne, *Principles of Financial Regulation* 617 (Oxford University Press, 2016), who characterize the post-crisis global financial regulatory order as '*a regime of international financial regulatory coordination*'.
[180] Rolf Sethe, *Das Drittstaatenregime von MiFIR und MiFID II*, Schweizerische Zeitschrift für Wirtschafts- und Finanzmarktrecht 615 at 625 (2014).

is to be expected that an equivalence decision would currently not run into any technical obstacles.[181] However, since the UK will cease to be bound by EU law once its withdrawal from the EU (and the EEA) becomes effective, it would practically be free to significantly ease its regulatory standards which might have an adverse effect on an equivalence assessment. To obtain and retain an equivalence decision, a certain degree of alignment with EU regulatory standards would have to be maintained even though it could impede political plans to increase the UK's attractiveness for financial institutions in a post-Brexit scenario by deregulating the financial sector.[182] Compliance with the relevant equivalence criteria, however, does not in any case guarantee an equivalence decision since it is at the European Commission's sole discretion to start the assessment and to adopt an equivalence decision. Even if substantive regulations remain practically identical, the European Commission could still argue that, from an institutional perspective, UK investment firms are not subject to effective supervision and enforcement on an ongoing basis.[183]

The assessment of equivalence is typically a lengthy and onerous process that can last a number of years.[184] Therefore, obtaining harmonized EU market access will likely not be available for third-country firms as of 3 January 2018. It can be expected that the UK will be highly interested to be acknowledged as an equivalent country under the MiFIR as part of the Brexit negotiations.

Once granted, the equivalence decision may at any time be revoked by the EU if material changes in the third country's or the EU's supervisory law lead to differing standards.[185]

The same applies to future changes of EU supervisory law: Even though the UK would not be obliged to mirror these changes, it would always have to take into consideration that significant deviances from the relevant Union law could lead to a revocation or denial of equivalence and, as such, to the loss of market access and operational privileges. Should the UK want to maintain

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[181] Niamh Moloney, *Brexit: An Uncertain Future for the City?*, 17 German Law Journal 75 at 78 (2016); see also Eilís Ferran, *The UK as a Third Country Actor in EU Financial Services Regulation*, University of Cambridge Faculty of Law Working Paper No 47/2016, September 2016, 20-6.

[182] Luca Enriques, *Why the UK has currently little chance to become a successful tax or regulatory haven*, Oxford Business Law Blog, 7 July 2016.

[183] Cf. Article 47(1)(2)(a) of MiFIR.

[184] BBA Brexit Quick Brief # 4, *What is 'equivalence' and how does it work?*, available on: https://www.bba.org.uk/wp-content/uploads/2016/11/webversion-BQB-4.pdf (last access on 14 January 2017).

[185] Articles 47(4) and 51(2) of MiFIR. So far, however, the Commission has never made use of its right to revoke equivalence. It is unknown if this is because the Commission exercises self-restraint in this regard, or, if it is simply because the countries that have been granted equivalence have refrained from deviating from the relevant EU standards. See Briefing by the European Parliament, 'Third-country equivalence in EU banking legislation',http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/587369/IPOL_BRI(2016)587369_EN.pdf (last access on 17 January 2017).

the equivalence, it would, to some extent, be limited in its regulatory actions with 'no seat at the table' in the legislation of EU financial regulation.[186]

(B) Further requirements for registration of a third-country firm with ESMA

In addition to an equivalence decision, the following conditions must be fulfilled in order for a third-country firm to be allowed to register with the ESMA. The third-country firm must be authorized to conduct cross-border investment services or activities in its home state, and it must be subject to effective supervision in its home state with regard to these services.[187] A co-operation arrangement between the ESMA and the relevant competent authorities of the third country must be adopted.[188] Although the ESMA is obliged to conclude a cooperation arrangement with the third-country authority once an equivalence decision has been adopted, the content of this arrangement is at the ESMA's discretion. Article 47(2) of MiFIR only mentions the relevant aspects that the arrangement must *at least* specify. They relate to the mechanism for the exchange of information between the ESMA and the third-country authorities,[189] the mechanism for prompt notification to the ESMA in case the investment firm infringes supervisory law,[190] and the procedures concerning the coordination of supervisory activities.[191] The ESMA could demand additional criteria to be included into the cooperation arrangement as Article 47(2) of MiFIR does not provide an exhaustive list. The registration with the ESMA can therefore be even more delayed if, after the adoption of an equivalence decision, no cooperation arrangement has been concluded yet. It will be interesting to see how the ESMA will handle its right to negotiate the specific content of the cooperation agreements with the third-country authorities and whether (or presumably to which extent) this will delay the entire process.

The third-country firm's actual registration with the ESMA is subject to the provision of all required information[192] and can take up to another 210 days in total (in addition to the time that the third-country firm needs to wait for the adoption of an equivalence decision by the European

[186] Under the catch-word ' no seat at the table' the weakness of non-EU EEA members' position is frequently being pointed out when a post-Brexit EEA membership of the UK is discussed, see Ulrich G. Schroeter and Heinrich Nemeczek, The (Uncertain) *Impact of Brexit on the United Kingdom's Membership in the European Economic Area*, European Business Law Review 921 at 954-5 (2016). See also Rolf Sethe, *Das Drittstaatenregime von MiFIR und MiFID II*, Schweizerische Zeitschrift für Wirtschafts- und Finanzmarktrecht 615 at 625 (2014).
[187] Article 46(2)(b) of MiFIR.
[188] Articles 46(2)(c) and 47(2) of MiFIR.
[189] Article 47(2)(a) of MiFIR.
[190] Article 47(2)(b) of MiFIR.
[191] Article 47(2)(c) of MiFIR.
[192] See European Commission, Draft Delegated Regulation (EU) of 14 July 2016, C(2016)4417 final.

