

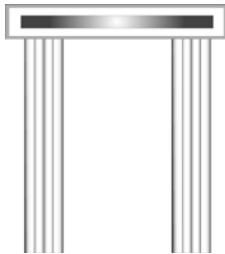
Barnabas Reynolds

The Art of the No Deal

**How Best to Navigate
Brexit for Financial Services**

POLITEIA

A FORUM FOR SOCIAL AND ECONOMIC THINKING



POLITEIA

A Forum for Social and Economic Thinking

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The Art of the No Deal

How Best to Navigate Brexit for Financial Services

Barnabas Reynolds

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PREFACE

The UK's financial services have developed over centuries as a global industry with a huge diversity of activity, range and scale. Success has been built on strong foundations, constitutional and political as well as economic: the common law tradition, stable institutions, freedom under the law and parliamentary democracy – all underwritten by Government's accountability to the electorate. Economically, the UK's openness to global markets and competitive free trade, and London's magnetic attraction for global capital, have also contributed to the success. So much so that today Britain remains one of the most stable, predictable and transparent places where the financial sector can do business and trade globally and with the EU.

That will not change after Brexit. Even France, despite Emmanuel Macron's eagerness to attract UK-based firms, is finding that initial forecasts of thousands preparing to relocate have not materialised. Other fears in the sector about ending the passport have diminished as the true position becomes clear: for most cross-border transactions the passport is unnecessary, and for the small number of activities which need it, different arrangements can be substituted with little extra cost. Nonetheless, though these fears have lessened, others have filled their place, encouraged by the obstacles and delays since June 2016.

In Brussels the EU, contrary to the Article 50 terms, has refused to start trade talks and instead seeks to extract an ever bigger divorce settlement with a high exit fee and numerous other concessions, although Britain is under no legal obligation. In London the interventions of the courts and the House of Lords added their own chapters to the saga, as each seemed to misinterpret its role in Britain's constitutional balance of powers. To the delays can be added the further scaremongering that has distracted focus from the need to be ready for March 2019.

The claim that business faces a 'cliff edge' has re-emerged in Parliament's debate on the EU (Withdrawal) Bill, fuelled by the members of the political opposition.¹ As this volume will explain, the claim is a legal fallacy, because continuity of current operations is protected under EU and International Law. Moreover, a transition deal is unnecessary in law and is a potential distraction from the real goal.

These developments must not be allowed to divert the focus from the fundamental question for this country and its Government, which is about the legal framework for the financial sector's future under which its businesses will operate. They need to prepare now to exploit the new circumstances that Brexit will bring in March 2019. These circumstances will result from one of two outcomes, that of reaching a free trade agreement with the EU, or the alternative, 'no deal' scenario. The Government and the sector's many businesses should prepare for both.

The first, a free trade agreement with the EU based on enhanced equivalence and the mutual recognition of each other's laws and standards is one option, for which the detailed proposals have been explained in previous volumes in this series. The second, 'no deal' outcome, is one which could bring many benefits. Moreover, as in any negotiation, this alternative option should now be prepared, irrespective of the likelihood of an agreement, so that if necessary the arrangements for 'no deal' are in place and ready to come into force in March 2019. This volume will explain the legal framework and the steps which can and should now be taken.

Its author, Barnabas Reynolds, who leads his City law firm's global and EU regulatory practice explains how the Government and its regulators should prepare for no deal. He also sets out in detail the steps that business can take to maintain the benefits of agglomeration. He includes proposals aimed at a range of different types of UK businesses: investment banking and advisory services and commercial banking, asset management, insurance and reinsurance, derivatives and market infrastructure.

¹ House of Commons Debates, EU (Withdrawal) Bill, Committee Stage, 14-15 November 2017.

These proposals will be welcomed by many keen that Government and country must now be realistic about its future, which should no longer be left hanging on the thread of a possible deal with the EU. A deal, though not yet ruled out, cannot be counted on as a likelihood, given that time has moved on since the referendum, leaving many perplexed by both the slow motion saga of Brexit and the obstacles put in its way. To them the further delay is unwelcome. They voted to leave the EU after the most protracted political debate since that on the Corn Laws almost two centuries ago. They did so because continued membership went against Britain's constitutional freedom, against their ability to hold the Government to account. They now want the Government, without hesitation or prevarication, to do what is needed to shape the future destiny of this country as one of the world's leading market economies.

Sheila Lawlor
Director, Politeia
28 November 2017

THE AUTHOR

Barnabas Reynolds is a partner at Shearman & Sterling LLP where he is head of the global financial institutions and financial advisory practice. He practises in UK and EU financial regulation and advises all types of financial markets participants on their legal and regulatory situations, difficulties and opportunities, and their legal risk profiles. He is the author of *A Template for Enhanced Equivalence: Creating a Lasting Relationship in Financial Services Between the EU and the UK* and *A Blueprint for Brexit: The Future of Global Financial Services and Markets in the UK*, published by Politeia in July 2017 and November 2016 respectively.

After graduating in law from Downing College, Cambridge he took an LLM at Queens' College, Cambridge, and now lives in London.

Reynolds co-edits Sweet & Maxwell's *Journal of International Banking Law and Regulation* and is the co-author of *Shipowners' Limitation of Liability*, Kluwer Law, 2012. He writes regularly on financial services regulatory matters, including recently client money and assets, MiFID II, shadow banking, margin for uncleared swaps, derivatives clearing and senior management liability.

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SUMMARY

For the UK's global financial services industry future success and economic efficiency will depend on one of two Brexit scenarios: either a successful outcome of the Brexit negotiations or the UK boldly positioning itself for the default 'no deal' outcome. The City of London, which comprises the global markets hosted in the UK, is in many ways the world's leading financial services hub. It is as vital to the EU's and global economies as it is to that of the UK, and to the success of financial markets across Europe and beyond, that the optimum arrangements for the continued functioning and status of these markets are found. It is clear that the UK ought not to count on a satisfactory deal. It must take steps to ensure that a no deal eventuality is as positive for the market as a negotiated outcome. Planning for both eventualities is both sensible and essential. Such a dual approach should be actively embraced – just as happens in routine business preparations for any pending change of regime.

The Likelihood and Shape of a Deal

The most likely basis for a lasting relationship between the UK and the EU in financial services is the mutual recognition of standards in the form of 'enhanced equivalence'. The previous volume in this series, *A Template for Enhanced Equivalence: Creating a Lasting Relationship in Financial Services Between the EU and UK*,² sets out in detail what that relationship could look like, and how it could operate in practice. A regime based on enhanced equivalence³ has the potential, if properly implemented, to form the basis for a mutually-beneficial, stable long-term relationship. As outlined, the proposal would require a qualified majority vote in Council and a majority in the European Parliament in order to be adopted by the EU.

Neither the concept of equivalence nor its practice is new to the EU, having been developed as a regime over the past years within the EU with significant input from the UK. It essentially replicates the passport for non-EU providers and recognises the differences of approach in third country legal and regulatory regimes.

It is possible that the Brexit negotiations could result in a special bilateral mutual recognition arrangement between the UK and the EU across financial services, which would not supplement equivalence at all but could be even more permissive. Depending on the details, a new mutual recognition route could reduce the administrative burden in determining and monitoring equivalence, and give the UK more regulatory autonomy, which would (if achieved) be desirable from both a UK and an EU perspective. This could, however, be more cumbersome to achieve for a number of reasons including the voting requirements for such a deal to be put in place. Depending on its form, it could require Member State unanimity in the European Council unless the EU accepts Article 50 can be used to cover such an agreement. Further, the attractiveness of such an alternative would depend on the precise wording of the agreement. What might appear to be more flexible in terms of how recognition is determined, could be less so if other restrictions are also included.

As discussions with the EU advance, it should quickly become apparent what type of deal is achievable. For the UK, regulatory autonomy is key. This is essential for UK regulators to control systemic risk in the global markets hosted in the UK and so they have the flexibility to think independently of the EU, with its very different concerns mainly focused on its more domestic markets. The UK and its regulators cannot become 'rule-takers' such that they effectively just apply EU laws that are designed principally for users and not providers of financial services, with a protectionist, prescriptive philosophy. That would be a dangerous outcome for the global financial markets, for the UK and for the wider economy.

² Barnabas Reynolds, '*A Template for Enhanced Equivalence: Creating a Lasting Relationship in Financial Services between the EU and UK*', Politeia, 10 July 2017.

³ Including similar concepts such as mutual recognition, however named.

The Need for an Attractive Fallback

As with all negotiations, the parties must prepare as fully as possible for the eventuality that no agreement will be reached. Although the challenges in implementing a mutual recognition arrangement of some sort (whether based on enhanced equivalence or some new concept) can be overcome, it would be naïve to ignore the real possibility that there will not be the political will in the EU to grasp such a deal with the UK at this stage or to make it work.

France, Germany, Luxembourg, Ireland and other EU Member States have been making overtures to UK banks and financial institutions, looking to snap up their business in the event that a deal is not achieved. It would be a dereliction of duty if the UK did not similarly prepare to shore up its own position to protect the financial services industry from the impact of a no deal outcome. EU investors currently come to the City as a result of its competitiveness. But if that competitiveness is lost, they cannot be expected to remain in the City and will have no vested interest in its success. It is therefore up to the UK Government to take steps to preserve the City's attractiveness and avoid the systemic risks and costs associated with fragmentation, and working to that goal should now begin for the event of a no deal outcome.

The UK has a strong hand in relation to financial services, due to the strength of the City and the huge difficulties in separating off any parts without unravelling the complex web it comprises. It is clear that most international (particularly non-EU) institutions have no wish to move any meaningful business to the remaining EU. It is also clear that various senior politicians in the EU are starting to appreciate their economies would be damaged without a deal with the UK for financial services that preserves as much frictionless access as possible for EU customers to the City's innovation and services.

Main Proposed Steps and Techniques in this Book

This book divides itself into two parts. The first part deals with what the UK must do to optimise its position in the eventuality of a no deal Brexit. The second part addresses the steps businesses can take across the main financial services sectors to avoid moving much, if any, business to the ongoing EU.

Part I: What the UK Must Do and Why

In Part I, this book sets out what the UK needs to do to plan properly for a no deal outcome in financial services. It sets out ten practical steps the UK should take to bolster its position, as explained in Chapter 6, *Ten Steps For the UK to Take*, as follows:

1. *Re-vamp the UK's legal and regulatory framework for financial services, identifying and tackling key areas where EU requirements have led to a lack of competitiveness and unnecessarily burdensome regulation.*
2. *Facilitate innovative structuring by financial institutions and help establish private sector UK facilities to enable 'no move' contingency planning.*
3. *Engage with financial market participants to facilitate 'no move' contingency planning, avoiding the dangerous and unquantifiable systemic risks occasioned by significant moves.*
4. *Focus on market infrastructure and examine ways to ensure continuity of EU business within the UK's jurisdiction.*
5. *Defer, where legally possible, the implementation of EU laws and regulations which have yet to be implemented in the UK.*
6. *Reinstate some form of international competitiveness objective for the UK's regulators (subject to a systemic risk override) and remove the competition-based rulemaking function from the FCA.*

7. *Take steps to form other enhanced equivalence/mutual recognition arrangements internationally and act to reduce any adverse reactions by overseas regulators to 'politicised' EU interpretations of regulation.*
8. *Enhance the other, including soft, attractions of the City: in particular ensure our courts and ancillary legal fabric continue to be of the very highest standards.*
9. *Announce tax incentives as a fall-back in the case of a no deal outcome.*
10. *Insist on the proper interpretation of EU law.*

Most of these points can and should be carried out even if a deal with the EU is reached. Others are just contingency planning for a no deal outcome.

Part I of this book also addresses the two main potential outcomes for financial services after Brexit (Chapter 1), the EU's need to maintain open borders (Chapter 2), the position of the UK after Brexit under the WTO rules including the lack of any cliff edge (Chapter 3), the EU political backdrop and how to navigate that on a no deal scenario (Chapter 4), the ideal state of the UK's legal and regulatory landscape after Brexit (Chapter 5) and the role of market infrastructure and euro clearing (Chapter 7). Chapter 6 as mentioned above sets out ten steps for the UK to take to capitalise on its position in the event of a no deal outcome for financial services.

Part II: Steps and Techniques of Reasoning for the Industry to Minimise Business Moves

In Part II, this book covers various ways in which financial businesses can minimise moves to the EU,⁴ so that they can take full advantage of the network effects and talent available to them by being located in the global financial centre situated in the UK. Overall concepts and techniques of reasoning are set out in Chapter 8, followed by a list of ten steps business should consider taking in Chapter 9. There is then specific analysis of many business lines: Investment Banking and Advisory Services (Chapter 10), Commercial Banking (Chapter 11), Asset Management (Chapter 12), Insurance and Reinsurance (Chapter 13), Derivatives (Chapter 14) and Market Infrastructure (Chapter 15).

The EU applies the rule of law. The EU has made clear that it wishes any on-shore business to be conducted in accordance with existing laws. There are however numerous ways to provide financial services into and out of the EU without tripping over these requirements.

The following ten steps for the private sector (set out in more detail in Chapter 9) would assist it in maintaining the benefits of agglomerating business in the UK and avoiding costly and risky moves to the EU-27:

1. *Make a robust and thorough assessment of any perceived cliff edge issues for existing client relationships.*
2. *Make enhancements to existing relationships where possible (for instance by considering assignment clauses and reverse solicitation provisions where desired by the clients), so as to preserve and enhance those relationships post Brexit, allowing for future optionality – by amendments to contracts, side letters or email.*
3. *Ensure business which comes in through reverse solicitation is properly documented and accepted so that the framework is robust.*

⁴ This book generally refers to the EU. The position is of course essentially the same for the slightly wider European Economic Area ('EEA'), which comprises the EU as well as Iceland, Liechtenstein and Norway. To avoid confusion mention is generally only made of the EU.

4. Ensure a thorough analysis is made of what business is truly cross-border in law, so that non-UK regulatory provisions are applied only when necessary, and consider whether, with minor adjustments, the EU's regulatory perimeter need not be invoked at all.
5. Consider the silver bullet and other solutions for assisting customers in 'coming to the UK' in a low-cost way, for instance by establishing a small place of business here such that all future provision of financial service is purely domestic UK, and EU-facing activities are intra-group.
6. Consider other techniques for ensuring that regulatory provision takes place in the UK; for instance, the establishment of a trust to receive insurance policies and hold the benefit on trust for EU-27 customers.
7. Consider in detail individual business areas and the laws surrounding those areas to allow business moves to be minimised, for instance indirect clearing, agency arrangements, give-up agreements, delegation, outsourcings, branching back and reinsuring back into the UK from the EU-27.
8. Consider market-driven and infrastructure-based solutions, for instance UK infrastructure offering derivative or look-alike products which permit trading to continue in the UK in spite of any issues found in trading on EU-27 platforms.
9. Liaise with the UK Government on the introduction of possible tax incentives and regulatory improvements so as to optimise business models whilst ensuring they are safe for the UK, the global markets and the UK taxpayer.
10. Consider taking steps to retain talent and jobs by assisting staff with any immigration approvals or other support needed to allow them to stay in the UK.

By taking these steps the industry can work with the UK to minimise any business disruption from Brexit. It may well be that this reduces or removes the need for a transitional period. It will also affect the industry's and the UK's view of the best terms for any final trade deal between the UK and the EU in financial services. It should provide upside to the industry so that it can dispassionately and accurately evaluate the options, including the terms on which a post-Brexit trade deal would be attractive against the upside of a more radical set of adjustments to financial regulation – and tax – were there to be no deal.

Barnabas Reynolds

Partner, Shearman & Sterling LLP
28 November 2017

Special thanks to Daniel Frost for his extensive help in writing this book. Many thanks also to Thomas Donegan for all of his friendship, help and guidance, and to Oliver Linch, Christopher Hobson and Wilf Odgers for all of their assistance. All faults that remain, and the views expressed, are my own.

Introduction

Part I of this book (*The Political and Commercial Backdrop*) contains a thematic macro and policy-oriented discussion of how the UK should navigate Brexit for financial services so as to optimise the outcome for the UK and the financial services industry. Those readers solely seeking a technical analysis of various no-move solutions for specific business lines, are directed towards the sector-specific sections of Part II (*How to Optimise Business Models for a No Deal Brexit*).

UK Financial Services and Brexit – Friction-Free Trade, Greater Success

The UK's success as a global financial centre is the result of a number of strong and persistent economic drivers. They are what continue to attract business to the UK and will keep it there. The UK's decision to leave the EU has not changed this materially. Institutions that have examined the consequences of moving business from the UK to the remaining 27 EU countries are not keen to move. Indeed there is no need to do so in most cases, and institutions are likely to revise their overly-negative initial impact analyses.⁵ There are two forks in the road and either way the UK can continue to attract global business; and EU financial business can remain in the UK under a framework that works in both international and UK law.

A Deal for Brexit

First, there could be some form of deal between the UK and EU upon Brexit which preserves and enhances the two-way access we now have between UK-based financial institutions and EU customers (and *vice versa*). Provided it is drawn up correctly, the framework would provide for mutual access with a different, UK-based approach to regulation involving higher standards (which it currently adopts through so-called 'gold-plating' of EU rules) and fewer rules. It would allow the UK the freedom to regulate the sector in a more dynamic manner than now happens with EU directives, one which could be outcome-related, judgement-based and grounded in the common law. The UK traditionally applies *caveat emptor* in the wholesale markets (subject to oversight for market abuse and the like) and a more fiduciary-based approach for the retail markets. A return to this would create a framework more attractive to the participants in the global markets hosted in the UK. The basis for such mutual access is set out in two previous volumes, *A Blueprint for Brexit: the Future of Global Financial Services and Markets in the UK* and *A Template for Enhanced Equivalence: Creating a Lasting Relationship for Financial Services between the EU and the UK*.⁶ The approach should be actively pursued in the negotiations with the EU.

Irrespective of whether the EU is likely to agree to such a deal or do so in good time, the second option should now be simultaneously prepared so that in March 2019, deal or no deal, businesses in the EU and the UK can continue to trade without friction and grow their businesses with confidence and security before and after Brexit.

⁵ 'UBS to move fewer London jobs than initially feared', Financial Times, 29 October 2017; and 'US banks 'stop gap' Brexit plans set to retain London jobs', Financial Times, 14 November 2017.

⁶ By Barnabas Reynolds, published by Politeia on 3 November 2016 and 10 July 2017, respectively.

The Financial Centre Model

If no mutual access deal is possible the second option involves the UK pursuing the ‘Financial Centre Model’ to facilitate successful EU client business and avoid the friction, costs and inefficiencies of moving financial business merely in order to service EU clients. This publication, *The Art of the No Deal: How to Navigate Brexit for Financial Services* sets out the legal framework for the Financial Centre Model for the eventuality of a ‘no deal Brexit’. It shows that businesses do not need to move much, if any, business to the EU-27 to continue their service provision to EU customers. It sets out several ways and legal structures to achieve such an outcome, so that businesses can make preparations now. There may be a small number of borderline cases where such techniques do not apply, for instance, where EU businesses are required under their constitutive documents or EU rules to purchase services only from EU providers. This can arise, for instance, for certain EU purchasers of insurance or in Member State government bond markets. However, the steps proposed for becoming an independent financial centre remove the need to move the vast majority of the most expensive resources – people and infrastructure. Those cases involving restrictive rules are likely to create what will swiftly be seen as an additional cost for EU counterparties, which will lead to those restrictions being quickly removed. It is unlikely that commercial bodies – or even governments seeking funding – will pay for any such point of EU principle over the medium term.

‘... businesses do not need to move much, if any, business to the EU-27 to continue their service provision to EU customers.’

In essence, UK businesses can assist clients’ continued access by re-papering – i.e. putting new or amended terms of business, or even just new side letters or email indications of agreement in place with – their EU clients or by making minor adjustments to the way they provide their services so as to help EU customers to continue to benefit from the depth, breadth and cost efficiencies of the UK’s markets. Such adjustments will be discussed below, but they include (amongst other things), reverse solicitation, trust models, utilising EU affiliates or third parties to introduce or refer EU clients, or entering into transactions with EU clients which are then ‘given up’ to UK entities.

EU customers would not, as a result, incur significant or continued friction costs from having to change arrangements to access services from what now are less efficient and innovative financial centres in the EU or elsewhere. The framework for doing so is explained separately for the different parts of the financial sector and is set out in the later parts of this present publication.

The ‘Cliff Edge’ Fallacy: Contrary to EU and International Law

The scaremongering about an alleged ‘cliff-edge’ on Brexit, and claims that many client contracts between UK providers and EU customers will become illegal or unenforceable after Brexit,⁷ take no account of protections afforded under EU and international law. The worst-case forecasts in fact run against the EU’s application of the rule of law. The suggestion that the EU runs a capricious, whimsical and politicised system of law, capable of manipulation to political wishes, and which provides no coherent system of first-world governance, is far from the

⁷

See, e.g., the Bank of England’s Record of the Financial Policy Committee Meeting on 20 September 2017; and ‘German regulator seeks Brexit plans from UK-based insurers’, Financial Times, 30 October 2017.

truth. Whatever its flaws and irrespective of the EU's failings, the EU does respect the rule of law and its international obligations.

Three supra-national regimes, applicable within the EU, provide for the continuity of contracts. The right to property, as enshrined in Article 1, Protocol 1 of the European Convention on Human Rights (the '**Convention**') and the mirroring provision in the EU Charter of Fundamental Rights (the '**Charter**') protect persons' 'possessions' against interference. Contractual rights with economic value, existing at the time of Brexit, will constitute 'possessions' under the Charter and the Convention. It is hard to conceive of an existing financial instrument between UK and EU-27 businesses that will not have an ascertainable economic value and therefore fail to attract Convention and Charter protection. For example, under derivative contracts, where cash flows depend upon future price movements in a particular asset or benchmark, the value of the contract is estimable and will have an economic value at any given point. This applies even to unexercised rights, such as options that have been entered but not exercised prior to Brexit. Simply because the parties can elect not to trigger a contractual right until a later time, as is the case for options, it cannot be argued that such rights lack an economic value.

'Whatever its flaws
... the EU does
respect the rule of
law and its
international
obligations.'

Under the public international law concept of 'acquired rights', certain rights derived from an international treaty and vested in individuals up until the termination of that treaty may be shielded from intervention occasioned by treaty withdrawal. The concept of acquired rights should encompass contractual rights vested in specific businesses that have an ascertainable value at the point that Brexit takes effect. This will be the case for most financial contracts for the same reasons.

Contractual rights deriving from financial contracts will therefore benefit from protection against interference under public international law and both the Convention and the Charter. Indeed, private agreements can be adjusted to take full advantage of these protections prior to Brexit so as to broaden the parties' rights to ongoing contractual performance.⁸ (This will be discussed in more detail below in Chapter 3, *Going it Alone: Reinstating Autonomy and Competitiveness*, in the section entitled *The Cliff Edge in the Mind – International Law: Property Rights and Contractual Rights are Protected*.)

A Transition Deal – Unnecessary in Law and a Potential Distraction

The mistaken focus on an over-exaggerated cliff-edge has had unintended consequences, by prompting a view that the UK must negotiate a transitional deal to avoid an apocalyptic outcome. A transitional deal would clearly give businesses, government and citizens more time to prepare for Brexit, and so has various advantages. However, there is a danger that such a deal would be difficult to agree satisfactorily in the short timeframe available and would also distract from the ultimate goal. Any such deal might permit and facilitate the collection of the Eurozone's desired Financial Transactions Tax within the UK during the transition period. It could also facilitate the European Central Bank's ('**ECB**') wish to move euro clearing to the Eurozone in order to have control over margining and haircutting decisions, a policy which seeks artificially to support the value of euro sovereign debt and offloads

⁸

For a full technical analysis see '*Continuity of Contracts and Business on a 'Hard' Brexit: Human Rights and Reverse Solicitation to the Rescue!*', Shearman and Sterling LLP, 31 October 2017.

the risk of that support onto the international financial markets.⁹ There is also a fundamental conflict between the EU's desire to impose its framework, rules and budget costs on the UK, and the UK and Government's wish to exit the EU framework and reclaim sovereignty in line with the referendum mandate. It is difficult to reconcile the UK's position on sovereignty with a lengthy transitional period, after Brexit.

A transitional deal might not harm the financial sector so long as it is carefully negotiated and at the least it assuages those who have an exaggerated fear of discontinuity and regulatory change. However, it is not strictly necessary. Instead, by engaging in repapering and other limited adjustments to prepare for a no deal scenario, financial institutions can put themselves in a strong position, prepared for every eventuality. Either it is heads they win, because the UK obtains a mutual access deal that allows for more focused, less process-ridden and less politicised rule-making in the UK. Or, it is tails they win, because they have taken the steps needed to continue their EU business should there be no deal, and because they benefit significantly from being in a more competitive environment in the UK after Brexit, with better-tailored regulation.

Interim and Long-Term Success – The Best Basis

Part I of this volume addresses the macro and policy background. It sets out the two basic Brexit outcomes (Chapter 1), the drivers in favour of a deal (Chapter 2), how the UK can go it alone successfully (Chapter 3), the EU political backdrop (Chapter 4), the steps the UK needs to take to ensure a successful no deal outcome (Chapters 5 and 6) and the role of market infrastructure and euro clearing (Chapter 7).

Part II of this volume explains in detail how certain financial services businesses can operate with EU customers, from the City of London, after a no deal or 'hard' Brexit. The proposals here will be even more effective if the majority of large financial services businesses in the UK follow them, such that decisions taken by one financial institution do not adversely affect the preferences of others.

Part II focuses on specific industry areas and sets out how the following financial services can be provided to EU customers in the EU in the event of a hard Brexit in a number of common cross-border areas. After the conceptual overview (Chapter 8) and the ten steps businesses can take (Chapter 9) the following areas are addressed: investment banking and advisory services (Chapter 10), commercial banking (Chapter 11), asset management (Chapter 12), insurance and reinsurance (Chapter 13), derivatives (Chapter 14) and market infrastructure (Chapter 15). Retail financial services are not specifically addressed, since the cross-border market for such services is small and there are significant barriers to those wishing to deal with retail consumers on a cross-border basis, even within the EU.

This book proposes that financial institutions should concentrate their efforts on taking full advantage of the opportunities that Brexit will make available. Their focus should be on negotiating with the UK Government the incentives needed to cushion any negative impacts for particular sectors, affected at least in the short term by the changes Brexit brings with it. They should also focus on regulatory reform. Because EU rulemaking is federal and supervision is local, there has been over-

⁹ For further detail see 'UK Safer for City's Financial Sector than EU, Leading City Lawyer Cautions Firms Against Move to Eurozone', Politeia, 3 May 2017 by Barnabas Reynolds and 'EU-managed control of euro clearing is not viable', Financial Times, 15 May 2017 by Barnabas Reynolds.

regulation. The EU federal authorities have sought to remove as much supervisory discretion as possible from Member States and have introduced rulebooks constituting minutely detailed operations manuals for regulators and businesses which lack flexibility and often bring unintended consequences. Despite this, inconsistencies of supervisory approach have remained, leaving the system in a dangerous state and prone to systemic risks.

By contrast, the UK and global markets now have the opportunity to focus on regulation which ensures a stable financial system with appropriate market conduct without spurious political considerations or overly-prescriptive detail affecting the practice of regulation.

PART I

THE POLITICAL AND COMMERCIAL BACKDROP

1. The Two Basic Brexit Outcomes for Financial Services

Two broad policy options exist for financial services. First, there could be mutual access through enhanced equivalence or mutual recognition between the UK and the EU of each other's financial regulatory regime, whether through the existing equivalence or a new mutual recognition concept. In that model, trade would continue on a similar basis. If no deal can be reached, or no deal can be reached in time, the solution is the Financial Centre Model. The UK could reinforce its position as the world's financial centre, under the Financial Centre Model, where the UK pursues a 'better regulation' agenda and its regime is not automatically recognised as equivalent in the EU in all areas. Each option has advantages for UK-based financial businesses.

'The UK could reinforce its position as the world's financial centre, under the Financial Centre Model ...'

Option 1: Mutual Access

Continuing recognition of each other's regulatory regime, so as to provide for mutual access, is the outcome presently being sought by the UK Government. This involves some form of mutual recognition deal for financial services. Such an outcome could well be positive for both the UK and the EU.

Mutual recognition could be achieved by basing it on one of the two following methods:

- a. Enhancements to the current EU concept of 'equivalence' in financial services regulation ('**Enhanced Equivalence**'). Under this approach, if a non-EU country's laws and regulations in a certain area achieve similar outcomes to those in the EU, businesses incorporated in that non-EU country are able to operate across the EU by providing services cross-border. These would be provided under the local non-EU standards applied by the regulators in the non-EU country. The non-EU country's rules must reach certain desired outcomes determined by reference to international standards, where those have been developed.¹⁰ Where international standards do not exist as a suitable benchmark, principle-based objectives or outcomes can be agreed. In the wholesale context, these would avoid giving rise to significant systemic risk in either jurisdiction. In the retail context, this approach would ensure that firms would comply with the host jurisdiction's consumer protection laws when interacting with consumers in that jurisdiction. The recognition of branches of third-country firms could be based on existing intra-EU arrangements.
- b. Some new form of mutual recognition developed for the purposes of Brexit, which must (if it is to be acceptable) achieve equally as flexible a result, permitting the EU and the UK autonomy of rulemaking and regulation so long as certain agreed outcomes (where possible based on international standards) are met. This would require a free trade agreement, most likely ratified by all

¹⁰ Market bodies and financial regulators meet regularly in international fora to develop agreed international norms of financial regulation for different financial sectors e.g. the Principles for Financial Market Infrastructure, the International Organization of Securities Commissions' standards and the rules of the Basel Committee on Banking Supervision.

