

BREXIT DEVELOPMENTS to FEBRUARY 2017



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A TIMELINE

“Brexit means Brexit”, 11 July 2016

Statements by the British Prime Minister, Theresa May, on Brexit:

- 11 July 2016, *Brexit means Brexit—and we're going to make a success of it*
- 19 October 2016, *We are going to be a fully-independent, sovereign country, a country that is no longer part of a political union with supranational institutions that can override national parliaments and courts.*
- December 19 2016,
 - *People talk about the sort of Brexit that there is going to be—is it hard or soft, is it grey or white. Actually we want a red, white and blue Brexit...*
 - *This is more complex than simply saying: ‘Are you in or are you out of the customs union?’*
 - *[Businesses] don't want to wake up one morning, having had a deal agreed the night before, and suddenly discover that they have to do everything in a different way.*
 - *What's important is that when we leave the European Union, it's the British government that decides how taxpayers' money is spent.*
- 08 January 2017, *we mustn't think about this as somehow “we're coming out of membership, but we want to keep bits of membership”.*
- 09 January 2017, *I don't accept the terms hard and soft Brexit and What we are doing is going to get an ambitious, good, best possible deal in terms of trading with and operating within the single European market.*

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Theresa May, 2 October 2016

The U.K. must now determine its future relationship with the E.U. The final thing I want to say about the process of withdrawal is the most important. And that is that we will soon put before Parliament a Great Repeal Bill, which will remove from the statute book—once and for all—the European Communities Act.

This historic Bill—which will be included in the next Queen’s Speech—will mean that the 1972 Act, the legislation that gives direct effect to all E.U. law in Britain, will no longer apply from the date upon which we formally leave the European Union. And its effect will be clear. Our laws will be made not in Brussels but in Westminster. The judges interpreting those laws will sit not in Luxembourg but in courts in this country. The authority of E.U. law in Britain will end.

As we repeal the European Communities Act, we will convert the “acquis”—that is, the body of existing E.U. law – into British law. When the Great Repeal Bill is given Royal Assent, Parliament will be free—subject to international agreements and treaties with other countries and the E.U. on matters such as trade—to amend, repeal and improve any law it chooses.

Department for Exiting the European Union, 2 October 2016

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The European Communities Act (“ECA”) has meant that if there is a clash between an act of the British Parliament and E.U. law, E.U. law prevails. The European Court of Justice (ECJ) has interpreted E.U. law and delivered judgments that were binding on the U.K. and other member states. The repeal Bill will end ECJ jurisdiction in the U.K.

The Repeal Bill will include powers for ministers to make some changes by secondary legislation, giving the Government the flexibility to take account of the negotiations with the E.U. as they proceed.

It will also ensure that the Government can establish new domestic regimes in areas where regulation and licensing is currently done at an E.U. level, and amendments are required to ensure the law operates effectively at a domestic level. The ECA created a power which currently exists for Ministers to make secondary legislation to give effect to E.U. law. [...]

In order for the U.K. to withdraw in an orderly way, ECA repeal will ensure that legislation is passed in advance so that E.U. law ceases to apply and domestic law can take its place on the day of exit.

Theresa May, 17 January 2017

- On 17 January 2016, Theresa May offered an outline for the coming negotiations:
 - 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 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)
- This has subsequently become known as the path to “Hard Brexit”, one which will cost U.K. financial firms their “passports” into the E.U. single market for financial services.

Supreme Court, 24 January 2017

- On **24 January 2017**, the U.K. Supreme Court dismissed HM Government's appeal in a case about which arm of the constitutional government (Parliament or the Executive) can exercise the right to trigger Article 50 of the Treaty on European Union. This means Parliament will be required to give its approval before official talks on leaving the E.U. can begin.
- Following that decision, on 26 January, HM Government published a legislative measure to trigger Article 50, prompting the Opposition to table a series of proposed amendments, including one seeking to guarantee that Parliament gets a say on the final deal for Brexit.
- The European Union (Notification of Withdrawal) Bill, containing just two clauses and only 137 words long, states that its aim is to “confer power on the Prime Minister to notify, under Article 50(2) of the Treaty on European Union, the United Kingdom’s intention to withdraw from the E.U.”. It will have just 5 days for parliamentary scrutiny in the House of Commons.
- Although one question about the Article 50 process has been answered, many others remain, including the question whether once the Article 50(2) notice has been given, notice can be revoked by the Member State in question. A court case has been filed in Dublin, Ireland with the objective of referring this point to the European Court of Justice for decision.

