The Shape of Brexit and its Impact on the U.K. Financial Markets

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FINANCIAL MARKETS LAW COMMITTEE

Slide 1—The Shape of Brexit and its Impact on the U.K. Financial Markets

Hello and thank you.

It is a tremendous privilege to be here and please accept my apologies that this presentation will be in English.

Please feel absolutely free to interrupt me as we go along. That way we are much more likely to have an interesting discussion. I cannot promise to know the answers to any questions you may have… so much of Brexit is unknowable… but I can promise to take away any questions you may have and respond in person after the event.

This is my first presentation on Brexit outside the U.K.—I was recently saved from making one in the Hague by foggy conditions at London City Airport—and I know that any engagement with my points which you make today will improve the delivery next time.

Slide 2—Introduction

The Financial Markets Law Committee ("**FMLC**"), of which I am Chief Executive, was established by the Bank of England ("**BoE**") in 2002 to identify issues of legal uncertainty affecting wholesale financial markets, including inconsistencies between draft law or regulation and market practice, and to publish proposals for resolving them.

The FMLC incorporated as an independent company in 2013 and became formally recognised as a charity in December 2015.

As a charity, the aim of the FMLC is to advance the public interest in legal education and in particular education with respect to financial markets law, improving the public's understanding thereof and making developments in that field more accessible. To the extent that the FMLC's proposals to resolve issues of legal uncertainty are adopted, this also promotes the sound administration of the law.

Although a small organisation, we coordinate a large number of groups, sub-groups and individuals working to ensure that our charitable remit is met.

I think it is safe to say that Brexit represents the biggest challenge of coordination around issues of legal uncertainty ever faced by the FMLC.

Slide 3—23 June 2016

On 23 June 2016, the British public went to the polls to vote in an IN/OUT referendum on E.U. membership.

According to statistics published by the Electoral Commission, 72.2% of the population turned out to vote. Of those, 48.1% (34.7% of the population) voted to remain in the E.U. and 51.9% (or 37.5% of the population) voted to leave.

Slide 4—24 June 2016?

As it turns out, the elected government, which had campaigned to Remain, had no clear, detailed plan for leaving the E.U. and the Prime Minister, David Cameron, resigned the next day.

Although voters had been told that a vote to Leave would represent an irrevocable commitment to leave immediately, Cameron's resignation made that impossible.

A leadership election was fought and Theresa May was chosen to be Prime Minister by the Conservative Party. Although she herself had opted to Remain, she appointed several prominent so-called Eurosceptics to key cabinet positions.

Six months after the Referendum, neither the public nor Parliament has been informed in detail of the programme for leaving the E.U.

Slide 5—The Aftermath

The impact of the vote to Leave on the financial markets in the U.K. and E.U. was instant. The markets reacted initially as if they had sustained a severe shock.

- Five of the largest U.S. and U.K. CCPs demanded $27bn in additional collateral across derivatives products on 24 June.
- In both the E.U. and U.K., markets experienced large currency swings and significant equity price declines, particularly in bank stocks.
- GBP declined sharply to a 31-year low. It recovered slightly but remained lower against USD and EUR than before the referendum.
- In the E.U., stock prices dropped by around 10% but then gradually returned to pre-referendum levels for non-bank stocks over the summer.
- In the U.K., several open-ended property funds suspended redemptions.
- The Bank of England required U.K. banks to increase their capital and liquidity buffers.

In August, the Bank of England cut the Bank Rate to 0.25% and introduced a package of measures designed to provide additional monetary stimulus. Over the summer, U.K. and E.U. stock markets both recovered, although at varying speeds. Overall, the position stabilised, owing partly no doubt to the energetic action taken by the Bank of England.

The last available BoE forecasts for the U.K. predict growth of 1.4% in 2017 and 1.5% in 2018 with inflation of about 2.7% (higher than the centrally imposed target figure). Given that the actual growth figure since then has held steady at about 0.6% per quarter, many economists expect the BoE to increase its growth forecasts.

Concern remains, however, that Brexit will hurt trade and that this in turn will hit investment. Inflation may make the business environment less profitable, particularly for domestic businesses, and slow inflation

Slide 6—"Brexit means Brexit"

Despite strong and frequent calls for the public to be given a roadmap for Brexit, the Prime Minister initially refused to reveal her hand.

Statements on Brexit made in the second half of 2016 were, with the exception of remarks on a "Great Repeal Bill" (of which we shall hear more in a moment) offered in October at the Conservative party conference, vague to the point of being confusing. "Brexit means Brexit" became something of a popular meme. Unfortunately no one knew what it meant. And MPs, at least, seemed to have difficulty distinguishing between Brexit and breakfast!

Andrew Davies, the leader of the Welsh Conservatives, at Tory party conference cried, "We WILL make breakfast a success!"

Meanwhile Labour's Shadow Chancellor, John McDonnell, declared that "The Government is hurtling towards a chaotic breakfast." He also warned that "a chaotic breakfast will lead to job losses". And he remonstrated that voters "don't want a bankers' breakfast any more than I do".