Member States. It would also require the development of an entirely novel and wide-ranging mutual recognition concept and the corresponding rewrite of existing EU laws. This option does not depend on equivalence but allows a looser standard of comparability between UK and EU laws, and could be even more desirable, if achievable, since it could reduce the level of monitoring of law-making on both sides. However, whether such a wider deal is politically achievable on acceptable terms is unclear at the moment.

It may be that the equivalence route is the only realistic route that is acceptable to all parties since it already exists for many sectors, builds on tried-and-tested technology and does not bring with it politically (or commercially) unacceptable ancillary constructs, for instance restricting the UK from ensuring it is competitive in other areas such as employment law or tax. The UK must of course have one eye on these other available options, but Enhanced Equivalence, properly implemented such that the UK can regulate in its own way in accordance with international standards ought to be politically achievable and attractive.

A detailed exposition of the Enhanced Equivalence model, including drafts of an EU Enhanced Equivalence Regulation, UK implementing measures and a bilateral UK-EU agreement, is set out in my separate publication *A Template for Enhanced Equivalence*.¹¹ This route is more easily achievable than developing a novel form of mutual recognition, since a relatively extensive patchwork of equivalency regimes already exists in EU law, which the UK will also implement into its national law under the Great Repeal Bill. Additional procedural protections would be needed to ensure equivalency is granted on a predictable basis and cannot be revoked except after a proper process and notice period, and, for the future relationship, to coordinate new legislative or regulatory initiatives. Gaps in the existing equivalency framework would need to be filled in, for example where there is only a partial equivalence provision available under existing EU law or no equivalence is provided for at all in a specific sector.

The International Regulatory Strategy Group has developed a model which could lead to similar outcomes to the Enhanced Equivalence option. The proposal is for a novel mutual recognition concept whereby fresh rules are created to deal with future divergence between the UK and EU from the currently identical standards in place.¹² A material divergence would trigger a withdrawal of recognition, unless the divergence was rectified or agreed. So long as this model allows for appropriate flexibility and divergence from current standards, in principle it could achieve a similar result to the Enhanced Equivalence proposition.

Any solution will need to ensure that the EU does not attempt to limit or control tax, competition or other areas of UK policy which are not restricted by the Enhanced Equivalence or other mutual recognition concept. The EU has, in constructing its existing equivalence framework, quite rightly not sought to regulate such other areas of policy for the third country seeking recognition. Any approach of this nature would be inconsistent with international norms and global trade. Given the political

¹¹ ‘A Template for Enhanced Equivalence: Creating a Lasting Relationship for Financial Services between the EU and the UK’, Politeia, 10 July 2017 by Barnabas Reynolds. The model was also summarised in ‘A Blueprint for Brexit: the Future of Global Financial Services and Markets in the UK’, Politeia, 3 November 2016 by Barnabas Reynolds.

¹² ‘Mutual Recognition – a Basis for Market Access After Brexit’, International Regulatory Strategy Group, 11 April 2017.

backdrop, avoiding such an outcome being proposed will require good will, good faith, and cooperation on both sides of the Channel.

Option 2: The Financial Centre Model

The benefits of a ‘no deal’ Brexit can be capitalised under the ‘Financial Centre Model’. Simultaneously with exploring the possibility of a deal, the UK Government must prepare for no meaningful deal being reached and commit to implementing a successful and comprehensive alternative, the Financial Centre Model.

‘The Financial Centre Model does not mean severing links with the EU.’

This volume sets out a roadmap under which transition can swiftly be made, by the UK Government and businesses, to the Financial Centre Model. It discusses the misleading claims falsely alleging a cliff-edge after the current treaty arrangements are withdrawn. It considers how all of the key financial services (with limited exceptions) can be provided to EU customers without significant cost or friction, even where there is no financial services deal in place between the UK and EU after Brexit.

Under this model the UK would go it alone, refocusing its regulatory and tax regimes to be more rational and competitive, whilst ensuring the markets remain safe and the UK taxpayer is not exposed to bail-out risk.

The Financial Centre Model does not mean severing links with the EU. On the contrary, business and other links should remain strong. A close and lasting relationship with the EU is and will remain important. However, underlying such an approach is the need for the sector to be ready for whatever decision is or is not reached in the negotiations. In particular, businesses need to prepare for an outcome in which the EU may not agree to any mutually beneficial arrangements, such as an Enhanced Equivalence deal. Even though this would be to the detriment of EU customers, who would have to pay more to access the global financial markets on their doorstep, it would not be prudent for businesses to assume that they may continue without change, however unlikely such a scenario may seem. The UK’s regulators would not allow them to do so either, as market participants should be fully prepared for future adjustments to their businesses.

It is important to note however, that even on the Financial Centre Model, many of the existing equivalence regimes that exist under EU legislation, such as that in place between the US and EU for derivatives clearing houses or for reinsurance, are almost certain to be applied to the UK from the moment of Brexit despite the absence of any deal.

Under these existing equivalence regimes, many UK businesses will be able to operate cross-border into the EU in different ways whilst relying on UK legal and regulatory standards, and being regulated solely in the UK. I set out these equivalence regimes in a set of tables in my first publication, *A Blueprint for Brexit*.¹³ There are existing equivalence regimes in important areas such as capital requirements, which will enable inter-bank exposures between UK and EU institutions to be accounted for in a similar way to the current set up. For derivatives clearing, central counterparties (‘CCPs’) based in the UK are likely to be recognised under the EU equivalence regime, not least because of the negative systemic consequences for the EU if they are not. The number of diverse countries recognised under these regimes makes it politically and legally implausible for the UK, with its identical laws at the point of

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See Annex A of ‘*A Blueprint for Brexit: the Future of Global Financial Services and Markets in the UK*’, Politeia, 3 November 2016 by Barnabas Reynolds.

Brexit, not to be recognised. There are also new equivalence provisions effective from January 2018 that will enable non-EU firms to provide investment services to wholesale clients throughout the EU on the basis of registration with the European Securities and Markets Authority ('**ESMA**'), as set out in the Markets in Financial Instruments Regulation ('**MiFIR**').¹⁴

There is, of course, a small risk that the UK will be subjected to the equivalence determination process only once it becomes a third country, leaving a gap between the effective date of Brexit and the granting of equivalence status. However, this would be an unattractive situation for both the UK and the EU and could cause real problems for EU customers and the EU economy. For example, for clearing, exchanges and settlement systems, EU businesses would find themselves cut off from access to vital infrastructure and this would create systemic risk, which is something no EU government is likely to want to promote. Therefore, we should be confident that such a risk will not materialise even though the legal structures outlined in this book do not presuppose that such obviously sensible steps are taken.

So, preparations should be made for both the 'deal' and 'no deal' outcomes simultaneously, the latter being addressed on the most pessimistic but realistic of bases, even though there is also a good chance that some level of access through equivalence will in fact be applied even on a hard Brexit.

The first responsibility of the UK Government is to prepare the ground swiftly for, and to support the development of the Financial Centre Model. This would enable the UK's financial markets and the UK more generally to prosper and flourish.

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Regulation (EU) 600/2014). The UK may, however, choose not to seek equivalence for market access to wholesale investment services clients under MiFIR to avoid having to implement its more problematic aspects without modifications, such as some of the rules on research unbundling and the rules on transparency under MiFID II.

2. Drivers in Favour of Open Borders for the EU

This Chapter sets out to describe the wider context and why the EU needs open borders for financial business and to permit the free inward flows of financial capital, products and services into the EU.

The European Union, its Global Aspirations and Needs

The EU's commitment to promoting free and fair trade in its relationship with the wider world is enshrined in Article 21 of the Treaty on European Union (the '**Treaty**'). Furthermore, there is support for improving inter-connectivity and openness to global capital pools at the highest levels of the EU. Mario Draghi, President of the European Central Bank, has stated that maintaining 'open trade, investment and financial flows' will be a crucial part of raising productivity as part of the recovery of the global economy.¹⁵

The Particular Need for Openness in the Global Financial Services Sector

The international community recognises the interconnected nature of financial markets in the modern era. Financial institutions operate on a global scale and they and their clients rely on seamless access to multinational corporations, banks and other market participants. International bodies, such as the Financial Stability Board ('**FSB**'), the Basel Committee, the International Association of Insurance Supervisors ('**IAIS**') and the International Organization of Securities Commissions ('**IOSCO**'), drive regulatory developments in the context of a globalised financial services market which contributes towards a more harmonised international financial system. Despite occasional protectionist policies and rhetoric, the EU recognises this reality of a global network for the provision of financial services through its use of mutual recognition frameworks. These mutual recognition frameworks include equivalence. The EU recognises the arrangements governing a number of other developed markets and relies on their standards. The EU also plays a key part in the implementation and development of global regulatory standards, something on which the UK has also traditionally taken a leading role.

Viewed against this backdrop of the international financial markets, the EU and Europe as a whole stand to lose out if frictionless access to the City is lost as a result of Brexit. Many participants in the wholesale global markets are based in the City because access to these deep and developed markets could not be easily replicated from the smaller financial centres in the EU, which are not designed to enable global access and do not have the breadth of market participants found in the City or from markets in other time zones. The EU Parliament's own analysis shows that the vast majority of European capital markets and investment banking revenues are generated in the UK. The EU therefore needs to ensure that the fullest possible access to the City is maintained to avoid adverse impacts on individuals and the real economy in the EU that would result should access to the wholesale markets (which are increasingly global in nature) be lost. It is clear that low cost access to the City, and to other financial centres around the globe, can only be achieved on the basis of reciprocity. The EU cannot adopt a 'Fortress Europe' approach to this issue.

'The EU
Parliament's own
analysis shows that
the vast majority of
European capital
markets and
investment banking
revenues are
generated in the
UK.'

¹⁵

Mario Draghi, speech to the Economic Policy Symposium of the Federal Reserve Bank of Kansas City, Jackson Hole, 25 August 2017.

The EU is already set up to be outward-looking in its approach to financial services. It is a founding principle of the EU that relationships with third countries (i.e. non-EU countries, as the UK will be after March 2019) should be developed '*to promote multilateral solutions to common problems*'.¹⁶ This includes adopting policies and actions that '*encourage the integration of all countries into the world economy, including through the progressive abolition of restrictions on international trade*'.¹⁷ The EU must also achieve the object of developing '*a special relationship with neighbouring countries aiming to establish an area of prosperity and good neighbourliness . . . characterised by close and peaceful relations based on cooperation*'.¹⁸ If the EU is to live up to this principle, it must adopt an open approach to third countries, including the UK when it leaves the EU. This includes adopting a mutual recognition policy which facilitates access to financial services provided by firms that are regulated in a robust manner consistent with international standards.

Issues Largely Aligned, Discounting for Political Rhetoric

The interests of the EU and the remaining Member States are in fact to maintain the City as it is and indeed to see an enhancement of its position. The negotiations have been billed in terms of 'UK versus EU'. The reality is that by virtue of shared geography, history and culture, the relationship between the UK and the EU will always be of significant mutual importance. A strong financial centre is beneficial for all, not just the country in which it is based. The EU will continue to benefit greatly from the City being this financial centre following Brexit and, conversely, it will harm itself, its financial institutions and, ultimately, its citizens by attempting to weaken the cohesiveness of the City. Fractured markets are less efficient and to the disadvantage of everyone.

The real 'enemy' is not each other, but the spectre of significant amounts of business moving away from Europe altogether, either spooked by the infighting, or disincentivised by the breakdown of the cohesion of the City as a global financial centre. The concern is that if nationalist interests in France, Germany and elsewhere are engaged principally in attempts to pick bits off the City, they might find they have reduced it in the process, and that the whole of Europe is left with a significantly diminished offering. It is noteworthy that those countries with the least strong protectionist rhetoric at a political level – Ireland, Luxembourg and the Netherlands in particular – appear to be becoming the EU-27 'hub' of choice for many financial institutions.

Roughly 88% of the market in the City is rest-of-world or UK domestic. Only 12%, and for many institutions less than that, is EU-facing or needs to be EU-facing.¹⁹ There is little or no appetite among the City's major institutions to move significant business outside the City; they are looking at 'bare minimum' solutions wherever possible. EU Member States cannot move businesses to their territories by fighting against market forces. They will merely push businesses to adapt their distribution methods to access EU customers, with the increased costs in turn being charged back to their own customers. In the meantime, these attempts at

¹⁶ Article 21(1), Treaty on the European Union.

¹⁷ Article 21(2)(e), Treaty on the European Union.

¹⁸ Article 8(1), Treaty on the European Union.

¹⁹ 'Brief on the City after Brexit', Written Submission to House of Commons International Trade Committee, Economists for Britain, 22 December 2016.

attacking the City may have the effect of diminishing the only global financial centre in Europe, which will continue to be the most important market for those same countries.

What's 'In It' for the EU?

By continuing to collaborate with the UK, the EU can continue to influence this important market. The EU's voice will then be heard clearly in terms of future regulation of the City. It is to be expected – indeed welcomed – that the UK will take the opportunity to refocus and rebalance some of the more burdensome regulatory approaches and requirements of the EU. But provided the parties are not irreparably alienated, the EU – as a significant consumer from the UK's global markets – will continue to have an effect on that process. This matters to the EU, as its customers will still have to come to the City for their financing needs, as they have done for centuries and as customers still do from the rest of the world.

What if the EU Fails to See That?

The UK must be prepared for the EU to respond to the steps the UK might take to reinforce the City. The EU might impose protectionist measures on its own institutions by introducing prohibitions on EU financial institutions from taking advantage of certain financial services outside the EU. By way of example, if (as it should) the UK rebuffs any attempt to deprive the City of euro-clearing services, the EU could prevent its own financial institutions from trading or clearing euro-denominated instruments outside the Eurozone. However, this would primarily hurt those it is designed to protect, namely the EU financial institutions, who would be deprived of access to more liquid trading and clearing facilities elsewhere, and would be prevented from directly accessing those non-EU facilities supported by global financial institutions and infrastructure. This would significantly increase their costs and damage their reputation and would not in fact move the bulk of euro clearing out of the UK.

The threat of introducing protectionist measures might seem at first sight to be a useful tool for the EU during the Brexit negotiations. In reality, a proper analysis shows that protectionism will ultimately most adversely affect the EU, its institutions and customers. The EU should be invited to consider whether suffering such significant effects itself is worth it, simply for the price of attempting to give the UK or the City a 'bloody nose'. The success of European financial markets is too important for such nose-thumbing. It may stoke populist fires under the mantra, for example, of 'punishing' the UK and discouraging the exit of other countries from the EU, but the reality is that such protectionist responses would be counterproductive. The EU would deprive its own financial institutions and businesses of a vital point of access to the global financial markets and because it would highlight the attractiveness of the UK's free-market response, would more likely drive more business to the UK to the detriment of the EU, for example using some of the alternative structures discussed here.

'It may stoke populist fires under the mantra, for example, of 'punishing' the UK and discouraging the exit of other countries from the EU, but the reality is that such protectionist responses would be counterproductive.'

3. Going it Alone: Reinstating Autonomy and Competitiveness

There are a number of reasons why the UK cannot be significantly disadvantaged by forging ahead on its own without a deal.

WTO Rules

There are international law restrictions on the EU's room for manoeuvre. The World Trade Organisation ('**WTO**') rules provide a certain level of protection. The UK is not presently a standalone member of the WTO since this is an EU competence, but it is anticipated that the UK will rejoin as an autonomous member after Brexit since it was a signatory of the original General Agreement on Tariffs and Trade upon which the WTO was founded. Each member of the WTO must comply with the General Agreement on Trade in Services ('**GATS**'). In addition to general commitments, GATS includes schedules of specific commitments relating to: (i) market access, (ii) national treatment, and (iii) certain additional commitments.

Trade discrimination between WTO member states is broadly prohibited in GATS through the Most Favoured Nation Principle. This means that countries cannot grant certain trading partners favourable treatment without extending such treatment to all WTO members. The EU, as a trading bloc, is exempt from the Most Favoured Nation Principle under Article V of GATS for internal purposes in that trade preferences that apply among EU Member States do not have to be extended to other WTO members. However, the EU must generally treat all third country services and services suppliers alike in terms of the rules governing access to the EU single market. This means that the EU will not be able to 'punish' the UK by discriminating against it in contravention of WTO rules, for example by arbitrarily refusing to grant equivalence where the UK has similar standards to already recognised third countries, such as the US, Singapore, Hong Kong, Mexico or Bermuda (depending on the equivalency regime).

The Self-Contained Nature of Regulatory Regimes

In principle, global regulatory regimes are structured to protect markets and consumers within the relevant country (or, in the case of the EU, the internal market) in question. They do not generally affect those outside the country (or jurisdiction).

How does EU regulation work?

The UK has been the primary driver behind the development of much EU financial regulation and, in general terms, the outline of EU financial regulation reflects the overall approach that had been adopted by the UK historically. Regulation is undertaken for each defined financial 'service' or 'activity' carried on within the EU, such as the provision of investment advice, agency trading or deposit-taking. This approach was originally developed by the UK for the Financial Services Act 1986. The category or categories of service or activity that an institution conducts determine the extent of the rules to which the institution will be subject.

Thus, for example, a firm might conduct the regulated activity of 'accepting deposits' when it allows a customer to deposit funds in a current account with it, and might also engage in 'portfolio management' when it is given the authority to invest the customer's funds so deposited in different kinds of assets on the customer's behalf. Each regulated

service and activity requires a licence and brings with it the application of detailed rules. The UK or EU regulatory lawyer therefore needs to break down each specific activity conducted and apply the legal and regulatory framework to that activity to determine which rules are applicable and how it is to be supervised. The US, by contrast, regulates certain entity types differently, often by reference to the licensing regime that they participate in.

The list of services and activities which are regulated ranges across investment banking, advisory business, commercial banking, fund management, insurance, reinsurance and the provision of financial infrastructure services.

What about supervision?

‘... the idea of a calamitous cliff edge arising for existing financial contracts upon a no deal Brexit is simply inaccurate.’

Supervision is conducted within each Member State for all sectors with two exceptions. First, for the largest Eurozone banks whose failure would pose a systemic risk to the Eurozone, the ECB acts as a single regulator but operates under local law powers in coordination with local law authorities. Secondly, trade repositories and credit rating agencies are regulated centrally by ESMA.

Extraterritorial application of regulation

Consistent with global principles of regulation, applicable rules do not generally seek to impose EU regulation on business carried on outside the EU. Any such approach would face obvious practical difficulties, and would likely bring EU and Member State laws into disrepute for attempts to overreach their jurisdiction. Such an approach would also be inconsistent with international law and the wishes of the EU and other jurisdictions to respect each other’s sovereignty and autonomy. Any other approach would lead to the application of multiple overlapping, and potentially inconsistent, regulations, stifling business and the real economies within the EU and beyond with red tape. Extraterritorial regulations can reduce or potentially remove local access to international capital flows and are often contrary to the interests of local businesses and consumers. The US regulatory system has some extraterritorial effects but the general, though reluctant, acceptance of these tends to be based on the inescapable importance of the US dollar and the dollar markets.

The Cliff Edge in the Mind - International Law: Property Rights and Contractual Rights are Protected

Various voices have expressed concern that financial contracts in existence between UK providers and EU-27 customers or counterparties, or vice versa, at the point of Brexit may become illegal to perform due to a loss of ‘passporting rights’. The worry is that EU regulations springing up on Brexit will need to be complied with and UK-based businesses will not be able to do so unless there is equivalence-based access between the UK and EU, replicating the passport.

However, the idea of a calamitous cliff edge arising for existing financial contracts upon a no deal Brexit is simply inaccurate. First, not all instances of continued contractual performance will amount to the carrying out of a new regulated activity, triggering EU licensing concerns. Often the regulated activity is deemed to have been carried out at the time the contract was entered into, so continuing to perform pre-Brexit contractual obligations should not attract fresh EU licensing requirements despite the loss of the financial services passport. Secondly, the services

or products provided under many financial contracts are not cross-border in law. They are treated as being delivered solely where the provider is located, in this case the UK (or the EU, in the case of an EU provider).

As for the residual category of contracts which are affected, they are protected by the right to property, enshrined in the Convention and the Charter, as well as the international law doctrine of ‘acquired rights’.

The right to property, which is to be found in Article 1, Protocol 1 of the Convention and in an equivalent provision in the Charter, protects ‘possessions’ against interference. ‘Possessions’ has been interpreted broadly by the European Court of Human Rights and European Court of Justice and includes many kinds of contractual rights. The key question for determining whether an intangible asset, such as a contract, qualifies for protection is whether it *‘gave rise to financial rights and interests and thus had an economic value.’*²⁰ Tangibility, transmissibility or assignability, realisability and economic value are all relevant indicia for determining whether a contract constitutes a ‘possession’. Non-assignable contracts with economic value to the contracting parties are also capable of being ‘possessions’. In fact, it is difficult to conceive of a financial instrument existing at the point of Brexit which would not have a calculable economic value and therefore fail to constitute a ‘possession’.

In addition, a doctrine of acquired rights under international law has developed to protect a narrow scope of rights derived from an international treaty, and vested in individuals, when the treaty ceases to be effective. Ownership rights in real and personal property, certain contractual rights and concessionary rights are the three broad categories of contracts included under the doctrine of acquired rights. Generally, for a contractual right to be protected under international law, it must have an assessable monetary value and be personal in nature. Financial contracts entered into by businesses prior to the point of Brexit have these characteristics and will, therefore, generally be protected by these acquired rights.

The Convention and the Charter permit interference with contractual rights on proportionate, legitimate grounds, in the interests of the public. Similar public interest overrides apply to the doctrine of acquired rights. However, a UK-based entity will remain regulated by a UK regulator that will employ identical or similar standards to those found in the EU for the foreseeable future and will continue to act in accordance with the highest international supervisory standards. Imposing new regulatory barriers in a way that would render the performance of existing contracts illegal would create huge market disruption in the UK and EU-27, which would be contrary to the interests of the publics in both places. Therefore, it is difficult to see how the EU-27 Member States could succeed in showing that wholesale and abrupt interference with ongoing financial services contracts in these circumstances is necessary or proportionate in order to achieve a legitimate aim in the public interest.

Therefore, businesses should now consider any adjustments to their existing contracts so as to maximise their protections for the possible eventuality of a no deal Brexit. Parties should consider the adoption or adjustment of assignment clauses in their existing and prospective pre-Brexit contracts. Whilst many financial instruments should be protected anyway by virtue of having an economic value, the presence of

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Paeffgen GmbH v Germany (Application Nos 25379/04, 21688/05, 21722/05 and 21770/05 (unreported) given 18 September 2007, page 8.

'Studies have shown that firms that locate in leading financial centres grow faster than rivals ...'

assignment rights should put matters beyond doubt. The existence and terms of termination provisions for change of control and other 'party-specific' clauses should also be re-evaluated. Further, the terms of contracts could be expanded to cover business foreseen as being required to be undertaken around and after Brexit.

In addition, in the context of investment business conducted with large corporate and professional customers, and certain other areas of financial business, the above protections can be augmented by providing, before Brexit, for the application of the EU's reverse solicitation exclusion, due to be formalised in the second Markets in Financial Instruments Directive ('MiFID II') from January 2018.²¹ EU-27 customers can indicate, pre-Brexit, that they wish to operate on this basis after Brexit. Reverse solicitation is discussed further in Chapter 10, *Investment Banking and Advisory Services*.²²

The Lessons of History

The idea that London could cease to be one of the pre-eminent global financial centres as a result of Brexit has no logical basis. There have arguably only been four truly global financial centres in the last 400 years - Antwerp, Amsterdam, London and New York. Antwerp and Amsterdam lost their pre-eminent positions as a result of war or major shifts in the world balance of power. Occupation by a foreign army displaced activity from Antwerp to Amsterdam in 1585 and from Amsterdam to London in 1795. Likewise, the Second World War was a key factor in the shift from London to New York, while the US balance of payments deficit resulting from the Vietnam War stimulated London's revival in the 1960s as the epicentre of the burgeoning Eurodollar markets. Barring major world events, the network and agglomeration effects inherent in global financial centres make them an enduring feature of the landscape. London recovered from the Second World War, in which a third of the City was destroyed and an estimated 1.7m buildings were damaged in London overall. It takes an extreme calamity to force a financial centre to relocate. The financial services passport has only properly been in place since 2007 and its removal, whilst meaningful, is not such an event, given the relatively small proportion that EU businesses represent to the City.

Global financial centres exist by reason of cost efficiencies and savings, created by the depth and breadth of market participants interacting in one location, and a concentration of expertise. Studies have shown that firms that locate in leading financial centres grow faster than rivals, their superior performance being attributable to the scale and scope benefits of clustering.²³ Customers are attracted to the superior liquidity, pricing, choice and array of services. The world's next two biggest regional financial centres, Singapore and Hong Kong, have been built on similar premises to the existing global financial centres, London and New York. Business has concentrated in those regional centres for similar reasons of efficiency. Use of the common law is (probably not coincidentally) shared by all four systems. It is hard to see any similar centre developing

²¹ Directive 2014/65/EU.

²² The law surrounding the so-called cliff-edge is discussed in further detail in 'Continuity of Contracts and Business on a 'Hard' Brexit: Human Rights and Reverse Solicitation to the Rescue!', Shearman and Sterling LLP, 31 October 2017.

²³ Taylor, A.J., Beaverstock, J.V., Cook, G., Pandit, N. R. and Pain, K., (2003) 'Financial Services Clustering and its significance for London', citing Pandit, N. R., Cook, G. A. S. and Swann, G. M. P. (2001) 'The dynamics of industrial clustering in British financial services', The Service Industries Journal, 21, 33-61.

within the EU, and the competitive clamouring of regional European cities attempting to attract business from the UK demonstrates why no single centre is likely to emerge. With exception of Ireland, there are no pure common law systems in the EU-27.

Those seeking to provide the best services to their clients whilst also maximising shareholder value must keep in mind the importance of financial centres. Moving the minimum amount of business from London is the key to continued business success. Those who make other decisions now will find new businesses taking their place in the global markets. EU customers will seek out the cheapest and most cost effective financial services and will, over time, gravitate back to the nearest global financial centre, London. No doubt they will be prepared to make the relatively minor adjustments required to achieve such savings.

A Reminder of The UK's Attractiveness

The attractive force and momentum of the City should not be underestimated. It is based on a large number of well-known, multi-generational factors which have, if anything, become stronger over time. It is also based on the fact that cross-border legal and regulatory divergences add risk to the markets, which the markets seek to avoid by trading so far as possible domestically within a single jurisdiction – the UK.

Important factors that have led to the success of the City over many centuries include its common law tradition, world-respected courts, established financial system, talent pool, English language and time-zone. The UK's social, cultural and political strengths have added to its attractiveness.²⁴ From a legal perspective, the key factors contributing to the City's success include: the use of common law and a focused legislative approach; robust drafting and straightforward judicial interpretations; regulatory philosophy of focusing on outcomes; and highly skilled, market-experienced personnel at regulators, exercising real-time face-to-face judgement, including in rule-making. These factors are explained in more detail in Annex 1 to this paper.

The most significant benefit the City has enjoyed from being part of the EU has arisen from the so-called 'passport'. This has removed certain barriers to trade in financial services across the EU and allowed regulated institutions to operate solely under UK oversight and without duplicative local regulation and oversight in other EU countries (and vice versa). Many European institutions, including many of the EU-27's biggest banking groups, have their largest offices in London.

However it has been questionable throughout, and particularly since 2008, whether the benefits received are worth the price. Key factors that have led to the erosion of the City's competitiveness include: the civil law-'write everything down' approach to law-making; one-size-fits-all, overly prescriptive laws and regulations; dangerous splitting of rule-making and supervision; unsatisfactory and politicised rule-making processes; and competing social priorities, designed to promote a more managed economy. These factors are explained further in Annex 2 to this paper.

'Important factors that have led to the success of the City over many centuries include its common law tradition, world-respected courts, established financial system, talent pool, English language and time-zone.'

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Further analysis of the factors that contribute to the City's success generally can be found, for example, in the Briefing Document, '*Vision 2025 – The Role of Financial and Related Professional Services*', TheCityUK, March 2017. These include: lifestyle factors, tax environment, technology and infrastructure, access to skills, access to other markets, and domestic market size and nature.

'The cumulative effect of drags on UK competitiveness has been significant.'

The resulting effect has been to force an over-reliance on EU-driven rulemaking and ‘tick the box’ rules compliance, weakening the impact of focused – and challenging – discussions with boards and executives as was traditionally the case in the UK. Where regulators do try to engage in such processes, they are hampered by the backdrop of distracting and misdirected mandatory compliance requirements emanating from legislative efforts made far away, both geographically and – in terms of market experience and understanding – figuratively. It is arguable that this shift, resulting from EU rulemaking along, of course, with human error (including in the UK), added to the feeling of complacency which contributed in turn to the culture leading to the 2008 crisis itself.

Of course, the US system went through turmoil at that time and was applying a more traditional regulatory approach. It has adopted many of the concepts post 2008 that were originated in the UK and embellished in the EU, but notably without many of the EU's embellishments. The US has been more nimble in its ability to revisit concepts and legislation. The new administration appears likely to make further adjustments. The UK needs to move fast to ensure that it has more rational, tailored and better regulation.

