U.K. Withdrawal from the E.U.: Issues of Legal Uncertainty

September 2018

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THE ROLE AND REMIT OF THE FINANCIAL MARKETS LAW COMMITTEE

The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets, which might give rise to material risks, and to consider how such issues should be addressed.

The following is a selection of publications by the FMLC on issues of legal uncertainty arising in the context of the withdrawal of the U.K. from the E.U.

The FMLC wishes to thank the individuals credited in the subsequent pages for their assistance in the preparation of the publications included herein. Note that members of FMLC Working Groups act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.
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PREFACE
PREFACE: THE FMLC’S ENGAGEMENT IN ISSUES OF LEGAL UNCERTAINTY ARISING FROM THE U.K.’S WITHDRAWAL FROM THE E.U.

The role of the Financial Markets Law Committee (the “FMLC”) is to identify issues of legal uncertainty in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

On 23 June 2016, the U.K. voted by way of an in/out referendum to withdraw from the European Union (this process is known, colloquially and hereafter in this paper, as “Brexit”). The U.K.’s decision to withdraw from the E.U., following decades of integration, raises substantial legal uncertainties. The FMLC’s historical connections to institutions in the public and private sectors of the wholesale financial markets has meant that it is well-equipped to identify any risks stemming from these uncertainties—through the uncharted territory of the Article 50 negotiations and beyond—and to make recommendations to resolve them.

In the week following the referendum result, the FMLC established an Advisory Group of experts from the fields of law to give direction to the Committee’s work relating to Brexit. The Advisory Group meets quarterly to discuss developments related to Brexit and make suggestions for future work. On the Advisory Group’s recommendation, projects were initiated—and some completed—on uncertainties relating to governing law and jurisdiction clauses, the operation of E.U. “equivalence” requirements, general documentation issues and continuity of contracts and standstill or bridging requirements.¹

This booklet contains, in reverse chronological order of publication, the FMLC’s analysis on the many and varied legal complexities arising from Brexit, presented in the form of papers and letters to HM Government. These works have considered the general impact of Brexit on the functioning of the financial markets. The U.K.’s withdrawal from the E.U. will, of course, have more specific consequences for each individual sector. The FMLC has conducted such sectoral analysis—in particular, focusing on the legal uncertainties in relation to the provision of cross-border insurance business after Brexit. This can be found on the FMLC’s website.

Section 1 contains the most recent paper published by the FMLC, which addresses the question raised by many market participants and observers about whether, in the context of a hard Brexit, the performance of existing financial contracts would continue or whether Brexit would make their performance illegal, impractical or impossible in some way. This paper takes an in-depth look at the question of the continuity of legacy contracts and highlights the legal uncertainty

¹ A complete account of the FMLC’s work on Brexit as well as frequent updates on new publications, working groups and events, can be found on our website at: http://fmlc.org/fmlcworkonbrexit/.
which will arise in its regard if there is no clarity as to the future of the U.K.-E.U. relationship post-Brexit. The FMLC also examines some of the ways by which these issues might be mitigated, both by firms themselves—i.e., by novating the contracts onto other authorised parties—and by the U.K. and E.U., either in the Withdrawal Agreement or through E.U. legislative action.

In section 2, readers will find a letter sent in March 2018 from the FMLC to the Ministry of Justice. The FMLC identifies the potential for significant legal uncertainty and commensurate risk because of marked ambiguity arising from provisions in the European Union (Withdrawal) Bill (the "Withdrawal Bill"). The Withdrawal Bill provides, in essence, for the incorporation of E.U. legislation, as "operative immediately before exit day", into domestic law. In cases where an autonomous E.U. term or concept is defined before the day of the U.K.’s exit from the E.U., U.K. judges will follow that interpretation. Where the meaning of terms is not fixed by exit day—or their interpretation is discussed and adjudicated upon by the European Court of Justice ("ECJ") post-Brexit—there remains ambiguity as to how U.K. courts should proceed, which will present legal uncertainty with significant market impact. By way of example, the letter reflects on several cases in which the interpretation of E.U. regulatory concepts has had the ability to affect the financial markets, and notes that similarly important concepts may need to be examined by the U.K. judiciary in the context of new ECJ decisions.

The paper reproduced in section 3 of this booklet examines the future of the U.K.’s trade relationship with the E.U. in case no deal is agreed by the end of the Article 50 notice period in March 2019. The U.K.’s options include: (1) membership of the European Economic Area; (2) a transitional arrangement with the E.U.; (3) a new bespoke trade treaty between the U.K. and E.U.; or (4) conduct of business within the framework of World Trade Organization ("WTO") rules coupled (in the case of financial services) with reliance by U.K. firms on so-called “Third Country” access provisions in E.U. legislation. The paper offers an overview of the WTO rules and their application in the context of financial services, as well as an examination of the legal uncertainties arising from the impact of these rules on each of the options listed above. The FMLC also suggests ways by which HM Government might ensure greater legal certainty as the Brexit deadline approaches.

Section 4 contains a letter from the FMLC to the Ministry of Justice in response to a request for feedback on a policy paper on a framework for E.U.-U.K. cross-border civil judicial cooperation after Brexit (the “Cooperation Paper”). The letter observes the similarities between the Cooperation Paper and an FMLC Paper published on 2 December 2016 entitled Issues of Legal Uncertainty Arising in the Context of the Withdrawal of the U.K. from the E.U.—the Application of
English Law, the Jurisdiction of English Courts and the Enforcement of English Judgments (the “FMLC Paper,” reproduced in Section 9 of this volume). The letter also recommends that the Ministry of Justice considers some of the more granular points made in the FMLC Paper, such as those which deal with issues of transition.

The Ministry of Justice wrote to the FMLC seeking views on the Withdrawal Bill when it was first published. The Committee’s response is enclosed in section 5 of this booklet. The Committee’s letter drew attention to issues of legal uncertainty stemming from Clause 3 of the Withdrawal Bill, which concerns the incorporation of direct E.U. legislation into U.K. legislation. The letter concludes by stating that the FMLC will contribute further research and analysis when the draft statutory instruments made pursuant to powers set out in the Withdrawal Bill are published.

Section 6 of this volume contains the FMLC’s paper on uncertainties related to cross-border corporate insolvency proceedings following Brexit. Despite HM Government’s plans to transpose E.U. legislation into U.K. law by means of the Withdrawal Bill, in the event no bespoke agreement is negotiated between the U.K. and the E.U., several legal and operational uncertainties remain. Of particular importance to the financial markets is the loss of the mutual and reciprocal recognition provisions written into Regulation (EU) 2015/848 on insolvency proceedings (the “Recast EUIR”), which cannot be replicated by means of a wide-ranging reception statute. The paper considers this and other complexities relating to cross-border corporate insolvency—including the effect of restructuring tools such as schemes of arrangement or related financial services measures such as Directive 98/26/EC on settlement finality in payment and securities settlement systems (the “SFD”) and Directive 2002/47/EC on financial collateral arrangements (the “FCAD”). To address these uncertainties, the FMLC makes recommendations, which include a strong preference for preserving the mutual effect of the Recast EUIR via negotiation of transitional arrangements and/or a bespoke treaty between the U.K. and the E.U.

At 69 pages, the paper enclosed in section 7 of this booklet is the FMLC's most wide-ranging study of uncertainties arising from Brexit. It considers the legal repercussions arising from the loss by U.K.-based financial services providers of “passported” access to the E.U. markets and their having to rely instead on the provisions for non-E.U. countries (i.e., “Third Countries”) where these are provided by E.U. law. The paper analyses the fragmented, complex and uncertain nature of Third Country regimes, along with the market disruption and other legal uncertainties which may potentially arise at the point the U.K. withdraws from the E.U. in the absence of a new agreement. The provisions in E.U. financial markets legislation for Third
Countries exclude important business lines, like deposit-taking, lending and retail fund offerings, leaving providers to seek establishment and authorisation in the E.U. Moreover, where Third Country provisions are offered, they may be limited in scope, often only enabling the provision of specific services by Third Country firms in the E.U.

For each E.U. legislative measure, the threshold criteria for admission vary and are internally complex. The diversity and specificity of the conditions applied, combined with an almost universal requirement in these regimes for the adoption of a discretionary decision by ESMA, the European Commission and/or E.U. national competent authorities means that an application for access under a Third Country regime is often uncertain. The duration of each assessment and the timing of the decision and implementing act are unpredictable and likely to vary widely.

These are some of the legal uncertainties with which U.K. market participants who have been, and would like to continue, providing services into the E.U. are confronted. Having acknowledged these, the FMLC also outlines in the paper a range of mitigants, including: for the short-term, prioritising the negotiation of transitional provisions; and for the long-term, actions which financial markets participants might take themselves to ameliorate uncertainty.

In January 2017, the FMLC responded to a call for written submissions by the Treasury Select Committee on transitional arrangements between the U.K. and E.U. In this letter (available in section 8), the FMLC expressed the view that transitional arrangements would be a valuable method of promoting legal certainty and minimizing the disruption which could occur if there is a hiatus between U.K.-based market participants losing their “passports” to the E.U. market and being able to operate under the Third Country regimes. The FMLC also recommended that such arrangements be negotiated well in advance of the U.K.’s withdrawal from the E.U. and suggested a staged approach, whereby areas that are uncontroversial or offer mutual benefits are tabled for discussion first.

Section 9 contains the FMLC’s earliest work on Brexit, which addresses issues of legal uncertainty likely to arise in the context of cross-border commercial litigation in consequence of Brexit. It examines the situation with regard to choice of law clauses in financial markets contracts and concludes that contractual continuity would be enhanced by the preservation of the current rules following Brexit. The paper also attempts to address the question of jurisdiction, especially regarding the jurisdiction of English courts under an English choice-of-court agreement, the application of English law and the enforcement of English judgments, which may pose greater problems of legal uncertainty arising from Brexit. By way of solution, the paper analyses the consequences of replacing existing E.U. instruments in the U.K. by a new conflict of
laws agreement with the E.U. or a new accession to existing international conflict of laws instruments.

More papers are currently under production. Working Groups have been established to analyse complexities arising from Brexit in relation to: bank recovery and resolution; the future of the U.K.’s participation in the E.U. Emissions Trading Scheme; and the complexities around the status of E.U. legislation which will be retained on the U.K. statute book by means of the European Union (Withdrawal) Bill. In addition, in the context of the financial markets, HM Treasury has indicated that approximately 70 statutory instruments are expected to be laid before Parliament between July 2017 and January 2019, each making amendments to retained E.U. law to ensure smooth functioning and resolve linguistic and logical conundrums caused, for example, by references to “Member States” and E.U. supervisory authorities. The FMLC will continue to identify and analyse legal risks arising from the amendments proposed by these statutory instruments and the Brexit negotiations and to make recommendations to resolve them.

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If you would like to enquire about your firm’s representation on any of these working groups and/or the Advisory Group, please contact Rachel Toon at executivesupport@fmlc.org.
U.K. WITHDRAWAL FROM THE E.U.: PAPER ON THE
ROBUSTNESS OF FINANCIAL CONTRACTS

AUGUST 2018

August 2018

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Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.
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1. INTRODUCTION AND EXECUTIVE SUMMARY

Introduction

1.1. The role of the Financial Markets Law Committee (the “FMLC” or the “Committee”) is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. On 23 June 2016, the U.K. voted by way of an in/out referendum to withdraw from the European Union (this process is known, colloquially and hereafter in this paper, as “Brexit”). On 29 March 2017, HM Government officially served notice to the E.U. of the U.K.’s withdrawal under Article 50 of the Treaty on European Union (“TEU”), beginning the two-year “notice period”. Legislation—the European Union (Withdrawal) Bill (the “Withdrawal Bill”)—was introduced into the House of Commons in July 2017, aimed at repealing the European Communities Act 1972 and incorporating into U.K. law all applicable E.U. law. The Bill was enacted on 26 June 2018 as the European Union (Withdrawal) Act 2018 (the “Withdrawal Act”).

1.3. Negotiations between the U.K. and the E.U. about the nature of their post-Brexit relationship are also underway. On 7 December 2017, it was announced that the U.K. and E.U. had concluded the first part of the Article 50 negotiations. The U.K. had tentatively agreed to pay a financial settlement and to protect the rights of E.U. citizens resident in the U.K. In March 2018, the U.K. and E.U. published a draft Withdrawal Agreement which included the possibility of a transitional period running from 29 March 2019 to 31 December 2020, during which the U.K. will continue to participate in the single market and customs union. This has not yet, however, been confirmed. As per HM Government’s most recent White Paper, the U.K. will cease to be a Member State of the E.U. at the end of the Article 50 notice period on 29 March 2019 (defined in the Withdrawal Act as “Exit Day”). If the 21-month transitional period is ratified, E.U. laws will continue to apply in the U.K. for its duration.

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1 Barker, A. and Brunsden, J., “Brexit divorce deal: the essentials”, Financial Times, (8 December 2017), available at: https://www.ft.com/content/21c5d07e-dbee-11e7-a039-c64b1c09b482.


1.4. Little has been agreed in relation to the long-term relationship between the U.K. and the E.U. and there remains a possibility that the U.K. will leave the E.U. without having successfully negotiated a plan for the future (this has been referred to as a “cliff edge” scenario or a “hard” Brexit). In the event of a hard Brexit of this severity, U.K. firms will lose their ability to access the E.U. single market on the basis of the “passporting” rights by which a significant degree of access is currently ensured.\(^5\) U.K. and E.U. firms will be limited in their ability to provide financial services to E.U. and U.K. clients, respectively. U.K. firms may look to exemptions in local law which allow for access by firms from non-E.U. countries (“Third Countries”) or apply for permission from the European Commission or other E.U. bodies under the access regimes for Third Countries provided in E.U. legislation (the “Third Country regimes”). The concerns in this respect include not only the provision of services to new customers in the E.U. but also the smooth continuity of provision of services to existing customers.

1.5. A related question which has been raised by many market participants and observers, in the context of a hard Brexit, is whether the performance of existing—sometimes called “legacy”—financial contracts would continue or whether Brexit would make their performance illegal, impractical or impossible in some way.\(^6\) This paper takes an in-depth look at the question of the continuity of legacy contracts and highlights the legal uncertainty which will arise if there is no clarity as to the future of the U.K.-E.U. relationship post-Brexit. In section 5 of the paper, the FMLC suggests a number of ways by which these uncertainties might be reduced or avoided.

**Scope and Executive Summary**

1.6. This paper focuses on existing contracts, although some of the points discussed below may be equally relevant to wholly new contracts concluded after Exit Day.

1.7. It is also important to note that this paper exclusively concerns contractual rights and obligations. As explained in subsequent sections, however, the problem outlined herein is not confined to contractual rights and obligations and may arise in the context of

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\(^6\) See, for example:


activities performed in connection with a contract, for which there is no express contractual provision made. While questions about the continued performance of these services and activities are integral to the assessment of business continuity, they are not the primary focus of this paper.

1.8. Another matter which is beyond the scope of this report is the question of regulatory continuity and mutual market access for E.U. and U.K. firms across the Brexit divide. The FMLC has dealt with legal complexities arising from Brexit in relation to access for British firms to the E.U. financial markets under the Third Country regimes. In a later publication, the Committee considered the relation to rules of cross-border trade set by the World Trade Organization (“WTO”) in previous papers. It has also examined the freedom of establishment and the freedom to provide services in relation to the provision of insurance services in the E.U. This paper focuses, therefore, on the legal—rather than regulatory or commercial—implications of Brexit on contracts between participants in the U.K. and E.U.

1.9. Two fields in which some thought has already been given to the particular issues addressed in this paper include i) derivatives dealing; and ii) insurance provision. This may have something to do with the size of these financial markets or the sophistication of the market participants but it is more likely to arise from the fact that services in these fields can raise unique—or, at least, distinctive—questions concerning regulatory authorisation and permission in the ongoing performance of the contracts. For this reason, these markets receive a higher degree of attention in this report than some other financial services and most illustrative examples of market standard contractual obligations have been drawn from one or other of these fields. The general rule of thumb, however, is that the analysis provided is intended to cover all financial contracts incorporating the obligation in question unless the contrary is stated.

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1.10. The paper adopts the following structure: section 2 comprises an explanation of the current arrangements which enable financial contracts to be agreed and performed across the E.U. (including with the U.K.), an overview of the impact of Brexit on financial services business and an exploration the various options available to U.K. firms, post-Brexit, which might enable them to continue to access the E.U. market and fulfil pre-existing contracts. Section 3 is a note on contractual arrangements to forestall illegality. Section 4 considers the uncertainties arising from Brexit in relation to contracts, surveying any general law, contractual and penal/administrative consequences. In section 5, the FMLC discusses some ways by which these uncertainties might be reduced or avoided.

1.11. It is important to recognise that, where the U.K.’s withdrawal does not include mutual “passporting” or similar recognition arrangements, the issues identified here will affect E.U. firms as well as U.K. firms, and in both cases the impact will have a knock-on effect on E.U. customers. This paper, however, focuses on U.K. firms and E.U. customers for the purposes of illustration.

1.12. In the European Commission’s most recent Communication, it observed that there does not currently appear to be a general concern related to contractual continuity as, in principle, the performance of existing obligations can continue.\(^\text{11}\) It has advised, however, that each type of contract should be assessed separately. Thus, it remains important to take account of the legal implications of Brexit, the possible loss of authorisation, and the content of market standard terms in financial services contracts worldwide so as to identify any potential legal issues relating to the continuity of financial contracts. The FMLC has attempted such an analysis below. If contractual continuity is a desired end, for the E.U. and U.K. alike, then mutual “passporting” or similar recognition arrangements are particularly important.

2. THE U.K.’S WITHDRAWAL FROM THE E.U.

2.1. Currently, firms authorised in one Member State of the E.U. may carry out permitted activities in any other Member State without requiring further authorisation on the basis of the “passporting” rights to which the U.K. is entitled qua Member State.\(^\text{12}\) The E.U.

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\(^{12}\) Although this paper refers consistently to access by U.K. financial services providers to E.U. markets under E.U. law, this should be understood to include, *mutatis mutandis*, access to E.E.A. markets by virtue of the provisions of the Agreement on the European Economic Area (1994).
“passport” is not a homogenous right which applies across the financial services—E.U. legislation governing each sector of the financial services market sets out the activities which are “passportable”, and therefore permitted across the E.U. 13

2.2. Upon Brexit, the U.K. will lose these benefits of membership of the E.U. and become, from the perspective of E.U. law, a Third Country. The European Commission has announced that when the U.K. leaves the E.U., the “passporting” rights provided for in MiFID II will no longer apply 14 — access rights in other areas may also be rescinded. In a truly “hard Brexit” scenario, without treaty provisions establishing mutual access arrangements between the U.K. and E.U.—and in the absence of any other applicable exemptions under local Member State law—U.K. firms will require an additional layer of authorisation to provide services in the E.U. 15

13 “Passporting” rights are written into several regulations which govern the operation of cross-border financial services business. In relation to investment services and activities, Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (“Solvency II”) provides passporting rights to (re)insurers to establish a branch or provide services across the E.U. Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (“CRD IV”) allows banks authorized in one Member State to provide, inter alia, advisory services, lending or custody or deposit services to a business in another E.U. state. Regulation (EU) 648/2012 on OTC derivatives, central counterparties and trade repositories (“EMIR”) establishes a framework for clearing of over-the-counter (OTC) derivatives and for the functioning and governance of central counterparties (CCPs), which clear OTCs. Under passporting, CCPs can offer clearing services across the E.U. Several other “passports” are available for banks and financial services. A complete account of the Third Country Regimes can be found in the following report: International Regulatory Strategy Group, The U.E.’s Third Country Regimes and Alternatives to Passporting, (23 January 2017), available at: https://www.thecityuk.com/assets/2017/Reports-PDF/The-EUs-Third-Country-Regimes-and-Alternatives-to-Passporting.pdf


15 The effects of the U.K.’s withdrawal from the E.U. will, of course, also be felt by E.U. firms wishing to access the U.K. market. Statements from HM Government, however, seem to indicate that E.U. firms’ ability to access the U.K. market is less dependent on the form of the future relationship. The U.K. has a permissive regulatory perimeter for Third Country cross-border wholesale investment business, enshrined in the so-called “overseas persons exclusion” (“OPE”) in Article 72 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001. The OPE allows wholesale investment business to be carried out between foreign firms on the one hand and large corporates, sophisticated investors or regulated firms on the other hand, without coming under local regulation in the U.K. It is expected that the basic scheme of authorisation for investment firms under the Financial Services and Markets Act 2000 (the “FSMA 2000”) and the regulations made under it will be left in place—subject to amendment by secondary legislation made under the Withdrawal Act so far as is necessary to keep them workable—which means E.U. firms are likely to be able to continue to avail of the U.K.’s permissive regulatory perimeter.

2.3. Market participants have identified three ways by which U.K. firms might be able to continue providing business in the E.U. Under the first of these options, U.K. firms would have to apply for access to the E.U. market in respect of each activity under the relevant Third Country regime derived from the relevant E.U. legislation (or otherwise comply with the conditions of that regime). The scope, process and timing of this has been analysed in depth by the FMLC in a previous paper, which concluded that the patchwork of Third Country regimes was complex and an inadequate replacement to “passporting”. A second method would require firms to make arrangements with clients such that the E.U. client initiates the transaction, setting up a so-called “reverse solicitation” arrangement, which might avoid triggering a licensing requirement. While the process and implications of such a setup are beyond the scope of this paper—the FMLC intends to examine the utility and legal complexities of reverse solicitation in a future publication—it is important to note that this option is not available to all firms (see footnote 17, below). A third way by which U.K. firms might access the E.U. markets is by providing only those activities which are not caught by the relevant Member State’s regulatory perimeter (i.e., services which do not constitute regulated activities in the Member State of the customer). Most E.U. Member States, however, do not have a wide-ranging and permissive regulatory perimeter and the practicality of relying on such a regime also tends to vary considerably by country.

2.4. These options, individually and in sum, do not provide as comprehensive access to the E.U. markets as “passporting” currently does, not least because there may not be equivalent provisions for all the types of financial services that are covered by the various “passporting” rights that exist at present. This is likely to present problems for existing financial contracts—i.e., contracts made before Exit Day (or during a transitional period during which “passporting” rights were maintained) and which upon Brexit remain wholly or partly unperformed, or which the parties expect to be serviced through further agreements and the provision of further activities.

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16 See supra, n. 7.

17 This is permitted, at least, in the case of firms regulated by the MiFID II package and by the AIFMD through provisions which allow a Third Country firm to deal with customers in the E.U. if the client initiates the transaction. See, Article 42 (Provision of services at the exclusive initiative of the client) of MiFID II, Article 46 of MiFIR and Recital 70 of the AIFMD.

18 In the past the European Commission has given guidance as to when and how particular activities are regarded as being regulated in particular places of business involved in the relevant activity. For example, traditionally, deposit-taking has been regarded as only taking place in a regulated manner in the place of business of the branches of the institution taking the deposit but not in the place of business of the depositor: Commission interpretative communication: Freedom to provide services and the interests of the general good in the Second Banking Directive (97/C 209/04)). In contrast, insurance is often regarded as being provided in the place of business of the insured. It is not clear whether this guidance will be revisited following Brexit.
Important distinctions

2.5. If a firm deals on its own account (or “as principal”) in a kind of business and in a manner that requires regulatory authorisation, it must be authorised at the time it enters the contract—this applies even when the individual contract is made within the framework of an existing agreement between the same parties, such as the Master Agreements published by the International Swaps and Derivatives Association (“ISDA”). The general view has been that the performance of transactions which were covered by an authorisation at the time they were made will not be affected by a subsequent loss of authorisation. On that basis, loss of authorisation will not affect the firm’s performance of existing obligations under a transaction made as principal, such as making or collecting payments that become due, the provision or return of collateral (even in the form of transferable securities, including under a title transfer financial collateral arrangement), or the termination of an existing transaction. In some cases, the exercise of option rights under an existing transaction may also fall into this category.

2.6. The status of other pre-existing obligations, however, is less clear. This includes, for example, where an exercise of rights under a derivative transaction results in a subsequent transaction which might also require authorisation in its own right, such as the exercise of an option to cause a swap to come into effect, or where discretion is afforded to a party or to a calculation agent, which some have argued may fall into the category of portfolio management or the provision of advice. On the lending side, further drawdowns under revolving or, indeed, term loans, in a loan agreement with a term which extends beyond the date at which authorisation ceases (in Member States where lending is a regulated activity), could also be problematic. A financial institution which provides further services in respect of an existing contract may need to be authorised at the time the services are requested even if the services are “required” or referred to by the contract in question.

2.7. Where a firm is acting for a client, authorisation may be required for a wider range of activities: for the reception and transmission of orders in relation to financial instruments, the execution of orders on behalf of the client, portfolio management and the provision of advice; on-going services to be performed in respect to insurance contracts; payment services; and custody and investment management agreements. Even though the firm may have undertaken to provide services of these kinds in an

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existing contract, it is not clear whether the firm still needs authorisation at the time the further service is arranged. If it does, loss of authorisation is likely to affect its ability to provide the services.

2.8. The practical problem affecting existing contracts is, however, wider than this. Where a firm is dealing on its own behalf, the parties may expect the firm to carry out some routine operations that the contract does not require or provide for: for example, under a derivatives contract, “rolling” an open position by agreeing to terminate a transaction prior to the scheduled termination date and entering into a new transaction on similar terms, except for a longer maturity date; varying the terms of a transaction (for example by agreeing to increase or decrease the notional amount); novating a transaction to a third party (which includes clearing derivatives via a central counterparty); agreeing a consensual termination of a transaction; and entering into an offsetting transaction to close-out a position (in whole or in part). The same seems to be true of portfolio compression—i.e., replacing a number of offsetting transactions with a smaller number of transactions having the same overall economic profile. Depending on the applicability of EMIR, there may be a regulatory requirement to carry out this process as it is perceived to reduce the operational risk associated with derivative transactions and therefore reduce the risk in the financial markets. Thus all these activities will constitute either dealing by a firm when it is acting as principal, or providing investment services to a client, and therefore in principle require authorisation at the time, even if they relate to an existing contract.20

2.9. Thus there are some cases in which further agreements or activities are to be carried out under the terms of an existing contract but which will not be covered by an authorisation at the time the contract was made; and there will be many cases in which further agreements or activities in connection with an existing contract were contemplated but clearly involve fresh investment activities or services. But both types of case, compendiously referred to in this paper as “further activities”, would be affected by loss of authorisation. It has been pointed out that even the notion of providing further activities in respect of an existing contract does not capture the dynamic relationship between investment firms and their counterparties that may arise from the need to manage their positions. This may involve new, arms-length transactions with the same counterparty—anything beyond the servicing of existing contracts is, however, beyond the scope of this paper.

20 That is, unless they can be brought within one of the regimes, such as third-country firm, reverse solicitation, etc. discussed earlier.
3. **A NOTE ON CONTRACTUAL ADJUSTMENTS TO FORESTALL ILLEGALITY**

3.1. Financial contracts commonly contain clauses which apply if the performance of the contract becomes unlawful or impossible through *force majeure*. These clauses may also allow for the method of performance to be adjusted in a way such that operations which require authorisation may still be carried out lawfully. For example, while the 1992 ISDA Master Agreement provides for termination in the event of illegality (if that has occurred: on this, see below), it also anticipates, as a first step, that the party affected by the illegality will use reasonable efforts to transfer relevant transactions to another of its offices or to an affiliate so that the illegality ceases to exist. If the party in question does not effect such a transfer within a certain time frame, the other party has a further period of time within which to make a transfer. It is only at the end of this combined time period that, in case no transfer has occurred, the relevant transactions may be terminated.\(^{21}\)

3.2. Similarly, the 2002 ISDA Master Agreement includes provisions, further developed from the 1992 Agreement, which have been designed to give the parties time to mitigate the effect of an illegality or *force majeure* event. These provisions include greater clarity on the interaction with other ISDA Master provisions relating to the role of a head office in a branch scenario and a waiting period which must expire before the relevant transactions may be terminated. Although the Agreement does not specify the use to which the waiting period must be put, it gives time for the relevant illegality or *force majeure* to be resolved, where this is possible, or for the parties to take steps to transfer transactions to avoid termination where possible. It is conceivable that some such clauses give the firm the right to adjust the contract (e.g. by substituting other,

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\(^{21}\) It is worth pointing out that the parties, and particularly financial institutions, may be reluctant to raise illegality. If a financial institution is held to be wrong to have claimed the existence of an illegality so as to justify no longer performing the contract, it risks exposure for breach of contract and a claim for substantial damages as well as possible regulatory action.
authorised parties as counterparties),\textsuperscript{22} and consequently the right to prevent the loss of authorisation from affecting future operations, without the need to obtain the consent of the other party. Such a route based on consent would probably be impractical because of the significant numbers of transactions and counterparties involved for each regulated firm.\textsuperscript{23}

### 4. LEGAL UNCERTAINTIES RELATING TO CONTRACTUAL CONTINUITY

#### 4.1. The possible consequences of a “hard” Brexit, involving a wholesale loss of authorisations, may be divided into three broad categories: (1) consequences under the general law in those cases where the contract may be affected by illegality or frustration; (2) any consequences according to the terms of the contract itself, as, for example, in those cases where loss of authorisation may breach a representation and trigger a termination event; and (3) consequences under criminal law or similar sanctioning regimes which might come into play were the firm considered to be carrying on a regulated activity without authorisation. Each of these is considered in turn in this section.

**General law consequences**

#### 4.2. The consequences of loss of authorisation for further agreements or activities depends on (a) the governing law of the contract; (b) whether the further agreements or activities are to be or have been carried out in the European counterparty's home Member State in a manner that requires local regulation under the laws of the Member State in

\textsuperscript{22} For example, the Loan Market Association's standard form agreements make provisions for illegality such that:

If, in any applicable jurisdiction, it becomes unlawful for any Lender to perform any of its obligations as contemplated by this Agreement or to fund or maintain its participation in any Loan [or it becomes unlawful for any Affiliate of a Lender for that Lender to do so]:

that Lender shall promptly notify the Agent upon becoming aware of that event;

upon the Agent notifying the Company, each Available Commitment of that Lender will be immediately cancelled; and


\textsuperscript{23} See Bank of England, *Record of the Financial Policy Committee Meeting on 20 September 2017*, para 49: “To continue to service their contracts firms would need to replace cross-border business by novating contracts to new entities with the necessary regulatory permissions. For each of the large dealers, this would require the agreement of 2,000-4,000 counterparties who themselves may need to secure agreement with other involved parties.” (Available at: [https://www.bankofengland.co.uk/record/2017/financial-policy-committee-september-2017](https://www.bankofengland.co.uk/record/2017/financial-policy-committee-september-2017))
question; and (c) whether it is necessary to enforce the agreement in a court in the E.U. Member State.

4.3. While agreements made by U.K. firms are likely to be governed by English law, it is not uncommon for a U.K. firm to enter into an agreement which is governed by the law of an E.U. Member State—both instances are considered below. In the case of an English law-governed contract, it is the nature and location of the activities which might lead to illegality. Under the Financial Services and Markets Act 2000 (the “FSMA 2000”), the effect of a contract made by an unauthorised person is not to render it illegal: the contract is merely unenforceable against the other party, who is entitled to recover any money or other property paid or transferred by him under the agreement and compensation for any loss sustained by him as a result of having parted with it.24 Below, the paper delves into the various circumstances in which legacy contracts might be grouped and the ways in which English and foreign courts might contemplate them.

**Governed by English law and not illegal in place of performance**

4.4. If the contract is governed by English law and is legal under English law, it is in general immaterial that it happens to be illegal under the law of one party’s nationality,25 of the country in which the contract was made,26 or of the country in which performance of the contract may, but need not, take place.27

**Governed by English law but further agreements or activities must be performed in E.U.**

4.5. If the further agreements or activities have to be carried out in the E.U. Member State, there may be a problem if that Member State no longer treats the U.K. firm as having authority to conduct investment business, even if any enforcement action would be in an English court applying English law. It is a principle of English law that the court will not enforce a contract, even though the contract is perfectly legal under English law, if its performance is regarded as illegal in the place in which it has to be performed.28 For

24 See section 28(9) and section 26 of FSMA 2000.


28 *Ralli Bros v Compania Naviera Sota y Aznar* [1920] 2 K.B. 287. The rule appears to be one of English law, related to the doctrine of frustration by illegality, rather than one of private international law (see *Eurobank v Kallirroi* [2015] EWHC 2377, *Dana Gas PJSC v Dana Gas Sukuk* [2017] EWHC 1886 (Comm) at [58] and *Dicey & Morris* (15th edition) at 32–97 to 32–101. It is thought to have survived the adoption of what is now Article 9(3) of the Rome I Regulation, see below.
this purpose it seems to make no difference whether the contract has become illegal because of a change in law since it was made or was unauthorised at the time it was made (for example because it was an agreement to service an existing contract rather than being for services required by that contract). A problem is likely to arise if the following two conditions are satisfied: (i) the other State treats the performance, as opposed to merely the formation of the agreement, as illegal; and (ii) the performance has to be made in the other State. Subject to whether the illegality is being regarded as sufficiently serious to trigger this rule, it will render an agreement for further activities unenforceable, at least by a party who knew that performing in the place required would be illegal. A related challenge is presented by Article 9(3) of Regulation (EC) No 593/2008 on the law applicable to contractual obligations (the “Rome I Regulation”), which provides

Effect may be given to the overriding mandatory provisions of the law of the country where the obligations arising out of the contract have to be or have been performed, in so far as those overriding mandatory provisions render performance of the contract unlawful. In considering whether to give effect to those provisions, regard shall be had to their nature and purpose and to the consequences of their application or non-application.

It should be noted that Article 9(3) does not depend on the knowledge or intention of the parties. Whether an English court would regard the other Member State’s licensing requirement as an “overriding mandatory provision” is considered below. Therefore, in circumstances where the agreements or activities have to be performed in another Member State and that Member State’s law treats the performance as illegal, it seems that under English law the contract will be unenforceable by the U.K. firm and possibly by either party. Such a legal outcome will certainly affect some transactions, for example where payment has to be made into an overseas account.

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29 In the Ralli Bros case, performance became illegal under Spanish law after the contract had been concluded, but the same (or a closely similar) principle applies to existing illegality: see Robert Goff J. in Toprak Maksulleri v Finagrain [1979] 2 Lloyd’s Rep 98, 107, approved by the Court of Appeal [1979] 2 Lloyd’s Rep 112, 117, cited by Arnold J in Lilley Icos plc v 8PM Chemists Ltd [2009] EWHC 1905 (Ch), [2010] F.S.R. 4 at [262].

30 See Dicey, Morris & Collins, para 32-098.

31 Knowledge may be required because the ‘Ralli Bros’ principle is closely associated with the wider principle of ‘comity’ relied on in cases such as Foster v Driscoll [1929] 1 KB 470 (see below). In those cases it is established that the comity principle affects only a party who had ‘wicked intent’ deliberately to flout the law of the place or performance.
4.6. If a contract requires an activity, or if the purpose of the contract was to enable one of the parties to carry out an activity, which the parties envisage will take place in a Member State where the activity is illegal owing to Brexit, the contract may be unenforceable. This is because it is said that “[t]he courts will not enforce a contract made between parties to further an adventure to break the laws of a foreign State.” This is referred to in this paper as the “comity principle”. It only affects a party which had the deliberate (or “wicked”) intention to break the law of the country concerned, but that would include the U.K. firm and possibly also the E.U. counterparty.

4.7. It may be that, even though the services to be provided could have been carried out in the U.K., they are actually carried out in an E.U. Member State. This would certainly trigger the “comity principle” and thus might well prevent the U.K. firm that provided the services from enforcing the contract. Further, actual performance of the services in the E.U. Member State would again bring the case within Article 9(3) of the Rome I Regulation (see above).

Uncertainties in the performance of unauthorised activities

4.8. It is, however, unclear whether the principles discussed above would be applied to an agreement that had to be, might be or was performed in a foreign state merely because under the law of the state concerned the agreement was regarded as made without the requisite authorisation. It is possible that an English court would not regard a mere lack of authorisation in the counterparty’s home state as being sufficiently serious to invoke this principle. As stated above, the FSMA 2000 considers a contract made by an unauthorised person unenforceable against the other party and bestows upon the other party an entitlement to recover any money or other property paid or transferred by him under the agreement and compensation for any loss sustained by him as a result of

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32 Dicey, Morris & Collins on the Conflict of Laws (15th edn, 2012), para 32-191. An example is Foster v Driscoll [1929] 1 KB 470, in which Sankey LJ said (at 521-522): ‘An English contract should and will be held invalid on account of illegality if the real object and intention of the parties necessitates them joining in an endeavour to perform in a foreign and friendly country some act which is illegal by the law of such country notwithstanding the fact that there may be, in a certain event, alternative modes or places of performing which permit the contract to be performed legally’. It is not enough that the foreign law would treat performance as illegal wherever it took place. In Ispahani v Bank Melli Iran [1998] Lloyd’s Rep. Bank. 133, 139-140, Robert Walker LJ said: “international comity is naturally much readier to accept that a country’s laws ought to be obeyed within its own territory, than to recognise them as having extraterritorial effect”.

33 There is a debate over whether a payment made in a currency other than sterling can be said to have been made in the U.K., or whether it is always made in the financial centre for the relevant currency. If the latter is correct, it would have a significant impact on the issue being considered. There is a particular issue over insurance contracts, see below.
having parted with it.\textsuperscript{34} While there is no necessary connection between the way in which Parliament has chosen to treat investment contracts made without authorisation and what a court may think is required by international comity, it is doubtful whether an English court will regard the possible illegality of the contract under the law of another Member State for want of the requisite authorisation as raising a serious issue of comity.

4.9. Further, in \textit{Laboratoires Servier Inc v Apotex}\textsuperscript{35} the Supreme Court apparently proceeded on the basis that violations of foreign laws were to be treated in the same way as violations of local laws for the purposes of applying rules of English law founded on the maxim \textit{ex turpi causa non oritur actio}.\textsuperscript{36} The case involved a claim to enforce a cross-undertaking in damages given to the court. The Supreme Court held that the relevant wrongdoing (infringement of a Canadian patent) did not involve a sufficient degree of turpitude to engage the \textit{ex turpi causa} principle. If a breach of foreign law is to be treated in the same way as illegality under English law, the subsequent decision in \textit{Patel v Mirza} means that a “factors-based” approach is to be applied.\textsuperscript{37} This again suggests that the court might decide that lack of a licence to engage in the relevant activity under the law of the counterparty's home state does not involve a sufficient degree of turpitude so as to render the contract claim unenforceable or in response to which denying enforcement would not be considered proportionate.

4.10. Article 9(3) of the Rome I Regulation provides a discretion to apply the “overriding mandatory provisions” of the law of the country in which the contract has to be or has been performed. From case law, it seems that the phrase “overriding mandatory provisions” is to be interpreted narrowly.\textsuperscript{38} In light of the points made in the two preceding paragraphs, it is doubtful that an E.U. Member State’s rules on authorisations needed for the provision of financial services would be treated as “overriding mandatory provisions”.

\textsuperscript{34} See section 28(9) and section 26 of FSMA 2000.


\textsuperscript{36} This may be translated roughly as “no action may be founded on an immoral [or in this context, 'illegal'] act”.

\textsuperscript{37} [2016] UKSC 42, [2016] 3 WLR 399.

\textsuperscript{38} See \textit{United Antwerp Maritime Agencies NV (Unamar) v Navigation Maritime Bulgare} (C-184/12) [2014] 1 Lloyd’s Rep. 161, stating that mandatory rules of law of the forum should be given a narrow interpretation.
4.11. There is, therefore, a risk that an agreement for further activities that is governed by English law will not be enforced because the counterparty's Member State treats the provision of further activities as unauthorised. The FMLC acknowledges that the risk is small, even where the services are not performed in the U.K., and agreements for further activities with counterparties or clients in E.U. Member States may not necessarily be affected, provided that any necessary enforcement action would fall to be heard by an English court applying English law, but unfortunately it is impossible to be certain that this would be the outcome. If it is necessary to enforce the contract in the courts of an E.U. Member State, or where the contract is governed by the law of an E.U. Member State, and the law of the relevant State regards the contract illegal for want of authorisation, there is a risk that the contract will not be enforceable, or at least be enforceable only with considerable difficulty.

\textit{Contracts governed by an E.U. Member State's law}

4.12. It is not uncommon for a U.K. firm to enter into financial services contracts governed by the customer's or counterparty's law. In that case, the effect of the U.K. firm acting without authorisation would be governed by that law. Even where such a claim is heard by an English court, the court should give effect to the governing law, and the agreement for further activities might be unenforceable on the ground of illegality or an equivalent doctrine under the governing law. If the enforcement action were to take place in a court in the E.U. Member State concerned, the court would apply its own law. For example, where a lender under an existing loan contract has agreed to make a further advance at a time when it was no longer authorised, the lender might find that it can no longer recover the agreed interest or finance charges, and possibly even the further capital advanced.\textsuperscript{39} That said, the loan agreement may well contain a provision that an advance need not be made if it were illegal to do so, either as a condition precedent to making that advance or because of a breach of a representation on the point. A degree of complexity is introduced by the fact that, as explored in paragraph 4.8, for example, what constitutes illegality may itself be in dispute.

\textit{Insurance contracts}

4.13. Insurance contracts require special mention. A number of Member States (including France and Spain) treat insurance business as being carried out where the risk is situated, which, depending upon the nature of the risk, may be linked to the location of

\textsuperscript{39} If a loan is itself unenforceable, the lender might still have a claim in restitution to recover the sums advanced; but in some legal systems supervening illegality may be seen as a bar to restitution.
the asset insured or the place of business of the insured party. Thus, post-Brexit, unless special arrangements are agreed, those laws will regard U.K. insurers as unauthorised to effect insurance of risks in those Member States, even if the policy is taken out in the U.K. and both premiums and any claims are payable there. The effect will depend on the governing law, which court would have to consider any claim for enforcement and the effect of lack of authorisation under the relevant law. In some countries, such as Germany and the Netherlands, the Third Country insurer’s lack of local authorisation does not give rise to a right to avoid the contract by either party. A claim by the insurer or broker (for example, for unpaid premiums), however, might well be unenforceable if it would have to brought in the courts of the relevant Member State.

**Contractual consequences**

4.14. Many existing contracts will provide for events of default and/or termination events that give one or both of the parties the right to terminate the contract upon the occurrence of the event, and provide for the consequences of any such termination. The termination events that are of particular relevance in this context are illegality and *force majeure* termination events. For example, both the 1992 ISDA Master Agreement and the ISDA 2002 Master Agreement include an illegality termination event, and the ISDA 2002 Master Agreement includes a *force majeure* termination event.

4.15. Broadly, the illegality termination event will occur if, after the date on which a transaction is entered into, it becomes unlawful under the applicable law for a party to perform one or more obligations in relation to making or receiving payments or deliveries in relation to that transaction or complying with any other material provision of the agreement in relation to that transaction. Again, broadly, the *force majeure* termination event will occur if as a result of *force majeure* or an act of state, a party is prevented from performing one or more obligations in relation to making or receiving payments or deliveries in relation to that transaction or complying with any other material provision of the agreement in relation to that transaction or it becomes impossible or impracticable for a party so to perform. Both events comprise two main limbs: first, an event that occurs after the date on which the transaction is entered into, and second, as a consequence of such event a party is unable to perform in relation to that transaction. It will, of course, depend on the relevant obligation and the jurisdiction in which it is to be performed, but it seems unlikely that the mere

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40 ‘... under any applicable law (including without limitation the laws of any country in which payment, delivery or compliance is required by either party or any Credit Support Provider, as the case may be)...’ An alternative possibility, depending on the wording of the relevant clause, is that the clause would be triggered if and when a transaction results in one of the relevant countries’ authorities imposing a regulatory or criminal sanction on the one of the parties.
performance of an existing transaction after “passporting” rights have been lost will trigger either the illegality or the force majeure termination event under the ISDA Master Agreement. For further agreements or activities, however, the clauses may be relevant.