Commission and the conclusion of a cooperation agreement between the ESMA and the third-country supervisory authority).[193]

Upon successful registration of the third-country firm with the ESMA, it will be allowed to provide investment services directly to eligible counterparties and per-se professional clients in the entire EU without the establishment of a branch.[194] It will only be subject to the supervision of the competent third-country authority in its home state.[195] The ESMA may, however, intervene by withdrawing the third-country firm's registration if it comes to the conclusion that the interests of investors in the EU or the orderly functioning of EU financial markets are jeopardized by the third-country firm's provision of investment services in the EU or if it has well-founded reasons to believe that the third-country firm has infringed the provisions applicable to it in its home state, on which the European Commission's equivalence decision was based.[196]

(C) Applicable Organizational and Conduct Rules

Under current German law, any third-country investment firm which provides investment services or ancillary services for clients having their habitual residence or place of management in Germany must comply with certain conduct rules as well as additional supervisory rules in accordance with the permanent practice of BaFin, provided that the investment services or ancillary services and related ancillary services are not provided exclusively in a third country.[197] As the MiFID I did not provide any specific requirements for the supervision of third-country firms, the German legislation was free to apply certain rules of German securities regulation to third-country firms even if they did not have their seat nor any branch in Germany.

Under the MiFIR and MiFID II regime, firms that are registered with the ESMA under the equivalence regime and provide services only to eligible counterparties and 'per se' professional clients will no longer be required to comply with organizational or conduct rules set out in EU

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[193] See Article 46(4) of MiFIR.

[194] Article 46(1) of MiFIR.

[195] See Article 46(5) of MiFIR which establishes that the third-country firm must inform potential clients that it is not supervised in the EU and provide the name and address of the competent authority in its home state.

[196] The ESMA must, however, first refer the matter to the competent supervisory authority in the third-country firm's home state and may only withdraw the registration if this authority fails to take appropriate measures to protect the functioning of the market and the interest of investors, Article 49(1)(c) of MiFIR. See Simon Lovegrove, *Third country regime*, in Jonathan Herbst ed, A Practitioner's Guide to MiFID II, 412 at 413 (2nd ed; London; Sweet & Maxwell, 2015); Lennart Dahmen and Jochen Kindermann, *Zwischen Passport und Niederlassungszwang: Erbringung von Wertpapierdienstleistung aus einem Drittstaat*, in Hanno Teuber and Ulrich Schröer eds, *MiFID II/MiFIR Umsetzung in der Bankpraxis* para. 539 at 603-8 (Heidelberg; Finanz Colloquium, 2015) for an overview of the withdrawal mechanism.

[197] Section 31(10) of the German Securities Trading Act; see also below at 5(d)(iv) and 5(g)(i).

financial regulation or in the laws of the Member States.[198] If the EU Member States' lawmakers required registered firms conducting business with eligible counterparties and 'per se' professional clients only to comply with national laws transposing the MiFID II, this would contravene Article 46(3) of MiFIR. According to this provision, the Member States are not allowed to impose any additional requirements on registered third-country firm operating under the equivalence regime. The applicability of national rules would also contravene the purpose of the newly established equivalence framework, which is to harmonize the (currently highly fragmented) existing regulatory regimes of Member States for cross-border services provided by third-country firms.[199]

Organizational and conduct rules as part of the third-country framework must also be considered by the European Commission when assessing the equivalence of the third-country's regime.[200] This presupposes that these third-country rules also apply if third-country firms provide cross-border services into the EU, since otherwise reliance on home state rules would be meaningless and therefore not provide a framework having equivalent effect. As third-country firms will solely be supervised by their home state authorities[201], it would have been necessary to require those third-country authorities to supervise compliance with organizational and conduct rules set out in EU financial supervisory laws or in the laws of the Member States. However, this is not the case, as the equivalence regime under the MiFIR does not refer to any of these rules, but exclusively to third-country rules.

The grounds for withdrawal of registration under Article 49 of MiFIR finally confirm this view. The ESMA may withdraw the registration of third-country firms, *inter alia*, where the ESMA '*has well-founded reasons based on documented evidence to believe that, in the provision of investment services and activities in the Union, the third-country firm has seriously infringed the provisions applicable to it in the third country …*'.[202] The withdrawal of registration indirectly grants the ESMA an instrument to enforce financial regulation as the third-country firm thereby loses its right to provide services in the EU. If the third-country firm had to apply additional EU

[198] See also European Commission, Prosposal for a Regulation of the European Parliament and of the Council on markets in financial instruments of 20 October 2011, COM(2011)652 final, 2011/0296 (COD), point 3.4.12; but see Christian Hoops, *Die Drittstaatenregelung von MiFIR/MiFID und ihre Umsetzung im geplanten Finanzmarktnovellierungsgesetz*, Zeitschrift für Bankrecht und Bankwirtschaft, 47 at 52 (2016).
[199] See Recital 41 of MiFIR.
[200] See Article 47(1)(2)(c) and (d) of MiFIR.
[201] See Article 46(5) of MiFIR which requires third-country firms to disclose to their EU clients that they are not subject to supervision in the EU, and to indicate the name and address of the third-country authority.
[202] Article 49(1)(b) of MiFIR; the same argument can be based on Article 49(1)(c) of MiFIR as a ground for withdrawal where the '*third-country competent authority … has failed to demonstrate that the third-country firm concerned complies with the requirements applicable to it in the third country*'.

organizational or conduct rules, non-compliance with these EU rules would have been included in Article 49 of MiFIR as a reason for withdrawal of the registration.[203]