The UK has challenged encroaching EU financial regulation that has threatened the City on several occasions but has sometimes failed in these efforts. By way of important examples, the UK lost its case in the ECJ to prevent Brussels from winning powers to ban short selling in emergencies under Article 28 of the Short Selling Regulation.²⁵ The UK also failed to overturn the cap on bankers' bonuses under the Fourth Capital Requirements Directive ('**CRD IV**'),²⁶ withdrawing its claim after the EU Advocate General recommended that the ECJ dismiss the action.²⁷ The UK was also unsuccessful in its challenge to the proposals for a pan-EU financial transaction tax.²⁸

The UK was successful in its challenge to the ECB's location policy in respect of euro clearing. However, the main basis for the decision was the absence of adequate powers in the ECB's charter to impose a jurisdictional requirement on the provision of clearing services in respect of euro-denominated transactions. This reasoning arguably enables the ECB to try and impose a new location policy if it revises its charter or is given a new remit, as is now being proposed.²⁹ This low hurdle gives rise to a significant risk that the ECB will implement such a policy.³⁰

The cumulative effect of drags on UK competitiveness has been significant. According to a report by Open Europe,³¹ a sample of the most significant 100 EU measures cost the UK £33.3bn in the 2014-2015 tax year. Among the costliest regulations were the CRD IV package (recurring cost of £4.6bn a year) and the Alternative Investment Fund

²⁵ C-270/12.

²⁶ Directive 2013/36/EU.

²⁷ C-507/13.

²⁸ C-209/13.

²⁹ Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 648/2012 (EMIR) and Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 1095/2010 and amending Regulation (EU) 648/2012 (EMIR).

³⁰ See further EU Questions and Answers on the proposal to amend the European Market Infrastructure Regulation, 13 June 2017 which includes a new proposal on Euro clearing location requirements.

³¹ 'Top 100 EU rules cost Britain £33.3bn', *Open Europe*, 16 March 2015.

Managers Directive (recurring cost of £1.5bn a year). The costs of applying these EU-derived measures could be abrogated were the regulations to be simplified. However, the labyrinthine EU legislative process is inherently weighted against the simplification of regulation. Ultimately, rationalisation of these costly requirements under the EU legislative process would involve approval by qualified majority voting at least, and in practice even greater consensus among Member States.

4. Navigating the EU Politics

Like it or not, the EU is using what are at best questionable, and certainly one-sided, legal assertions as a political negotiating ploy. This starts with an assertion that a Brexit payment is owed in law, when it is not.³² It continues with the erroneous assertion that the UK cannot negotiate a trade deal prior to Brexit.³³ And in a commercial context it has involved all sorts of questionable assertions as to what business needs to take place where. These propositions have had noticeable impact because before the Brexit referendum the European Commission, which is the body making or orchestrating most of the statements, had a role which was largely impartial. Some people have yet to accept that many of the Commission's pronouncements after the Brexit referendum are nothing of the sort. However, despite such attempts at political level, the EU does in general terms observe the rule of law. When a matter is pressed further within the EU system as a whole, spurious propositions tend to fade away. Also, in general the operational functions within the EU bureaucracy tend to be less politicised.

'... it is important that businesses undertake a sophisticated analysis of law and regulation and do not rely on assertions.'

Given the situation, it is important that businesses undertake a sophisticated analysis of law and regulation and do not rely on assertions.

Politicisation of the Regulatory Environment in the EU

There are certain elements in the EU which would seek to force the relocation of some financial business to the EU by regulatory rulemaking and interpretation. Their endeavours are likely to prove counter-productive given that they are (if persisted with) likely to make EU businesses less competitive and undermine the EU economy. For example:

- a. The European Commission has proposed new rules on intermediate holding companies for financial institutions.³⁴ The ostensible rationale was to match rules in the US, but the US operates a very different system in this context and the EU's proposals are unnecessary to ensure bank and investment bank resolution proceeds smoothly. It is reasonable to question whether the declared motivations for this law are anything but 'tit for tat' for the introduction of the US's intermediate holding company requirements, Brexit-related opportunism (in seeking to pull more post-Brexit business into the EU-27) and protectionist. But, whatever they are for, this is a measure which is backfiring as businesses' interest in low-friction moves of certain aspects of their business wanes.³⁵

³² See 'Analysis of the UK's potential financial liabilities', September 2017, by Martin Howe QC and Charlie Elphicke MP, published jointly by Lawyers for Britain and the European Research Group. See also the House of Lords Report, 'Brexit and the EU Budget', 4 March 2017. The UK Government has also stated that it will '*honour commitments we have made during the period of our membership*' and that the EU-27 should be assured that their liabilities over the remainder of the current budget plan will remain the same despite the UK's decision to leave the EU (Prime Minister Theresa May's Florence speech: 'A new era of cooperation and partnership between the UK and the EU', 22 September 2017).

³³ See, for example, 'UK's Right to Negotiate Free Trade Agreements before leaving the European Union', Francis Hoar, 1 October 2016.

³⁴ Proposal 2016/0360 (COD) amending Regulation (EU) 575/2013 (CRR) and Proposal 2016/0364 (COD) amending Directive 2013/36/EU (CRD IV).

³⁵ 'UBS to move fewer London jobs than initially feared', Financial Times, 29 October 2017.

- b. Similarly, ESMA and the European Banking Authority (the ‘EBA’) have issued five somewhat politicised ‘opinions’ on aspects of EU regulation which, on some readings, overreach their legal powers and seek to claw more business than the law warrants into the EU by attempting to restrict the discretions available to national regulators.³⁶ The opinions set out ESMA’s and the EBA’s detailed ideas on how a supervisor should apply the laws allowing, amongst other things, delegation, outsourcing, back-to-back transactions and intragroup transactions.³⁷ The ECB has also recently issued a press release taking what might be viewed as a politicised approach to what it terms ‘empty shells’ or ‘letter box’ banks, covering circumstances where it is quite clear the entities in question are neither empty nor letter boxes.³⁸
- c. The euro CCP location policy³⁹ is designed to ensure the ECB can overrule the market’s independent view of the strength (or otherwise) of Eurozone credits and can require that haircutting and margining decisions take a more benign view of the shaky Eurozone system. The policy would subject financial institutions and CCPs to new underlying Eurozone related-systemic risks and legitimate queries have been raised by market participants as to the need for such a policy.⁴⁰
- d. Some proposals now on hold may be pushed through for political and fiscal reasons. For instance, various key EU politicians have reinvigorated discussions of the financial transactions tax, which they wish to impose in order to fund EU projects through profits from the international financial markets. Many of those pushing the introduction of a Eurozone or pan-EU financial transactions tax also seek to collect that tax through Eurozone-located clearing houses, which adds an additional edge to the wish of some EU politicians to try to force euro clearing into the Eurozone.
- e. Despite matters of taxation being matters of Member State competence under the Treaty, the European Commission has challenged that concept in the case of Ireland and elsewhere by seeking to address matters of taxation through competition laws, which are the provenance of the EU.⁴¹

³⁶ See ESMA’s ‘Opinion on general principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union’, 31 May 2017 (ESMA42-110-43); ‘Opinion to support supervisory convergence in the area of investment firms in the context of the United Kingdom withdrawing from the European Union’, 31 July 2017 (ESMA35-43-762); ‘Opinion to support supervisory convergence in the area of secondary markets in the context of the United Kingdom withdrawing from the European Union’, 13 July 2017 (ESMA70-154-270) and ‘Opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union’, 13 July 2017 (ESMA34-45-344). See also the EBA’s ‘Opinion on issues related to the departure of the United Kingdom from the European Union’, 12 October 2017 (EBA/Op/2017/12).

³⁷ The European Commission’s recent proposals to enhance the supervisory powers of the European Supervisory Authorities reveal that the EU intends to extend this federal level of supervision going forward.

³⁸ See the ECB’s press release ‘Brexit, an ECB supervision perspective’, 15 November 2017.

³⁹ See the European Commission’s proposal for amending the regulation on OTC derivatives, central counterparties and trade repositories (Regulation (EU) 648/2012) (COM/2017/0331 final - 2017/0136 (COD)), and ECB Recommendation 2017/18.

⁴⁰ For further detail see ‘EU-managed control of euro clearing is not viable’, Financial Times, 15 May 2017 by Barnabas Reynolds and ‘Deutsche Bank chief questions EU clearing quest’, Financial Times, 12 November 2017.

⁴¹ ‘State aid: Commission refers Ireland to Court for failure to recover illegal tax benefits from Apple worth up to €13 billion’, European Commission, 4 October 2017.

- f. The recent attempt by ESMA to restrict direct electronic access to EU trading venues being provided by third country members of those venues (even third country firms licensed in 'equivalent' jurisdictions) by the latest ESMA Q&A⁴² is similarly protectionist and inconsistent with the UK's more open approach to facilitating direct electronic access.

All of these steps evidence the sort of protectionist instincts that have rendered financial business in the EU less attractive than it could be. A highly prescriptive approach to regulation means that these instincts permeate the EU financial system.⁴³ Institutions should be aware that relocating their businesses (including CCP relocation) will risk further exposure to EU prescription, to policies such as the financial transactions tax and to new underlying Eurozone-related risks.⁴⁴

The Need for Rigorous and Versatile Lawyers

'Some commentary is so extreme that it appears designed for political ends ... Whatever one's view of the merits of staying in or leaving the EU, such notions seem unfounded.'

There is some shrill and far-fetched commentary in the legal community regarding Brexit. Some seek to assert that the EU will not apply its laws properly to the UK after Brexit or will change them overnight out of spite. Such thinking is most unlikely to be accurate, unless many, many new laws similar to those listed in the previous section and prohibiting cross-border business are introduced in the EU prior to Brexit – which seems impractical and implausible. The EU operates a system of law which, whilst far from perfect, gives consistent meaning to adopted laws. It applies those laws under the oversight of a court system that, whilst again far from perfect, seeks to ensure that the laws achieve their purpose. Member States also operate under the rule of law.

Some commentary is so extreme that it appears designed for political ends. On the one hand, those making these assertions sometimes argue that the UK has no option but to stay in the EU or accede to any EU demands. On the other, they imply that the EU and its Member States have so little respect for the rule of law that the very system they advocate the UK participating in is actually illusory – since their arguments are based on EU law being an entirely political and arbitrary instrument. This is not the case, especially given the need for the EU to remain internationally credible and to remain an attractive destination for business and investment. Whatever one's view of the merits of staying in or leaving the EU, such notions seem unfounded.

The fact is that Member State laws and pan-EU laws seek to permit business flows in and out of the EU. The Treaties make this clear. Financial flows into the EU are key for providing lending to businesses and access by such businesses to the capital markets. The Eurozone requires such funds if it is to thrive, especially as the euro and the structures underlying it develop.

⁴² Answer 25, ESMA Q&A On MiFID II and MiFIR Market Structures Topics, 15 November 2017.

⁴³ See, for example, '*An EU Plan to Invade US Markets*', Opinion Of CFTC Chairman J. Christopher Giancarlo, 6 November 2017, in which he notes that '*The European Union favours a highly prescriptive and rules-based approach to financial market supervision in contrast to the US principles-based approach.*'

⁴⁴ For further detail see '*UK Safer for City's Financial Sector than EU, Leading City Lawyer Cautions Firms Against Move to Eurozone*', Politeia, 3 May 2017 by Barnabas Reynolds and '*EU-managed control of euro clearing is not viable*', Financial Times, 15 May 2017 by Barnabas Reynolds.

5. The Need for the UK to Ensure an Attractive ‘No Deal’

The UK has yet to set out its desired position for the post-Brexit legal, regulatory and tax environment. In terms of the financial sector's future, many want continued two-way access between the UK and the EU in financial services. They would like that access to be founded on the mutual recognition of standards and embedded in a free trade agreement or mutual recognition agreement. The UK is seeking such an arrangement and indeed that might be achieved. Others have argued that in many ways the harder the Brexit, the better the consequences for businesses.⁴⁵

The UK Government should take steps to offset the impacts for business in the event of a no deal outcome, and ensure the attractiveness of the UK as a destination for investment. Such steps could involve a ‘better regulation’ agenda, rationalising regulation to focus on the requirements of the global markets hosted in the UK to ensure they compete and flourish. They could also involve amendments to tax law.

The result of such an approach will be that the position for international financial businesses is ‘win-win’. Either there will be some form of deal largely replicating the *status quo* but permitting a greater level of autonomy for UK legislators and rulemakers in ensuring properly dynamic laws and supervision can exist, or the UK’s markets will be adjusted to be even more competitive, with a specially focused and tailored approach permitting accelerated capital growth and better value for customers. Many would advocate the attractions of the latter model. If it becomes evident that no reasonable ongoing access and free trade deal is on the cards, the Financial Centre Model remains a viable and workable option and needs to be made all the more so.

In the meantime, the UK should where possible defer any protectionist, unnecessary or anti-competitive EU legal and regulatory provisions due to come into force in the UK (such as the open access requirements of MiFID II and the intermediate holding company rule), and should seek to apply, sensibly, any exemptions and exclusions that meet with regulatory objectives so as to facilitate UK regulation taking a different path after Brexit in a no deal scenario, should that arise. A list of provisions relevant to financial services including derogations and opt-outs that could be considered is set out in Annexes 3, 4 and 5.

‘... the UK should where possible defer any protectionist, unnecessary or anti-competitive EU legal and regulatory provisions due to come into force in the UK ...’

The Need to Reconsider Regulation and Remove Red Tape

The global financial markets face change. The regulatory framework put in place after the credit crunch is gradually being re-evaluated, so far principally in the US. Brexit brings with it the potential for more change. Regulatory reform is long overdue. Although the post 2007-2008 financial crisis reforms were put in place pursuant to unprecedented global cooperation, many of the individual reforms were implemented on a unilateral basis in a matter that went beyond what was agreed, and their cumulative impact was not properly considered. Safety belt after safety belt was fastened, resulting in a restriction on the proper functioning of the market and high costs.

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‘Brexit could leave UK better off, says Mervyn King’, The Independent, 29 August 2017; ‘UK can expect £135bn windfall after Brexit, say Economists for Free Trade’, Bailiwick Express, 13 November 2017.

This is particularly the case for post-crisis EU regulation. Whilst the underpinnings for most of the EU's reforms were globally-driven (and in fact based significantly on UK expertise), local implementation inevitably involved highly charged political considerations coming to the fore. An irritation and obsession with bankers' pay distracted lawmakers from focusing on safety and soundness considerations, exposing balance sheets to higher fixed overheads. A political suspicion of fund management led to overly intrusive regulation. Insurance was subjected to an extraordinary panoply of solvency regulation that stifles innovation and penalises new product development, based on little or no evidence of the need for such extensive reform. Banking and investment banking, the sectors most in the public eye for a re-vamp of oversight, were enveloped in a plethora of rules. Many of these rules are extraordinarily detailed and went further than necessary, in a Cartesian attempt to throw a safety blanket over the market, prescribing pre-determined business operating models. Civil law thinking, under which absolutely everything was written down in laws, has prevailed and detracts from the common law fabric of the market, resulting in the further stifling of business.

Structurally, the politics predominated also. The UK vote in the EU was temporarily weakened by politicised assertions that somehow the financial crisis in the EU was caused by the UK and not lax EU rulemaking and race-to-the-bottom competition amongst some EU regulators willing effectively to ignore the wording of EU regulation. The EU sought to federalise the oversight of Member State regulators, most notably establishing an overseer for the regulation of the securities markets, ESMA, in Paris in a manner detached physically and practically from the markets themselves. The EU also introduced bureaucratic systems of Colleges of Regulators, further to centralise but in reality to diversify oversight through the dilution of powers of autonomous decision-making. Moreover, this aspect of federalisation has increased regulatory uncertainty. Interpretations are sought to be harmonised across the EU through a Byzantine process which is unresponsive to the detail and dynamism of the market.

These structures ossify business models, slow down new developments and introduce significant systemic risk into the markets by reducing the ability for the sophisticated UK regulators, who are located alongside the markets and most attuned to them, to operate dynamically and responsively. In further evidence of the triumph of politics over safety and soundness, the EU has subsequently sought to add to the powers of the Paris-based ESMA rather than the London-based EBA in relation to many areas – for instance, derivatives regulation, clearing, trade repositories, credit rating agencies and so on – which would far more safely be carried on holistically as part of bank supervision in the UK and, were EU federalism genuinely to have been required, would have fallen most naturally into the remit of the EBA.⁴⁶

Overall, the EU has, for political reasons, over-emphasised rulemaking (which in the EU is largely federal) at the expense of equally if not more important supervision (which is still essentially local or relies on local powers). The EU has therefore responded to the crisis by creating what are in essence hugely detailed instruction manuals for local EU Member State regulators and regulated firms.

This is not how to regulate a safe market. The good news is that Brexit brings with it the overdue opportunity to re-vamp financial regulation in

⁴⁶ It has now been announced that the EBA will move to Paris and after the move takes place, it may well be that this phenomenon is reversed.

one of the world's two global financial centres, and to focus regulatory and supervisory attention on what matters for financial soundness, consumer protection and market safety, rather than on a project of regulatory harmonisation and bureaucracy which in some instances appears to have prioritised consistency and federalisation (including by diversifying decision-making) over what is worthwhile and necessary.

Not Being Afraid to Say ‘No’

Two suggestions in particular crop up in the UK’s Brexit negotiations. First, that the UK should give away elements of business, perhaps euro clearing, in order to secure a deal. Secondly, that the UK should share regulatory sovereignty with the EU.

Why to say no to business cessation

It should be up to the markets to decide where they are located, not governments. Quite apart from the absurdity of applying a law in the UK which prevents certain business from being done there, the UK should not concede pieces of business in order to obtain a deal. The UK will only achieve the success it seeks if it negotiates with the understanding that, if it is to survive and thrive, the City cannot be carved up, with bits of its infrastructure sold off as part of a compromise.

‘Fragmentation, or attempting to carve out parts of the network, leads to the introduction of significant legal complexity and risk, as competing legal systems inter-relate in complex and often unpredictable ways.’

A financial centre is more than a collection of parts. Global financial centres comprise a complex web of inter-connected, sophisticated components working together to attract financial services. The City, as one of the two largest financial centres in the world, has many features which make it such a success. But these are not independent features which can be cordoned off and given away. Rather, they all work together to provide for a cohesive, comprehensive centre which continues to attract new business.

Financial centres are successful because they provide a physical location for market participants to engage and trade. A financial centre, if it is to succeed on a global scale, must provide a comprehensive array of services. Financial centres that provide more services are more successful, as market forces drive business to that centre. Government’s role, rather than seeking to manipulate or affect these services, must be to support the infrastructure and allow the market to determine where its resources are most efficiently allocated. Fragmentation, or attempting to carve out parts of the network, leads to the introduction of significant legal complexity and risk, as competing legal systems inter-relate in complex and often unpredictable ways.

For the City to continue to build on its status as an international financial centre, it must not allow its advantageous positioning to slip by giving away a vital part of its market infrastructure, and in particular it must remain a key centre for the trading and clearing of instruments denominated in any globally important currencies, including the dollar and sterling as well as the euro. This is explained in Chapter 7, *The Role of Market Infrastructure and Euro Clearing*.

Not conceding on supervisory sovereignty

The other suggestion that has been floated is that the UK should somehow share regulatory sovereignty with the EU. This is a most dangerous notion. It is hard to believe the EU would wish to do so reciprocally. In order for regulation to be safe, there needs to be one

ultimate decision-maker, and that needs to be the UK given its taxpayers are ultimately exposed to any mishap.

There is everything to be said for regulatory cooperation between the UK and EU regulators. Indeed, this is provided for in the Enhanced Equivalence proposal set out in *A Template for Enhanced Equivalence*.⁴⁷ However, a situation in which it is unclear who calls the ultimate shots would be highly unsatisfactory.

In addition, a practical outcome where there are regulators operating in some form of College or committee, second-guessing each other and disagreeing on supervisory steps as priorities would be undesirable. It would stifle the dynamism of the markets and would reduce the ability of the markets to respond rapidly to developments, both positive and negative.

Instead, Brexit needs to be seen by all as an opportunity for the EU to complete its integration project and to concentrate sovereignty within itself, in order to operate safely as a single jurisdiction, whilst the UK repatriates sovereignty in order to operate more safely within itself.

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'A Template for Enhanced Equivalence: Creating a Lasting Relationship in Financial Services between the EU and UK', Politeia, 10 July 2017 by Barnabas Reynolds.

6. Ten Steps For The UK To Take

The UK needs actively to consider steps that would improve its competitiveness and productivity and it should plan for a swift implementation of a fall-back in the case that no deal is struck with the EU. Given the real possibility of such an eventuality, it is only right (and objectively defensible) that the UK should seek to maximise its advantages and put itself in a position to move forward energetically, so that the UK public will, whatever the outcome, see some immediate benefits from Brexit in terms of productivity, market activity and revenue rather than waiting for those benefits to materialise whilst the EU continues to attempt to attract businesses from the City. In addition, a reinvigoration of the City's natural advantages as a financial centre will remove EU drag factors to its success that have resulted from membership and reduce the wish on the part of firms to implement contingency plans for Brexit that involve moving businesses to the EU.

'Brexit presents the UK with an opportunity to retake control over its legislation and to develop better, more focused financial regulations.'

The UK should take the following ten steps right now to secure its financial services sector, whether or not there is a wider economic deal with the EU:

1. *Re-vamp the UK's legal and regulatory framework for financial services, identifying and tackling key areas where EU requirements have led to a lack of competitiveness and unnecessarily-burdensome regulation.*

Brexit presents the UK with an opportunity to retake control over its legislation and to develop better, more focused financial regulations. The UK can and should cut back on prescriptive regulatory processes, so long as the desired outcomes are clearly achieved. In rebalancing the UK's regulatory framework, it must be recognised that it is not simply a matter of 'more' or 'less' regulation, but rather *better* regulation to which the UK should aspire. Powers and discretions should be pushed back to the regulators. Committee-based approaches involving possible new European Supervisory Authorities ('**ESAs**') and College-of-Regulator style rule-making institutions without supervisory functions should be eschewed. This would crimp the ability of the UK's regulators to exercise their own judgement in rulemaking and day-to-day regulation.

There are areas where the UK can refocus its regulatory sphere and ensure intelligent oversight and compliance, in line with its status as a global financial centre. The extent to which the UK will have a free hand in designing its post-Brexit rules will depend, to some extent, on the nature of any UK-EU deal. A full Enhanced Equivalence package could bring certain advantages but could limit the UK's abilities to remove itself entirely from the EU's requirements. If such a deal is reached, the UK needs to ensure it has autonomy in how to achieve agreed outcomes and an ability to opt out of equivalence for topics where it disagrees with the EU's approach (and *vice versa*). No deal at all would give the UK a much freer hand, and the UK could align itself purely with global standards and best practices.

The UK also needs to ensure it is free to adopt a 'better regulation' approach under any Enhanced Equivalence/mutual recognition deal, for which it needs to be in a position to identify immediately to the EU what this means in order to avoid any misunderstanding during and after the negotiations. Any lack of meeting of minds on this point could lead to ongoing problems in the implementation of such a deal.

Better regulation would reduce costs and allow the City to compete with other financial centres on the basis of international standards. Such efforts would not be deregulatory in the sense of lowering standards, which is a point that must be made clear in any discussions of the topic.⁴⁸

2. *Facilitate innovative structuring by financial institutions and help establish private sector UK facilities to enable ‘no move’ contingency planning.*

The UK must do all it can to enable freedom of access to the City for EU financial institutions and customers following Brexit. It should avoid any protectionist measures, seeking instead to press on as a global financial centre with, so far as possible, friction-free borders.

‘Just as French, German and other EU governments are ‘setting out their stall’ for their respective jurisdictions post-Brexit, the UK Government should be speaking to key financial institution shareholders and financial institution analysts to get them on board with a different and more positive way of thinking about the UK post Brexit ...’

On a practical level, this means engaging with innovative structures designed to ensure that the bare minimum of business – if any – needs to move to the EU, and offering practical assistance to those looking to implement such structures.⁴⁹ The UK Government should encourage the development, sharing and use of workaround solutions for any financial institutions considering moving their business or parts of their business to the EU.

The UK should also take active steps to reduce costs for customers coming to the UK’s markets by facilitating the establishment of places of business here (which could be staffed and run by people from a UK-based service provider) or through establishing arrangements which make clear that the EU customers are reaching out from the EU under ‘reverse solicitation’.⁵⁰ This latter concept comprises a technique permitted under EU laws for EU customers to purchase services and products in many instances from outside the EU without triggering EU regulatory requirements applicable to the service provider or seller. UK businesses could set up EU-based agencies which act as agent for the EU customers in reaching into the UK to ask for services to be continued and provided by service providers here, under the ‘reverse solicitation’ exclusion in MiFID II and more generally.

3. *Engage with financial market participants to facilitate ‘no move’ contingency planning, avoiding the dangerous and unquantifiable systemic risks occasioned by significant moves.*

The UK regulators (the Bank of England, PRA and FCA) should engage with all firms, and ask them to develop and share with their regulators contingencies for a no deal outcome that do not involve moving, on the basis that any moves would involve potential systemic risk to the global markets the UK hosts. A mass-exodus of firms would overwhelm financial regulators and systems that are untested to the degree required. Just as French, German and other EU governments are ‘setting out their stall’ for their respective jurisdictions post Brexit, the UK Government should be speaking to key financial institution shareholders and financial institution analysts to get them on board with a different and more positive way of thinking about the UK post Brexit, which is also reflective of the

⁴⁸ See also Annexes 1 and 2, for the background to build on and what to avoid.

⁴⁹ See Chapters 8-15.

⁵⁰ See further, Chapter 8, *How Businesses Can Best Identify the Brexit Opportunities*.

significant risks to the global financial system in any meaningful moves to jurisdictions that are untested to the requisite degree.

4. *Focus on market infrastructure and examine ways to ensure continuity of EU business within the UK's jurisdiction.*

The UK must recognise the importance of the cohesiveness of market infrastructure (exchanges, trading venues, clearing houses, settlement systems and trade repositories) to the success of the City.

Several practical steps can be taken. UK regulators can engage with EU-headquartered infrastructure firms, asking them about their contingency plans for a no deal Brexit. UK regulators can also engage with UK infrastructure providers to develop and offer similar products to their EU counterparts so that market participants in the City can continue trading in, clearing or otherwise dealing in these products within the City post Brexit – on UK-based platforms rather than EU-based ones.⁵¹ Finally, the UK Government should consider, at least for a transitional period, unilaterally recognising EU infrastructure as equivalent for UK purposes, regardless of the EU's approach, in order to ensure that businesses here can still access and use EU platforms post Brexit. There is a strategic decision to be taken as to whether withholding recognition of EU infrastructure providers is a useful bargaining chip but recognising those providers and declaring a totally open market from the outset is likely to allow the City to retain and attract the most business.

5. *Defer, where legally possible, the implementation of EU laws and regulations which have yet to be implemented in the UK so as to ensure maximum flexibility for the post-Brexit regulatory environment.*

This includes pushing back so far as possible any unnecessary EU financial regulatory initiatives currently working their way through the EU legislative process.⁵²

6. *Reinstate some form of international competitiveness objective for the UK's regulators (subject to a systemic risk override) and remove the competition-based rulemaking function from the FCA.*

The international competitiveness objective was removed in light of the financial crash of 2007-2008 on the basis it was thought to have led to inappropriately lax regulation. However, the complete removal of the objective was a mistake. Clearly, any such objective should be subsidiary to an objective to ensure the financial markets remain safe from a systemic risk (and UK taxpayer liability) perspective. However, this can be achieved in the statutory drafting and the objective should be reinstated to ensure the UK's regulators are guided by the need to ensure regulation is not unnecessarily damaging to the UK's competitiveness. To date, UK regulators have instead been promoting damage to the City by requiring businesses to make 'worst possible outcome' Brexit contingency plans based on often ludicrous assumptions, such as a lack of mutual QCCP status, whilst making no attempt to ask firms for 'minimum staff disruption' based planning.

The FCA's competition-based rulemaking function is out of sync with the position in the major world markets and involves the potential for

⁵¹ See Chapter 15, *Market Infrastructure*.

⁵² See Annexes 3, 4 and 5.

a priori rulemaking designed to ensure markets are competitive, rather than the traditional, proven and market-friendly approach of only making competition-based rules where a market mischief has been identified and proven in accordance with the quasi-judicial processes of a proper competition authority.

7. *Take steps to form other Enhanced Equivalence/mutual recognition arrangements internationally and act to reduce any adverse reactions by overseas regulators to ‘politicised’ EU interpretations of regulation.*

The UK should investigate creative ways to form Enhanced Equivalence/mutual recognition arrangements with non-EU countries, designed to augment the City's status as a global hub.

‘... the UK must take active steps to ensure that it continues to attract and retain the best and brightest talent, both in the City itself and in the legal structures and courts that support it.’

The UK Government should also take steps to liaise with other jurisdictions as regards interpretations of EU and UK law post Brexit. By way of example, global financial institutions with US Department of Justice and other US settlements are very cautious on any interpretations of points that could be seen as offences if their interpretation is wrong, since in that case the settlement is violated. The UK Government could assist in the alleviation of such concerns by liaising with the DOJ and other US authorities to ensure that institutions would not be in breach of their settlement by pursuing any strategies based on objectively accurate interpretations of EU laws post Brexit. This would mean that unexpected, implausible or politicised EU interpretations of relevant provisions (for example by way of land-grab attempts by EU regulators) will not have the effect of prejudicing financial institutions' positions under the settlements. Removing the threat of withdrawal of settlement for financial institutions in circumstances where erroneous legal propositions are peddled would be very helpful to institutions in this febrile environment.

8. *Enhance the other, including soft, attractions of the City.*

In particular, ensure the UK's courts and ancillary legal fabric continue to be of the very highest standards. In addition, the UK should consider ways in which it can continue to grow and expand the advantages offered by the City on a social, political and cultural level.⁵³ For example, the UK must take active steps to ensure that it continues to attract and retain the best and brightest talent, both in the City itself and in the legal structures and courts that support it. A new deal for skilled workers and stable immigration status for EU national workers in the City – who contribute significantly to the economy and tax revenues – is anticipated.