4.16. If the contract has in fact become illegal (for example, because it has to be performed in an E.U. Member State which regards performance as illegal), it is possible that an illegality termination event clause may not be fully effective for a different reason, at least when the contract is governed by English law. If the contract can be “saved” by the sort of adjustment discussed earlier, so that the “adjusted” contract can be carried out lawfully, this would be considered acceptable. On the other hand, if a clause were to require a party to undertake a further action which requires an authorisation no longer possessed by the party, the supervening illegality means the contract would be frustrated. The fact that the contract makes provision for the payment is arguably irrelevant; unlike in other cases of impossibility, in which the parties may make provision in the contract for supervening events and so in effect exclude application of the doctrine of frustration, with supervening illegality it is generally said that the parties cannot determine the consequences of supervening illegality by express provision. It is true that the precedent on which this view rests involved trading with an enemy, and the principle might not be applied to the less serious case of contracting without authorisation, but it is hard to be sure.

4.17. It also possible that, although the loss of authorisation does not render the contract illegal under English law, it will trigger an illegality termination event clause, because the concept of “illegality” in the clause is wider than the illegality which renders a contract unenforceable. For example, the clause might be interpreted as being triggered because the operation is “illegal” in the sense that it is forbidden in the relevant Member State, even though the illegality does not render the contract “illegal” in the sense of

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41 See ISDA, Brexit FAQs (2018), Question 1 (‘the performance of pre-existing contractual obligations (not involving a dealing type activity that in effect involves entry into a new trade in a “financial instrument”)’ is unlikely to be an Illegality Termination Event.

42 The Ralli Bros principle, see above, n 28.

43 Compare the cases involving prohibitions on export, where provisions allowing a party to pay a sum of money instead of performing the illegal act have been held to be effective, e.g. Johnson Matthey Bankers Ltd v State Trading Corp of India [1984] 1 Lloyd’s Rep 427 (invoicing back clause): see Treitel, Frustration and Force Majeure (3rd edn, 2014), para 8-058.

44 See Ertel Bieber & Co v Rio Tinto Co Ltd [1918] AC 260 (clause providing for suspension of some obligations in event of war; held that its operation would still contravene the public policy against giving aid to the enemy).

being unenforceable. The interpretation of each clause in its context will determine the outcome.

4.18. As another possible example, under the ISDA Master Agreement, the “Misrepresentation” clause might be triggered. Representations are made under Sections 3(a)(iii) and 3(a)(iv) of the ISDA Master Agreement that performance does not violate applicable law and that all consents have been obtained, respectively. Breach of these representations would constitute a Misrepresentation Event of Default under Section 5(a)(iv) of the Agreement. At the time of the original contract there would have been no misrepresentation, and mere performance after loss of authorisation is unlikely to trigger the clause, but to the extent that the occurrence of any of the events discussed above could be construed as entry into a “new” OTC derivative transaction (namely rolling an option position, novations, “material” amendments and unwinds or portfolio compression exercises carried out by way of entering into an offsetting or replacement transaction, as the case may be), it may be that such representations will then be deemed to be repeated—at which point they will no longer be true.46

4.19. Therefore, the loss of “passporting” rights—and the consequence that future operations required by the contract or contemplated by the parties will be unauthorised—might trigger some unexpected contractual consequences, even if they do not result in the contract becoming illegal and being frustrated under the general law.

Penal or administrative sanctions

4.20. If the relevant authority in an E.U. Member State regards a U.K. firm as carrying on business in its territory without the necessary authorisation, which, given the complexity of local regulation that is currently masked by the E.U. “passporting” system, may not be easy to predict, there is also a risk that the authority will impose regulatory or even criminal sanctions on the U.K. firm or its employees.47 This would have adverse reputational and financial consequences for the firm and/or the employees concerned as it may, in turn, act as a trigger in other financial contracts of the U.K. firm (such as loans, collateral management agreements and others).


47 For example, in Germany, section 32 of the Banking Act stipulates that any person who performs regulated banking activities or financial services requires prior authorisation by the Federal Financial Supervisory Authority. Were a firm to be found to be providing regulated services or products to customers in Germany in a manner determined to be prohibited by German law, this may constitute a criminal offence (Section 54(1) of the German Banking Act) punishable on indictment by a term of up to five years of imprisonment and/or a fine. In addition, non-compliance with regulatory duties is potentially subject to administrative fines. Under German law, a bank can be held liable to administrative fines, but not for criminal violations (which would instead potentially apply to relevant staff or management).
5. SOLUTIONS WHICH HAVE BEEN SUGGESTED

5.1. As noted above there are risks for parties to contracts concluded by U.K. firms with E.U. clients or counterparties before the U.K.’s departure from the E.U., where these contracts remain to be performed or otherwise operated after the U.K. departs. There are significant legal uncertainties in respect of whether U.K. firms may require E.U. or local (Member State) regulatory authorisations for the performance or operation of those contracts after the U.K.’s exit, authorisations which cannot practically be obtained and the absence of which might mean that a U.K. firm is exposed to criminal or administrative sanctions or other adverse regulatory consequences and/or that the contracts may be found to be illegal or unenforceable.

5.2. The FMLC is aware that market participants have been considering reverse solicitation arrangements and human rights provisions as means by which contractual continuity can be secured—the FMLC intends to analyse these in a forthcoming publication. Two other paths are among those receiving consideration: (1) transfer contracts to an appropriately authorised entity in the E.U.; and (2) depend on contractual arrangements as a remediation strategy. Another way by which long-term legal certainty might be provided is through the successful negotiation of an agreement between the U.K. and E.U. to grandfather existing contracts. Each of these three options is explored below.

Transfer to an E.E.A. entity

5.3. Statutory mechanisms such as those mentioned above are unlikely to be available in all cases and guidance from the E.U. has suggested that European authorities expect U.K. firms to address such issues through private law measures such as transferring business to appropriately authorised entities in the E.U. Perhaps the most obvious way in which firms can work around the authorisation requirement would be by establishing a subsidiary in the E.U. and apply for authorisation to provide services through that subsidiary or apply to a local regulator for authorisation. The contracts could then be novated to the entity in the E.E.A. The FMLC has considered previously the difficulties in subsidiarisation in the context of Brexit. In some cases, it may be

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48 Similar issues potentially also arise for E.U. firms which have concluded contracts with U.K. clients and counterparties before Brexit. As stated above, HM Government has published a draft statutory instrument establishing a “temporary permissions regime” under which E.U. firms and funds operating in the U.K. may obtain a “temporary permission” to continue their activities in the U.K. for a limited period after withdrawal.

49 See, for example, European Insurance and Occupational Pensions Authority, Opinion on service continuity in insurance in light of the withdrawal of the United Kingdom from the European Union (21 December 2017) available at: https://eiopa.europa.eu/Publications/Opinions/2017-12-21%20EIOPA-BoS-17-389_Opinion_on_service_continuity.pdf

50 See supra n. 7
possible to carry out a novation without obtaining the specific consent of the E.U. client or counterparty by availing of provisions in the contract which might permit such a transfer without the consent of the client or counterparty (as discussed further, below) or by using available statutory mechanisms. Many categories of contracts do not, however, contain permissive clauses and in those cases, firms’ ability to transfer existing contracts will depend upon obtaining the consent of the client or counterparty to the transfer. Even if firms are able to surmount the practical obstacles of engaging with a large number of clients and counterparties, potentially in a compressed period, there may be countervailing reasons for the client or counterparty to refuse consent, including adverse tax consequences or because a transfer of the contract will trigger clearing or margin requirements under EMIR.

5.4. The scale and complexity of this process is undeniable. Large market participants have several thousand relationships, clients and counterparties to manage. The implications of such restructuring may involve not only significant demands upon time and resource, including reorganisation, capital and human resources costs, there is also the danger of ongoing expense and uncertainty where it is not possible to restructure the affected contract on a like-for-like basis. Further, the transfers will have to be synchronised with other related changes—such as, operational adjustments required to amend collateral arrangements or to address new clearing procedures. In the case of derivative contracts, often a transaction will be linked to another transaction or other services—for example, with a prime brokerage or a clearing arrangement—and it will therefore be necessary to carry out any novation as a package. Another challenge arises in the case of insurance contracts where novation is not available and insurers have to apply for a transfer of business under Part VII of the FSMA 2000.

5.5. Another option, if the contracts so provide (as for example with loan agreements which contain illegality provisions) would be for the U.K. firm to terminate its continuing obligations under the contract. This scenario may be unattractive from the point of view of the E.U. client or counterparty and the firm may be compelled to agree to a requested transfer of the contracts notwithstanding any adverse consequences it may suffer as a result.

For example, using a cross-border merger under the E.U. cross-border mergers directive, a statutory banking or insurance business transfer scheme under Part VII of the Financial Services on Markets Act 2000 (reflecting Article 39 (Transfer of Portfolio) of the Solvency II Directive on the transfers of portfolios of insurance contracts) or conversion of a U.K. company into a Societas Europea (SE) and the relocation of its head office to the E.U. under the E.U. regulation on SEs.
Contracts as a remediation strategy

5.6. One possibility which market participants have been exploring is the insertion of a “Brexit clause" into contracts entered into after the referendum. A “Brexit clause" is a contractual provision which triggers some change in rights/obligations as a result of a defined Brexit-related event. The clause therefore sets out two basic things: (a) the specific Brexit related event triggering the clause; and (b) the contractual consequences of that event. These clauses have been compared to Material Adverse Change clauses.52

5.7. In some cases, identifying the provisions under part (a) of the clause (the specific Brexit related trigger) might be relatively straightforward—for example: a change in laws such that a party is no longer entitled by law to operate in the E.U.; there are, however, other circumstances, such as in relation to insurance contracts, where the lack of clarity as to what constitutes “carrying on” business would lend further complexity to identifying such a trigger. It is likely that the actions under part (b) will prove substantially more difficult to agree. The potential consequences could range from the allocation of responsibility for ensuring authorisation (through any of the means described in section 3 above) or to the subsequent transfer of business to an authorised entity (more on which, below). This solution will, however, require a significant repapering exercise and will involve substantial cost to market participants.

Public sector solution

5.8. In acknowledgment of the limitations of the private sector solutions, market participants have suggested that legal and regulatory action by authorities in the U.K. and E.U. might better mitigate these risks.53 Such action, whether included in the Withdrawal Agreement, undertaken by the E.U. or initiated by individual Member States, would apply similarly to business conducted in the E.U. as that proposed by U.K. authorities in relation to business conducted in the U.K., and would involve legislative provisions continuing, after the U.K.’s exit from the E.U. (likely to be at the end of the transition period), the E.U. regulatory authorisations of U.K. firms which formerly benefitted from the “passport" to the limited extent necessary to enable an orderly wind down of their business with E.U. clients and counterparties. Such provisions could be further

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52 In the insurance section, the Aviation Insurance Group has published a new model E.U. contract continuation clause (see: http://www.iua.co.uk/IUA_Member/Press/Press_Releases_2017/Publication_of_EU_Contract_Continuation_Clause.aspx) as has XL Catlin (see: https://www.insurancetimes.co.uk/xl-catlin-outlines-innovative-brexit-continuity-clause/1426657.article).

53 The broader implications for financial stability that such legal uncertainties can produce have been acknowledged in the establishment, in April 2018, of a joint technical working group of the Bank of England and the European Central Bank to study risk management around the departure of the U.K. from the E.U. and its implications for the financial services industry.
enhanced to allow for continued performance and enforcement of rights under contracts in existence on the date of exit (or the end of the transition period) and also for any amendments and new contractual arrangements necessitated by the existing contracts (examples include the facilitation of advances under revolving credit facilities and the operation of collateral arrangements and portfolio compression exercises, etc.). For such a solution to function efficiently, decisions would need to be made as to how long these authorisations might continue—whether they would last until the final maturity of the contract or they might impose a suitable-but-unrelated cut-off date.

5.9. Such continued authorisation would require related provisions to ensure that changes in law do not negate the benefit of the continuing authorisations as well as safeguards to ensure that regulators are able to take enforcement action against firms contravening local law requirements as well as have precautionary powers to take action against firms that clearly put clients’ interests, market integrity or financial stability at risk during the wind-down period. It would also be desirable to put in place co-operation arrangements between the E.U. and U.K. authorities for the supervision of these activities. A first step might have been taken through the establishment of the joint technical working group of the Bank of England and European Central Bank. Three ways by which such legislative provisions can be made are discussed below.

Withdrawal Agreement

5.10. Since the result of the 2016 referendum was announced, market participants have highlighted the successful negotiation of a bespoke treaty between the U.K. and E.U. as the most efficient model for a future relationship. Such a treaty would provide for future and continued equivalency or mutual recognition of U.K. firms in the E.U., and vice versa, and provide certainty to market participants. The Withdrawal Agreement could, therefore, provide an opportunity for the relevant provisions continuing the ability of firms to provide services in the E.U. and the U.K. after the end of the transition period to the extent necessary to allow the wind down of existing contracts. Any deal on mutual access would address illegality issues, since the continued cross border provision of services between U.K. and E.U. persons would then be legal in all relevant countries. These provisions could be similar to the provisions in the draft Withdrawal Agreement continuing certain privileges, immunities and other rights of the European Central Bank and the European Investment Bank in the U.K. after the end of the transition period to enable them to wind down their existing U.K. operations. See Articles 112, 113, 118 and 119 of the draft Withdrawal Agreement between the EU and the UK.
inclusion of such provisions in the Withdrawal Agreement would substantially increase legal certainty as it would provide an E.U.-wide solution, avoiding the need for any individual Member State legislation, and secure consistency and reciprocal provisions for U.K. and E.U. firms conducting cross-border business. This approach would be consistent with the E.U. negotiating directives which envisage that negotiations should, to the extent possible, address uncertainties affecting those that have entered into contracts on the assumption of continued U.K. membership of the E.U. \(^{55}\) It would also be consistent with the E.U. position, published in Summer 2017, regarding governing law and jurisdiction clause in contracts entered into prior to the date of the U.K.’s departure from the E.U. \(^{56}\)

5.11. There might be concerns as to whether this is a subject that can be properly addressed within the scope of a Withdrawal Agreement under Article 50. It could be argued, however, that the subject matter is closely linked to the withdrawal process and the envisaged provisions are similar in concept to other provisions already included in the Withdrawal Agreement providing for the continued application of specific rights under E.U. law in relation to transactions started before the end of the transition period. It would also be important to agree these provisions as part of the Withdrawal Agreement concluded before the U.K.’s exit from the E.U. Uncertainty might be exacerbated if the U.K. and E.U. would defer the discussion of this approach to a later stage with a view to using the mechanisms in Article 50 to amend the Withdrawal Agreement to include such provisions.

*Action by individual Member States*

5.12. Individual Member States could legislate to address the continuity issues for existing contracts, in a way similar to that proposed by U.K. authorities. This would have the advantage of overcoming any residual concerns about the ability of the parties properly to include such provisions in the Withdrawal Agreement and would mitigate the risk that the Withdrawal Agreement is not agreed, ratified or concluded for any reason so that there is no transition period. There are, however, significant and possibly overwhelming challenges in putting appropriate legislation in place in all E.U. and E.E.A. Member States, even by 31 December 2020 when the transition period is supposed to end, let alone by March 2019. Further, the likely possibility of variations in


approach across the Member States would also create additional concerns relating to fragmentation and uncertainty.

E.U. legislative action

5.13. The E.U. could adopt an E.U. regulation to address the continuity issues for existing contracts, again in a similar way to that proposed by U.K. authorities. This would have similar advantages to the action by individual Member States discussed above. It is more credible that E.U. legislation could be put in place relatively quickly and this would ensure that the E.U. takes a harmonised approach. Nevertheless, there would still be formidable timing challenges if the E.U. is to legislate before March 2019. Additionally, where the E.U. has made commitments on its WTO schedule of commitments to provide other Third Countries with access to its market, the WTO most-favoured nation obligation prevents the E.U. from treating the U.K. more favourably than it would any other Third Country.\(^{57}\)

6. CONCLUSION

6.1. In this paper, the FMLC has highlighted the questions which will be faced by market participants in relation to the continuity of contracts following a hard Brexit. The FMLC has found that, for the most part, it is in agreement with the European Commission’s Communication of July 2018 (mentioned in paragraph 1.12 above) and considers it unlikely that Brexit will give rise to issues of contractual continuity in a general sense and so far as it is a matter of English law and jurisdiction. Nevertheless, the FMLC has explored the potential consequences to all concerned, including clients and markets, where authorisations are lost without adequate alternatives. Finally, the FMLC has examined some of the ways by which these issues might be mitigated, both by firms themselves and through legislative action, including within an agreement between the U.K. and E.U.

\(^{57}\) For a more in-depth exploration of the impact of the WTO rules on the U.K.-E.U. future relation, see the FMLC paper mentioned in footnote 8 above.
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EUROPEAN UNION (WITHDRAWAL) BILL: LETTER TO MINISTRY OF JUSTICE ON CLAUSE 6 AND JUDICIAL INTERPRETATION

MARCH 2018
19 March 2018

Eral Knight
Head of European Civil and Private International Law Team
Europe Division
Global Britain Directorate
Ministry of Justice
102 Petty France
London SW1H 9AJ

Dear Mr Knight

European Union (Withdrawal) Bill 2017—clause 6 and judicial interpretation

As you know, the role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

Following the referendum in June 2016, in which the U.K. voted to withdraw from the European Union, the FMLC established an Advisory Group of experts to give direction to the Committee’s work relating to Brexit. Members of that Advisory Group drew the FMLC’s attention to potential legal uncertainties arising from provisions in the European Union (Withdrawal) Bill (the “Withdrawal Bill”), which will, post-Brexit, govern the interpretation by U.K. courts of E.U. concepts.1

The Withdrawal Bill provides, in essence, for the incorporation of E.U. legislation, as “operative immediately before exit day”, into domestic law. Clause 5 of the Withdrawal Bill states that the principle of the supremacy of E.U. law will not apply to any enactment or law passed or made on or after exit day, except so far as relevant to the interpretation, disapplication or nullifying any enactment or law passed or made before exit day. Clause 6, quoted below, provides guidance on the relationship between courts in the U.K. and the European Court of Justice (the “ECJ”).

Interpretation of retained EU law

(1) A court or tribunal—

(a) is not bound by any principles laid down, or any decisions made, on or after exit day by the European Court […]

(2) A court or tribunal need not have regard to anything done on or after exit day by the European Court, another EU entity or the EU but may do so if it considers it appropriate to do so (emphasis added).

(3) Any question as to the validity, meaning or effect of any retained EU law is to be decided, so far as that law is unmodified on or after exit day and so far as they are relevant to it—

(a) in accordance with any retained case law and any retained general principles of EU law […]

1 Registered Charity Number: 1164902.

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Where ECJ case law exists in relation to retained E.U. law, therefore, U.K. courts are instructed to follow such decisions; correspondingly, where the meaning of an autonomous E.U. term or concept is defined before exit day, U.K. judges will follow that interpretation. Where the meaning of terms is not fixed by exit day—or their interpretation is discussed and adjudicated upon by the ECJ post-Brexit—there remains ambiguity as to how U.K. courts should proceed.

In the absence of statutory direction, U.K. courts customarily treat foreign court judgments as persuasive but short of binding. The introduction of the concept of “appropriateness” in clause 6(2) gives rise to unforeseen complexities as the Withdrawal Bill does not offer any guidance as to the meaning of “appropriate”. The term “need not have regard” is another area of potential difficulty—the FMLC notes the use of the term “have regard” has caused interpretational difficulties in the past.

It is the view of the FMLC that such ambiguity in the guidance offered to judges will present legal uncertainty with significant market impact, supplementing the operational challenges caused by the increased likelihood of inconsistent first-instance judgments and the lengthier-than-usual waiting times for hearings at the Court of Appeal and Supreme Court, especially in the event that European and U.K. judges take differing approaches to interpretation. It might be helpful to reflect on a number of cases in which the interpretation of key E.U. regulatory concepts has had the ability significantly to affect the financial markets.

One such example is the definition of “derivative” (and, correlatively, the definition of “spot”, since “spot” contracts are not “derivative” contracts) under the regulatory regime for markets in financial instruments. Foreign exchange derivatives such as forwards are regulated under this regime but spot foreign exchange contracts are not. The settlement cycle, however, means that spot contracts are settled forward of the parties entering into the contract. Thus, the boundary between “spot” and “forward” is a nuanced one with a penumbra of uncertainty. The U.K. Financial Services Authority (“FSA”)—and subsequently the Financial Conduct Authority (“FCA”)—developed a practice of using the concept of “commercial purposes” as the basis for distinguishing the two contracts but other E.U. Member States took a different approach. Owing to the substantial uncertainty to which this divergence gave rise, the European Commission was asked for guidance by the European Securities Markets Authority (“ESMA”) and issued a retrospective opinion under Directive 2004/39/EC on markets in financial instruments (“MiFID I”). A legislative definition was then introduced for the purposes of Directive 2014/65/EU on markets in financial instruments (“MiFID II”). It is possible, however, that given the importance of the issue and the impact of such divergent approaches, this issue would have become a question for the ECJ to address in the absence of a legislative definition.

It is also possible that the ECJ would have adopted an interpretation with which the FCA would, questions of comity aside, not have been inclined to concur. Post-Brexit, such divergence could well see the question on the meaning of “spot contract” referred to the U.K. judiciary. The risks which the courts' approach might pose for the markets would be the alternate risks of inadvertently regulating an unregulated and thriving foreign exchange spot market, which is essential to commercial activity of all kinds, or deregulating certain foreign exchange derivatives markets and potentially jeopardising an equivalence decision. Given the significance of the question to the financial markets, its evident impact on the conduct and nature of foreign exchange business, the size of the foreign exchange markets in London and the highly technical material which would be necessary to reach an informed decision on the point, the U.K. courts would likely find it helpful to receive guidance not only on the technical issues but also
Another past example is the question of what it means to be an “insider” for the purposes of the insider trading regime first established under Directive 2003/6/EC on insider dealing and market manipulation (the “Market Abuse Directive” or “MAD”). The question of whether insider trading can comprise trading while in possession of inside information or, more restrictively, comprises only trading on the basis of inside information was one which was settled by the ECJ (in favour of the wider definition) during a period in which the FSA’s preferred approach was a narrower and therefore divergent interpretation. Regulation (EU) No 596/2014 on market abuse (the “Market Abuse Regulation” or “MAR”) reflects the approach adopted by the ECJ. If this question were to have arisen under the Market Abuse Directive for consideration after Brexit, it would doubtless have reached the U.K. courts which would have had to consider the proper deference to be given to the ECJ’s judgment. The risks which the courts’ chosen approach might pose include the risk of the U.K. markets being perceived to be less well-regulated than E.U. markets, with a potential impact, again, on supervisory and equivalence decisions.

The FMLC recommends, therefore, that careful thought be given to the practical use of the “appropriateness” test. It would be beneficial if HM Government were to provide the judiciary with either principles by which it can evaluate consistently whether consideration should be given to post-Brexit ECJ judgments or with a mechanism which might confer aides to interpretation. While the FMLC recognises that the degree of influence the ECJ’s decisions may have on judgments by U.K. judges depends to a certain extent on the composition of the final Withdrawal Agreement, it considers it essential that HM Government makes independent provisions which can guide judicial deliberation. One such provision might be to confer upon judges the ability to request from relevant bodies, such as the FCA, *amicus briefs* which provide judges with the necessary background.

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely,

Joanna Perkins
FMLC Chief Executive


The U.K. Supreme Court is given, by means of point 4(a) in clause 6, the power to depart from ECJ decisions on the same basis as it is currently able to depart from its own decisions.

The FMLC observes that this ambiguity was noted by the former President of the Supreme Court, Lord Neuberger, who remarked in the media that judges would require guidance from HM Government on how U.K. courts should interpret European concepts and judgments post-Brexit. See, Coleman, C., “U.K. judges need clarity after Brexit - Lord Neuberger”, BBC News, (8 August 2017), available at: http://www.bbc.co.uk/news/uk-40855526.

For example, in relation to section 172 of the Companies Act 2006 (see, R (on the application of People & Planet) v HM Treasury [2009] EWHC 3020 (Admin) and S. F. Copp “S. 172 of the Companies Act 2006 Fails People and Planet” [2010], Company Law 406). The Law Society had raised a concern that the provision could raise the spectre of courts reviewing business decisions taken in good faith by subjecting such decisions to objective tests, with serious resulting implications for the management of companies by their directors. See, the Law Society’s ‘Proposed Amendments and Briefing for Parts 10 & 11’ (issued 23 January 2006);

The MiFID regulatory regime comprises Directive 2004/39/EC on markets in financial instruments (“MiFID I”), which has now been replaced by Directive 2014/65/EU on markets in financial instruments (“MiFID II”) and Regulation (EU) No 600/2014 on markets in financial instruments (“MiFIR”).

“Inside information”, defined in Article 7, has been interpreted widely by ECJ under MAD I. To trigger the prohibition, information must be “precise”, non-public and price-sensitive. Under Article 8, a breach occurs where a person possesses inside information and uses it by acquiring or disposing of (related) financial instruments or by cancelling or amending an order where the order was placed before the person obtained inside information.

MAR creates a presumption that a person in possession of inside information who carries out transactions connected with that information is deemed to have used that information, reflecting the ECJ decision in Spector Photo Group v CBFA [2009] C-45/08. Under Article 9 the presumption is rebuttable where one of the following legitimately occurs:

- the natural person who decides to enter into a transaction on behalf of a legal entity is not himself in possession of inside information or influenced by one who is (a “Chinese Wall” defence);
- a market-maker or broker is acting in the normal course of that function;
- the person who trades is subject to a pre-existing obligation to enter into the transaction when he acquires the inside information;
- the insider is proceeding with a merger or takeover, prior to public disclosure, and the information relates to that activity;
- the inside information is that the insider himself has decided to make this trade.

There is no general defence in respect of due care and diligence or safe systems and controls.

In view of the fact that this solution would require the cooperation of the U.K. regulatory authorities, Sean Martin and Sinead Meany took no part in the preparation of this letter and the views expressed should not be taken to be those of the FCA and the Bank of England.
U.K. WITHDRAWAL FROM THE E.U.: PAPER ON THE APPLICATION AND IMPACT OF WORLD TRADE ORGANIZATION RULES ON THE FINANCIAL SERVICES

DECEMBER 2017
U.K. WITHDRAWAL FROM THE E.U.: PAPER ON ISSUES OF LEGAL UNCERTAINTY ARISING FROM THE APPLICATION AND IMPACT OF WORLD TRADE ORGANIZATION RULES ON THE FINANCIAL SERVICES

December 2017

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Financial Markets Law Committee

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² The FMLC is also grateful to Lorand Bartels, Special Counsel at Linklaters LLP and Reader in International Trade Law at the University of Cambridge, to whom any errors in this paper should not be attributed.
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1. **INTRODUCTION**

1.1. The role of the Financial Markets Law Committee (the “FMLC” or the “Committee”) is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. On 23 June 2016, the U.K. voted by way of an in/out referendum to withdraw from the European Union (“Brexit”). In the aftermath of the referendum, and in the absence of any official roadmap for the upcoming separation, discussion about the U.K.’s future relationship with the E.U. has followed two main strands. In the first, the U.K.’s withdrawal from the E.U. would be complemented by the successful negotiation of a new U.K.-E.U. relationship—for example, in the form of a new trade agreement. The second option, dubbed in the media the “cliff-edge”, would entail the U.K. leaving the E.U. without signing a new agreement, as a result of which the conduct of business across borders would be governed by World Trade Organization (“WTO”) rules.

1.3. On 17 January 2017, U.K. Prime Minister, Theresa May, offered a first outline for the upcoming negotiations with the E.U. The Prime Minister stated at that time that it was her intention to seek a customs agreement with the E.U. that would leave the U.K. free to establish its own individual tariff schedules at the WTO, “meaning we can conclude new trade agreements, not just with the European Union but with old friends and new allies from outside Europe too”. She observed that the U.K. cannot remain within the European single market. This latter thought was reiterated in Mrs May’s speech in Florence in September 2017, and this time accompanied by a proposal for a transitional deal of “around two years” based on “the existing structure of E.U. rules and regulations”, leading eventually to a “new, deep and special partnership” partnership with the E.U.

1.4. On the domestic front, preparations for withdrawal have continued. On 29 March, HM Government officially served notice of the U.K.’s withdrawal to the E.U. under Article 50 of the Treaty on European Union (“TEU”). On the following day, the U.K.

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3 Theresa May’s Speech: The government’s negotiating objectives for exiting the E.U., (17 January 2017), the full text of which is available here: https://www.gov.uk/government/speeches/the-governments-negotiating-objectives-for-exiting-the-eu-pm-speech.

4 See point 9: “New trade agreements with other countries”, in PM Theresa May’s Speech (supra, n. 2).

Department for Exiting the European Union published a White Paper introducing HM Government’s proposals to repeal the European Communities Act 1972 and incorporate E.U. law into U.K. law by way of a “Great Repeal Bill”. The Bill, officially titled the European Union (Withdrawal) Bill (the “Withdrawal Bill”), was introduced into the House of Commons on 13 July. It completed its Committee Stage there, having been amended, on 20 December 2017.

1.5. At the end of the two-year Article 50 notice period—i.e., on the day which is defined in the Withdrawal Bill as “Exit Day”—the U.K. will cease to be an E.U. Member State unless there is unanimous approval from other E.U. Member States to extend this period. Given the absence of an official position on the future relationship between the U.K. and the E.U. and the protracted nature of the Article 50 negotiations, it was equally plausible at the outset of this project that the relationship between the U.K. and E.U. might either be governed, as described in paragraph 1.2, by a treaty agreement or by the WTO rules. The basis for the U.K.’s trade with the E.U. could take the form of: (1) U.K. membership of the European Economic Area (“E.E.A.”), subject to the European Economic Area Agreement (the “E.E.A. Agreement”); (2) a transitional arrangement; (3) a new bespoke treaty; or (4) E.U. commitments to the WTO with the U.K. qualifying as both a WTO Member and a “Third Country” under existing E.U. access provisions (this fourth option is referred to in this paper as the “fallback scenario”). Each of these options is impacted by the WTO’s principles which have influenced and shaped international trade since 1947.

1.6. On 7 December 2017, the U.K. and E.U. concluded negotiations on the first part of the Article 50 negotiations, with the U.K. agreeing to pay a financial settlement and to protect the rights of E.U. citizens resident in the U.K. As the negotiations move on to

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7 The E.E.A. Agreement governs relations between the E.U. and the three states of the European Free Trade Association (“EFTA”)—Iceland, Liechtenstein and Norway—which make up the European Economic Area (“E.E.A.”), In *Yalland and others v Secretary of State for Exiting the E.U.* [2017] EWHC 630, the Applicants sought a declaration that it would be unlawful for the Prime Minister to take the U.K. out of the E.E.A. by serving a withdrawal notice under Article 127 of the Agreement on the European Economic Area (the “E.E.A. Agreement”) and that, absent such notice, the U.K. remains bound as a Contracting Party to the E.E.A. Agreement. One limb of the Appellants’ argument rested on the contention that an action under a Treaty to which EFTA states were not party, i.e. under Article 50 of the Treaty of the European Union, could not unilaterally affect the rights of those states vis-à-vis the U.K. under the E.E.A. Agreement. The High Court refused to hear the case in February 2017 on the grounds that the application was premature. Since then HM Government has submitted an Article 50 withdrawal letter which makes no mention of the need to give notice under Article 127 of the E.E.A. Agreement.

8 See definition in paragraph 1.7.

9 Barker, A. and Brunsden, J., “Brexit divorce deal: the essentials”, *Financial Times*, (8 December 2017), available at: https://www.ft.com/content/21e58076-dbee-11e7-a039-c64b1c09b482.
focus on the trade deal, the FMLC acknowledges that the possibility of the occurrence of the fallback scenario might have reduced. The possibility is, however, given due consideration in this paper so as to provide a comprehensive picture of the legal complexities.

1.7. In this paper, the FMLC examines the future of the U.K.’s cross-border trade with the E.U. and the potential impact of the WTO’s rules. Section 2 contains an overview of the WTO agreements relevant to financial services while section 3 delves more deeply into the application of these rules including the operation of the prudential carve-out and the ways in which they support the negotiation of a Free Trade Agreement (“FTA”). Section 4 offers an analysis of the impact of the WTO’s principles on each of the options outlined in the preceding paragraph and section 5 considers briefly the U.K.’s future arrangements with non-E.U. countries (or “Third Countries”).

1.8. It is not for the FMLC to comment on matters of policy or the form that future regulatory approaches, if any, should take and this paper should not be understood to constitute comments thereon.

2. THE WTO RULES APPLICABLE TO THE FINANCIAL SERVICES

2.1. The WTO provides a common framework for trade in goods and services, as well as the protection of intellectual property rights. The Marrakesh Agreement establishing the World Trade Organization (“WTO Agreement”) provides the basic rules on membership, structure and decision-making and is applicable to 164 Members worldwide. The E.U. currently represents itself and the E.U. Member States, including the U.K., in the WTO. The U.K. is, however, also independently a WTO

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10 The United Kingdom may be able to inherit existing E.U. preferential FTAs with certain Third Countries but this will require the agreement of the Third Country in question, and possibly also the assistance of the E.U. This is elaborated upon in the European Council Draft Guidelines XT 21001/17 of 31 March 2017, which state that the United Kingdom “will no longer be covered” by E.U. agreements with Third Countries. However, it goes on to say that the European Council “expects” the U.K. to honour its share of commitments and indicates that there needs to be a “constructive dialogue” to achieve this. See European Union, Press Release: “European Council (Art. 50) guidelines following the United Kingdom’s notification under Article 50 TEU”, (29 April 2017), available at: http://www.consilium.europa.eu/en/press/press-releases/2017/04/29/euco-brexit-guidelines/#.

11 Unlike the E.U. rules and the single market directives, individual financial institutions cannot invoke the WTO rules in order to gain market access. However, governments can and do act as proxies for their companies in the WTO.

12 For the sake of internal consistency, Member nations of the E.U. will be referred to throughout this paper as “E.U. Member States” or as “Member States”. Signatories to the WTO Agreement are referred to as “WTO Member(s)”.

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Member and a party to the WTO multilateral agreements, including the General Agreement on Tariffs and Trade 1994 (“GATT”) and the General Agreement on Trade in Services (“GATS”).

2.2. The WTO rules and disciplines applicable to trade in financial services are contained in three legal instruments: the GATS, the Annex to the GATS on Financial Services (the "Annex") and the Understanding on Commitments in Financial Services (the "Understanding").

GATS: objectives, coverage and disciplines

2.3. The GATS was the first multilateral trade agreement to be signed which concerned services. It applies in principle to all service sectors, with two exceptions:

i. GATS Article I.3 excludes “services supplied in the exercise of governmental authority”. These are services that are supplied neither on a commercial basis nor in competition with other suppliers. Cases in point are social security schemes and other public services provided at non-market conditions.13

ii. The Annex on Air Transport Services exempts from coverage measures affecting air traffic rights and services directly related to the exercise of such rights.

2.4. Article I of the GATS distinguishes between four modes of supplying services:

i. **Mode 1 Cross-border supply**, which covers services from the territory of one WTO Member into the territory of another WTO Member (e.g. banking or architectural services transmitted via telecommunications or mail);

ii. **Mode 2 Consumption abroad** refers to situations in which a service is supplied in the territory of one WTO Member to the service consumer of another WTO Member (e.g. tourist or patient);

iii. **Mode 3 Commercial presence** refers to the supply of a service by a service supplier of one WTO Member through commercial presence in the territory of another WTO Member, such as through ownership or lease of premises (e.g. domestic subsidiaries of foreign insurance companies or hotel chains); and

13 See 1(b) of the Annex on Financial Services.
iv. **Mode 4 Presence of natural persons** is the supply of a service by a service supplier of one WTO Member through the presence of natural persons in the territory of another WTO Member (e.g. accountants, doctors or teachers and provision of “fly in, fly out” services, whether employed or self-employed).

2.5. The GATS imposes upon all WTO Members two broad categories of obligations: (i) general obligations, which apply to all WTO Members trading in services; and (ii) commitments concerning market access and national treatment in specifically designated sectors. Of the general commitments, perhaps the best known is the Most Favoured Nation (“MFN”) treatment. Article II:1 of the GATS provides:

> With respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country.

The MFN obligation applies to any measure that affects trade in services in any sector within the scope of GATS, whether or not specific commitments have been made.

2.6. Derogations from the MFN treatment are possible in the form of the so-called Article II exemptions.15 WTO Members were allowed to seek such exemptions for existing measures before the WTO Agreement entered into force. New exemptions can only be granted to new Members at the time of accession or, in the case of current Members, in exceptional circumstances, by way of a waiver under Article IX:3 of the WTO Agreement. For those WTO Members which negotiated MFN exemptions, these are specified in their MFN exemption lists, specifying the measures for which the derogations were obtained. These exemptions are subject to review and should not—in principle—have lasted longer than 10 years, although many are expressed to last indefinitely.

2.7. FTAs are another form of derogation from the MFN obligation, permitted by Article V of GATS under certain conditions. One requirement of such an agreement is that it “has substantial sectoral coverage”, which the GATS further states should be understood

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14 The Annex to the GATS on Movement of Natural Persons specifies, however, that Members remain free to operate measures regarding citizenship, residence or access to the employment market on a permanent basis.

15 These exemptions are provided in the Annex to the GATS on Article II Exemptions.
in terms of number of sectors, volume of trade affected and modes of supply. In order to meet this condition, agreements should not provide for the \textit{a priori} exclusion of any mode of supply.\textsuperscript{16}

2.8. Reinforcing this, one WTO Panel has observed that

the purpose of Article V is to allow for ambitious liberalization to take place at a regional level, while at the same time guarding against undermining the MFN obligation by engaging in minor preferential arrangements. However, in our view, it is not within the object and purpose of Article V to provide legal coverage for the extension of more favourable treatment only to a few service suppliers of parties to an economic integration agreement on a selective basis, even in situations where the maintenance of such measures may explicitly be provided for in the agreement itself.\textsuperscript{17}

2.9. With reference to the specific commitments, each WTO Member maintains a schedule which provides a record of its individual commitments of market access and national treatment with respect to the four modes of service supply. Although these are the schedules of individual Members, they are negotiated texts and by virtue of Article XX:3 of GATS are an integral part of GATS with the same treaty status. In sectors where market-access commitments have been undertaken, Article XVI of GATS provides that certain “quantitative restrictions” cannot be imposed by a WTO member on services, unless these are specified in its schedule. These quantitative restrictions include maximum limitations on the number of service suppliers; the total value of service transactions; the total number of service operations or employees in the sector; the legal form of the service supplier; or the participation of foreign capital. For the sectors included in its schedule, Article XVII of GATS requires each WTO Member to provide national treatment, i.e., to accord to services and service suppliers of any other WTO Member treatment no less favourable than that it accords to its own like (similar) services and service suppliers, subject to any limitations in its schedule. Article VI of GATS requires that for scheduled services new domestic regulations must be no more trade restrictive than necessary to ensure the quality of the service.

\textsuperscript{16} GATS Article V and footnote 1.

The Annex on Financial Services

2.10. The Annex provides a detailed definition of the financial services covered. The Annex includes a so-called “prudential carve-out”, which provides in part that

Notwithstanding any other provisions of the [GATS], a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system.18

The Annex does not provide any definition or indicative list of prudential measures that would be covered by this provision. While governments have considerable discretion in introducing prudential measures, the GATS provides that the prudential exception “shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement”.19

2.11. The Annex also provides the legal basis for WTO Members to enter into mutual recognition agreements (“MRAs”) under which they may recognise each other’s prudential and certification measures (as to more on the practical use of both of these measures, see paragraphs 3.12 to 3.14 below).

The Understanding on Commitments in Financial Services

2.12. The Understanding was agreed at the same time as the GATS.20 It has no legal effect per se, but has effect insofar as its terms are incorporated in individual WTO Members’ schedules. Several WTO Members which have accepted it, including the E.U. (and thus, the U.K.), the U.S. and other OECD countries.

2.13. The Understanding builds on the GATS, first by imposing a standstill obligation under which parties undertake not to introduce more restrictive measures in respect of trade in financial services. In addition, the Understanding creates obligations which build on the basic GATS obligations of market access and national treatment. The obligations on market access are further broken down into the following categories: monopoly

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18 GATS Annex on Financial Services, paragraph 2(a). The other general exceptions provided for in GATS Article XIV apply to all services sectors and measures.

19 Ibid.

20 The text of the Understanding on Commitments in Financial Services is available here: https://www.wto.org/english/docs_e/legal_e/54-ufins_e.htm.
rights; financial services purchased by public entities; cross-border trade; commercial presence; new financial services; transfers of information and processing of information; temporary entry of personnel; and non-discriminatory measures. The national treatment provision imposes upon WTO Members that have accepted the Understanding the obligation to grant financial service suppliers of any other WTO Member established in their territories access to payment and clearing systems operated by public entities and to official funding and refinancing facilities.

3. APPLICATION OF THE WTO RULES TO FINANCIAL SERVICES

Certification of schedules of Commitments at the WTO

3.1. In accordance with the requirement in the GATS and the WTO Agreement, each WTO member has annexed a schedule of commitments setting out its market access and national treatment commitments. WTO Members can amend their own schedules in case of changing circumstances, provided that WTO rules are followed. This section sets out the process for registering a GATS schedule with the WTO with reference to the procedures for the rectification or modification of schedules set out in the GATS and two related decisions of the WTO Council for Trade in Services (the “GATS Council”).

3.2. The overarching authority to modify services commitments is set out in GATS Article XXI. GATS Article XXI provides in part that a WTO Member (referred to in this context as the “modifying Member”) may “modify or withdraw any commitment in its schedule” by notifying its intent to the GATS Council.\textsuperscript{21}

3.3. Other WTO Members which consider their benefits have been affected by the modifying Member’s proposed modification have the right to object and to seek “compensatory adjustment” in the form of additional market access in other sectors in the modifying Member’s services schedule. If no agreement is reached on the compensatory adjustment, the matter can referred to arbitration.\textsuperscript{22} In case of arbitration, were the modifying Member to implement changes to its schedule without

\textsuperscript{21} GATS Article XXI:1(a) and (b).

