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Gavin Davies
The Financial Conduct Authority
12 Endeavour Square
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By email: cp18-29@fca.org.uk

12 December 2018

Dear Mr Davies

FCA CP18/29 – Temporary permissions regime for inbound firms and funds

The City of London Law Society ("**CLLS**") represents approximately 17,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

This letter has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). The Committee not only responds to consultations but also proactively raises concerns where it becomes aware of issues which it considers to be of importance in a regulatory context.

We welcome the opportunity of responding to this consultation (CP18/29) in which the Financial Conduct Authority ("**FCA**") consults on its proposed approach to the temporary permissions regime. The temporary permissions regime is intended to allow EEA firms and funds to continue to regulated business in the UK should the UK leave the European Union without an implementation period in place. CP18/29 sets out the FCA's expectations on how this regime is expected to operate. Broadly speaking we welcome the pragmatic approach that the FCA proposes to take, but we have identified a technical issue in the approach described by the FCA which raises risks to the protection of the interests of clients of firms benefitting from the temporary permissions regime.

The issue that concerns us relates to the protection of client money and assets where the UK branch of such an EEA firm holds such money or assets. For convenience, this letter responds to Question 5 in Chapter 4 of CP18/29, although (as noted below) a similar issue arises in connection with Chapter 5 of the CP. For ease of reference, this letter (where relevant) adopts the same abbreviations with the same meanings as set out in Annex 6 in CP18/29.

Q5) Do you agree with our proposals on protecting client assets held by firms in the TPR? If not, why not?

We are concerned that the proposed approach set out in CP 18/29 will not provide adequate protection for client money and client assets in circumstances where these are held by a UK branch of a TP firm. This is because of a difference that will arise in the handling of insolvency proceedings for investment firms and credit institutions in the absence of an implementation period.

Under the existing EEA-wide arrangements the insolvency regime for a credit institution or of an investment firm is that of that firm's home state. A UK branch of an EEA firm is thus administered as part of the overall home state insolvency regime, under the Credit Institutions Winding up Directive (i.e. Directive 2001/24/EC) (as amended) – the jurisdiction of the UK courts is disapplied in favour of the home state procedure. Thus the insolvency procedure, and jurisdiction, for a credit institution and an investment firm is consistent with the allocation of responsibility for matters of an organizational/prudential nature under the Markets in Financial Services Directive ("**MiFID**", i.e. Directive 2014/65/EU). In particular, the responsibility for implementing the MiFID requirement for ensuring the protection of client assets and client money is allocated to the home state (see MiFID, Article 16(8) and (9)). This combination is important in ensuring that the courts responsible for monitoring the administration of an insolvency proceeding are also familiar with, and subject to, the legal structures used to implement the Article 16 requirements.

In the absence of any agreed implementation period, or any other agreement between the EU and the UK on cross-border insolvency procedures that addresses the issue, the provisions of the draft Credit Institutions and Insurance Undertakings Reorganisation and Winding Up (Amendment) (EU Exit) Regulations 2018 (the "**Insolvency SI**") will come into effect. For the purposes of this letter we assume that the draft published on 30 November 2018 sets out the substance of the measures stated to "address deficiencies" resulting from the UK leaving the EU.

Under the Insolvency SI, the UK branches of TP firms will cease to have any special treatment, and will be subject to the operation of UK law on insolvency proceedings and related matters. The Insolvency SI explicitly (except in limited transitional circumstances) excludes the cross-border operation of the Credit Institutions Winding up Directive. The effect of this is that there will no longer be any requirement for the UK to recognize and operate the current single, EEA-wide, insolvency procedure. Equally assets held by a UK branch will not fall to be considered in the same was as generally applicable in the UK to such holdings (though this may involve consideration of laws applicable locally if the UK branch holds those assets outside the UK).

In order to administer the UK branch in an insolvency, insolvency practitioners will need to make an application in the UK to effect the winding up of a UK branch, or to have their home state appointment recognized for the purposes of the UK (or both). Under Part V of the Insolvency Act 1986 (which is applied, in effect, by the Insolvency SI) a UK branch of a TP firm may be wound up as an "unregistered company" – in practice treated as if it was a separate entity incorporated in the UK. (While not addressing the position of a branch in Northern Ireland, we understand that the relevant insolvency legislation would result in the same result.)