9. *Announce tax incentives as a fall-back in the case of a no deal outcome, to create a ‘heads you win, tails you win’ environment for institutions wishing to keep everything in the UK.*

There could be a temporary tax break (perhaps time limited by several years) offered on the contingency of ‘no deal’ only, whereby anyone in the UK dealing with EU customers and counterparties cross-border into the EU after Brexit, or with a UK affiliate of those customers, would be able to do so with a reduced UK tax burden. This would offset and counterbalance incentives being offered by EU

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See Chapter 3, *Going it Alone: Reinstating Autonomy and Competitiveness*, in the section entitled ‘A Reminder of the UK’s Attractiveness’, and Annexes 1 and 2.

countries to attract business and would help in avoiding business fragmentation (i.e. the danger of the EU business pulling with it other business currently conducted in the UK). A similar break could be offered for euro clearing. There would no doubt have to be anti-avoidance provisions to prevent non-EU businesses re-routing their orders through EU affiliates. This initiative would help get the industry to work with the UK to find solutions, rather than against the UK. It would mirror the incentives being offered by EU countries to relocate business, which creates systemic risk for global financial markets and the UK due to fragmentation and unnecessary business reorganisations.

10. *Take a robust view on the proper interpretation of EU law.*

The UK should take a strong view on human rights and international law protections for existing contractual arrangements between UK providers and EU counterparties, such that existing arrangements are recognised as having continuity through the Brexit period and are not disrupted by Brexit itself, even in the absence of a deal. In addition, the UK should issue and stand behind a strong view on other interpretations of EU law which facilitate the run-off of existing business in the event that no broader deal is reached. It can also take a proper view of the EU's reverse solicitation exclusions, which on some scaremongering interpretations are denuded of meaning entirely. Such steps would help demonstrate to the market that there is no 'cliff-edge'. HM Treasury could coordinate the UK's approach in this regard and could become party to any cases in the ECJ on these points in any ECJ litigation.⁵⁴

This is a non-exhaustive list. Other options arise. For instance, at the more aggressive end of the spectrum, the UK Government could also consider establishing a financial free zone within the UK (for example in parts of London, Edinburgh or Belfast).⁵⁵ This would help develop a new region, and also attract more business and jobs to the UK.

⁵⁴ See also the section in the Introduction entitled '*The 'Cliff Edge' Fallacy: Contrary to EU and International Law*', and Chapter 4, *Navigating the EU Politics*.

⁵⁵ See the Shearman & Sterling LLP client note '*Brexit: A Financial Free Zone Within the City*' for more details on this.

7. The Role of Market Infrastructure and Euro Clearing

Robust market infrastructure is important for the success of a financial centre, as it promotes confidence, predictability and trust in a centre. Some EU countries have entered into the Brexit negotiations looking to attract bits of the City to relocate, which they have attempted to characterise as under threat following the Brexit vote. However, unravelling the complex threads that make up the City is a perilous task. The effects of such attempts on legal efficacy and certainty are unknowable. This is particularly true of market infrastructure and systems that allow the City to provide global offerings such as settlement in multiple currencies, which are significant elements in the web that makes up the City.

Exchanges

Exchanges are fundamental to the equities and derivatives markets. They are used by every major financial institution to trade. Closing prices on exchanges are seen as the most reliable and trustworthy, with UK exchange prices and indices such as FTSE and Brent oil being used as the benchmark for investment performance around the world.

Clearing Houses

Clearing houses are a key part of the plumbing of the financial system. They stand in the middle of the trades between two counterparties which execute on or off an exchange, taking on the credit risk against both. They allow transactions to be settled on an anonymised basis, where traders need consider only the clearing house's investment risk and not the counterparty risk of the entity they trade with. Clearing houses also enable offsetting transactions to net down, saving in the order of trillions of dollars in collateral. Central counterparties reduce the risk in the markets and allow regulators to monitor and control more effectively the systemic risks arising from the market.

A major indicator of the importance of this infrastructure is shown in the response of the G20 after the 'credit crunch' of 2007-2008. One of the main items for reform on the G20's agenda was to mandate all liquid derivatives contracts to be placed into clearing (and where possible also to force trading onto exchanges, to ensure the most transparent pricing).⁵⁶ This was rightly seen to reduce systemic risk in the financial markets. Absent clearing, financial institutions have exposures on derivatives, repos and other long-term contracts to each other on a bilateral and gross basis. It is almost impossible in such circumstances to determine the effects of the interconnectedness of all parties, let alone the knock-on impact of a single institution or marketplace collapsing. The move to clearing leaves a residual systemic risk in the clearing house itself, but the UK has led the way in thinking through how to manage and mitigate that risk and clearing houses have performed well in every financial crisis for two centuries.

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See the Leaders' Statement from the G20 Pittsburgh Summit in September 2009.

The Importance of Not Conceding on Euro Clearing

The ability to clear in multiple currencies is of vital importance to any sophisticated financial centre. Notwithstanding the natural tendency of protectionist governments to assert some kind of ‘ownership’ over their own currency, the reality is that quick and easy access to clearing in major reserve currencies – including the euro – is to the benefit of all financial market participants.

‘The ability to clear in multiple currencies is of vital importance to any sophisticated financial centre.’

There have been some calls from and for the EU to ‘move’ the location of clearing in euros from the City to the Eurozone itself. This is misconceived both as a matter of law and in terms of the practical effect. As a matter of law, the European Central Bank no more ‘owns’ the euro than the Federal Reserve ‘owns’ the US dollar, which is the currency of clearing at the highest volume in the City. There is no legal mechanism by which the EU can force the City to cease providing euro clearing services, and in light of the practical difficulties set out below, the UK should resist any inclination voluntarily to attempt to give it up.

The idea of state-based control of central clearing, including in particular the margining and haircutting of collateral (which various politicians in the EU have made no secret of wishing to achieve), should alarm the markets. It constitutes a real attempt at the managed economic treatment of instruments denominated in euros, which is aimed to force the private markets to operate on a risk assessment for Eurozone sovereign debt instruments based on the Eurozone’s own political calculations.⁵⁷ This must be robustly resisted by the UK as part of the Brexit negotiations, and not allowed through ‘on the nod’.

In addition to these harms to markets and market participants, on a practical level there has thus far been insufficient attention paid to the significant, long-term and irreversible detrimental effect both to the City and to the EU as a whole that would be realised if the UK permits euro clearing to move away from the City. The euro is the second most important reserve currency after the US dollar and is widely used in international trade. The UK is currently home to the largest OTC interest rate derivatives and euro foreign exchange transactions markets in the world, with approximately one trillion euros exchanged in the UK a day.⁵⁸ LCH.Clearnet has the largest share of this euro-denominated market in the UK and, through its SwapClear service, it clears over half of the interest rate contracts and 95% of the cleared OTC interest rate swap market in the UK.⁵⁹

Xavier Rolet, the outgoing CEO of the London Stock Exchange (which owns LCH.Clearnet) estimated in September 2016 that at least 100,000 jobs across the country will be under threat if the European Union demands that euro-denominated clearing cannot take place in the UK following Brexit.⁶⁰ A private report by EY of late 2016, commissioned by the LSE, estimated 83,000 related job losses over the next seven years if euro-denominated clearing is forced out of the City into continental

⁵⁷ See further detail on the negative effect on the markets of such a policy in my article ‘EU-managed control of euro clearing is not viable’, *FT*, 15 May 2017.

⁵⁸ ‘Brexit and the UK’s Euro-denominated market: the role of clearing houses’, by Uuriintuya Batsaikhan, Bruegel, 7 June 2016.

⁵⁹ *Ibid.*

⁶⁰ ‘At least 100,000 finance jobs face clearing threat following Brexit, warns LSE boss’, Daily Telegraph, 23 September 2016. In reality, this was probably an overestimate.

Europe.⁶¹ Whatever the true figure, it is clear that a significant number of jobs in the UK are reliant on this sector. However, these jobs would not just move to the EU. The likely result of rendering UK operations illegal would be for US clearing houses to operate this business and for the market to move products that settle in different currencies.

Preserving the UK's market-driven approach to euro-denominated financial instruments would go some way to mitigating the inherent risks associated with the structural difficulties arising from the fact that the euro is a 'half-way house' currency. It is risky due to the fact that, as an EU regulatory matter, Eurozone Member State bonds are treated as zero risk weighted (i.e. equivalent to cash) when in reality under the Eurozone structure they are more akin to municipal bonds, since the issuer does not control the central bank of the currency. As a result Eurozone Member State bonds should require meaningful amounts of regulatory capital to be held by financial institutions wishing to purchase them. This is because true sovereigns need never go bust, since they can print more money to repay their debts. The Eurozone countries do not control the ECB, so they cannot do that.

Furthermore, local financial institutions are maintained as champions regardless of their true state of solvency, in order to provide a ready purchaser of the local state's government bonds (which would otherwise attract little market interest at an affordable interest rate).⁶² International financial institutions located in the EU are being required to pre-fund a pan-EU deposit guarantee scheme that means that collapses of financial institutions which have been overly-supported will, to a large degree, be at the expense of the international financial markets not the local taxpayers. And the bail-in rules can be used to force the risk of this set-up still further onto the international financial community.

All of this introduces moral hazard and systemic risks that arise essentially due to the Eurozone having no single sovereign state standing behind it. The current location of financial institutions, principally in London and New York, subject to regulation under those two regimes, has somewhat shielded the markets from the lurking risk associated with the structure of the Eurozone. Any movement of euro clearing or indeed of significant financial business to the Eurozone exposes and exacerbates these risks, to the detriment of the financial markets globally given the interconnectedness of the markets. Governments, regulators and financial institutions should consider these concerns in detail.⁶³

⁶¹ 'Losing euro-denominated clearing would cost London 83,000 jobs', Financial Times, 14 November 2016.

⁶² Although the EBA has taken some steps to address this issue through an ongoing peer review exercise into whether its 2014 Guidelines for Identification of Other Systemically Important Institutions are being complied with, in reality the problem remains.

⁶³ See further, Barnabas Reynolds, 'UK Safer for City's Financial Sector than EU', Politeia, 3 May 2017.

PART II

HOW TO OPTIMISE BUSINESS MODELS FOR A NO DEAL BREXIT

8. How Businesses Can Best Identify the Brexit Opportunities

A no deal outcome is not to be feared. It is likely in the long term to have benefits which could even be as good as mutual recognition (Enhanced Equivalence or otherwise).

‘... the current legal framework of the EU already permits much business to continue on a ‘no deal’ scenario.’

The ‘problem’ which Brexit requires financial businesses to find a solution for is how to continue to service EU customer and counterparty needs. In principle there are two ways of doing this. The first is to regard the passport as paramount and to endeavour to move certain business or personnel to new hubs in the ongoing EU. The second is to take advantage of the clustering benefits of the City and to find ways to continue providing services into the EU from the UK. This book focuses on the latter option. There are a number of ways in which businesses can minimise moves by making relatively small adjustments to their business models.

The Approach Necessary from Business

Some financial services market participants and industry bodies have been slower than they might have been to work through the detailed analysis required to make the most of Brexit for themselves, their shareholders or stakeholders, and the financial markets as a whole.

The basis for a successful Brexit is through establishing the right legal and commercial structures. The solution is in the law and requires careful and detailed analysis. It requires versatile lawyers, able to move beyond the nostrums and assumptions derived from within the EU panoply, to working from outside it – as those in successful non-EU financial sectors already do – from a common law tradition. It means working to overcome potential obstacles in the interests of the market, rather than seeking to shadow the EU system. This analysis is now taking place. However, there is still room for further innovation in establishing and planning ways to ‘solve’ Brexit. This volume seeks to cut across the assertions and accusations and to show how it can be achieved.

Many of the solutions involve minimal or even no changes in business methodologies.

Cross-Border Capital Flows: Existing EU Arrangements Facilitating Friction-Free Movement

First, it is important to understand the conceptual framework behind financial regulation in both the UK and EU. What is regulated and when and what is not at all?⁶⁴ This is because the current legal framework of the EU already permits much business to continue on a ‘no deal’ scenario.

In particular, and as explained below, there are three concepts in law which would allow UK firms to continue servicing EU clients and to do so

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See Chapter 3, *Going it Alone: Reinstating Autonomy and Competitiveness*, in the section entitled *The Self-Contained Nature of Regulatory Regimes*, for a summary of how UK and EU regulation works.

in many cases even in the absence of a mutual recognition deal and on the whole without expensive restructuring. The message for UK firms is therefore to prepare. Some will need to make changes in order to take advantage of such arrangements. In many cases the use of these concepts will enable UK firms to avoid costly restructuring.

The three concepts that underpin the Financial Centre Model are as follows:

a. Characteristic performance

European guidance states that the location of service is determined by reference to the 'characteristic performance' of that service.⁶⁵ This means that a service is deemed to be provided where the essential supply of the service for which payment is due takes place. If that essential supply occurs in the UK and not in the EU-27, then UK regulation, and UK supervision, will be solely applicable to the service in question.

As an example, under the 'characteristic performance' test, deposit-taking is said to take place at the location of the branch where a bank's books and records are kept. Not all EU Member States adopt this approach but it is one mandated by European Commission guidance that has not been repealed.⁶⁶ Similarly, fund management is said to occur in the place the manager is located.

By undertaking a careful analysis of current business practices it is possible to assess which activities carried out from the UK are actually cross-border in law, and which are either performed solely in the UK (due to their characteristic performance), or can be performed solely in the UK by making modifications to current practices to ensure that characteristic performance occurs within the UK. Any such activities performed in the UK would not, by definition, be performed in the EU-27, and so would not be subject to EU laws and regulation.

b. Reverse solicitation

It is possible to rely in many instances, most notably in the wholesale context, on the 'reverse solicitation' exclusion to provide many types of service to customers in the relevant EU Member States solely under UK regulation and supervision. Under this concept, EU customers reaching out from within the EU to providers outside the EU are permitted to extricate themselves from EU regulation and to obtain the non-EU financial service or product in accordance with the protections provided to them in the non-EU jurisdiction. Essentially, the characteristic performance in such an instance is seen as being outside the EU.⁶⁷

This concept is being harmonised for wholesale investment business from the beginning of next year under MiFID II. It also exists for funds under AIFMD and is a feature of many national laws in the EU-27.

⁶⁵ Commission Interpretative Communication '*Freedom to Provide Services and the Interest off the General Good in the Second Banking Directive*', 20 June 1997 (SEC(97) 1193 final) and Commission Interpretative Communication on the Freedom to Provide Services and the General Good in the Insurance Sector (2000/C 43/03).

⁶⁶ *Ibid.*

⁶⁷ See Chapters 2, *Drivers in Favour of Open Borders for the EU*, and 3, *Going it Alone: Reinstating Autonomy and Competitiveness*, for an explanation of why the EU has – and needs – an exclusion of this nature.

Use of the reverse solicitation exclusion under MiFID II requires the provision of the service by the UK firm to be at the client's exclusive initiative. It is possible to construct business on this basis, so long as the first move in the relationship is made by the EU customer(s). This is barely a handicap, as the analysis set out later in Chapter 10, *Investment Banking and Advisory Services* reveals. Further, existing clients make solicitations pre-Brexit, to preserve business activity and avoid any cliff edge, as explained in Chapter 3, *Going it Alone: Reinstating Autonomy and Competitiveness*, in the section entitled *The Cliff Edge in the Mind – International Law: Property Rights and Contractual Rights are Protected*.

Many lawyers have feared that somehow the reverse solicitation concept, which is clearly written into EU law, is meaningless and will be the subject of politicised interpretations. They fear the door can be shut on a whim, with criminal law consequences resulting from what would then be an inadvertent breach of the EU's regulatory perimeter, enforced by regulatory or criminal authorities that wanted to be acting without regard for the law. Such thinking involves assuming that EU law is essentially a sham which cannot be relied upon, and that it is a purely political instrument, applied in bad faith by regulators and courts alike.

Fortunately, such a characterisation of EU law is flawed. For all of its faults, EU law is indeed 'law', which is applied in good faith and in accordance with its wording and purpose with a pan-national court (the ECJ) that brings Member States into line and protects non-EU persons as well as EU persons with a legitimate interest. It is generally possible to document things so that it is clear there is a reverse solicitation from the EU to UK so that the EU regulatory perimeter is not breached. Where the UK firm has an EU affiliate, it may be possible in certain types of business for that affiliate to act as agent on behalf of its EU clients to sign up to services from the UK firm, for instance as set out in Chapter 14, *Derivatives*, under the 'Agency' Model. This could be structured as a reverse solicitation by the EU client, provided the EU client requests that the EU institution act on its behalf to procure such services from non-EU firms. Such an approach, where available, can be structured so as to avoid any issues with jurisdictions that 'look through' the agent to the contractual counterparty when assessing who is providing a service in that jurisdiction.

Experience of working with US and Asian institutions accessing EU customers for investment, lending and trading purposes has shown it is possible to obtain local law firm opinions across the EU confirming this analysis.

c. Customer Office in the UK

The other way for businesses to service EU customers entirely from within the UK is for those customers to establish small branches or offices in the UK to receive the services. These need only be minimally staffed. Large EU corporates are already engaged in ensuring they have such places of business. Services provided to UK establishments take place solely within the UK's regulatory jurisdiction and EU regulatory restrictions do not apply to any consequent back-to-back group arrangements for unregulated corporates.

These key concepts would allow UK firms to continue servicing EU clients in many cases, even in the absence of an equivalence-based mutual recognition deal upon Brexit. UK firms and EU customers may need to adjust their practices in order to ensure that their activities are

purely domestic for the purposes of EU law or that they fall squarely within a relevant exemption or exclusion. In many cases, the use of these concepts will enable UK firms to avoid costly restructurings.

Realistic Assessment of Likely Default Equivalence Arrangements

It is also important to bear in mind that, realistically, many existing EU equivalence regimes are almost certain to be applied in favour of UK businesses from the point of Brexit, regardless of the absence of any deal. Equivalence is often described only as a ‘patchwork’ solution, but this is a misconception. There are existing equivalence regimes in important areas such as the Capital Requirements Regulation ('**CRR**')⁶⁸, which will enable inter-bank exposures between UK and EU institutions to be accounted for in a way generally similar to that in use today. CCPs based in the UK are very likely to be recognised under the EU equivalence regime, not least given the systemic access and capital consequences for the EU banks if they are not. The MiFID II equivalence provisions will enable third country firms to provide investment services to wholesale clients throughout the EU on the basis of an ESMA registration, although there are no precedents yet for this regime and the UK may choose not to seek equivalence for the purposes of this provision to avoid having to implement the more problematic aspects of MiFID II, such as some of the rules on research unbundling and the rules on transparency.⁶⁹

The Silver Bullet

There is a ‘silver bullet’ solution available that would allow EU customers and counterparties to continue accessing the City’s services in most circumstances even if there is no enhanced-equivalence type deal between the UK and EU after Brexit. This should be considered across the industry.

The solution is for a service provider to set up UK-based corporate entities (or limited partnerships or trust vehicles) for usage by EU customers and counterparties.⁷⁰ These UK entities would become owned by the EU customers and counterparties. The service provider would manage the UK group entity day-to-day at the EU customer’s expense. The EU clients would enter into all financial contracts through this UK affiliate, for whatever services they wished to have access to in the City.

The affiliates themselves would be unregulated. The relevant regulated financial services activity would take place in the UK under the oversight of the UK regulators. The affiliate would receive any loans, make any deposits, be the counterparty to any trades and receive the benefit of insurance (albeit it might be necessary for the UK to adjust the definition of insurable interest to permit this). Thereafter, the affiliate would upstream the proceeds to its parent in the EU. Depending on the transaction, the UK affiliate may need to benefit from a guarantee or

‘... realistically, many existing EU equivalence regimes are almost certain to be applied in favour of UK businesses from the point of Brexit, regardless of the absence of any deal.’

⁶⁸ Regulation (EU) 575/2013 on prudential requirements for credit institutions and investment firms.

⁶⁹ The MiFID II ‘open access’ regime is also unattractive for systemic risk and other reasons, particularly in light of Brexit.

⁷⁰ See Chapter 6, *Ten Steps for the UK to Take*. The UK Government could assist in setting up such a facility.

collateral provided by its EU parent, or some other form of arrangement that ensures certainty.⁷¹

The Insurance and Reinsurance Trust

In the insurance and reinsurance context, it should in principle be possible to establish a trust in the UK, which holds the benefit of insurance policies on trust for EU-based beneficiaries, such that the regulated activity of writing the insurance takes place solely within the UK's jurisdiction. Premiums and claims payments would flow through the trustee.

The role for the UK Government is to ensure that its tax arrangements do not skim off improper amounts on the way out of the country. It would also need to check the clarity of application of concepts such as insurable interest, which require an insured to have an interest in the risk that is underwritten for it, as well as other EU Member State laws (although these would generally permit a UK subsidiary of substance to conduct business solely regulated in the UK). The UK would also have to check its double tax arrangements throughout the EU, although these are generally very sophisticated and appear to work favourably.

The EU could of course seek to change its laws to prohibit such structures and introduce protectionist measures such as taxing the proceeds on their way into the EU from the UK-based affiliates of EU customers. To act in such a manner unilaterally with respect to the UK, however, would have adverse effects on US and other interests, making such action unlikely. It would also run counter to world trade laws and the principles set out in Chapter 2, *Drivers in Favour of Open Borders for the EU*.

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See further, Barnabas Reynolds, 'A Blueprint for Brexit: The Future of Global Financial Services and Markets in the UK', Politeia, 2016, page 29 'The UK-EU Relationship: Attracting Business to the UK'.

9. Ten Steps for UK-Based Financial Businesses to Take

Most businesses do not wish to move elements of their operations to the EU-27, even on a no deal scenario. They appreciate the clustering benefits of the City and the fact that their operations are likely to be less profitable and less dynamic if they make any such moves.⁷²

In addition, UK regulators and firms need to give considerable weight to the systemic risk that would be inserted into the global financial markets through the making of meaningful moves of business (including technology and contractual arrangements) to the EU-27 in anticipation of or upon Brexit. This is not just because of the risks introduced by making the moves themselves, but because the EU-27 regimes and supervisors are essentially untested for the business required and unprepared, in practical terms, given the uncertainties arising in what is to a large degree a newly-fledged environment. Their laws and regimes have no track record in dealing with the sophisticated details of the financial markets. The risks are further exacerbated by the divergent characteristics of the states being considered for the moves and the simultaneous, uncoordinated nature of the moves.

It does not make sense for the regulators or the markets to plan for such moves without having examined all options for minimising them.

It is possible to minimise and in many cases avoid any requirements to move through taking the following ten steps which enable firms to continue servicing EU customers and counterparties from the City:

1. *Make a robust and thorough assessment of any perceived cliff edge issues for existing client relationships.*

The assertions of a cliff edge on a no deal Brexit ignore key areas of law. The section in Chapter 3, *Going it Alone: Reinstating Autonomy and Competitiveness*, entitled *The Cliff Edge in the Mind – International Law: Property Rights and Contractual Rights are Protected* sets out how international law and rights to property will protect most financial contracts in place between UK and EU-27 parties at the time of Brexit.⁷³

2. *Make enhancements to existing relationships where possible (for instance by considering assignment clauses and reverse solicitation provisions where desired by the clients), so as to preserve and enhance those relationships post Brexit, allowing for future optionality – by amendments to contracts, side letters or email.*

Businesses can amend their existing contractual arrangements now, so as to strengthen their position and expand the areas covered by international law and property rights protections. This is set out in the section in Chapter 3, *Going it Alone: Reinstating Autonomy and*

⁷² See the section entitled *The Lessons of History* in Chapter 3, *Going it Alone: Reinstating Autonomy and Competitiveness*.

⁷³ See also ‘*Continuity of Contracts and Business on a ‘Hard’ Brexit: Human Rights and Reverse Solicitation to the Rescue!*’, Shearman and Sterling LLP, 31 October 2017.

Competitiveness, entitled *The Cliff Edge in the Mind – International Law: Property Rights and Contractual Rights are Protected*.⁷⁴

There are various indicia relevant to whether contracts are protected in their full performance by international law and property rights after Brexit. These indicia should be considered in detail against specific arrangements. The EU law concept of reverse solicitation should also be considered.⁷⁵ Thought should be given to whether pre-Brexit arrangements can be enhanced and expected future events protected against, for instance by making adjustments to permit actions otherwise requiring a new agreement after Brexit, such as derivatives portfolio compression.

If proper reliance is placed on the law,⁷⁶ it should be possible to avoid any cliff edge and extend the performability of existing contractual arrangements well into the future after Brexit.

3. *Ensure business which comes in through reverse solicitation is properly documented and accepted, so that the framework is robust.*

Reliance on reverse solicitation will need to be evidence-based. It is important to maintain proper evidence that any EU-27 customer or counterparty coming in through this route was the first to initiate the relationship by asking about a specific service or product. The key moment is the transition from normal website awareness-raising as well as background, brand-based awareness-raising by the firm to the customer seeking to initiate a conversation or other interaction about a specific service or product.⁷⁷

4. *Ensure a thorough analysis is made of what business is truly cross-border in law, so that non-UK regulatory provisions are applied only when necessary, and consider whether, with minor adjustments, the EU's regulatory perimeter need not be invoked at all.*

This involves a careful consideration of the 'characteristic performance' test set out in Chapter 8, *How Businesses Can Best Identify the Brexit Opportunities*, and an examination of relevant local laws.

5. *Consider the silver bullet and other solutions for assisting customers in 'coming to the UK' in a low-cost way, for instance by establishing a small place of business here such that all future provision of financial service is purely domestic UK, and EU-facing activities are intra-group.*

See Chapter 8, *How Businesses Can Best Identify the Brexit Opportunities*.

⁷⁴ See also *ibid.*

⁷⁵ See Chapters 8, *How Businesses Can Identify the Brexit Opportunities*, and 10, *Investment Banking and Advisory Services*.

⁷⁶ See Chapter 4, *Navigating the EU Politics*.

⁷⁷ See Option 1 in Chapter 10, *Investment Banking and Advisory Services*, for further discussion of this point.

6. Consider other techniques for ensuring regulatory provision takes place in the UK, for instance the establishment of a trust to receive insurance policies and holding the benefit on trust for EU-27 customers.

See Chapter 8, *How Businesses Can Best Identify the Brexit Opportunities*.

7. Consider in detail individual business areas and the laws surrounding those areas allowing business moves to be minimised, for instance indirect clearing, agency arrangements, give-up agreements, delegation, outsourcings, branching back and reinsuring back into the UK from the EU-27.

See Chapters 10 to 14.

8. Consider market-driven and infrastructure-based solutions, for instance, UK infrastructure offering derivative or look-alike products, which permit trading to continue in the UK in spite of any issues found in trading on EU-27 platforms.

See Chapter 15, *Market Infrastructure*.

9. Liaise with the UK Government on the introduction of possible tax incentives and regulatory improvements so as to optimise business models whilst ensuring they are safe for the UK, the global markets and the UK taxpayer.

See Chapter 6, *Ten Steps for the UK to Take*.

10. Consider taking steps to retain talent and jobs by assisting staff with any immigration approvals needed to allow them to stay in the UK.

10. Investment Banking and Advisory Services

Regulatory Treatment of Investment Banking Services Under EU Law

Investment banking services are currently regulated pursuant to laws adopted in Member States implementing the first markets in financial instruments directive ('MiFID I'),⁷⁸ which will be replaced by MiFID II in January 2018. MiFID II will comprise a revised directive as well as a new regulation, MiFIR. As the implementation date for MiFID II is imminent, and arises before Brexit will take effect, this book generally refers to MiFID II only, except where the MiFID I position is discussed in certain sections.

Under MiFID II, investment firms that carry out investment services and/or perform investment activities as a regular occupation or business on a professional basis within the EU must obtain prior authorisation (i.e., a licence).⁷⁹ Regulated investment services and activities in investment banking include:

- a. Reception and transmission of orders in relation to one or more financial instruments;
- b. Execution of orders on behalf of clients;
- c. Dealing on own account;
- d. Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis; and
- e. Investment advice.

Firms carrying out any of the above activities by way of business in the EU will be required to obtain authorisation unless they: (i) are able to use an exemption; or (ii) are able to restructure to ensure continued access to the EU market for such services without authorisation.

When developing plans for the continuation of investment banking activity after Brexit, firms must also engage with the question of access to EU financial market infrastructure ('FMI'), including exchanges, clearing houses and settlement systems. Chapters 14, *Derivatives*, and 15, *Market Infrastructure*, of this book set out points for UK firms to consider when planning for continued FMI access.

Structuring Options for Wholesale Investment Banking Business Lines on a No Deal Scenario

The first step when developing a strategy for post-Brexit access to the EU market for investment banking services is to determine whether the investment banking business conducted by the UK-based firm is in fact regulated in the EU. Some aspects of investment banking are not regulated, such as M&A advisory activities and business consulting.

A separate question arises as to whether the relevant services are actually cross-border in nature. This should be determined by applying the characteristic performance test (see Chapter 8, *How Businesses Can Best Identify the Brexit Opportunities*) in respect of the service and also (in light of that) all the local law tests for the location of regulated

⁷⁸ The Markets in Financial Instruments Directive 2004/39/EC.

⁷⁹ Article 5(1), MiFID II.

activities in all of the EU jurisdictions in which investment banking activities are carried out.

If the UK firm determines that its investment banking business in the EU-27 is in principle subject to local regulation and is also cross-border in nature, there are broadly speaking four options available to continue providing investment banking services to EU clients in the EU.

Option 1 – Rely upon Reverse Solicitation Exclusion

Summary of Analysis

Reverse solicitation is permitted for wholesale clients under Recital (43) and Article 46(5) of MiFIR, which should be read in accordance with EU rules of construction.