Slide 7—Tax Haven or Beacon of Social Justice

The Referendum result appears to have left the Government with a dilemma. A policy of occupying the political centre ground with a philosophy of compassionate conservativism has delivered the Conservatives into power in the two previous elections. Moreover, it is clear that many Leave voters were inspired by the expectation (not necessarily accurate) that more money could be spent on issues like health and welfare if the U.K. reduced its contribution to the E.U. budget.

On the other hand, many Eurosceptics see Brexit as a different kind of opportunity altogether… they endorse a set of policies designed to attract foreign investment by cutting tax and regulation.

These two visions of Brexit seem quite hard to reconcile for many and exacerbate the sense of political uncertainty.

Thus, the dilemma (discussed below) whether to maintain E.U. regulatory standards after Brexit in order to preserve access to the Single Market is symptomatic of the larger question of what kind of reform Britain wants outside the E.U.

Will that reform favour the socially oppressed by making big business accountable, or will it favour business and investment by cutting tax and regulation?

Slide 8—The Way Ahead

For those particularly troubled by the lack of clarity, the position improved on 17 January 2017 when Theresa May gave a speech outlining her negotiating position for the forthcoming "divorce" negotiations between the E.U. and the U.K.

She stipulated that among the U.K. objectives there would be:

- No membership of the Single Market.
- A customs agreement with the E.U. that leaves the U.K. free to reach individual tariff schedules at the World Trade Organisation ("**WTO**")

- New bilateral trade deals with Third Countries
- Transitional arrangements for financial services
- No more consolidated U.K. contributions to the E.U. budget (although contributions to particular projects may be forthcoming)

More recently, under pressure from Members of Parliament on both sides of the House, the Prime Minister has promised to produce a "White Paper" setting out her negotiating objectives in detail.

Slide 9—Article 50(2) TEU

Since the Prime Minister delivered that speech, the government's position on Brexit has become complicated by a legal decision on 24 January 2016 on the operation of Article 50 of the Treaty on European Union ("**TEU**") (the provision under which Brexit will take place).

If you recall, Article 50 provides:

1. *Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.*
2. *A Member State which decides to withdraw shall notify the European Council of its intention […].*
3. *The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.*

One of the biggest challenges facing the Government is how to secure an agreement within the two-year period specified under paragraph 3 and avoid withdrawing from the Union without any deal. The closer the U.K.'s negotiating position is to its own wish list of Single Market access with "no strings attached", the less likely that position is to be acceptable to a qualified majority of Member States. In those circumstances, there is a real risk of being wholly excluded from the Single Market. For reasons that will become apparent later on, establishing a deal or re-joining the Union at a later date, only after a decisive rupture in the U.K.'s passporting rights would almost certainly still leave the U.K. financial services industry damaged.

Slide 10—Brexit: A Rapidly Diminishing Array of Options

So, what might the Prime Minister's white paper look like once it's published? Given the indicators in her speech on 17 January, the range of options and the chance of full Single Market access is rapidly diminishing. Let's take a look at some of the choices open to her and what they mean for the legal and regulatory framework within which the financial services industry operates in the U.K.

Slide 11—The Norwegian Model: E.E.A. Membership

When people speak of "soft Brexit" what they usually mean is continued membership of the European Economic Area ("**E.E.A.**") One simple Brexit option would have been for the U.K. to join/remain in the E.E.A. In this regard, there is a live question whether the U.K., which is already a party to the E.E.A. Treaty (*qua* E.U. Member State), will automatically "fall out of" the E.E.A when it leaves the E.U. The better view is probably that it will.

Given this, the U.K. would have to re-join the E.E.A., this time by virtue of being an European Free Trade Area ("**EFTA**") member state. In order to do this, the U.K. would be legally required to join EFTA. The E.E.A. legal framework has existed since 1994.

Slide 12—The Norwegian Model: E.E.A. Membership (cont)

This model reflects a number of advantages and disadvantages for the U.K., which are listed on the slide. In addition to these, it would end the jurisdiction of the European Court of Justice ("**ECJ**") in the U.K., although not the impact of its decisions on the interpretation of those European standards which are commonly applied between member states of the E.E.A.

Slide 13—The Norwegian Model: E.E.A. Membership (cont)

EFTA has its own institutions analogous to the organs of the E.U. These are necessary because the E.E.A. Treaty imposes an obligation of "homogenity" on contracting states. Notable among them is the EFTA Surveillance Authority which has powers similar to the European Commission to pursue breaches of competition law and other lapses in the standards which are applied throughout the E.E.A.

Slide 14—The Norwegian Model: E.E.A. Membership (cont)

E.E.A. states have what are termed co-determination rights in respect of EU legislation but not co-decision rights. As I learned from a speech given by Professor Baudenbacher[1] in London last year, Jacques Delors, who was the President of the Commission at the time, said on 17 January 1989: "We offer the EFTA States a more structured partnership *with common decision-making* and administrative institutions."

Delors took his pledge back one year later. The EFTA States obtained a co-determination right in the preparation of new E.U. legislation, which is then transposed into E.E.A. law, but no co-decision right.

Slide 15—The Norwegian Model: E.E.A. Membership (cont)

The rejection of ECJ jurisdiction has become something of a key theme for Eurosceptics since the referendum. In light of the fact that E.E.A. states are not bound by decisions of the ECJ, perhaps the strongest political reason to adopt the Norwegian model is the idea that it retains Single Market access while avoiding the need to be strictly bound by the decisions of the ECJ.