(ii) European Passport Light

Firms seated in third countries for which equivalence decisions are adopted also have the opportunity to apply the so-called 'European passport light'[204] as set out in Article 47(3) of MiFIR. A third-country firm which has established a branch in an EU Member State[205] may provide its services to eligible counterparties and 'per se' professional clients in other Member States of the EU without the establishment of new branches for each additional EU Member State.[206] The reference in Article 47(3) of MiFIR to Article 39 of MiFID II should not be understood as referring only to branches that have been established in EU Member States who have chosen to make use of the option provided by Article 39 of MiFID II and have thus made the establishment of a branch mandatory for third-country firms outside the scope of the equivalence regime.[207] Even if a third-country firm establishes a branch in an EU Member State that does not require third-country firms to establish a branch in its territory under Article 39(1) of MiFID II, such as Germany, may apply the 'European passport light'. This view is supported

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[203] The Draft Bill of the German Government for the Second Financial Market Amendments Act which is intended to implement MiFID II into German national law sets out that '*subject to Article 46 of MiFIR*' third-country firms have to comply with the German organizational and conduct rules if they have not obtained a newly introduced BaFin waiver from these requirements. As described at 5.(iv) below, the waiver is only available if a third-country firm is not registered with the ESMA. If one argued that Article 46 of MiFIR does not include an exception from the application of German organizational and conduct rules and that these rules applied to registered third-country firms, this would lead to a situation in which third-country firms could be exempted from applying all organizational and certain conduct rules with respect to their business with German retail and 'opt-in' professional clients pursuant to the new Section 91 of the German Draft Securities Trading Act, but would have to apply all German organizational and conduct rules if they provide services to eligible counterparties and 'per se' professional clients. Considering the increased level of protection that MiFIR/MiFID II intend to introduce for retail and 'opt-in' professional clients, such an interpretation by which eligible counterparties and 'per se' professional clients would receive more protection than retail and 'opt-in' professional clients would not be persuasive. The German legislator rather takes the view that third-country firms which are registered pursuant to Article 46 of MiFIR are not subject to German organizational and business conduct rules if they conduct business with eligible counterparties and 'per se' professional clients.

[204] Christian Hoops, *Die Drittstaatenregelung von MiFIR/MiFID und ihre Umsetzung im geplanten Finanzmarktnovellierungsgesetz*, Zeitschrift für Bankrecht und Bankwirtschaft, 47 at 50 (2016); Rolf Sethe, *Das Drittstaatenregime von MiFIR und MiFID II*, Schweizerische Zeitschrift für Wirtschafts- und Finanzmarktrecht 615 at 626 (2014); see also Danny Busch and Marije Louisse, *MiFID II/MiFIR's Regime for Third-Country Firms*, in Danny Busch and Guido Ferrarini eds, *Regulation of the EU Financial Markets: MiFID II and MiFIR* paras. 10.52-4 (Oxford; Oxford University Press, 2017).

[205] Article 39 of MiFID II.

[206] See in more detail: Christian Hoops, *Die Drittstaatenregelung von MiFIR/MiFID und ihre Umsetzung im geplanten Finanzmarktnovellierungsgesetz*, Zeitschrift für Bankrecht und Bankwirtschaft, 47 at 50 (2016).

[207] Article 39(1) of MiFID II only applies to cases outside the equivalence regime. Third-country firms that only provide cross-border services to eligible counterparties and 'per se' professional clients under the equivalence regime may therefore not be required by Member States to establish a branch in their territories. The opposite view is taken by Danny Busch and Marije Louisse, *MiFID II/MiFIR's Regime for Third-Country Firms*, in Danny Busch and Guido Ferrarini eds, *Regulation of the EU Financial Markets: MiFID II and MiFIR* paras. 10.64 (Oxford; Oxford University Press, 2017).

by the fact that branches of third-country firms in Germany have to adhere to all organizational and conduct rules, as far as applicable, under the German Securities Act[208] and would therefore not be treated more favourably than branches established in EU Member States that require third-country firms to establish a branch in their territories pursuant to Article 39 of MiFID II.[209]

As no reference is made in Article 47(3) of MiFIR to the registration procedure in Article 46(2) of MiFIR, the registration of a third-country firm with ESMA is not a prerequisite to make use of the 'European Passport light'. This is also confirmed by the mere wording of Article 47(3) of MiFIR which only speaks of a '*third-country firm <u>established</u> in a country whose legal and supervisory framework has been recognised to be effectively equivalent'*.[210]

What remains doubtful is whether a third-country firm whose registration was withdrawn by the ESMA[211] will still be able to conduct cross-border business through a branch established within the EU in accordance with Article 47(3) of MiFIR. While in theory such a provision of cross-border services through a branch is not dependent upon a third-country firm's registration with the ESMA, it seems rather contradictory to assume that the ESMA's assessment regarding possible dangers to the interests of investors and the functioning of the market in the EU originating from the provision of cross-border services by this firm would not have any effect on its allowance to provide cross-border services through a branch within the EU. It should, however, be noted that in such cases the criteria for a withdrawal of the branch's authorization will probably also be fulfilled[212] so that this issue will most likely remain of low practical relevance. Due to the principle of sincere cooperation[213] the competent authority will practically