Recital 43 of MiFIR states that:

'The provisions of this Regulation regulating the provision of services or undertaking of activities by third-country firms should not affect the possibility for persons established in the Union to receive investment services by a third-country firm at their own exclusive initiative or for Union investment firms or credit institutions to receive investment services or activities from a third-country firm at their own exclusive initiative or for a client to receive investment services from a third-country firm at their own exclusive initiative through the mediation of such a credit institution or investment firm. Where a third-country firm provides services at the own exclusive initiative of a person established in the Union, the services should not be deemed as provided in the territory of the Union. Where a third-country firm solicits clients or potential clients in the Union or promotes or advertises investment services or activities together with ancillary services in the Union, it should not be deemed as a service provided at the own exclusive initiative of the client.' [Emphasis added.]

Article 46(5) of MiFIR provides that:

'Member States shall ensure that where an eligible counterparty or professional client within the meaning of Section I of Annex II to Directive 2014/65/EU established or situated in the Union initiates at its own exclusive initiative the provision of an investment service or activity by a third-country firm, this Article⁸⁰ does not apply to the provision of that service or activity by the third-country firm to that person including a relationship specifically related to the provision of that service or activity. An initiative by such clients shall not entitle the third-country firm to market new categories of investment product or investment service to that individual.' [Emphasis added.]

Therefore, it will be lawful for UK-based service providers, after Brexit, to provide services and sell products to wholesale customers where:

- a. The customer seeks out the UK service provider, perhaps after reviewing the provider's website or after a member of staff from the provider has spoken at a conference or engaged in brand awareness-raising. The customer asks for the service provider to

⁸⁰

This reference is to Article 46, MiFIR, which requires third country firms to register with ESMA before providing services to wholesale clients in the EU. Recital (43) and the *travaux préparatoires* make clear that reverse solicitation is not dependent upon the ESMA registration provisions coming into operation.

'Properly documented, it should therefore be possible for third country providers to deliver services and products safely into the EU without tripping over the EU's regulatory perimeter.'

agree to provide any services or products within its offering suite, as subsequently indicated (including in interactive discussion) by the customer from time to time. This approach can be memorialised in writing. The service provision or sale can then be evidenced as being at the customer's request.

Notably, the UK service provider should not have to restrict its website so as to avoid EU-27 access since otherwise the reverse solicitation regime would impose impractical extraterritorial restrictions which cannot be taken to have been intended as a matter of law.⁸¹ When the client asks to discuss specific services or products, the UK provider should request that the client reads and signs a request form.⁸²

- b. There is nothing in the reverse solicitation exclusion prohibiting the customer from signing up to request ongoing provision in the same way, to save the customer from having to make repetitions of their request. Indeed, such an approach can be made to be consistent with *Bundesanstalt für Finanzdienstleistungsaufsicht* ('BaFin') guidance on the existing German Member State reverse solicitation exclusion so long as it is made at the client's request.⁸³
- c. The customer's original request can also cover new services and products. The customer can request in writing or even by contract that the service provider sends details as it sees appropriate of specific new services and products, or those that have yet to be tried out by the customer. In such a situation, the provision of those details should not constitute 'marketing' within the meaning of the exclusion since the customer had requested them, although care must be taken not to stray outside these strict confines.
- d. Pre-Brexit, potential new customers can be marketed to in accordance with existing EU law. Or they can be marketed to after Brexit through non-affiliated intermediaries within the EU that are licensed as investment firms or credit institutions.⁸⁴ Once aware of the UK service-provider and indicating an interest in finding out more through locally regulated entities, the EU customer can be asked whether it might wish to sign up to a request.

Properly documented, it should therefore be possible for third country providers to deliver services and products safely into the EU without tripping over the EU's regulatory perimeter. The investment funds industry and US bank lending sector have operated on this basis for decades, when accessing Europe. Obviously, reverse solicitation only applies to third country entities and not to EU subsidiaries.

⁸¹ See for example the European Commission's guidance in the context of packaged retail and insurance-based investment products (point 14, Commission Communication (2017/C 218/02)). The guidance states that the mere fact that a website can be accessed by a customer located in an EU Member State does not necessarily imply that investment products on that website are being marketed or directed at such customers. It would, however, be prudent to avoid being seen as actively targeting clients in the EU-27, for example by creating a particular area of the website for EU-27 clients, or providing targeted translations.

⁸² The service provider should also inform the EU-27 client in writing and in a prominent way, before the provision of any investment services, that the provider (in relying upon this exclusion) is not allowed to provide services to EU clients other than wholesale clients and that they are not subject to supervision in the EU. They must also state the name and the address of their UK regulator(s).

⁸³ See the Shearman & Sterling LLP Client Note, '*Continuity of Contracts and Business on a 'Hard' Brexit: Human Rights and Reverse Solicitation to the Rescue!*' for more on this and additional details.

⁸⁴ See Recital (43) of MiFIR.

It has sometimes been asserted that reverse solicitation cannot be relied upon systematically due to soft concerns that EU regulators might not like it. Any such dislike would have no basis in law. EU law, as a proper system of law, can be relied upon in accordance with its terms. What the assertion might be intended to indicate, which would be correct, is that care must be taken in relying upon this exclusion to ensure that proper records are kept of the customer's initial solicitation, so that this fact can if necessary be proved to any regulator or court. Absent evidence of overt direct marketing by UK entities, duress or fraud, a written document signed by a wholesale customer⁸⁵ should be valid evidence of their wish to instigate a relationship along the lines stated above.

Notably, when MiFID II/MiFIR were being drafted, there was a policy discussion regarding the continued existence of the UK's 'overseas persons exclusion', which essentially provides that non-UK based investment business providers can operate cross-border, selling their services from abroad into the UK without a place of business in the UK so long as they comply with the UK's marketing restrictions (which are essentially disallowed for wholesale business). At the time, continental countries emphasised the flexibility of 'reverse solicitation' and its permissiveness for cross-border business. It was, however, eventually agreed that that the UK's exclusion and other national exceptions could continue alongside the reverse solicitation exclusion in MiFIR.⁸⁶

Repapering Existing EU Clients Before Brexit

In order to provide for the widest possible forward-looking array of services to be performed, it would be worthwhile before Brexit for clients of UK-based institutions to indicate in written form that they request future information on a comprehensive list of services provided by those institutions post Brexit. This would invoke the reverse solicitation exclusion in its broadest sense and mean that businesses can continue to operate on a wide-ranging basis solely under UK regulation and supervision after Brexit. EU laws should not be triggered in respect of those clients.

If the list of services and products that existing customers express a wish to procure also includes services and products that they ask merely to be kept informed about in case they wish to purchase them in due course, that is likely also to be permissible under the reverse solicitation provisions, since any provision of information relating to new services and products so specified will involve the provision of information in performance of contractual obligations and not the marketing of new services and products to the customer.

Acquiring New Clients After Brexit

EU clients wishing to sign up to UK-based institutions' services and product offerings after Brexit will be able to do so on their own initiative. They can sign up to terms which request the provision of services and

⁸⁵ A wholesale customer will be presumptively sophisticated, which is most likely why the reverse solicitation exclusion in MiFIR expressly references them. As a result, the evidence provided by what is effectively their written attestation of their solicitation of the provider and expression of wishes for ongoing provision should be treated at face value. Indeed, were they to allege subsequently they did not mean what they said, this would be an actionable misrepresentation vis-à-vis the provider under English law and potentially even fraud. For this reason, such statements should be capable of being relied upon with confidence.

⁸⁶ See also Article 46(4), MiFIR.

'UK-based institutions can in principle still travel into Member States of the EU to raise brand awareness in a generic form, at conferences and in other such fora.'

products across a broad spectrum and can seek to oblige the UK provider, contractually, to inform them of new services and products which the provider thinks are relevant to them from time to time.

UK-based institutions can in principle still travel into Member States of the EU to raise brand awareness in a generic form, at conferences and in other such fora. This should not constitute marketing to the customer of services or products contrary to the reverse solicitation exclusion. In addition, specific meetings with potential EU-27 wholesale clients to explain service and product offerings should be permissible so long as these are at the client's request. BaFin guidance on the existing German reverse solicitation exclusion recognises this possibility. Also, Recital 43 to MiFIR recognises that a regulated investment firm or credit institution within the EU can market to potential EU clients and then, if those clients wish, can put them into contractual relations with a UK-based provider. The terms of that relationship could include the ongoing relationship maintenance provisions mentioned above, whereby the client asks to be kept abreast of new opportunities of the provider.

Option 2 – Adopt a Back-to-Back Booking Model

Under this model, EU clients will trade with an EU affiliate of the UK investment firm. The EU affiliate will then trade an identical product back-to-back with the UK investment firm, thus retaining a single trading book. The UK firm should be able to trade back-to-back with its EU affiliate as such intragroup trades should not trigger any requirement to obtain authorisation under MiFID II.⁸⁷ The EBA has recently stated its expectations of the supervision of back-to-back structures by Member State supervisory authorities. Back-to-back models may be used so long as the EU affiliate is not an 'empty shell' and has adequate levels of Pillar 1 and 2 regulatory capital, in-house risk management and operational capability to absorb any material unhedged positions in the event of default of the UK entity to which risks have been transferred.⁸⁸

A back-to-back booking model is likely to be appropriate for certain investment banking services only. For example, execution of orders on behalf of clients is likely to be easily facilitated through a back-to-back model. However, services such as underwriting are likely to be more difficult to filter through the back-to-back booking process. Reverse solicitation may provide a better route for such services. The back-to-back booking model would also attract meaningful costs compared to reverse solicitation due to the establishment costs for the EU affiliate, subsequent individual capital requirements and separate operational and risk-management capacity required for the EU affiliate.

This option would require mutual UK-EU capital reliefs under CRD IV such that 'group' exposures could be given a lower risk weighting for capital purposes.

Option 3 – Split Out the EU Business

This is the most expensive option, both in terms of initial set-up, ongoing costs and human resources. Under this option, the EU customer-facing

⁸⁷ Article 2(1)(b), MiFID II. In some EU jurisdictions (e.g. France), the exemption under Article 2(1)(b), MiFID II has been implemented to prevent firms that provide services other than to their affiliates from relying on the exemption.

⁸⁸ EBA's '*Opinion on issues related to the departure of the United Kingdom from the European Union*', 12 October 2017 (EBA/Op/2017/12).

investment banking business would be transferred to an existing or newly formed affiliate in the EU.

The EU affiliate would be required to obtain authorisation in the jurisdiction in which it is established. This is a time-consuming process, taking at least 6 months.⁸⁹ However, regulators are able to ‘stop the clock’ on the application process in order to request further information, so in practice the authorisation process tends to take much longer.

There are ongoing costs associated with running a fully-fledged investment firm in the EU. These costs include capital costs (which vary depending on the size of investment banking business being undertaken) and staffing costs. Relocating suitably qualified employees can also be difficult, especially as EU regulators will require a core of employees to be locally resident, sufficiently expert, and fit and proper to carry out their functions.

Option 4 – Branch-Back and/or Outsource-Back into the UK

A further option is the ‘branch-back’ and/or outsource-back approach whereby the separately authorised EU affiliate also establishes a London branch and/or outsources back to the UK. The London branch or outsourcing entity could carry out certain functions for the main EU office of the EU affiliate (mitigating the need to relocate some staff and functions) and some front office functions to interface with the London market if required. This option merits consideration, as it could mitigate some of the costs and disruption entailed under Option 3. The EU affiliate would provide to the UK investment firm all of the advantages of the EU investment services passport, while there is the possibility for certain functions to be carried out by UK-based staff who do not need to relocate.

In the UK the FCA and PRA will need to be consulted to ensure that there are no supervisory concerns. EU regulators will also need to be consulted in case there are particular concerns as to the extent of staffing and business functions carried out in the London branch for the EU affiliate. A recent ESMA Opinion has stressed that the EU affiliate must be sufficiently independent and have the ability to control and manage its outsourcing and delegation arrangements.⁹⁰ It also stresses the importance of supervision of the entity not being adversely affected by outsourcing or delegation arrangements. A comparable approach is likely to apply to the ‘branch-back’ proposition. For example, the EU-compliant internal procedures of the EU affiliate must be effectively implemented in both the London branch and the main EU office of the affiliate. The ESMA Opinion also states that the use of non-EU branches must be based on objective reasons and the EU affiliate must be able to show that the non-EU branch will be effectively supervised. These considerations do not prevent the ‘branch-back’ approach from being adopted. However, it is clear that early discussions with regulators are required. From a UK perspective it may also be appropriate to consider the extent to which the UK regulators can adopt a facilitative attitude towards this option, especially if the option might be pursued by a significant number of UK-based investment firms. The specific topic of derivatives clearing is dealt with in Chapter 14, *Derivatives*.

⁸⁹ Article 7(3), MiFID II.

⁹⁰ See ESMA’s ‘*Opinion to support supervisory convergence in the area of investment firms in the context of the United Kingdom withdrawing from the European Union*’, 31 July 2017 (ESMA35-43-762).

11. Commercial Banking

Regulatory Treatment of Commercial Banking Under EU Law

Under the EU architecture, traditional banking is regulated separately from investment banking. Deposit-taking banks – or ‘credit institutions’ in EU terminology – are regulated under the Fourth Capital Requirements Directive or CRD IV.⁹¹ A ‘credit institution’ is defined as an undertaking which takes deposits or other repayable funds from the public and grants credits for its own account.⁹² Alongside CRD IV, the Capital Requirements Regulation (or CRR) contains various equivalence regimes and capital rules.⁹³ Commercial banking includes the following activities that are regulated under CRD IV and CRR:

- a. Taking deposits and other repayable funds;
- b. Lending;
- c. Financial leasing;
- d. The provision of payment services, e.g. the execution of payment transactions (direct debits etc.); and
- e. Guarantees.⁹⁴

Credit institutions are also entitled to conduct investment business. The analysis for their investment business activities is set out in Chapter 10, *Investment Banking and Advisory Services*.

Payment services are separately regulated under the Payment Services Directive ('**PSD**') (which from 13 January 2018 is to be repealed and replaced by the Second Payment Services Directive ('**PSD II**')).⁹⁵ The PSD sets out the types of payment services that may be undertaken by payment service providers and sets out the conditions for authorisation of certain payment institutions. Under Article 10(1) of the PSD (or Article 11(1) of PSD II), credit institutions authorised under CRD IV and branches of third country credit institutions may provide payment services in the EU without obtaining separate authorisation under the PSD.

Structuring Options for Commercial Banking Business Lines

Just as for investment business, the threshold question for wholesale commercial banking is whether the relevant activity is regulated within a relevant EU Member State and whether it is conducted cross-border into the EU. In general, deposit-taking is not seen, under the ‘characteristic performance’ test, to be cross-border but is seen to take place in the branch of the deposit-taking institution where the books and records are kept and the liability is incurred,⁹⁶ although this varies on a jurisdiction-by-

⁹¹ Directive 2013/36/EU.

⁹² Article 4(1)(1), CRR.

⁹³ Regulation 575/2013.

⁹⁴ Annex I, CRD IV.

⁹⁵ Directive 2007/64/EC. The PSD is due to be repealed and replaced by the Second Payment Services Directive (EU) 2015/2366 from 13 January 2018.

⁹⁶ This is the view that has historically been taken by the UK. The ‘characteristic performance’ test is contained in Commission Interpretative Communication, ‘Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive’, 20 June 1997 (SEC(97) 1192 final).

jurisdiction basis. Many payment services are also not cross-border but are similarly seen to be provided where the accounts across which the debits and credits are made are located.

Option 1 – Consider UK Only Restructure

It is likely that a significant amount of commercial banking business takes place only in the UK under the ‘characteristic performance’ test.⁹⁷ This refers to the place where the essential supply of the services for which payment is due. The Financial Conduct Authority (‘FCA’) has confirmed that UK firms should use the characteristic performance test to determine the place of supply of services provided by them.⁹⁸ The Commission has also stated that the provision of distance banking services such as online banking should not be deemed to be carried out in the territory of the EU customer.⁹⁹ UK firms should determine whether a service is located in an EU jurisdiction by reference to whether the essential supply for which payment is due takes place in an EU jurisdiction. Upon carrying out a technical review of its commercial banking activities and reviewing the perimeter guidance of any other relevant Member States, firms may find that all or most of their business is, under the characteristic performance test, legally deemed to be carried out in the UK only.

Option 2 – Use Local Law Exemptions

Firms may also be able to operate those business lines that are cross-border within the EU on the basis of a branch network. CRD IV does not prohibit Member States from allowing third country credit institutions to establish branches in their jurisdictions. Article 47 of CRD IV only provides that such branches should not receive favourable treatment when compared with branches of credit institutions with head offices in the EU. The EU may also agree with a third country, here the UK, to afford equal treatment across the EU to branches of credit institutions with head offices in that third country (e.g., in the UK).¹⁰⁰

A branch network is likely to be viable for firms that operate in only certain EU jurisdictions. Local Member State law will govern the process for establishing branches in each jurisdiction. EU regulators are likely to require a cooperation agreement with the UK regulators, they may require assets to be ring-fenced at the branch in lieu of formal capital requirements and they may impose liquidity requirements.

Option 3 – Split Out the EU Commercial Banking Business

This option would involve the UK firm establishing an authorised credit institution in the EU. In order to obtain authorisation, the EU affiliate must submit a programme of operations setting out the business plan of the EU bank,¹⁰¹ the EU bank must hold sufficient initial capital,¹⁰² there must

⁹⁷ Commission Interpretative Communication ‘Freedom to Provide Services and the Interest of the General Good’ in the Second Banking Directive, 20 June 1997 (SEC(97) 1193 final). The European Commission’s view for the purposes of the Investment Services Directive (the precursor to MiFID) was that the activity occurred wherever the ‘characteristic performance’ of the activity took place. This view was adopted by the Financial Services Authority (the precursor to the FCA). However, the FCA notes that this view is not shared by all other EEA states (FCA Handbook, SUP App 3 3.3.8G).

⁹⁸ FCA Handbook, SUP App 3.6.8G.

⁹⁹ Commission Interpretative Communication ‘Freedom to Provide Services and the Interest of the General Good’ in the Second Banking Directive, 20 June 1997 (SEC(97) 1193 final).

¹⁰⁰ Article 47(3), CRD IV.

¹⁰¹ Article 10, CRD IV.

be at least two persons directing the business of the EU bank¹⁰³ and the shareholders must meet the suitability criteria.¹⁰⁴ Regulators of the jurisdiction of the EU affiliate applying for authorisation under CRD IV must decide whether to grant or refuse the application within 12 months of receipt of the application.¹⁰⁵

The EU affiliate will be subject to the prudential requirements of CRR. These currently apply directly in the UK. However, if in the future the UK diverges in a material way from the EU approach to capital requirements such that either loses equivalence, the UK bank and EU affiliate may be subject to penal capital requirements for intra-group expenses. Furthermore, if the EU affiliate is established in a Eurozone country and is deemed to be a 'significant' credit institution for the purposes of Article 6 of the Single Supervisory Mechanism Regulation (the '**SSM Regulation**')¹⁰⁶, it will be subject to direct oversight by the ECB.¹⁰⁷

Capital should be capable of being managed using sub-participations and other techniques to reduce the cost of splitting the balance sheet in this manner, though it is still the least efficient of the options.

Option 4 – Branch-Back and/or Outsource-Back into the UK

The 'branch-back' or outsourcing-back model involves the separately authorised EU banking affiliate establishing a UK branch, or outsourcing back, thus mitigating the extent to which staff would need to relocate to the main office of the EU affiliate. The proposition merits further consideration, as it could mitigate the costs and disruption of Option 3. A recent EBA Opinion stresses that outsourcing, delegation and 'empty shell' entities will be scrutinised closely.¹⁰⁸ This is not unexpected and does not exclude the 'branch-back' approach. So long as the EU affiliate has sufficient independent corporate 'substance' (including adequate governance, risk-management and oversight arrangements) and regulatory supervision is not adversely affected, outsourcing and delegation arrangements are legitimate. Similar reasoning may apply to UK banks pursuing the 'branch-back' approach. The ECB has also made recent statements indicating that 'dual-hatting' (i.e., staff carrying out functions in more than one group entity) is likely to be scrutinised strictly due to, *inter alia*, conflicts of interests and capacity issues. Concerns would also be raised if employees of a euro area bank were spending most of their working hours in a third country rather than being physically present in the euro area – instead, control functions and local governance of EU-authorised banks must be sufficiently independent and the EU affiliate has sufficient numbers of local staff to operate

¹⁰² Article 12, CRD IV.

¹⁰³ Article 13, CRD IV.

¹⁰⁴ Article 14, CRD IV.

¹⁰⁵ Article 15, CRD IV.

¹⁰⁶ Regulation (EU) 1024/2013.

¹⁰⁷ The criteria for determining the significance of a credit institution are set out in Article 6, SSM Regulation. Article 6 provides that a credit institution will be deemed to be significant if (i) its total assets exceed EUR 30bn, (ii) the ratio of its total assets over the GDP of the Member State of establishment exceeds 20%, or (iii) the national regulator notifies the ECB that it considers the credit institution to be significant and the ECB agrees.

¹⁰⁸ See the EBA's '*Opinion on issues related to the departure of the United Kingdom from the European Union*', 12 October 2017 (EBA/Op/2017/12).

effectively.¹⁰⁹ Again, this does not exclude the ‘branch-back’ or outsource-back approach provided there is careful deliberation and open discussion with the relevant regulators.

Other Considerations for Commercial Banking

In order to provide payment services to customers in the EU, it will be necessary for UK credit institutions to access payment schemes that allow for settlement in euro. UK banks may continue to access TARGET2 as direct participants after Brexit pursuant to Article 6 of the TARGET2 Guideline. They will no longer be able to participate as indirect participants as such participants must be credit institutions with head offices in the EEA. However, provided that UK banks obtain direct participant status, real time gross settlement in euro through TARGET2 should be unaffected.

TARGET2 is generally more useful for high value payments in euro. Retail payments are usually routed through the Single Euro Payments Area (**‘SEPA’**) system, Step2. This system results in lower costs for processing lower value euro-denominated transactions by netting payments on an intraday basis. After Brexit, it will no longer be possible for UK banks to access the SEPA payment systems unless the European Payments Council grants access in respect of UK credit institutions.¹¹⁰ If such access is not granted, retail payments in euro would have to be settled through TARGET2, resulting in higher costs for consumers.

¹⁰⁹ See ‘*Brexit: an ECB supervision perspective*’, ECB, 15 November 2017.

¹¹⁰ Non-EEA bank access to SEPA is governed by the SEPA criteria and assessment process outlined in SEPA document, ‘*Criteria for Participation in the SEPA Schemes for Communities of Banks or Financial Institutions outside the European Economic Area*’ (EPC061-14).

12. Asset Management

Regulatory Treatment of Asset Management under EU Law

Institutional asset managers are regulated pursuant to laws adopted in Member States that implement one of two pieces of EU legislation. The alternative investment fund managers directive ('AIFMD')¹¹¹ captures fund managers, and MiFID II (discussed in Chapter 10, *Investment Banking and Advisory Services*) captures other asset managers, such as those who are delegated authority to manage or advise funds or who manage or advise individual investors under separate account arrangements. Many managers are effectively subject to both sets of rules, since they both manage funds and perform MiFID II type activities.

The AIFMD regulates any manager ('AIFM') that is domiciled, or has its registered office, in the EU, to the extent that it manages any fund (other than a UCITS fund, which is subject to its own bespoke legislation). An authorised AIFM is able to manage funds domiciled anywhere in the EU, and to market those funds widely across the EU to professional investors, by using a marketing 'passport'.

These management and marketing passports are, however, currently only available where both the AIFM and the fund are within the EU. The traditional hedge fund model still used by many hedge fund managers, where a UK-based AIFM manages a Cayman Islands or other offshore fund, does not qualify for the passports. Those AIFMs therefore find themselves subject to the entire 'stick' of the AIFMD in terms of regulatory burden, but cannot enjoy the 'carrot' of the passports. Instead, to the extent that they want to market to EU investors, they do so under private placement or via reverse solicitation – just like any non-EU manager.

In due course it is hoped that the passports will be extended to some non-EU countries. The AIFMD itself contains a detailed mechanism for this¹¹² but, since the initial date of 2015 for this extension came and went, progress has been glacial.

For asset managers subject to AIFMD, the need to consider Brexit structuring options generally only arises where the manager already manages, or wishes to manage, an EU fund and thus take advantage of the passports. For many UK-based managers, this is not the case. Furthermore, for numerous types of EU funds, there is currently no requirement to have an EU-based manager. In those circumstances, whether there is a restructuring need really comes down to the importance for the particular manager of the EU investor base. Nevertheless, a number of structuring options are set out below.

The structuring options focus on AIFMs, since the principles discussed in Chapter 10, *Investment Banking and Advisory Services*, apply to MiFID II-regulated managers and advisers. As with the rest of this book, this Chapter does not focus on the retail market and, therefore, does not deal with UCITS funds or other EU retail vehicles.

¹¹¹ Directive 2011/61/EU.

¹¹² Articles 35 and 39-40, AIFMD.

Structuring Options for Asset Management Business Lines

Option 1 – Operate through an EU affiliate, and delegate

Whether regulated under the AIFMD or under MiFID II, UK managers may choose to establish an (or use an existing) EU entity to act as the AIFM of the fund. That EU entity could then delegate much of the day-to-day management (including, critically, portfolio management activities) back to the UK manager – now characterised as a sub-manager.

Any delegation needs to comply with detailed rules contained in the AIFMD, including that:¹¹³

- a. the AIFM can justify its entire delegation structure on objective reasons (things such as expertise and efficiency can qualify as objective reasons);
- b. the delegate must be sufficiently resourced, of sufficiently good repute, and sufficiently experienced;
- c. the delegate must be regulated as an asset manager;
- d. there must be cooperation arrangements in place between the relevant EU country and the country of the delegate;
- e. the delegation must not prevent the AIFM from acting, or the fund from being managed, in the best interests of its investors;
- f. the delegate must have been selected with all due care and will be monitored;
- g. the AIFM must be able to give instructions to the delegate and, if in the interest of investors, withdraw the delegation with immediate effect; and
- h. the AIFM does not delegate its functions (i.e., management) to such an extent that it can no longer be considered to be the manager of the fund, and to the extent that it becomes a 'letter-box entity'.

The delegation requirements are similar to those in the UCITS regime for retail funds. Under both the AIFMD and the UCITS Directive, the delegation model has been used for many years by managers located all over the world. Broadly speaking, the onshore EU manager typically retains the risk management function (or part of it), and delegates the portfolio management to the UK sub-manager. Adopting this approach thus allows the UK entity to carry on the day-to-day management, and yet benefit from the 'passport' that is only available to EU managers.

Recent pronouncements from ESMA have suggested that, going forward, there will be an additional focus on delegations, and in particular there may be a need to enhance the substance of, and the activities performed by, the onshore EU manager.¹¹⁴ But this does not eliminate the

¹¹³ Article 20, AIFMD.

¹¹⁴ See ESMA's '*Opinion on general principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union*', 31 May 2017 (ESMA42-110-43); '*Opinion to support supervisory convergence in the area of investment firms in the context of the United Kingdom withdrawing from the European Union*', 31 July 2017 (ESMA35-43-762); and '*Opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union*', 13 July 2017 (ESMA34-45-344). On 20 September 2017 the European Commission also published a proposal (COM(2017) 537 final) for a draft regulation increasing the direct supervisory powers of ESMA.

delegation model as an option¹¹⁵; rather, it may simply involve a modest increase in the personnel staffed in the onshore EU affiliate.

Option 2 – Operate using a White Label Platform, and Delegate

Very similar to Option 1, this focuses on the delegation model. But instead of using an affiliated entity as the onshore EU manager, the UK sub-manager would use the services of an existing third-party platform provider.

Many third-party platform providers in the EU exist now. In a typical structure, the platform provider is the manager of an EU umbrella fund (set up in, say, Luxembourg or Ireland). At the request of a non-EU manager, the platform provider will create a new 'sub-fund' of its umbrella fund, and then delegate management to that non-EU manager. That sub-fund, for all practical purposes, is treated as an entirely separate fund, can have bespoke terms just like a standalone fund, and can even be branded with the name of the sub-manager. This model has been, and is being, used by countless non-EU managers in the US, Asia and elsewhere.

Just as with Option 1, ESMA's recent opinions have suggested a renewed focus on platform providers. However, this is again likely to be a question of degree in terms of the functions carried on by the platform provider. This Option is likely to continue to be attractive to non-EU managers.

Option 3 – Reverse Solicitation

The AIFMD explicitly carves out from its regime any marketing that is 'at the initiative of' the investor.¹¹⁶ Many non-EU managers forego private placement regimes currently and, to the extent that they do accept non-EU investors into their funds, do so solely on the basis of reverse solicitation. Indeed, many EU managers also do the same in the context of their non-EU funds (including a number of UK-based managers who manage offshore hedge funds).

There is no pan-EU understanding of what constitutes a reverse solicitation in the context of fund marketing. Indeed, a number of EU national regulators have issued their own pronouncements that vary considerably. The result is that some countries are flexible and generous; others are notoriously restrictive and make reverse solicitation difficult. Yet the fact remains that marketing at the initiative of the investor does happen, especially where mature market participants are involved. Many managers (including in the UK) already operate on this basis. So for a number of managers, this option really just retains the status quo. For others who genuinely make considerable use of the AIFMD marketing passport, it may mean foregoing a section of the EU investor market. But it does not eliminate the prospect of EU investors and is a popular and viable alternative for non-EU managers already.

¹¹⁵

On 16 November 2017, Chairman Steven Maijor of ESMA said in Brussels that '*we recognize that delegation plays a key role in the current industry set-up and that it has contributed to the success of EU funds, particularly the UCITS label, across the globe... We also recognize that delegation of key functions – including to non-EU countries – is expressly foreseen by the UCITS directive and the AIFMD... Our opinions do not call into question the delegation model. Rather, they aim to provide clarity on such elements as the appropriate substantive presence in the home Member State, the importance of oversight arrangements and the role and status of non-EU branches.*'

¹¹⁶

Recital 70, AIFMD.