Among E.E.A./EFTA states, the EFTA court has jurisdiction. There is no written obligation on the courts of last resort of EFTA member states to make a reference to the EFTA Court. The preliminary rulings of the EFTA Court are not Binding on national courts. They are termed "advisory" opinions. They do, however, have strong persuasive and moral force. The E.E.A. Agreement has formulated homogeneity rules, which in essence Bind the EFTA Court to follow relevant ECJ case law. Norway's review of the E.E.A. Agreement found that the EFTA Court is stricter than the ECJ according to a 2012 report by the Norwegian government

Slide 16—A Summary of the Norwegian Model by Open Europe

I thought I would include this helpful summary from Open Europe in the slide deck.

Slide 17—The Swiss Model: "Voluntary Alignment"

A different model of neighbourliness with the E.U. has been adopted by Switzerland. Switzerland is part of EFTA but not E.E.A. To facilitate trade and market access, Switzerland has negotiated a large number of bilateral treaties and sectoral agreements with the E.U.

Slide 18—The Swiss Model: "Voluntary Alignment" (cont)

In fact Switzerland's relationship with the E.U. is marked out by over 120 sectoral agreements. When a dispute arises over the application of these agreements, its resolution is in the hands of diplomatic joint committees. There is no common surveillance institution and no common court.

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[1] President of the EFTA Court.

There is no sectoral agreement in financial services and reports suggest that there is no appetite in the E.U. for concluding one.

According to E.U. policy, Single Market access for Non-E.U. states to the Single Market is only possible if the state participates in a supra-national surveillance authority and court mechanism. Liechtenstein, Norway and Iceland have the EFTA Surveillance Authority and the EFTA Court but Switzerland does not. According to reports, the E.U. authorities have informed the Swiss government that no new market access agreements will be concluded without supra-national surveillance and dispute resolution mechanisms.

The solution that has allegedly been proposed is the so-called "docking solution" whereby Switzerland agrees to accept oversight by the EFTA surveillance authority and the EFTA Court of proceedings relating to the sectoral agreements. The Swiss government is reportedly antagonistic to this solution which, it says, would cede jurisdiction to a partial entity dominated by judges who are steeped in E.U. jurisprudence and principles but not in Swiss law.

Slide 19—The Swiss Model: "Voluntary Alignment" (cont)

In practice in the field of financial services, Switzerland must align its policies with E.U. regulation so as to preserve Third Country access for its financial services providers. In this respect, its position is like that of any Third Country. The difference is that the E.U. is its biggest market and right on the doorstep. This is the position that the U.K. will find itself in.

Slide 20—The Baudenbacher Model: Renegotiation of the E.E.A. Agreement

I have already mentioned Professor Baudenbacher, Chair of the EFTA Court. He has raised an interesting possibility, commenting that the U.K. could join EFTA and then unite with Norway and, perhaps, Switzerland to secure revisions to the E.E.A. Agreement. Following this, the U.K. and Switzerland could join the E.E.A. on favourable terms.

Slide 21—The Baudenbacher Model: Renegotiation of the E.E.A. Agreement (cont)

This offers an intriguing third way between membership of the E.E.A./EFTA and falling back to a bilateral free trade agreement ("**FTA**") with the E.U.

It is not clear, however, what parts of the E.E.A. Agreement might be open to renegotiation or might be prioritised by the states in the new alliance. Popular but controversial suggestions would include:

- a cap on the free movement of persons;
- a relaxation of the principle of homogeneity, (in particular in the manner in which ECJ decisions Bind the EFTA Court); and/or
- political influence in the processes of developing and negotiating E.E.A.-relevant E.U. legislation, i.e. rights of co-decision.

Slide 22—The U.S. Model: Third Country Equivalence

Given the comments made by the Prime Minister on 17 January 2017, it would appear that a "soft Brexit" has now been excluded from the menu of potential negotiating positions. In those circumstances, the U.K. will find itself in the same position as any other Third Country with an international financial centre and a thriving financial services sector… for example, the U.S.

The E.U. has negotiated an ambitious and balanced trade and investment deal with the U.S.: the Transatlantic Trade and Investment Partnership ("**TTIP**"). The future of this trade deal is now highly uncertain under the new U.S. administration. In any event, the deal will not include financial services. At the moment U.S. financial services providers rely on sectoral Third Country regimes in order to obtain access to the E.U. Single Market. The best-known element of these regimes is the concept of "equivalence" (which I shall discuss further below).

Slide 23—The U.S. Model: Third Country Equivalence (cont)

The provision of U.S. financial services into the E.U. is increasingly subject to a determination by the European Commission that the U.S. is an "equivalent" regulatory regime. An "equivalence" test is the commonest threshold standard for E.U. access by Third Country service providers across market sectors but it does not mean the same thing in each sector in which it applies and it is important to bear in mind that in some sectors there is no standard for, or means of, access; and in others the key test may be something other than "equivalence". For the remainder of this presentation, I will use "equivalence" as it has come to be used in the media: as a kind of short-hand proxy for a complicated patchwork of regulatory Third Country regimes which apply to different market activities under different E.U. regulations.