[208] Branches of third-country institutions which are established in accordance with Section 53 of the German Banking Act are to be considered as investment firms pursuant to Section 2(4) of the German Securities Trading Act (*Wertpapierhandelsgesetz*) or, respectively, the future Section 2(10) of the German Securities Trading Act. The German legislator makes use of the option provided for in Article 4(1) point 1(2) of MiFID II pursuant to which Member States may include undertakings which are not legal persons into the definition of investment firms. As such they must adhere to the full amount of the organizational and conduct rules of the German Securities Trading Act. The restrictions of Section 31(10) of the German Securities Trading Act or, respectively, the future Section 91 of the German Draft Securities Trading Act (see below at 5(d)(iv)) are not applicable as they only govern the extent of the German Securities Trading Rules that apply to third-country institutions in respect of the provision of cross-border services.
[209] Pursuant to Article 41 of MiFID II branches established in accordance with Article 39 of MiFID II must adhere to certain organizational rules of MiFID II/MiFIR. EU Member States are prevented from imposing any additional requirements on the organization and operation of such branches in respect of the matters covered by MiFID II.
[210] Emphasis added.
[211] The requirements and consequences for a withdrawal of registration are stipulated in Article 49 of MiFIR.
[212] This is the case because the firm no longer meets the conditions under which authorisations was granted (Article 43(c) of MiFID II) or has seriously and systematically infringed the provisions adopted pursuant to the MiFID II governing the operating conditions for investment firms and applicable to third-country firms (Article 43(d) of MiFID II).
[213] Article 4(3) of the TEU.

be bound to exercise its discretion[214] in such a way as to withdraw the branch's authorization where ESMA has withdrawn the firm's registration. As soon as the branch's authorization is withdrawn, the third-country firm will no longer be entitled to provide cross-border services into other Member States on the basis of the 'European passport light'.

It remains questionable whether many firms will actually make use of the 'European passport light'. Compared to the possibility of providing cross-border services directly from the firm's home country after registering with the ESMA, the 'European passport light' does not grant any notable regulatory advantages. A firm will only apply the 'European passport light' if it wants to provide services to retail clients or 'opt in' professional clients in a particular EU country, an option that is not possible under the equivalence regime as it is limited to the provision of services to eligible counterparties and 'per se' professional clients. For third-country institutions that are not interested in the provision of services to retail clients, the registration procedure appears to be the preferable option because the registration with the ESMA will generally be less onerous than the establishment and authorization of a third-country branch in an EU Member State as, for example, Germany. The decision between the sole registration with the ESMA and the 'European passport light' could also be influenced by whom the investment firm is to be supervised: A third-country firm that chooses to provide cross-border services directly from its home state without the establishment of a branch in the EU will remain under the sole supervision of its home state authority, to which the firm might have already established a certain degree of routine. A third-country firm that provides cross-border services from a branch located in an EU Member State will by contrast be supervised by the competent authority of that Member State.

(iii) Third-Country Regime for Retail and 'Opt-In' Professional Clients

If investment services are directed at retail clients or 'opt in' professional clients[215], the national legislator is competent to decide if and how such services may be provided. An EU Member State may, subject to the equivalence regime, require third-country firms to establish a branch in its territory if they intend to provide services in that Member State.[216] If a Member State opts to do so, the criteria which must be fulfilled by such a branch are exhaustively listed in Article 39(2) of MiFID II.

[214] Article 43 of MiFID II establishes that the competent authority in a Member State *may* withdraw the authorization of a branch in the listed cases. For Germany, see Sections 33 and 35(2) of the German Banking Act.
[215] Professional clients within the meaning of Section II of Annex II of MiFID II.
[216] Article 39(1) of MiFID II.

These criteria refer to the standards that the third-country firm, its competent home state authority and the third country where the firm is seated must fulfil and have the aim to protect. As for the firm, it is obliged to have sufficient initial capital at free disposal of the branch[217] have appointed one or more persons that are responsible for the management of the branch[218] and belong to an investor-compensation scheme[219]. Moreover, the provision of the intended services must be authorised and supervised in the third country where the investment firm is established.[220] The third-country authority must pay due regard to any FATF recommendations in the context of anti-money laundering and countering the financing of terrorism[221] and must have concluded cooperation arrangements, that include provisions regulating the exchange of information for the purpose of preserving the integrity of the market and protecting investors, with the competent authority of the EU Member State where the branch is to be established.[222] In order to combat tax evasion, the third country must have signed an agreement with the Member State where the branch is to be established which complies with the standards under Article 26 of the OECD Model Tax Convention on Income and on Capital and ensures an effective exchange of information in tax matters.[223]

If the EU Member State decides not to make use of the option provided by Article 39(1) of MiFID II, its own national regime remains in place.[224] In Germany, third-country firms are obliged to establish, at least, a subsidiary or a branch[225] if they want to provide services on German territory. They may, however, be exempted from this requirement.[226] The Draft Bill of the German Government for the Second Financial Market Amendments Act[227] which implements the MiFID II does not make any significant amendments to this exemption mechanism, but rather enshrines

[217] Article 39(2)(c) of MiFID II.
[218] Article 39(2)(d) of MiFID II; the regulatory standards that the responsible manager must comply with are provided by Article 9 of MiFID II and Articles 88, 91 of CRD IV. For example, the manager must be of sufficiently good repute and possess sufficient knowledge, skills and experience to perform their duties (Article 91(1)(1) of CRD IV).
[219] Article 39(2)(f) of MiFID II.
[220] Article 39(2)(a) of MiFID II.
[221] Article 39(2)(a) of MiFID II.
[222] Article 39(2)(b) of MiFID II.
[223] Article 39(2)(e) of MiFID II.
[224] Cf. Recital 109 of MiFID II; see also Danny Busch and Marije Louisse, *MiFID II/MiFIR's Regime for Third-Country Firms*, in Danny Busch and Guido Ferrarini eds, *Regulation of the EU Financial Markets: MiFID II and MiFIR* paras. 10.50-1 (Oxford; Oxford University Press, 2017).
[225] A branch will, despite its legal dependency, be treated as legal separate entity (see above at 2(c)).
[226] See above at 5(c).
[227] See http://www.bundesfinanzministerium.de/Content/DE/Downloads/Abt_7/2016-12-21-Zweites-Finanzmarktnovellierungsgesetz-anl.pdf;jsessionid=E0DE1B23045E560136FC775F2D92D142?__blob=publicationFile&v=4 (last access on 12 January 2017).

the permanent BaFin practice and thus imposes the same prerequisites as discussed above at 5. (c).