13. Insurance and Reinsurance

Regulatory Treatment of Insurance and Reinsurance Under EU Law

Insurance and reinsurance undertakings are regulated in accordance with the Solvency II Directive ('**Solvency II**').¹¹⁷ Under Article 14 of Solvency II, all undertakings involved in direct insurance or reinsurance in the EU must obtain prior authorisation to carry out those activities.

Direct insurance includes both life and non-life insurance products.¹¹⁸ Reinsurance includes one of the following activities under Solvency II:

- a. accepting risks ceded by an insurance undertaking or third-country insurance undertaking, or by another reinsurance undertaking or third-country reinsurance undertaking;
- b. Lloyd's underwriting; and
- c. the provision of cover by a reinsurance undertaking to an institution for occupational retirement provision falling within the scope of the Directive covering that topic.¹¹⁹

Structuring Options for Insurance and Reinsurance Business Lines

Option 1 – Operate Through a Branch Network

Solvency II sets out a harmonised approach to the supervision of branches of third country insurance and reinsurance undertakings. After Brexit, a UK insurer or reinsurer will be able to establish an EU branch to carry out insurance or reinsurance activities provided all of the applicable conditions are met. The conditions are set out in Article 162 of Solvency II and are as follows:

- a. the UK firm must be entitled to pursue insurance business in the UK;
- b. the UK firm must establish a branch in the territory of the Member State in which authorisation is sought;
- c. the UK firm must set up accounts for the EU branch specific to the business pursued in the branch and must keep records of branch business;
- d. a general representative of the UK firm must be appointed, subject to approval by the regulator;
- e. the UK firm must have sufficient initial assets;
- f. the UK firm must cover the capital requirement that would be attributable to the branch under Article 166 of Solvency II;
- g. the UK firm must communicate the name and address of the claims representative appointed in each Member State other than the Member State in which authorisation is sought where the risks to be covered are classified in a certain way;

¹¹⁷ Directive 2009/138/EC.

¹¹⁸ Annex I, Solvency II. Non-life insurance categories include accident, sickness, vehicles and ships. Life insurance includes marriage assurance, permanent health insurance and tontines.

¹¹⁹ Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IOPRs). See Article 13, Solvency II.

- h. the UK firm must submit a business plan for the branch; and
- i. the governance requirements must be fulfilled.

UK firms that choose to operate a branch network in the EU cannot access the Solvency II passport.¹²⁰ Furthermore, branches of third country insurance undertakings are not allowed simultaneously to pursue life and non-life insurance activities in the same Member State.¹²¹ UK insurers and reinsurers with an EU branch network should consider the extent to which they might, technically, be carrying out cross-border insurance or reinsurance activity out of the branch they have established in a Member State. Solvency II prescribes a cross-border test based on where the risk is located and the type of insurance and reinsurance undertaken (e.g., for life policies, the risk is deemed to be located in the habitual residence of the life policy holder). Upon carrying out an analysis of the insurance business taken out, UK firms will be able to confirm the extent of insurance business which is actually deemed to be carried out cross border in the EU and whether further third country branches authorised under Article 162 of Solvency II need to be established in other Member States.

The analysis above only considers how UK insurers and reinsurers could carry out the activities of insurance and reinsurance by establishing locally authorised Member State branches. UK insurance and reinsurance intermediaries (i.e., entities which do not insure or reinsurance themselves, but only advise on, propose or carry out preparatory work relating to, insurance and reinsurance contracts) will need to consider the extent to which separate authorisation of an EU subsidiary under the second Insurance Distribution Directive (due to come into effect in February 2018) ('IDD') is needed.¹²² Member States are also permitted to set their own requirements for insurance intermediaries established in third countries to carry out business in that Member State, so long as equal treatment is provided to the third country firm and that firm is not treated more favourably or given more rights than the EU firms benefiting from passporting rights under the IDD.¹²³

For EU insurers and reinsurers, it is possible that Solvency II (when it is implemented into UK law) could be adapted appropriately to enable insurers from the EU Member States to write UK risks cross-border without a place of business in the UK. Unlike Solvency II, UK financial regulation has tended to be activity-based rather than focusing on the location of the risk to be insured. Some Member States, such as Germany, also permit 'home-foreign insurance' based on reverse solicitation. See Chapter 10, *Investment Banking and Advisory Services*, for a general explanation of the reverse solicitation concept. Reverse solicitation, for insurance/reinsurance, occurs when a person based in a Member State takes out insurance with a non-EU insurer on their own initiative and without being induced by or on behalf of the insurer/reinsurer. The insurer/reinsurer is not regarded as conducting insurance business in the relevant Member State and does not need to establish authorisation in that state. This option is likely to be more relevant for wholesale rather than retail insurance business. National perimeter rules will need to be assessed on a case-by-case basis under this Option. However, experience has shown it is possible to obtain high-

¹²⁰ Articles 145 to 147, Solvency II.

¹²¹ Article 169(1), Solvency II.

¹²² Directive 2016/97.

¹²³ Article 1(6), IDD.

quality local law opinions across the EU on this topic. Group supervision and solvency should also be considered.¹²⁴

Option 2 – Operate Through an EU Subsidiary and Reinsure/Branch/Outsource-Back

UK insurers may choose to establish an EU subsidiary to carry out insurance or reinsurance activities in the EU, if they do not already have one. Capital costs can be minimised by reinsuring most if not all of the risk back to the UK.

As part of the process for authorisation as a standalone EU insurer, the shareholders of the EU affiliate will be assessed and must meet suitability requirements.¹²⁵ Furthermore, the insurance or reinsurance undertaking must take one of the legal forms prescribed in Annex III of Solvency II (which includes a body corporate).¹²⁶ An EU subsidiary that obtains authorisation as an insurance undertaking will be able to provide services throughout the EU on the basis of the Solvency II passport.¹²⁷

There are different permutations of this model available for UK insurers to consider. Upon establishing an EU subsidiary, the UK insurer may consider the following: (i) the EU Institution carries out EU insurance activities, and functions are delegated or outsourced back to the main London group entity; and/or (ii) the EU Institution carries out EU insurance activities and also establishes a London branch to carry out certain functions and to carry out UK insurance business.

This option can be applied flexibly for the individual circumstances of each UK insurer to mitigate the costs, disruption and duplication entailed in establishing a separately authorised EU insurance subsidiary. It will be up to each UK insurer to consider the extent of staffing and scale of management that is required for the EU insurance subsidiary, taking into account the amount of EU insurance business that is envisaged and the local regulator's approach to supervising the EU subsidiary.

The European Insurance and Occupational Pensions Authority ('**EIOPA**') has recently issued Brexit-related guidance for all Member State insurance regulators to follow.¹²⁸ The Opinion acknowledges that outsourcing and delegation arrangements are likely to be used by many UK insurers setting up separately authorised EU subsidiaries. It acknowledges that so long as the 'corporate substance', risk management and governance of the EU subsidiary is proportionate to the business that it carries out, delegation or outsourcing arrangements are workable. Outsourcing and delegation must also not affect the relevant Member State regulator's supervision and enforcement of the EU affiliate. Therefore, with careful calibration and advance discussion with relevant EU Member State regulators, the need to relocate staff and business can be mitigated.

¹²⁴ See the Shearman & Sterling LLP Client Note, '*Brexit: Implications for the Insurance and Reinsurance Industry*' for technical analysis of these points.

¹²⁵ Article 24, Solvency II.

¹²⁶ Article 17, Solvency II.

¹²⁷ Article 15(1), Solvency II.

¹²⁸ See EIOPA's '*Opinion on supervisory convergence in light of the United Kingdom withdrawing from the European Union*', 11 July 2017 (EIOPA-BoS-17/141).

EU Member State regulators are likely to be incentivised to be constructive in pre-emptive regulatory discussions. As EIOPA itself notes, the UK carries out 24% of the 28 EU Member States' combined financial and insurance activities.¹²⁹

UK insurers should also consider the extent to which EU Member State authorised insurance mediation firms can assist with marketing to local customers. Third party insurance mediation firms could be used or UK insurers could establish an EU insurance intermediation subsidiary authorised under the IDD (which would benefit from the IDD EU passport for insurance intermediation, thus avoiding the need to review each Member State's insurance intermediation rules). EU insurance intermediaries could also then branch back and/or outsource back certain activities to a UK entity. Relocation of staff would therefore be mitigated by the activities carried out by the EU subsidiary's UK branch or activities delegated back to a UK-based group entity.

The possibility of using a locally established insuring entity and the availability of third country equivalence provisions for group solvency calculations, group supervision and the determination of a single group supervisor means that many of the practical implications for UK insurers and reinsurers can largely be mitigated.

Option 3 – (Reinsurers Only) Operate on the Basis of an Equivalence Decision

This option assumes that an equivalence determination for reinsurance has been made, which seems particularly likely (given that such a decision is already in place for many relevant countries) so the option is expressly considered here. The Commission may determine that the UK's solvency regime is equivalent to the standards set out in Solvency II pursuant to Article 172 of Solvency II. If it does so, UK firms that only carry out reinsurance business will be able to conclude contracts with insurers and reinsurers established in the EU and continue with minimal post-Brexit adjustment. These contracts will be treated in the same manner in the EU as reinsurance contracts concluded with undertakings authorised in accordance with Solvency II.¹³⁰ If an equivalence decision is made with respect to reinsurance, this further increases the utility of Option 2 above, as UK-based insurers should be able to access EU customers by establishing a separately authorised 'pass-through' EU vehicle which reinsurance risks efficiently to their head office.¹³¹

The Commission has made equivalence determinations with respect to the solvency regimes of Australia, Bermuda, Brazil, Canada, Japan, Mexico, Switzerland and the US.¹³² As the UK has implemented Solvency II in national law, its solvency regime has been crafted on an absolutely identical approach to that of the other Member States. The UK is therefore uniquely qualified to be considered as equivalent under Article 172 of Solvency II.

¹²⁹ Point 8, EIOPA's '*Opinion on supervisory convergence in light of the United Kingdom withdrawing from the European Union*', 11 July 2017 (EIOPA-BoS-17/141).

¹³⁰ Article 172(3), Solvency II.

¹³¹ For further details please see the Shearman & Sterling LLP Client Note, '*Brexit: Implications for the Insurance and Reinsurance Industry*'.

¹³² See the table of Equivalence Decisions adopted by the European Commission (last updated 3 October 2017).

Option 4 – Client Use of a UK affiliate or Trust Arrangement

UK insurers and reinsurers should also consider establishing a customer trust in the UK, which will receive the benefit of insurance policies and hold them on trust for the beneficiaries in the EU. This would mean that the regulated activity in connection with the provision of insurance is being carried out in the UK, in favour of the trust. The EU customer ends up economically in the same place. The structure therefore allows EU clients efficiently to access UK insurers and reinsurers.¹³³

¹³³

See also the end of Chapter 8, *How Businesses Can Best Identify the Brexit Opportunities*.

14. Derivatives

Ways to Conduct Cleared Derivatives Business for EU Customers After a Hard Brexit

There are various ways to carry on business in respect of exchange traded and cleared products in the EU from the UK in the absence of any mutual recognition deal. This is one of the more complex areas of financial regulation which is deeply integrated and harmonised throughout the EU.

The analysis set out below demonstrates solutions for a base case scenario. The nuances and complexities of sophisticated financial institutions mean that aspects will need tailoring and modifying to the individual circumstances. The intention, however, is to demonstrate that there are structures that can be established to ensure that limited change is needed under the Financial Centre Model, even in this highly sophisticated and harmonised area of financial regulation.

An analysis of the effect of a Financial Centre Model on market infrastructure (exchanges and CCPs) in the UK and EU is set out at Chapter 15, *Market Infrastructure*.

The models and detailed technical analysis that follow assume a hypothetical (but common) scenario, where a group containing a firm established and regulated in the UK, whether it is an investment firm or a credit institution (the '**UK Institution**'), currently offers trading and clearing services to clients established both in the EU and in third countries, and wishes to continue to do so in the absence of an equivalence-based deal between the UK and the EU post Brexit. In the UK and the EU, such services are currently provided either by CRD IV-authorised credit institutions or MiFID II-authorised investment firms. The models assume that the group containing the UK Institution also has (or will establish) a regulated EU entity to carry out certain regulated activities in the EU. This would also be regulated either as a CRD IV-authorised credit institution or a MiFID II-authorised investment firm (the '**EU Institution**').

The models set out a mechanism by which the UK Institution can continue to provide clearing services to both EU clients and third country clients based on: (i) CCPs established in the EU-27 ('**EU CCPs**') and; (ii) CCPs established in a third country ('**Third Country CCPs**') such as in the UK after Brexit and elsewhere, with minimal disruption to its existing business model. Some changes, such as making use of an EU Institution and establishing personnel in the EU, will be necessary, but the models set out how those can be minimised.¹³⁴

Three models are discussed:

- a. Split clearing;
- b. Indirect clearing; and
- c. Agency or Give-up clearing.

Each of these models would enable the UK Institution ultimately to provide clearing services to EU clients and access EU markets.

¹³⁴

See Chapter 15, *Market Infrastructure*, for further techniques which would reduce the need to consider trading and clearing within the EU.

General reliance on reverse solicitation for cleared trades is not considered in this Chapter. Such reliance is in principle permissible and would enable EU customers to trade and clear in the UK and elsewhere outside the EU, except where they are caught by the requirement to clear in the European Market Infrastructure Regulation ('EMIR')¹³⁵ and the relevant CCP is not an RCCP. Reverse solicitation is therefore worthy of separate consideration for those wholesale clients who come in, in conformity with the relevant test, as explained in Chapter 10, *Investment Banking and Advisory Services*.

Key Considerations

In developing these models with respect to continued access to EU CCPs, the below considerations have been taken into account.

a. Legal and Regulatory Obligations

A successful model must allow UK Institutions to continue to provide a mechanism whereby clients are able to discharge their own regulatory obligations, including, in particular, the clearing obligation under EMIR (the '**EMIR Clearing Obligation**') and the derivatives trading obligation under MiFID II (the '**Derivatives Trading Obligation**') (and any post-Brexit UK equivalent of these regimes that is implemented in the UK).¹³⁶

b. Licensing Requirements

The model must provide sufficient certainty in terms of ensuring compliance with legal obligations, including compliance with EMIR and MiFID II (and any post-Brexit UK equivalent thereof that is implemented in the UK) and, to the extent required, local licensing obligations and other requirements such as compliance with the clearing rules of the relevant CCPs.

c. Capital efficiency

Institutions' Brexit strategies must maximise the efficient allocation of resources. This includes the use of capital-efficient structures, both for UK Institutions and for their clients.

Assumptions

The following (realistic) assumptions are relied on (to the extent noted below) in the various models presented:

- a. that EU CCPs will be granted QCCP status in the UK post Brexit (the '**UK QCCP Designation Assumption**');¹³⁷
- b. that Third Country CCPs will be granted QCCP status in the EU (the '**EU QCCP Designation Assumption**'). This is because the EU Institution will incur an exposure to a Third Country CCP on a solo basis under all models. In addition, if the EU client is itself regulated under CRR, it would wish for the Third Country CCP to be so designated; and

¹³⁵ Regulation (EU) 648/2012.

¹³⁶ See the following subsection entitled (8) *MiFID II/MiFIR Trading Obligation* and Article 28(4), MiFID II and Article 4, EMIR.

¹³⁷ A qualifying CCP (or QCCP) is one that attracts a lower risk-weight for the purposes of calculating minimum capital requirements for exposures to that CCP in accordance with the CRR (in the case of the EU) or the UK's post-Brexit equivalent of the CRR (in the case of the UK).

- c. that there is no impediment to the UK Institution being a clearing member of, and clearing trades at, EU CCPs (the ‘EU CCP Assumption’).¹³⁸

Assumptions relied on in each model	Split Clearing	Indirect Clearing	Agency/Give-Up
UK QCCP Designation Assumption	✓	✓	✓
EU QCCP Designation Assumption	✓	✓	✓
EU CCP Assumption		✓	✓

Where a model provides for EU clients’ trades to be cleared at a Third Country CCP, this will only be economically viable if the Third Country CCP has QCCP status in the EU. If the transaction is subject to the EMIR Clearing Obligation, the Third Country CCP will also need to be recognised as a Third Country CCP under EMIR (an ‘RCCP’).¹³⁹

Split Clearing Model

The Split Clearing Model envisages a ‘Track A’ (for EU clients) and ‘Track B’ (for third country clients) for the trading and clearing of different types of client transactions.

Track A

Track A is for all trades that, as a result of MiFID II, must (at least initially) be conducted for execution and counterparty purposes by a MiFID II-authorised firm. This is assumed to include all business currently conducted by UK firms with clients established in the post-Brexit EU, EU fund managers (regardless of the location of the funds managed) and fund managers (wherever established) with respect to post-Brexit EU funds under their management, where such management takes place in the EU (i.e. through an EU management company) and the UK Institution transacts with the EU management company (together ‘EU Clients’).¹⁴⁰

Track B

Track B of the Split Clearing Model is, essentially, for all other rest-of-world trades; namely with respect to the UK Institutions’ clients established in a third country, including third country fund managers and third country funds (together ‘Third Country Clients’). Track B also

¹³⁸ In the event that reliance on this assumption is not valid, the UK Institution could potentially instead clear at a UK branch of an EU CCP (rather than the EU CCP itself), if one exists, as discussed at the section entitled C. CCP Rules below. Otherwise, the Split Clearing Model would need to be used.

¹³⁹ This is not, strictly speaking, an ‘assumption’ on which the models rely, rather it is a limitation on the types of Third Country CCP at which EU Clients’ trades can be cleared and merely reflects the status quo. It has not yet been determined that UK CCPs will be granted either CCP or QCCP status by the EU on Brexit.

¹⁴⁰ For third country fund managers managing EU funds, either the fund is the Client, in which case Track A applies, or the fund manager is the client, in which case Track B applies. This depends on the fund structure. Potentially either the fund or the fund manager (if EU) could be subject to reverse solicitation.

provides a route to clearing for the UK Institution's own internal clearing needs and activities.

This model assumes that the UK Institution will retain its membership of all its current Third Country CCPs. The EU Institution will become a member of all relevant post-Brexit EU CCPs. It is assumed that the UK Institution's current Third Country CCP memberships, and the EU Institution's membership of such CCPs, will be permitted under the local law of the place of business of the CCP.

The two tracks operate as follows:

Track A (EU Clients):

- **Trading under Track A:** Post Brexit, EU Clients trade with the EU Institution.
- **Clearing under Track A:**

Scenario 1: Where an EU Client wishes to clear trades at an EU CCP, the EU Institution acts as clearing member and clears trades through a post-Brexit EU CCP.

Scenario 2: Where an EU Client wishes to clear trades at a Third Country CCP, then:

- **Scenario 2A:** (if the EU Institution is permitted to be a clearing member of such Third Country CCP under local law): the EU Institution acts as clearing member and clears trades through the Third Country CCP; or
- **Scenario 2B:** (if the EU Institution is not permitted to be a clearing member of such Third Country CCP under local law, or if client group facing collateral efficiencies apply (as explained below)) the UK Institution would act as clearing member for the EU Institution as client and clear the trades through the Third Country CCP. The EU Institution's clients become 'indirect clients' of the UK Institution for the purposes of EMIR, and the EU Institution remains 'in the chain' intermediating the EU Clients.

Clearing of EU Client trades at a Third Country CCP under Track A, Scenario 2A will only be economically viable at a Third Country CCP that has QCCP status in the EU. If the trade is subject to the EMIR Clearing Obligation, clearing at a Third Country CCP will only be possible if that Third Country CCP is recognised as a Third Country CCP ('**RCCP**') under EMIR. It has not yet been determined that UK CCPs will be granted either status by the EU following Brexit.

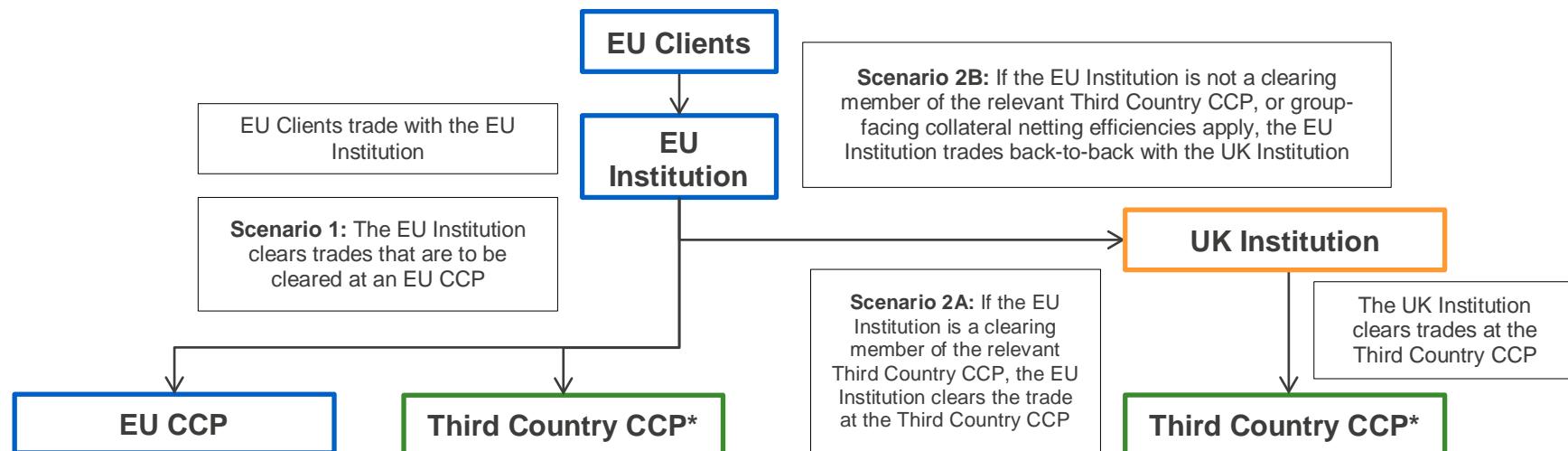
Track B (Third Country Clients):

- **Trading under Track B:** Post Brexit, Third Country Clients trade with the UK Institution.
- **Clearing under Track B:**

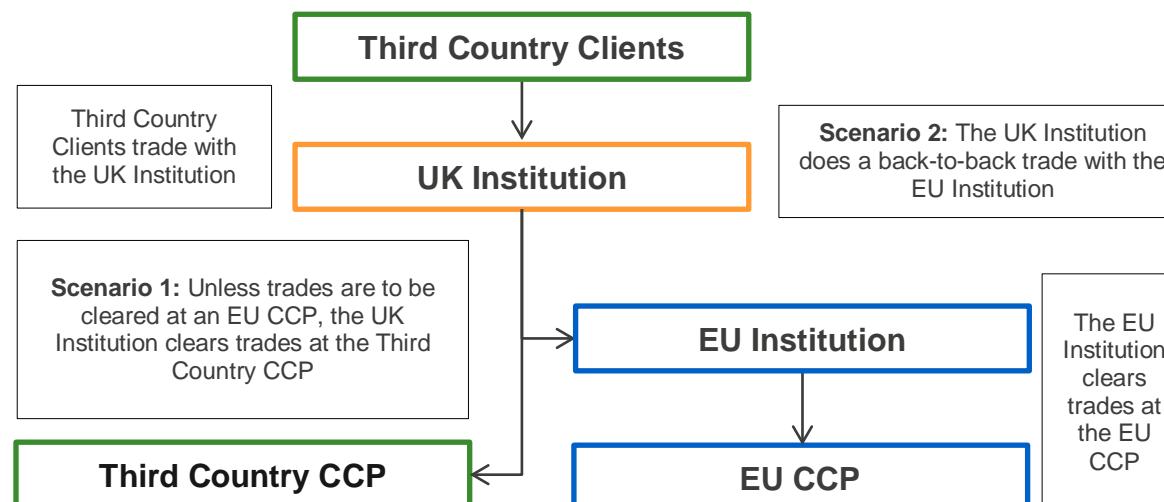
Scenario 1: Unless the trade is to be cleared at an EU CCP, the UK Institution acts as clearing member and clears trades through a Third Country CCP.

Scenario 2: If the trade is to be cleared at an EU CCP, then the EU Institution would act as clearing member for the UK Institution as client and clear the trades through an EU CCP. The UK Institution's clients become 'indirect clients' of the EU Institution for the purposes of EMIR, and the UK Institution remains 'in the chain', intermediating the Third Country Clients.

Split Clearing Model: Track A (EU Clients)



Split Clearing Model: Track B (Third Country Clients)



* Clearing of EU Client trades at a Third Country CCP will only be economically viable at a Third Country CCP that has QCCP status in the EU. If the trade is subject to the EMIR Clearing Obligation, clearing at a Third Country CCP will only be possible if that Third Country CCP is an RCCP under EMIR. It has not yet been determined that UK CCPs will be granted either status by the EU on Brexit. In addition, some Third Country CCPs require clearing members to be established in the same jurisdiction as the CCP itself or that of the customers (e.g. US Futures Commission Merchants clearing exchange business for US customers).

Analysis of the Split Clearing Model

The Split Clearing Model provides for a mechanism under which UK firms can continue to provide clearing services to all clients in accordance with applicable laws, without reliance on any approval, status, condition or permission outside UK firms' direct control (except UK QCCP status for EU CCPs, EU QCCP and RCCP status of UK and other Third Country CCPs and the EU Institution's licensing in the EU).

Track A: EU Clients

Under Track A of the Split Clearing Model, all EU Clients trade with the EU Institution.

EU Clients with trades to be cleared at an EU CCP follow Scenario 1 of Track A. Trades would be cleared at an EU CCP either because the EMIR Clearing Obligation applies, or because the client so elects. These clients simply trade with the EU Institution (which avoids any licensing difficulties for the UK Institution under MiFID II or any need for reverse solicitation), and the EU Institution then acts as the CCP clearing member (which satisfies the EMIR Clearing Obligation if applicable).

EU Clients may prefer to have their trades cleared at a Third Country CCP (Scenario 2 of Track A). The Split Clearing Model provides for this. However, clearing of trades of EU Clients at a Third Country CCP where an EU CCP also offers clearing services for such trades will only be economically viable if the Third Country CCP has QCCP status in the EU. Further, if the trade is subject to the EMIR Clearing Obligation, clearing at a Third Country CCP will only be possible if that Third Country CCP is an RCCP under EMIR. Many Third Country CCPs of which UK firms are currently members have been subject to transitional arrangements under CRR while QCCP status is considered. Moreover, several Third Country CCPs are RCCPs under EMIR and so are automatically deemed to be QCCPs. While the UK is part of the EU, EMIR-authorised CCPs in the UK are deemed to have QCCP status under the CRR. During the CRR transitional period, all CCPs listed on the Bank of England register of Recognised Clearing Houses, and those Third Country CCPs that currently provide clearing services to UK credit institutions or to their subsidiaries, will be considered to be QCCPs. However, without more, these statuses would fall away upon the UK becoming a third country. The granting of QCCP and RCCP status has an established approval process under the relevant EU regulations. It is not certain that either such status will be given in the EU to UK CCPs on Brexit.

EU Clients wishing to clear trades at a Third Country CCP would follow either Scenario 2A or Scenario 2B of Track A, depending on: (i) whether local law in the jurisdiction of the relevant Third Country CCP permits the EU Institution to become a clearing member of CCPs in that jurisdiction; and (ii) whether any collateral netting considerations apply because the client group comes in to that CCP through different tracks under the Split Clearing Model, for instance, through Track A of the Split Clearing Model for some group trades and Track B for others.

The choice of Scenario 2A or 2B (i.e. where a Third Country CCP is to be used to clear the EU Client's derivatives trades) applies as set out below.

- a. **Track A, Scenario 2A:** If local law in the jurisdiction of the relevant CCP permits the EU Institution to become a clearing member of CCPs in that jurisdiction, and no collateral netting considerations apply, EU Clients trade with the EU Institution (which avoids any

difficulties under MiFID II), and the EU Institution then acts as clearing member (again avoiding any difficulties under MiFID II) at the Third Country CCP. If the EMIR Clearing Obligation applies, the Third Country CCP must be an RCCP in the EU.

- b. **Track A, Scenario 2B:** If local law in the jurisdiction of the relevant CCP does not permit the EU Institution to become a clearing member of CCPs in that jurisdiction, or if collateral netting considerations apply, clients trade with the EU Institution (which avoids any difficulties under MiFID II), the EU Institution then enters into back-to-back trades with the UK Institution pursuant to pre-established arrangements (as an intragroup transaction, this does not entail any difficulties under MiFID II). The UK Institution acts as clearing member for the EU Institution as client and clears the trades through the Third Country CCP. The EU Institution's clients then become 'indirect clients' of the UK Institution, and the EU Institution remains 'in the chain' intermediating the EU Clients, so avoiding MiFID II licensing difficulties.