\textsuperscript{22} GATS Article XXI:3(a). Moreover, the “modifying Member may not modify or withdraw its commitment until it has made compensatory adjustments in conformity with the findings of the arbitration”. GATS Article XXI:4(a).
complying with the arbitral findings, affected WTO Members would have retaliation rights.\textsuperscript{23}

3.4. In 1999, the GATS Council adopted procedures to implement the GATS provision on modifying services schedules. They provide in part that other WTO Members must submit any objections within 45 days of the notification of the proposed modification or withdrawal.\textsuperscript{24} If no claims are made during that period, then “the modifying Member shall be free to implement the proposed modification or withdrawal” and it shall be deemed certified.\textsuperscript{25}

3.5. In 2000, the GATS Council adopted additional procedures related to the “rectification” of a WTO Member’s GATS schedule.\textsuperscript{26} These procedures state in part that

new commitments, improvements to existing ones, or rectifications or changes of a purely technical character that do not alter the scope or the substance of the existing commitments, shall take effect by means of certification.\textsuperscript{27}

The proposed changes will enter into force 45 days from the date of circulation “provided no objection has been raised by any other Member”.\textsuperscript{28} If any objection has been made and not withdrawn, the 2000 Procedures cease to apply and the matter must be resolved under the 1999 Procedures for modifications, described above.\textsuperscript{29}

\textsuperscript{23} “If the modifying Member implements its proposed modification or withdrawal and does not comply with the findings of the arbitration, any affected Member that participated in the arbitration may modify or withdraw substantially equivalent benefits in conformity with those findings”. GATS Article XXI:4(b).

\textsuperscript{24} World Trade Organization, Procedures For The Implementation Of Article XXI of the General Agreement On Trade In Services (GATS) (Modification Of schedules), adopted by the Council for Trade in Services on 19 July 1999, S/L/80, (the “1999 Services Council Procedures”), paragraph 3.

\textsuperscript{25} 1999 Services Council Procedures, para. 3. The certification procedures provide in part that “[a]t the end of the 45-day period, if no objection has been raised, the Secretariat shall issue a communication to all Members to the effect that the Certification procedure has been concluded, indicating the date of entry into force of the modifications”. 1999 Services Council Procedures, para. 20. If Members object to the proposed certification, “the Certification will be deemed concluded upon the withdrawal of the objections by all objecting Members”.

\textsuperscript{26} World Trade Organization, Procedures for the Certification of Rectification or Improvements to schedules of Specific Commitments, Adopted by the Council for Trade in Services on 14 April 2000, S/L/84 (the “2000 Services Council Procedures”).

\textsuperscript{27} 2000 Services Council Procedures, para. 1.

\textsuperscript{28} 2000 Services Council Procedures, para. 1.

\textsuperscript{29} 2000 Services Council Procedures, para. 4.
The E.U.’s GATS schedule

3.6. The E.U. has registered a schedule of commitments with the WTO on behalf of the E.U. and its Member States. The E.U.’s schedule of commitments enumerates commitments for the bloc as a whole, with derogations listed for individual Member States.

3.7. The GATS financial services schedule from 1999 (the “1999 schedule”) is the most recent certified schedule containing the commitments of the E.U. and its Member States. The 1999 schedule affirms that the E.U. and its Member States have undertaken commitments on financial services in accordance with the Understanding. It includes Member States’ limitations on market access and national treatment in relation to these commitments. In 2006, the E.U. published amended draft GATS schedules (the “draft 2006 schedules”) to reflect the addition of new E.U. members. These schedules, however, have not been formally certified at the WTO. The 2006 draft schedules contain the new E.U. Member States’ commitments and restate the commitments set out in the 1999 schedules for the existing E.U. Member States. The 2006 draft schedules also set out a significant number of limitations by the additional Member States. These schedules, however, have not come into force because some Member States are yet to ratify them individually.

3.8. E.U. Member States have provided very limited commitments reflecting those in the Understanding to allow non-resident suppliers to supply (on the basis of terms and conditions that accord national treatment) the following services:

i. insurance of risks relating to: (i) maritime shipping, commercial aviation and space launching and freight (including satellites); and (ii) goods in international transit;

ii. reinsurance, retrocession and the services auxiliary to insurance such as consultancy, actuarial, risk assessment and claim settlement services;

iii. provision and transfer of financial information and financial data processing and related software by suppliers of other financial services; and

iv. advisory and other auxiliary services, excluding intermediation, relating to banking and other financial services.

The 1999 and draft 2006 schedules also contain E.U. Member States’ limitations on market access and national treatment. While each Member State’s limitations differ, a
number of Member States have imposed restrictions on the provision of insurance and insurance-related services on a cross-border basis.\[30\]

3.9. In relation to commercial presence, some E.U. Member States offer financial service suppliers from any other WTO Member “the right to establish or expand within its territory … a commercial presence” although Members can impose terms, conditions and procedures for authorisation of the establishment and expansion of a commercial presence. The 1999 and the draft 2006 schedules contain E.U. Member States’ limitations in relation to the commercial presence commitment.\[31\]

3.10. Finally, the E.U.’s schedule applies only

to the territories in which the Treaties establishing the European Communities are applied and under the conditions laid down in these Treaties.\[32\]

Following Brexit, as the United Kingdom will not be an E.U. Member State, the U.K. will have to establish its own GATS schedule (for more on this, see paragraphs 4.2 to 4.6.

**Free Trade Agreements as an Exception to the MFN rule**

3.11. The MFN obligation establishes a prohibition, in principle, of preferential arrangements among groups of Members in individual sectors or of reciprocity provisions which confine access benefits to trading partners granting similar treatment. By way of exception, the WTO provides for parties to agree Preferential Trade Agreements (“PTAs”) amongst themselves on the condition that such agreements facilitate trade, increase economic integration between the relevant parties and do not raise barriers to trade with respect to Third Countries not participating in the agreement. In that sense, PTAs are a tool for trade liberalisation and are considered to be “WTO-plus” in effect,

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\[30\] For example, in Germany, “compulsory air insurance” policies can only be underwritten by a subsidiary established in the E.U. or by a branch established in Germany. Furthermore, if a foreign insurance company has established a branch in Germany, it may only conclude insurance contracts in Germany relating to international transport through the branch established in Germany. In France, only insurance firms established in the E.U. may carry out insurance of risks related to ground transport. (Please see Draft 2006 schedule of Commitments, p. 182.)

\[31\] For example, in Spain, before establishing a branch or agency to provide certain classes of insurance, foreign insurers must have been authorised to operate in the same classes of insurance in its country of origin for at least five years. In France, the establishment of branches in the insurance sector is subject to a special authorisation for the representative of the branch, while in Ireland, the right of establishment in the insurance sector does not cover the creation of representative offices. In relation to banking and other financial services, in Italy, for example, representative offices of foreign intermediaries cannot carry out activities aimed at providing investment services. (Please see Draft 2006 schedule of Commitments, pp. 187, 188 and 197 respectively.)

\[32\] Draft 2006 schedule of Commitments, p. 7
both with regards to the scope and depth of liberalisation. For services, such PTAs are called “economic integration” agreements. Their requirements are specified in Article V of GATS, which provides that an economic integration agreement must have “substantial sectoral coverage”, and must provide for “the absence or elimination of substantially all discrimination”, between or among the parties, in the covered sectors, subject to some specified exceptions.  

**Mutual Recognition Agreements**

3.12. Article VII of GATS provides principles in relation to Mutual Recognition Agreements (“MRAs”) which state (inter alia):

> For the purposes of the fulfilment, in whole or in part, of its standards or criteria for the authorization, licensing or certification of services suppliers, and subject to the requirements of paragraph 3, a Member may recognize the education or experience obtained, requirements met, or licenses or certifications granted in a particular country.

One obligation imposed upon WTO Members concerning MRAs is that they must not accord recognition in a discriminatory manner between countries. In case of an existing MRA, Members to that agreement are required to provide other WTO Members adequate opportunity to negotiate their accession to such an agreement or arrangement or to negotiate comparable ones with it. The Annex provides for the possibility of WTO Members recognising the prudential measures of other countries.

**The Prudential Carve-out**

3.13. The prudential carve-out was considered for the first time in WTO dispute settlement in the case of Argentina – Financial Services, in which Panama brought a complaint against Argentina for measures regarding its transparency and the application of tax regulations, claiming that those measures were inconsistent with the MFN, market access, national treatment and other GATS provisions. Argentina argued, among other things, that its regulations were “defensive tax measures” that were designed to protect Argentina's tax base by preventing tax evasion, tax avoidance and fraud. The WTO
Appellate Body confirmed in its ruling that three requirements must be fulfilled for any measures to be justified under the prudential carve-out:

First, there is the threshold, or preliminary, question of what types of measures may potentially fall within the scope of paragraph 2(a). Second, a measure must have been taken "for prudential reasons". Finally, under the second sentence of paragraph 2(a), the measure "shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement". Only when a measure falls within the scope of paragraph 2(a) will there be a need to evaluate whether it was taken "for prudential reasons" and whether it fulfils the requirement in the second sentence of paragraph 2(a).\(^{36}\)

3.14. Further, the Appellate Body concluded, among other things, that:

- The prudential exception covers all measures affecting the supply of financial services.
- The prudential exception covers violations of obligations under any provision of the GATS Agreement, which means that the exception “could be invoked to justify inconsistencies with all of a Member's obligations under the GATS”.\(^{37}\)

Thus, according to the only WTO Appellate Body ruling on the prudential exception, it covers all measures affecting the supply of financial services, as well as any violations of GATS obligations, provided that the Member complies with the requirements of the provision.

**Interim Agreements**

3.15. Article XXIV of GATT allows for an “interim agreement” to be signed among parties as a precursor to an FTA in goods. With reference to services, GATS Article V permits parties to enter into “an agreement liberalizing trade in services between or among the parties to such an agreement”, provided that certain conditions are met, including “substantial sectoral coverage”. The agreement must provide

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for the absence or elimination of substantially all discrimination…either at the entry into force of that agreement or on the basis of a reasonable time-frame…

3.16. This interim arrangement could continue for some time. The Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994 provides, in the parallel context of FTAs on goods, that the “reasonable length of time … should exceed 10 years only in exceptional cases.”

**Dispute Resolution**

3.17. Trade disputes concerning the GATS are governed by the WTO Understanding on Rules and Procedures governing the Settlement of Disputes (the "DSU"), which was adopted as part of the package of WTO agreements in 1994 and came into force as of 1 January 1995. The Dispute Settlement Body (the "DSB") administers the rules and the procedures of the DSU. The procedures of the DSU are the only formal means to resolve disputes between WTO Members regarding a violation, or other nullification or impairment of GATS obligations. Failure to comply with the DSB recommendations and rulings within a reasonable period of time may lead to demands for compensation, failing which, the complainant may request authorisation temporarily to suspend concessions or other obligations under the relevant agreements (i.e. retaliation) until such time as the defending Member brings itself into conformity. The DSB must authorise the retaliation unless there is consensus to reject the request. If the level of retaliation is opposed, the matter will be referred to arbitration.


4.1. As set out above, the shape of the future partnership between the U.K. and the E.U. is as yet undecided. In broad terms, the future relationship could take the form of: (1) U.K. membership of the E.E.A. on a transitional or even permanent basis;38 (2) a transitional agreement; (3) a bespoke FTA or (4) the U.K. trading with the E.U. on the basis of both parties’ WTO scheduled commitments and the E.U.’s existing Third Country provisions. Some of these options are more straightforward than others: were the U.K. to join the E.E.A., for example, its relationship with the E.U. would be shaped by the E.E.A. Agreement, which might be considered simply a continuation of an old

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38 Accession to the E.E.A. would be subject to agreement and ratification by both the E.U. 27 and by the EFTA State parties.
agreement. Somewhat more complicated is a scenario in which the U.K. and E.U. are unable to agree on any future arrangements and trade in services must continue on the basis of existing provisions for cross-border trade, such as those offered in each party’s schedule of commitments and those requirements imposed by the E.U. via the Third Country regimes codified in E.U. law—the FMLC explores this briefly below. The WTO rules have greatest impact and raise most questions, however, in the event the U.K. negotiates with the E.U. a new future agreement, whether transitional or in the form of an FTA. In this section, the FMLC considers the ways in which the rules set at the WTO, explained above in sections 2 and 3, would affect or limit the U.K.-E.U. relationship. First, however, the U.K. would have to certify its schedule of commitments at the WTO.

Certifying the U.K.’s GATS schedules

4.2. In order to reflect its new position as an independent WTO Member, the U.K. must prepare its own schedules of MFN commitments for goods and services and seek approval for these from other WTO Members. The U.K. Secretary of State for International Trade, Dr Liam Fox MP, has stated that the U.K. intends to prepare “draft schedules which replicate as far as possible our current obligations”. As the E.U.’s schedule of commitments on market access and national treatment for services includes the U.K., the process of preparing a U.K. GATS schedule should not be technically difficult. Unless the U.K. decided to change any of its existing commitments, the schedule would contain the same commitments set out in the E.U. schedule, which include the limitations scheduled by the U.K. (of which there are very few).

4.3. If the U.K. leaves unchanged its current services commitments, it could claim that there is no change in their scope or their substance and present its new schedule in the WTO as a rectification under the 2000 procedures. If, however, another WTO Member objects that its trade interests are nonetheless affected (e.g., that the division of the E.U. into two markets will increase costs for its services exporters), or if the U.K. changes any of its commitments, the U.K. may need to use the 1999 procedures for the modification of schedules (both of these procedures are described at paragraphs 3.4-3.5 above).

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39 The E.U. will also undertake a similar process to rearrange its commitments and limitations without the U.K.

4.4. Those WTO Members which consider their market access benefits to have been affected by the U.K.’s proposed modification have the right to object and to seek “compensatory adjustment” in the form of additional market access in other sectors in the U.K.’s services schedule. As described in paragraph 3.3, in the case no agreement is reached on such a compensatory adjustment, the affected Member may refer the matter to arbitration, in which it can be joined by any other WTO Member who may be similarly affected. If the U.K. were to modify its schedule without complying with the arbitral findings, the affected Members would have retaliation rights whereby they may modify or withdraw with regards to the U.K. “substantially equivalent benefits”, i.e., limited to the value of the lost trade.\footnote{GATS Article XXI:4(b).}

4.5. The jurisprudence of the WTO suggests that it may be difficult to for the U.K. to argue that its new GATS schedule is a rectification rather than a modification. The WTO Appellate Body has essentially interpreted the term “modify” to mean any substantive change. Although it was interpreting the obligations with respect to trade in goods, its ruling may well serve as a precedent for services as well:

The ordinary meaning of the term "modify" appears to include both the situation in which the scope of a concession is reduced (for example, a tariff increase) and when the scope is expanded (for example, a tariff reduction). In fact, whether the proposed modification actually constitutes a reduction or an expansion of the concession may only become clear in the course of the renegotiations and will determine whether and to what extent the modifying Member owes compensatory adjustment…\footnote{Appellate Body Reports, European Communities – Regime for the Importation, Sale and Distribution of Bananas – Second Recourse to Article 21.5 of the DSU by Ecuador, WT/DS27/AB/RW2/ECU, adopted 11 December 2008, and Corr.1 / European Communities – Regime for the Importation, Sale and Distribution of Bananas – Recourse to Article 21.5 of the DSU by the United States, WT/DS27/AB/RW/USA and Corr.1, adopted 22 December 2008, DSR 2008:XVIII, p. 7165 .}
4.6. The procedure for certifying the new U.K. services schedule would depend on whether any other WTO Member were to lodge an objection to its automatic certification and request that the U.K. enter into negotiations.\footnote{On 26 September 2017, the U.K. Ambassador to the WTO in Geneva received a letter from seven WTO Members—the United States, Canada, New Zealand, Brazil, Argentina, Thailand and Uruguay—objecting to a proposal for the E.U. and the U.K. to split Tariff Rate Quotas (TRQs) based on historical averages. This issue relates to trade in goods rather than services, but it helps to illustrate how quickly other WTO Members will assert their rights. The letter began by stating that the seven signatories “support the United Kingdom’s interest in establishing its own WTO schedules so as to provide a seamless transition upon its exit from the European Union”. Having said that, it referred to the TRQ proposal, objecting that “such an outcome would not be consistent with the principle of leaving other World Trade Organization Members no worse off, nor fully honour the existing TRQ commitments. Thus, we cannot accept such an agreement”. They added that “[t]he modification of these TRQ access arrangements cannot credibly be achieved through a technical rectification. None of these arrangements should be modified without our agreement”. \url{http://im.ft-static.com/content/images/ec0a64b2-a95f-11e7-ab55-27219df83c97.pdf}}

**A. The “fallback” scenario**

4.7. The E.U. represents the highest level of integration available in any PTA through, amongst other measures, the establishment of a customs union and an extremely high level of regulatory convergence and mutual recognition. In services terms, the four modes of supply of services set out in paragraph 2.4 of this paper are unrestricted. The function of GATS, besides the MFN and transparency commitments, is for Members to set out the maximum commitments they will accept for granting market access in the absence of an FTA (such as that provided for in GATS Article V). The GATS does not, therefore, offer a satisfactory substitute for the passporting arrangements currently available under E.U. rules.

4.8. Whilst the WTO obligations of national treatment and market access have played some role in expanding the rather limited provision for financial services granted in the schedules which entered into force in 1995, this falls a long way short of the liberalisation achieved by the E.U. single market. Following Brexit and as things currently stand, the U.K. will lose access to the E.U.’s single market and indeed to the “passporting” rights written into certain E.U. legislative measures, which allow a financial service supplier authorised in an E.U. Member State to provide services in another Member State and to trade on a cross-border basis within the single market without the need for a second authorisation. Without “passporting” rights, WTO Members have very limited access to the E.U. market under GATS. The U.K. will subsequently have the right to trade in services with the E.U. under the conditions or limitations specified by it in its specific schedules of commitments and its rules for Third Country access. The FMLC published a paper in July 2017 considering the partial and uncertain nature of Third Country regimes and highlighting complexities relating to: their scope; the specificity of conditions which must be met in order to gain access; and...

4.9. Even where national rules allow the cross-border provision of services this will not be as seamless as the provision of services across the single market. Market participants may be subject to restrictions and duplicative rules. Although recorded on a single schedule of commitments, as each E.U. Member State’s commitments and limitations can differ, a financial service supplier wishing to operate in more than one E.U. Member State might need to satisfy multiple requirements or sustain more than one business model.

4.10. Importantly, WTO Members are only bound by their scheduled commitments, even though autonomous trade liberalisation has progressed in reality, and thus countries can revert to operating on the basis of their schedules at any time. A 2012 World Bank report observed that, since the binding commitments made under the GATS during the Uruguay Round are on average 2.3 times more restrictive than currently prevalent trade policies, countries could more than double their trade barriers without violating their commitments.\footnote{Hoekman, B and Matoo, A. “Liberalising Trade in Services: Lessons from Regional and WTO Negotiations”, \textit{World Bank: Regulatory Cooperation for Services Trade Liberalisation and Policy Reform} (2012), p. 6.}

4.11. Finally, trade disputes between the E.U. and the U.K. will have to be resolved under the WTO dispute settlement system, which is time-consuming and may result in the imposition of retaliatory measures failing compliance with the dispute settlement ruling and recommendation or an agreement on compensation.

B. \textbf{Transitional Arrangements}

4.12. A key concern among financial markets participants relating to the Brexit process has been the prospect of a “cliff-edge” whereby, should the U.K. exit the E.U. without successfully negotiating a future trade agreement, financial service suppliers will lose their “passports” to the single market and may be unable to service existing (legacy) business or initiate new business in the E.U. unless and until access is acquired on some other basis. The question of legacy business alone would potentially give rise to considerable market disruption—in addition to the market dislocation experienced in regard to new and future business—and litigation risk, since contracts do not always make clear or provide for the allocation of risks associated with regulatory displacement.
when it arises from an Act of State and the interplay of geopolitical forces. The extent to which the impact of this economic disruption can be smoothed for the benefit of both the E.U. and the U.K. depends on the ability of all parties to agree to transitional arrangements.

4.13. The FMLC has previously expressed support for the desirability of transitional plans, first in a letter to the U.K. Treasury Select Committee, in which it encouraged a staged approach to negotiating and developing such provisions.\(^ {46} \) In August 2017, some Members of Parliament, too, expressed support for a transitional deal between the U.K. and the E.U. which would last until 2022.\(^ {47} \)

4.14. Nonetheless, the negotiation of transitional arrangements represents a unique set of circumstances. The logic of Article V of GATS, which provides Preferential Trade Agreements as an exception to the MFN rule, covered in paragraph 3.16, is to foster an increase in economic integration between two or more WTO Members. By contrast, the parties to any agreement post-Brexit will start from a very high degree of integration and liberalisation. The U.K.’s current membership of the E.U. already satisfies the requirements of Article V because it provides for substantial sectoral coverage (paragraph 1(a) of Article V) and it eliminates and prohibits discriminatory measures between the U.K. and the other Member States of the E.U. (paragraph (1)(b) of Article V). Unless the U.K. were to continue to participate fully in the single market, which has been ruled out by HM Government, the terms of any future PTA between the E.U. and U.K. on services, including a transitional agreement, might be expected to increase discriminatory measures between the U.K. and E.U. vis-à-vis the status quo ante, while its effect vis-à-vis a (hypothetical) baseline of trading under MFN rules remains unclear.\(^ {48} \)

C. Bespoke treaty

4.15. Whilst FTAs can be useful instruments to deepen liberalisation for financial services and enhance regulatory reform, they do not provide the same degree of market access or level of integration as the E.U. framework and do not replicate the effects of passporting rights or regulatory conformity. Given that the European Council guidelines for the U.K.’s withdrawal explicitly indicate that a non-E.U.-member cannot have similar

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\(^ {46} \) The FMLC’s letter to the Treasury Select Committee is available at: [http://www.fmlc.org/letter-to-treasury-select-committee-on-transitional-arrangements.html](http://www.fmlc.org/letter-to-treasury-select-committee-on-transitional-arrangements.html)

\(^ {47} \) George Parker, “Conservatives come together to sell a Brexit transition”, Financial Times, (29 August 2017), available at: [https://www.ft.com/content/315ecb00-8bd0-11e7-a352-e46f43c5825d](https://www.ft.com/content/315ecb00-8bd0-11e7-a352-e46f43c5825d)

\(^ {48} \) It should be noted that it is the latter which is the test to be applied under Article V.
rights as those of E.U. Member States,\textsuperscript{49} it is likely to be challenging to agree a U.K.-E.U. FTA to replicate the market access rights currently enjoyed by the U.K. through membership of the single market.

4.16. The E.U. has historically included, within its FTAs, regulatory frameworks which address trade barriers and promote trade liberalisation. There are two main options for ensuring trade liberalisation through an FTA: (i) the parties choose to list all those subsectors in which they are committing to trade liberalisation (the “positive list approach”);\textsuperscript{50} or (ii) the parties only list those sectors or subsectors that are excluded from trade liberalisation (the “negative list approach”).\textsuperscript{51} Whilst it is generally agreed that the latter provides a broader scope of liberalisation, the degree of liberalisation achieved in the past has depended less on the adopted approach than on the impact of the notified restrictions and the supply modes of services affected by those restrictions. In either case, some of the E.U.’s FTAs have included an MFN clause requiring concessions granted to the services and service suppliers of a third party to be extended to the preferential partner.\textsuperscript{52} This clause could restrict the E.U.’s ability to provide U.K.-based services and service suppliers more access than that accorded to preferential partners, like Korea or Canada.

4.17. Of particular importance to financial services is the caveat that GATS forbids an FTA which only covers financial services. Arguably, this has, in any event, already been excluded by the European Council’s Guidelines for Brexit negotiations.\textsuperscript{53}


\textsuperscript{50} The E.U.’s FTA with Korea follows a “positive approach” and includes rules for Mutual Recognition Agreements, transparency and the treatment of confidential information, domestic regulation and governance. The specific regulatory framework for financial services includes provisions on self-regulatory organisations, payment and clearing systems, new financial services, data processing, prudential carve-out, specific exceptions and dispute settlement.

\textsuperscript{51} In the E.U.-Canada Comprehensive Economic and Trade Agreement (“CETA”), the E.U. adopted a “negative approach”. Whilst CETA prevents parties from introducing similar limitations to market access as those permitted by GATS Article XVI, parties are allowed the freedom to impose conditions. While CETA’s commitments on market access for cross border financial services have been criticised as only reflecting current levels of liberalisation, CETA Article 13.7.6 arguably eliminates licensing or commercial presence requirements, and parties are able to permit a person located in its territory, and a national wherever they are located, to purchase a financial service from a cross-border financial supplier located in the territory of the other party.

\textsuperscript{52} See for example, E.U./Korea Article 7.8(1) and E.U./Canada Article 9.5(1). The FMLC notes, however, that these clauses are subject to certain carve-outs which have not been examined in this paper.

\textsuperscript{53} See Core Principle (2) in European Council (Art. 50) guidelines, supra n. 45.
5. THE IMPACT OF THE WTO RULES ON THE U.K.’S TRADE AGREEMENTS WITH NON-E.U. COUNTRIES

5.1. The E.U. is currently party to FTAs which cover financial services liberalisation with South Korea and with developing countries such as Colombia, Peru and the CARIFORUM (Dominican Republic and the Caribbean countries). The E.U. has concluded FTA negotiations with Singapore and Canada but those agreements are not yet in force although they are provisionally applied. Negotiations for an FTA with Japan are ongoing while talks have just been launched for a bilateral trade agreement with China.

5.2. Upon Brexit, these FTAs will no longer apply to the U.K. In order to trade with any of the countries listed above on a preferential basis, the U.K. will have to negotiate new trade agreements or transitionally adopt the existing FTAs with all parties’ agreement. Until Exit Day, the U.K., as an E.U. Member State, is bound by the E.U.’s Common Commercial Policy and arguably cannot become party to independent FTAs with Third Countries. During a trip to Japan in August 2017, U.K. Prime Minister Theresa May said that the U.K. will seek first to replicate the E.U.’s trade deals with Third Countries and then recast new agreements.\(^{54}\)

5.3. While the E.U.’s FTAs with Third Countries are not as comprehensive as the E.U. single market, they do allow E.U. financial service suppliers significant market access abroad. For instance, the E.U.-South Korea FTA enables the removal of limitations on market access and national treatment concerning access, establishment and operation of E.U. suppliers and investors in the South Korean market in a way that goes beyond the requirements of the Understanding. Another important improvement, in contrast with the GATS, is that the FTA includes liberalisation commitments that will apply to new financial services once they appear, hence safeguarding the application of the bilateral commitments to the evolution of financial services and related products. This commitment has also been replicated in the E.U. FTAs with Colombia/Peru, CARIFORUM, Singapore and Canada. The E.U.-Korea FTA also includes rules to address regulatory barriers that can be quite damaging for financial services. These rules refer to transparency in financial regulation and its application to foreign suppliers, implementation of international standards and the recognition of professional

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\(^{54}\) Wright, R., “Theresa May looks to reassure Shinzo Abe over Brexit”, Financial Times, (31 August 2017), available at: https://www.ft.com/content/558ef0e8-8e16-11e7-a352-e46d43c5825d.
qualifications and prudential measures. Furthermore, regulatory obligations in FTAs also cover investment protections and government procurement provisions.

5.4. Upon Brexit, and in the absence of a new FTA, the U.K. will trade with South Korea on the same basis as any other WTO Member, on the basis on South Korea’s schedule of commitments.

6. SOLUTIONS AND MITIGANTS

6.1. Previous sections of this paper have examined in detail the principles set by the WTO to promote trade growth and progressive liberalisation, especially in relation to financial services. These rules, as highlighted in section 4 above, generate two sets of uncertainties. In the event the U.K. were to withdraw from the E.U. without successfully negotiating a post-Brexit deal, transitional or otherwise, the WTO only requires the E.U. to grant to the U.K. MFN treatment, leading to a scenario in which U.K.-based financial service suppliers will have considerably less access to the E.U. market than is currently available. Second, were the U.K. and the E.U. to agree upon a future trade deal, transitional or otherwise, which provides a significant reduction in market access and/or a corresponding increase in conditions applied to enable such access, this will present a dissonance with the WTO’s aims of encouraging economic integration. In this section, the FMLC offers suggestions by which these uncertainties might be mitigated, first specifically with regard to transitional and free trade agreements, and then in the form of a different U.K.-E.U. relationship. The FMLC does not express a view on the political merits and demerits of the various alternatives explored in this section.

Transitional Arrangements

6.2. Many commentators have argued that transitional arrangements between the U.K. and E.U. which apply from the end of the Article 50 notice period (March 2019) and through the period of negotiation of a future relationship are essential to prevent the market disruption likely to be caused by a hiatus in the provision of financial services across borders.55

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55 As noted above, the WTO envisages transitional agreements—or “interim” agreements—as a stage during which parties boost economic integration with the aim of signing an FTA within a “reasonable” period of time in which such integration is enhanced and confirmed.
6.3. One way by which the U.K. and E.U. could continue to interact during the transition period is by agreeing to a “standstill” transition whereby current market access arrangements would be extended for a fixed period of time.\textsuperscript{56} This would entail extending the U.K.’s membership of the E.U. up to the point at which the new FTA would become applicable. Such an agreement might be considered simply a continuation of the old agreement rather than the creation of a new transitional agreement, which would greatly increase certainty amongst market participants. Such an extension would also reduce the burden on market participants and regulators who, in the case of an interim and subsequent bespoke agreement, would have to engage twice in the onerous and costly processes of adapting to new market access permissions and requirements.

\textbf{A comprehensive trade agreement}

6.4. The FMLC considers the negotiation of a bespoke treaty essential to legal and operational certainty. In order to avoid legal risks as far as possible, the U.K. and E.U. would have to work toward a wide-ranging deal, with substantial sectoral coverage in relation to the volume of trade, sectors and modes of supply, within which U.K. and E.U. financial service suppliers might be offered the ability to engage in cross-border trade that is as close to status quo as possible.

6.5. A key element of any FTA would be the development of regulatory mechanisms that facilitate trade in financial services, perhaps based upon the common features of the regulatory regime which will prevail until the U.K. withdraws from the E.U. One of the, if not \textit{the}, most important of those regulatory mechanisms would be mutual recognition provisions. Those measures might focus on additional specific agreements and regulatory convergence or acceptance of a lead regulator as the basis for the parties to grant mutual access rights for financial services to operate without the need for specific authorisations from the regulators in both the U.K. and the pertinent E.U. Member State and avoid the need for multiple authorisations. It would be equally important for those additional measures or arrangements to avoid the need for financial service suppliers to establish subsidiaries or branches to supply financial services in the single market. The FMLC recommends that such measures also advance provisions dealing with recognition and international standards which have been written into current FTAs.

\textsuperscript{56} HM Government has previously indicated preference for this option. Gordon, S. and Parker G, “Philip Hammond seeks ‘off-the-shelf’ Brexit transition”, \textit{Financial Times} (27 July 2017), available at: \url{https://www.ft.com/content/cc1d8b94-71fc-11e7-ac6f-c6bd07d1fa3c}.
6.6. Moreover, Article 13.7.6 of the E.U.-Canada Comprehensive Economic and Trade Agreement ("CETA") eliminates licensing or commercial presence requirements, requiring the E.U. and Canada to permit the purchase of a financial service from a cross-border financial service supplier of the other party.\(^{57}\) As the agreement is not yet in force, there are different interpretations as to the scope of this provision, which makes it difficult to ascertain how close CETA will be in reality to a passporting system for cross-border financial services. In any event, given the existing level of integration and regulatory convergence between the U.K. and E.U., it is recommended that this U.K.-E.U. FTA not build upon CETA, as has been suggested in a number of quarters, but negotiate from the current conditions of market access and make decisions about which sectors, services and/or activities might be excluded or restricted.\(^{58}\)

**Membership of the E.E.A.**

6.7. The U.K. is currently party to the E.E.A. Agreement as an E.U. Member State. The U.K. could become a member of the E.E.A. by rejoining the existing FTA between EFTA and the E.U. To do so, the U.K. would need to rejoin EFTA.\(^{59}\)

6.8. As an E.E.A. state, the U.K. would benefit from an FTA with the E.U. in the form of the E.E.A. Agreement, a reasonably straightforward option under WTO law because it implies the U.K.'s participation in an FTA which has been already notified to the WTO

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\(^{57}\) Article 13.7.6 of CETA provides:

> Each Party shall permit a person located in its territory, and a national wherever they are located, to purchase a financial service from a cross-border financial service supplier of the other Party located in the territory of that other Party. This obligation does not require a Party to permit such suppliers to do business or solicit in its territory.

\(^{58}\) The FMLC observes that it is standard practice for governments to consult industry experts to benefit from their technical knowledge during the negotiation processes of FTAs. While it is not for the FMLC to advise HM Government on such policy matters, the FMLC acknowledges that such an approach would ensure transparency and, consequently, legal certainty.

\(^{59}\) See Article 128 of the E.E.A. Agreement which provides that: “Any European State becoming a Member of the Community shall, and the Swiss Confederation or any European State becoming a Member of EFTA may, apply to become a party to this Agreement.”
and ensures certainty for market participants. This option is said to be politically unattractive, not least because it involves the U.K. being in essence a rule-taker.

**Grandfather FTAs between the U.K. and Third Countries**

6.9. The U.K.’s Department of International Trade (“DIT”) has announced as a priority the grandfatherting of current FTAs with Third Countries to which the U.K. is a party *qua* membership of the E.U. The DIT hopes that the U.K. will inherit the levels of market access it currently has in these Third Countries. The confirmation of multiple FTAs, however, is likely to require time and human resources. As the U.K. is unable to become party to independent FTAs with Third Countries while it remains an E.U. Member State and bound by the Common Commercial Policy, the FMLC urges HM Government to prioritise the agreement with the E.U. of a mechanism whereby it might be permitted formally to discuss and provisionally to agree future FTAs with Third Countries during the Article 50 negotiations. These successor FTAs would then have to be signed as of Exit Day.

6.10. The FMLC also considers the reestablishment of other framework arrangements, which may not be embedded in FTAs, to be of utmost importance. Such provisions include the frameworks for cooperation and mutual recognition between financial markets regulators between the E.U. and the U.S. HM Government will have to provide a recognition mechanism to those Third Country firms which have availed of the Third Country provisions in E.U. law to attain the right to operate in the U.K.

7. **CONCLUSION**

7.1. Following the end of the two-year Article 50 notice period, the future relationship between the U.K. and the E.U.—whether in the form of an FTA or not—will be shaped by the non-preferential international trading rules of the WTO. In this paper, the

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60 The EEA Agreement (to which the U.K., all other E.U. Member States and the three E.E.A. countries are party) is already notified to the WTO under Article V of GATS (see: [http://rtais.wto.org/UI/PublicShowRTAIDCard.aspx?rtaid=114&lang=1&redirect=1](http://rtais.wto.org/UI/PublicShowRTAIDCard.aspx?rtaid=114&lang=1&redirect=1)) while the original Treaty of Rome is separately notified to the WTO under both Article XXIV of GATT and Article V of GATS as a customs union and economic integration agreement covering both goods and services (see: [http://rtais.wto.org/UI/PublicShowRTAIDCard.aspx?rtaid=120&lang=1&redirect=1](http://rtais.wto.org/UI/PublicShowRTAIDCard.aspx?rtaid=120&lang=1&redirect=1)).


62 The E.U. has previously recognised the necessity for such dialogue. See paragraph 13 of the European Council (Art. 50) guidelines, *supra* n. 45.
FMLC has first examined the rules and obligations created by the WTO in relation to financial services, and reviewed their application in specific contexts. In section 4, the FMLC analysed the impact of these rules on the following options for a future U.K.-E.U. deal: (1) the fallback scenario; (2) a short-term transitional arrangement; and (3) a bespoke new treaty. Section 5 considered briefly the U.K.’s arrangements with Third Countries. In section 6, the FMLC suggested mitigants by which HM Government could ensure great legal certainty in the financial markets.
FINANCIAL MARKETS LAW COMMITTEE MEMBERS

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Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.
23 November 2017

Nic Turner Esq
Ministry of Justice
102 Petty France
London
SW1H 9AJ

Dear Mr Turner

U.K. EXIT FROM THE EUROPEAN UNION – CROSS-BORDER CIVIL JUDICIAL COOPERATION

Thank you for your letter to Lord Walker dated 22 August 2017, regarding the publication of a Government policy paper entitled Providing a cross-border civil judicial cooperation framework: a future partnership paper (the “Cooperation Paper”) on the same day. In your letter, you invited Lord Walker to share any thoughts or comments on the Cooperation Paper and the Government’s position. Lord Walker and the Financial Markets Law Committee (the “FMLC” or the “Committee”) have asked me to respond to this invitation.

As you may know, the role of FMLC is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed. Pursuant to this role, on 2 December 2016 the FMLC published a paper entitled Issues of Legal Uncertainty Arising in the Context of the Withdrawal of the U.K. from the E.U.—the Application of English Law, the Jurisdiction of English Courts and the Enforcement of English Judgments (the “FMLC Paper”), which I enclose.

The FMLC welcomes the approach taken in the Government’s Cooperation Paper, which is closely aligned with its own recommendations set out in the FMLC Paper.

The FMLC Paper

The FMLC Paper identifies issues of legal uncertainty which may arise in the context of cross-border commercial litigation in consequence of Brexit and, where appropriate, suggests potential solutions to these issues. In particular, the FMLC Paper draws attention to: 1) the possibility of reduced certainty and predictability in the field of contractual and non-contractual obligations if the Rome I and Rome II rules on


choice of law were no longer to apply in the U.K.; and 2) the mutual loss of advantages and protections—which may be experienced by the courts and litigants of both the U.K. and the E.U. Member States—if U.K. participation in the conflict of laws framework reflected in the Brussels Recast Regulation 5 is allowed to lapse as a result of Brexit.

In order to mitigate these uncertainties, the FMLC Paper sets out a number of recommendations, including that:

a) Rome I and Rome II should continue to apply under U.K. law after Brexit;

b) the U.K. should become a party to the 2005 Hague Convention on Choice of Court Agreements 6 and the 2007 Lugano Convention; and that

c) the U.K. should try to conclude an agreement with the E.U. under which the Recast Brussels Regulation would continue to apply to the U.K. after it leaves the E.U.

The FMLC Paper also anticipates and reflects on some of the practical issues that may arise when implementing these recommendations.

The Cooperation Paper

The Cooperation Paper—which outlines the Government’s desire for a “deep and special partnership” with the E.U. 8—advocates: (i) for the incorporation of the Rome I and II instruments into domestic law; (ii) participation in the 2005 Hague Convention on Choice of Court Agreements; and (iii) participation in the 2007 Lugano Convention. In this way, the Cooperation Paper chimes with that produced by the FMLC.

The Cooperation Paper further states that the U.K. will

...seek an agreement with the EU that allows for close and comprehensive cross-border civil judicial cooperation on a reciprocal basis, which reflects closely the substantive principles of cooperation under the current EU framework. 10

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7 Convention on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters 2007, O J 2009 L 147, p. 5, available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=LEGISSUM:l16029. The FMLC Paper further observes that accession to the Lugano Convention will be particularly important if the U.K. does not secure an arrangement under which it continues to be bound by the Recast Brussels Regulation, and that—if possible—the Lugano Convention should be amended to include improvements adopted in the Recast Brussels Regulation.

8 See fn1, supra, p.2.

9 See fn1, supra, p.6, paragraphs 19, 21-22, and Box 2. See also Regulation 3 of the draft European Union (Withdrawal) Bill 2017, which incorporates direct E.U. legislation, available at https://publications.parliament.uk/pa/bills/cbill/2017-2019/0005/18005.pdf.

10 See fn1, supra, paragraph 19, p.6.
Based on the Cooperation Paper’s description of the current E.U. framework (Box 1 of the Cooperation Paper lists the existing measures that make up this framework, and includes the Brussels Recast Regulation) this statement suggests that the Government will seek an agreement with the E.U. which replicates the substance of the Brussels Recast Regulation.

**Recommendations**

While the Cooperation Paper and the FMLC Paper appear to share a common vision for the cross-border judicial cooperation framework post-Brexit, the FMLC Paper offers more granular detail on practical issues such as transition. As such, the FMLC Paper might prove useful to the Government as the first steps towards building the cooperation framework are made.

To this end, the FMLC draws your attention, in particular, to:

a) **paragraph 3.5**: this paragraph—in the context of the ongoing application of Rome I and Rome II—considers the transition from the old regime to the new one, and more specifically raises the issues of “grandfathering” governing law clauses in legacy financial markets transactions, and the ongoing treatment of the decisions of the CJEU; and

b) **paragraphs 5.16-5.24**: these paragraphs give thought to issues of transition that will arise if instruments such as the 2005 Hague Convention on Choice of Court Agreements, the 2007 Lugano Convention and the Recast Brussels Regulation enter into force in the U.K: specifically, when each instrument would enter into force, and what arrangements should be made for cases which span the two regimes (i.e. “before” and “after”).

To aid clarity, the FMLC also recommends that the Government confirms its intention to replicate the substance of the Brussels Recast Regulation, allowing for close and comprehensive cross-border civil judicial cooperation on a reciprocal basis.

**Annex A**

A final, brief, observation remains to be made in respect of paragraph 7 of Annex A of the Cooperation Paper, which sets out the proposed general approach to the winding down of the U.K’s existing relationship in the event that no agreement on a future relationship can be reached. This approach is unsatisfactory and would lead to significant market disruption, as it leaves no provision for new E.U. judicial decisions and new contracts concluded after the withdrawal date.

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me should you require further information or assistance.

Yours sincerely,

Joanna Perkins
FMLC Chief Executive
EUROPEAN UNION (WITHDRAWAL) BILL: LETTER TO MINISTRY OF JUSTICE ON CLAUSE 3

AUGUST 2017
Dear Mr Knight,

**European Union (Withdrawal) Bill 2017**

Thank you for your email to Lord Walker, dated 14 July 2017, regarding the introduction of the European Union (Withdrawal) Bill 2017 (the “Withdrawal Bill”). In your email—which provided helpful context—you invited the Financial Markets Law Committee (the "FMLC" or the "Committee") to discuss the Withdrawal Bill. Lord Walker and the Committee have asked me to respond to this invitation.

The role of the FMLC is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed. At this early stage, the FMLC would like to draw attention to issues of legal uncertainty arising out of Clause 3 of the Withdrawal Bill.

Under Clause 3 subsection (1), “**direct E.U. legislation**” forms part of domestic law on and after **exit day**, provided that it is “operative immediately before exit day”. Clause 3 subsection (3) clarifies that direct E.U. legislation will be considered to be “operative immediately before exit day” if:

a. in the case of anything which comes into force at a particular time and is stated to apply from a later time, it is in force and applies immediately before exit day;

b. in the case of a decision which specifies to whom it is addressed, it has been notified to that person before exit day; and

c. in any other case, it is in force immediately before exit day.

**Direct E.U. legislation which applies section by section**

Paragraph 84 of the Explanatory Notes to the Withdrawal Bill comments that this Clause 3 subsection (3) operates to ensure that E.U. legislation—where it comes into application section by section, in a staggered way over time—will be converted into domestic legislation only in so far as the instrument has entered into force and applies before exit day. Where the date of application of a provision falls after exit day, the provision will not be converted into domestic law.

It is the view of the FMLC that this approach introduces legal uncertainty on a number of fronts. First and foremost, it results in an increase in complexity for market participants attempting to establish which legal obligations apply to them. The need to decouple the provisions of direct E.U. legislation which are “operative immediately before exit day” from those in the same measure which are not, and then interpret the resultant part-legislation (which may make reference to provisions that are not "operative immediately
before exit day”) received into domestic law will place no small burden on market participants, and could introduce significant uncertainties.

Secondly, this approach will result in a divergence between U.K and E.U. legislation in fairly short order. Where the U.K. prefers to keep in line with the direction of E.U. legislation—particularly in those situations where the U.K. wishes to and expects to attract an “equivalence” decision from the European Commission—the approach taken in Clause 3 of the Withdrawal Bill will require the U.K. to implement separately any relevant E.U. provisions in direct legislation which had not come into application before exit day. In practice, such a process may lead to considerable legal uncertainty. For example, a situation could arise where the U.K. government signals its intention to implement a particular E.U. provision in direct legislation which had not come into application before exit day. Such a provision could, however, become applicable in the E.U. at a date before the U.K. has had time to implement it domestically. This would leave market participants unsure as to their obligations.