This indicates that the German legislator will not make the establishment of a branch compulsory and thus refrain from the use of the option provided in Article 39 (1) MiFID II.[228]

To the extent that no equivalence decision is adopted by the European Commission with respect to a third country, firms from that country are not entitled to apply the 'European passport light' and provide cross-border services to retail clients and 'opt in' professional clients in other EU Member States through a branch established in another EU Member State.[229] Firms from such non-equivalent third countries wishing to provide services to these types of clients across the EU would have to establish branches in each EU Member State that requires the establishment of a branch[230] or comply with the national laws of all other EU Member States. This illustrates that the MiFIR and MiFID II only partially harmonize the cross-border regulation of third-country firms with regard to retail clients and 'opt in' professional clients.

(iv) Future German National Exemption

The German BaFin exemption regime remains of relevance within the scope of MiFIR and MiFID II in certain cases, for example, with respect (i) to services provided to retail and 'opt-in' professional clients and, (ii) services provided to eligible counterparties and 'per se' professional clients as long as no equivalence decision has been adopted.[231] As banking business is not covered by the MiFIR and MiFID II, the BaFin's exemption regime[232] also applies to UK institutions that intend to provide banking services to clients in Germany.

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[228] Lennart Dahmen and Jochen Kindermann, *Zwischen Passport und Niederlassungszwang: Erbringung von Wertpapierdienstleistung aus einem Drittstaat*, in Hanno Teuber and Ulrich Schröer eds, *MiFID II/MiFIR Umsetzung in der Bankpraxis* para. 539 at 618 (Heidelberg; Finanz Colloquium, 2015) take the view that German law includes a branch requirement as foreseen in Article 39(2) of MiFID II. They disregard that Article 39(2) of MiFID II does not provide for an exemption of the branch requirements as German law does and that establishing a branch in Germany may be an option, but not a requirement.

[229] See Recital 109 of MiFID II: third-country firms '*do not enjoy the freedom to provide services and the right of establishment in Member States other than the one where they are established*.'

[230] Article 39(1) of MiFID II.

[231] See also Christian Hoops, *Die Drittstaatenregelung von MiFIR/MiFID und ihre Umsetzung im geplanten Finanzmarktnovellierungsgesetz*, Zeitschrift für Bankrecht und Bankwirtschaft, 47 at 49 (2016).
Hoops, ZBB 2016, p. 47, p. 49; Detmar Loff and Jasper Lembke, Zugang von Drittstaaten-Finanzmarktakteuren in die EU, Recht der Finanzinstrumente 101 at 104-5 (2016).

[232] It is currently stipulated in Section 2(4) of the German Banking Act and will, following the Second Financial Market Amendments Act, be transposed to Section 2(5) of the Draft Banking Act.

An exemption for the provision of services to retail clients is still only to be granted if a domestic institution which is authorized for the German market provides initial assistance at setting up the individual client relationship as an intermediate institution (*Anbahnungsinstitut*).

While the requirements of the BaFin's exemption from the licensing requirement remain identical, the number of applicable organizational and conduct rules increases under the German rules transposing MiFID II into German law. Currently, third-country firms which provide investment services on a cross-border basis must only comply with the conduct rules that are explicitly mentioned in Section 31(10) of the German Securities Trading Act as well as certain additional conduct rules in accordance with the permanent practice of BaFin.[233] As of 3 January 2018, third-country firms have, in principle and subject to the equivalence regime under the MiFIR[234], to comply with all conduct and organizational rules of the German Securities Trading Act.[235] However, BaFin is entitled to waive the application of all organizational and certain conduct rules[236] if no additional supervision of the third-country firm through BaFin is required insofar as the firm is effectively supervised in its home state.[237] The conditions for this waiver from all organizational and certain conduct rules are similar to the conditions for obtaining an exemption from the licensing requirement.[238] The waiver is only granted if no registration notification with the ESMA has been filed by the third-country firm.[239]

(e) Memorandum of Understanding

Following Brexit, the British Government as well as the PRA and FCA could aim at entering into a bilateral agreement with the German Government and BaFin to facilitate the access to the German market for UK institutions. The 'Memorandum for procedural aspects of cross-border activities in the financial sector' ('MoU') concluded between the Federal Republic of Germany and the Swiss Confederation, which was further substantiated by an execution agreement

[233] See at 5(d)(i)(C) above.
[234] See at 5(d)(i)(C) above.
[235] See Sections 63-96 of the Draft Securities Trading Act, currently stipulated in Sections 31-37 of the Securities Trading Act.
[236] The possible exemptions relate to the rules listed in Section 91 of the German Draft Securities Trading Act.
[237] A waiver pursuant to Section 91 of the German Draft Securities Trading Act may only be granted to such firms that have already obtained an exemption pursuant to Section 2(5) of the German Draft Banking Act. See the explanatory memorandum regarding the Draft Bill of the Second Financial Market Amendments Act, p. 303.
[238] As described above under 5(c).
[239] See the explanatory memorandum regarding the Draft Bill of the German Government for the Second Financial Market Amendments Act Draft Bill of the Second Financial Market Amendments Act, p. 303.

between BaFin and the Swiss Financial Market Supervisory Authority 'FINMA' could serve as an illustrating example for such an agreement.[240]