Parliament, 26 January 2017

- In consequence of the Supreme Court decision, a Bill to trigger Article 50 was introduced into Parliament on 26 January 2017. It received 5 days' scrutiny on the floor of the House of Commons.
- Hundreds of amendments were proposed but only a handful were tabled for a vote. These were ultimately blocked by HM Government and rejected in a vote on 8 February 2017.
- The Bill is now being considered in the House of Lords.
- The legislative process is expected to be completed by 7 March 2017.

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THE FUTURE

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“Hard Brexit”

- With the U.K.’s departure from the single market, the U.K. will become a Third Country as far as European markets are concerned.
- The UK’s ability to provide financial services into the E.U. will depend on the various regimes for Third Countries that are written into key regulations, unless it can cut a “bespoke” deal with the E.U. The best-known Third Country regimes are those which depend on the E.U. Commission adopting an “equivalence” decision.

Supra-equivalence

- Several interest groups have recommended that the U.K. should adopt as its negotiating objective a more robust, bespoke equivalence regime.
 - *A Blueprint for Brexit: The Future of Global and Financial Services and Markets in the UK* by Barnabas Reynolds on behalf of Politeia, advocates for “Expanded Equivalence” as one possible way forward.
 - *The EU’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.
- Anecdotally the idea is said to be “controversial” among the 27 remaining Member States.

Transition

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- Given the uncertainties inherent in the U.K. falling back on Third Country regimes, market participants are keen that the U.K. and E.U. should agree transitional arrangements as early as possible.
 - From the U.K.'s perspective this should include a continuation of passporting rights until an alternative basis for access to the single market can be negotiated.
 - Given the complexity of the issues and markets at stake, it seems likely that a staged approach will be taken to negotiating transitional arrangements, starting with areas where the mutual benefit in preserving current arrangements is clearest or the issue is otherwise uncontroversial. (One example of an early deal that could usefully be made is over the use of London-based financial benchmarks for valuation and reference rate purposes by E.U. supervised entities.)

The pressure point: authorisation

- Without a passport, U.K. firms will need to obtain authorisation to do business in the E.U.—as a subsidiary or *via* a branch (“direct authorisation”, this is less common).
- 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.
- 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.

Uncertainty ahead

- A number of legal and practical uncertainties have come to the fore 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 ESAs regarding U.K. entities after Brexit?

A thorny issue: Euro clearing

- London is the world's biggest centre for clearing EUR derivatives.
- In 2015, the ECB lost a case at the European Court of Justice 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 UK-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 UK 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.

London—the investment banker of Europe

- On 30 November 2016 the Governor of the Bank of England observed that the UK was “effectively the investment banker for Europe”.
- 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 will occur in part 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 fx derivatives, large risk insurance and reinsurance, and interbank lending are examples of markets likely to suffer from this fragmentation.

CONCLUSION

- To summarise, there are, at this time, very significant challenges facing the UK financial services industry.
- This is an industry that, according to a recent report by the City of London International Regulatory Strategy Group, employs around 2.2 million people across the UK, 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 vital to ensure that the financial sector in the UK continues to function effectively post-Brexit.
- The challenges are not restricted to those facing the UK financial services industry. The loss of the City of London as a primary resource for investment banking activity throughout the E.U. is likely to have a damaging effect on financial services providers and their clients in the remaining 27 Member States.
- It is possible that there will be a real economic impact in both the U.K. and the E.U.

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