The FMLC recommends, therefore, that further careful thought be given to the mechanics and operation of Clause 3 of the Withdrawal Bill. In particular, the legal uncertainty arising from the distinction it draws between the provisions of direct E.U. legislation that apply before exit day, and those which do not, must be managed. One solution might be to adjust the wording of Clause 3 subsection (3) so that direct E.U. legislation which has come into force before exit day (even if it is not yet applicable) will be considered “operative immediately before exit day”, and so incorporated into domestic law under Clause 3 subsection (1) of the Withdrawal Bill. This inclusion could be subject to the caveat that such direct E.U. legislation will only apply domestically from the time at which it would have otherwise applied under its native E.U. timetable.

Later application of implementing and regulatory technical standards

Similar points may be made in respect of those E.U. legislative acts, such as implementing regulations, which are often referred to as “Level 2” measures designed to enhance and clarify “Level 1” directives and regulations. Described as “tertiary legislation” in the Explanatory Notes, these measures are typically drafted first—in a financial services context—as regulatory and implementing technical standards (“RTS” and “ITS”, respectively) by the European Supervisory Authorities (the “ESAs”) and adopted by the European Commission.

Where E.U. measures reflecting RTS and ITS are not received into domestic law via the Withdrawal Bill—owing to the fact that they are not in force or do not apply before exit day—the issues of legal uncertainty described above are thrown into sharper relief. This is because, without the benefit of particular RTS and/or ITS, Level 1 regulations and directives that become part of domestic law through the Withdrawal Bill simply may not function properly.

This point can be illustrated with the example of Directive 2015/2366/EU on payment services in the internal market (“PSD2”). PSD2 entered into force on 12 January 2016 and will apply from 13 January 2018 (and so will be preserved in domestic legislation under Clause 2 of the Withdrawal Bill). The associated measures reflecting RTS on strong authentication and secure communication will not, however, come into force before exit day, and so will not be received into domestic legislation. Yet these RTS are, as the EBA itself states, key to achieving the objectives of PSD2 of enhancing consumer protection, promoting innovation and improving the security of payment services across the E.U.; in their absence, it will be difficult for market participants to implement PSD2 effectively.

Such legal uncertainty is only amplified by the opacity surrounding the manner in which the role of the ESAs will be replicated in the U.K. after exit day. Which U.K. bodies (if any) will take on mantle of the ESAs after exit day, and whether they will take up the task of drafting similar standards, and with what resources, is far from clear. For example, it
could be that—initially—whoever is deemed responsible for these standards will have a policy of tracking the wording of RTS and ITS produced by the ESAs until such as time as they have sufficient resources to produce standards themselves. Alternatively, from the very beginning, domestic standards could be produced in lieu of E.U. RTS and ITS. The lack of clarity on the applicable structures and mechanisms makes it difficult for market participants to anticipate how tertiary legislation will operate with respect to E.U. regulatory regimes which have only partly been received after exit day.

In addition to its recommendations above, therefore, the FMLC suggests that the U.K. Government clarifies which U.K. bodies (if any) are to take on the role of the ESAs, how this role will be defined (to include any potential role in the production and oversight of equivalent RTS/ITS legislation), and how this will be resourced as soon as possible. It may also be prudent to have a plan in place for those situations where—as with PSD2—particular RTS or ITS are required to enable domestic legislation to function effectively.

With these exceptions, the FMLC declines to comment on the Withdrawal Bill at this time, believing that—given its expertise in issues of legal uncertainty—it can most usefully contribute research and analysis when the statutory instruments made pursuant to powers set out in the Withdrawal Bill are published.10

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely,

Joanna Perkins
FMLC Chief Executive

2 The progress of the Withdrawal Bill can be monitored at http://services.parliament.uk/bills/2017-19/europeanunionwithdrawal.html.
3 Under Clause 3 subsection (2) of the Withdrawal Bill, “direct EU legislation” includes any E.U. regulation, E.U. decision or E.U. tertiary legislation, subject to certain carve-outs, as it has effect in E.U. law immediately before “exit day”, infra n.3.
4 Under Clause 14 of the Withdrawal Bill, “exit day” means “such day as a Minister of the Crown may by regulations appoint”.
7 The ESAs comprise the European Securities and Markets Authority (“ESMA”), the European Banking Authority (“EBA”) and the European Insurance and Occupational Pensions Authority (“EIOPA”).
A visual aid showing European Banking Authority ("EBA") mandates in PSD2 and their timelines, produced by the EBA, is available here: https://www.eba.europa.eu/documents/10180/87703/EBA+Mandates+PSD2.pdf/5c2493ad-ef26-4434-8338-736895bd4d2f.


For further information as regards these powers, see Clauses 7 -10, 17 and Schedules 2 and 7 of the Withdrawal Bill.
U.K. WITHDRAWAL FROM THE E.U.: PAPER ON THE IMPACT OF CROSS-BORDER INSOLVENCY PROCEEDINGS

AUGUST 2017
U.K. WITHDRAWAL FROM THE E.U.: PAPER ON ISSUES OF LEGAL UNCERTAINTY ARISING FROM THE IMPACT ON CROSS-BORDER INSOLVENCY PROCEEDINGS

August 2017

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Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.
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1. **PREFACE**

1.1. The role of the Financial Markets Law Committee (the “FMLC” or the “Committee”) is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. Following the referendum on Thursday 23 June 2016, in which the U.K. voted to leave the E.U., the FMLC announced that it would work with experts in law and financial services to identify, analyse and address related legal uncertainties potentially arising in connection with the prospective U.K. withdrawal from the E.U. (“Brexit” or the “Withdrawal”) and that it would establish a High Level Advisory Group (the “HLAG”) to give direction to the Committee's future work in this field. Its research programme is now well under way.²

1.3. At the inaugural meeting of the HLAG, it was determined that the FMLC should convene a working group to consider questions of applicable law, jurisdiction and recognition/enforcement in the context of corporate insolvency and the impact of Brexit on the legal framework embodied in Regulation (EU) 2015/848 on insolvency proceedings (the “Recast EUIR”) which, from 26 June 2017, replaced Regulation (EC) 1346/2000 on insolvency proceedings (the “EUIR”).³

2. **INTRODUCTION AND EXECUTIVE SUMMARY**

2.1. In the 14 months since the referendum, discussion about the form of the U.K.’s future relationship with the E.U. has centred on the options of a “soft” Brexit—wherein the U.K. might decide to remain within the European Economic Area (the “E.E.A.”) or conclude a completely new U.K.-E.U. trade agreement—or a “hard” Brexit, in which eventuality the U.K. would leave the E.U. without any treaty provision for trade. While Prime Minister Theresa May had previously indicated a willingness to leave the E.U. without any treaty provisions for the future, the result of the general election held

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² The text of the announcement and further details of the FMLC’s work in this area are available at: [http://www.fmlc.org/brexit.html](http://www.fmlc.org/brexit.html).

³ The EUIR and the Recast EUIR will operate, however, in parallel for a transitional period of indeterminate length. While the Recast EUIR applies to legacy insolvency proceedings opened on or after 26 June 2017, Article 84(1) of the Recast EUIR makes clear that any proceedings opened before that date will be governed by the EUIR.
in the U.K. in June 2017, which resulted in a hung Parliament, has again focused media attention on the possibility of a “soft” Brexit.4

2.2. In the meanwhile, HM Government has taken steps to begin withdrawal proceedings. On 29 March 2017, HM Government officially served notice of the U.K.’s withdrawal to the E.U. under Article 50 of the Treaty on European Union (the “TEU”). On 13 July 2017, a bill, formally known as the European Union (Withdrawal) Bill (the “Withdrawal Bill”), was introduced to the House of Commons.

2.3. The Withdrawal Bill serves two main purposes: (i) it provides for the repeal of the European Communities Act 1972; and (ii) it enables the incorporation of the body of E.U. legislation—known as the “acquis”—into U.K. law. E.U. law applies in the U.K. both by means of directly-applicable treaties and regulations (which the Withdrawal Bill refers to as “Direct E.U. Legislation”) as well as via domestic implementing legislation, which is passed specifically with the aim of implementing E.U. directives (referred to as “E.U.-derived Domestic Legislation”).6 Clauses 3 and 2, respectively, of the Withdrawal Bill provide that both E.U. legislation that is directly applicable as well as any that is enabled by U.K. implementing acts will be incorporated into domestic law. The EUIR, as an “E.U. regulation” will be incorporated into U.K. law under clause 3(2) of the Withdrawal Bill. In addition, clause 7 of the Withdrawal Bill makes provisions for secondary legislation to be passed in order to deal with any “deficiencies” caused by this transposition, including addressing the need for reciprocal arrangements as explained below.

2.4. Despite these plans to accommodate the acquis in the domestic legal framework, several legal and operational uncertainties remain. This paper addresses those uncertainties which arise with respect to cross-border insolvency—uncertainties which, in a financial markets context, may mean that it is harder to resolve non-performing loans, facilitate business rescues via reorganisations, settle commercial disputes and collect debts.

2.5. On withdrawal from the E.U., the U.K. will cease to be a Member State and U.K. creditors will necessarily lose the benefit of reciprocity in the mandatory recognition of U.K. insolvency proceedings in the E.U. This phenomenon is referred to throughout

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4 See, for example: Blitz, “Soft Brexit hopes seen providing a cushion for the pound”, Financial Times, (9 June 2017), available at: https://www.ft.com/content/42679902-4cd5-11e7-919a-1e14ce4af89b?mhq5j=e3.

5 Capital letters “D” and “L” and punctuation points here are an editorial addition to bring a defined term into conformity with FMLC publishing guidelines and do not appear in the Withdrawal Bill.

6 See ibid.
this paper as the “loss of reciprocity”. The loss cannot, unlike some other benefits of E.U. law, be rectified by receiving or transposing key E.U. legislation—in this case, the Recast EUIR—into domestic legislation because it is the U.K.’s status as a Member State which gives rise to the obligation on other Member States’ courts to enforce the insolvency judgments of U.K. courts and to recognise their proceedings.

2.6. The impact of Brexit will also be felt in connection with restructuring tools, such as schemes of arrangement, as well as in connection with financial markets infrastructure, where E.U. financial services measures—such as Directive 98/26/EC on settlement finality in payment and securities settlement systems (the “SFD”) and Directive 2002/47/EC on financial collateral arrangements (the “FCAD”)—are key to the elimination of uncertainty from insolvency proceedings and their adverse effect on collateral and financial market transactions.

2.7. This paper examines these and other elements of the legal framework for cross-border insolvency proceedings and considers the extent to which they may be affected by or give rise to issues of uncertainty in consequence of Brexit. The benefits of the current regime, and the cause of the Committee’s concern, are explored in section 3. In section 4, the paper examines some of the particular benefits that arise from insolvency-related legislation such as the SFD and FCAD. Section 5 explores the consequences for insolvency proceedings should these regimes be no longer applicable in the U.K., including the impact on the recognition of E.U. and U.K. insolvency proceedings, the impact on the recognition of U.K. schemes of arrangement and the potential impact on the choice of English law to govern finance documents.

2.8. Sections 6 and 7 set out the Committee’s recommendations and conclusions. Section 6 explores whether it may be possible to resolve the uncertainty by concluding a U.K.-E.U. agreement under which the Recast EUIR would continue to apply to the recognition of U.K. proceedings in the E.U. post-Brexit, without any loss of reciprocity. The section also consists of an exploration of alternative options for the smooth operation of insolvency proceedings upon Brexit, including: (i) amendments to the Cross-Border Insolvency Regulations 2006 (“CBIR”); (ii) extension of the list of countries covered by section 426 of the Insolvency Act 1986; (iii) relying on English common law and the impact of the rule in Gibbs v Societe Industrielle des Metaux (1890) 25 QBD 399 (“the rule in Gibbs”); and (iv) participation by the U.K. in the 2005 Hague Convention on Choice of Court Agreements (the “Hague Convention”).
2.9. This paper does not cover resolution proceedings under Directive (EU) 2014/59 establishing a framework for the recovery and resolution of credit institutions and investment firms (the “BRRD”), nor does it cover insolvency or reorganisation proceedings in respect of such entities falling under Directive (EU) 2001/24 on the reorganisation and winding-up of credit institutions (the “CIWUD”) or the insolvency or reorganisation of insurance undertakings falling under the Insurers (Reorganisation and Winding Up) Regulations 2003.

2.10. It is not for the FMLC to comment on matters of policy or the form that future regulatory approaches, if any, should take and this paper should not be understood to constitute comments thereon.

3. CROSS-BORDER INSOLVENCY MEASURES

1. The Recast EUIR

3.1. The Recast EUIR applies to proceedings opened on or after 26 June 2017 in E.U. Member States to determine the proper jurisdiction and the applicable law for cross-border insolvency proceedings and provides for mandatory—i.e. mutual and reciprocal—recognition of those proceedings. It has two principal policy objectives: i) to provide a framework (through directly applicable law) for conducting cross-border cases; and ii) to remove incentives for parties to transfer assets or judicial proceedings from one E.U. Member State to another so as to seek a more favourable legal position through so-called forum-shopping.

3.2. Where a debtor’s centre of main interests (“CoMI”) is located within an E.U. Member State, the Recast EUIR identifies that Member State as the appropriate forum for the main insolvency proceedings and requires recognition of the proceedings by the courts of other E.U. Member States. The Recast EUIR also guides the operation of any parallel secondary insolvency proceedings in other E.U. Member States and the

7 The EUIR is not binding on and does not apply in Denmark by virtue of the limited Danish ratification of the Treaty on the European Union (under which it acquired a complete opt-out on monetary union, the Common Security and Defence Policy (CSDP), Justice and Home Affairs (JHA) and the citizenship of the European Union). Insolvency issues between citizens and/or companies domiciled in any of the Nordic countries (Sweden, Norway, Finland, Iceland and Denmark) are ruled by the Nordic Bankruptcy Convention 1933 and there is full recognition between the five countries of bankruptcy decrees from another Nordic country.

8 More specifically, the Recast EUIR is concerned, much like the EUIR, with intra-E.U. insolvency proceedings and, therefore, with only those cases where the debtor has its centre of main interests (“CoMI”) in the E.U.
interaction of any such proceedings with the main proceeding. Importantly, it also governs the recognition and enforcement of insolvency-related judgments.\textsuperscript{9}

3.3. Since the regime was brought into force by the EUIR in 2000, it has conferred a significant advantage on E.U. creditors and liquidators in the form of increased legal certainty regarding cross-border insolvency matters. Prior to that date, courts in E.U. Member States proceeded in relation to recognition \emph{via} the application of \textit{ad hoc} rules under their own private international law, which resulted in inconsistencies across the E.U. With the introduction of the EUIR, the law with respect to the recognition of cross-border insolvency proceedings was made more functional and certain.

3.4. Central to the framework of the Recast EUIR is the concept of a debtor’s centre of main interests, which is defined in Article 3(1) as “the place where the debtor conducts the administration of its interests on a regular basis and which is ascertainable by third parties”. Revisions to the EUIR have been incorporated in the Recast EUIR in an effort by legislators to clarify a legal entity’s CoMI and bring greater certainty to the framework for allocating effective and enforceable insolvency jurisdiction.\textsuperscript{10}

3.5. The Recast EUIR provides reciprocal benefits among E.U. Member States, including, currently, the U.K. U.K. insolvency proceedings, in respect of companies with a CoMI in the U.K. have automatic recognition across the E.U. and insolvency proceedings initiated in the E.U. in respect of companies with a CoMI in one of the other Member States will be automatically recognised in the U.K.

\textsuperscript{9} The enforcement of non-insolvency related judgments takes place pursuant to the Regulation (EC) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (the “\textit{Recast Brussels I Regulation}”).

\textsuperscript{10} As far as companies are concerned, Article 3(1) provides that the CoMI shall be presumed to coincide with the place of the registered office:

1. […]

2. In the case of a company or legal person, the place of the registered office shall be presumed to be the centre of its main interests in the absence of proof to the contrary. That presumption shall only apply if the registered office has not been moved to another Member State within the 3-month period prior to the request for the opening of insolvency proceedings.
3.6. Two provisions of the Recast EUIR, in particular, are crucial in the predictable application of insolvency judgments in a financial markets context: i) Article 8, which protects rights *in rem*;\(^{11}\) and ii) Article 9, which protects set-off.\(^{12}\)

3.7. Article 8, which operates only where assets “are situated within the territory of another Member State” (emphasis added), ensures that rights *in rem* (including fixed and floating charges) over U.K. assets are respected in insolvency proceedings opened against the debtor in another Member State.

3.8. Being within the scope of the reciprocal benefits conferred by this article is of considerable importance to the financial markets. The protections in Article 8 apply where a collateral-provider enters into insolvency proceedings to preserve the benefits of E.U. transaction finality legislation—including the FCAD, as implemented in Member States—in these circumstances.\(^ {13}\) For this reason, it is beneficial to banks exposed to credit risk because it promotes the enforceability of a collateral-taker’s rights over collateral. As a result, financial institutions can rely on collateral to secure their rights

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\(^{11}\) Article 8 of the Recast EUIR (originally Article 5 of the EUIR) provides:

1. The opening of insolvency proceedings shall not affect the rights in rem of creditors or third parties in respect of tangible or intangible, moveable or immovable assets, both specific assets and collections of indefinite assets as a whole which change from time to time, belonging to the debtor which are situated within the territory of another Member State at the time of the opening of proceedings.

2. The rights referred to in paragraph 1 shall, in particular, mean:
   - a) the right to dispose of assets or have them disposed of and to obtain satisfaction from the proceeds of or income from those assets, in particular by virtue of a lien or a mortgage;
   - b) the exclusive right to have a claim met, in particular a right guaranteed by a lien in respect of the claim or by assignment of the claim by way of a guarantee;
   - c) the right to demand assets from, and/or to require restitution by, anyone having possession or use of them contrary to the wishes of the party so entitled;
   - d) a right in rem to the beneficial use of assets.

[...]

4. Paragraph 1 shall not preclude actions for voidness, voidability or unenforceability as referred to in point (m) of Article 7(2).

\(^{12}\) Article 9 of the Recast EUIR (originally Article 6 of the EUIR) provides:

(i) The opening of insolvency proceedings shall not affect the right of creditors to demand the set-off of their claims against the claims of a debtor, where such a set-off is permitted by the law applicable to the insolvent debtor's claim.

(ii) Paragraph 1 shall not preclude actions for voidness, voidability or unenforceability as referred to in point (m) of Article 7(2).

\(^{13}\) See below, paragraph 4.6.
under financial contracts which in turn means that, for regulatory capital purposes, they can reduce the risk weighting for those exposures.14

3.9. Article 9 is an equally important safeguard which protects creditors’ rights of set-off by ensuring that, if these are effective under the law which governs the agreement giving rise to the debtor-company’s (cross-)claim, they will be enforceable by the creditor whether or not they are recognised by the law of the insolvency forum.

3.10. Like Article 8, Article 9 allows those giving the legal opinions required by rating agencies and regulators to give clear and consistent advice regarding methods of credit enhancement, i.e. security and set-off. If uncertainty regarding the recognition of such rights emerges, the consequences for cross-border investment and funding would be negative, with a potential impact on the cost of credit.

2. Domestic law on cross-border insolvency proceedings

3.11. Besides the Recast EUIR, there are two key statutory cross-border insolvency regimes in place in the U.K.: (i) the CBIR; and (ii) the provisions relating to cooperation between courts in the Insolvency Act 1986.

(i) The CBIR implement the Model Law on cross-border insolvency proceedings (the “Model Law”) adopted by the United Nations Commission on International Trade Law (“UNCITRAL”) in 2007. The Model Law is a set of internationally harmonised model legislative provisions on cross-border insolvency sponsored by UNCITRAL and designed to assist Nation States in modernising their cross-border insolvency legislation.15 The guiding principle of the Model Law is that insolvency proceedings brought in the jurisdiction which is the debtor’s CoMI should be given priority.

(ii) Section 426 of the Insolvency Act 1986 (“section 426”) requires U.K. insolvency courts to assist foreign insolvency courts in any country or territory designated by the Secretary of State by order. Its scope is inherently geographically limited and it

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14 Collateral will be recognised as eligible for this purpose only if supported by a reasoned legal opinion confirming that the collateral arrangement being used is legally effective and enforceable in the default or insolvency of the counterparty in all relevant jurisdictions (see Article 194(1) of the Regulation 575/2013 on prudential requirements for credit institutions and investment firms (the “Capital Requirements Regulation”), implementing Basel III).

15 Currently, the following countries and territories have adopted the Model Law: Australia; Benin; British Virgin Islands; Burkina Faso; Cameroon; Canada; Central African Republic; Chad; Chile; Colombia; Comoros; Congo; Côte d’Ivoire; Democratic Republic of the Congo; Dominican Republic; Equatorial Guinea; Gabon; Gibraltar; Greece; Guinea; Guinea-Bissau; Japan; Kenya; Malawi; Mali; Mauritius; Mexico; Montenegro; New Zealand; Niger; Philippines; Poland; Republic of Korea; Romania; Senegal; Serbia; Seychelles; Singapore; Slovenia; South Africa; Togo; Uganda; United Kingdom; United States of America and Vanuatu.
applies only to the approximately two dozen members or former members of the Commonwealth or Empire. The Republic of Ireland is the only E.U. Member State which has been designated under section 426.

3.12. The CBIR apply generally to any situation in which those with an interest in foreign proceedings require assistance or co-operation from courts in the U.K.\textsuperscript{16} All foreign insolvency proceedings are within scope, no matter where the forum. Notably, it is not a requirement that the foreign jurisdiction involved should itself have implemented the Model Law (i.e., there is no requirement for reciprocity). Where the proceedings are initiated in the E.U., the CBIR state that the provisions of the Recast EUIR prevail.\textsuperscript{17}

3.13. Article 21 of the Model Law, as implemented by the CBIR, deals with the types of discretionary relief which might be granted to a representative of foreign proceedings, including: i) staying proceedings before the court;\textsuperscript{18} and ii) giving procedural assistance, for example, by providing for the examination of witnesses. The list is non-exhaustive and a general catch-all reference to “granting any additional relief that may be available to a British insolvency officeholder” is included at Article 21(1)(g). Article 25 provides that co-operation with foreign courts and foreign representatives may be given “to the maximum extent possible” and Article 27 provides that co-operation under Article 25 may be implemented by “any appropriate means”.\textsuperscript{19}

3.14. In the case of \textit{Rubin v. Eurofinance S.A.} [2012] UKSC 46 ("Rubin"), the Supreme Court considered the question whether a judgment arising out of Chapter 11 proceedings in New York could be enforced through the CBIR. The court held \textit{per curiam} that the relevant provisions of the CBIR are concerned with procedural matters and, whilst they should be given a purposive interpretation, there is nothing to suggest that they provide

\textsuperscript{16} The CBIR apply where:
- assistance is sought in Great Britain by a foreign court or a foreign representative in connection with a foreign proceeding;
- assistance is sought in a foreign State in connection with a proceeding under British insolvency law;
- a foreign proceeding and a British insolvency proceeding in respect of same debtor are taking place concurrently; or
- creditors or other interested persons in a foreign State have an interest in requesting commencement of, or participating in, proceedings under British insolvency law.

\textsuperscript{17} The CBIR were amended by the Insolvency Amendment (EU 2015/848) Regulations 2017 (SI 2017/702), which came into force on 26 June 2017, so as to extend references to the EUIR to include the Recast EUIR.

\textsuperscript{18} Where the foreign proceedings have already been recognised, a stay will occur automatically under Article 20(a). In the case of a stay, security enforcement or set-off are not affected.

\textsuperscript{19} Under Article 1(4) of the CBIR, however, relief is not available where it would be prohibited under or by virtue of Part 3 of the FCARs or Part 3 of the SFRs in the case of a proceeding under British insolvency law, or would interfere with or be inconsistent with the rights of a collateral-taker exercised under Part 4 of the FCARs in the case of such a proceeding. It is assumed that these exceptions will continue to apply after Brexit.
for the reciprocal recognition and enforcement of foreign judgments. The court observed that it would be surprising if the Model Law was intended to deal with judgments in insolvency matters by implication where it is expressly concerned only with procedural matters.\textsuperscript{20}

3.15. As a result of the limitations of the Model Law highlighted in \textit{Rubin} and the absence of any applicable international convention or other regime to address the recognition and enforcement of insolvency judgments (together with a concern that the uncertainty created by the \textit{Rubin} judgment might have a "chilling effect" on continued adoption of the Model Law), the UNCITRAL Working Group has had since 2014 held a mandate to develop a model law to provide for the recognition and enforcement of insolvency-related judgments. The text is currently being developed as a stand-alone instrument, rather than forming part of the Model Law. It is hoped that a final form of the text will be adopted in 2018.

3.16. Under section 426 of the Insolvency Act 1986, an English court with jurisdiction in relation to insolvency law has the discretion, on receipt of a letter of request from a court having the corresponding jurisdiction in any other part of the U.K. or in “any relevant country or territory”, to give assistance to that court. The obligation to provide assistance only extends, outside an intra-U.K. context, to a country designated for the purposes of section 426(4) by the Secretary of State by means of a statutory instrument. The list of designated countries is currently a short one, being limited to various common law based jurisdictions such as Australia, Canada, New Zealand and the Republic of Ireland.

3.17. Section 426(5) provides that a request from a foreign court is authority for the English court to apply, in relation to the matters specified in the request, either English insolvency law or the insolvency law of the requesting court. The “insolvency law” of the relevant country is defined for these purposes in section 426(10)(d) as “so much of the law of the country or territory as corresponds to” either provisions contained in the Insolvency Act 1986 or certain provisions contained in the Company Directors’ Disqualification Act 1986.

3.18. In relation to the application of English insolvency law, section 426 gives the English court an express statutory power to make orders which could not have been made under the laws of the requesting state, thereby creating additional options for the foreign

\textsuperscript{20} In \textit{Rubin}, a judgment of the Australian court was denied recognition under the CBIR because it did not fall sufficiently under the definition of an “insolvency” judgment.
officeholder. Section 426 has, for example, been used to make administration orders and apply the company voluntary arrangement provisions contained in the Insolvency Act 1986 to foreign companies at the request of a foreign court.  

3.19. Turning to the application of foreign insolvency law, section 426 has been used, *inter alia*, to apply provisions of Australian insolvency law concerning the examination of witnesses and request that South African insolvency law provisions relating to fraudulent trading and preferential transactions should be applied. There is, however, a strict limit on the English court’s ability to give assistance under section 426. The Supreme Court held in *New Cap Reinsurance Corporation Ltd (in liquidation) and Ors v Grant and Ors* [2012] UKSC 46—a case heard together with *Rubin*—that the assistance provided for in section 426(4) does not extend to the enforcement of foreign insolvency judgments.

3.20. In addition to these two regimes aimed at improving coordination between insolvency forums, Part V (*Winding up of Unregistered Companies*) of the Insolvency Act 1986 permits the mandatory winding-up of foreign companies under section 221(1) which provides that "any unregistered company may be wound up under this Act" (where the effect of section 220 of the 1986 Act is that the expression "unregistered company" includes any foreign company). According to case law, U.K. courts can wind up foreign companies under section 221(1) where three conditions are satisfied: 1) there is a sufficient connection with the U.K.; 2) there is a reasonable possibility that the order will benefit those applying; and/or 3) at least one person interested in the company’s assets is a person over whom the U.K. courts can exercise jurisdiction.

3.21. Common law principles may also apply. It is possible for a foreign bankruptcy to be recognised in the U.K. at common law on the basis of three clearly established criteria: (i) the domicile of the debtor; (ii) submission by the debtor to the foreign insolvency proceedings; and (iii) the carrying on of business by the debtor in that foreign


22 *Fourie v Le Roux (No.2)* [2005] EWHC 922 (Ch).

23 Under the Foreign Judgments (Reciprocal Enforcement) Act 1933, judgments obtained in the courts of specified foreign countries with which the U.K. has entered into bilateral treaties, may also be recognised in the U.K. The countries covered by this Act include Australia, Canada, Guernsey and India.

24 See, for example, the judgment in *Re Drex Holdings Ltd* [2003] EWHC 2743 (Ch), where the Court held that it had the jurisdiction to order the meetings and approve the schemes of two foreign companies because they had a sufficient connection with the U.K.

25 This includes situations where the debtor is the claimant or a counter-claimant in the foreign proceedings.
jurisdiction. Recognition of foreign proceedings implies that the U.K. court will afford active assistance to the foreign court. The common law assistance cases have been largely concerned with matters such as the vesting of English assets in a foreign officeholder, the staying of domestic proceedings, orders for examination in support of the foreign proceedings, and orders for the remittal of assets to a foreign liquidation. In Rubin, however, the scope for the recognition and enforcement of foreign judgments at common law was narrowly circumscribed, being limited to situations involving one of the three criteria set out above. The Supreme Court declined to adopt a more liberal rule in the interests of the universality of bankruptcy.

3.22. One rule of common law which does not support coordination in insolvency proceedings is the rule in Gibbs. That is, the rule that a party to a contract governed by English law is not discharged from liability under the contract by a discharge in foreign insolvency proceedings. It is a common feature of many insolvency regimes (such as Chapter 11 of the U.S. Bankruptcy Code) and indeed a fundamental principle of the Recast EUIR that contractual rights can be overridden. The rule was implicitly criticised in the case of Global Distressed Alpha Fund I LP v PT Bakrie Investindo [2011] EWHC 256 (Comm) by Teare J, who nevertheless held that he was bound to follow the decision. At present, the effects of the rule in Gibbs do not apply in the context of European insolvency proceedings because provisions of the Recast EUIR which require automatic recognition of insolvency judgments override the rule. If the Recast EUIR is incorporated into English law by the Withdrawal Bill, as anticipated, European insolvency proceedings will continue to be unaffected by the rule in Gibbs.

3. Schemes of arrangement

3.23. The purpose of a scheme of arrangement is to allow a debtor-company to reach agreement for a consensual restructuring with 75% by value—and more than 50% by number—of a certain class of its creditors, which then binds all creditors in that class. A scheme can be used to amend, release or write-off debt, release guarantors, provide a standstill from creditor claims and put in place new debt/equity instruments. Schemes,

26 Rubin, [7]-[10].


28 Rubin [31].

29 Rubin [115]. The central premise of “universalism” is that the debtor’s assets should be collected and distributed in a single set of bankruptcy proceedings in the debtor’s jurisdiction of domicile, residence or incorporation.
which have achieved increased status and importance in recent years as a restructuring tool, fall outside the scope of the Recast EUIR.

3.24. There are, currently, two chief means by which the recognition of schemes sanctioned by U.K. courts may be achieved in other E.U. jurisdictions on behalf of debtors and creditors:30 i) pursuant to Regulation (EU) No 1215/2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (recast) (the “Recast Brussels I Regulation”) or—at least in relation to schemes compromising English law governed finance documents—ii) pursuant to Regulation (EC) No 593/2008 on the law applicable to contractual obligations (“Rome I”). Common law principles of private international law may also assist.

i) Recast Brussels I Regulation: in Rodenstock ([2012] BCC 459 (Ch)) (“Rodenstock”) Mr Justice Briggs took the view that the Recast Brussels I Regulation provides a jurisdictional basis for the recognition of a scheme. He concluded that the sanction of a standalone scheme (outside an insolvency) was not constrained by what is now the Recast EUIR and did, therefore, fall within the scope of Article 1(1) (“civil and commercial matters”) of what is now the Recast Brussels I Regulation, according to the principle that the Judgments Regulation and the Insolvency Regulation were “intended to dovetail almost completely with each other”.31 The exclusion for insolvency matters in Article 1(2)(b) of what is now the Recast Brussels I Regulation was, he held, to be construed as being specific and so should only exclude proceedings within the scope of the EUIR Annexes, i.e. not schemes of arrangement.32 This, then, reflects the settled view of the English courts but it is a view which is not necessarily shared by courts in other E.U. Member States. Shortly before Rodenstock was heard, a German court declined to recognise an English judgment sanctioning a solvent scheme in comparable, but not identical, circumstances—creditors’ rights were governed

30 U.K. schemes of arrangement have been effected by companies incorporated in Austria, Belgium, Bulgaria, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain and Sweden.

31 This was an observation made in paragraph 53 the Schlosser Report (OJ 1979 C 59/71) to the Brussels Convention. The Brussels Convention on civil jurisdiction and the enforcement of judgments was signed at Brussels in 1968 by the members of the European Economic Community and acceded to by the U.K. in 1978. It has since been largely superseded by the Recast Brussels I Regulation and the Lugano Convention, a treaty signed in 1988 between the Member States of the E.U. and the member states of EFTA (the “Lugano Convention”).

32 This was also confirmed by Mr Justice Richards in Magyar Telecom [2013] EWHC 3800 (Ch), in which a Dutch holding company of the Invitel group of companies and one of the leading telecommunication services providers in Hungary, completed the restructuring of its €345 million 9.5% Senior Secured Notes due 2016. Mr Justice Richards concluded it logically follows from the exclusion of schemes from Annex A of EUIR (and now the Recast EUIR) that that the Recast Brussels I Regulation should apply, and that the exclusion of insolvency proceedings from the scope of the Recast Brussels I Regulation does not extend to a scheme of arrangement involving an insolvent company unless that company is also subject to an insolvency proceeding.
by German, not English, law—pursuant to what is now the Recast Brussels I Regulation on the ground that an order for sanction by an English court is not a judgment within the meaning of the regulation.33

ii) **Rome I:** Although this decision by the German court boded ill for the recognition, in Germany, of his order sanctioning the scheme, in *Rodenstock* Mr Justice Briggs drew comfort from the view of German law experts that, in practice, his decision to sanction the scheme would be legally effective in Germany because the German courts would, pursuant to the Rome Convention, apply English law to the question whether the rights of creditors under finance documents been varied by the scheme. The possibility of viewing the recognition of schemes as a contractual issue governed by Article 12 of Rome I has also been accepted by the English Courts and by legal counsel in many other E.U. Member States.34 The recognition is founded, where the underlying financing arrangements are governed by English law, on the basis that Article 12 (1)(d) of Rome I provides that the governing law of a contract should also govern “…the various ways of extinguishing obligations ... and limitation of actions” in relation to that contract. Counter-arguments to this view have, however, been raised by commentators. Article 1(2)(f) excludes from the scope of Rome I “questions governed by the law of companies…such as the creation…legal capacity, internal organisation or winding up of companies”. A dissenting creditor might argue that schemes fall within this exclusion. Similarly, Recital 7 of Rome I provides that the substance and scope of Rome I should be consistent with the Recast Brussels I Regulation which itself excludes “judicial arrangements, compositions and analogous proceedings”.35

3.25. In addition to the instruments above, it may in some cases be possible to argue in Member States’ courts, where recognition of an English-law-sanctioned scheme is

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33 Decision of the *Oberlandesgericht Celle* in case 8U46/09. The case is discussed by Briggs J in *Rodenstock* at [74]:

Strictly, that case is distinguishable from the present case precisely because the relevant creditors' rights were governed by German rather than English law, but that was not the basis of the regional court of appeal's reasoning. Rather, its conclusion was that the English court's decision to sanction the Scheme could not be characterised as a judgment within the meaning of Article 32 of the Judgments Regulation.


35 It should be noted that in *Rodenstock*, these arguments relating to Recital 7 and Article 1 (2) (f) of Rome I were dismissed by both Mr Justice Briggs at [76-77] inclusive of his judgment and by German lawyers Mr Kirchof and Professor Peter Mankouski who gave compelling expert evidence in that case in relation to German law and the construction of the Recast Brussels I Regulation and Rome I. Separately, it might be noted that the U.K. is also party, in its capacity as a Member State, to the Lugano Convention, which is discussed later in the paper and which contains similar language to that in Article 1(2)(f) of the Recast Brussels I Regulation, although it is by no means certain that the same reasoning and interpretation would apply in this context.
sought, that the debtor had already accepted the jurisdiction of the English courts to modify its rights with respect to the indebtedness by entering into an English law financing contract and that this submission to the jurisdiction should be recognised under generally accepted principles of private international law. This analysis would focus on the wording of jurisdiction clauses, which typically sets out the circumstances in which English courts would have the jurisdiction to settle any dispute arising out of, or in connection with, the relevant agreement, including any dispute relating to its existence, modification, validity or termination. The argument may, however, meet the objection that the debtor incorporated non-exclusive jurisdiction clauses into its finance documents or it may be the case that the courts where recognition is sought regard the *lex incorporationis* (or the law of the debtor’s CoMI) as determinative of the issue as to whether a U.K. scheme should be recognised.

3.26. As a final point on the recognition of schemes, it should be noted that the U.K. is also a signatory to the Hague Convention in its capacity as a Member State of the E.U. The Hague Convention requires the court or courts designated in an exclusive choice-of-court agreement to hear a case within the scope of the agreement. It precludes courts of other contracting states from hearing parallel proceedings and it requires any judgment granted by the designated court to be recognised and enforced in other contracting states. It does not apply to insolvency proceedings but, in the absence of any other applicable instrument, may play a role in coordinating the recognition of schemes of arrangement (see below, paragraphs 6.14 to 6.17).[^36]

4. TRANSACTION FINALITY

4.1. In several financial markets contexts, finality and certainty are provided not by insolvency legislation in the strictest sense but by other European legislation relating to financial collateral, the operation of payment and securities settlement and clearing (central counterparties) systems. By guaranteeing transaction finality, these laws reduce systemic risk. Instances of the relevant legislation include the SFD and the FCAD.

1. **Settlement Finality Directive**

4.2. The SFD, which is restricted to settlement systems governed by the law of a Member State, has been implemented in the U.K. through the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (SI 1999/2979), as amended (the “SFRs”). This legislation provides key systemic safeguards that contribute to the stability and efficiency of the financial markets.

4.3. In the U.K., the SFRs allow payment and settlement systems to apply for certain protections against what might otherwise be the adverse effects of normal insolvency law insofar as it applies to transfer orders entered into the system and the operation of the rules of the system (e.g. in relation to the system’s default arrangements and netting). By disapplying insolvency law, the SFRs protect the finality and irrevocability of the transfer orders, and help to ensure the enforceability of collateral security.

2. **Financial Collateral Arrangements Directive**

4.4. The FCAD was introduced with the objective of establishing a minimum regime for the provision of financial collateral and of promoting the integration, cost efficiency and stability of the financial markets in the E.U. It requires E.U. Member States to remove formalities to the creation, perfection or enforcement of financial collateral arrangements and to ensure that provisions of E.U. Member States' insolvency law, which may prevent enforcement of security, do not apply to collateral arrangements meeting certain requirements. It also safeguards other contractual rights such as close-out netting and rights of use, establishes a right of appropriation for the collateral taker and permits enforcement of a financial collateral arrangement notwithstanding the imposition of a moratorium on insolvency by a national court.

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37 Article 1 of the SFD restricts its scope.

**Article 1**

The provisions of this Directive shall apply to:

(a) any system as defined in Article 2(a), governed by the law of a Member State (emphasis added) and operating in any currency…,

(b) any participant in such a system;

(c) collateral security provided in connection with:

— participation in a system, or

— operations of the central banks of the Member States in their functions as central banks (emphasis added).

38 Extensive safeguards are available to recognised investment exchanges and recognised clearing houses under Part VII of the Companies Act 1989 in the insolvency or default of a party to a market transaction, including protections for market charges. However, as Part VII is domestic U.K. legislation, it does not appear to protect against claims raised outside the U.K. (e.g. in respect to non-U.K. held collateral) unless the claimant has entered into insolvency proceedings in a jurisdiction where U.K. law is recognised as applicable.
4.5. The FCAD has been implemented in the U.K. by the Financial Collateral Arrangements (No. 2) Regulations 2003 (S.I. 2003/3226) (the “FCARs”) which are wider in scope than the FCAD. The FCAD will apply to a collateral arrangement if (broadly speaking) at least one of the parties to the arrangement is a financial institution. It provides for not only the disapplication of certain provisions of insolvency law but also the application, to questions concerning entitlement to the collateral, of the law of the country in which the relevant securities account is maintained under Article 9. The FCARs are not limited in the same way and cover arrangements between any non-natural persons.39

4.6. Recitals (1) to (4) of the FCAD make clear that it forms part of the legal framework, together with the SFD, the EUIR (and CIWUD), which was designed to contribute to the stability of the E.U. financial markets. The Recast EUIR in turn dovetails with the FCAD by protecting rights in rem in Article 8. Whether a financial collateral arrangement is created by way of title transfer or security interest, it will normally give rise to a right in rem in favour of the collateral-taker. The protections in Article 8 of the Recast EUIR, which were considered above, will apply where the collateral-provider enters into insolvency proceedings, subject to a few uncertainties, and will preserve the effect of the FCAD (as implemented in Member States) in these circumstances. Similarly, the Recast EUIR (in recital 71 and Article 12) recognises the “special protections” in the case of payment systems and transactions in the financial markets established under the SFD, and that they should take precedence over the rules laid down in the Recast EUIR. It is desirable, therefore, that these or equivalent protections continue to apply after Brexit between the U.K. and E.U.

5. IMPACT OF BREXIT

5.1. In the context of the historical inter-dependency between the U.K. and the E.U., Brexit is likely to present a significant disruption. Among other aspects of this discontinuity, the U.K. will, upon its ceasing to be a Member State, lose all mutual recognition benefits to which it is entitled qua Member State, unless further provision is made by treaty. The impact of a permanent loss of reciprocity has, in the context of the Recast Brussels I Regulation, already been considered by the FMLC.40

39 The FCARs define “non-natural persons” as: “any corporate body, unincorporated firm, partnership or body with legal personality except an individual, including any such entity constituted under the law of a country or territory outside the United Kingdom or any such entity constituted under international law.”

40 Supra, references at n. 36.
5.2. The retention in the U.K. of all effective E.U. regulations in some form and their incorporation into domestic law upon Brexit under the Withdrawal Bill is currently the anticipated political outcome. There is no reason to believe that the E.U. legislation discussed in this paper is any different and it is, therefore, assumed in the subsections below that it will be retained, albeit in modified form.

1. Impact on recognition of E.U. insolvency proceedings in the U.K.

5.3. The probability that the Recast EUIR will be retained as Direct E.U. Legislation under the Withdrawal Bill, albeit in modified form, is likely to mitigate the impact of Brexit on cross-border insolvency proceedings in the U.K. In the event that rules requiring U.K. courts to recognise E.U. insolvency proceedings were not retained, significant uncertainty would almost certainly be caused. In particular, any effective compromise of the rights of creditors with respect to English law-governed financings by the debtor would incur the increased costs of pursuing parallel, interlocking proceedings in the U.K. thereby inhibiting effective debt recovery and weakening the mechanisms for business exits and rescues so as to create higher cost of capital and heightened perception of risk among investors and financial institutions.

