BREXIT
Significant Opportunities for a Regulatory Reboot

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THE U.K.'S VOTE TO LEAVE the European Union has triggered a change in the political climate and in the way banks and financial markets participants are likely to be regulated in the region. The newfound fondness for the financial sector among political decision-makers is unlikely to presage a return to regulatory arbitrage, which has long been blamed as a cause of the credit crisis. However, the situation presents considerable opportunities for improving the regulatory framework for the sector as a whole.

On Brexit, there is a well-known need for an agreement to be struck between the U.K. and EU on passporting – that is, the facility for financial institutions to provide cross-border services to customers in EU countries – or for some suitable replacement. We discuss the likely shape of such an agreement and its implications below. However, the more important point is that, after Brexit, the U.K. is likely to create an environment for financial institutions that is far more attractive and reflects traditional U.K. instincts to avoid overregulation and to spread economic risks and rewards. Of course, the U.K. will still need to continue those mechanisms that clearly address too-big-to-fail (TBTF) and other matters that arose in the last crisis, in accordance with international standards. However, some of the overly zealous European regulations that came into effect after the credit crunch, which have cumulatively affected return on capital and the ability of banks to perform their functions for the benefit of the economy, could be revisited in the U.K. The U.K. can be adept and swift at deregulating and removing unnecessary red tape, and the U.K. appears already to be considering a lightening of the tax burden.

After the credit crunch, a suite of new financial regulatory measures was introduced, purportedly to address the need to avoid future taxpayer-funded rescue packages, the TBTF issue, systemic risk, and regulatory arbitrage. Before the credit crunch, some countries in Europe had sought to attract business by not rigorously applying rules. Laws and regulations were, in part, a marketing tool. This position was dealt with heavily by the G20 after the credit crunch. A G20-led set of initiatives resulted in a new array of worldwide financial regulation – from derivatives clearing to capital, as well as new concepts (in a global context) such as the liquidity ratio. The Volcker Rule and Vickers/Liikanen reforms were separate initiatives designed for similar ends in terms of reforming bank structures. Legislators have acknowledged that the cumulative impact of this raft of new regulation was unknowable until after the rules were applied. Only now is evidence arising that regulations have in some places gone too far, given the retrenchment of business lines in many banks and consequent effects on competition. Lord Jonathan Hill, the British former commissioner in the European Commission, recently kicked off a process intended to rationalize European financial regulation to some degree – for the first time in financial services in the EU. However, Brexit triggered Hill's resignation and the EU program is now in doubt. An even broader exercise of EU deregulation was proposed in former Prime Minister David Cameron's EU deal of February 2016, which now lies moribund following the Brexit vote. The U.K.'s willingness to deregulate remains, and there is now an opportunity (at least in the U.K.) for a proper reconsideration of whether all of the post-credit-crunch regulation is suitable. The U.K. will have more autonomy in determining the environment it creates for the City of London.

The result won't be a complete bonfire. Post-credit-crunch reforms aimed at regulatory harmonization and mutual recognition of premier regulators are likely to remain. However, measures that don't meaningfully reduce systemic risk, or represent a European addition to international standards, are likely to be up for examination.

THE ONGOING U.K.-EU RELATIONSHIP

Any assessment of the possible new U.K. regulatory framework must be viewed within the context of the ongoing U.K. and EU relationship. For financial services, this requires the U.K. to consider the extent to which it wishes to be able to provide certain services to EU-based customers who don't have places of business in the U.K. This is currently permissible because of passporting.

Various EU laws allow certain banks, brokers, exchanges, fund managers, clearinghouses, and other financial organizations established in the EU to "passport" the cross-border provision of their services into other EU member states without the need for further local regulatory approvals or supervision. Passport rights can also in most cases be exercised by establishing a branch in the other member state, which follows a relatively simple process. Furthermore, passporting does not only apply in the EU. It also applies in the three European Free Trade Association (EFTA) countries (Iceland, Liechtenstein, Norway) that are part of the European Economic Area (EEA), known as the EEA EFTA States. The EU plus the EEA EFTA States comprise the EEA.

The passporting system was founded in the Treaty on European Union and the EEA Agreement, both providing for the free movement of goods, services, and capital.

These concepts have been developed further by the EU by sector, with a particular recent focus on financial services. Similar passporting regimes apply for securities issuers selling their securities, filing accounts, and making other reports connected with their listings. It's worth noting that, even with a passport, some local law issues will apply, particularly consumer protection laws and some contract laws. The local courts may also have jurisdiction and, particularly (though not exclusively) for consumer matters, they can favor their own consumers. So the passport is not a panacea, but it is a helpful regulatory tool.