On the basis of the MoU and the execution agreement, Swiss institutions may receive an exemption in a 'simplified procedure'. For this purpose, Swiss institutions subject themselves to certain German consumer protection and anti-money laundering provisions which they normally would not have to comply with under the regular exemption procedure.[241] Swiss institutions that are not willing to subject themselves to these provisions can still apply for an exemption under the regular procedure which remains available as an alternative.[242] The significant advantage of the exemption granted in the simplified procedure compared to the regular exemption procedure is that it allows exempted institutions to build relationships with retail clients without the requirement of an intermediate institution (*Anbahnungsinstitut*)[243] that is authorized for the German market.[244]

(f) Privileged Treatment through German Legislative Decree

Another possible course of action for the UK would be to obtain a privileged treatment for its institutions through negotiations with the EU or Germany followed by the enactment of an ordinance by the German Federal Ministry of Finance.[245] In such a case, the privileged cross-border regime for EEA institutions can also be applied, partially or wholly, to institutions seated in the UK.[246] This exemption could be granted either on the basis of an agreement with the EU[247] or on the basis of a bilateral agreement[248]. While the agreement with the EU may include any

[240] The Memorandum for procedural aspects of cross-border activities in the financial sector was concluded between the Swiss Confederation and the Federal Republic of Germany on 15. August 2013 and further substantiated by the execution agreement concluded between the FINMA and BaFin which entered into force on 1. January 2014. The full (German) text of the MoU is available on: http://www.news.admin.ch/NSBSubscriber/message/attachments/31642.pdf (last access on 21 January 2017).
[241] FINMA, Vereinfachtes Freistellungsverfahren für Schweizer Banken bei grenzüberschreitenden Tätigkeiten im Finanzbereich in Deutschland, FINMA-Mitteilung 54 (2014) – 6 January 2014, para. 1 regarding the simplified exemption procedure for Swiss banks conducting cross-border activities in the financial sector in Germany, para. 1.
[242] FINMA, Vereinfachtes Freistellungsverfahren für Schweizer Banken bei grenzüberschreitenden Tätigkeiten im Finanzbereich in Deutschland, FINMA-Mitteilung 54 (2014) – 6 January 2014, para. 1.
[243] See above at 5(c).
[244] FINMA, Vereinfachtes Freistellungsverfahren für Schweizer Banken bei grenzüberschreitenden Tätigkeiten im Finanzbereich in Deutschland, FINMA-Mitteilung 54 (2014) – 6 January 2014, para. 3.3.
[245] See Section 53c of the German Banking Act.
[246] Christian Hoops, *Die Drittstaatenregelung von MiFIR/MiFID und ihre Umsetzung im geplanten Finanzmarktnovellierungsgesetz*, Zeitschrift für Bankrecht und Bankwirtschaft, 47 at 52 (2016).
[247] Section 53c(1) of the German Banking Act.
[248] Section 53c(2) of the German Banking Act.

type of cross-border activity, the bilateral agreement is limited to the establishment of branches and does not include the provision of cross-border services.[249]

(g) Reverse Solicitation

In any case, carrying out banking business and providing investment services on a (passive) reverse solicitation basis remains possible for third-country institutions without triggering any licensing requirements. Several third-country institutions (partially) rely on this exception from German licensing requirements which has long been recognised by BaFin practice.[250] This reverse solicitation business model is particularly relevant for institutions that carry out a limited amount of business with professional clients which typically invite institutions to 'pitch' their offerings or to participate in 'beauty contests'. It may also be useful for servicing existing clients in the course of legacy business. On the other hand, institutions that intend to actively gain market share, especially in the retail banking sector should rather opt for other alternatives, for example, applying for a license or an exemption.

(i) Current BaFin Practice

According to BaFin's practise, third-country credit institutions and investment firms are not required to obtain any domestic license nor any exemption if they provide services upon the clients' request, because in such cases the services are not deemed to be provided 'in Germany'.[251]

(A) Marketing

Third-country institutions relying on reverse solicitation only may not direct any form of product-specific advertisement at German clients.[252] The realm of permissible marketing activities is

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[249] See Section 53c(2)(b) of the German Banking Act; Wolfgang Vahldiek, *§ 53c*, in Karl-Heinz Boos, Reinfrid Fischer and Hermann Schulte-Mattler eds, *Kreditwesengesetz, VO (EU) Nr. 575/2013 (CRR)* para. 5 (5th ed.; Munich, 2016).

[250] See BaFin, Guidance Notice – Notes regarding the licensing requirements pursuant to section 32 (1) of the German Banking Act (Kreditwesengesetz – KWG) in conjunction with section 1 (1) and (1a) of the KWG for conducting cross-border banking business and/or providing cross-border financial services, 5 April 2005. See also Wolfgang Vahldiek, *§ 53a*, in Karl-Heinz Boos, Reinfrid Fischer and Hermann Schulte-Mattler eds, *Kreditwesengesetz, VO (EU) Nr. 575/2013 (CRR)* para. 26 (5th ed.; Munich, 2016); Andreas Schwennicke, *§ 32*, in Andreas Schwennicke and Dirk Auerbach eds, *Kreditwesengesetz* para. 12 (4th ed.; Munich, 2016)
Schwennicke, in: Schwennicke/Auerbach, KWG, 3. Edition (2016), Section 32 no 12; Jörg Schwerdtfeger, *Europäischer Pass für Leasing und Factoring*, Zeitschrift für Bank- und Kapitalmarktrecht 53 (2010).

[251] Within the meaning of Section 32(1) of the German Banking Act, BaFin, Guidance Notice – Notes regarding the licensing requirements pursuant to section 32 (1) of the German Banking Act (Kreditwesengesetz – KWG) in conjunction with section 1 (1) and (1a) of the KWG for conducting cross-border banking business and/or providing cross-border financial services, 5 April 2005.