5.4. For the time being, there remains considerable uncertainty as to how the Recast EUIR will be modified as domestic legislation. There are 62 references to “Member States” in the Recast EUIR and more than 100 to “Member State” in the singular. Relatively few of these references will be logical or appropriate in domestic legislation after Brexit. This is not simply a drafting issue: most of the references reflect a policy choice to make provision for debtors, creditors or assets in the E.U. on the basis that standards in the region are broadly convergent on corporate law, insolvency law, civil procedure and contract finality and on the assumption that those benefits will be reciprocal throughout all participating Member States. Replacing “Member State” with “U.K.” in phrases such as “the territory of another Member State” makes no sense whatsoever; retaining “Member State [of the E.U.]” might seem oddly discriminatory after Brexit where, say, other G20 countries are concerned, and an unthinking substitution of “Member State” with a general reference to any “country” might not only give priority to laws and standards which do not converge with those in force in the U.K. but would almost certainly have the effect of curtailing the international jurisdiction of the English courts to wind up companies.41

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41 The effect of Articles 3(1) and 3(2) of the Recast EUIR is that, in relation to a company with its CoMI in a Member State other than the U.K., the English courts have jurisdiction to wind up only if the company possesses an establishment within the U.K. This limitation does not currently apply to companies with a CoMI in a non-E.U. jurisdiction.
5.5. Article 8 of the Recast EUIR will cease to operate in the 27 E.U. Member States in such a way as to protect the application of the governing law to proprietary rights in assets situated in the U.K. when the U.K. leaves the E.U. since it applies only with regards to assets “which are situated within the territory of another Member State”. This adds a further dimension to the general loss of reciprocity in respect of insolvency proceedings.

5.6. Moreover, although it seems likely that efforts will be made to retain the Recast EUIR and incorporate it into domestic law, it is unclear how Article 8, with its odd reference to “the territory of another Member State”, will be adjusted (if at all) and incorporated as Direct E.U. Legislation. Given what is said above, U.K. courts may, post-Brexit, be asked by claimants to recognise and enforce insolvency judgments issued by the courts of E.U. Member States against assets in the U.K. in circumstances where the Member States’ courts no longer recognise the Article 8 protections as applicable in respect of U.K. assets and where, in reaching their judgments, the courts of the insolvency forum have disregarded both the law governing the asset and local law in the U.K. The U.K. courts may, in these circumstances, find themselves without clear direction from Direct E.U. Legislation as to the enforceability of the foreign judgment.

5.7. The prospective impact of Brexit on the Article 9 safeguard is likely to be less damaging than it is on the safeguard in Article 8 because Article 9 does not refer to Member States. The better view is—subject to only a small degree of residual interpretative uncertainty—that Article 9 may be safely relied upon where the law applicable is that of a jurisdiction outside the E.U. If this view is correct, there will be no loss of reciprocity for rights of set-off unless the provision is repealed or disapplied in the U.K. Given this, the prospective retention of the provision under the Withdrawal Bill and its incorporation into domestic law can be expected adequately to preserve legal certainty in relation to rights of set-off.

2. **Impact on recognition of U.K. insolvency proceedings by courts in Member States**

5.8. When the U.K. ceases to be a Member State of the E.U., this will necessarily trigger the loss of reciprocity vis-à-vis the recognition of U.K. insolvency proceedings under the Recast EUIR in the E.U. One consequence of this will be a need for costly parallel proceedings in Member States’ courts. Another, given that recognition may be denied on a number of grounds, will be legal uncertainty. In some E.U. jurisdictions, non-E.U. (or “Third Country”) insolvency judgments have been denied recognition on a wide variety of public policy grounds.
5.9. In some E.U. Member States, a U.K. insolvency proceeding may still be afforded recognition based on the domestic law of the particular jurisdiction. These rules are likely to vary, however, depending on the jurisdiction in question, leading to a lack of certainty.

3. Impact on recognition of schemes of arrangement

5.10. Means by which orders by U.K. courts sanctioning schemes of arrangement might garner recognition in other E.U. jurisdictions were discussed in paragraphs 3.23 to 3.26 above. Following Brexit, U.K. schemes may continue to benefit from some of these existing private international law regimes, including the provisions of Rome I, in certain cases—in particular where English law governs the obligations subject to the scheme.

5.11. The subject of the impact of Brexit on the Recast Brussels I Regulation and on Rome I has been comprehensively addressed by the FMLC elsewhere. The FMLC has observed that in order to avoid a loss of reciprocity with respect to the recognition and enforcement of judgments under the Recast Brussels I Regulation, a treaty would need to be put in place providing in essence that the U.K. is still to be treated, post-Brexit, as if it were a Member State for this purpose. Absent such a treaty, the Withdrawal Bill will not prevent a loss of reciprocity and, post-Brexit, the Recast Brussels I Regulation will no longer provide a basis—even to the uncertain extent it currently does so—on which to secure the recognition of U.K.-sanctioned schemes of arrangement in other Member States.

5.12. Rome I, on the other hand, may provide a continuing basis, even after Brexit, for the reciprocal recognition of U.K.-sanctioned schemes of arrangement in other Member States because, unlike the Recast Brussels I Regulation and the EUIR, the choice of law rules which it establishes do not refer exclusively to the law of Member States. Thus, to the extent that Rome already provides a basis for recognising schemes sanctioned in the U.K., it should continue to do so even when the U.K. is no longer a Member State. It should be noted, however, that although a number of expert opinions on the recognition of schemes have, to date, referred to and relied on Rome I, it is possible that courts in Member States may read Rome I more restrictively following Brexit. Restrictive

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42 Supra, references at n. 36.

readings would be likely to emphasise the limitations set out in paragraph 3.24(ii) above.

5.13. The extent to which shared principles of private international law can be relied upon in the courts of E.U. Member States to fill any lacunae in the support for schemes provided by Rome is already unclear, as highlighted in paragraph 3.25 above. The likely success of this argument in E.U. courts following Brexit is even less clear for the reason suggested above, i.e. that, where there is ambiguity, a restrictive approach may be more likely.

4. Settlement Finality Directive

5.14. Once the U.K. ceases to be an E.U. Member State, the insolvency courts of the remaining E.U. states will not be required to recognise SFD protections in so far as they are afforded by the SFRs in the context of insolvency proceedings opened against a participant in a U.K. designated system.44

5.15. This is another aspect of the general Brexit-related loss of reciprocity between the U.K. and E.U. systems of law and means, in effect, that, following Brexit, U.K. settlement systems will fall out of scope of provisions which currently prevent courts in any other E.U. Member State from revoking a relevant transfer order given by the insolvent participant in a U.K. designated system, preventing the operation of any netting arrangements of a U.K. designated system or obstructing the proprietary rights of a collateral-taker in respect of collateral security provided by the insolvent participant. The loss of the SFD protections could potentially have a negative impact on the stability and efficiency of the relevant U.K. designated system and, in consequence, on the financial markets.

5.16. These issues cannot be ameliorated or mitigated by the retention of the SFRs under the European Union (Withdrawal) Bill because the issue is the loss of reciprocity rather than a potential lacuna in the U.K. legal framework.

5. Financial Collateral Arrangements Directive

5.17. The same issues do not arise under the FCAD. The implementing measures of E.U. Member States, if they follow the scope of the FCAD, are not expressly limited to the protection of collateral arrangements affecting collateral situated in a Member State, although this is often a prerequisite for enforcement proceedings in the courts of that

44 Supra, references at n. 37.
state, or benefitting only collateral-takers and collateral-providers located in a Member State.\textsuperscript{45} Thus, U.K. collateral-takers and collateral-providers will not automatically fall out of scope when the U.K. withdraws from the E.U. For example, where a U.K. financial institution has posted collateral with an E.U. central bank, and the collateral is situated in and subject to the laws of an E.U. Member State, the legislation of that state implementing the FCAD should apply to the collateral, notwithstanding the withdrawal of the U.K. from the E.U.

5.18. Nevertheless, some residual uncertainty arises in respect of the interplay of the FCAD and Article 8 of the Recast EUIR in the courts of the other 27 E.U. Member States vis-
à-vis the application of English law and the FCAR in particular to collateral situated in the U.K. Article 8(1) will no longer require courts in other E.U. Member States to have regard to the rights \textit{in rem} of creditors or third parties where the assets are situated in the U.K. This means that, as far as a court in an E.U. Member State is concerned, the insolvency law of the forum—incorporating what is likely to be a narrower implementation of the FCAD—could prevail in respect of rights \textit{in rem} in assets situated in the U.K., rather than the generous protections afforded by the FCAR.\textsuperscript{46}

6. SOLUTIONS AND MITIGANTS

1. Bespoke E.U.-U.K. agreement

6.1. If, as part of the Brexit negotiations, a deal were reached between the U.K. and the E.U. to continue the operation of the Recast EUIR—whether as part of transitional or final trading arrangements—then U.K. insolvency proceedings would continue to benefit from recognition in E.U. Member States (and \textit{vice versa}) for so long as the deal were in place. The advantage would be that the \textit{status quo} would be preserved.\textsuperscript{47}

\textsuperscript{45} According to the FCAD, the collateral-taker and the collateral-provider must be one of the persons listed in Article 1(2). This list includes, by reference to Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions, financial institutions authorised in a Third Country and, subject only to the qualification that the other party to the arrangement must be a financial institution or public body, “a person other than a natural person, including unincorporated firms and partnerships”.

\textsuperscript{46} An important point here is that the E.U. Member State in question will have itself implemented the FCAD which provides, in Article 9, that title to book-entry securities collateral, as well as the question of “the steps required for the realisation of book entry securities collateral following the occurrence of an enforcement event” are governed by the law of the country (a term which includes Third Countries) in which the relevant securities account is maintained. Therefore, the private international law rules applicable in the insolvency forum should refer these questions to English law where the arrangement falls within the scope of the implementing legislation.

\textsuperscript{47} If an agreement with the E.U. as a bloc were not possible, it would have been beneficial to enter into bilateral treaties with individual Member States. The European Council Article 50 Guidelines for Brexit negotiations (available at: http://www.consilium.europa.eu/en/press/press-releases/2017/04/29-euco-brexit-guidelines/) set out core principles, however, which prohibit this. In any event, the implications of this on any secondary legislation made under section 7 of the Withdrawal Bill would need to be considered carefully.
6.2. This option is likely to entail the recognition and acceptance by the U.K. of the role of the European Court of Justice (the “ECJ”) as the ultimate arbiter of disputes under the Recast EUIR. The U.K. Government made it clear in the March 2017 White Paper preceding the Withdrawal Bill that it intends to end the jurisdiction of the ECJ.

6.3. If a treaty is agreed to establish reciprocity with E.U. Member States in relation to cross-border insolvency proceedings, provision should also be made in respect of the mutual recognition of the protections granted to U.K. designated systems and their participants under the SFD to sustain wider confidence in the U.K.’s financial markets and infrastructures.

2. Transposition of a modified, expanded EUIR

6.4. As mentioned above, in paragraph 5.2, the U.K. is expected to incorporate the text of the Recast EUIR, as at the date of Brexit, into domestic law under the Withdrawal Bill. It could, however, legislate in due course unilaterally to extend the national provisions beyond E.U. Member States (following in the footsteps of Germany). Under this option, the U.K. would recognise insolvency proceedings opened in any jurisdiction in which a debtor has its CoMI. This would promote the concept of universalism and recognise that insolvency proceedings are more efficiently dealt with if one jurisdiction deals with the insolvent whilst preserving the position on rights in rem and set off as set out in the Recast EUIR. A significant disadvantage of this option, however, is that it would considerably narrow the international jurisdiction of the English courts—as insolvency proceedings in the U.K. would only be provided for if they were linked to CoMI or an establishment in the U.K. With this in mind, a compromise solution would be to expand the U.K.’s recognition framework (i.e. to encompass insolvency proceedings in any jurisdiction where the insolvent entity has its CoMI) without restricting the U.K. courts' own insolvency jurisdiction in such circumstances. It is to be doubted, however, whether any strategic expansion of the regime established by the

48 An alternative may be to adopt a solution similar to that of Norway and other EFTA states (barring Liechtenstein) under the Lugano Convention whereby ECJ decisions are persuasive but not binding. This may assist with recognition of Schemes of Arrangement but does not fix the problem of the recognition of E.U. or U.K. insolvency proceedings


50 The U.K. could, of course, also restrict the domestically received EUIR by legislation in due course. This option would see the U.K. not adopt those provisions which may be more challenging in practice post-Brexit, such as continued cooperation of courts and insolvency officeholders or the group coordination concept as set out in the Recast EUIR. See also paragraph 6.5.
EUIR can be achieved under the powers of modification established by the Withdrawal Bill as they are currently drafted.

6.5. An important point to note, whether in respect of a transposed Recast EUIR or an expanded recognition regime, is that a unilaterally-adopted framework would not be based on reciprocity or mutual recognition. Thus, whilst the U.K. would recognise insolvency proceedings initiated elsewhere, other E.U. Member States—or foreign courts under an expanded regime—may not afford reciprocal recognition to insolvency proceedings opened in the U.K. One mitigant might be to incentivise mutual recognition by, for instance, making clear that the U.K. could recognise and enforce insolvency judgments issued by Member States' courts only to the extent that the judgment respects rights in rem in U.K.-situated assets. Arguably, modifications of this kind would fall within the ministerial power to remedy or mitigate deficiencies in retained E.U. law set out in clause 7 of the Withdrawal Bill in the case of a transposed Recast EUIR.

6.6. The clause 7 power could also be used to address any difficulties—discussed above at paragraph 5.4—caused by the fact that the drafting in the EUIR is largely unsuited to a new role as domestic legislation and that, even if there were no perceived need to address the automatic loss of reciprocity that will follow Brexit, many of these difficulties would persist.

6.7. Given that the Recast EUIR is regularly updated, thought will, in any event, need to be given as to whether correlative updates will be made to domestic law. While the text of the Recast EUIR does not change that often, the Annexes do. Regardless of what is said above about strategic expansion and modification, for transposition to result in domestic legislation which tracks the Recast EUIR as closely as possible, corresponding amendments will need to be made to U.K. domestic legislation.

3. Expansion of the scope of the CBIR

6.8. One option would be for the U.K. to consider: (i) making amendments to the CBIR so as to allow for the recognition of insolvency-related judgments; and (ii) promoting the Model Law throughout the E.U. Commentators have suggested that this would bridge any gaps created by the exclusion of the Recast EUIR.

6.9. In relation to the former proposal, even if the scope of the CBIR were extended to cover insolvency-related judgments, this would not bridge the gap left by the Recast EUIR.
That is, not least because the implementation of the Model Law has differed across jurisdictions.

6.10. In fact, only five E.U. Member States (namely, the U.K., Greece, Poland, Romania and Slovenia) have adopted the Model Law to date. It has been suggested that, while the Model Law is of benefit to non-E.U. Member States in trade terms, it is less advantageous to Member States, which can rely instead on the Recast EUIR. This will continue to be the case after Brexit in the remaining 27 Member States. Even if the CBIR are extended to cover the limitations identified in Rubin, E.U. Member States would continue to benefit from the Recast EUIR and the Recast Brussels I Regulation. Together, these circumstances make it difficult to see what incentive other Member States would have to adopt the Model Law after Brexit.

4. Section 426 of the Insolvency Act 1986

6.11. Another option would be to expand the current scope of section 426 of the Insolvency Act 1986, which constitutes a provision dealing with cooperation between courts exercising jurisdiction in relation to insolvency. The two key advantages of extending section 426 would be that: (i) it would give the English court a wider jurisdiction to assist courts in other Member States than currently exists under the common law; and (ii) an extension of section 426 would be relatively easily to implement.

6.12. The extension of section 426 to include E.U. Member States gives rise to attendant concerns, however, regarding the appropriateness of the mechanism in cases where the new (i.e. E.U.) jurisdictions proposed to be included within the section have a significantly different approach to insolvency law than does the U.K. For this reason, and given that the strategy would not result in reciprocal recognition of U.K. insolvency proceedings, it is hard to see how this option would improve upon the expected retention of the Recast EUIR and its incorporation into domestic law under the Withdrawal Bill.

5. Reliance on and possible adaption by statute of the common law

6.13. The same may be said of reverting to the common law—the actual scope and consequences of recognition are much more complex and uncertain at common law than under the Insolvency Act 1986 or the Recast EUIR. The rule in Gibbs will not affect E.U. insolvency proceedings if, as anticipated, the Recast EUIR, which supports the general principle of "universalism", is transposed into English law through the Withdrawal Bill. If rights in rem over U.K. assets were no longer protected by Article 8
of the Recast EUIR, however, it might be important for the English court to be able to rely on the rule in \textit{Gibbs} when deliberating the recognition of the effect of a foreign compromise proceeding over secured assets in circumstances where the security agreement is governed by English law.

6. Schemes of arrangement

6.14. It is possible that signing the Hague Convention could assist with the recognition of schemes in the E.U. after Brexit. That is, in particular, if no treaty is put into place providing that the U.K. is still to be treated, post-Brexit, as if it were a Member State for the purpose of the Brussels I Regulation.\footnote{\textit{Supra}, references at n.43.} The U.K. is currently a signatory to the Hague Convention by virtue of its status as an E.U. Member State. Following Brexit, however, the U.K. has the option of becoming a signatory in its own right, which would not require the consent of the remaining E.U. Member States.

6.15. Reliance on the Hague Convention may nevertheless engage a number of questions of legal uncertainty in the context of schemes of arrangement, including the questions whether: i) schemes may fall within an exclusion set out in Article 2(2)(e) which establishes that “insolvency, composition and analogous matters” are not within the scope of the convention; and ii) whether a scheme sanction order is a “judgment” for the purposes of Article 4(1) of the Hague Convention.

6.16. The Hague Convention would, moreover, only assist with the recognition of scheme sanction orders if the parties to the finance documents have agreed to the exclusive jurisdiction of the English courts. Although this will sometimes be the case in a financial markets context, it will not always be so.\footnote{In particular, some finance documents on Loan Market Association standard terms may include asymmetric jurisdiction clauses. Courts in other E.U. jurisdictions have previously concluded that these are not exclusive jurisdiction clauses for the purpose of the Brussels I Regulation and the authors of the explanatory report to the Hague Convention took the same view. In paragraph 106 of that report, the authors note that it was agreed by the Diplomatic Session that asymmetric jurisdiction clauses would constitute exclusive jurisdiction clauses for the purposes of the Hague Convention (see para 73) and the Recast Brussels I Regulation (see para 79). The issue of asymmetric jurisdiction clauses has been discussed in a previous FMLC publication: FMLC, \textit{Paper on Issues of Legal Uncertainty Arising in the Context of Asymmetric Jurisdiction Clauses}, (29 July 2017), available at: \texttt{http://www.fmlc.org/paper-on-asymmetric-jurisdiction-clauses.html}.}

6.17. In summary, although it would be relatively easy for the U.K. to adopt the Hague Convention following Brexit, and this may assist with the recognition of schemes in certain cases (i.e. where there is an exclusive jurisdiction clause where all parties agree
to sue before the U.K. courts), it would not assist in all areas. In particular, it would not result in the recognition of either E.U. or U.K. insolvency proceedings.

6.18. The FMLC has previously recommended that HM Government give further consideration to signing the Hague Convention against the backdrop of Brexit and its impact on the civil jurisdiction and judgments framework embodied in the Recast Brussels I Regulation.53

7. CONCLUSION

7.1. In this paper, the FMLC has considered issues of legal and operational uncertainty in relation to cross-border insolvency proceedings, which may arise in consequence of Brexit. Although the shape of the future U.K.-E.U. relationship remains unknown, it seems inevitable that, absent any bespoke agreement, all mutual recognition arrangements between the U.K. and the E.U. will cease. Of particular importance to the financial markets are the mutual and reciprocal recognition provisions written into the Recast E.U. Insolvency Regulation, which cannot be resolved by means of a wide-ranging reception statute such as the Withdrawal Bill.

7.2. Acknowledging this, and other complexities relating to cross-border corporate insolvency—including the effect of restructuring tools such as schemes of arrangement or related financial services measures such as the SFD and the FCAD—the FMLC has provided in this paper an extensive background to E.U. and U.K. cross-border insolvency measures. It has considered, in depth, rights which are written into the EUIR and the loss of which may prove problematic for U.K. market participants. In section 4, the FMLC has examined finality as provided by the SFD and FCAD, which reduce systemic risk.

7.3. In section 5, the FMLC turns to the specific incidents of uncertainty which will arise upon Brexit, should the Recast EUIR be transposed into U.K. law but no other agreement ensuring reciprocity be signed between the U.K. and the E.U. These include questions about: (i) the recognition of E.U. insolvency proceedings in the U.K.; (ii) the recognition of U.K. insolvency proceedings in the E.U.; (iii) the recognition of U.K. schemes of arrangement in the E.U.; (iv) the loss of reciprocity as currently ensured under the SFD; and (v) conflicts arising under the FCAD.

53 Supra, references at n. 36.
7.4. To address these uncertainties, the FMLC has made recommendations in section 6 which include a strong preference for preserving the mutual effect of the Recast EUIR via negotiation of transitional arrangements and/or a bespoke treaty between the U.K. and the E.U. It has also recommended that any such treaty or arrangements should establish mutual recognition with E.U. Member States in relation to the protections granted under the SFD to sustain wide confidence in the U.K.’s financial markets.
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1 In view of the role of HM Government and the Bank of England in the preparations relating to the forthcoming withdrawal by the U.K. from the E.U., Stephen Parker and Sinead Meany took no part in the preparation of this paper and the views expressed should not be taken to be those of HM Treasury and the Bank of England.

2 Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.

3 The FMLC is grateful to Claire Swirski, previously of Clifford Chance LLP, for her contribution to earlier versions of this paper.
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1. **PREFACE AND INTRODUCTION**

**Preface**

1.1. The role of the Financial Markets Law Committee (the “FMLC” or the “Committee”) is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. Following the result of the E.U. Referendum, the FMLC announced that it would work with experts in law and financial services to identify, analyse and address legal uncertainties relating to the U.K.’s withdrawal from the E.U. ("Brexit") and that it would establish a High Level Advisory Group (the “HLAG”) to give direction to the Committee's future work in this field. Its research programme is now well under way.4

1.3. At a meeting of the HLAG held in October 2016, the FMLC Chief Executive delivered a presentation entitled *Brexit: Transition and Standstill*, mapping the provisions of key E.U. regulatory measures and analysing related provisions governing market access by financial services providers based in jurisdictions outside the E.U. (“Third Countries”). At the meeting, members of the HLAG recommended that the FMLC engage further with issues of legal uncertainty arising in the process of secession and transition. The Committee agreed with this assessment and resolved, in accordance with the FMLC's educational remit, to produce a paper highlighting related issues of legal uncertainty and making recommendations to resolve them.

1.4. This paper focuses on issues of legal uncertainty specific to the application of E.U. legislation to U.K.-based financial services providers in the event that the U.K. withdraws from the E.U. without retaining access to the single market under any other legal provision. It is not for the FMLC to comment on matters of policy or the form that future regulatory approaches, if any, should take and this paper should not be understood to constitute comments thereon.

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4 The text of the announcement and further details of the FMLC’s work in this area are available at: [http://www.fmlc.org/the-fmlcs-work-on-brexit.html](http://www.fmlc.org/the-fmlcs-work-on-brexit.html).
Introduction and Executive Summary

1.5. In the months after the E.U. referendum, there arose a perception that the future of the U.K.’s relationship with the E.U. was beset by a significant lack of clarity. In the absence of any official roadmap, the debate revolved around the idea of a “soft Brexit”—with the U.K. retaining membership of the European Economic Area (“E.E.A.”) or at least the European Free Trade Association (“EFTA”)—or the “hard Brexit” options of concluding a completely new E.U.-U.K. trade agreement or leaving the E.U. without any treaty provision for trade.

1.6. HM Government’s intention to opt for a “hard Brexit” was made clear in a speech delivered on 17 January 2017 by the Prime Minister, in which she stated her intention to seek a customs agreement with the E.U. that would leave the U.K. free to reach individual tariff schedules at the World Trade Organisation (“WTO”). On 29 March 2017, HM Government officially served notice of the U.K.’s withdrawal to the E.U. under Article 50 of the Treaty on European Union (the “TEU”). On the following day, the U.K. Department for Exiting the European Union published a White Paper outlining HM Government’s proposals to repeal the European Communities Act 1972 and transpose the existing body of E.U. law—commonly known as the “acquis”—into U.K. law by way of a “Great Repeal Bill”. Following the result of the June 2017 general election in the U.K., which established a hung Parliament, market participants and media commentators have suggested that the possibility of a “soft Brexit” has come back into focus. At the time of the publication of this paper, the negotiations provided for in Article 50(2) of the TEU have only recently been initiated and the form of the future relationship between the U.K. and E.U. is unclear.

1.7. In a truly “hard Brexit” scenario, without treaty provisions of any kind, at the end of the two-year Article 50 notice period (29 March 2019), the U.K. will lose the benefits of membership of the E.U. and will become, from the perspective of E.U. law, a Third Country. In these circumstances, the ability of U.K. firms to provide financial services into the E.U. from the day of Brexit would largely depend on the existing E.U. legal

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6 See, for example: Blitz, “Soft Brexit hopes seen providing a cushion for the pound”, Financial Times, 9 June 2017, available at: https://www.ft.com/content/42679902-4cd5-11e7-919a-1e14ce4af89b?mhq5j=e3.

7 Although this paper refers consistently to access by U.K. financial services providers to E.U. markets under E.U. law, this should be understood to include, mutatis mutandis, access to E.E.A. markets by virtue of the provisions of the Agreement on the European Economic Area (1994).
framework for service providers based in Third Countries. This framework comprises various regimes ("Third Country regimes") written into key pieces of E.U. legislation.

1.8. The Third Country regimes offered by E.U. law are multiple and diverse but they do not, even in aggregate, offer comprehensive access to the single market, i.e. across the full range of financial services business lines. Direct access to E.U. markets is not facilitated by Third Country regimes, for instance, as far as the following E.U.-regulated activities are concerned: retail investment services, 8 retail fund offerings, 9 wholesale or retail banking services (i.e. deposit taking and lending), 10 or direct insurance. 11 This carries the necessary implication that withdrawal from the E.U. without a treaty agreement would entail a loss of E.U.-related business that could be transacted by U.K.-based financial services firms. Where access provisions do exist, they are often uncertain in their extent or restricted in their coverage. In section two, below, the FMLC analyses legal complexity related to the scope of Third Country regimes.

1.9. The diversity of Third Country regimes, the peculiarity of the decision-making mechanisms which characterise them and the specificity of the—often highly detailed and exacting—requirements they impose on firms in different industry sectors are explored in section three. A number of issues of legal complexity are identified here which may mean that firms based in a Third Country face difficulty or delay in bringing themselves within the parameters of the legislative requirements for access.

1.10. The issue of delay is further considered in section four. This section makes the point that the process of reaching a decision on the application of Third Country regimes to firms based in the U.K. will only begin, in all likelihood, once the U.K. has withdrawn

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8 The Third Country regime which will become available under Directive 2014/65/EU on markets in financial instruments ("MiFID II") and Regulation (EU) No 600/2014 on markets in financial instruments ("MiFIR"), as of January 2018, is limited to services provided to professional clients and eligible counterparties.

9 Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast) (the "Recast UCITS Directive") does not contain provisions establishing access for Third Country undertakings for collective investment in transferable securities ("UCITS"). Third Country UCITS may be marketed, under certain conditions, to professional investors in the E.U. under Directive 2011/61/EU on alternative investment fund managers (the "AIFMD").

10 Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms ("CRD IV") and Regulation 575/2013 on prudential requirements for credit institutions and investment firms (the "CRR") establish a Third Country regime which covers the prudential treatment of exposures to foreign institutions. This regime does not establish direct access to E.U. customers for Third Country banking services providers, although an E.U. Member State may permit Third Country firms to provide services through a branch established in its territory.

11 Directive 2009/138/EC (as amended by Directive 2014/51/EC) on the taking-up and pursuit of the business of insurance and reinsurance ("Solvency II") only provides rights of direct access for reinsurance services providers, although an E.U. Member State may permit Third Country firms to obtain authorisation in respect of services provided through a branch in established in its territory.
from the E.U. It goes on to consider the factors which may affect the decision-making timetable followed by the E.U. authorities.

1.11. In each of these sections—two, three and four—the FMLC provides examples from a diverse range of wholesale financial industry sectors—banking; investment services; services offered by central counterparties ("CCPs") and trading venues; alternative investment funds and fund management; insurance; and issuing securities—but this selection is considered only for the purposes of illustration. A large number of financial industry sectors and activities have been omitted on the grounds that not only would an account covering these areas represent a very significant challenge to the FMLC’s resources but the resulting wealth of technical detail might make it difficult to draw out the broader implications for operational, legal and regulatory continuity after Brexit.12

1.12. The three issues—scope, specificity and timing—which are explored in sections two to four of this paper represent for some or, possibly, all market participants a possible “cliff-edge” scenario at the point of the U.K.’s departure from the E.U. Those who currently provide services in areas not covered by Third Country regimes will, in the absence of an agreement, lose market access; other financial services providers may find that only a part of their offerings are permitted under Third Country provisions or will be permitted only after a substantial delay. The impact for firms of losing access rights are explored in section five. In section six, the FMLC offers a range of short and long term mitigants which may aid in the resolution of these uncertainties.

1.13. The impact of a “cliff-edge” scenario on the financial system as a whole is not explored in this paper. The FMLC is aware that it is widely inferred that an abrupt de-coupling of markets and financial service providers would lead to a fragmentation of liquidity and credit with consequential increases in costs and volatility, all of which could produce a series of shocks to the financial system.13 A study of possible systemic effects, however, is beyond the scope of this paper. The FMLC notes that in this context, any

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12 Areas not considered, or not considered in detail, in this paper include but are by no means limited to: payment services, mortgage provision, securities depository services, securities settlement, treasury services, spot foreign exchange services, e-commerce and e-money services, trade repository services, audit and accounting services and advising on corporate finance.

13 For example, Federal Reserve Governor, Jerome Powell, has said that “splintering central clearing by currency area”—a reference to the possibility that the clearing of euro derivatives may be forced to relocate from London under newly proposed E.U. legislation—"would fragment liquidity and reduce netting opportunities, which in the case of events like Brexit could actually trigger even greater liquidity risk” (see Powell, “Central Clearing and Liquidity”, speech delivered on 23 June 2017, available at: https://www.federalreserve.gov/newsevents/speech/powell20170623a.htm); and Bank of England Governor, Mark Carney has observed that “[w]hatever is agreed, there are risks to financial stability both in the transition to the new [E.U.-U.K.] relationship and in the new steady state” (see Carney, “The high road to a responsible, open financial system”, speech delivered on 7 April 2017, available at: http://www.bankofengland.co.uk/publications/Documents/speeches/2017/speech073.pdf).
reverberations which may be felt by the U.K. financial system are likely to be experienced by the E.U. financial system too.\textsuperscript{14} A related point of note is that, although this paper considers operational, legal and regulatory uncertainties in relation to access by U.K. financial services providers to the E.U., similar uncertainties will be faced by E.U. financial services providers in seeking access to markets in the U.K.

\textbf{A brief taxonomy of Third Country regimes}

1.14. It is possible to identify four broad categories of Third Country regimes set out in E.U. legislation. These, outlined below, confer on firms in the Third Country—and, thus, in the U.K. following Brexit—varying degrees of permission to engage in cross-border business with the E.U.

i. Third Country regimes which confer access rights for Third Country firms to provide services in the E.U., such as rights for Third Country investment firms to provide services and conduct investment activities with \textit{per se} professional clients and eligible counterparties under Regulation (EU) No 600/2014 on markets in financial instruments ("MiFIR").\textsuperscript{15} Similar rights are codified in respect of clearing services under Regulation (EU) 648/2012 on OTC derivatives, central counterparties and trade repositories ("EMIR").\textsuperscript{16}

ii. Third Country regimes which permit financial products from outside the E.U. to be marketed or sold in the E.U., such as rights for Third Country alternative investment fund managers ("AIFMs") to market Third Country alternative investment funds ("AIFs") under Directive 2011/61/EU on alternative investment fund managers (the "AIFMD").\textsuperscript{17} Under Directive 2001/34/EC on the prospectus to be published when securities are offered to the public or admitted to trading (the "Prospectus Directive"), prospectuses drawn up under the laws of a Third Country can be approved by E.U. competent authorities for

\textsuperscript{14} See Carney, \textit{ibid}, at p.4: “London is Europe’s investment banker…”

\textsuperscript{15} Article 46 of MiFIR provides the general provisions for the provision of services and performance of activities by Third Country firms following an equivalence decision with or without a branch.

\textsuperscript{16} Article 25 of EMIR.

\textsuperscript{17} Articles 35 and 36 of the AIFMD provide the conditions for the marketing in the E.U. of Third Country AIFs by E.U. AIFMs with and without an AIFMD “passport” (for more on which, see paragraphs 2.16 to 2.19).
use in connection with an offer to the public or admission to trading on a regulated market in the E.U.\textsuperscript{18}

iii. Third Country regimes which permit the use of Third Country entities to meet E.U. market conduct obligations, including the use of recognised Third Country CCPs under EMIR to satisfy the mandatory clearing obligation in EMIR and the use of equivalent Third Country trading venues to meet the mandatory trading obligations for shares and derivatives under MiFIR.\textsuperscript{19}

iv. Third Country regimes which permit arrangements with equivalent Third Country entities to be treated in a similar way for prudential purposes to arrangements with E.U. entities: both the treatment of reinsurance contracts with Third Country reinsurers under Directive 2009/138/EC (as amended by Directive 2014/51/EC) on the taking-up and pursuit of the business of insurance and reinsurance ("Solvency II")\textsuperscript{20} and the treatment of risk exposures to certain Third Country entities under Regulation 575/2013 on prudential requirements for credit institutions and investment firms (the "Capital Requirements Regulation" or the "CRR") fall in this category.\textsuperscript{21}

1.15. Other means of classifying Third Country regimes include a categorisation according to either: (i) the nature of the requirements that must be satisfied under the regime before a firm in the Third Country is able to provide services or to carry on activities within the E.U.; or (ii) the nature and freedom conferred once those requirements are satisfied. As to the latter, in some cases, Third Country provisions bestow upon the Third Country rights very similar to those encoded in the "passporting" regime applicable to E.U. Member States. In other cases, the Third Country regimes provide for only very limited rights of access.\textsuperscript{22}

1.16. As to the nature of the requirements that must be satisfied, there is a diverse range of provisions, including, but not limited to, the following.

\textsuperscript{18} Article 20 of the Prospectus Directive.

\textsuperscript{19} Article 28 of MiFIR

\textsuperscript{20} Article 227(1) of Solvency II

\textsuperscript{21} Article 107(3) of the CRR provides that exposures to Third Country investment firms, credit institutions or clearing houses and exchanges shall be treated in a manner similar to exposures to E.U. entities only if the Third Country applies prudential and supervisory requirements to that entity that are at least equivalent to those applied in the E.U.

\textsuperscript{22} Paragraphs 2.1 to 2.5 below.
i. Access is most often, but not always, subject to the Third Country’s ability to prove that its legal, regulatory and oversight regimes meet the requirements and thresholds set by the E.U. in relation to the activity in question. When this condition is met to the satisfaction of the European Commission, the Third Country is considered to be “equivalent” to the E.U. and is said to benefit from a positive equivalence determination. In some cases, for example with regards to clearing services, the equivalence determination must be made not only in respect of the applicable domestic regulation but also in respect of tangentially-related laws, such as those facilitating mutual recognition;23

ii. In some cases the undertaking must also show that it is authorised in the jurisdiction in which its head office is established and prove that it is subject to effective supervision in that jurisdiction;

iii. Third Country firms may be required to submit disputes to the jurisdiction of a court or tribunal in a Member State;

iv. Some regimes impose a requirement for a supervisory cooperation agreement between the home regulator and the European Securities and Markets Authority (“ESMA”) in addition to an equivalence requirement;

v. Several Third Country regimes require individual undertakings to register with ESMA, normally in conjunction with an equivalence requirement and other requirements listed above;

vi. CCPs and (in future) central securities depositories are required to go further than mere registration and obtain recognition from ESMA. Recognition will depend on the service provider satisfying several of the independent requirements listed above;

vii. In one case (i.e. non-systemically important credit ratings provided by Third Country credit rating agencies), services may be subject to an E.U. certification requirement in addition to several of the requirements listed above;

viii. The AIFMD, which will apply in the future to alternative investment funds and their managers, relies on the concept of a “Member State of Reference” and

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23 Article 25(6) of EMIR provides that, in addition to any legal and supervisory oversight requirements, the Third Country from which a CCP seeks access to the E.U. must also provide for an equivalent system for the recognition of E.U. CCPs.
requires fund managers to obtain full authorisation, under prescribed conditions, from the competent authority in that Member State.

ix. The concept of a “Member State of Reference” also makes an appearance in relation to services provided by Third Country benchmark administrators under the Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (the “Benchmarks Regulation”). A Third Country benchmark administrator which does not benefit from a positive equivalence requirement (or from an endorsement) will be required to obtain recognition under Article 32 from the competent authority of its Member State of Reference if it wishes the benchmark to be used by supervised entities in the E.U.;

x. In certain financial services sectors, Third Country provisions may stipulate that, if access is possible at all, the Third Country firm must satisfy discretionary national requirements for so-called “direct authorisation” (i.e. authorisation to conduct business through a branch established in the Member State in question) or apply for full authorisation on the basis of subsidiarisation within the Member State.

A preliminary question

1.17. This paper is concerned with the legal uncertainties relating to the ability of U.K. financial services firms to continue to provide services to, and conduct activities with, E.U.-based customers following Brexit. It is not always clear, however, whether the level of a firm’s engagement with its clients amounts to “providing services” or, mutatis mutandis, amounts to “carrying on activities”. For instance, it may be doubted whether the existence of a policyholder in a Member State of the E.U. necessarily gives rise to the inference that the insurer in question is “carrying on” insurance business in that Member State. One factor which inevitably contributes to this ambiguity is the nature of financial services and activities themselves: they are often carried on remotely, on a cross-border basis and by means of electronic media, which means that identifying a locus for the provision of the service is challenging.

1.18. There is very little regulatory guidance dealing with this issue. The European Commission published an interpretative communication in 1997 entitled “Freedom to Provide Services and the Interest of the General Good in the Second Banking

24 As to endorsement, see Article 33 of the Benchmarks Regulation.
Directive” (the “1997 Interpretative Communication”), which addressed, *inter alia*, the question of when a Member State was entitled to prevent a firm from exercising the freedom to provide services from another Member State. The analysis necessarily involved an assessment of when a credit institution would be considered to be providing services “within the territory of another Member State”. The Commission’s preferred approach relied on a concept of “characteristic performance”, which led to the interesting observation that the provision of banking services through the internet “should not, in the Commission’s view, require prior notification” to the host Member State. While this provides an insight into the European Commission’s decision-making process, the FMLC recognises that the guidelines are two decades old and that it is far from clear whether the approach and conclusions in the 1997 Interpretative Communication would be applied in the context of Brexit. Further analysis on this is beyond the scope of this paper. What is clear, however, is that, in some circumstances, there are significant legal complexities and uncertainties in determining whether access rights are required at all.

A word about scope

1.19. Beyond the threshold question mentioned above, there are a great many legal intricacies involved in considering how Third Country regimes might apply to firms in the U.K. when Brexit materialises. This paper aims to highlight some of these complexities but it is beyond the scope of this paper to explain the complicated web of issues which arise across the field of financial services as a whole.

1.20. Any difficulties faced by U.K. firms as a result of these intricacies will depend upon the legislation and the regime in question but they can include the following issues for particular financial services sectors.

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27 European Commission staff have acknowledged the heterogeneity of equivalence regimes:

Each [equivalence] provision tends to follow the logic of the legal act it belongs to, presenting challenges to third-country authorities who may wish to seek commonality with EU equivalence procedures under different pieces of EU legislation.

i. **Limited or no coverage**: the applicable E.U. legislation may not, in fact, contain provisions allowing firms from a Third Country to offer the cross-border services in question into the E.U.;

ii. **Interpretative uncertainty**: the Third Country regime and the applicable assessment criteria, may be subject to varying interpretations;

iii. **Non-compliant supervisory practices**: A Third Country may be able to demonstrate a broadly compliant framework of laws and regulations and yet be unable to satisfy E.U. legal requirements as to supervision and control (usually involving a requirement as to enhanced supervisory cooperation with the E.U.);

iv. **Falling short in practice**: even if its own legislative and regulatory rules are broadly consistent with the requirements of the E.U. law in question, firms’ compliance records and/or regulators’ enforcement records may not establish that those standards are, in fact, adhered to.

v. **Changes required**: the Third Country may be required to make changes to its legislation or supervisory practice in order to fulfil the requirements of the Third Country regime, in which case the question arises whether it is able and prepared to do so, and within the stipulated timeframe;

vi. **Lengthy timetable**: the (often prolonged) timetable for assessing equivalence or the fulfilment of other criteria specified by the Third Country regime is potentially disruptive and the risk arises that changes will occur either to the E.U. legislation or to the Third Country regulatory framework during the assessment period;

vii. **Lack of clarity as to the role of the European Supervisory Authorities (the “ESAs”)**: existing Third Country regimes do not offer a coherent or consistent answer as to what the role of the ESAs should be in Third Country assessments;\(^\text{28}\)

viii. **Discretion on the part of the European Commission in applying the criteria**: where it has a role to play, for example in relation to an equivalence decision, the European Commission adopts a risk-based approach to assessments and observes the principle of proportionality in the application of the necessary criteria, applying the legislative standard according to the specific features of

\(^{28}\) *Ibid*, at p.11.
each individual case. This inevitably implies a degree of discretion on the part of the European Commission and makes outcomes hard to predict;

ix. **Possible imitations on the scope of the approval granted:** where the Third Country regime does depend upon an assessment or decision by the European Commission (e.g. as to equivalence), there may be difficulty caused by the limited extent of the approval granted, which may: (1) cover only some part of the activities falling within the scope of the legislation; (2) be dependent upon fulfilment of some prior condition(s) at the U.K. level; or (3) be time limited;

x. **Withdrawal of approval:** not only may the initial approval be limited but it is clear that it may—at least in the case of an equivalence decision—be withdrawn at any time; and/or

xi. **Additional firm-specific requirements:** several Third Country regimes set out specific requirements for individual firms, including licensing, certification, registration and/or even authorisation requirements. In some cases these are in addition to an assessment or approval—e.g. a positive equivalence decision—which must first be granted to the Third Country as a whole.

1.21. Many of the complexities listed above are paradigmatically illustrated by the process of reaching an equivalence decision. Earlier this year, the European Commission published a Staff Working Document providing an overview of the E.U. equivalence framework for financial services (the “**European Commission Staff Paper**”), acknowledging the heterogeneity of equivalence regimes across regulations and across business sectors, identifying some of the challenges the regimes pose for Third Country authorities and noting the impermanence and mutability of the decisions themselves.

1.22. It is important to note the policy underlying the availability of equivalence, which is underscored in the European Commission Staff Paper: the European Commission views equivalence as a tool to benefit and protect E.U. market participants and not a vehicle for liberalising international trade in financial services. Accordingly the European Commission Staff Paper states that equivalence is:

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29 Ibid, at p. 8.

30 As to withdrawal, see ibid at pp. 9-10. In the case of the U.K., this means that Third Country regimes cannot offer the long-term security of the “passport” to which the U.K. is entitled qua Member State.

31 Supra, references at n. 27.
a key instrument to effectively manage cross-border activity of market players in a sound and secure prudential environment with third-country jurisdictions that adhere to, implement and enforce rigorously the same high standards of prudential rules as the E.U.