Track B: Third Country Clients

Under Track B of the Split Clearing Model all Third Country Clients continue to trade with the UK Institution (or using existing arrangements with other local legal entities). This potentially includes third country fund managers with respect to post-Brexit third country funds under their management.¹⁴¹

- a. **Track B, Scenario 1:** Unless the trade is to be cleared at an EU CCP, Third Country Clients trade with the UK Institution, and the UK Institution then acts as clearing member and clears the trade at a Third Country CCP. Third Country Clients' trades may in rare cases be subject to the EMIR Clearing Obligation, in which case the trade must be cleared at an EU CCP or a Third Country CCP that has RCCP status under EMIR. This will only be the case in the exceptional circumstances where the EMIR Clearing Obligation's anti-avoidance provisions are triggered. As such, it is unlikely that Third Country Clients' trades will be subject to the EMIR Clearing Obligation.
- b. **Track B, Scenario 2:** Third Country Clients may prefer to have their trades cleared at an EU CCP, or may be required to do so if the EMIR Clearing Obligation applies (and a Third Country CCP with RCCP status is not available). In those circumstances Third Country Clients trade with the UK Institution, the UK Institution then enters into back-to-back trades with the EU Institution pursuant to pre-established arrangements. The EU Institution acts as clearing member for the UK Institution as client and clears the trades through an EU CCP. The UK Institution's clients then become 'indirect clients' of the EU Institution, and the UK Institution remains 'in the chain' intermediating the Third Country Clients.

Issues

The following administrative or practical consequences arise as a result of the Split Clearing Model:

- a. CCP memberships: The EU Institution will need to establish a number of new CCP memberships.

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See footnote 140 above which considers how third country fund managers can use Track B of the Split Clearing Model if managing EU funds.

- b. QCCP implications: EU Clients wishing to clear their trades at Third Country CCPs that are non-QCCPs will only be able to do so in a way that is not economically viable, assuming that the increased capital cost is passed on to the EU Clients.
- c. RCCP status: EU Clients wishing to clear their trades at Third Country CCPs where such trades are subject to the EMIR Clearing Obligation will only be able to do so if the relevant Third Country CCP has been granted RCCP status under EMIR. This is the (pre-Brexit) status quo for most of the commercially important CCPs. However, UK CCPs will be Third Country CCPs following Brexit and it has not yet been determined whether they will be granted RCCP status under EMIR and, if granted, when the RCCP status will become effective (e.g. immediately from Brexit, after any transitional agreement expires or at some other point).
- d. Re-documentation with the UK Institution: As a result of the requirement that all EU Clients trade with the EU Institution, rather than their current trading arrangements with the UK Institution, all EU Clients potentially need to have their client relationship with the UK Institution re-documented to reflect the new legal relationships. Re-documentation may also be required as a result of the issues discussed at point (j) below.
- e. Re-documentation with the EU Institution: Where the UK Institution is not able to act as a clearing member of an EU CCP (and access to such EU CCP is available only indirectly through the EU Institution, under Track B, Scenario 2), affected Third Country Clients potentially need to have their client relationship with the UK Institution re-documented to reflect a relationship with the EU Institution as clearing member for all trades to be cleared at an EU CCP. Re-documentation may also be required as a result of the issues discussed at point (j) below.
- f. Third country fund managers: Third country fund managers, who are categorised as 'EU Clients' when managing EU funds through an EU management company (as MiFID II requires such trades to proceed down Track A), and 'Third Country Clients' when managing third country funds, will need clearing arrangements with the UK Institution for trades relating to third country funds (which are to be cleared at a Third Country CCP) and the EU Institution for trades relating to EU funds (which are to be cleared at an EU CCP).¹⁴²
- g. Collateral and netting: Collateral and netting capital inefficiencies may arise for corporate groups that include both EU and third country entities as clients, which seek to clear at a single Third Country CCP. Third country entities in that group would be allocated to Track B, Scenario 1 (transacting with the UK Institution, which would then act as clearing member at the relevant Third Country CCP). EU entities in that group would be allocated either to Track A, Scenario 2A (transacting with the EU Institution, which then acts as clearing member at the relevant Third Country CCP) or Track A, Scenario 2B (transacting with the EU Institution, which then enters into a back-to-back trade with the UK Institution, and the UK Institution then acts as clearing member at the relevant Third Country CCP).
- h. Netting across different clearing members: If EU entities are allocated to Track A, Scenario 2A, collateral inefficiencies arise as a

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See footnote 140 above which sets out how third country fund managers can use Track B of the Split Clearing Model if managing EU funds.

result of the fact that entities in the same corporate group accessing the same Third Country CCP are doing so through different clearing members (third country entities are clearing through the UK Institution, and EU entities are clearing through the EU Institution). Given that most CCPs will not permit netting arrangements across different clearing members (even if they are affiliated), there would be a doubling up of collateral requirements as the external positions held by the two affiliated client entities would not offset one another. Such offsets could, however, be achieved by restructuring the client to place all market-facing transactions in the same legal entity. There are potential options for achieving the same economic effects of the current, pre-Brexit netting arrangements, but these rely on certain limited (but realistic) regulatory contingencies and as such do not fall squarely within the Split Clearing Model. The other models examined below address these issues.

- i. Indirect clearing and segregation implications: If EU entities are allocated to Track A, Scenario 2B, collateral inefficiencies will arise in jurisdictions that, as a result of their indirect clearing rules, require segregation of direct and indirect client positions, and do not permit netting of collateral across direct and indirect clients. This is the case, for example, in the EU under EMIR and will therefore be the case in the UK as it grandfathered in EU rules (unless and until the UK subsequently eliminates these aspects of the indirect clearing rules).
- j. Direct Electronic Access: The Split Clearing Model (and the Indirect Clearing, Agency and Give-Up Models described in the following sections) each involve trades being placed for EU Clients and Third Country Clients. These trades might be concluded on a regulated market, organised trading facility (an '**OTF**'), or a multilateral trading facility (an '**MTF**') (each, a '**trading venue**').¹⁴³ Banks and investment firms (e.g. the UK Institution or EU Institution) often offer their clients direct electronic access (or '**DEA**').¹⁴⁴ This enables the client to directly enter into, for example, a derivatives trade on a trading venue (whether it is a regulated market, OTF or MTF) without having to be a member of that trading venue. In relation to regulated markets, Article 48(7) of MiFIR states that only MiFID II-licensed investment firms and CRD IV-licensed credit institutions are allowed to offer DEA services to their clients (the '**DEA Restriction**').¹⁴⁵ Due to Article 18(5) of MiFID II the DEA Restriction also applies to the other types of trading venues. Recently issued ESMA Q&A guidance has also repeated the wording of the Article by stating that only trading venue members which are EU credit institutions or investment firms may

¹⁴³ Derivatives transactions can potentially be executed on a range of different types of trading venues: regulated markets, OTFs or MTFs. The DEA considerations above relate to the recent interpretative guidance issued in relation to Article 48(7) of MiFID II. This article governs which categories of the members of a regulated market are allowed to offer their own clients DEA to conclude transactions on a regulated market. Due to Article 18(5) of MiFID II the DEA Restriction also applies to the other types of trading venues (OTFs and MTFs).

¹⁴⁴ MiFID II defines 'direct electronic access' as '*an arrangement where a member or participant of a trading venue permits a person to use its trading code so the person can electronically transmit orders relating to a financial instrument directly to the trading venue and includes arrangements which involve the use by a person of the infrastructure of the member or participant or client, or any connecting system provided by the member or participant or client, to transmit the orders (direct market access) and arrangements where such an infrastructure is not used by a person (sponsored access)*' (Article 4(41), MiFID II).

¹⁴⁵ Or recognised third-country equivalent entities. Given that they are able to perform investment services and activities such as dealing as agent and receiving and transmitting orders under MiFIR, MiFID II's linguistic restrictions on DEA (which are simply a form of those services) would be over-ridden by an equivalence determination.

offer DEA access to the venue to their clients.¹⁴⁶ While this may appear reasonable in the first instance as it repeats the text of Article 48(7) of MiFID II, there are strong arguments that this interpretation is inconsistent with the intent of other provisions of the MiFIR/MiFID II legislative package (for further details see the subsection entitled *A. Trading* at the section entitled *Additional Legal Considerations for Derivatives Clearing* below). If correct, this interpretation has a number of consequences for Track B of the Split Clearing Model if the UK Institution offers DEA services to its clients for the execution of derivatives trades on an EU trading venue. Post Brexit, the UK Institution would be a third country member of an EU trading venue and not a MiFID II-licensed investment firm or CRD IV-licensed credit institution. For Third Country Clients executing derivatives transactions on a trading venue in the EU through DEA offered by the UK Institution in Track B, Scenario 1, DEA services will instead have to be provided by the EU Institution acting as a member of the relevant trading venue. The transaction would be cleared by the EU Institution at either a Third Country CCP or an EU CCP. Otherwise the transaction could be cleared by the UK Institution.¹⁴⁷ This issue does not prevent proprietary transactions or non-DEA client trading activities from being carried out by a third country venue member, however.

¹⁴⁶ Answer 25, ESMA Q&A On MiFID II and MiFIR Market Structures Topics, 15 November 2017.

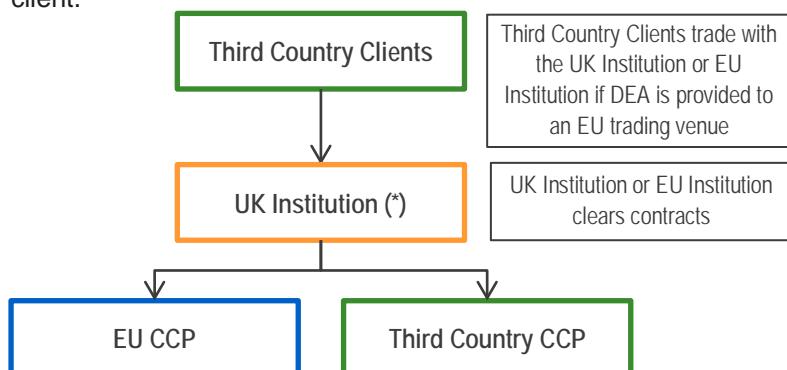
¹⁴⁷ See however Chapter 15, *Market Infrastructure*, for techniques to avoid using EU platforms and clearing houses post Brexit.

Indirect Clearing, Agency and Give-Up Models

Third Country Clients

There are three additional models by which clearing services can be provided: the Indirect Clearing Model, the Agency Model and the Give-up Model. These three models share a single route for all Third Country Clients (subject to non-EU, non-UK requirements to use local clearing members). Third Country Clients trade with the UK Institution. The UK Institution then acts as the clearing member, and clears the trades as follows:

- a. (in the unlikely event that the trade is subject to the EMIR Clearing Obligation)¹⁴⁸ the trade is cleared at an EU CCP or at a third country RCCP; or
- b. (if the trade is not subject to the EMIR Clearing Obligation) the trade is cleared at an EU CCP or Third Country CCP as requested by the client.



* DEA rules may require client trading and exchange membership to be carried out via a MiFID II-authorised EU investment firm or a CRD IV-authorised EU credit institution. Note that this DEA Restriction does not currently apply in the UK, which has implemented the restriction through a UK statutory instrument in a way that permits third country exchange memberships of trading venues for clients trading via DEA.

In addition to assuming that EU CCPs have UK QCCP status, these models rely on the EU CCP Assumption. As noted in point (j) in the section above entitled *Issues*, a strict interpretation of the DEA Restriction in MiFID II may require client trades to be executed by an EU Institution instead of the UK Institution but this would not prevent the UK Institution clearing the transaction.¹⁴⁹ The DEA Restriction also only applies if the relevant derivatives transaction is carried out using DEA on a trading venue in the EU.

EU Clients

As a result of the MiFID II Trading Prohibition, except where reverse solicitation applies¹⁵⁰, EU Clients¹⁵¹ are unable to trade directly with the

¹⁴⁸ This is only if there are special circumstances triggering the EMIR Clearing Obligation's anti-avoidance provisions. There is no current indication whether UK CCPs will be recognised as Third Country RCCPs under EMIR on Brexit.

¹⁴⁹ See Chapter 15, *Market Infrastructure*, for how to avoid using EU platforms.

¹⁵⁰ See Chapter 10, *Investment Banking and Advisory Services*.

¹⁵¹ Namely clients established in the post-Brexit EU, EU fund managers (regardless of the location of the funds managed) as well as, potentially, fund managers (wherever established) with respect to post-

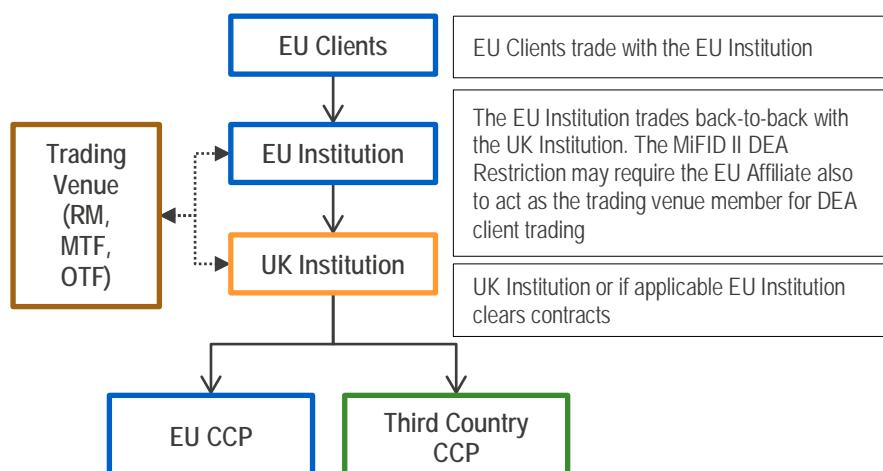
UK Institution, but must instead trade directly with the EU Institution. However, if the EU CCP Assumption is valid for the relevant EU jurisdictions, the UK Institution will be able to act as clearing member and clear the trade either at an EU CCP or a Third Country CCP.

The most straightforward mechanism for achieving this outcome is the ‘Indirect Clearing Model’. Two alternative models – the Agency Model and the Give-up Model – provide separate possibilities with various advantages to each.

In any event, EU Clients will need to have their client relationship with the UK Institution re-documented to reflect the new legal entity they will be facing. Under each model, the UK Institution will act as clearing member for the trade. As such the UK Institution will remain a member of all its current CCPs, and the EU Institution will not need to become a clearing member of any CCPs.

Where the client is itself also regulated under the CRR, this model also makes use of the EU QCCP Designation Assumption. If this assumption is not made, the model is not economically viable for the EU Client or EU Institution on a solo basis.

The Indirect Clearing Model



Under this model post-Brexit EU Clients trade with the EU Institution as their executing broker and principal, avoiding the MiFID II Trading Prohibition. The EU Institution contracts back-to-back with the UK Institution. This is an intragroup transaction for the purposes of MiFID II, and therefore also avoids any MiFID II Trading Prohibition issues entirely.¹⁵² The EU Institution’s clients become ‘indirect clients’ of the UK Institution, and the EU Institution remains in the contractual chain, intermediating the EU clients. The UK Institution then acts as clearing member for the EU Institution as client, and clears the trades as follows:

Brexit EU funds under their management. See footnote 140 however on the application of the Derivatives Trading Obligation to third country fund managers of EU funds.

¹⁵² See ‘Questions and Answers: Implementation of the Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR)’, 2 October 2017, ESMA, OTC Question 12, sub-question G, which states that ‘Article 11 of EMIR only applies to OTC derivative contracts not cleared by a CCP, irrespective of its status under EMIR.’ This means that if the UK Institution clears the trade at any CCP the derivatives trade does not constitute a non-centrally cleared OTC derivative contract for the purposes of the margin rules. See the subsection entitled (2) EMIR further below in this section.

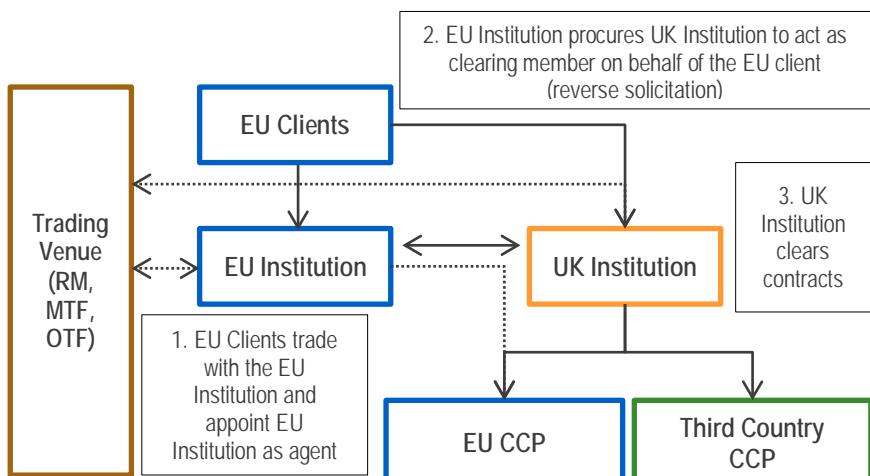
- a. if the trade is subject to the EMIR Clearing Obligation, at an EU CCP or at a third country RCCP; or
- b. if the trade is not subject to the EMIR Clearing Obligation, either at an EU CCP or at a Third Country CCP that has EU QCCP status, at the client's option.

If the DEA Restriction applies and the derivatives transaction is being executed on an EU trading venue then the DEA service can only be offered by the EU Institution (who must also be a member of the relevant trading venue). Clearing could still be carried out by the UK Institution at an EU CCP or Third Country CCP as set out above.

Additional Issues Arising From the Indirect Clearing Model

Collateral and netting capital inefficiencies may arise for corporate groups with both EU and third country entities seeking to clear at a single CCP if that CCP is located in a jurisdiction which, as a result of its indirect clearing rules, requires segregation of direct and indirect client positions and does not permit netting of collateral across direct and indirect clients. This is the case, for example, in the EU under EMIR and will therefore be the case in the UK as it grandfathered in EU rules (unless and until the UK subsequently eliminates the indirect clearing rules or these aspects of them).

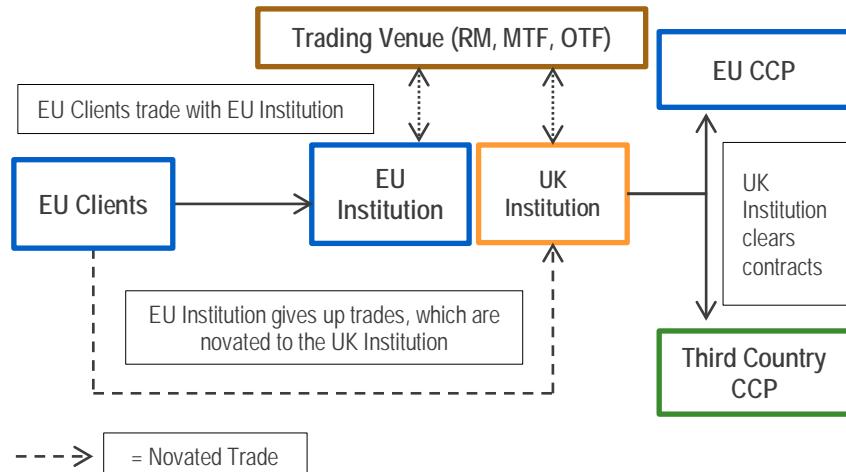
The Agency Model



Under this model, post-Brexit EU clients trade with the EU Institution as their broker, thus avoiding any MiFID II Trading Prohibition issues. Clients also engage the EU Institution to act as agent to procure clearing services. The EU Institution solicits the UK Institution to act as the clearing member for the transaction. This is capable of being structured as a 'reverse solicitation', whereby the provision of dealing services by the UK Institution is initiated by the EU Client on its own initiative (albeit with support from the EU Institution). The UK Institution then (on the basis of this reverse solicitation) holds the contracts directly and clears for the EU Client.

If the DEA Restriction applies and the derivatives transaction is being executed on an EU trading venue then the DEA service can only be offered by the EU Institution (who must also be a member of the relevant trading venue). Clearing could still be carried out by the UK Institution at an EU CCP or Third Country CCP as set out above.

The Give-Up Model



Under this model, post-Brexit EU Clients trade with the EU Institution as their broker, thus avoiding any MiFID II Trading Prohibition issues. The EU Institution then gives up the trade, which is novated by way of pre-established arrangements, to the UK Institution. The UK Institution thereby becomes the counterparty to the trade. This would be carefully structured with a view to such give-up being treated as being at the exclusive initiative of the client. The UK Institution's dealing services would be capable of being structured as being provided on the basis of a reverse solicitation or as a 'passive booking vehicle', and would therefore be excluded from the MiFID II Counterparty Prohibition.¹⁵³ The EU Institution's clients thereby contract directly with the UK Institution as today, and the EU Institution drops out of the chain. The UK Institution acts as clearing member for the EU Clients.

If the DEA Restriction applies and the derivatives transaction is being executed on an EU trading venue then the DEA service can only be offered by the EU Institution (who must also be a member of the relevant trading venue). Clearing could still be carried out by the UK Institution at an EU CCP or Third Country CCP as set out above.

Advantages of the Agency Model and Give-up Model

These models avoid some of the re-papering, structuring, segregation, collateral and netting capital inefficiencies that may arise under the Split Clearing Model and the Indirect Clearing Model. This is because in the case of both EU and Third Country Clients, the UK Institution is providing clearing services for the clients (both EU Clients and Third Country Clients) directly, rather than a combination of directly and indirectly. Under these models, operational issues such as whether collateral payments and on-boarding are conducted by or through the EU Institution or the UK Institution will need to be considered. In particular, where EU Clients are direct customers of the UK Institution for clearing purposes, ongoing operational matters (e.g. relating to porting, deliveries, new products etc.) may, under local laws, be deemed to constitute new

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See Article 42, MiFID II: '*Member States shall ensure that where a retail client or professional client within the meaning of Section II of Annex II established or situated in the Union initiates at its own exclusive initiative the provision of an investment service or activity by a third-country firm, the requirement for authorisation under Article 39 shall not apply to the provision of that service or activity by the third country firm to that person including a relationship specifically relating to the provision of that service or activity.*'

and additional services falling outside the scope of the reverse solicitation exclusion.

Additional Legal Considerations for Derivatives Clearing

The scope of the EU regulatory perimeter varies between Member States and has not been subjected to any material harmonisation measures for third country access to date. In particular, there is divergence between Member States as to the existence and scope of 'reverse solicitation' exclusions under MiFID I as implemented in each Member State. Under new rules, with effect from January 2018, the 'reverse solicitation' exclusion is being introduced as a pan-EU standard in a harmonised form in MiFID II (as contained in MiFIR). Under this exclusion, third-country entities such as the UK Institution in a post-Brexit UK will be able to deal with EU Clients so long as the relevant activity, which would otherwise be subject to regulation under MiFID II, is initiated by the client.

A working assumption has been made that this exclusion will not always be available for UK Institutions when clearing for clients in the EU, regardless of how the arrangements arise and are structured. However, many institutions operate global clearing arrangements using US-incorporated Futures Commission Merchants, including when contracting with some non-UK EU Clients today, apparently without falling within EU Member States' regulatory trading perimeter. Non-EU clearing members of major EU CCPs also exist, who are apparently able to act outside the EU Member State's clearing perimeter. The situation for third country access is likely to improve further when MiFID II enters into force in 2018. As a result, direct access by the UK Institution to EU CCPs and possibly EU Clients is likely to be possible, particularly in respect of institutional clients and/or clients with which the UK Institution has existing relationships.

The remainder of this section analyses relevant regulatory requirements. It is, except where stated, assumed here that the 'reverse solicitation' exclusion is not being relied upon. The Split Clearing Model does not rely on any use of the exclusion. Nor does the Indirect Clearing Model. The Agency and Give-up Models rely on it to a very limited degree.

(1) MiFID

A. Trading

In the 'trading' phase of a derivatives transaction, the activity of brokering trades with EU clients will likely, depending on the regulatory perimeter, result in the regulatory authorities of the client's Member State regarding an investment service as taking place in their jurisdiction. MiFID II regulates both services and activities, and each of these limbs must be analysed. The MiFID II-regulated services and activities that are likely to be relevant in this situation are:

- a. execution of orders on behalf of clients;
- b. reception and transmission of orders;
- c. dealing on own account or as agent (depending on the structures implemented); and
- d. investment advice (may be applicable, if the client is being provided or has requested investment advice).

B. Becoming Counterparty to the Resulting Transactions with Clients

If the UK Institution becomes a counterparty to a transaction with a client, this will involve the MiFID II service and activity of 'dealing on own account'. The activity would take place at the place of business of the UK Institution. Many or all Member States are likely to regard the related service of 'execution of orders on behalf of clients' as occurring at the location of the clients also.

In addition to the requirement for MiFID II services and activities to be authorised, Article 48(7) and Article 18(5) of MiFID II require regulated markets, MTFs and OTFs to permit only MiFID II investment firms or CRD IV credit institutions (i.e., firms authorised in an EU Member State and not third country firms) to provide DEA to their trading platform for their clients (i.e. the DEA Restriction, see also the discussion at point (j) above in the subsection entitled *Issues*). In contrast to the DEA Restriction, Article 46 of MiFIR provides that third country firms may provide services into the EU for certain classes of clients where an equivalence determination is made in respect of that jurisdiction and the entity is registered with ESMA. Where no equivalence decision has been made (which is currently the case for all third countries in relation to Article 46 of MiFIR as MiFIR takes effect on 3 January 2018), *each Member State may apply its own domestic law* governing the provision of investment services by third-country firms and its regulatory perimeter.

ESMA has recently released an 'interpretation' of Article 48(7) of MiFID II to the effect that it interprets Article 48(7) of MiFID II as literally *only* permitting members of EU trading venues to provide DEA if that venue's members are investment firms or credit institutions authorised under MiFID II or CRD IV,¹⁵⁴ which, it is true, is what the provision states. Whilst ESMA's guidance would superficially appear logical, there are questions regarding this interpretation of the DEA Restriction. Article 48(7) of MiFID II (which sets out the DEA Restriction) should not be allowed to conflict with Article 54(1) of MiFIR. Article 54(1) of MiFIR states that '*Third-country firms shall be able to continue to provide services and activities in Member States, in accordance with national regimes until three years after the adoption by the Commission of a decision in relation to the relevant third country in accordance with article 47 [of MiFIR]*'.¹⁵⁵ MiFIR is directly applicable and will override any national Member State legislation implementing Article 48(7).¹⁵⁶ The prevalence of Article 54(1) MiFIR is also clear from a 'purposive' perspective, which is a key interpretative principle under EU law. Article 54(1) of MiFIR reflects a significant policy decision proposed at Council (Member State) level during the finalisation of the MiFIR/MiFID II legislative package. The provision was hard-fought by the 'open market' Member States (such as the UK) but opposed by the European Commission and the 'closed market' Member States (notably France and Germany) which had attempted to close Europe's doors to third country business except in 'reverse solicitation' situations or where an equivalence decision for the regulatory regime for investment firms in the relevant third country has been adopted by the

¹⁵⁴ Answer 25, ESMA Q&A On MiFID II and MiFIR Market Structures Topics, 15 November 2017.

¹⁵⁵ Article 47 of MiFIR establishes the third country equivalency regime for investment firms.

¹⁵⁶ Article 46 of MiFIR establishes a third-country regime. There are good grounds to argue that Article 46 of MiFIR would override Article 48(7) of MiFID II, which, as a directive, would need to be implemented through national Member State law. EU regulations supersede national laws incompatible with their substantive provisions. See, for example, *R v Secretary of State for Transport Ex parte Factortame Ltd (No. 2) [1991] 1 A.C. 603*.

European Commission.¹⁵⁷ Whilst an equivalency regime also exists in MiFID II, in the absence of any equivalence determinations the regulatory perimeter for financial services activities is clearly reserved for national laws under MiFID II. The ESMA guidance contradicts these important structural principles underlying MiFID II.¹⁵⁸

The UK and the more ‘open market’ Member States such as Ireland and Luxembourg have traditionally operated ‘overseas persons’¹⁵⁹ regimes which allow cross-border wholesale financial business to take place without local regulation of foreign-based participants. This approach has been fundamental to the City, and the emergence of the financial sectors in Ireland and Luxembourg. Where a more closed market approach has been adopted, the inability of non-EU entities to access such jurisdictions has resulted in a primarily domestic or regional financial services market. MiFIR provides (subject to the terms of Article 54(1) of MiFIR, for three years if the relevant equivalence decision has been granted) for existing national perimeter regimes to be preserved. It is doubtful that such a key policy decision should be undermined by a case of legislative self-contradiction in this manner.

The ESMA interpretation is also inconsistent with the UK’s implementation of the DEA Restriction and for the reasons explored in the subsection entitled (5) *UK Regulatory Requirements* below does not, for now, have practical legal effect for individuals.

As far as non-DEA exchange access is concerned, in Germany membership of a German trading venue should not *per se* breach any regulatory perimeter and the activities of a trading venue’s member are unregulated in Germany. Trading proprietary business would constitute the MiFID II activity of ‘dealing on own account’ but such activity would generally be construed as occurring in the location of the trading venue member (for example, in the UK in the models where the UK Institution retains exchange membership). Trading on a client account would constitute the MiFID II activity of ‘execution of orders on behalf of clients’ and such activity would be construed as occurring at the location of the relevant client. Where the UK Institution is the trading venue member and

¹⁵⁷ See the Council of the European Union’s General Approach (11006/13), 18 June 2013; the Council of the European Union’s General Approach (11007/13), 18 June 2013 and paragraph 54 of the Council of the European Union’s Progress Report (16523/12), 13 December 2012.