[252] See BaFin, BaFin, Guidance Notice – Notes regarding the licensing requirements pursuant to section 32 (1) of the German Banking Act (Kreditwesengesetz – KWG) in conjunction with section 1 (1) and (1a) of the KWG for

limited to brand advertising campaigns and sponsorship projects without product- or service-specific content.[253] Services provided to existing clients only fall within the scope of permissible reverse solicitation if they are deemed to be part of the existing client relationship which in turn is to be determined by looking at the entire client relationship on the basis of the contractual documentation.[254]

(B) Applicable Conduct Rules

Certain conduct rules under the German Securities Act also apply to third-country firms if they provide services to clients having their usual place of residence or management in Germany unless the investment service or ancillary investment services are 'exclusively provided in a third country'.[255] Up to now, BaFin has not published explanatory guidelines or guidance as to whether the provision of unsolicited services is deemed to be an exclusive provision of services in a third country. It is submitted that the applicability of conduct rules to such cases should be determined on a case by case basis and depending on whether there are characteristic (partial) services that are received in Germany.[256]

(ii) Impact of MiFID II/MiFIR on Reverse Solicitation

The MiFIR and MiFID II expressly acknowledge the principle of reverse solicitation for investment services beyond the scope of German financial supervisory law.[257] It is not yet entirely clear which impact the MiFIR and MiFID II have on the practise of reverse solicitation. Due to ambiguity in the wording of the relevant recitals and provisions of MiFIR and MiFID II, the risk remains that the reverse solicitation exception will be interpreted differently in each EU Member State.[258]

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conducting cross-border banking business and/or providing cross-border financial services, 5 April 2005, point 1 relevant scenarios giving rise to licensing requirements pursuant to section 32 (1) of the KWG, subsection on advertisement.

[253] See BaFin, Guidance Notice – Notes regarding the licensing requirements pursuant to section 32 (1) of the German Banking Act (Kreditwesengesetz – KWG) in conjunction with section 1 (1) and (1a) of the KWG for conducting cross-border banking business and/or providing cross-border financial services, 5 April 2005, point 1 relevant scenarios giving rise to licensing requirements pursuant to section 32 (1) of the KWG, subsection on advertisement.

[254] BaFin, Guidance Notice – Notes regarding the licensing requirements pursuant to section 32 (1) of the German Banking Act (Kreditwesengesetz – KWG) in conjunction with section 1 (1) and (1a) of the KWG for conducting cross-border banking business and/or providing cross-border financial services, 5 April 2005, point 1 relevant scenarios giving rise to licensing requirements pursuant to section 32 (1) of the KWG, subsection on mail/fax/email.

[255] Section 31(10) of the German Securities Act; see above at 5(d)(i)(C) and 5(d)(iv).

[256] See also Sven H. Schneider, *Nichtanwendbarkeit des KWG bzw. WpHG trotz Erbringung regulierter Tätigkeiten*, Wertpapier-Mitteilungen 285 at 291 (2008).

[257] See Article 47(5) and Recital 43 of MiFIR, Article 42 of MiFID II and Recitals 85, 111 of MiFID II.

[258] Lennart Dahmen and Jochen Kindermann, *Zwischen Passport und Niederlassungszwang: Erbringung von Wertpapierdienstleistung aus einem Drittstaat*, in Hanno Teuber and Ulrich Schröer eds, *MiFID II/MiFIR Umsetzung in der Bankpraxis* para. 539 at 582 (Heidelberg; Finanz Colloquium, 2015).

(A) Marketing

One of the key questions is which type of marketing methods a third-country institution may apply without falling out of the scope of the reverse solicitation exception under the MiFIR and MiFID II.

Recital 43 of MiFIR and Recital 111 of MiFID II state that services provided by a third-country firm are not to be regarded as having been performed upon the sole initiative of the client if the third-country firm actively solicited (potential) clients or promoted investment services or activities in the EU. By contrast, Recital 85 of MiFID II sets out that the provision of services is to be considered as having been provided at the sole initiative of the client even if these services are demanded by the client following the receipt of a promotion or offer by the third-country firm in respect of a specific financial instrument or specific transaction as long as this communication was of mere general nature aiming at the public or a large group of clients and not at the client individually. The wording of Recital 85 of MiFID II appears to contradict Recital 43 of MiFIR and Recital 111 of MiFID II which prohibit product-specific advertisement regardless of whether it is directed at individuals or at the general public.

This contradiction might be resolved by arguing that Recital 85 of MiFID II specifies certain types of advertisement that are in line with the concept of reverse solicitation. Accordingly, it has been argued that promotions being aimed at the general public or a large group of clients should be exempted from the ban of promotion set out in Recital 111 of MiFID II and Recital 43 of MiFIR.[259] If that were the case, the EU definition of reverse solicitation would actually be broader than the view held by BaFin that prohibits any form of product advertising to new clients and does not distinguish between individualized and general forms of advertisement.

However, the scope of Recital 85 of MiFID II is limited to defining when services by an EU institution are to be regarded as being provided at the sole initiative of the client. This is of relevance for the level of information that investment firms must obtain from their clients[260], but it is not for defining the allowed extent of marketing allowed within the limits of ‘reverse solicitation’. This view is supported by Recital 43 of MiFIR and Recital 111 of MiFID II which both explicitly refer to services provided by a ‘third-country firm’ and which are located in midst of the recitals dealing with third-country provisions. By contrast, Recital 85 of MiFID II only

[259] Rolf Sethe, *Das Drittstaatenregime von MiFIR und MiFID II*, Schweizerische Zeitschrift für Wirtschafts- und Finanzmarktrecht 615 at 630 (2014) favours this interpretation and does not analyse potential contradiction between Recital 111 of MiFID II and Recital 43 of MiFIR on the one hand, and Recital 85 of MiFID II on the other hand.
[260] See Article 25(3) and (4) of MiFID II.