Any country whose trade arrangements with the E.U. do not cover financial services will have to comply with the equivalence standard before domestic financial services firms can provide services into the E.U. The U.S. benefits from equivalency decisions in respect of 16 E.U. financial services regulations. (Japan benefits from 17, Canada from 16, Switzerland from 10 and Turkey from 5; a significant number of these equivalence decisions were taken in the last six months of 2016).

At the moment there is no standardised template or precedent for equivalence determinations.

Recently, however, equivalence determination has been linked in E.U. legislation to compliance with international principles (for example, a new equivalence provision in the E.U. Benchmarks Regulation refers to the *Principles for Benchmarks* established by the International Organization of Securities Commissions "**IOSCO**")), which sets a useful precedent and implies that the Commission's approach may be subject to greater standardisation in future.

Slide 24—The U.S. Model: Third Country Equivalence (cont)

The path to an equivalence determination rarely runs smoothly. I myself had some familiarity with the U.S.-E.U. dialogue on mutual recognition of CCPs. That dialogue was not only fraught with technical complications but also became highly politicised.

The U.K. has a strong argument that it is equivalent but, as we shall see, there is considerable uncertainty as to the timing and specificity of any equivalence decisions. There is also, of course, the Brexit dilemma mentioned earlier: if the UK wishes to position itself as an international offshore centre—according to the "tax haven" roadmap—then it will look to cut the volume of regulation that applies to financial services. In this case, the U.K. legal framework is unlikely to remain fully "equivalent" for very long.

Slide 26—The Canadian Model: Free Trade Agreement

Many who campaigned for the U.K. to "Leave" the E.U. view a bilateral FTA between the E.U. and U.K. as the most likely model for their future relationship. Canada concluded a free trade agreement with the E.U. in 2014 but it has not yet been ratified. On 24 January 2017 the international trade committee of the E.U. Parliament recommended that the trade deal be approved.

Slide 27—The Canadian Model: Free Trade Agreement (cont)

The most important point to note about the Canadian-E.U. Comprehensive Economic and Trade Agreement ("**CETA**") is that it does not cover financial services. That means that the provision of Canadian financial services into the E.U. is subject to a determination that the regulatory framework in Canada, for that market sector or activity, is equivalent, just as it is in the U.S.

Slide 28—The Turkish Model: Customs Union

The last alternative is a customs union, which is something that Theresa May has suggested she will pursue. The E.U. currently has one with Turkey.

Slide 29—The Turkish Model: Customs Union (cont)

There is no existing model of a customs union which extends to financial services and, given what was said earlier about Swiss sectoral agreements and the apparent E.U. policy of requiring supra-national surveillance and dispute resolution mechanisms before reaching any agreement on trade in financial services, it seems unlikely that the U.K. will be able to negotiate one which covers financial services. The provision of Turkish financial services into the E.U. remains subject to a series of equivalence determinations.

Slide 30—The "Rest of the World" Model: WTO Rules

That leaves us with the WTO rules. All 173 members of the WTO are parties to the General Agreement on Trade in Services ("**GATS**").

Slide 31—The "Rest of the World" Model: WTO Rules (cont)

The GATS contains "most favoured nation" ("**MFN**") provisions, which require, subject to exceptions, WTO member countries not to discriminate between services and service providers from other WTO member countries.

Some in the U.K. see these rules as a safety net for U.K. financial services providers hoping to trade in services cross-border but it is equally likely that they will provide a platform from which to challenge any bespoke mutual recognition agreement which is more favourable to the UK than to other Third Countries.

While the GATS in effect exempts certain mutual recognition agreements between WTO member countries there is legal uncertainty about the scope and ultimate effects of these provisions of the GATS.

This is likely to be an issue for transitional arrangements, in particular.

Slide 32—The "Rest of the World" Model: WTO Rules (cont)

Without any free trade or sectoral agreement in place and relying solely on WTO rules, the U.K. would have to re-establish customs controls at borders with E.U. Member States. It would then be subject to the E.U.'s common external tariffs.

Trade between the E.U. and Russia, for example, relies heavily on WTO rules and principles. (Russia benefits from only one equivalence decision—on statutory audit).

Slide 33—Super- and Supra-Equivalence

At this point, I would like to take a little time to look at the E.U.'s regulatory regimes for Third Countries in a little more depth and to consider the concept of "equivalence", in particular.

Slide 34—Hard Brexit, hard choices

What we observed at that point was that any decision to cut and reshape financial services regulation to attract investment and business from overseas will lead to the U.K. losing its equivalent status. But the reverse is also true: if the U.K. intends always to adhere closely to E.U. regulation, what was the point of Brexit (especially given the cost and resourcing implications)? This can be described as the "Third Country Bind".

The sense of having little room for manoeuvre is exacerbated by the fact that, as you know, so much of financial services regulation in G20 countries in this post-crisis era is pre-determined by the application of international standards set by the Financial Stability Board ("**FSB**"), IOSCO, Bank of International Settlements ("**BIS**") and others.