It goes on to explain that the purpose of an equivalence decision is to achieve one or more of the following:

i. reduce or even eliminate overlaps in compliance for the E.U. entities concerned and in the supervisory work of E.U. competent authorities;

ii. allow the application of a less burdensome prudential regime in relation to E.U. financial institutions’ exposures to an equivalent Third Country; and

iii. provide E.U. firms and investors with a wider range of services, instruments and investment choices originating from Third Countries.32

1.23. The nature and features of the process by which the European Commission reaches an equivalence determination are discussed in greater detail in section three below.

2. THE RANGE AND EXTENT OF THIRD COUNTRY REGIMES

2.1. A number of E.U. financial services regulatory instruments do not, as noted in paragraph 1.8 above, provide for access by Third Country firms at all, leaving financial services groups to establish fully authorised subsidiaries in the jurisdiction(s) where they wish to carry on activities (as to which, see below). Thus, for instance, there is no regime covering the marketing and sale to retail investors of units issued by Third Country undertakings for collective investment in transferable securities (“UCITS”) under Directive (2009/65/EC) on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast) (the “Recast UCITS Directive”).33 There is

32 European Commission Staff Paper, at p. 5.

33 Various provisions of the Recast UCITS Directive, however, provide that E.U. UCITS may themselves invest in Third Country collective undertakings, provided that those undertakings are subject to equivalent supervision and regulation vis-a-vis unit-holders in their home jurisdiction. See, for example, Article 50(e). Moreover, Third Country UCITS may be marketed under certain conditions to professional investors in the E.U. under the AIFMD.
also no legislative provision for access to E.U. markets in the case of insurance mediation and distribution.  

2.2. Certain other activities, some of which were also mentioned in paragraph 1.8 above, offer a more restrictive Third Country regime by which firms may obtain access not to the single market as a whole but to E.U. Member States on a country-by-country basis. Solvency II, for example, requires that an insurer must seek authorisation from a competent authority in an E.U. Member State in order to carry on insurance business there, and in order to apply for authorisation it must establish a branch in the territory of the Member State in question. The provisions relevant to these sectors are considered in paragraphs 2.20 to 2.22 below.

2.3. Typically, however, Third Country regimes provide some kind of “gateway” to the single market for Third Country firms which satisfy the threshold requirements laid down in the legislation. The best known and most widely analysed of these threshold requirements is that the firm should be able to demonstrate a positive “equivalence” decision by the E.U. Commission with respect to the Third Country regulatory framework. According to the European Commission Staff Paper, 15 E.U. legislative acts relevant to the financial markets contain an equivalence regime.

2.4. Thus Third Country regimes providing a gateway to the single market are available for certain types of market infrastructure providers such as CCPs and benchmark administrators. Access to wholesale customers in the E.U. will be available, from 2018, for Third Country firms wishing to provide core investment services under MiFIR; and Third Country issuers who wish to market securities in the E.U. may do so if they satisfy the requirements of the Third Country regime set out in the Prospectus Directive. In each of these sectors, an equivalence threshold test is incorporated into

34 Insurance intermediation is governed by Directive 2002/92/EC on insurance mediation (the “Insurance Mediation Directive” or the “IMD”), which will be replaced from 23 February 2018 by Directive (EU) 2016/97 on insurance distribution (recast) (the “Insurance Distribution Directive” or the “IDD”). Both measures provide no means of access for Third Country insurance intermediaries.

35 Article 162 of Solvency II.


37 Paragraphs 2.12 to 2.15 and paragraph 2.23.

38 Paragraph 2.10.

39 Paragraphs 2.24 to 2.28.
Collectively, the legislative measures which comprise the E.U. framework for Third Country access to the single market offer patchy coverage, at best. In January 2017, the International Regulatory Strategy Group, in collaboration with Hogan Lovells International LLP, produced a report entitled *The E.U.’s Third Country Regimes and Alternatives to Passporting* (the “IRSG Report”), which considered the scope of existing Third Country regimes, the challenges which might be faced by British financial services providers in order to make use of Third Country regimes, and the processes for securing access under such existing regimes. The IRSG Report concluded that Third Country regimes only cover a narrow range of activities and may not sufficiently obtain the “maximum possible access” to E.U. markets that is expressed to be the objective of HM Government in the context of Brexit. Accordingly, financial markets participants have expressed concern that it will not be possible to provide a significant proportion of U.K. business lines currently provided into the E.U. under any existing Third Country regime, even assuming that threshold tests as to equivalence are satisfied under such regimes. These concerns give rise both to operational and legal uncertainty about the conduct of existing (“legacy”) business, which is addressed in section five of this paper.

In the subsections below, the FMLC sets out a few key sectors for which Third Country access is limited and gives details of the ways in which the restrictions apply.

**Banking**

2.7. The “CRD IV Package” is a suite of E.U. legislation establishing prudential rules for banks, building societies and investment firms, most of which have applied since 1 January 2014. The two primary measures in the CRD IV Package are: Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (the “Capital Requirements
Directive”) and the CRR. The prudential requirements established by the CRD IV Package are treated by national competent authorities in the E.U. as conditions for continuing authorisation and permission to carry on certain banking activities, including deposit-taking, lending, payment services, issuing other means of payment (e.g. travellers’ cheques) and issuing e-money. The firm’s ability to meet the requirements will be subject to regular supervisory assessment and a breach, or a threatened breach, of the requirements may be grounds for withdrawing authorisation and/or a determination that the institution in question has reached the point of non-viability and should be resolved under the E.U.’s bespoke restructuring regime for failing banks.

2.8. Title V of the Capital Requirements Directive establishes the basic single market “passport” for banking services in the E.U. Article 33 provides that a Member State must allow banks based in other E.U. Member States to establish a branch and/or to provide services directly into their jurisdiction. There is no comparable passport for Third Country institutions: the CRD IV Package does not create a gateway for access by Third Country banks to the E.U. Article 47 of the Capital Requirements Directive, however, recognises that a Member State can, at its discretion, permit Third Country banks to establish branches in its territory with the caveat that the regulation and supervision of Third Country branches must be equivalent, if not more stringent, to that of branches established by banks from other Member States. With a view to harmonising the treatment of Third Country banks, Article 47(3) records that the E.U. may negotiate an agreement with a Third Country which would ensure that branches of banks from that country are treated in the same manner in different Member States across the E.U.

Investment Services

2.9. Several of the banking activities listed in Annex I of the Capital Requirements Directive are also investment services for the purposes of Directive 2004/39/EC on markets in financial instruments (“MiFID”). In the case of these and other investment services,

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43 These activities are listed in Annex I of the Capital Requirements Directive.

44 Article 18(d) of the Capital Requirements Directive and also Article 32(4) of Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms (the “BRRD”), where one of the grounds for resolution is that the institution in question infringes, or will infringe in the near future, the requirements for continuing authorisation.

45 Article 47(1) of the Capital Requirements Directive.

46 Annex I, sections A and B, of both MiFID and MiFID II. Examples of overlap with the activities listed in Annex I of the Capital Requirements Directive include but are not limited to: trading in financial instruments for the account of customers; portfolio management; underwriting securities issues; and (on an ancillary basis): advising on mergers and acquisitions; foreign exchange services; custodianship and the safekeeping of securities.
Third Country banks and other Third Country providers may be able to benefit from the access provisions set out in the “MiFID II Package”, a suite of E.U. legislation establishing market conduct rules for investment services providers, which will apply from 3 January 2018. The primary measures in the MiFID II Package are Directive 2014/65/EU on markets in financial instruments (“MiFID II”) and MiFIR.

2.10. Article 46 of MiFIR also provides a gateway mechanism for Third Country access whereby Third Country firms can register with ESMA in order to provide services to eligible counterparties and per se professional investors in the E.U. on a cross-border basis. This provision is dependent on, among other supplementary requirements, the adoption by the European Commission of an equivalence decision, in accordance with Article 47(1) of MiFIR, which states that the Third Country’s legal and supervisory arrangements align with those of the E.U. For the three years that follow the adoption of an equivalence decision under Article 47(1), Third Country firms may either register with ESMA or, in the alternative, continue to conduct investment services business with eligible counterparties or professional clients in compliance with Member States’ national regimes, by virtue of transitional provisions set out in Article 54 of MiFIR.

2.11. Under Article 39 of MiFID II, Member States may require that Third Country firms intending to provide investment services to retail and elective professional clients within the territory establish a branch within the jurisdiction. This provision means that Member States may choose not to require establishment of a branch to provide services in this way, and may choose to allow services to be provided on some other basis. Article 39 sets out certain requirements with which a branch of a Third Country firm will have to comply in order to be authorised by the national competent authority. Where a Member State implements MiFID II to require the establishment of branches, a Third Country firm that has not established a branch in that Member State will not be able to provide investment services to retail clients or elective professional clients. Where a Member State does not implement the requirement to establish a branch, the provision of services to retail clients and elective professional clients will be subject to existing national law and regulation. The U.K. has decided to retain its “overseas persons exemption” in Article 72 of the Financial Services and Markets Act 2000 (Regulated Activities) Order (SI 2001/544, the “RAO”)—allowing Third Country firms to provide services to U.K. clients without needing to establish a branch—but this approach is by no means uniform across the European Union.

47 MiFID does not contain any provisions on Third Country access, leaving the decision on whether to provide access to each Member State’s discretion.
2.12. The list of investment services regulated by the MiFID II Package includes the activity of operating a Multilateral Trading Facility (“MTF”) or an Organised Trading Facility (“OTF”). These services are subject to the same market access regime for Third Country providers as other investment services listed in Annex I of MiFID II. An MTF or OTF operator in a Third Country will also be able to request access to E.U. CCPs, provided that the European Commission has adopted a decision stating that the legal and supervisory framework for trading venues in that Third Country is equivalent to the requirements for trading venues under MiFIR. There is no Third Country Regime for the provision into the E.U. markets of trading platform services other than by means of an MTF or OTF.

2.13. Third Country firms that act as CCPs benefit from access provisions in two key E.U. regulatory measures—EMIR and MiFIR. Article 25 of EMIR provides for access to E.U. markets if the Third Country CCP satisfies a number of requirements, including a positive equivalence determination by the European Commission vis-à-vis the regulatory and prudential framework for CCPs in the Third Country in question. A Third Country CCP whose jurisdiction has been granted equivalence in this way will obtain access across the E.U. by virtue of it subsequently being “recognised” under Article 25(2) of EMIR by ESMA.48 It will thereby also attain the status of “qualifying central counterparty” for the purposes of favourable treatment of its clearing participants’ own funds requirements for CCP exposures under the CRR.49

2.14. In addition to the provisions for CCPs under EMIR, Third Country CCPs may also benefit the following provisions under MiFIR.

i. **Access to trading venues**: under Article 38(1) of MiFIR, a CCP established in a Third Country may request access to a trading venue in the E.U. subject to that CCP being recognised under Article 25 of EMIR. In addition, it is required that the Commission adopt a decision with regards to the legal and supervisory framework of the Third Country in accordance with Article 38(3) of MiFIR, confirming that it provides an effective equivalent system for permitting CCPs and trading venues authorised under foreign regimes access to CCPs and trading venues established in that Third Country.

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48 Third Country CCPs granted EMIR Article 25(2) recognition status by ESMA are listed on the ESMA website.

49 Article 4 of EMIR.
ii. **Access to trade feeds**: Third Country CCPs which have been recognised by ESMA under EMIR will also be granted the non-discriminatory access to trade feeds from trading venues as guaranteed to E.U. CCPs by Article 36 of MiFIR.

iii. **Access to E.U. benchmarks**: similarly, Third Country CCPs which have been recognised by ESMA under EMIR will be granted non-discriminatory access to E.U. benchmarks as guaranteed to E.U. CCPs by Article 37 of MiFIR. The Third Country CCP is required to apply to the benchmark administrator itself for a licence to use the benchmark.

2.15. The European Commission has recently published proposed amendments (the “**EMIR Review Proposal**”) to the EMIR Third Country regime for CCPs in the context of the debate about London’s status as a clearing hub for euro-denominated derivatives after Brexit. Proposed amendments to Articles 6 and 25 and a new Article 25a are designed to bolster the EMIR Third Country regime in the following ways, among others:

i. to enhance the implementation of the equivalence criteria by allowing the European Commission to specify the applicable criteria by means of a delegated act, adding further conditions to those set out in EMIR;\(^{51}\)

ii. to provide for the classification by ESMA of Third Country CCPs as systemically important or non-systemically important;\(^{52}\)

iii. to lay down four criteria—which are subject to further specification by the Commission—for the classification of Third Country CCPs as systemically important;\(^{53}\)

iv. to stipulate additional conditions for the recognition of systemically important Third Country CCPs;\(^{54}\)

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51 New Article 25(6a).

52 New Article 25(2)(e)

53 New Article 25(2a).

54 New Article 25(2b).
v. to introduce a system of “comparable compliance” vesting ESMA with powers—similar to the powers of U.S. regulators to recognise “substituted compliance”—to allow a Third Country CCP to rely on its compliance with the regulatory framework of the Third Country in question;\(^55\)

vi. to allow ESMA to determine, in agreement with E.U. central banks, that the risks posed by a Third Country CCP are of such magnitude that the CCP should not be recognised at all;\(^56\)

vii. to empower the European Commission to take a decision that a Third Country CCP should not be recognised as such and should only be allowed to provide clearing services on the basis of establishment in a Member State and full authorisation;\(^57\)

viii. to specify that ESMA must keep the recognition of Third Country CCPs under regular review;\(^58\) and

ix. to add a requirement that cooperation arrangements with Third Country regulatory authorities must be effective in practice\(^59\) and should allow on-site inspections by ESMA and “the central bank(s) of issue”.\(^60\)

**Investment Funds and their Managers**

2.16. The AIFMD does not establish an equivalence regime in the manner of the regime for CCPs under Article 25 of EMIR. Instead it provides two regimes for access to the E.U. market by Third Country AIFMs:\(^61\) (i) Article 42 which sets out the minimum conditions which E.U. Member States must apply in order to allow a Third Country AIFM to carry on marketing activities in respect of any AIF without an AIFMD

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\(^{55}\) New Article 25a.

\(^{56}\) New Article 25(2c).

\(^{57}\) *Ibid.*

\(^{58}\) New Article 25b.

\(^{59}\) New Article 25(7).

\(^{60}\) New Article 25e.

\(^{61}\) The term “non-E.U.” is used throughout the AIFMD but E.U. institutions have subsequently adopted the term “Third Country” when speaking about non-E.U. AIFs. This paper adopts “Third Country” in relation to such AIFs and AIFMs for the sake of internal consistency.
“passport”;62 and (ii) Articles 37 and 39 to 41 which in aggregate provide for the authorisation of Third Country AIFMs intending to market and manage E.U. or Third Country AIFs with an AIFMD “passport”. Articles 35 and 36 govern the situation in which an E.U. AIFM wishes to carry on marketing activities in respect of a Third Country AIF and apply to situations in which the AIFMD “passport” is either available (Article 36) or unavailable (Article 35).

2.17. Article 42 of the AIFMD provides the national private placement regimes (“NPPRs”), by which individual Member States may allow Third Country AIFMs to market AIFs to professional investors in their territory subject to certain conditions (as to which, see paragraphs 3.23 to 3.24 below). The marketing to professional investors in the E.U. of Third Country AIFs by Third Country AIFMs is also governed by Article 42 of the AIFMD. Third Country AIFMs must comply with each Member State’s individual regime when they market AIFs in that country.

2.18. The AIFMD provides for a second and separate regime under which, after a transitional period and the entry into force of a delegated act by the European Commission, a harmonised firm-specific “passport” regime is to become applicable to: (i) Third Country AIFMs performing management and/or marketing activities within the E.U.; and (ii) E.U. AIFMs managing Third Country AIFs. The requirements of this regime are set out in Article 37 and Articles 39 to 41 of the AIFMD. In this context, the term “passport” refers not to Member States’ access to the single market but rather to the stringent regulatory framework for the activities of Third Country AIFMs which establishes the conditions subject to which a Third Country AIFM can obtain an authorisation to manage E.U. AIFs and/or to market AIFs to professional investors in the E.U. In other words, rather than a liberalising measure for international trade in fund management services, it is a licensing measure which requires Third Country AIFMs to submit an application for authorisation in the E.U. This regime is, however, not yet in application.

2.19. Unlike the AIFMD, the Recast UCITS Directive does not contain provisions establishing access for Third Country providers. This means that Third Country UCITS cannot be marketed in the E.U. as retail funds. They may, however be marketed, under the conditions outlined above, to professional investors as alternative investment funds under the AIFMD.

62 On a point of disambiguation, the AIFMD Third Country “passport” is to be distinguished from the so-called single market “passport” which Member States of the E.U. enjoy by virtue of their membership. For further details, see paragraph 2.18.
Insurance and reinsurance

2.20. Solvency II implements the main framework for insurance and reinsurance regulation throughout the E.U. While Solvency II contains the concept of equivalence, it does not provide for cross-border access in a uniform manner. Article 162 specifically states that the provision of direct insurance within the E.U. by a Third Country insurer must be subject to local authorisation through a branch in each Member State in which it wishes to write business. There is no consistent approach relating to the treatment of cross-border services business (often referred to as "non-admitted" insurance) from outside the E.U. In some E.U. states, the prudential regime may be triggered when a Third Country firm covers risks located in the state in question but has no other presence there; in others, an on-going presence is required before any regulatory authorisation becomes necessary.

2.21. The equivalence provisions in Solvency II only apply in the following three contexts, none of which relate to mutual access.

i. **Reinsurance provided by a Third Country reinsurer**: under Article 172 of Solvency II, reinsurance contracts between an E.U. cedant and a Third Country reinsurer which is located in a jurisdiction whose solvency regime is assessed to be equivalent for the purposes of Article 172 must be treated in the same manner as if the contract were concluded with an E.U. reinsurer.

ii. **Group solvency**: Article 227 provides that where a Solvency II group contains a Third Country (re)insurer which is located in a jurisdiction whose solvency regime is assessed to be equivalent for the purposes of Article 227, the group may apply to use local rules for the Third Country (re)insurer in their group capital calculations carried out under the deduction and aggregation method rather than having to apply Solvency II rules to the Third Country (re)insurer.

iii. **Group supervision**: under Article 260, where a Solvency II group is headquartered in a Third Country which is assessed as having a system of group supervision that is “equivalent” to that operated under Solvency II, E.U. supervisors must rely on the supervision of that group at a worldwide level by the national supervisor in that jurisdiction. This does not, however, prevent E.U. regulation at a European sub-group level.

2.22. Insurance intermediation is currently subject to a single market “passport” throughout the E.U. under Directive 2002/92/EC on insurance mediation (the “Insurance
Mediation Directive” or the "IMD”). This will be replaced from 23 February 2018 by Directive (EU) 2016/97 on insurance distribution (recast) (the “Insurance Distribution Directive” or the "IDD"). There is no Third Country regime under either measure that provides a means of access for Third Country insurance intermediaries.

Benchmark Administrators

2.23. The Benchmarks Regulation will become applicable in January 2018, following which financial institutions in the E.U. will only be able to use benchmarks registered with ESMA. For Third Country administrators, registration is only possible on the basis of: (i) a positive equivalence decision; (ii) recognition by the competent authority in the administrator’s “Member State of Reference”; or (iii) endorsement by an E.U. administrator, with full authorisation, of the benchmark(s) which it provides. The Benchmarks Regulation lays down, in Articles 32 and 33, specific requirements which must be fulfilled for either recognition or endorsement to occur and which may, in part, be satisfied by demonstrating compliance with certain international standards.63

Issuers

2.24. The Prospectus Directive has established common and enhanced standards for the issue of securities within the E.U. and also permits the “passporting” of a prospectus which has been approved by an E.U. Member State’s competent authority across the E.U. Under certain circumstances, a prospectus issued by a Third Country issuer under the laws of a Third Country may also be approved by the competent authority of an E.U. Member State and then “passported” into other Member States.64

2.25. Specific provisions for issuers registered in a Third Country are established by Article 20 of the Prospectus Directive. These provide that the competent authority of the “home Member State” of the issuer in question can approve a prospectus for an offer to the public or for admission to trading on a regulated market in the E.U., subject to certain additional requirements relating to disclosure and information.65 Here, “home Member State” is defined as the Member State where the issuer has its “head office” or “principle business location”.

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64 On a point of disambiguation, “passport” here refers to the means by which a prospectus can be approved in one Member State and relied upon by the issuer in other Member States for the purposes of a public offering or for admitting securities to trading. It is to be distinguished from the single market passport which is available to Member States by virtue of their membership of the E.U. The use of the term in relation to prospectuses can be seen, for example, in an opinion given by ESMA on the “Framework for the assessment of third country prospectuses under Article 20 of the Prospectus Directive”, (20 March 2013), available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-317.pdf.

65 These are discussed further below in paragraph 3.46.
State” is a concept not entirely dissimilar to that of “Member State of Reference” in other E.U. measures and, according to the definition in Article 2, means, very broadly, the Member State where the securities are intended to be offered to the public by the issuer for the first time or where the first application for admission to trading on a regulated market is made, subject to an element of election on the part of the Third Country issuer.

2.26. Currently, the U.K. Listing Authority (“UKLA”), which is part of the Financial Conduct Authority (“FCA”), is the competent authority in the U.K. and can approve Prospectus Directive-compliant prospectuses for Third Country issuers whose “home Member State” is the U.K. Once the U.K. leaves the E.U., approval granted by the UKLA will no longer enable the provision of such prospectuses in the E.U.

2.27. There are, however, a number of exemptions in the Prospectus Directive from the requirement to prepare a Prospectus Directive-compliant approved prospectus.66 Where an offer of securities falls within an exemption, it may be possible to use a Third Country prospectus or similar offering document within the E.U. One exemption is available where the offer is made solely to “qualified investors”.

2.28. A new Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market (“PD III”), which repeals the Prospectus Directive, enters into force on 20 July 2017 and will apply from July 2019. Chapter VI of PD III establishes specific rules in relation to issuers established in Third Countries and provides two means by which a prospectus drawn up by an issuer established in a Third Country may form the basis of an offer of securities in the E.U.:

(a) by virtue of Article 28, a Third Country issuer intending to offer securities to the public in the E.U. and to seek admission to trading on an E.U. regulated market may draw a prospectus up in accordance with PD III and seek approval of its prospectus from the competent authority of its “home Member State”. Once such approval is received, the prospectus will entail all the rights and obligations provided for a prospectus under PD III; and

(b) under Article 29—which is set out in terms very similar to those in Article 20 of the Prospectus Directive—the competent authority of a Third Country issuer’s

66 These exemptions are listed in Article 4 of the Prospectus Directive.
“home Member State” can also approve a prospectus drawn up under the laws of the Third Country. In these circumstances it must apply requirements similar to those laid down in Article 20 of the Prospectus Directive and also satisfy itself that it has concluded adequate cooperation arrangements with the relevant supervisory authorities of the Third Country in question.

3. SPECIFICITY OF THRESHOLD CONDITIONS

3.1. In section two, above, two broadly different approaches to Third Country access were observed in E.U. legislation: a restrictive, country-by-country approach relying on authorisation for market participants in Member States; and a “gateway” approach relying on threshold requirements which, if satisfied, allow a Third Country firm to obtain access to the single market. One characteristic which is common to both approaches is the need for a decision by European authorities. Another is predictive uncertainty about the progression, timing and detail of the decision-making process.

3.2. As far as authorisation is concerned, an Opinion published by ESMA in May 2017, which provides to the national competent authorities of E.U. Member States nine general principles to support supervisory convergence in the context of Brexit (the “2017 ESMA Opinion Paper”), provides some indication of the likely approach.67 It offers, even at a liberal reading, a disappointing response to those who argue that the U.K.’s withdrawal from the E.U. need not adversely affect regulatory continuity. For instance, principle one provides that existing authorisations of U.K.-based entities will not automatically be recognised in the 27 remaining E.U. Member States upon Brexit.68 Even though the U.K. will remain a Member of the E.U. until at least 29 March 2019, authorisations granted by the Prudential Regulation Authority or the FCA in the two intervening years will not be automatically recognised.

3.3. The 2017 ESMA Opinion Paper also encourages competent authorities to scrutinise applicant firms’ governance structures, human and technical resources, geographical distribution of activities, outsourcing and delegation arrangements. ESMA encourages competent authorities to verify the objective reasons for relocation, warns against the

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68 Ibid, at p. 3.
establishment of letterbox offices and sets out stricter conditions for the outsourcing and
degregation of business to Third Countries. 69 Given that assessments of equivalence are
sometimes performed by the European Commission on the basis of technical advice
from European supervisory agencies, 70 including ESMA, it is not unreasonable to
expect ESMA’s strict stance on the authorisation of relocating entities to be replicated in
reference to equivalence assessments vis-à-vis the U.K.

3.4. The European Commission Staff Paper referred to in section one above makes it clear
that each equivalence decision is not only discretionary but may also be changed or
rescinded at any time by the Commission. 71 This discretionary element and the risk
that the decision will be rescinded necessarily contribute to the difficulty that Third
Country firms and authorities have in assessing the likelihood of obtaining access to
E.U. markets by this route.

3.5. A significant proportion of the predictive uncertainty experienced by Third Country
authorities and firms is attributable to the European Commission’s normative approach
to the assessment process, which is described in the European Commission Staff Paper
as “risk-based” and guided by the “principle of proportionality”. 72 When seeking to
determine whether a Third Country’s regulatory system might be compliant with its
own, the European Commission first identifies risks to which the E.U. financial system
might be exposed by granting equivalence to the Third Country. The assessment is
undertaken in respect of those particular risks. Although equivalence provisions are
tailored to the needs of each specific act, the European Commission’s assessment with
regards to a particular Third Country’s framework may look beyond the prescribed
technical solutions and the decision may be taken to ensure regulatory objectives and
protect the E.U. financial system from the risks identified.

3.6. Crucially, as the European Commission Staff Paper points out, the interconnectedness
of the Third Country’s market with the E.U. financial market, and thus also its share of

69 Principles 2 to 5, in ibid, at pp. 3-5.
70 European Commission Staff Paper, at p.8. Alternatively, the European Commission’s equivalence assessment process may
begin by a consideration of recommendations from international organisations, public bodies or stakeholder organisations.
71 Ibid, at p. 7.
72 Ibid, at p. 8.
the single market, form integral components of the risk exposures which need to be addressed.73

3.7. The legislation that embodies the equivalence requirement may itself prescribe the characteristics by which equivalence is to be assessed. In addition to a broad alignment of regulatory rules, it may require any or all of the following: (i) an alignment of incidental rules (e.g., on the conflict of laws);74 (ii) an alignment of prudential standards to support an equivalence decision on conduct regulation (and vice versa);75 (iii) close coordination of supervisory practices;76 and/or (iv) adherence by the Third Country in question to shared international commitments and standards.77 In this regard, the prevalent equivalence requirement that Third Country frameworks demonstrate “effective supervision and enforcement”78 in their jurisdiction gives rise to particular difficulty. There is little guidance in the relevant regulations themselves about how the European Commission might judge a supervisory authority “effective” for these purposes.

3.8. An equivalence decision is, in any event, only the beginning of the process by which Third Country firms may gain access to E.U. markets. Where the European Commission has made a positive equivalence decision, an implementing act must be confirmed by a regulatory committee, which contains representatives of Member States, and adopted. Thereafter, the firms are likely to have to satisfy a range of other criteria or threshold tests, of which typical examples are given for the purpose of illustration in paragraph 1.16 above.

3.9. Below, this paper continues the discussion, which began in section two, of the Third Country threshold requirements established for certain key industry sectors. Section two provided an introduction to each regime and an outline of its scope. The paragraphs below provide further detail, highlighting technical differences among the various regimes and the specificity and exacting nature of the requirements themselves.

73 European Commission Staff Paper, at pp. 8-9.
74 See, for example, Article 25(6) of EMIR. For more on which, see also paragraph 3.19.
75 Article 25(2) of EMIR.
76 See, for example, Article 30(2) of the Benchmarks Regulation.
77 Article 30(2)(a) of the Benchmarks Regulation.
78 Article 30(2)(b) of the Benchmarks Regulation.
**Investment services**

3.10. Under MiFID II, Member States may allow Third Country firms to provide services from a branch in that Member State where it determines that: (i) the relevant firm is subject to authorisation and supervision in its home country; (ii) the Third Country pays due regard to any Financial Action Task Force ("FATF") recommendations on anti-money laundering and countering terrorist financing; (iii) there are appropriate cooperation agreements in place between the competent authorities of the Member State and the relevant Third Country; and (iv) the relevant Third Country has signed an tax exchange agreement, which is compliant with standards set by the Organisation for Economic Cooperation and Development ("OECD"), with the relevant Member State. The decision on whether the Third Country framework meets these requirements is, therefore, taken by each relevant E.U. Member State under MiFID II.79

3.11. Under MiFIR, Third Country firms can seek to be registered with ESMA, as discussed in paragraph 2.10 above, where the European Commission has adopted an equivalence decision. This requires the Commission to determine that the legal and supervisory arrangements of the relevant Third Country ensure that firms comply with legally binding prudential and conduct of business arrangements equivalent to the requirements of MiFIR and MiFID II. ESMA is required to establish cooperation agreements with the competent authorities of Third Countries judged by the European Commission to be equivalent.

3.12. Under Article 46(6) of MiFIR, Third Country firms must, before providing any service or performing any activity in relation to a client established in the E.U., “offer to submit any disputes relating to those services or activities to the jurisdiction of a court or arbitral tribunal in a Member State”. Although this requirement does not appear in other Third Country regimes, it is noteworthy that the MiFID II Package contains one of the most recent Third Country regimes to be developed. It is unclear how literal any interpretation of this provision must be and there is uncertainty around whether the Third Country firm is required to submit to the court in the Member State or if it is only required to make the offer with the option for the E.U. counterparty to waive it.

3.13. EMIR imposes clearing and reporting obligations on investment firms and credit institutions that wish to enter into certain types of derivative contracts. These obligations are deemed to have been fulfilled by Third Country firms where the

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79 Article 39(2) and (3) of MiFID II.
European Commission has adopted an equivalence decision. Article 13 of EMIR stipulates that the European Commission must determine that the legal, supervisory and enforcement arrangements of the Third Country are equivalent to the conditions imposed by EMIR on the E.U. Member State, including the provision on the protection of professional secrecy.

**Infrastructure: CCPs**

3.14. A Third Country CCP can provide services into the E.U. under Article 25 of EMIR, if it satisfies the following requirements:

   i. the European Commission is able to determine that the CCP’s home jurisdiction has an equivalent regulatory regime and it provides for reciprocal arrangements for foreign CCPs;

   ii. the CCP is subject to effective supervision and enforcement in the Third Country jurisdiction in which it is authorised;

   iii. ESMA and the Third Country’s regulator have negotiated a cooperation agreement; and

   iv. the Third Country has an equivalent anti-money laundering regime.

The equivalence assessment undertaken by the European Commission will take into account technical advice from ESMA in each case.

3.15. The Third Country regime for CCPs under EMIR is already operational. Since 2012 the European Commission has assessed a number of regulatory frameworks in Third Countries and recognised a number of individual CCPs. In some cases the assessments have proceeded smoothly. The decision-making process proved particularly complex and lengthy, however, in the case of the United States. As a case study, the U.S. assessment provides an illustrative example of how complex an equivalence determination can become when negotiations between the E.U. and a Third Country do not run smoothly.

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80 As discussed above in paragraph 2.15, the European Commission has recently proposed amendments to these rules.

81 Several jurisdictions have been determined to have equivalent regulatory regimes for CCPs under EMIR, including Australia, Brazil, Canada, the Dubai International Financial Centre, Hong Kong, India, Japan, Japan Commodities, Mexico, Singapore, South Africa, South Korea, Switzerland and the U.S.
3.16. E.U. and U.S. regulators were unable to agree that the E.U. and U.S. regulatory systems for CCPs guaranteed similar market conduct and prudential outcomes because of technical differences between the two systems. The most frequently publicised grounds for disagreement were the differing margining periods and netting rules applied by the two regulatory regimes. Regulatory standards in the E.U. specified a two-day liquidation period for calculating initial margin on exchange-traded derivatives, whereas U.S. rules allowed only a one-day period. On the other hand, U.S. rules required the provision of margin on customer positions on a gross basis whereas the E.U. rules would allow margin to be provided on a net basis on omnibus accounts.\(^{82}\)

3.17. Market participants followed the process of negotiations with concern. Many E.U. firms rely on clearing services provided by the Chicago Mercantile Exchange (the “CME”) to clear popular “Eurodollar” derivatives, which are purchased as a hedge against movements in U.S. interest rates.

3.18. Four years after EMIR came into force and with the “cliff edge” deadline for mandatory clearing hanging over E.U. firms, E.U. regulators adopted a positive equivalence determination vis-à-vis the U.S. system. The CME was recognised by ESMA shortly afterwards. As a condition of the decision, the U.S. was required to extend mutual recognition to E.U. CCPs. This was done this in March 2016 by means of the “substituted compliance” mechanism.

3.19. The example illustrates two important and often overlooked aspects of the equivalence assessment process. The first is that even where the European Commission’s approach to equivalence determination is said to be broadly outcomes-based\(^{83}\), it may refuse or delay a positive decision on the basis of regulatory differences which have not been shown to introduce market conduct or systemic stability risks. The second is that some equivalence regimes, such as the one set out in Article 25 of EMIR, introduce an additional conflicts of law requirement, namely that the Third Country’s legal system must itself incorporate rules facilitating regulatory recognition in the same way that the E.U.’s own financial services framework does.

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3.20. The EMIR Review Proposal establishes additional criteria—and powers for E.U. authorities to supplement existing criteria—both for a positive equivalence determination and recognition of an individual Third Country CCP. In particular, the proposed amendments would:

i) allow the European Commission to specify the applicable equivalence criteria by means of a delegated act, adding further conditions to those set out in EMIR;

ii) stipulate additional conditions for the initial and ongoing recognition of Third Country CCPs which are systemically important or “likely to become systemically important”, including a) ongoing compliance with the prudential requirements established by EMIR for E.U. CCPs; b) written confirmation from “relevant E.U. central banks of issue” that it complies with any requirements imposed by those central banks in the exercise of their monetary policy functions; and c) written consent from the Third Country CCP itself to ESMA accessing any information held by the CCP and any of its business premises on request.

3.21. The proposals are very new and may change significantly in the course of co-decision by the European Council and Parliament. Moreover, even were the EMIR Review Proposal draft legislation already adopted, it would be hard to foresee how the new provisions would apply in practice. The following additional features should be noted, however, as giving rise to legal complexity in the recognition process:

i) there is significant ambiguity in the concepts of “systemically important” and “likely to become systemically important”, introduced by a new Article 25(2a), which are not defined and which may, in practice, confer a wide discretion on ESMA;

ii) under the new Article 25(2b) a systemically important Third Country CCP must satisfy a recognition condition by providing “unconditional written consent” to provide data on request. Given existing legal, practical and regulatory restrictions on data transmission, it may be difficult for Third Country CCPs to provide consent that is truly unconditional; and

iii) recognition can be withdrawn by ESMA in the circumstances laid down in the proposed new Article 25m, which does not prescribe a timetable or a notice period for the withdrawal. Third Country CCPs may find that an undefined and unlimited power of withdrawal of this kind, which arguably itself represents a systemic risk, affects their regulatory status in other jurisdictions outside the E.U.
Alternative Investment Funds and their Managers

3.22. One Third Country framework which takes a very different approach is that set out by the AIFMD, which, as noted above, offers two regimes—with and without the AIFMD “passport”—for Third Country AIFs and Third Country AIFMs.

3.23. Article 42 (Conditions for marketing in Member States without a passport of AIFs managed by a non-EU AIFM) provides that Member States may allow Third Country AIFMs to market AIFs to professional investors in their territory subject to certain conditions. One such condition is that:

apposite cooperation arrangements for the purpose of systemic risk oversight and in line with international standards are in place between the competent authorities of the Member States where the AIFs are marketed, insofar as applicable, the competent authorities of the EU AIFs concerned and the supervisory authorities of the third country where the non-EU AIF is established and, in so far as applicable, the supervisory authorities of the third country where the non-EU AIF is established in order to ensure an efficient exchange of information that allows competent authorities of the relevant Member States to carry out their duties in accordance with this Directive.

It is an obvious point but worth stating that, the U.K. has not, to date, needed to enter into supervisory cooperation arrangements with competent authorities in E.U. Member States. Whether it can and will do so and the time taken to implement the arrangements once agreed are factors which will affect the availability and timing of access to E.U. investors by U.K. funds after Brexit. They are, however, questions which are wholly unclear at this time.

3.24. Another requirement set out in Article 42 is that the AIFM must comply with the transparency requirements laid down in Articles 22 to 24 of the AIFMD. Even so, Member States are permitted, under Article 42(2) to impose stricter rules on Third Country AIFMs than are applicable under the AIFMD.

3.25. Similar requirements must be satisfied under Article 36 in respect of an E.U. AIFM marketing a Third Country AIF, including the requirement for appropriate cooperation arrangements. In addition, the AIFM must comply with all the requirements of the AIFMD, excepting only the rules on the appointment of depositories.
3.26. The alternative access provisions “with a passport” set out in Article 37 and Articles 39 to 41 of the AIFMD do not yet apply. In order for the regime provided under these Articles to be brought into application, the requirements of Article 67 of the AIFMD must be satisfied. These include, sequentially: (i) positive advice to the European Commission by ESMA on the application of the passport to Third Country AIFMs and AIFs—which advice is to be based on the existing marketing and management of those entities in Member States under the NPPRs—and (ii) a delegated act by the European Commission under Article 67(6).

3.27. Under Article 67(4), ESMA’s positive advice to the European Commission must include advice to the effect that “there are no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risk” (emphasis added) which would impede the application of the “passport” to Third Country AIFMs and AIFs. Similar issues must be taken into account under Article 67(6) by the European Commission before it can adopt a delegated act. The natural inference is that ESMA will, in examining the existing use of the NPPRs by Third Country AIFMs and AIFs, consider whether the legal and regulatory frameworks in place in their home jurisdiction establish adequate standards on investor protection, market conduct, competition and systemic risk.

3.28. Although Article 67 the AIFMD only refers in general terms to a single positive advice from ESMA (to be issued by 22 July 2015) and a single delegated act required to bring Articles 37 to 41 into application, ESMA has, in fact, taken a country-by-country approach, releasing advice in relation to specific Third Countries on separate occasions. A first set of advice on the application of the passport to six countries (Guernsey, Hong Kong, Jersey, Singapore, Switzerland and the United States) was published in July 2015 and a second, on the application of the passport to 12 countries (Australia, Bermuda, Canada, Cayman Islands, Guernsey, Hong Kong, Isle of Man, Japan, Jersey, Singapore, Switzerland and the United States) was published in September 2016.84 In this latest report, ESMA has suggested that the European Commission may wish to wait until ESMA has delivered positive advice on a sufficient number of Third

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Countries before triggering the legislative procedures foreseen by Articles 67(5) and (6).  

3.29. Once the U.K. has withdrawn from the E.U. and is considered a Third Country, its regulatory and oversight framework will presumably also be assessed by ESMA. The FCA rules which apply to the authorisation of E.U. AIFMs in the U.K. and to the marketing to professional investors in the U.K. of E.U. AIFs could influence ESMA in its assessment of the U.K.

3.30. In its second advice, ESMA given the following examples of questions that may be applied under the heading “obstacles to competition”.  

   a) Is the process operated by the Third Country [regulatory authority] to authorise E.U. AIFMs or allow marketing of E.U. AIFs in the Third Country reasonable in terms of clarity, predictability, cost and regulatory expectation? Is there a level playing field between E.U. and Third Country AIFMs as regards market access, particularly in view of the procedures that would apply to the authorisation of Third Country AIFMs in the event that the “passport” is extended?

   b) Are E.U. AIFMs and E.U. AIFs treated in the same way as managers and collective investment undertakings of the Third Country in terms of regulatory engagement, including regulatory fees and documentation to be provided prior to authorisation?

   c) Does the Third Country [regulatory authority] treat all E.U. Member States equally?

3.31. Since the U.K. has implemented the AIFMD in full, it could be expected that ESMA would find no significant obstacles to competition. It is worth noting, however, that in its advice on AIFMs and AIFs based in Hong Kong, Singapore and Australia, ESMA noted, in considering whether a level playing field existed under the heading “obstacles to competition”, that the local regimes facilitated market access by retail funds (including UCITS) from only certain E.U. Member States. It is therefore possible that,

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85 Ibid (12 September 2016), at p.7.

86 Ibid, at p. 12.

87 Ibid, at pp. 45, 57 and 67.
in assessing whether to give positive advice in relation to the U.K. on AIFMs and AIFs, the basis on which UCITS from Member States are granted access to investors in the U.K. may be a consideration.

3.32. With regard to obstacles to the monitoring of systemic risk, ESMA is required to base its advice, inter alia, on the existence and effectiveness of cooperation arrangements for the purpose of systemic risk oversight between the competent and supervisory authorities of the Member State and the Third Country. As the U.K. is currently not party to any such cooperation arrangements, it is uncertain how ESMA would carry out this part of its assessment, particularly as ESMA’s assessment for the purposes of its advice requires a consideration of how well the cooperation arrangements in question are working and, in the absence of evidence in relation to the working of an existing cooperation agreement, whether previous supervisory engagement provides support for the expectation of good supervisory cooperation.

3.33. Other issues which ESMA has indicated the European Commission may also wish to consider alongside its advice, which are not expressly referred to in the AIFMD, include: (i) fiscal matters in the Third Country; and (ii) the anti-money laundering and counter-terrorism financing regime in the Third Country.88 If the Commission determines to adopt these criteria, it is uncertain how it will apply them in relation to the U.K.

3.34. Although Article 67 of the AIFMD only refers in general terms to a single positive advice from ESMA (as noted above) and a single delegated act required to bring Articles 37 to 41 into application for all Third Countries, ESMA’s approach to date suggests that the evaluation of a Third Country’s regulatory framework will be relevant to the prospects of funds based in that jurisdiction for obtaining access to the E.U. It may be that legislative revisions to the all-or-nothing approach set out in Article 67 will be proposed at a later date or that the European Commission will imply a power to bring the AIFMD “passport” into application on a country-by-country basis. In any event, it is likely that ESMA’s country-by-country assessments will become relevant to a Third Country AIFM’s application for authorisation under the comply-or-demonstrate-equivalence approach which is to be applied by E.U. competent authorities under Article 37(8) (see paragraph 3.37).

88 Ibid, at p. 12
If and when the “passporting” regime comes into application, by virtue of the delegated act specified in Article 67(6), Third Country AIFMs and E.U. AIFMs managing Third Country AIFs will be subject to an authorisation and licensing regime. The authorisation of Third Country AIFMs is provided for in Article 37 AIFMD, which requires a Third Country AIFM to become authorised in a Member State of Reference and thus to comply with the provisions of the AIFMD as implemented in that Member State. Consequently, a U.K. AIFM, which intended either to manage an E.U. AIF or market a Third Country AIF in the E.U., would have to comply both with AIFMD as implemented in its Member State of Reference and also with the rules applied to it by the FCA in the U.K. This could in due course lead to legal uncertainty, in particular if the FCA rules were to diverge from those in the Member State of Reference.