The passport was not always available in the EU or its predecessor, the European Community. The primacy of home member-state regulation and the current scope of the passport date from 2007. As a result of the ease of obtaining a regulatory passport, lawyers have not applied themselves in recent times to considering whether services provided are truly cross-border. Before 1995, significant cross-border business took place within the City of London without triggering the laws and regulations of other countries since the main customer base was (and still is) located in the City itself. This happened through European counterparties and customers having branches or affiliates in London or by U.K. entities using applicable exemptions under EU national laws for wholesale business, private placements, and so-called reverse solicitation. The whole point of a financial center is that it is indeed a center, where people benefit from face-to-face, local interactions.

In fact, most of the services that U.K.-based entities provide are not cross-border in law, or could be made so with minor amendments. Deposit-taking, in the U.K.'s view, takes place where the books and records of the bank are located. Phoning or emailing overseas customers needs to be more rigorously considered in determining whether it is truly a cross-border provision of services or whether it is merely marketing or a response to an inquiry (reverse solicitation). In many member states, the passport is only needed to avoid marketing restrictions, not regulatory restrictions, raising the possibility of regulated EU-based subsidiaries providing a more limited marketing service to support U.K. operations and not being responsible for the actual provision of financial services. In summary, many, if not most, of the services provided by UK-based financial markets participants do not trigger the need for an EU passport and the fact that the institutions concerned have such a passport anyway is superfluous to their needs.

CONTINUED U.K.-EU-U.K. ACCESS

For situations where the cross-border services passport has truly been necessary, the U.K. needs to consider possible trade-offs when deciding the extent to which it wishes to continue the current access arrangements for the EU's markets. There are two basic models for continuing access. First, there could be a negotiation of some version of the current passporting arrangements. Second, there could be equivalence-based access that arrives at much the same place. This is because most of the passporting regimes for EU financial institutions coexist with a side-by-side regime for third-country (non-EU) access where the regulatory framework of the third country is determined to have a set of regulations equivalent to those in that sector in Europe. These equivalency-based rights provide for access, particularly wholesale market access, for many businesses, including brokers, fund managers, investment advisers, reinsurers, and other financial entities. Equivalence-based rights operate in a similar fashion to the EU passport in relying on the supervision of the home state regulator.

Most notably, the Markets in Financial Instruments Directive (MiFID) II, which comes into effect on January 3, 2018, well before Brexit takes effect, provides for equivalency-based access for EU nonretail investment business. This applies to broker-dealers, investment advisers, portfolio managers, non-bank custodians, and banks' investment businesses, among others. In addition, under MiFID II, U.K. firms can provide wholesale services across Europe once they have established a retail branch in a relevant member state, again subject to certain conditions, including equivalence. This provides flexibility for investment businesses operating from the U.K.

It's important to remember that access needs to be two-way. It needs to apply from the U.K. to the EU and back to the U.K. There are more than 70 EU banks in the City of London, many of which operate through branch passports. The passport overrides the policy applied by the Prudential Regulation Authority that banks or investment firms from other countries operating systemically risky or significant businesses in the U.K. need to do so through local subsidiaries. The costs required for U.K. subsidiarization by EU institutions could be substantial, mirroring the significant costs imposed by the intermediate holding company requirement for certain foreign banking organizations with the largest U.S. non-branch operations. The U.K. regulators have indicated that they wouldn't apply these requirements to EU institutions going forward, but that assumes that the EU provides for suitable access for U.K.-based institutions.

Cross-border access from the EU to U.K. markets would currently be governed by the so-called "overseas persons exclusion" that allows all firms, both EU and non-EU, to access the wholesale U.K. markets for cross-border business without local regulation. Firms are merely required to comply with the U.K.'s marketing laws. Just like outbound U.K.-EU business, this arrangement doesn't work well for retail business, which remains very state-based and protectionist across most of Europe. The U.K. will have a policy choice to make as to whether to change its current level of inbound access to mirror any U.K.-EU outbound arrangements or whether to take the view that cross-border business is to be encouraged and not to impose barriers.