Slide 35—Being a Third Country

Serious disruption could occur if there is any *hiatus* between the availability of the financial services "passport" and the availability of the more limited access which can be achieved under Third Country regimes.

The prospect of this *hiatus* arises because there is uncertainty as to timing. Without transitional arrangements, the E.U. Commission will not make any equivalence determinations—and the European Supervisory Authorities ("**ESAs**") will not take any consequential recognition or registration decisions—until the U.K. has already left the E.U. This would lead to a "cliff edge" effect in terms of lost access to the Single Market on day one of Brexit.

U.K. providers of financial services would be—at least temporarily—deprived of access to key E.U. markets unless they were first individually to acquire authorisation (either for a subsidiary or for the U.K. firm "directly" *via* a branch (discussed below)).

But even if transitional arrangements are successfully negotiated and put in place, there are still a number of challenges facing the U.K. in preparing for a Brexit which will retain some kind of access to the E.U. financial markets under Third Country regimes:

- Even if the U.K. begins by being "super-equivalent" (see below), it will soon fall victim to the *Third Country Bind* mentioned above. Do future U.K. Governments spend public resources to replicate E.U. laws in order to remain super-equivalent? Or do they take a different path—there is sometimes talk in the media of a "bonfire of the regulations"—without any guarantee of remaining equivalent? Is there a middle way?

- For those who would wish to preserve access to the E.U. Single Market as a Third Country, there are very real questions about how existing E.U. laws can and should be transposed and adapted into U.K. law (see "Standstill" below).

- The U.K. will lose its role in the co-operative institutions of the E.U. It may lose oversight of security, stability and conduct risks which arise in neighbouring jurisdictions.

- Some regulations (the Bank Recovery and Resolution Directive, the Credit Institutions Winding Up Directive, the E.U. Insolvency Regulation, Brussels I) establish a mutual enforcement regime between Member States which cannot easily be replicated in favour of a Third Country. Transposition of E.U. laws will not overcome this difficulty.

Slide 36—Equivalence

I mentioned that equivalence determinations are not a foregone conclusion. There are many misconceptions about equivalence. Contrary to popular belief:

- Regulations applying in many areas of market activity have no concept of equivalence: some offer an alternative regime (e.g. the Markets in Financial Instruments ("**MiFID II**") "passport"), some have no regime for cross-border business other than by means of authorisation in the host state (e.g the Alternative Investment Fund Managers Directive ("**AIFMD**")).

- Many financial services business lines (e.g. retail investment business) are excluded *ab initio* from any regime permitting the cross-border provision of services into the E.U. other than by branch or authorised subsidiary.

- Equivalence is not a unitary concept, it means different things in relation to different market activities.

- The E.U. Commission can rescind a favourable equivalence decision, once granted.

- No country has an automatic right to a favourable equivalence decision.

- Equivalence can require more than an alignment of core legislative rules (see next slide).

- Equivalence is not a "maximum harmonisation" decision. Some Third Country regimes permit Member States to impose optional additional constraints on Third Country service providers.

Slide 37—Super-equivalence

I also mentioned earlier that the U.K. is virtually guaranteed to have equivalent laws on day one of Brexit because its laws will be the same as EU laws. We can refer to this relationship of identity as "super-equivalence". But "super-equivalence" does not mean that the U.K. will necessarily be guaranteed an early and positive equivalence determination.

There are two reasons for this: first, the role of ancillary considerations in an equivalence determination and, second, the possibility of changes occurring in U.K. regulation between Brexit and the time when the determination is made.

Slide 38—Supra-equivalence

It is for this reason that several interest groups have recommended that the U.K. should adopt as its negotiating objective a more robust, bespoke equivalence regime. These include:

- *A Blueprint for Brexit: The Future of Global and Financial Services and Markets in the U.K.* by Barnabas Reynolds on behalf of Politeia, advocates for "Expanded Equivalence" as one possible way forward.

- *The E.U.'s Third Country Regimes and Alternatives to Passporting* by Hogan Lovells on behalf of the International Regulatory Strategy Group, advocates for a bespoke market access regime between the U.K. and E.U. based on mutual recognition and, in the alternative, for "extending and enhancing" existing Third Country Regimes.

A new "supra-equivalence" regime would ideally provide more predictability than the current patchwork of sectoral Third Country regimes. It might, for example, include a guarantee that an equivalence determination could not be withdrawn without notice and it might vest the U.K. with a right to refer an equivalence decision to a diplomatic joint committee established for the purpose. (These possibilities remain, however, politically controversial in many of the 27 Member States of the E.U.)

Slide 39—"Fourth Country" Anyone?

On this subject, there is one aspect that is often overlooked: the loss of the E.U.'s mutual recognition arrangements with other Third Countries. The U.K. will no longer receive the benefit of any regulatory concessions made by Third Countries in response to negotiations undertaken by the E.U. on mutual recognition.

For example, U.K. clearing counterparties ("**CCPs**") may not automatically qualify for the substituted compliance concessions awarded recently to E.U. CCPs by the U.S. Commodity Futures Trading Commission ("**CFTC**").

It will be necessary to start from scratch and for U.K. competent authorities to negotiate bilateral mutual recognition arrangements for each Third Country jurisdiction in each area of market activity.