Article 37(7) AIFMD provides that no authorisation shall be granted to a Third Country AIFM unless the following requirements, *inter alia*, are met:

- **(d)** appropriate cooperation arrangements are in place between the competent authorities of the Member State of Reference, the competent authorities of the home Member State of the E.U. AIFs concerned and the supervisory authorities of the third country where the non-E.U. AIFM is established, in order to ensure an efficient exchange of information that allows the competent authorities to carry out their duties in accordance with [the AIFMD];

- **(f)** the third country where the AIFM is established has signed an agreement with the Member State of Reference, which fully complies with the standards laid down in Article 26 of the [OECD] Model Tax Convention on Income and on Capital and ensures an effective exchange of information in tax matters, including any multilateral tax agreements.

At the present time the U.K. has not entered into any such arrangements or agreement and it is uncertain how long it will take to put them in place.

In addition, Article 37(8) provides that the authorisation of Third Country AIFMs shall be subject not only to the criteria laid down for E.U. AIFMs by Chapter II of the AIFMD but also to additional criteria which include the provision of supplementary
information, including a requirement to show that, where compliance with an E.U. rule is impossible

the relevant third country law provides for [an equivalent rule], which has the same regulatory purpose and offers the same level of protection to investors of the relevant AIFs and that the AIFM complies with that equivalent rule[.]

ESMA is mandated under Article 37(23) to develop regulatory technical standards specifying the conditions under which a Third Country rule can be considered equivalent and to have the same regulatory purpose while offering the same level of investor protection.

3.38. Another aspect of the regime which is worthy of note is that introduced by Article 38: Peer review of authorisation and supervision of non-EU AIFMs. Under this article, ESMA may issue guidelines and recommendations with a view to “establishing consistent, efficient and effective regulatory practices” by Member States’ competent authorities with regard to the Third Country AIFMs which are authorised in each Member State.

**Insurance and reinsurance**

3.39. The Solvency II regime sets out a list of the conditions which must be fulfilled by a Third Country for an equivalence determination in each of the three cases mentioned previously. The criteria include: (i) a provision for the existence of a risk-based supervisory system; (ii) sufficiently resourced and empowered supervisory authorities which are able to protect policyholders and beneficiaries; (iii) adequate capital requirements imposed on (re)insurers; and (iv) effective governance systems. On the day that the U.K. separates from the E.U., the U.K. will have implemented all of Solvency II as required, which in theory implies that U.K. regulators and insurance providers could be considered eligible to meet the criteria for Third Country equivalence.

3.40. In practice, however, these conditions have proved difficult to satisfy. Only two countries currently have full equivalence in all three areas—Switzerland and Bermuda. In the case of Bermuda, the European Commission’s decision was the result of an

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89 Supra paragraph 2.21. That is, reinsurance provided by a Third Country reinsurer, group solvency and group supervision, covered by articles 172, 227 and 260 of Solvency II.

90 In respect of reinsurers, the equivalence requirements are set out in Article 378 of Commission Delegated Regulation (EU) 2015/35. See also, Articles 379 and 380 with respect to Third Country insurance groups.
iterative process where only provisional equivalence for group solvency was granted on the first assessment. Japan has temporary equivalence for reinsurance (until 31 December 2020) and provisional equivalence for group solvency calculations for ten years, as do Australia, Brazil, Canada, Mexico and the U.S.

**Benchmark Administrators**

3.41. Although the Benchmarks Regulation offers access to Third Countries by way of equivalence, recognition or endorsement, there continues to be ambiguity about the standards that apply to each threshold test for access. The availability of a positive equivalence determination in favour of the U.K. will depend on the application of the requirements set out in Article 30(2) and 30(3) of the Regulation. Those paragraphs require that the framework must be equivalent
taking account of whether the legal framework and supervisory practice of [the Third Country] ensures compliance with the IOSCO principles for financial benchmarks...

3.42. In addition, a positive equivalence decision will only be granted where benchmark administrators are subject to effective supervision and enforcement on an on-going basis in the Third Country in question.

3.43. It is difficult to predict how these requirements will be applied when the Benchmarks Regulation begins to apply in January 2018 but it is expected that, by the time the U.K. withdraws from the E.U. it will have implemented the Regulation fully and will, on that basis, be potentially eligible for a positive equivalence determination. As in all other sectors, eligibility for an equivalence decision does not necessarily guarantee that one will be available immediately after the U.K.’s withdrawal from the E.U., unless transitional arrangements have been adopted. (The issue of timing is discussed further in the next section.)

3.44. By virtue of Article 30(1), a Third Country administrator which is established in a jurisdiction which benefits from a positive equivalence decision will be in a position to register with ESMA as a benchmark provider in the E.U. only if it can also show:

i) that it is authorised or registered, and is subject to supervision, in the Third Country in question;
ii) that ESMA has been notified of the list of the benchmarks for which the administrator has given consent to be used and of the home competent authority responsible for its supervision in the Third Country; and

iii) that cooperation arrangements are operational as between ESMA and the administrator’s home competent authority.91

Issuers

3.45. If a Prospectus Directive-compliant approved prospectus is required—for example, where a U.K. issuer that intends to list on a U.K. trading venue wants to extend a retail offer to E.U. investors—then, following Brexit, the issuer would need to have its prospectus approved by an E.U. competent authority, namely the competent authority of its “home Member State”. Approval by the UKLA would not be sufficient in the circumstances of the U.K.’s withdrawal without a bespoke agreement or transitional arrangements. If the U.K. retains rules post-Brexit which require U.K. prospectuses to meet the same standards as a Prospectus Directive-compliant prospectus, then it may be the case that (subject to any translation required) essentially the same document can be submitted to a competent authority for approval for use in the E.U.

3.46. A prospectus can only be approved by a competent authority in the E.U. under Article 20 of the Prospectus Directive if it has been drawn up in accordance with international standards on disclosure. The issuer is also required to show that the information requirements laid down by legislation in the country where it has its registered office are “equivalent” to requirements under the directive. Under Article 20(3), the European Commission is empowered to determine that a Third Country “ensures the equivalence of prospectuses drawn up in that country with this Directive”. As of July 2017, however, no equivalence decision has been adopted in respect of a Third Country under this provision. In March 2013, ESMA published advice identifying the information that may be added to a prospectus drawn up under the laws of a Third Country—a process that ESMA referred to as adding “an equivalence wrap”—so that the resulting document meets the standards of the Prospectus Directive.92 By this means a prospectus drawn up by a Third Country issuer is able to meet an “equivalence” standard even if

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the information requirements laid down by law in the Third Country are not equivalent for the purposes of Article 20.

3.47. Article 29 of the PD III, which will apply from 20 July 2019, is similar to Article 20 of the Prospectus Directive and provides that an offer of securities can be made to the public or admitted for trading on a regulated market on the basis of a prospectus drawn up under the laws of a Third Country if it is approved by the competent authority of the issuer’s “home Member State”. A prospectus can only be approved by the competent authority in question if it has been drawn up in accordance with international standards on disclosure and the issuer can show both: i) that cooperation arrangements on supervision are in place between the “home” competent authority and authorities in the Third Country; and ii) that the information requirements laid down by legislation in the country where it has its registered office are “equivalent” to requirements under PD III.

3.48. Under Article 29(3), the European Commission is empowered to adopt delegated acts establishing general equivalence criteria as well as to take an implementing decision on whether the particular information requirements imposed in a Third Country jurisdiction meet the equivalence requirement. At the end of February 2017, the European Commission issued mandates to ESMA to advise on the development of delegated acts on, inter alia, the general equivalence criteria for Third Country prospectuses. It is anticipated that these acts will be finalised by early 2019. Although the Prospectus Directive contained a similar Third Country equivalence requirement (in Article 20(3)), no positive equivalence determination was made under this provision. It is difficult in these circumstances—and before ESMA has published its advice—to predict the nature of the equivalence standards that will be applied.

3.49. Alternatively, a Third Country issuer can seek approval for a prospectus under Article 28 from the same competent authority on the basis that the prospectus itself has been drawn up in accordance, not with the laws of the Third Country in question, but in accordance with PD III.

4. TIMING

4.1. A further issue of legal complexity is presented by uncertainty as to timing in the process of meeting threshold conditions established by Third Country regimes.
4.2. It is strongly to be inferred that the process of reaching a decision on the application of Third Country regimes to the U.K. will only begin once the U.K. has withdrawn from the E.U. Taking equivalence as a case study, it is to be doubted whether a decision can be adopted, weighed by the European Commission, or even sought by the applicant under E.U. law in respect of an existing Member State of the E.U. (which is not, _ipso facto_, a Third Country). Therefore, assuming that the process itself takes at least a little time, a _hiatus_ will likely occur between this event and the conferring of access as a Third Country on the basis of a positive equivalence determination or satisfaction of any other threshold requirement.

4.3. There is the related question of the length of time the European authorities might require to make a decision on equivalence or any other requirement. There exists no guidance, for example, as to the timetable for progressing an equivalence decision and the length of time any assessments and deliberations might take remains open-ended. The 2017 ESMA Opinion Paper acknowledged that any assessment processes for entities looking to relocate will take time and urged firms to approach competent authorities as early as possible. The timetables for the assessments of Third Country regulatory frameworks are likely to be similarly long and fraught with uncertainty. For instance, while ESMA negotiated 11 cooperation agreements in relation to access to Third Country CCPs under EMIR in under two years, the deliberations pertaining to the U.S. application for equivalence with regards to CCPs—referred to in paragraphs 3.15 to 3.19 above and discussed further in paragraph 4.6 below—extended over nearly four years. The period of time taken to reach equivalence decisions with respect to credit rating agencies under the Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies (the “CRA Regulation”) have been similarly diverse and unpredictable: one (Japan) took just over six months, three (Australia, Canada and the U.S.) took between 18 months and two years and five (Argentina, Brazil, Hong Kong, Mexico and Singapore) took over four years.93

4.4. Once a Third Country has received a positive determination of equivalence from the E.U., individual Third Country firms are required to file applications for access to the E.U. financial market.

4.5. The question of timing is considered in relation to three illustrative industry sectors below.

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93 The IRSG Report, p. 50
4.6. In the example of the CME and its application for admission to the E.U. market as a provider of clearing services (paragraphs 3.14 to 3.19 above), the process of obtaining recognition took four years. The CME was obliged by Article 89 of EMIR to apply for recognition by 15 March 2013 but the process assessing the U.S. regulatory regime for the purposes of an equivalence determination began much earlier when EMIR came into force in 2012. ESMA published positive technical advice on equivalence in relation to the U.S. on 1 September 2013 but it was not until two and a half years later that the European Commission passed an implementing measure adopting a positive determination. During this time, negotiations advanced slowly, then stalled, and a deadline for an agreement was ultimately pushed back twice in 2016. At one point, the executive chairman of CME, frustrated with the E.U.’s approach to equivalence, called for access by E.U. CCPs to U.S. markets to be restricted by the Commodity Futures Trading Commission in a tit-for-tat move.94

4.7. Given that the new EMIR Review Proposal introduces several new criteria for an equivalence determination and recognition of a Third Country CCP, it is safe to say that the amendments proposed could appreciably lengthen either process, particularly in cases where the Third Country CCP seeking recognition is held to be “systemically important” or “likely to become systemically important”. No timeframes have been given, however, in the draft legislation so the issue remains subject to a significant lack of clarity.

Alternative Investment Funds and their Managers

4.8. Under the NPPRs, provided for by Article 42 of the AIFMD, cooperation agreements need to be signed between the Third Country and the Member State of Reference. As noted above, the U.K. is currently not party to any such cooperation arrangements with any Member State and it is uncertain how long it will take to put them in place.

4.9. The issue of timing is complicated further by the “passporting” regime provided for by Article 37 and Articles 39 to 41 of the AIFMD, which do not yet apply. Prior to being brought into force, Article 67(4) of the AIFMD requires that ESMA make the determinations listed in paragraph 3.27 above. Article 67(6) of the AIFMD goes on to provide that the European Commission will adopt a delegated act within three months

94 See: Stafford, “CME urges tougher US response to EU clearing dispute”, Financial Times, (25 March 2015), at: https://www.ft.com/content/efbe0e0e-d2d7-11e4-a792-00144feab7de?mha3i=e2.
of receiving positive advice from ESMA specifying the date when Article 37 and Articles 39 to 41 of the AIFMD become applicable in all Member States. ESMA has to date published advice on the application of the AIFMD “passport” to 18 Third Countries in respect of some of which it issued positive advice. The timeframe for assessing additional countries is unclear and it appears that this will be an ongoing process.

4.10. Further, ESMA has suggested that the European Parliament, the Council and the European Commission may wish to consider whether to wait until ESMA has delivered positive advice on a sufficient number of Third Countries before triggering the legislative procedures which would require the European Commission to adopt a delegated act.95 As such, the “passporting” regime may not come into force until ESMA considers a sufficient number of Third Countries have qualified. As the European Commission may or may not choose to follow ESMA’s suggestion, the timing of the extension of the AIFMD “passport” is uncertain.96

4.11. As noted above in paragraph 3.34, if and when the “passporting” regime comes into application, Third Country AIFMs and E.U. AIFMs managing Third Country AIFs will still be subject to an authorisation and licensing regime. A Third Country AIFM must obtain authorisation in its Member State of Reference. Since the “passporting” regime is as yet untested, it is unclear how long the authorisation process will take.

Insurance and reinsurance

4.12. There are several steps which lead up to an equivalence determination for insurance and reinsurance business.97 First, an assessment of the Third Country's regulatory regime is undertaken by the European Insurance and Occupational Pensions Authority (“EIOPA”) against the criteria set out in Solvency II and expanded upon in the previous sections of this paper. EIOPA may publish a report on its findings and may undertake a consultation, as was the case during the first wave of assessments in 2014.

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96 It is worth noting that under Article 68 of the AIFMD, which offers rules for switching from the NPPR to the “passporting” regime, ESMA shall issue advice to the Commission on the termination of the NPPRs provided for by Article 42 of the AIFMD three years after entry into force of the delegated act by which the Commission specifies the date when the “passporting” regime under the AIFMD becomes applicable. Following this, the Commission is required to adopt a delegated act within three months “switching off” the NPPRs.

which covered Switzerland, Bermuda and Japan. The findings are then presented to the European Commission, which is required to consult with EIOPA about its technical assessment.

4.13. An equivalence finding is made at the discretion of the Commission and there are no set periods within which a decision or finding must be made. By way of example, the European Commission’s decision to grant equivalence to Bermuda under Solvency II was a product of six years of negotiations.\(^98\) Once a decision is made, the European Council and Parliament have three months—or within six months if the objection period is extended—within which they may register any objections to the decision.

4.14. Equivalence assessments may also be carried out by E.U. supervisors in accordance with EIOPA guidelines where such an assessment is not made by EIOPA.\(^99\) Positive assessments require regular review every three years or following significant developments in the jurisdiction assessed.

5. **IMPACT**

5.1. Given the preponderance of uncertainties inherent in the scope, process and timing of Third Country threshold requirements for access to E.U. markets as a Third Country, financial services providers based in the U.K. are likely to come up against a number of legal uncertainties related to the continued operation of their business following Brexit.

5.2. In March 2019, when the Article 50 notice period runs out and in the absence of a bespoke deal with the E.U. for trade in services entering into force and/or special transitional arrangements providing continuity with the current regulatory regime, financial markets participants in the U.K. will presumably lose their “passports” to the single market. At that point, they face the prospect that they are no longer able to initiate new business in the E.U. Moreover, it seems unlikely that they will be permitted to continue servicing legacy business, since this in itself would constitute providing services or carrying out activities in the E.U. This question of legacy business alone would give rise to considerable market disruption—in addition to the market dislocation experienced in regard to new and future business—and litigation risk, since

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\(^{99}\) Under Article 227(2) of Solvency II Directive, the group supervisor can carry out the verification of the equivalence of the Third Country regime for the purpose of the group solvency calculation.
contracts do not always make clear or certain provisions for the allocation of risks associated with regulatory displacement when it arises from an Act of State and the interplay of geopolitical forces.

5.3. These risks represent a “cliff edge” scenario for those market participants who currently provide services in areas not covered by Third Country regimes and who will, in consequence, undoubtedly lose market access (subject to what is said elsewhere about bespoke deals and transitional arrangements). It is, however, likely that Brexit would also represent a risk of significant dislocation for those firms who provide services in sectors covered by Third Country regimes on account of the multiplicity of factors listed above that make a decision by E.U. authorities on whether threshold conditions have been satisfied uncertain as to timing and outcome.

**Short-term Impact**

5.4. Accordingly, ahead of Brexit and immediately after withdrawal, one of the most significant features of the landscape is likely to be operational, practical, legal and regulatory uncertainty. It is to be expected that market participants will engage with both their advisers and the authorities, in the U.K., in the E.U. and in E.U. Member States, at heightened levels of enquiry in a bid to bring light to bear. Another, related feature of the Brexit landscape in this period may be business restructurings which allow market participants to maximise the opportunities for continued access to E.U. markets in the face of potential market dislocation and so create their own solutions to the uncertainty. (This feature is discussed in greater detail in section six, below.)

5.5. Many of the questions and uncertainties which firms will wish to address around Brexit can be determined or ameliorated in the discussions which will undoubtedly take place with professional advisers and with authorities. These include some questions relevant to determining access to the E.U. as a Third Country firm. A good example is the preliminary question, identified in section one above, about when a firm will be considered to be “providing services” or “carrying out activities” in the E.U.

5.6. Many other questions concerning the availability of market access, however, may not prove so tractable or susceptible to legal clarification, including the overarching question: “when, if at all, will the threshold conditions be satisfied for Third Country access by U.K. firms?”

5.7. For those business sectors where the dominant regulation includes an equivalence test, the equivalence decision itself is likely to be the most uncertain element in determining
whether threshold conditions have been satisfied. This can be readily inferred from the features of the equivalence standard outlined in the European Commission Staff Paper at paragraph 1.22 and discussed in sections one and three. The uncertainty is not likely, however, to be much less significant in those sectors where the Third Country regime relies on different threshold criteria, given the prevalence of requirements focusing on discretionary or risk-based determinations by E.U. authorities.

**Long-term Impact**

5.8. In the longer term, market participants in the U.K. face restrictions and limitations on doing business in the E.U. coupled with uncertainty as to both: (i) the availability and scope of authorisation in E.U. Member States; and (ii) the possibilities for conducting business in the E.E.A.—including legacy business—without authorisation.

5.9. Access to the single market for U.K. participants would mean acquiring 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.

5.10. In order to establish and resource a subsidiary that is large enough to conduct the volume of business that is currently “passported” out of London, a large group is likely to require a significant period of time. Drawing up an application for authorisation, and the determination itself, may take many more months, particularly in a bottleneck situation. The direct authorisation process typically requires the participation of the “home” supervisory authority (a Memorandum of Understanding 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.

5.11. The longer-term impact of withdrawal and the legal and regulatory uncertainty which is bound to accompany it is considered below in greater detail for certain key financial services sectors.

**Infrastructure: CCPs and trading venues**

5.12. In the absence of a bespoke deal with the E.U. and/or special transitional arrangements providing regulatory continuity, CCPs in the U.K. will lose their status as “legal person[s] established in the Union” on Brexit and, as a logical corollary, lose their status as CCPs authorised under Article 14 of EMIR. If they do not then immediately become Third Country CCPs recognised under Article 25 of EMIR, market participants (i.e. “financial counterparties” and “non-financial counterparties” within the meaning of
Article 2 of EMIR) can no longer satisfy the regulatory clearing obligation set out in Article 4 of EMIR by using their services in respect of OTC derivative contracts. Moreover, the CCPs themselves will be in breach of Article 25, which permits a CCP to provide services to E.U. clearing members only where the CCP in question has first obtained recognition from ESMA.

5.13. The potential systemic effects of even a temporary withdrawal of clearing services from the E.U. by U.K. CCPs have been widely commented on. The International Regulatory Strategy Group has observed that

If no arrangements are made to manage the transition between regimes at Brexit, there is a risk of market disruption and sharply increased costs of clearing, both of which will affect the nonfinancial end-users of markets in both the [U.K. and the 27 remaining E.U. Member States].100

5.14. Media comment has so far focused on the need for transitional arrangements for U.K. CCPs because it is expected that, although there may be a worrying hiatus at the point of departure, in the long run U.K. CCPs will obtain recognition under Article 25 of EMIR and be permitted to provide clearing services to E.U. clearing members on that basis.101 The grounds for this view are said to be chiefly that, if the acquis is received into U.K. law as expected, the U.K. regulatory regime will be not only equivalent, but identical, to the EMIR framework for E.U. CCPs after Brexit. The EMIR Review Proposal, however, has made this prospect much less certain in respect of London’s largest CCPs, which are very likely to be classified as “systemically important” under proposed amendments.

5.15. The EMIR Review Proposal has been introduced in the context of calls by politicians from Euro Area Member States for the activity of clearing euro-derivatives to be relocated away from London and into the Euro Area. The reasons given for this move are said to be that, given the role of the European Central Bank as a liquidity backstop in relation to the euro, euro-denominated clearing should take place in a CCP subject to its supervision and control. Although the EMIR Review Proposal does not impose general relocation requirements it does set out provisions which would:


101 See, for example, Kirton, “No transition deal for UK’s clearing houses post-Brexit will hurt the other EU member states”, City A.M. 20 February 2017, available at: http://www.cityam.com/259365/no-transition-deal-uks-clearing-houses-post-brexit-hurt
a) allow ESMA to determine, in agreement with E.U. central banks, that the risks posed by a Third Country CCP are of such magnitude that the CCP should not be recognised at all; and

b) empower the European Commission to take a decision that a Third Country CCP should not be recognised as such and should only be allowed to provide clearing services on the basis of establishment in a Member State and full authorisation.102

5.16. These amendments raise the spectre of the eventual re-location of euro-denominated derivatives clearing activities away from the U.K. The damaging long-term effects of this outcome on the U.K. economy and the risks to financial stability in the E.U. have previously been the subject of comment by leading figures from the public and private financial sectors.103

5.17. U.K. operators of MTFs and OTFs may also find themselves facing a regulatory hiatus and a temporary loss of market access on the U.K.’s withdrawal from the E.U. This is again because, under the MiFID II Package, U.K. MTF and OTF operators provide their services on the basis of authorisation as required by Title II of MiFID II. On the U.K.’s withdrawal from the E.U. authorisations granted by the U.K. authorities will prima facie lapse. It is then to be expected for reasons given elsewhere in this paper that the process of re-establishing operations in the E.U. (either as a branch or as a provider registered with ESMA)104 from the U.K. will take time.

5.18. Assuming U.K. MTF and OTF operators are able to access the E.U. as Third Country providers in due course, they may nevertheless face an additional element of operational complexity as a result of legal uncertainty under the MiFID II Package. There are certain legislative provisions for Third Country access in MiFID II which are inconsistent with the guidance provided in MiFIR and which give rise to legal uncertainty. Article 23 of MiFIR provides that an E.U. investment firm must ensure that its trades in shares admitted to trading on a regulated market or traded on a trading venue must take place

102 See paragraph 2.15 above.


104 See paragraph 2.12 above where the point is made that operating an OTF or MTF is treated in the same way under the MiFID II Package as other wholesale investment services, as to which see paragraphs 2.9 to 2.11.
on a regulated market, multilateral trading facility or systematic internaliser, or a Third-Country trading venue assessed as equivalent in accordance with Article 25(4)(a) of [MiFID II].

Article 25(4)(a) of MiFID II, however, only refers to Third Country markets which have been considered equivalent to regulated markets, without any mention of Third Country MTFs or OTFs. It is not clear whether this inconsistency is intentional or a drafting oversight, but as it stands the wording suggests that E.U. investment firms and credit institutions may not be permitted to trade equities on Third Country MTFs and OTFs unless those trades come within the relevant exceptions.

5.19. There is no Third Country regime for the provision into the E.U. markets of trading platform services other than by means of an MTF or OTF nor, however, is there any existing, formal “passporting” regime between E.U. Member States in respect of such platform services. Operators of regulated markets located within one E.U. Member State are generally permitted by E.U. competent authorities to operate in other Member States for the purposes of facilitating trading by members in those Member States but it seems likely that this practice will cease once the U.K. withdraws from the E.U. In this case, U.K.-based operators of regulated markets such as the London Stock Exchange, LIFFE or NYSE Euronext may face the prospect of losing access to E.U. markets.

Insurance and reinsurance

5.20. In preparation for losing access to the E.U. single market, many (re)insurance groups have begun the process of establishing new subsidiaries in the E.U. or applying for the authorisation of branches in order to be able to continue to write new business in the E.U. post Brexit. These authorisation procedures are quite intensive and their completion can take up to a year once an application is submitted. There are also significant questions as to how much of a presence will be required locally and which activities can be outsourced back to the U.K.—and the consequent requirements imposed by supervisors locally and in the U.K.

5.21. The issue of how (re)insurers will continue to deal, post-Brexit, with existing cross-border business is one of even greater and immediate importance. This is relevant for both existing (pre-Brexit) business written from an E.U. branch of a U.K. insurer and from the U.K. branch of an E.U. insurer. It also arises for business written on a services

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105 See Ralph, “London’s insurers rush to cover the Brexit bases”, Financial Times, (London, 29 September 2016), available at: https://www.ft.com/content/11a6e368-7e86-11e6-bc52-0c7211ef3198
basis either into or out of the U.K. and is a particular concern for U.K. life insurers with retired policyholders in E.U. jurisdictions. The position for U.K. (re)insurers with E.U. policy-holders or covering E.U. risk is not uniform across the 27 E.U. Member States and in some jurisdictions there is no clarity. In Ireland, for example, paying claims in Ireland would be viewed as carrying on insurance business and thus be considered an offence by an unauthorised insurer. Legislation in some other jurisdictions is silent on the point.

5.22. Finally, Solvency II is silent on many aspects of insurance business, including the access requirements for reinsurers to access the E.U. Reinsurance business is then dependent on the position of individual Member States.

5.23. As there is currently no Third Country regime applicable to insurance intermediation, U.K. insurance intermediaries will have to consider various practical alternatives. These may include:

i. to the extent allowed by the law of the relevant E.U. Member State, establishing branches in other jurisdictions and obtaining authorisation for such branches;

ii. setting up a new legal entity in an E.U. Member State and applying to the local regulator for the necessary insurance intermediation permissions; and

iii. acquiring an existing intermediary that is already authorised in an E.U. jurisdiction.

5.24. Insurance intermediaries who have set up or acquired an E.U. authorised insurance intermediary in an E.U. Member State would, in principle, be able to exercise their “passporting” rights derived from the IDD in order to carry on business in, or establish a branch or permanent presence in, any other E.U. Member State.

5.25. A particular point of note is that insurance intermediaries which act as the agent of the insurer rather than the insured customer (for example, managing general agents), and their insurer principals, will need to consider the extent to which such agents are able to underwrite contracts of insurance and/or carry out other activities on behalf of U.K. and/or E.U. insurers without causing the relevant insurers to be deemed to be effecting or carrying out contracts of insurance in a jurisdiction in which the insurer is not authorised. For example, there is a risk that a U.K. insurer could be deemed to be carrying on insurance business in France if it were to have an agent entering into binding contracts of insurance on its behalf in France. Similarly, a French authorised
insurer bound by a managing general agent operating in the U.K. could, in principle, be brought within the U.K. regulatory remit and therefore need to be directly authorised under the U.K. regime.

Benchmark Administrators

5.26. Although the Benchmarks Regulation provides for Third Country access through recognition or endorsement as an alternative to registration with ESMA on the basis of a positive equivalence decision, the application of those alternatives is not without uncertainty. E.U. supervised firms, for example, may only use a Third Country benchmark which benefits from recognition until such time as a positive determination of equivalence is reached.\(^{106}\) It would appear to be a logical corollary of this that there may be a temporal lacuna after an equivalence determination is made but before the administrator has satisfied the other threshold conditions set out in Article 30 (such as the requirement for cooperation arrangements to be in place). Third Country benchmark administrators may thus find themselves in the inconvenient situation where they are technically unable to rely on recognition but access is not yet available on the basis of equivalence.

5.27. The impact of Brexit on regulatory continuity for benchmark administrators could present a serious issue for legacy contracts and existing funds entered into by E.U. supervised entities which reference benchmarks produced by U.K. administrators (including benchmarks such as LIBOR, SONIA, ICE Brent, LBMA Gold Price).\(^{107}\) The E.U. Benchmarks Regulation includes transitional provisions allowing the use of benchmarks produced by Third Country administrators until 1 January 2020.\(^{108}\) These provisions are not, however, a panacea for the difficulties to which Brexit may give rise owing to the obvious and significant consideration that the processes by which U.K. benchmark administrators can obtain registration with ESMA as a Third Country provider on the basis of equivalence, recognition or endorsement, may drag on past 1 January 2020. (There is additional debate as to whether these provisions cover only benchmarks that exist on the date of entry into force of the Benchmarks Regulation, or on its date of application, or whether they also cover new benchmarks developed—say, 

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106 Article 32(1) of the Benchmarks Regulation.
107 Under Article 29 of the Benchmarks Regulation, E.U. supervised entities are only permitted to use compliant benchmarks registered with ESMA once the regulation comes into application.
108 Article 51 of the Benchmarks Regulation.
in response to calls for benchmark reform—between 1 January 2018 and 1 January 2020.)

5.28. Additional transitional provisions for legacy contracts in Article 51(4) do not appear to apply to Third Country benchmarks given that they refer to continuity measures which may be taken by “the competent authority of the Member State where the index provider is located” (emphasis added).

6. **SOLUTIONS AND MITIGANTS**

**Short-term mitigants**

6.1. As highlighted in the sections above, the limitations of the patchwork of Third Country regimes which are incorporated in E.U. financial services legislation and uncertainties relating to the satisfaction of the threshold requirements for these regimes could mean that U.K. providers of financial services will be—at least temporarily—deprived of access to key E.U. markets on the withdrawal of the U.K. from the E.U., unless they first individually acquire authorisation (either for a subsidiary or for the U.K. firm “directly” via a branch).

6.2. As regards equivalence decisions, in particular, this paper has set out some of the complexities attached to the processes for securing equivalence decisions relating to provisions in European legislation that provide a basis for some types of Third Country firms to access E.U. markets. Whilst the legislative test of equivalence adopted by the E.U. has evolved, a central requirement is the alignment of core substantive provisions governing the conditions on which licences are granted and the ongoing prudential and other requirements to be met in carrying on business. A positive equivalence determination for the U.K. will likely require the E.U. authorities to have confidence in the effectiveness of the supervision and enforcement processes as well as in the U.K.’s ongoing commitment to cooperation and adherence to recognised international standards. These requirements contribute to uncertainty about the timeframe within which a positive equivalence decision might be available. In any event, positive equivalence determinations, although helpful in many cases, would not resolve the issues facing, for example, U.K. AIFMs, as under the AIFMD access to the E.U. for Third Country firms is not subject to an equivalence decision. Nor would it address areas, such as retail investment services, where no Third Country regime is available except by establishment (e.g. as a branch) and authorisation in the E.U.
6.3. Transitional plans could alleviate some of the difficulties and uncertainties outlined in this paper 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 Treaty of the European Union. The FMLC has previously expressed support for the desirability of transitional plans, most recently in a letter to the U.K. Treasury Select Committee (the “TSC Letter”), in which it encouraged a staged approach to negotiating and developing such provisions.109

6.4. In this regard, the FMLC is of the view that transitional arrangements, as well as any newly-negotiated agreements between the U.K. and the E.U. could usefully include some form of “grandfathering” under which any “legacy” products issued before Brexit will continue to be regarded as valid in all relevant jurisdictions to avoid significant disruption.

**Transitional Equivalence**

6.5. The U.K. has over several decades played a significant role in the development of European and international financial regulation. HM Government has made clear its intention to transpose E.U. law, including financial regulatory law, into U.K. law through the Great Repeal Bill, so that the body of European financial regulation that applies at the point of Brexit will continue to apply in the U.K. Accordingly, at the point in time that the U.K. leaves the European Union, it would be odd—notwithstanding the procedural and other complexities and uncertainties discussed in section three above—if the U.K. were not regarded as meeting the substantive tests for equivalence across the full range of financial services for which equivalence-based Third Country regimes are available.

6.6. Arguably, then, it should be possible for the terms of the U.K.’s withdrawal from the E.U. to include a late-stage transitional provision for the recognition of the U.K.’s equivalence as a Third Country for the purpose of the various tests contained in E.U. financial regulatory legislation. On the assumption that the “soft Brexit” option set out below is rejected as a long term solution, “transitional equivalence” recognition would ideally come into late effect as part of a phased approach to transition. That is, it would come into effect following the expiry of more inclusive and comprehensive (or, in the language of political commentary, “softer”) arrangements contemplating wider access to the E.U. for U.K. service providers, which would arguably be an appropriate early

staging post immediately after the U.K.’s withdrawal. “Transitional equivalence” could either remain in place for so long as no contrary determination is made—which would surely be the least administratively burdensome option for the institutions of the E.U.—or until the expiry of a defined transitional period. The FMLC recommends that HM Government give careful consideration to securing—or attempting to secure—transitional provisions of this kind, which would reduce uncertainty and the impending “cliff edge” effect in some industry sectors.

**Longer-term mitigants**

6.7. The sections above demonstrate the limited nature of the provisions currently available to Third Countries for access to the E.U. single market for financial services. In order to ensure access for U.K. financial service providers to the E.U. markets, the FMLC has set out below seven proposed potential mitigants to the issues of legal uncertainties raised above. These mitigants imply different models of E.U.-U.K. relationship following British withdrawal. It is not for the FMLC, however, to comment on matters of policy or the form that the regulatory landscape should take in the U.K. post-Brexit.

**Soft Brexit**

6.8. A simple option by which the U.K. can gain access to the E.U. single market is by retaining its membership of the E.E.A. The U.K. is already a party to the E.E.A. Treaty as an E.U. Member State and, although the question is not legally certain, it is generally believed that the U.K. will leave the E.E.A. when it leaves the E.U. Even if this is correct, the option exists for the U.K. to re-join the E.E.A by becoming a signatory to the E.E.A Treaty as an EFTA member state. In order to do this, the U.K. would be legally required to join EFTA.

6.9. As a member of the E.E.A., the U.K. would be subject to the common rules and equal conditions of competition which apply across the E.E.A. by virtue of the Agreement on the European Economic Area (“E.E.A. Agreement”). This imposes an obligation of “homogeneity” on contracting states which is currently satisfied on their behalf by certain EFTA institutions, including: the EFTA Surveillance Authority, which has

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110 In *Yalland and others v Secretary of State for Exiting the E.U.* [2017] EWHC 630, the Applicants sought a declaration that it would be unlawful for the Prime Minister to take the U.K. out of the E.E.A. by serving a withdrawal notice under Article 127 of the Agreement on the European Economic Area (the “E.E.A. Agreement”) and that, absent such notice, the U.K. remains bound as a Contracting Party to the E.E.A. Agreement. One limb of the Appellants’ argument rested on the contention that an action under Article 350 of the Treaty of the European Union, could not unilaterally affect the rights of those states vis-à-vis the U.K. under the E.E.A. Agreement. The High Court refused to hear the case in February 2017 on the grounds that the application was premature. Since then HM Government has submitted an Article 50 withdrawal letter which makes no mention of the need to give notice under Article 127 of the E.E.A. Agreement.
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., and the EFTA Court. There is no written obligation on the courts of last resort of EFTA member states to make a reference to the EFTA Court and its preliminary rulings are not binding on national courts. (They are termed “advisory” opinions.) The E.E.A. Agreement’s homogeneity rules, however, bind the EFTA Court to follow relevant ECJ case law.

6.10. By this route, U.K. financial services firms would obtain continued access to the single market on terms very similar, if not identical, to the terms on which business is conducted today. E.U. regulatory measures in all fields would continue to apply to the U.K. much as they did pre-Brexit.

**Bespoke Deal**

6.11. Many who campaigned for the U.K. to “Leave” the E.U. view a bilateral Free Trade Agreement (“FTA”) between the U.K. and the E.U. as the most efficient model for their future relationship. The proponents of such a bespoke deal hope for “preferential access” for U.K. services providers to the E.U. market on terms which would mimic the single market framework for financial services.

6.12. Before the U.K. can negotiate an FTA with the E.U. (or indeed any other country), its schedules at the WTO must be established and confirmed so as to provide context to negotiations with respect to the terms being offered to the rest of the world. A degree of uncertainty is raised in relation to the General Agreement on Trade in Services (“GATS”) of the WTO, which contains “most favoured nation” (“MFN”) provisions. These require, subject to exceptions, WTO member countries not to discriminate between services and service providers from other WTO member countries. While the GATS, in effect, exempts certain mutual recognition agreements between WTO member countries from this strict version of MFN, there is legal uncertainty about the scope and ultimate effects of these provisions which will have, therefore, to be taken into account as any FTA is designed and agreed.

6.13. Another uncertainty that arises in relation to any bespoke deal is the question of the appropriate dispute resolution mechanism. HM Government has said that Brexit will end the jurisdiction of the European Court of Justice (the “CJEU”) in the U.K. which

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111 Membership of the E.E.A. would end the “determination” rights of the U.K. to vote on E.U. legislation. Implementation of E.U. directives in E.E.A. states is also subject to a time lag, which may give rise to complexities in the passporting of cross-border business.

112 Article 2 of the GATS.
raises the question of which court or tribunal would have the power to hear disputes arising out of the operation of any bilateral agreement between the E.U. and the U.K. In this regard, the relationship between Switzerland and the E.U. may be illustrative of the problems that can arise.\footnote{113}

6.14. The E.U.-Swiss relationship is marked out by over 120 sectoral agreements. (It is important to note that there is, as yet, no sectoral agreement in financial services and reports suggest that there is no appetite in the E.U. for concluding one.) When a dispute arises over the application of one of these agreements, the resolution of the dispute is submitted to one of many diplomatic joint committees. There is no common surveillance institution for the agreements and no common court. 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.\footnote{114} 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. It is unclear whether HM Government would, in the case of one or more bilateral agreements with the E.U., consider that accepting oversight by the EFTA Court would breach its resolve to “take back control of our laws and bring an end to the jurisdiction of the European Court of Justice in Britain”.\footnote{115}

**Expanded equivalence**

6.15. A third model for the future relationship between the U.K. and the E.U. is the adoption by the E.U. of an expanded or enhanced framework for equivalence decisions.


\footnote{114}{An overview of the “docking solution” can be found in a speech delivered by Professor Dr Carl Baudenbacher, President of the EFTA Court, “After Brexit: Is the E.E.A. an option for the United Kingdom?” (13 October 2016), at pp. 5-6, available at: \url{https://www.kcl.ac.uk/law/tli/about/Baudenbacher-Kings-College-13-10-16.pdf}.

\footnote{115}{Speech by Prime Minister Theresa May “Negotiating Objectives for Exiting the E.U.”, (17 January 2017), available at: \url{https://www.gov.uk/government/speeches/the-governments-negotiating-objectives-for-exiting-the-eu-pm-speech}. These sentiments were reiterated by Mrs May in Parliament on 29 March 2017 on the occasion of giving notice under Article 50 of the Treaty on European Union, see \url{http://www.telegraph.co.uk/news/2017/03/29/full-theresa-mays-article-50-statement/}.}
6.16. As mentioned above, unless the current scope of equivalence regimes were significantly expanded, this would not resolve the issues facing, for example, U.K. AIFMs given that, under the AIFMD, access to the E.U. is not subject to an equivalence decision. Nor would it address areas, such as retail investment services, where no Third Country regime is available except by establishment (e.g. as a branch) and authorisation in the E.U.

6.17. It has been suggested that, building upon the interdependence of the U.K. and the remaining Member States, a solution could be negotiated by filling in these sizeable gaps.\textsuperscript{116} The expanded framework, it is said, could either be negotiated piecemeal or achieved by means of the adoption into E.U. law of a proposal which introducing a general right of Third Country access by way of a framework Regulation would provide for Third Country access in all sectors of the single market in financial services.

**Overseas Persons Exemption**

6.18. Another option for consideration may be for the U.K. to seek an arrangement with the E.U. by which U.K. firms would be permitted to provide investment services into the E.U. under some form of exemption specifically designed for Third Country market participants. The U.K.’s overseas persons exemption under Article 72 of the RAO can be used by an overseas person\textsuperscript{117}—defined as a person who carries on certain regulated activities but not from a permanent place of business in the U.K.—to carry on business either (i) with or through a person authorised by the FCA or the Prudential Regulation Authority or a person considered exempt under the RAO, such as certain regulated exchanges and clearing houses and various non-governmental bodies; or (ii) as a result of a “legitimate approach”, i.e., without having breached the U.K.’s restrictions on financial promotions.

6.19. It has been suggested that a similar regime could be developed to grant U.K. firms access to the E.U. There are, however, currently no E.U.-wide exemptions of this kind on which U.K. firms could rely to secure access. There are some exemptions in certain individual Member States but to rely on these the U.K. would have to consider its position with each Member State separately.

\textsuperscript{116} See references at n. 41 supra

\textsuperscript{117} See paragraph 2.11 above.
U.K. de-subsidiarisation for E.U. groups

6.20. An option that is gaining traction among financial markets commentators as a solution for E.U. financial services groups is sometimes referred to as “de-subsidiarisation”. This would involve a partial reversal of the process of local subsidiarisation which was implemented in the wake of the financial crisis to ensure that firms operating in the U.K. could be resolved locally. Where complex groups have an operating company in the remaining 27 Member States of the E.U., it may be easier to conduct business in the U.K. through a branch, rather than a subsidiary, after Brexit. The London-based branch of an E.U. parent may find it easier to satisfy competent authorities in one or more of the remaining 27 Member States of its regulatory standing to provide wholesale investment services into the E.U. than would a U.K. operating company or subsidiary.

E.U. establishment, authorisation and booking models for U.K. groups

6.21. Correlatively, a U.K. firm could either establish a subsidiary in the E.U. and apply for authorisation to provide services through that subsidiary or apply directly to a local regulator for authorisation in a Member State. In the case of “direct” authorisation of the latter kind, the U.K. firm would typically have to establish a branch office in the Member State in order to obtain authorisation. This is, however, only permitted in some Member States. In an attempt to avoid a race to the bottom amongst the Member States' regulatory standards to attract relocating firms and to prevent firms' from forum-shopping, ESMA has hinted at plans to establish a Supervisory Coordination Network, which will provide a forum for the national competent authorities of the remaining E.U. Member States to report and discuss Third Country applications and ensure consistency in decision-making.118 As briefly mentioned in section three, authorisations granted by the U.K.'s competent authorities will no longer be recognised in the E.U., and U.K. entities will have to undergo the process of obtaining separate authorisation.

6.22. The process of obtaining authorisation, or amending or upgrading an existing license in a Member State, is likely to prove time consuming and costly. The Opinion issued by ESMA earlier this year warns that the process for the authorisation of relocating entities will be time-consuming and that firms should factor such time into their plans.119 Costs could include moving staff and infrastructure (such as risk management and regulatory reporting systems) to the new jurisdiction and legal and compliance expenses in setting up or expanding a subsidiary. It is also possible that regulators will require an increase

119 2017 ESMA Opinion Paper, p. 3.
in the capital resources required to be maintained to support the group’s operations in that jurisdiction.

6.23. Furthermore, the extent to which a newly authorised entity will be permitted to outsource activities such as risk management and trading back to a U.K.-based firm is subject to stricter conditions established in the 2017 ESMA Opinion Paper. As a general principle ESMA advises firms to only outsource or delegate tasks or functions, not responsibilities. It also requires as part of the authorisation process all data related to outsourced activities and that outsourcing and delegation arrangements should not have an impact on business continuity, confidentiality and conflicts of interest. ESMA also directs competent authorities to scrutinise applicant firms' integral functions, such as internal control functions, risk assessment, compliance functions, key management functions and sector-specific functions.\textsuperscript{120} The process of gaining authorisation for a branch in an E.U. Member State is then only some degrees less complex than applying for equivalence but may, at least, offer more comprehensive access to the single market.