refers to ‘firms’ and is, from a systematic perspective, located in a different part of the Recitals. There are therefore good grounds to conclude that Recital 85 MiFID II should not be of relevance when defining the type and scope of marketing allowed within the limits of reverse solicitation. Rather, Recital 111 of MiFID II and Recital 43 of MiFIR are relevant for determining the allowed extent of marketing within the limits of reverse solicitation. Following this interpretation, the promotion of investment services or activities prevents the subsequent provision of services as reverse solicitation. This means, that the distinction existing under the current BaFin practice between prohibited product-specific advertisement and permissible brand-marketing will also prevail under the harmonized European regime. Sole brand marketing does not fall under the definition of investment services or activities under the MiFIR and MiFID II and does also not qualify as promotion of such services or activities. Only marketing of specific investment services, activities or products would be regarded as promotion within the meaning of Recital 111 of MiFID II and Recital 43 of MiFIR. Brand-marketing can thus be launched by a third-country firm and does not prevent that subsequent services or activities are provided under the concept of reverse solicitation.

Within an already existing client relationship, reverse solicitation under the MiFIR and MiFID II appears to be narrower in scope than the definition of reverse solicitation under the current BaFin practice.[261] The wording indicates that it is limited to the specific services requested by the client[262] and does not include the promotion of services that are deemed to be expected within the existing client-relationship as it is the case under the current BaFin practice. However, if the contractual framework between the client and the firm includes a clause by which the client requires the third-country institution to inform the client about the range of (new) products and services, the promotion would occur at the request of the client, this means on the basis of reverse solicitation.[263]

[261] Jochen Eichhorn and Ulf Klebeck, Drittstaatenregulierung der MiFID II und MiFIR, Recht der Finanzinstrumente 189 at 194 (2014).

[262] See Article 42(2) of MiFID II, Article 47(5)(2) of MiFIR; see also Simon Lovegrove, *Third country regime*, in Jonathan Herbst ed, A Practitioner’s Guide to MiFID II, 412 at 415 (2nd ed; London; Sweet & Maxwell, 2015), who asserts that the ‘exclusive initiative test applies on a service by service basis, not on a relationship basis’.

[263] Moreover, where no such clause is included in the contractual framework, but the client has requested advice from or even granted an asset management mandate to the firm, the firm will also be obliged to bring new products to the attention of the client. Such information measures that are to be treated as clients’ requests, rather than as not requested promotion.

(B) Applicable Organizational and Conduct Rules

The MiFIR, MiFID II and the implementation through the Draft Bill of the German Government for the Second Financial Market Amendments Act are likely to have an impact on the scope of organizational and conduct rules to be adhered to by institutions when providing services to German clients on a 'reverse solicitation' basis.

Outside the scope of the equivalence regime under the MiFIR,[264] the organizational and conduct rules[265] will as of 3 January 2018 apply to third-country firms that provide cross-border investment services 'in Germany' (*im Inland*).[266] As BaFin generally takes the view that services provided on the basis of reverse solicitation are not performed in Germany[267], services provided on a reverse solicitation basis should not be subject to German organizational and conduct rules under the German Securities Trading Act. This interpretation is supported by Recital 43 of MiFIR and Recital 111 of MiFID II, which set out that services being provided at the own exclusive initiative of a person in the EU should not be deemed as having been provided in the territory of the EU. As MiFIR, MiFID II and rules transposing MiFID II into the Members States' laws should only apply to investment services and activities provided within the EU, no MiFIR and MiFID II organizational and conduct rules should apply to services provided at the own exclusive initiative of a client.

6. Conclusion

The passporting framework currently entitles UK institutions to conduct cross-border activities across the EEA without obtaining a license in each EEA country. This regime would no longer be available if the UK withdraws from the EU and the EEA.

Instead, a UK institution that intends to offer its services in Germany, will, in principle, be required to establish a subsidiary in Germany. This subsidiary would have to apply for an individual license and would have to meet the comprehensive requirements that apply to institutions in Germany under the supervision of BaFin and/or the ECB. Alternatively, UK institutions may opt for establishing a new 'EEA hub' in another EEA country which would be entitled to apply the European passport and set up a branch or offer cross-border services in

[264] See above at 5(d)(i).
[265] Sections 63-96 of the German Draft Securities Trading Act.
[266] See Section 91 of the German Draft Securities Trading Act and above at 5(d)(iv).
[267] See BaFin, Guidance Notice – Notes regarding the licensing requirements pursuant to section 32 (1) of the German Banking Act (Kreditwesengesetz – KWG) in conjunction with section 1 (1) and (1a) of the KWG for conducting cross-border banking business and/or providing cross-border financial services, 5 April 2005, point 1 which refers to the use of 'in Germany' in Section 32(1)(1) of the German Banking Act.

Germany or other EEA countries. The UK institution could also apply for a German national exemption from the license requirement mentioned above and, subject to certain conditions, provide services on a cross-border basis to German clients.

As third-country firms, UK institutions would be granted more comprehensive access to EEA markets under the MiFID II/MiFIR framework applying as of 3 January 2018. This framework will enable the European Commission to adopt equivalence decisions allowing third-country firms to register with the ESMA and provide services to eligible counterparties and 'per se' professional clients. However, this regime is only applicable with respect to investment services and activities, but not to banking business. The CRR/CRD IV does not include a harmonized set of rules allowing third-country institutions to carry on banking business with EEA clients. Moreover, the equivalence regime does not entitle third-country institutions to provide investment services to retail clients and 'opt in' professional clients. Therefore, UK institutions will also alternative options for accessing the EEA financial markets, such as providing services on the basis of reverse solicitation.