For a significant period, then, the U.K. may be in a less advantageous position than other Third Countries, given that it must renegotiate financial markets access with both the E.U. and with other Third Countries. (Would this make it, in some sense, a "Fourth Country"?)

Slide 40—Transition

Given the uncertainties just mentioned, market participants in the U.K., who will lose their "passports" to the E.U. Single Market for financial services, are keen that the U.K. and E.U. should agree transitional arrangements as early as possible. The FMLC is of the view that such arrangements would offer a valuable means of promoting legal certainty and minimizing the disruption which could occur if there is any *hiatus* between the availability of the financial services "passport" and the application of the Third Country regimes.

The question of transitional provisions is an urgent one. Nevertheless, given the complexity of the issues and markets at stake, the question would clearly benefit from as much careful research and analysis as time will afford. One way to reconcile the exigencies of the political timetable with the intricacy of the issues at stake would be to adopt a staged approach, starting with areas where the mutual benefit for both the E.U. and the U.K. in preserving current arrangements is clearest or the issue is otherwise uncontroversial. (One example of such arrangements that could usefully be made is the continued use of London-based financial benchmarks for valuation and reference rate purposes by E.U. supervised entities, and *vice versa*.)

As I mentioned earlier, assuming that transitional arrangements are found to be desirable from a policy perspective, they must be tested against WTO rules. The MFN provisions of the GATS, which require WTO member countries not to discriminate between services and service providers from other WTO member countries, should be considered as any transitional agreement favouring the U.K. is designed and negotiated

Slide 41—Standstill

I'd like to turn on that note to the proposal for transposing E.U. law into domestic law. Transposition measures of this kind, which are familiar in a variety of contexts, are often colloquially referred to as "standstill" legislation. They are familiar to the U.K. in the form of "reception statutes", which have been enacted in each former British colony as it has gained independence. In that context, "standstill" or "reception" is the process by which the new nation adopts pre-independence English common law, to the extent not explicitly rejected by the constitution of the new nation.

The proposal, for a Great Repeal Bill, which should—if the *acquis* is transposed without significant substantive revisions—mean that the U.K. is *de facto* equivalent, even if it does not yet benefit from any determination to that effect.

Slide 42—Theresa May, 2 October 2016

This slide sets out extracts from a speech given by the Prime Minister on 2 October 2016 when she laid down plans for what she called a "Great Repeal Bill". Information was scarce at the time—the public did not learn details about the Bill from the speech that are not set out on this slide.

Slide 43—Department for Exiting the European Union, 2 October 2016

A little amplification to these comments was, however, provided by the newly appointed Minister for Exiting the European Union. Strikingly, one of the points which is given early priority by DEx.E.U. (as it is commonly known) was the proposal to bring an end to the jurisdiction of the European Court of Justice in the U.K.

Slide 44—The Great Repeal Bill: What We Do Know About It …

In summary, from these statements, we learned that…

- The Bill will be included in the Queen's Speech next spring (May 2017).
- That means it is scheduled to come after the Prime Minister's March 31 deadline for triggering Article 50
- It will repeal the European Communities Act 1972.
- It will take effect on the day the U.K. ceases to be part of the E.U.
- E.U. law will then, by virtue of the new provisions, cease to apply in the U.K.
- The new Act will transpose the E.U. *acquis* into U.K. law.
- It will include powers for ministers to alter the *acquis* by secondary legislation.
- And it will establish a new domestic platform for regulatory agencies.

No further clarity has been given on the contents of the Bill since then.

Slide 45—The Great Repeal Bill: What We Don't Know About It …

On this slide, I set out some of the things we <u>don't</u> know about the Bill:

- We don't yet know whether the U.K. transpose the entire *acquis* on Brexit day, or just those parts regarded as favourable or essential. For reasons discussed below, it may not be practicable to incorporate the entire *acquis* "at the stroke of a pen".
- The impact of the new Act, if any, on the wider exit negotiations is unclear.
- There is as yet no indication of the sort of Parliamentary scrutiny will there be (a) of the new Act; (b) of the exercise by ministers of their legislative powers to alter the *acquis* under the new Act.
- The manner in which the devolved parliaments/assemblies will interact with the legislative process has received media attention but has not been clarified.
- It is expected that the new Act will stipulate or imply that rules of the *acquis* are no longer be required to be interpreted in a manner consistent with ECJ case law. If so, a question arises as to whether new guidelines on the interpretation of the *acquis* will be enacted.

Slide 46—The Great Repeal Bill: Issues and Challenges I

A Bill to transpose E.U. law into U.K. law is essential because, without it, E.U. Regulations would simply evaporate on day one of Brexit. This is a consequence of the doctrine of direct effect and its incorporation in the European Communities Act of 1972.

The Bill presents a number of challenges. The first of these is the simple, practical challenge of writing a Bill to transpose E.U. law in its entirety into U.K. law. One single clause won't achieve this. That is because, as you know, E.U. laws are full of Articles referring to the institutions of the European Union. Clauses submitting matters to the authority of the ECJ and the European Commission are arguably exactly what UK citizens have voted to abolish. So every law must be re-written so as to make sense without these clauses.