In a post-Brexit insolvency proceeding, therefore, assets held by a UK branch of a TP firm may fall to be analysed under UK insolvency proceedings, and assets held in the UK would ordinarily be considered under applicable UK property laws.

If the client asset protection required by MiFID is implemented by the home state in a way that relies on administrative provisions and/or features of that home state's domestic property laws, then there is serious risk that those protections would be found to be ineffective in relation to assets held by the UK branch in the UK should the protections be challenged by the general creditors of the branch. (To the extent that the UK branch holds the relevant assets elsewhere in the EEA, this may not be an issue.)

The effectiveness of the trust-based approach adopted under section 137B of the Financial Services and Markets Act 2000, and the separate nominee basis for assets adopted under CASS, have been found to be robust (though potentially complex) to ensure protection of client assets and money against such challenges. We are aware that there have been cases (albeit not in the context of mandated client money or asset protection) that have found other segregation methods to be insufficient to protect funds or assets from such challenge. For example, therefore, an English court overseeing the liquidation of a London branch of a TP firm would potentially be faced with a competition between well-established case law under which mere segregation is found to be insufficient, and a plea to give effect to a system of protection which has no legislative or regulatory basis in the UK. Even the risk of such a challenge, we suggest, gives rise to unwarranted risks for clients of TP firms.

While, therefore, we support the proposal under paragraphs 4.44-4.46 of CP18/29 requiring TP firms to make disclosures about the non-UK regime for insolvency and client protection, and any client assets being held in non-UK countries (including other EEA countries), we do not consider that this is sufficient.

To address the potential for a challenge to client money and client asset protections other than those specified under the UK regulatory regime, we suggest that TP firms could be made subject to the CASS requirements in the same way as for third country firms for money and assets that the branch holds outside the EEA. We acknowledge that this would give rise to some practical issues, and that we do not have a sense of the size of the population of firms in respect of which this might prove a significant concern. We would be happy to discuss some possible approaches further with you if that would be of interest.

Chapter 5 concerning electronic money institutions and payment institutions

We appreciate that the FCA is not proposing to amend its Handbook for EMIs and PIs and has not included questions for consultation in Chapter 5 of CP18/29. However, issues concerning cross-border insolvency could also arise in this sector. We therefore suggest the FCA review its Approach Document (September 2017) to:

- ensure that it includes appropriate material requiring appropriate disclosures about the operation of non-UK insolvency and client protection regimes; and

- ensure that the assets held outside the EEA by the UK branch of a TP firm are subject to effective safeguarding methods, including taking steps to ensure that such accounts are acknowledged by the relevant institutions as being used for that purpose alone and thus not to be considered assets of the TP firm.

Both the Payment Services Regulations 2017 and the Electronic Money Regulations 2011 require segregation of funds in certain cases, for the protection of clients. While not explicit, the way in which the relevant obligations are framed indicate that the UK's interpretation of the relevant EU provisions is to allocate home state responsibility for the means of segregation (where relied on). Unlike the position for client money and assets that are required to be protected under MiFID, each of these sets of Regulations adopts particular language about segregation and its effect.

According to the draft Electronic Money, Payment Services and Payment Systems (Amendment and Transitional Provision) (EU Exit) Regulations 2018 (the "**Payments SI**"), electronic money institutions ("**EMI**") and authorized payment institutions ("**API**") will be permitted to make use of safeguarding accounts held with non-UK banks (Paragraph 7(1) and 29(1), Schedule 2). As we understand it, the Payments SI also permits the use by UK branches of EMI or API that are TPR firms of UK accounts for the purpose of segregation. The insolvency procedure applicable to the UK branch of an API or an EMI operating as a TP firm, should the UK leave the EU without an implementation period, will be as described in the previous section. To the extent that such a branch holds funds in an account in the UK (or indeed elsewhere outside the EEA), we consider that the relevant TP firm should be expected to take the same steps as any other firm authorized as an EMI or an API to minimize the risk of challenge to the effectiveness of segregation to the detriment of their clients.

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact Karen Anderson by telephone on +44 (0) 20 7466 2404 or by email at Karen.Anderson@hsf.com in the first instance.

Yours sincerely

Karen Anderson
Chair, CLLS Regulatory Law Committee

THE CITY OF LONDON LAW SOCIETY
REGULATORY LAW COMMITTEE

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