THE LIKELY WAY FORWARD

It seems doubtful that an acceptable version of the passporting arrangements is capable of being negotiated, given the importance of sovereignty as an issue in the Brexit referendum. Passporting requires that the U.K. applies identical rules in a similar manner to the EU. Two issues of sovereignty arise. The first issue relates to rule-making. EU financial services laws are currently made through the EU legislative process. If legislation is to be applicable in the U.K., then the U.K. would wish to have a seat at the table, which looks like participation in an EU legislative project of a kind that has been rejected in the referendum. Furthermore, it's difficult to see how the U.K. could be protected from being outvoted. Arrangements had been introduced for dealing with eurozone countries outvoting the U.K. within the existing EU construct. But even if something similar were adopted, this doesn't amount to giving the U.K. a veto over proposed rules.

The U.K. also has a fundamentally different legislative approach and legal tradition compared with many EU countries and the European Commission (EC). The commission, which has sole authority within the EU to propose legislation, has never repealed financial services regulation. It has only added to or re-enacted regulations. The EC's instinct is to make more and more rules. In addition, various European countries take a protectionist approach to rule-making rather than the free market, deregulatory approach favored by the U.K. After the credit crunch, despite the globally agreed upon need for extensive regulation to resolve too-big-to-fail concerns, many would agree that some EU laws have gone too far. The U.K. would not wish to have to persuade others to come along with it on the reformist path, and to be subject to evolving regulation that is likely to be at odds with its freer market wishes.

> The post-Brexit arrangements present **significant opportunities** for the rationalization and reduction of some of the heavy-handed **cumulative effects** of multiple separate legislative and regulatory initiatives.

The second issue of sovereignty relating to passporting arises from the involvement of supranational bodies. The passport necessitates taking an equivalent interpretative approach to the rules. In order to achieve this, the EU has introduced European Supervisory Authorities (ESAs), which are intended to ensure a consistency of interpretation by national regulators. These agencies don't directly supervise institutions, with the exception of trade repositories. However, they have supranational authority.

The interpretation of EU laws and regulations is also ultimately decided by the European Court of Justice (ECJ), a body many in the U.K. regard as highly politicized such that legal rigor can be sacrificed, particularly in favor of EU integration. The ECJ has made no positive decisions on "subsidiarity," for instance, which was a concept introduced in part at the behest of the U.K. in 1993 to ensure decisions are taken, where possible, at a member-state level.

It is possible that arrangements could be set up where the U.K. courts were the ultimate arbiter on the meaning

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of pan-EU rules as applied in the U.K., and the U.K. and European institutions coordinated the application of those rules across the U.K. and Europe together. There could be a joint body of the U.K. and EU established to resolve any differences. However, there are still fundamental issues, in light of the vote, with the U.K. adopting rules coordinated by a supranational body with a view to reflecting some form of combined U.K.-EU set of interpretations – and presumably the same concerns would arise in the EU.

On top of all of this, some in the EU have stated that passporting can't come without freedom of movement for people. It is conceivable that some restriction could be placed on that free movement. For instance, if the U.K. became an EEA EFTA State, it could impose restrictions on immigration in the way that Liechtenstein has done. Whether the other EU and EEA states would accept this and whether any new restrictions would satisfy the U.K. public's concerns over migration is not at all certain.

EQUIVALENCE

As a result of the potential obstacles for maintaining passporting post-Brexit, equivalence-based access requires consideration. This approach involves more work for the U.K. and EU, since it involves a determination on a topic-by-topic basis of how equivalent outcomes might be achieved. There are certain gaps in the coverage of the equivalence regimes that would need to be considered.

Third-country equivalency rights are typically based on three things: the relevant institution being properly supervised in its home country; the legal and regulatory regime, including AML and tax arrangements, of the home country being deemed "equivalent"; and the establishment of cooperation arrangements between the home country and EU states or the European Securities and Markets Authority (ESMA). Some equivalence regimes further require a "member state of reference" to take responsibility for the third-country firm. Countries as culturally and legally diverse as Australia, Bermuda, Canada, Hong Kong, Mexico, Singapore, and the U.S. have all been declared equivalent under the regimes for reinsurance and clearinghouses, and their financial institutions in the relevant sectors have access to the EU single market. For some sectors, such as stand-alone lending or insurance mediation, there is no such equivalence framework yet, but one could be developed based on the existing blueprints.

For the U.K. to fall within equivalency regimes will require cooperation between the U.K. and EU regulators and rule-makers. Regulators know from the credit crunch that harmonized rule-making is essential to manage systemic risks and minimize regulatory arbitrage. The U.K. regulators already work closely with their EU counterparts.