6.24. For many global banks, the U.K. authorised bank or investment firm operates as the main booking entity for E.U. and some Asian trading business. As with outsourcing, E.U. and national regulators will wish to understand and supervise any arrangements by which E.U. client trades are ultimately booked through a U.K. entity, either through intra-group back-to-back trades or through direct booking with the U.K. firm.

**Partial or sectoral solutions**

6.25. Finally, the FMLC calculates that there are partial solutions available in respect of many sectors of the wholesale financial markets. Enumerating each of these solutions is beyond the remit of this paper. One in particular, however, is suggested below by way of outline.

6.26. In the fields of insurance and reinsurance, Solvency II offers guidance as to the establishment of an insurer in the E.U. but no guidance with regards to the establishment of a branch of a Third Country reinsurer in the E.U. or the provision of reinsurance services by a Third Country reinsurer into the E.U. Each Member State is thus free to determine its own preconditions for access. The only restriction to which a Member State is subject is the requirement that the Third Country reinsurer is not treated more favourably than an E.U. reinsurer. This route paves the way for U.K. reinsurers to continue servicing business in the E.U. It has also been suggested that this

\textsuperscript{120} 2017 ESMA Opinion Paper, p. 5-6.
may provide a partial solution for U.K. writers of direct insurance. It is likely, however, that obstacles will remain, particularly in relation to the active marketing of business in the E.U., and the viability of this option may be subject to a review of the requirements imposed by each Member State and on the ease of the withdrawal negotiations.

7. CONCLUSION

7.1. In this paper, the FMLC has examined the provision of services by U.K. financial markets participants into the E.U. single market in the event the U.K. were to become, from the perspective of European legislation, a Third Country, with no treaty provision governing the supply of financial services. In such circumstances, the ability of U.K. financial services providers to access the E.U. single market will be delimited by existing provisions for Third Countries, where these are written into relevant E.U. legislation. These provide, for the most part, either: (i) access by Third Country firms to E.U. Member States on a country-by-country basis; or (ii) threshold requirements (most often for equivalence), having met which Third Country firms may be allowed to operate across the single market.

7.2. The analysis above has drawn attention to the partial, complex and uncertain nature of Third Country regimes and to the market disruption which may potentially arise at the point at which the U.K. withdraws from the E.U. if no additional provision is made. To that end, the FMLC has highlighted the following complexities relating to the use of Third Country regimes: their scope; the specificity of conditions which must be met in order to gain access under these regimes; and the uncertainty in the timing of any assessment. The FMLC has not undertaken an exhaustive examination of Third Country regimes; rather, the case studies of specific sectors presented in this paper are illustrative of these risks.

7.3. The provisions in E.U. financial markets legislation for Third Countries exclude important business lines, like deposit-taking, lending and retail fund offerings, leaving providers to seek establishment and authorisation in the E.U. As explored in section two of this paper, even where Third Country provisions are offered, they may be limited in scope, often only enabling the provision of specific services by Third Country firms in the E.U.

7.4. In section three, the paper examined the stringency and particularity of the rules for Third Country firms written into each Third Country regime. For each E.U. legislative
measure, the threshold criteria for admission vary and are internally complex. The diversity and specificity of the conditions applied, combined with an almost universal requirement in these regimes for the adoption of a discretionary decision by ESMA, the European Commission and/or E.U. national competent authorities means that an application for access under a Third Country regime is often fraught with uncertainty.

7.5. The regimes apply, eponymously, to “Third Country” regulatory systems and firms. The U.K. and U.K. services providers will not acquire this status until the end of the two-year Article 50 notice period, which implies that the application process cannot start until the U.K. leaves the E.U. The time taken for each assessment, decision and implementing act are similarly diverse and unclear.

7.6. Together, these uncertainties paint a daunting picture for U.K. market participants who have been, and would like to continue, providing services into the E.U. The risk of a “cliff edge” presents a substantial danger of market disruption and of litigation in relation to legacy business.

7.7. The FMLC sets out, in section six, a range of short- and long-term mitigants to these uncertainties, while acknowledging that the uncertainties raised in this papers will not be easily resolved. In the short-term, the FMLC has already recommended prioritising the negotiation of transitional provisions. For the long-term, the FMLC has identified actions which financial markets participants might take themselves to ameliorate uncertainty—including “de-subsidiarisation”, establishment and authorisation in the E.U. and other sector-specific solutions—as well as mitigants which might be reflected in forthcoming negotiations between the E.U. and the U.K.—such as a bespoke FTA, an expanded equivalence model, or the development of a regime similar to the U.K.’s overseas persons exemption.
GLOSSARY OF TERMS


“AIF” means alternative investment fund.

“AIFM” means alternative investment fund manager.


“Benchmarks Regulation” refers to the Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds.

“Brexit” refers to the U.K.’s withdrawal from the European Union.

“BRRD” means Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms.

“Capital Requirements Directive” refers to Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

“Capital Requirements Regulation” and “CRR” refer to the Regulation 575/2013 on prudential requirements for credit institutions and investment firms.

“CRD IV Package” refers collectively to the Capital Requirements Directive, the CRR and secondary E.U. legislation implementing these measures.

“CCP” means central counterparty.

“CJEU” refers to the European Court of Justice.

“CME” means CME Group Inc. or the Chicago Mercantile Exchange, as the context requires.


“E.E.A.” means the European Economic Area.

“E.E.A. Agreement” refers to the Agreement on the European Economic Area, which entered
into force in 1994.

“E.U.” refers to the European Union.

“E.U. Member States” or “Member States” refers to member states of the European Union.

“EFTA” means the European Free Trade Association.

“EIOPA” is the European Insurance and Occupational Pensions Authority.


“EMIR Review Proposal” refers to COM(2017) 331 final: Proposal for a Regulation amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs.

“ESAs” refers to the European Supervisory Authorities.

“ESMA” refers to the European Securities and Markets Authority.


“European Commission” is the E.U.’s executive body.

“FATF” is the E.U.’s Financial Action Task Force.

“FCA” is the U.K.’s Financial Conduct Authority.

“FTA” refers to a free trade agreement.

“GATS” refers to the General Agreement on Trade in Services of the WTO.


“IRSG Report” refers to a report entitled The E.U.’s Third Country regimes and Alternatives to Passporting, published in January 2017 by the International Regulatory Strategy Group in collaboration with Hogan Lovells International LLP.

“MFN” refers to the Most Favoured Nation provision of the WTO GATS which requires WTO
member countries not to discriminate between services and service providers from other WTO member countries.


“MTF” refers to a multilateral trading facility within the meaning of MiFID II.

“NPPRs” means the national private placement regimes, provided for under the AIFMD.

“OECD” is the Organisation for Economic Cooperation and Development.

“OTF” refers to an organised trading facility within the meaning of MiFID II.

“PD III” refers to the Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC.

“Prospectus Directive” refers to the Directive 2001/34/EC on the prospectus to be published when securities are offered to the public or admitted to trading.


“Third Country” refers to a jurisdiction outside of the E.U./E.E.A.

“Third Country regimes” refers to the various provisions written into E.U. legislation which permit, under specific conditions, non-E.U. countries to provide services into the E.U.

“TEU” refers to the Treaty on European Union.

“TSC Letter” refers to a letter sent by the FMLC to the U.K. Treasury Select Committee in response to a consultation on the need and importance of transitional arrangements between the U.K. and the E.U., upon Brexit.
“UCITs” are undertakings for collective investment in transferable securities.

“UKLA” is the U.K. Listing Authority.

“WTO” refers to the World Trade Organisation.
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U.K. WITHDRAWAL FROM THE E.U.: LETTER TO TREASURY SELECT COMMITTEE ON TRANSITIONAL ARRANGEMENTS

JANUARY 2017
Inquiry on the U.K.’s future economic relationship with the E.U.

The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.1

The Committee regularly produces publications that are received with widespread approbation by both industry and public sector bodies, domestically and overseas. These are available on its website at www.fmlc.org. The Committee also regularly engages with members of the European Commission, Financial Stability Board and international regulators on matters of concern to the wholesale financial markets.

Following the result of the E.U. Referendum, the FMLC announced that it would work with experts in law and financial services to identify, analyse and address legal uncertainties relating to the U.K.’s withdrawal from the E.U. (“Brexit”) and that it would establish a High Level Advisory Group (“HLAG”) to give direction to the Committee’s future work in this field. Its research programme is now well under way.2 In this context, the FMLC welcomes the opportunity afforded by the Treasury Select Committee’s inquiry into the U.K.’s future relationship with the E.U. to contribute to the ongoing discussions on securing the optimum transitional arrangements for an orderly withdrawal.

In a speech delivered on 17 January 2017, Prime Minister Theresa May offered an outline for the U.K.’s coming negotiations with the E.U., stating her intention to obtain a customs agreement with the E.U. that leaves the U.K. free to reach individual tariff schedules at the World Trade Organisation (“WTO”) and to seek transitional arrangements for financial services. She observed that the U.K. "cannot possibly" remain within the European single market.

In accordance with this plan, at the end of the two-year Article 50 notice period, when the U.K. ceases to be a member of the E.U., it will automatically lose all access rights to the European single market in financial services and will become, from the perspective of E.U. law, a “Third Country”. While there exist already under many E.U. regulatory measures Third Country regimes that allow financial services activities to be conducted on a cross-border basis, there remains uncertainty as to the conditions that the U.K. and British regulators will have to satisfy in order to be able to secure a

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1 In view of the role of HM Government in the negotiations for withdrawal, Sinead Meany, Stephen Parker and Sean Martin took no part in the preparation or discussion of this letter and it should not be taken to represent the views of the Bank of England, HM Treasury or the Financial Conduct Authority.

2 The text of the announcement and further details of the FMLC’s work in this area are available at: [http://www.fmlc.org/the-fmlcs-work-on-brexit.html](http://www.fmlc.org/the-fmlcs-work-on-brexit.html).
positive determination on access and the timescale within which such determinations might be made.

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 upon Brexit, regard it as essential 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.

A hiatus of this kind could mean that 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). For many, this would require establishing a new entity within an E.U. Member State or otherwise restructuring the group.

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 Treaty of the European Union.

In light of these considerations, the question of transitional provisions would appear to be an urgent one. Nevertheless, given the complexity of the issues and markets at stake, the Committee takes the view that the question would benefit from as much careful research and analysis as time will afford. One way in which 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.)

Assuming that transitional arrangements are found to be desirable from a policy perspective, it will be important to consider the status under international trade law of any such arrangements. In particular, the General Agreement on Trade in Services (“GATS”) of the WTO 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. While the GATS, in effect, exempts certain mutual recognition agreements between WTO member countries from this strict version of MFN, there is legal uncertainty about the scope and ultimate effects of these provisions which should, therefore, be taken into account as any transitional agreement is designed and negotiated.

The FMLC is in the process of analysing and addressing legal uncertainties in the context of Brexit and has undertaken to publish, in particular, work in relation to Third Country regimes in European financial services regulation. The Committee expects to have further comments to make on transitional issues based on such future work. In the meantime, the Committee remains at your disposal should you require further clarification on issues of legal uncertainty arising from Brexit in the wholesale financial markets.
I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely,

Joanna Perkins
FMLC Chief Executive

DECEMBER 2016
FINANCIAL MARKETS LAW COMMITTEE


DECEMBER 2016

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1. **INTRODUCTION**

1.1 The role of the Financial Markets Law Committee (the “FMLC” or the “Committee”) is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2 On Thursday 23 June 2016, the U.K. voted to leave the E.U. In the wake of the referendum result, the FMLC announced the establishment of a High Level Advisory Group (“HLAG”) to give direction to the Committee’s future work programme in this area and to convene a standing forum of experts to contribute to research and publications. Drawing on these and other resources, the FMLC said it would work to identify, analyse and address legal uncertainties relating to the U.K. withdrawal (“Brexit”). Pursuant to the announcement, the HLAG on Brexit was convened by the FMLC Secretariat in July to offer guidance on the approach that the FMLC should take. At the inaugural meeting, the HLAG recommended that the FMLC should establish a working group of experts to consider uncertainties relating specifically to English governing law and jurisdiction clauses in cross-border financial markets transactions and reliance on these clauses in international commercial litigation. Accordingly, a Working Group was established in August 2016 and its discussions form the basis of the analysis set out in this paper.

1.3 In the course of its discussions, the Working Group made reference to a number of legal instruments which form the bulk of private international law (or “conflict of laws”) rules which apply in the U.K. to regulate financial markets transactions—and, indeed, all commercial contracts. The looming issue of legal uncertainty can, perhaps, best be summarised by observing that all of these instruments apply in the U.K. solely by reason of the fact that the U.K. is a Member State of the E.U.:

(a) the 2005 Hague Convention on Choice of Court Agreements the “Hague Convention”),

(b) the 2007 Lugano Convention (the “Lugano Convention”);

(c) the Recast Brussels Regulation (the “Recast Brussels Regulation”);

(d) the Rome I Regulation (“Rome I”), and

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2 The text of the announcement and further details of the FMLC’s work in this area are available at: [http://www.fmlc.org/the-fmlcs-work-on-brexit.html](http://www.fmlc.org/the-fmlcs-work-on-brexit.html).

3 Convention of 30 June 2005 on Choice of Court Agreements (available at: [www.hcch.net](http://www.hcch.net)).


The sections below address issues of legal uncertainty likely to arise in the context of cross-border commercial litigation in consequence of Brexit. The cause of the Committee’s concern and engagement is briefly stated in section 2. In section 3, the paper examines the situation with regard to choice of law clauses in financial markets contracts and concludes that contractual continuity would be enhanced by the preservation of the current rules after Brexit. Sections 4 and 5 focus on the question of jurisdiction, especially regarding the jurisdiction of English courts under an English choice-of-court agreement and the enforcement of English judgments. These sections acknowledge the greater problems of legal uncertainty to which Brexit is likely to give rise and, by way of solution, they analyse the consequences were existing E.U. instruments to be replaced in the U.K. by a new conflict of laws agreement with the E.U. or a new accession to existing international conflict of laws instruments. Following this analysis, the FMLC’s conclusions and recommendations are briefly restated, by way of closing, in section 6.

2. THE PROBLEM OF UNCERTAINTY

2.1 Many commercial contracts contain a choice-of-court clause designating the courts of England, often accompanied by a choice-of-law clause designating English law. Frequently, the parties will have no connection with England: they choose English courts and English law because they want a neutral forum and a system of law that is known to them and believed to be satisfactory from a business point of view.

2.2 Until recently, there has been a high degree of certainty that the provisions on choice of law and choice-of-court would be valid and effective both in the U.K. and in other E.U. and EFTA Member States. This is in large part owing to the U.K.’s membership of the E.U. The sections below consider the potential consequences of leaving the E.U. first in relation to choice of law and then jurisdiction and judgments.

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8 For an earlier study on this topic, see Masters & McRae, “What Does Brexit Mean for the Brussels I Regime?” (2016) 33 Journal of International Arbitration 483.

9 Separate working groups are being established to consider the question of cross-border insolvency and bank resolution, respectively.
3. **CHOICE OF LAW**

3.1 The two main E.U. instruments in this area are the Rome I Regulation and the Rome II Regulation. Rome I is a more significant element in the legal framework for cross-border financial markets transactions. It deals with the applicable law for contracts and its importance for markets in financial instruments, which are characterised by the prevalence of contracts on market standard terms, cannot be overstated. The commercial heart of the Rome I Regulation is to be found in Article 3(1) which provides that “[a] contract shall be governed by the law chosen by the parties…” but Article 4 (*Applicable law in the absence of choice*) provides a useful rule for determining the governing law of a contract in financial arrangements which do not incorporate a choice of law agreement. Rome II deals with non-contractual obligations and, by way of example, may apply to determine the system of law which will apply to a cross-border claim involving alleged professional negligence or negligent misstatement. In a financial markets context, such claims might include, for instance, claims by investors against issuers, where the investors have purchased their securities in the secondary markets.

3.2 Both instruments require courts of the Member States to respect governing law clauses, subject to certain limited exceptions, and are based on the principle of universal application: the rules they lay down operate in the same way irrespective of whether the country whose law is to be applied is a Member State of the E.U. or a Non-member State. Therefore, the application of English law under these instruments—for example, under an English choice-of-law clause—will not be affected by Brexit as far as proceedings in the courts of E.U. Member States are concerned. In other words, Member States’ courts would continue to respect English governing law clauses in the wake of Brexit as they do now, and subject to essentially the same limited exceptions.

3.3 It is to be assumed that both Rome I and Rome II will cease to apply in the U.K. under E.U. law once Brexit takes place, although a similar result will often be reached under the pre-existing English-law rules. There is, however, much to be said in favour of the U.K. adopting legislation for the continued application of Rome I and Rome II as a matter of U.K. law. Although the common law rules on choice of law are broadly similar to those set out in these instruments, lawyers and courts in England and elsewhere have grown familiar

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10 Choice of law clauses are less common in some standard form financial transactions than others. Letters of credit, for example, do not always incorporate choice of law clauses.

11 Rome I, Article 2; Rome II, Article 3.

12 There is no existing model relationship with the E.U. under which a third country agrees to be bound by E.U. conflict of laws regulations. The Agreement on the European Economic Area (which entered into force in 1994), represents the closest treaty relationship yet developed between E.U. and non-E.U. States. It requires implementation by the non-E.U. signatories only of those E.U. rules relating to the four freedoms of movement within the internal European market. On 2 October 2016, the Prime Minister of the U.K. announced plans for a Great Repeal Bill which will, when it comes into force, repeal the European Communities Act 1972. Section 2(1) of the 1972 Act provides that provisions of E.U. law are automatically binding in the U.K. When the 1972 Act is repealed, directly effective E.U. laws such as Rome I and Rome II will cease to have effect in the U.K. unless the contrary is expressly provided for in the Great Repeal Bill.

13 When this happens, there will no longer be references to the CJEU from U.K. courts on the interpretation of the Regulations.
with these regulations over the years and their higher level of development—for example, the fact that Rome II makes it clear that a choice of law for non-contractual obligations will be respected—makes outcomes under them more predictable. Retaining their application and effect in the U.K. would help alleviate uncertainty regarding the effects of Brexit.

3.4 The Committee is, therefore, of the view that legal certainty would be enhanced were Rome I and Rome II to continue to apply under U.K. law after Brexit, subject only to minor technical amendments, principally to reflect the fact that the U.K. will no longer be part of the E.U.\textsuperscript{14} This result might be achieved either by a “standstill” provision under the Great Repeal Bill referring directly to Rome I and Rome II, or by new statutory provision for the conflict of laws in the U.K.

3.5 The FMLC notes that consideration might usefully be given to arrangements for the transition from the old regime to the new one and for “grandfathering” governing law clauses in legacy financial markets transactions. For example, a choice-of-law clause adopted when Rome I applies as a matter of E.U. law should apply in the same way after the U.K. leaves the E.U. Continuity would be enhanced were the courts of the U.K. to be required, where appropriate, to have regard to relevant decisions of the CJEU in interpreting the retained provisions.\textsuperscript{15}

4. CIVIL JURISDICTION AND JUDGMENTS

4.1 The position will be different with regard to jurisdiction and recognition of judgments. The Recast Brussels Regulation distinguishes between parties domiciled in a Member State and those not so domiciled, between proceedings in the courts of a Member State and proceedings in other courts, and between judgments given by the courts of Member States and other judgments. For this reason, the U.K.’s withdrawal from the E.U. may make a significant difference, although in relation to the allocation of jurisdiction pursuant to a choice-of-court agreement and the enforcement of judgments, the difference may be greater in theory than in practice (see paragraph 4.4 below).

4.2 The most important benefits conferred on Member States (including the U.K.) by the Recast Brussels Regulation are:

\textsuperscript{14} References in the instruments to the “European Union” and to “Member States” would no longer be appropriate. In the case of Rome I, these include Article 1(4) (definition of “Member State”), Article 2 (principle of universality) and Article 3(4) (the rule that in certain situations a choice of law by the parties does not prejudice the application of E.U. law). It would also be desirable to make changes to the provisions in Article 7 on insurance contracts, especially in so far as these distinguish between Member States and non-member States. Article 25 should make clear that the rules laid down in the instrument would apply within the U.K.—for example, between England and Wales, on the one hand, and Scotland, on the other hand—in the same way as they apply internationally.

\textsuperscript{15} A statement published by HM Department for Exiting the European Union on 2 October 2016 announced that the Great Repeal Bill would end the jurisdiction of the CJEU in the U.K. The statement is available at: https://www.gov.uk/government/news/government-announces-end-of-european-communities-act
(a) in proceedings in the courts of E.U. Member States, U.K.-domiciled defendants are protected from exorbitant jurisdiction—for example, jurisdiction based on the nationality or domicile of the claimant;

(b) if the U.K. courts have exclusive jurisdiction—for example, regarding title to land in the U.K., or the validity of U.K.-registered IP rights—the courts of other Member States are precluded from hearing the case;

(c) if the English courts are the first courts seised of a matter, the courts of other Member States are precluded from hearing a parallel action (an action between the same parties regarding the same matter);

(d) if an English court gives a judgment, there is a simple and effective procedure for enforcing it in other Member States; and

(e) where a contract is governed by an exclusive English choice-of-court agreement, courts of other Member States are precluded from hearing a case to interpret and/or enforce the terms of the contract (this has been made more effective in the Recast Brussels Regulation, which contains provisions to make a jurisdictional manoeuvre known as the “torpedo” ineffective).16

4.3 After Brexit, absent any agreement with the remaining Member States (as to which see further below), it is to be assumed that the provisions of the Recast Brussels Regulation which confer these benefits will cease to apply to the U.K.17 The benefits listed above will then be conferred on the U.K., if at all, only on some other basis. Similarly, they will cease to apply (at least on a formal treaty basis) to parties domiciled in the E.U. Member States, insofar as such parties may be subject to proceedings in the U.K.

4.4 As regards benefits currently conferred on the U.K., some may be retained on one of more of the following grounds:

(a) some benefits may be conferred on U.K.-domiciled defendants under the national laws of E.U. Member States;

(b) protection for U.K. proceedings may be conferred by the courts of E.U. Member States, who have a discretionary power under the Recast Brussels Regulation to stay proceedings, in specified circumstances, where the courts of a non-member State are

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16 Recast Brussels Regulation, Article 31, paragraphs (2) to (4), read with Recital 22. The “torpedo” refers to a variety of forum shopping whereby a prospective defendant seeks pre-emptively to initiate proceedings in a jurisdiction where court procedure militates against a swift resolution of questions of forum or jurisdiction. The objective of the manoeuvre is to delay or postpone proceedings in the courts favoured by a contractual jurisdiction clause (which the defendant anticipates will be disinclined to look favourably on his/her defence) on the grounds that the court first (i.e. pre-emptively) seised must of its own motion decline jurisdiction before proceedings can continue in the contractually favoured forum.

17 See n.12 supra.
seised first. The protection would be narrower and less effective than under the current regime; and

c) the judgments of U.K. courts may be recognised and enforced under the national law of the Member State concerned.19

4.5 The position regarding choice-of-court agreements in financial markets transactions is more complex. What is said above with regard to the recognition of judgments—i.e. that it may still be achieved under national law in at least some cases—would also apply to judgments granted under a choice-of-court agreement. There is, however, some uncertainty as to the approach that Member States’ courts will take to English jurisdiction clauses following Brexit. This is because the Recast Brussels Regulation does not provide expressly for what Member States’ courts should do if proceedings are brought in the courts of an E.U. Member State which have jurisdiction under the Recast Brussels Regulation (for example, because the defendant is domiciled there), but there is an exclusive choice-of-court agreement designating the courts of a non-Member State—for example, the U.K. Uncertainty has been generated by an Opinion of the CJEU given with a view to determining whether the E.U. had exclusive competence to conclude what became the Lugano Convention.20 A Full Court of the CJEU (21 judges) took a view which, despite earlier authorities to the contrary,21 appears to suggest that the choice-of-court agreement would have no effect.

4.6 The CJEU held that the E.U. had exclusive competence to conclude the Lugano Convention.22 To establish this, the CJEU had to show that the proposed Convention would affect an existing E.U. measure. It said that it would affect the Brussels Regulation 2000 (the predecessor to the Recast Brussels Regulation). To illustrate this, the CJEU took the example of two parties, one of whom is domiciled in an E.U. Member State, who conclude a choice-of-court agreement designating the courts of a State which is not an E.U. Member State but which would be a Party to the proposed Convention. It assumed that the party

18 Recast Brussels Regulation, Articles 33 and 34.

19 Before the U.K. joined the E.U., it had judgment-recognition conventions with a number of Member States (France, Belgium, Germany, Austria, Italy and the Netherlands; see OJ 2015, C 390/6, List 3). These were superseded by the Brussels Convention and, subsequently, by the Recast Brussels Regulation. These might revive, but this is uncertain. In any event, the law is different in each Member State and in some Member States it is restrictive. In all cases, “exequatur” would have to be obtained and the foreign court would scrutinize the grounds on which the English court took jurisdiction to see whether they were acceptable under its national conflict of laws rules. That is not to say, however, that English judgments will not be enforceable in the Member States post-Brexit. Indeed, in many cases they will be (in the same way as judgments from other non-member States e.g. New York are currently enforced in the E.U.). It will, however, make enforcement more time consuming and costly.


22 A procedure under Article 218(11) of the Treaty for the Functioning of the European Union allows the Commission, the Council, the Parliament or a Member State to seek the opinion of the Court on the compatibility between the Treaties and an agreement that the Union proposes to conclude with a non-Member State or an international organisation. In such a case, the CJEU opinion is binding.
domiciled in the E.U. Member State is sued in the courts of that Member State. In such a situation, said the CJEU, the court of the Member State would have jurisdiction without the Lugano Convention but would have no jurisdiction with it.\(^{23}\) Whilst it is far from certain that the CJEU would adopt this approach in the future, the possibility that it might is enough to add a layer of uncertainty.\(^{24}\)

**Conclusions on the effect of Brexit**

4.7 The FMLC concludes, on the basis of the analysis above, that Brexit would exacerbate legal uncertainty concerning the enforceability of jurisdiction clauses favouring, and, to some extent, the recognition and enforcement of the judgments of, courts of the U.K. unless additional remedial action were taken to obviate the uncertainty as part of the legal arrangements for the withdrawal.\(^{25}\) A similar point can be made, mutatis mutandis, about the recognition in the U.K. of jurisdiction clauses favouring, and the judgments of, the courts of E.U. Member States.

5. **POTENTIAL SOLUTIONS FOR JURISDICTION AND JUDGMENTS**

**The Hague Convention**

5.1 At present, the U.K. is not a party to the Hague Convention in its own right: the E.U. is a party and the Hague Convention applies to the U.K. under European law.\(^{26}\) In the event of Brexit, the Hague Convention will cease to apply in the U.K. In these circumstances, the U.K. would be entitled to become a party in its own right and this would not require the consent of the E.U. or other contracting states.

5.2 The Hague Convention can be summarised as follows: it requires the court or courts designated in an exclusive choice-of-court agreement to hear the case; it precludes courts of other contracting states from hearing parallel proceedings; and it requires any judgment granted by the designated court to be recognised and enforced in other contracting states.

\(^{23}\) Paragraph 153 of the judgment.

\(^{24}\) In subsequent cases in which it could have decided the point, the CJEU has not done so: Case C-154/11, Mahamdia v. Algeria, ECLI:E.U.:C:2012:491; Case C-175/15, Taser International, ECLI:E.U.:C:2016:176.

\(^{25}\) There has been speculation as to whether the 1968 Brussels Convention (OJ 1978, L 304, p. 77) or the 1988 Lugano Convention (OJ 1988 L 319/ 9) might revive after Brexit: see Dickinson, “Back to the Future: the U.K.’s E.U. Exit and the Conflict of Laws” (2016) 12 Journal of Private International Law 195. Both conventions cover roughly the same ground as the current Recast Brussels Regulation. The Brussels Convention was superseded by the Brussels Regulation, 2000 (and now by the Recast Brussels Regulation), except as regards a few obscure overseas territories: Brussels 2000, Article 68; Recast Brussels Regulation, Article 68. The 1988 Lugano Convention was superseded by the 2007 Lugano Convention. It is doubtful whether either of these conventions would revive – the final word, as regards the other E.U. Member States, rests with the CJEU – and there are various practical problems. In any event, the system they establish is outdated compared with the Recast Brussels Regulation: see Dickinson (above), at pp. 203–207.

\(^{26}\) The Hague Convention entered into force in respect of Mexico and the E.U. Member States (excluding Denmark) on 1 October 2015. The transitional provisions of the Convention mean that it will only apply to exclusive choice of court agreements in favour of an E.U. Member State, or Mexico, concluded on or after 1 October 2015.
5.3 Its particular advantages from the point of view of parties to a choice-of-court agreement are that, if there were an exclusive choice-of-court agreement designating the courts of the U.K., the Hague Convention would—subject to a possible exception discussed below—prevent parallel proceedings in E.U. Member States (except Denmark)\(^{27}\) and it would require E.U. Member States (except Denmark) to recognise and enforce the resulting judgment.\(^{28}\) The Hague Convention is, however, more limited in its application than the Recast Brussels Regulation.

5.4 First, it applies only to exclusive choice-of-court agreements.\(^{29}\) Moreover, an agreement is regarded as exclusive only if it is exclusive irrespective of the party bringing the proceedings.\(^{30}\) Thus, it would not apply to an “asymmetric” jurisdiction agreement, which provides: “The lender may sue the borrower in England or in any other country the courts of which have jurisdiction under their law, but the borrower may sue the lender only in England.”

5.5 Secondly, its subject-matter scope is limited. For example, it does not apply to the carriage of persons or goods by land, sea or air;\(^{31}\) so choice-of-court agreements in bills of lading are excluded.

5.6 Thirdly, the obligation not to entertain parallel proceedings is subject to significant qualifications. Thus, if a party lacks the capacity to conclude the agreement under the law of the State of the court seised, that court would not have to decline jurisdiction.\(^{32}\) It would also not have to decline jurisdiction if giving effect to the agreement would lead to a “manifest injustice” or would be “manifestly contrary to the public policy of the State of the court seised.”\(^{33}\) These exceptions mean that the circumstances in which a contracting state’s courts may be able to refuse to decline jurisdiction in favour of a court designated in an exclusive jurisdiction clause are wider than those under the Recast Brussels Regulation.

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\(^{27}\) Denmark has an opt-out from the relevant E.U. provisions; so it is not bound by the Hague Convention as an E.U. Member State. It has not yet ratified the Convention in its own right.

\(^{28}\) In addition, it would grant us benefits with regard to non-E.U. contracting states, at present Mexico and Singapore.

\(^{29}\) Hague Convention, Article 22 provides for its judgment-recognition provisions to be extended to non-exclusive choice-of-court agreements as between contracting states which have made a declaration to that effect, but the E.U. has made no such declaration.

\(^{30}\) This is not expressly stated in the text but see Minutes No 3 of the Twentieth Session, Commission II, paragraphs 2–11. See, further, the Hartley/Dogauchi Report, paragraph 106.

\(^{31}\) Hague Convention, Article 2(2)(f).

\(^{32}\) Hague Convention, Article 6(b). This would mean that if the agreement designates the courts of the U.K. and the parties both have capacity under English law, a court in which parallel proceedings were brought would not have to decline jurisdiction if one party lacked capacity under its law.

\(^{33}\) Hague Convention, Article 6(c).
Fourthly, the obligation to recognise and enforce judgments given under a choice-of-court agreement is subject to similar exceptions.34

Finally, if there were a direct conflict between the Hague Convention and E.U. law, E.U. law would prevail under the terms of the Hague Convention, unless one of the parties was resident in a State that was a party to the Hague Convention but not a Member State of the E.U.35 This means that the Recast Brussels Regulation would prevail if the parties were, for example, French and German or French and Japanese (assuming that Japan does not join the Hague Convention).

This last restriction would constitute a problem only if there were a direct conflict between the Hague Convention and the Recast Brussels Regulation. The only situation in which this might occur is that discussed above: that is, where the choice-of-court agreement designates the courts of a non-Member State—for example, the U.K. after Brexit—and the proceedings are brought in the E.U. Member State in which the defendant is domiciled. In this situation, there is a possibility that the CJEU might decide that the court of the Member State is precluded from declining jurisdiction, although, as explained above, it is far from certain that it would do so. Even were it to do so, there would still be many situations in which the Hague Convention would require E.U. courts to decline jurisdiction.36

The Lugano Convention

The 2007 Lugano Convention replaces the 1988 Lugano Convention. The parties to this treaty are the E.U., Denmark, Iceland, Norway and Switzerland. Its purpose is to extend the Brussels regime for jurisdiction and judgments to Iceland, Norway and Switzerland. The U.K. is not a party to the Convention but is bound by it because the U.K. is an E.U. Member State. Once the U.K. leaves the E.U., it will no longer be bound. If the U.K. were to become a member of EFTA, it would have a right to join the Lugano Convention.37 Otherwise, it can join only with the unanimous consent of the other parties.38 This means that the E.U. would have to consent.

The main drawback of the Lugano Convention is that it is based on the Brussels Regulation of 2000, now superseded by the Recast Brussels Regulation. This means that it lacks the improvements to be found in the latter instrument, especially the provisions designed to make the jurisdictional “torpedo” manoeuvre ineffective. On a positive note, however, it is

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34 Hague Convention, Article 9.
35 Hague Convention, Article 26(6).
36 For example, where the defendant was not domiciled in an EU Member State; or in which one of the parties was domiciled in the U.K. or in another non-EU State that was a Party to Hague.
37 Lugano Convention, Article 71 read with Article 70(1)(a).
38 Lugano Convention, Article 72(3).
reported that efforts will be made to update the Lugano Convention with a view to incorporating these improvements.

5.12 Under the Lugano Convention, the final authority for interpreting the Convention is the CJEU as regards cases in E.U. Member States, and the Supreme Courts of the other parties as regards cases in their courts. There is, however, a provision that these courts must “pay due account” to each other’s judgments.\(^{39}\) In practice, the judgments of the CJEU carry considerable weight.

**Recast Brussels Regulation**

5.13 A third possibility is that the U.K. might choose to remain bound by the Recast Brussels Regulation even after it leaves the E.U, with the concurrence of other Member States. A treaty would need to be put in place between the E.U. and the U.K. to achieve this, providing in essence that, for the purpose of the Recast Brussels Regulation, the U.K. is to be treated as if it were still a Member State.

5.14 There is precedent for this. Because the Maastricht Treaty accords Denmark the right to opt out of E.U. provisions on private international law, Denmark is not bound by the Recast Brussels Regulation. It has, however, concluded a special treaty with the E.U. under which it is bound as a matter of international law. This treaty makes provision for Denmark to be bound by revisions to the Regulation as well. Were this treaty relationship to be replicated between the U.K. and U.K.-domiciled parties and E.U. Member States (and Member State-domiciled parties) by enhancing legal certainty, preserving continuity to the greatest extent possible and conferring the mutual advantages of the Recast Brussels Regulation on courts and litigants in both the U.K. and the E.U., even after the U.K.’s withdrawal.

5.15 It should be noted that the treaty with Denmark provides for references from the courts of Denmark to the CJEU. A statement published by HM Department for Exiting the European Union on 2 October 2016 announced that the proposed Great Repeal Bill would end the jurisdiction of the CJEU in the U.K.\(^{40}\) Were there sufficient political will on both sides, this potential inconsistency could, perhaps, be resolved by requiring the U.K. Supreme Court to pay due account of judgments of the CJEU without being bound by them, but it is not clear that a compromise of this nature will be available.

**Coming into force and transitional issues**

5.16 Transition involves two issues: first, when would one of the putative instruments discussed above enter into force in the U.K. and, second, what arrangements should be made for cases which span the two regimes (i.e. “before” and “after”). These problems will be discussed separately for each instrument.

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\(^{39}\) Lugano Convention, Protocol 2, Article 1(1).

\(^{40}\) See n.15 supra.
Hague Convention

5.17 Once Brexit takes place, the Hague Convention will cease to apply in the U.K. unless the U.K. becomes a Party in its own right. If this were done, the Convention would come into force for the U.K. on the first day of the month following the expiration of three months after the deposit of the U.K.’s instrument of ratification. This three-month gap would be unfortunate—unless alternative arrangements were made, it would give rise to a “cliff edge” descent into temporary but acute uncertainty during the 3-month window and disproportionately disadvantage a small number of litigants who had the misfortune to be in dispute at that time. Accordingly, it is desirable that the gap should be eliminated. Whether or not the U.K. would be able in good faith to deposit its instrument of ratification three months before leaving the E.U. is partly a political question, one which would be affected by all the circumstances of the withdrawal.

5.18 There are two rules as regards transitional issues. The primary rule is set out in Article 16(1): “the Hague Convention applies to choice-of-court agreements concluded after the entry into force of the Convention in the Home State of the chosen court.” The secondary rule is contained in Article 16(2) of the Convention: “the Convention will not apply to proceedings instituted before its entry into force for the State of the court seised.”

5.19 The entry into force of the Hague Convention occurred for all Member States of the E.U.—except Denmark but including the U.K.—on 1 October 2015. In the view of the FMLC, assuming the 3-month gap discussed above can be eliminated, the Hague Convention should apply in respect of all choice-of-court agreements designating U.K. courts concluded after 1 October 2015, notwithstanding that the basis on which the U.K. accedes to the Hague Convention may change.

The Lugano Convention

5.20 The position regarding the Lugano Convention depends on whether the U.K. joins the existing Convention, or joins a new, revised Convention (incorporating the improvements adopted in the Recast Brussels Regulation). If the U.K. were to join the existing Convention, it could do so by accession. The current Parties, including the E.U., would have to give their consent. Assuming this was forthcoming, the Depositary (Switzerland) would invite the applicant State to accede by depositing its instrument of accession. The

41 Hague Convention, Article 31(2)(a).
42 Article 70(1)(c), Article 72 and Article 73.
43 Article 72(3). There is a certain inconsistency between this provision and Article 72(4), the latter suggesting that if not all existing Parties give their consent, the Convention will enter into force between the acceding State (the U.K.) and those Contracting States which have not made any objections to the accession. If there is an inconsistency, Article 72(4) prevails, since Article 72(3) states that it is without prejudice to Article 72(4).
44 Article 72(3) states that the Contracting Parties must endeavour to give their consent within one year of being invited to do so by the Depositary.
Convention would enter into force on the first day of the third month following the deposit of the instrument of accession.45

5.21 If the U.K. were to become a Party to a revised Convention, the coming into force of that Convention would depend on its terms. It would be desirable for provision to be made bringing it into force as between the U.K. and the E.U. as soon as it had been ratified by these two parties, even if other Parties had not yet ratified it.46 If this were done, delays in ratification by other Parties would not prejudice the position between the U.K. and the E.U. In any event, the damaging effects of legal uncertainty in both the U.K. and the E.U. can be minimised by reducing, or preferably eliminating, any temporal gap between the date at which the Brussels Recast Regulation no longer has effect in the U.K. and the entry into force of the (revised) Lugano Convention.

5.22 As far as applicability to individual proceedings is concerned, the crucial date is the date when the legal proceedings are instituted.47 So if, when the proceedings are instituted, the Lugano Convention applies in the U.K., either because the U.K. is a Member State of the E.U. or because the U.K. is a contracting state in its own right, those proceedings will be covered by the Convention. If proceedings are subsequently taken to enforce the judgment in another contracting state, the Convention might not apply unless the U.K. were still a Party to the Convention. There is no obvious reason, however, why it should matter if it were, by then, acceding on a different basis. So there would again appear to be no transitional problems, provided there was no gap between the two regimes.

The Recast Brussels Regulation

5.23 The position with regard to the Recast Brussels Regulation would appear to be similar. The putative treaty establishing the new relationship between the U.K. and the E.U. for this purpose would stipulate when it would come into force and set out the necessary transitional provisions. There would again appear to be no transitional problems, provided any temporal gap can be eliminated.

5.24 Finally, the FMLC observes that the E.U. treaty-making procedure is complex and tends to be lengthy. For this reason, it is desirable that negotiations on any proposed new instruments or accession arrangements should begin as soon as possible.

Guidance as to preferred political outcomes

5.25 In view of the uncertainty created by the U.K.’s intention to leave the E.U., which the FMLC understands is already affecting cross-border financial transactions, public guidance by HM Government as to the action it will take to deal with the matters addressed in this

45 See the Explanatory Report by Professor Fausto Pocar, OJ 2009, C 319/1 at pp. 51–52.
46 There is a provision along these lines in the 2007 Lugano Convention. See Article 69(4).
47 Article 63(1).
paper would be helpful. Such guidance should ideally be as detailed and specific as possible. This would do much to reassure parties to contracts subject to the jurisdiction of the English courts, or to which English law is applicable, that the provisions of their contracts will continue to be effective.

6. CONCLUSION

6.1 The objective of this paper has been to identify and, where appropriate, suggest potential solutions to issues of legal uncertainty which may arise in the context of cross-border commercial litigation in consequence of Brexit. The FMLC has drawn attention in particular to: 1) the possibility of reduced certainty and predictability in the field of contractual and non-contractual obligations if the Rome I and Rome II rules on choice of law were no longer to apply in the U.K.; and 2) the mutual loss of advantages and protections, which may be experienced by the courts and litigants of both the U.K. and E.U. Member States, if U.K. participation in the conflict of laws framework reflected in the Brussels Recast Regulation is allowed to lapse as a result of the withdrawal of the U.K. from the E.U.

6.2 To address these uncertainties, the FMLC has made recommendations regarding U.K. legislation and accession to both new treaties and existing international agreements. These have been amplified, where appropriate, by suggestions for revisions to existing treaties and agreements. Broadly, the FMLC’s recommendations are as follows:

(a) Rome I and Rome II should continue to apply under U.K. law after Brexit, whether as a result of a “standstill” provision under the Great Repeal Bill or by virtue of new statutory provision for the conflict of laws in the U.K., and subject only to minor technical amendments. In the case where new legislative provision is introduced in respect of contractual obligations, careful attention should be given to arrangements for “grandfathering” choice of law agreements concluded before the provision enters into force;

(b) the U.K. should become a party to the Hague Convention. Efforts should be made to ensure that there is no gap in its applicability between the U.K. leaving the E.U. and its coming into force in the U.K.;

(c) the U.K. should, if possible, become a party to the Lugano Convention. This will be particularly important if the U.K. does not secure an arrangement under which it continues to be bound by the Recast Brussels Regulation (as to which see below). If possible, the Lugano Convention should be amended to include the improvements adopted in the Recast Brussels Regulation;

(d) unless the Lugano Convention is amended to include the improvements adopted in the Recast Brussels Regulation, the U.K. should also try to conclude an agreement
with the E.U. under which the Recast Brussels Regulation would continue to apply to the U.K. after it leaves the E.U.;

(e) if the U.K. becomes a party to the Lugano Convention and, equally, if it remains covered by the Recast Brussels Regulation, the relevant provisions should ensure that there is a smooth transition from the present regime to the new one. There should be no gap between the U.K. being bound by these instruments as a Member State of the E.U. and being bound by them under the new arrangements; and

(f) guidance in the form of a public statement by HM Government as to the action it will take to deal with the matters discussed in this paper would help to minimise uncertainty.
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