It would seem to be very difficult indeed to do this according to the timetable laid down by Theresa May. So, it is possible that the Great Repeal Bill will take the form of a short Bill incorporating the *acquis*, leaving it to Ministers to amend the acquis and adapt it to the domestic framework within the two years before the Bill comes into effect. This raises a different sort of problem, discussed on the next slide.

Slide 47—The Great Repeal Bill: Issues and Challenges II

The Bill has already proved highly controversial. It will contain sweeping new powers for ministers set out in what are known as "Henry VIII" clauses.

These would seem to be intended either (1) to preserve the option, which we noted earlier in discussing the Third Country Bind, of making a rapid departure from the policies and principles adopted in the E.U. by amending the transposed laws; or (2) to allow ministers to make changes necessitated by the fact that surveillance and dispute resolution will be referred to British, rather than E.U., authorities during the two years between the Bill's passage through Parliament and its coming into force. In other words, it is unclear whether ministers are expecting to make technical or policy revisions to the transposed E.U. laws.

The difficulty is that once sweeping powers to make new laws are conferred on politicians, it is very difficult to take them back again.

Slide 48—The Great Repeal Bill: Issues and Challenges III

Another difficulty is the simple process of keeping U.K. law up-to-date for so long as it is intended to be equivalent to E.U. law. The E.U. *acquis* is a "living" body of law which, even in the absence of new legislative proposals by the E.U. Commission, is frequently consolidated, amended and/or supplemented by legislative activity at all three levels of authority (primary, secondary and tertiary). E.U. measures which are already in existence at the date of Brexit will soon begin to look different from the *acquis* adopted by the U.K. In some cases the policy behind the changes will be rejected the U.K. but in large numbers these legislative "refreshers" are likely be formal, sensible or uncontroversial. There is a risk that U.K. ministerial resources will be unnecessarily monopolised by the activity of assessing each update to see whether it should be reflected in U.K. law.

If the U.K. is hoping to establish "equivalence", the process of keeping up-to-date may be particularly important.

The challenges are more acute in relation to Regulations (in respect of which changes can take effect without any further implementation process owing to their "direct effect") than in relation to Directives.

Slide 49—The Great Repeal Bill: Issues and Challenges IV

I mentioned earlier that the laws cannot logically refer to the E.U. authorities.

The difficulty then is to decide which authorities should be referred to.

Even when this is done, there is the Third Country Bind… will these authorities simply take the same decisions as E.U. authorities, making them arguably redundant and costly, or will they take different decisions and jeopardise firms' access to the Single Market?

When we look at the variety and volume of secondary and delegated decision-making in the E.U. legislative apparatus it is clear that this is a very real problem.

Slides 51-53—Key E.U. Legislation Affecting the Financial Markets

When the Referendum result was first announced my colleagues and I drew up a table to analyse the major E.U. financial services regulations to see how many of them made references to E.U. institutions.

The table is far from complete. It doesn't, for example, contain key insurance measures, (like Solvency II) but it does give a flavour of the problem.

Slide 54— The Great Repeal Bill: Issues and Challenges V

Finally, there is the very particular problem of the ECJ and the interpretation of the transposed laws once the *acquis* is absorbed into domestic law. The question arises of whether, and to what extent, ECJ case decisions will retain the force of precedent or persuasive authority in the English and Scottish legal systems: a) in relation to the transposed acquis; and b) in relation to any new rules of U.K. statute law that are aligned, for reasons of equivalence or otherwise, with E.U. laws brought into force after Brexit.

On the one hand, following ECJ jurisprudence arguably amounts to giving continued effect to decisions of the ECJ, and to do so in a situation where the U.K. will not have been able to nominate judges to the court or advocate for its preferred approach.

On the other hand, abandoning any expectation that ECJ jurisprudence is binding, or at the least heavily persuasive, would leave a disconcerting and possibly disruptive legal vacuum. It would also allow divergences to grow between E.U. and U.K. law in areas where there might be much to be said for trying to maintain consistency.

Slide 56—The Pressure Point: Authorisation

With the departure of the U.K. from the E.U., U.K. providers of financial services may be—at least temporarily—deprived of access to key E.U. markets unless they were first individually to acquire authorisation (either for a subsidiary or for the U.K. firm "directly" *via* a branch).

For many, this would require establishing a new entity within an E.U. Member State or otherwise restructuring the group. For example, for a large group to establish and resource a subsidiary large enough to do the volume of business currently passported out of London is likely to take a significant length of time. Drawing up an application for authorisation, and the determination itself may take many months more, particularly in a bottleneck situation.

But, even by a different route, the authorisation process is likely to be lengthy:

- The direct authorisation process typically requires the participation of the "home" supervisory authority (an MoU between home and host authorities may be required), and can take even longer.

- These processes could become more fraught in the context of the Article 50 negotiations. For example, the status of U.K. staff wishing to work in the E.U. may be unclear.

- Some applications for authorisation could be slowed by discussions about the extent to which functions can be outsourced to London (see next slide).

- Additional sectoral restrictions may apply: e.g. insurers wishing to transfer risks between group companies must comply with Part VII of the Financial Services and Markets Act.