The process of being deemed "equivalent" following Brexit should be reasonably straightforward. There is a fast route and a more negotiated route available. On the fast route, the U.K. would grandfather all existing EU legislation "as is," so the U.K.'s laws would be identical to the EU's, not just equivalent. Going forward, the U.K. could, in dialogue with the EU, gradually move away from current EU laws and develop its own approach. The slower route would involve a more negotiated solution, removing or paring back EU laws that are seen by many to have overreached.

There is much to be said for the slower route. Numerous aspects of financial services regulation are not of systemic importance, and could be done away with without damaging any credible application of equivalence. Examples include the requirement in European Market Infrastructure Regulation for both counterparties to a derivative to report trades; some of the antitrust-driven financial infrastructure access rules in MiFID II, which trespass on the U.K.'s sovereignty to deal with market structure and potentially have negative systemic effects such as the fragmentation of markets; the application of the Basel capital standards to domestic and smaller banks; and the bonus cap, which the U.K. addresses in a different way through longer deferral periods (and which the U.K. even challenged in the ECJ). Further, the Liikanen reforms, which were the EU's answer to the Volcker Rule and the U.K.'s similar Vickers proposals, could be reconsidered in their U.K. application.

Brexit represents a moment for the U.K. to reboot its markets and, in the words of some of its proponents, "take back control." Clearly, in many areas, equivalence discussions will require the U.K. to continue applying the thrust of EU laws. But "equivalent" does not mean "identical." The equivalence route should provide an opportunity for businesses to adopt a more unique approach within the U.K. to regulation and other topics.

In addition, the U.K. could consider establishing financial free zones, such as the one just established in Abu Dhabi, the Abu Dhabi Global Market. Such zones could be carved out of any equivalence discussions and could be purely for local dealings. An even more business-friendly approach could be adopted in the zones, which could, for instance, be set up in Scotland, Wales, and Northern Ireland.

Equivalence determinations can take time if there are material differences to be considered. This, however, is not a position unique to the U.K. All third countries relying on equivalency determinations for third-country passporting will need to take into account those determinations in formulating their own financial regulatory laws. Equivalency determinations have thus far been highly technical matters. For example, equivalency with respect to the United States for derivatives clearing was delayed while a deal was negotiated on the technicalities of different margin calculations arising from two methodologies of calculation, which are now broadly harmonized.

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THE PRACTICALITIES

There are those seeking to prevent Brexit completely. There is a challenge before the U.K. courts seeking to require a vote of Parliament prior to the service of the Article 50 notice. This is despite it seeming fairly clear as a constitutional law question that the government may enter into and terminate treaties under its royal prerogative powers. Article 50 of the Treaty on European Union (the Lisbon Treaty) provides that a state may withdraw from the EU "in accordance with its own constitution." Parliamentary approval will, however, be required for the purposes of amending existing U.K. legislation to implement Brexit.

There is also an issue of which aspects of Article 50 require only a "qualified majority" vote (QMV) – a vote weighted by size of population in each member state – and which aspects default to a requirement for unanimous voting by EU members. Article 50 requires that the EU shall reach an agreement with the departing state "setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union."

The extent to which the future trading relationship must be included within the Article 50 agreement is subject to argument. The agreement that is covered by Article 50 requires a QMV of remaining EU member states to vote in its favor and a majority vote of the European Parliament. It must also be ratified by the U.K. Parliament. This contrasts with the position for new treaties, which require unanimity among member states and in some cases other national referenda. On a plain reading, it would appear that Article 50 is intended to be all-encompassing and for QMV to apply to all aspects. It is difficult to see how the withdrawal arrangements could take into account "the framework for [the U.K.'s] future relationship with the [EU]" unless that framework has been agreed upon as part of the same process.

Finally, unless the U.K. is certain that there will be an adequate transitional arrangement such that businesses can wait until termination has been negotiated before considering their positions, the U.K. should not serve its Article 50 notice at all but should continue current discussions so that there is clarity on the deal.

WHAT TO DO NOW

Although many institutions are sensibly considering contingency plans, there are many reasons to wait and see. Both the U.K. and EU need to come up with a new deal for financial services access that preserves the current access arrangements and potentially relieves (at least in the deregulation-minded U.K.) some of the regulatory burdens currently inflicted upon financial institutions. We expect these outcomes to be achievable. The post-Brexit arrangements present significant opportunities for the rationalization and reduction of some of the heavy-handed effects of separate legislative and regulatory initiatives. There is good reason for financial businesses to be optimistic about the post-Brexit outcome. ■