- Firms may find that these processes, aimed at obtaining comprehensive authorisation within the E.U. for business lines currently provided out of London, take more than two years. For that reason, many U.K.-based firms are already in discussion with authorities in other Member States regarding shifting operations out of London.

Decisions of this kind must be taken well in advance of the point at which the U.K. withdraws from the Single Market and so the process of giving notice under Article 50(2) is likely to increase the pressure on firms to put restructuring decisions into effect. Transitional plans could ease this pressure by reducing practical uncertainty about access to the Single Market for a period beyond the two-year period specified in Article 50(3) of the TEU.

Slide 57—Uncertainty Ahead

Many firms are already considering whether to restructure and apply for authorisation in the remaining states of the E.U.

Others are trying to ascertain the extent to which they can carry on cross-border business from the U.K.

In both cases, a number of legal and practical uncertainties are being faced as financial institutions consider their group structure and the conduct of cross-border business after Brexit:

- Which cross-border activities, if any, can be carried on in the E.U. without authorisation?

- To what extent might a banking licence in an E.U. Member State allow financial products which are "fronted" (marketed, sold, traded, advised upon and reported) by an authorised entity to be "backed" (invested, collateralised, underwritten, etc.) by an entity in the U.K.? Or would this run contrary to E.U. capital adequacy rules?

- Can products sold by an authorised entity in the E.U. be serviced by U.K. servicers under outsourcing arrangements?

- What is the minimum presence that must be established in a Member State for authorisation to be obtained?

- Can legacy business with E.U. clients continue to be serviced by U.K. financial institutions after Brexit? Will the answer vary from jurisdiction to jurisdiction?

- To what extent, if any, do WTO rules guarantee freedom to financial service providers to conduct cross-border business between WTO member states?

- What will be the role of the European Supervisory Authorities regarding U.K. entities after Brexit?

Slide 58—A Thorny Issue: Euro Clearing

A talk of this kind would not be complete, of course, unless I were to touch on the thorny issue of Euro derivatives clearing. London is the world's biggest centre for clearing EUR derivatives and, in 2015, the European Central Bank ("**ECB**") lost a case at the ECJ over whether clearers of EUR derivatives should be located in the Eurozone. Since then the ECB has set up a swap line with the Bank of England, where sterling can be exchanged for euros, should liquidity shortages occur.

Since the referendum result, the ECB has warned that it will be difficult for the U.K. to retain this role after Brexit. Benoît Coeuré, a member of the ECB's executive board, said it would be "challenging" for Britain to devise post-Brexit regulations that would provide sufficient confidence for U.K.-based CCPs to continue to process trades in EUR.

The ECB has also called for E.U. institutions to seek more oversight of EUR trade in London. A letter from Mario Draghi to a member of the European Parliament, sent on 10 January 2017, noted that E.U. financial regulations give the ECB "broadly appropriate guarantees for the supervision and oversight" of U.K. CCPs, including participation in supervisory colleges. He wrote that "It will be important to find solutions that at least preserve, or ideally enhance, the current level of supervision and oversight".

Xavier Rolet, CEO of the London Stock Exchange, has said recently, speaking before the Treasury Select Committee, that 232,000 U.K. jobs are at stake if clearing of EUR derivatives moves out of the U.K. He said the figure came from a report produced by professional services firm EY for the LSE and that it not only took into account the "few thousand" jobs lost from EUR derivatives clearing directly, but the indirect impact on financial services (including: trading, syndication, distribution, risk management, IT and treasury management) if the operation was moved outside the UK.

Slide 59—Conclusion

To summarise, there are, at this time, very great challenges facing the U.K. financial services industry.

This is an industry that employs around 2.2 million people across the U.K., generates more in tax revenue and attracts more foreign direct investment than any other.

London is one of only a handful of truly global financial centres. Given how interconnected and interdependent the global financial markets and services have become, it will remain a political imperative to ensure that the financial sector in the U.K. functions efficiently post-Brexit.

Slide 60—*Postscript*: London—The Investment Bank of Europe

But it is not only the U.K. that stands to lose. Europe benefits from having London as a base for companies based outside Europe wanting to access the Single Market. The U.K. financial markets and the deep liquidity which London, as a global financial centre, provides help to enable economic growth and jobs across the U.K. and Europe. This was a point made recently by the Governor of the BoE when he observed that the U.K. was "effectively the investment banker for Europe".

The impact of Brexit on U.K. financial institutions is likely to be significant for the reasons outlined above but the impact of Brexit on the E.U. (and indeed the global economy) should not be ignored.

One of the consequences of the restructuring of U.K. banks and infrastructure bodies so as to conduct business, in part, through E.U. authorised entities is likely to be a fragmentation of pools of liquidity. This in turn is likely to lead to increased costs, risks and volatility in E.U. financial services.

The fragmentation is likely to be all the more severe because it appears unlikely that any other city could, in the short term, absorb the City of London ecosystem wholesale, meaning that institutions and markets are likely to be divided up piecemeal among financial centres in, say, Dublin, Paris, Luxembourg, Frankfurt and Amsterdam. Foreign exchange and foreign exchange derivatives, large risk insurance and reinsurance, and interbank lending are examples of markets likely to suffer significant negative effects from this fragmentation.

THE END