¹⁵⁸ It is possible, on a literal approach, to argue that the provision of DEA is not part of the investment ‘services’ referred to in Article 54(1) of MiFIR, as DEA is not included in the annexed list of ‘investment activities and services’ contained in MiFID II. There is also no specific grandfathering regime nor recognition process with regard to the provision of DEA. This may be construed as an unintended oversight and therefore Article 54(1) of MiFID II should be construed broadly to capture third country investment firms offering both MiFID services and DEA. However, from a practical perspective, DEA is nothing more than a subset of the MiFID investment services or activities of ‘dealing as agent’ or ‘reception and transmission of orders’. Providing DEA services on-exchange will inevitably involve the provider’s systems being used to enter into trades on the execution platform and at clearing house level, with the intermediary either acting as agent for a customer or minimally being involved in the information transmission in a meaningful way, such that the DEA provider is responsible under the venue’s rules for the relevant activities. Since DEA is nothing more than a subset of an investment service, the restriction in MiFID II on DEA is on a proper interpretation logically, practically, factually and legally inconsistent with the third country provisions of MiFIR – as was concluded by the UK authorities when they developed the UK’s national implementing measures for MiFID II. As a result, recognised third-country equivalent entities should be able to provide DEA services, given that they are able to perform investment services and activities such as dealing as agent and receiving and transmitting orders under MiFIR. Any linguistic restrictions on DEA (which are simply a form of those services) would be overridden by an equivalence determination.

¹⁵⁹ See the subsection entitled (5) *UK Regulatory Requirements* below for further explanation of the ‘overseas persons regime’.

enters into back-to-back arrangements and contracts with the EU Institution, the EU Institution's clients would not be deemed to be clients of the UK Institution for the purposes of the German regulatory perimeter.

In respect of the DEA Restriction, the relevant German draft implementing legislation does not specifically address the issues described above.

From a French law perspective, membership of a French trading venue for non-DEA purposes does not *per se* breach the French regulatory perimeter, although a cooperation agreement is required between the French regulator and the competent authority in the third country jurisdiction of the member. Proprietary trading activities would likely be viewed as taking place at the location of the trading venue member while executing client orders would likely be construed as taking place at the location of the trading venue or the location of the trading venue member's client. The intra-group exemption in MiFID has been implemented narrowly under French law however, so if the UK Institution were to be a trading venue member and the EU Institution were its client, the intragroup exemption would not apply if the UK Institution also provides other investment services to non-affiliates. This means that the UK Institution's services to the EU Institution would fall within the MiFID II regulatory perimeter and be deemed to be located in France (as the location of the trading venue) or the jurisdiction of the EU Institution as the client. Further analysis and structuring work may be necessary to ensure that the activity would be construed to be located solely in another jurisdiction where the EU Institution was located, such as Ireland, where the intra-group exemption under MiFID is interpreted more broadly.

In respect of the DEA Restriction, the French financial code has been amended to require members of a French market to be MiFID II investment firms or credit institutions. There is therefore little scope for UK Institution to retain membership of any trading venue in France after Brexit if it is offering DEA to clients. The French implementation was therefore already generally aligned with the recent ESMA guidance on the DEA Restriction.

The DEA Restriction (and ESMA's interpretation of it) does not apply at the clearing level, since the trading venue member could have all of its transactions cleared by another legal entity, which would not necessarily need to be an EU investment firm or credit institution.

Where the EU Institution intermediates between the UK Institution and the client, German laws would generally not require the UK Institution to have a licence for MiFID II services or activities. However under French law it would not be possible for the UK Institution to remain a member of a trading venue due to the narrow application of the intra-group exemption in France or the French implementation of the DEA Restriction. In the case of, for example, the Euronext markets and for the clearing or trading of client and group transactions in particular, UK firms may wish to consider alternative routes to access such markets, such as access via Euronext Brussels, Lisbon or Amsterdam (or potentially London in the case of cash equities).¹⁶⁰

¹⁶⁰

See also the section entitled *EU CCPs* in Chapter 15, *Market Infrastructure*.

C. Becoming Counterparty to a CCP

The models considered above will require an entity (the UK Institution or the EU Institution) to act as a clearing member at various points of the different scenarios. Acting as a clearing member involves the MiFID II activity of ‘dealing in investments as principal’ with respect to the clearing house (or CCP) that is involved in the transaction. Such MiFID II activity will take place at the place of business of the clearing member. It is unlikely that any MiFID II service would also take place at the place of business of the CCP, as the CCP will more usually be regarded as providing services to the clearing member, not *vice versa*. There may be other barriers to CCP access in certain jurisdictions, either as a matter of local law, or under the rules of the relevant CCP. For example, the relevant CCP may require legal opinions supporting post-insolvency rights under the laws of business of its members or other local law approval requirements before CCP access is granted.

The UK Institution would, on Brexit, cease to be a MiFID II-authorised firm and, based on the above assumptions, will therefore not be able to:

- a. provide brokerage services to EU Clients (the ‘**MiFID II Trading Prohibition**’); or
- b. become a counterparty to transactions with EU Clients resulting from such brokerage (the ‘**MiFID II Counterparty Prohibition**’),
without:
 - i. establishing or using EU branches licensed in the place of business of its EU Clients;
 - ii. arranging for the EU Clients to deal with the UK Institution through their own UK branches or subsidiaries; or
 - iii. reverse solicitation applying.¹⁶¹

It is possible that there may also be restrictions on interfacing with a CCP located within the EU under local laws or CCP rules.

(2) EMIR

Under EMIR, financial counterparties¹⁶² must clear certain classes of OTC derivative contracts. Currently, the EMIR Clearing Obligation only applies to certain classes of derivatives (currently, credit default and interest rate swaps) entered into with financial and certain non-financial counterparties. Where the EMIR Clearing Obligation applies, this means that the transaction must be cleared either with an EU authorised CCP or a Third Country (e.g. US) CCP which is recognised under EMIR – an RCCP. Transactions are regarded as having been cleared where entered into in the capacity as a client with a clearing member of such a CCP which itself clears the transaction or through indirect clearing arrangements. For the purposes of the EMIR Clearing Obligation, in-scope transactions for ‘financial counterparties’ (such as the EU Institution) include contracts that have been concluded with:

¹⁶¹ See Chapter 10, *Investment Banking and Advisory Services*.

¹⁶² The EMIR Clearing Obligation applies differently depending on the status of the relevant counterparty to a particular derivatives transaction. Generally ‘financial counterparties’ are more likely to be subject to the obligation, as non-financial counterparties are only subject to the EMIR Clearing Obligation if they enter into a significant volume of derivatives transactions over quantitative thresholds (and are referred to as NFC+s). Financial counterparties will generally include regulated entities such as banks, investment firms, insurers, reinsurers, funds and fund managers, and pensions institutions.

- a. another EU financial counterparty; or
- b. an EU non-financial counterparty whose rolling average position over 30 working days in a particular derivative exceeds the threshold specified for that derivative by ESMA (an '**NFC+**'); or
- c. an entity established in a third country that would be subject to the clearing obligation if it were established in the EU (a '**Clearing TCE**').

The EMIR Clearing Obligation will also apply to two Clearing TCEs if the contract has a direct, substantial and foreseeable effect within the EU or where such an obligation is necessary or appropriate to prevent the evasion of any provisions of EMIR. Relevant RTS under EMIR greatly restrict this concept.

Thus, EMIR requirements are generally only relevant to the limited class of OTC derivatives required to be cleared under EMIR, in situations where the EU Institution's EU client is a regulated EU or non-EU financial institution, investment fund or NFC+. The thresholds are such that almost all corporate clients will not count as an NFC+ but will instead be an NFC- and therefore not subject to the EMIR Clearing Obligation. Of course, the client or the UK Institution (or both) may nevertheless wish to clear certain trades which are not subject to the EMIR Clearing Obligation at an EU CCP or another CCP on a voluntary basis, to manage risk or reduce collateral or capital costs of trading.

EMIR also imposes risk mitigation requirements for OTC derivatives not cleared by a CCP. Under the relevant RTS, additional margin requirements are imposed for non-centrally cleared OTC derivative contracts, even if the contract is subsequently centrally cleared. In the case of the Split Clearing Model, this could even be asserted to capture the client trade or the back-to-back arrangement between the EU Institution and UK Institution. However, the better interpretation of the RTS, and the interpretation supported by ESMA, is that such arrangements would be regarded as 'cleared' for the purposes of the RTS, even if the CCP used for such clearing is neither an RCCP under EMIR nor a QCCP.¹⁶³

(3) Indirect Clearing

This arises under the Indirect Clearing Model itself but also under Track A, Scenario 2B of the Split Clearing Model, which involves EU Clients entering into transactions with the EU Institution, which then enters into back-to-back transactions with the UK Institution, which in turn clears the trade at a Third Country CCP. The EU Client thereby becomes an indirect client of the UK Institution. Indirect clearing arrangements for OTC and exchange-traded derivatives are regulated under Article 4 of EMIR, Article 30 of MiFIR and the RTS which have recently been published thereunder. Amendments to the indirect clearing RTS under EMIR and a new indirect clearing RTS under MiFIR to address certain difficulties in the current EMIR requirements and to expand the scope to exchange-traded derivatives have recently been published in the Official Journal.¹⁶⁴

¹⁶³ See 'Questions and Answers: Implementation of the Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR)', 2 October 2017, ESMA, OTC Question 12, sub-question G, which states that 'Article 11 of EMIR only applies to OTC derivative contracts not cleared by a CCP, irrespective of its status under EMIR.'

¹⁶⁴ In relation to MiFIR see RTS 2017/2154 and in relation to EMIR see RTS 2017/2155. These were published in the Official Journal on 21 November 2017 and apply from 3 January 2018.

An RTS under EMIR sets out the segregation requirements currently in force for OTC derivatives, but these are not widely used in the OTC market. The segregation requirements include requirements relating to account segregation options and porting, as well as measures regarding leapfrog payments and information flows. To the extent that the EU Institution or UK Institution offers indirect clearing, a number of structural changes to existing documentation, CCP accounts and systems are necessary as from January 2018. A further complication is that many of the steps required of clearing members in respect of indirect clearing are not currently possible under national insolvency regimes, as was recognised in the EMIR review.¹⁶⁵

The indirect clearing RTSs which have recently been published contain various limitations whereby extended ‘long chains’ of clearing intermediaries are only permitted under certain circumstances. This includes limits on the number of intermediaries which may be in the same corporate group. This may have a significant impact on the UK Institution’s operations where the EU Institution, UK Institution and other third country intermediaries are used, or will be used, to facilitate customer clearing.

The Indirect Clearing Model might also result in additional regulatory approvals being required under MiFID II. In most situations it is unlikely that the EU Institution would seek to become an OTF, which would require it to be a ‘multilateral system’ engaging with ‘multiple third party buying and selling interests’ which ‘interact’ with the system.¹⁶⁶ However, the EU Institution may become, or wish to be, a systematic internaliser (‘SI’), under the modified MiFID II definition.

In MiFID I, SIs are defined in such a way as to cover only a small number of active market-making institutions, but the relevant requirements will be wider in scope under MiFID II. In MiFID II, it may be advantageous to become an SI (or OTF or MTF) because the Derivatives Trading Obligation can be satisfied by trading on an SI or MTF (in the case of cash equities) or an OTF or MTF (for derivatives), although MTFs are prohibited from executing client orders against proprietary capital or engaging in matched principal trading.¹⁶⁷ Recent ESMA Q&As have clarified that a key differentiator between an SI and an OTF or MTF is that an SI provides liquidity bilaterally to clients by trading at risk. Automated riskless transactions would therefore need to be avoided for the purposes of ensuring that any SI does not constitute an OTF or MTF. If the EU Institution is on-risk for transactions for a period of time prior to the back-to-back transaction with the UK Institution being established in relation to uncleared OTC contracts, this reduces OTF recharacterisation risk. The ECB has recently issued a statement that it would not be comfortable with an approach where all market risks are transferred to a

¹⁶⁵ The Commission has proposed amendments to EMIR which attempt to clarify that assets covering positions recorded in an account are not part of the insolvency estate of the CCP or clearing member. The proposals are inconsistent with the national insolvency laws of many Member States and EMIR provides no override to such laws. Instead of resolving this issue, the proposal extends the scope of Article 39 to include CCP default, which will have unintended legal consequences. Various proposals are now being made during the course of the legislative process to stop the damage that would be caused by the Commission’s proposed new bankruptcy remoteness requirements (in terms of adversely affecting the rights of CCPs and investment firms to apply collateral against losses). However, none of these proposals to date fully addresses the underlying lack of insolvency law protections for actions taken pursuant to EMIR.

¹⁶⁶ Article 4(1)(23), MiFID II.

¹⁶⁷ Article 19(5), MiFID II.

third-country group entity. This could have implications on the structuring of the back-to-back transactions for the Indirect Clearing Model.¹⁶⁸

(4) QCCP Status

Under Basel III, capital charges imposed on banks' exposures to CCPs arising from derivatives and securities financing transactions are significantly lower (based on a risk weighting of 0%-4%) if the relevant CCP has been deemed to be a QCCP. In the EU, the client transaction (and related exposures for return of client collateral held by CCPs) should have zero risk weighting for any CCP (including non-QCCP) exposures.¹⁶⁹ However, if the CCP is not a QCCP, any related proprietary account transactions, proprietary account collateral and default fund contributions will be subject to risk weightings on the basis of standard corporate exposures, which may be up to 100% on standardised models but, it is understood, more realistically c. 8-15% under more advanced approaches. In many cases, an absence of QCCP status will render it not commercially viable to compete with other clearing member firms.

In the EU, all authorised or recognised CCPs are automatically QCCPs. Following Brexit, the UK will need to establish its own requirements for clearing houses to be given QCCP status. The EU Institution, as an EU entity, will in practice only be able to be a clearing member of a CCP which is an authorised or recognised CCP under EMIR. Various transitional instruments have been introduced under the CRR to deem CCPs which have not yet been recognised as QCCPs for the purposes of calculating own funds requirements and these are still in force for various Third Country CCPs.

Similarly, the UK Institution, as a UK entity, will in practice only be able to be a clearing member of a CCP which has been granted QCCP status by the UK (i.e. a UK CCP and such other CCPs as the UK may elect to recognise).

It is anticipated, but not certain, that there will be reciprocal granting of QCCP status effective from Brexit, such that all UK CCPs will be granted QCCP status by the EU and all EU CCPs will be granted QCCP status by the UK. QCCP status is an international standard set by the Basel Committee, reducing the possibility for political considerations to affect the decision. Moreover, the impact on EU institutions of no such reciprocal finding could be substantial.

(5) UK Regulatory Requirements

The UK's regulatory perimeter for incoming business activities is relatively liberal. For the purposes of designing the models above, the key considerations must be analysed: the intra-group exemption under MiFID II, the 'overseas person exclusion' in UK law and the UK's mechanism for regulating overseas clearing houses.

¹⁶⁸

See 'Brexit: an ECB supervision perspective', ECB, 15 November 2017 which states '*Many banks have indicated their wish to transfer all market risk to a third-country group entity. In practice, this would mean that the banks in question were fully reliant on the third-country entities. In terms of supervision, the ECB is not comfortable with such an approach, which, as the recent past has revealed, could create risks in crisis situations where local capabilities may be crucial to continue operations. This is a key reason why the ECB and the national supervisors expect banks – at least over the medium term – to manage parts of their risks locally and not to be fully reliant on back-to-back transactions of this type.*'

¹⁶⁹

Under Article 306(1)(c), CRR.

MiFID II does not apply to persons that provide investment services exclusively for their parent undertaking, for their subsidiaries, or for other subsidiaries of their parent undertakings (the '**intra-group exemption**'). The intra-group exemption has been implemented in the UK on a transaction-by-transaction basis, such that no regulated activity takes place in the UK in relation to a principal-to-principal trade between members of the same group. As such, the UK does not require the entity to provide services 'exclusively' for group entities to benefit from the exemption; instead all transactions with group entities are exempt and the exemption can be combined with other exemptions. Under the UK's intra-group exemption, as long as all activities that would otherwise constitute a specified type of regulated activity take place wholly within a group of companies there is no need for authorisation.

The UK has long had a permissive view of the scope of the reverse solicitation exclusion from the requirement for authorisation for most incoming business activity. The exclusion is reflected in the UK's 'overseas persons exclusion', whereby non-UK persons are excluded from the relevant requirements in carrying on regulated activities for UK-based clients or counterparties, provided that they do not do so (or offer to do so) from a permanent place of business in the UK. To make use of this exclusion, they must only do business with regulated entities and high net worth corporates (amongst various other types of sophisticated counterparty), and they must comply with the UK's financial promotions restrictions (e.g. by using one of the exemptions under the Financial Promotion Order).¹⁷⁰

As noted in point (j) in the section above entitled *Issues*, the UK has, predictably, in implementing the DEA Restriction in MiFID II, maintained an 'open market' approach. The UK's implementation of Article 54(1) of MiFIR (on equivalent third country investment firms) has been through the 'overseas persons exclusion' and allows 'overseas persons' to offer DEA services to their clients. Since DEA is merely a particular kind or subset of the investment service of 'dealing as agent' or 'receiving and transmitting orders', Article 54(1) of MiFIR clearly applies to it. The relevant statutory instrument states that the provision of DEA is in accordance with the UK's national regime for the purposes of MiFIR if the DEA is provided by persons falling within Article 72 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 ('RAO'). As a matter of UK national law, the recent ESMA guidance¹⁷¹ on the DEA Restriction is of no practical effect since it purports to create only criminal or regulatory breaches, not to confer rights in the UK – and so cannot have automatic direct effect. From the perspective of private individuals and companies, the UK legislation implementing MiFID II may be relied upon as prevailing over informal guidance of this nature. Any shortfall in the UK implementation is an issue between the UK and European authorities, not capable of resulting in actions under UK laws for breach. As a result, UK markets will likely continue operating in a way that allows DEA access by overseas persons, unless and until the UK statutes change. Pre and post Brexit, it remains to be seen whether the UK will change its statute to limit DEA. As this would clearly limit the attractiveness of trading venues located in the UK to third country members, it is unlikely that Parliament would pass new legislation that is detrimental to the City solely to give effect to EU regulatory guidance with a doubtful legal basis contradicting the 'open market' jurisdictions' settlement in MiFIR.

¹⁷⁰ Article 72, RAO.

¹⁷¹ Answer 25, ESMA Q&A On MiFID II and MiFIR Market Structures Topics, 15 November 2017.

CCPs that are not incorporated in the UK are able to provide services in the UK as recognised overseas clearing houses ('ROCHs'), and are subject to supervision by the Bank of England. Following the introduction of EMIR, EU CCPs previously operating in the UK as ROCHs had this status removed upon EMIR recognition. It is anticipated that EU CCPs already operating in the UK will be granted (or re-granted) ROCH status without significant difficulties and those CCPs could therefore deal with UK clearing members either under the overseas persons exclusion or as a ROCH. However, this is not assumed to be the case for this discussion.

(6) EU CCP Issues

All of the models set out above assume that there is no impediment to the UK Institution becoming a clearing member of, and providing clearing services with respect to, EU CCPs. This on the basis that:

- a. EU law, in particular MiFID II (as implemented in each relevant Member State) and EMIR, would not prohibit a firm such as the UK Institution from becoming a clearing member of, and providing clearing services with respect to, EU CCPs or, to the extent EMIR provides for regulatory controls around this, such controls are surmountable and subject to multiple relevant precedents;
- b. local law in each relevant EU Member State does not prohibit the UK Institution from becoming a clearing member of, and providing clearing services with respect to, EU CCPs located in that Member State; and
- c. the UK Institution would be permitted, under the rules of each relevant CCP, to continue to be and act as a clearing member of the CCP.

Each of these limbs is examined below.

Note that the DEA Restriction (and ESMA's interpretation of it) does not apply at the clearing level, since the venue member could have all of its transactions cleared by another legal entity, which would not necessarily need to be an EU investment firm or credit institution.

A. EU Law

MiFID

MiFID II regulates both services and activities, and each of these limbs must be analysed. Being a clearing member and providing clearing services would potentially involve the MiFID II activity of 'dealing in investments as principal' with respect to transactions facing the CCP. However, such MiFID II activity will take place at the place of business of the clearing member. It is unlikely that any MiFID II service would take place at the place of business of the CCP, as the CCP will more usually be regarded as providing services to the clearing member, not *vice versa*. As such, no MiFID II issues arise as a result of the UK Institution continuing to be a clearing member of an EU CCP are anticipated, as its activities will not fall within the MiFID II regulatory perimeter.

Note that this point is separate from the MiFID II Trading Prohibition and MiFID II Counterparty Prohibition discussed in the Split Clearing Model in the section entitled *Analysis of the Split Clearing Model* above. It is also separate from the DEA Restriction discussed at the subsection entitled (5) *UK Regulatory Requirements* above and at point (j) of the section entitled *Issues* above.

SFD

A CCP may only be authorised under EMIR¹⁷² if it is notified as a system pursuant to the Settlement Finality Directive ('SFD').¹⁷³ The SFD seeks to reduce the systemic risk associated with participation in payment and securities settlement systems and, in particular, the risk linked to the insolvency of a participant in such a system. This is achieved by giving various insolvency law protections to CCPs in respect of the transfers of collateral to and from them, and for some aspects of transaction settlement. However such protections only apply as between the operator of the SFD system and its 'participants'.

The following definitions are relevant for the discussion below. In the SFD:

- a. a 'participant' is defined as '*an institution, a central counterparty, a settlement agent, a clearing house or a system operator*';¹⁷⁴
- b. an 'institution' is defined as '*a credit institution as defined in Article 4(1) of [CRD IV]...,¹⁷⁵ an investment firm as defined in [MiFID], public authorities and publicly guaranteed undertakings, or any undertaking whose head office is outside the Community and whose functions correspond to those of the Community credit institutions or investment firms*';¹⁷⁶ and
- c. a 'credit institution' is defined in CRD IV by reference to the CRR,¹⁷⁷ which in turn defines it as '*an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account*'.¹⁷⁸

It should be noted that the CRR definition of a 'credit institution' is not on its face restricted to EU entities, and so arguably includes deposit-taking institutions wherever they are established. Some commentators, however, have taken the more conservative view that 'credit institution' for CRR purposes should be interpreted to only include EU entities.¹⁷⁹ In any event, non-EU credit institutions would be captured by the final section of the definition of 'institution' in the SFD (*'any undertaking whose head office is outside the Community and whose functions correspond to those of the Community credit institutions or investment firms'*).

Third-country entities can therefore be considered 'participants' under SFD either (a) by virtue of being a 'credit institution' under the CRR definition (on the interpretation that such definition is not restricted to EU entities), or (b) by virtue of having functions that 'correspond' to those of EU credit institutions or investment firms. Post Brexit, many UK firms would be likely to qualify under either limb. However, this is ultimately a matter of implementation of the SFD at the Member State level, and some jurisdictions may have introduced conditionality around what is

¹⁷² Article 17(4), EMIR.

¹⁷³ Directive 98/26/EC.

¹⁷⁴ Article 2(f), SFD.

¹⁷⁵ Directive 2006/48/EC was repealed and replaced by CRD IV.

¹⁷⁶ Article 2(b), SFD.

¹⁷⁷ Article 3(1)(1), CRD IV.

¹⁷⁸ Article 4(1)(1), CRR.

¹⁷⁹ Some provisions of CRR and CRD IV use the term 'credit institution' in a way that only makes sense when restricted to EU-regulated firms.

required under the second limb in terms of local regulatory review. CCP rulebooks may also have bespoke definitions of the ‘participant’ for the purposes of the relevant designated system operated by that CCP.

There is no third country equivalence regime under the SFD. As a result, there is no assurance that matters governing participation in SFD-designated systems would be governed by relevant system laws (as opposed to local defaulter insolvency laws). As a result, the risks of allowing access to EU clearing or settlement systems from the UK (or *vice versa*) on a cross-border basis after Brexit would be increased for system operators and participants in those systems, since positions recorded in those systems could potentially become subject to claims based on insolvency moratoria or claw-back rules.¹⁸⁰

EMIR

EMIR does not require clearing members of EU CCPs to be established in the EU. However, pursuant to the RTS made under EMIR,¹⁸¹ EU CCPs are required to ‘*identify and analyse potential conflicts of law issues and develop rules and procedures to mitigate legal risk resulting from such issues. If necessary, independent legal opinions shall be sought by the CCP for the purpose of this analysis.*’ In practice, this has been interpreted as a requirement for EU recognised CCPs to obtain legal opinions on the enforceability of their default rules and collateral and conflicts of law issues under the laws of the jurisdictions where all clearing members are located. Such opinions are, in practice, subject to regulatory review by a CCP’s competent authority and, often, its EMIR college. Any legal opinions supporting membership of UK clearing members by EU CCPs would doubtless need to be revised following Brexit. Any new material impediments to enforceability or new conflicts of law issues presented by Brexit could present a barrier to the CCP being permitted to offer continuing membership to UK clearing members by its regulator or its EMIR college. Insolvency law carve-outs for EU CCP default rules currently recognised under the UK’s implementation of EMIR (via Part VII of the Companies Act 1989) and the SFD (through the UK’s Financial Markets & Insolvency (Settlement Finality) Regulations 1999) would need to continue to apply as protections for EU CCPs post Brexit. Currently, such protections only extend to EU CCPs and to ROCHs, making a fast path to ROCH (or other protected) status for EU CCPs in the UK an important issue. Steps taken by EU CCPs in relation to non-EU (UK) clearing members may also need additional legal protections under the insolvency law of the place of business of the CCP.

B. Local Law

This section and the following section entitled *CCP Rules* set out an illustrative analysis of the post-Brexit considerations that could apply to the UK Institution as a member of an EU CCP. The implications under French and German law have been set out and for the purposes of this illustration it has been assumed that the UK Institution is a clearing member of two significant EU CCPs, Eurex Frankfurt AG (**Eurex**) in Germany and LCH.Clearnet SA in France.

Under German law, the UK Institution’s membership of Eurex would not entail an investment service provided by the UK Institution to Eurex. The service, if any, would be seen to arise from Eurex to the UK Institution

¹⁸⁰ See Chapter 15, *Market Infrastructure*, in the section entitled ‘*Impact of No Deal on UK Exchanges*’.

¹⁸¹ Article 5(4), Commission Delegated Regulation (EU) 153/2013.

and from the UK Institution to its EU Institution as client for the reasons set out the previous section entitled *Additional Legal Considerations for Derivatives Clearing*.¹⁸²

Under French law, the membership prerequisites contained in LCH.Clearnet SA's Clearing Rule Book (discussed below) are premised upon French legislation that requires the *Autorité de Marchés Financiers* ('AMF') to approve a third-country entity being a clearing member if such entity is subject in its home state to rules governing the conduct of clearing and supervision that are equivalent to those in effect in France.¹⁸³ As such, the UK Institution would require approval (or a cooperation agreement between the UK Prudential Regulation Authority (the 'PRA') and the AMF would have to be in place) in order to continue as a clearing member of LCH.Clearnet SA. It appears that the cooperation agreement between the US Federal Reserve System and the AMF (described below) is the only agreement entered into with the AMF regarding exemption for prior authorisation as a clearing member.

See also point (j) of the subsection entitled *Issues above and B. Becoming Counterparty to the Resulting Transactions with Clients* concerning additional restrictions arising as a result of the recent ESMA guidance on the DEA Restriction¹⁸⁴ and local MiFID II implementation, as applicable to trading where this involves DEA.

C. CCP Rules

Each EU CCP has its own membership criteria set out in its clearing rules. The clearing rules of LCH.Clearnet SA and Eurex, as two of the most significant EU CCPs, are examined here.

LCH.Clearnet SA Clearing Rule Book

Article 2.1.1.2(5) of the LCH.Clearnet SA Rule Book states:

'The following entities are eligible to become a Clearing Member, pursuant to Article L 440-2 of the French Monetary and Financial Code: [...]'

(5) In the circumstances set out in the general regulations of the Autorité des Marchés Financiers (AMF), Credit Institutions and investment firms which do not have their head office neither in a European Community Member State, nor in a State party to the Agreement on the European economic area, and legal persons whose principal or sole object is the clearing of Financial Instruments, that are not established in metropolitan France or in French overseas departments, under prior approval of the Autorité des Marchés Financiers. An agreement between the Autorité des Marchés Financiers and (an) other Competent Authority(ies) may provide for an exemption from prior authorisation for a category of entities.'

¹⁸² According to BaFin, 'dealing on own account' by a general clearer constitutes a service (*Eigenhandel*) that is provided by the general clearer to the ordinary trading participant that could not otherwise access the relevant financial market infrastructure. See the relevant guidance contained in '*Merkblatt - Hinweise zu den Tatbeständen des Eigenhandels und des Eigengeschäfts*', dated 6 July 2017.

¹⁸³ Article 541-16, AMF General Regulations.

¹⁸⁴ Answer 25, ESMA Q&A On MiFID II and MiFIR Market Structures Topics, 15 November 2017.

As a non-EU firm following Brexit, the UK Institution would be able to maintain its membership of LCH.Clearnet SA either with prior approval of the AMF, or if the PRA and AMF came to an agreement regarding an exemption. Although it seems reasonable to assume that an agreement to cooperate will be reached between the PRA and AMF,¹⁸⁵ such agreement might only be effective from the date of Brexit. It would therefore be prudent for the UK Institution to seek individual approval from the AMF in advance of Brexit, so as to avoid issues with the UK Institution continuing to be a clearing member of LCH.Clearnet SA on day 1, and also to approach the PRA to encourage it to establish cooperation arrangements with the AMF.

Eurex Clearing Conditions

Number 2.1.2(2)(ee), Chapter 1 of the Eurex Clearing Conditions states that a clearing license will only be granted to:

'(ee) an institution domiciled outside the EU or Switzerland which is (i) permitted in its country of domicile to provide credit to customers in relation to Transactions and receive collateral in the form of cash or securities and (ii) supervised in its country of domicile according to standards equivalent to the applicable regulatory standards of the EU as determined by Eurex Clearing AG, provided that (iii) the competent supervisory authority is a signatory to Appendix A of the IOSCO Multilateral Memorandum of Understanding or has signed an applicable bilateral memorandum of understanding with the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – 'BaFin')...'

Following Brexit, the UK Institution will be an institution that is domiciled outside the EU and so long as it is permitted in its country of domicile to provide credit and receive collateral it satisfies condition (i) above. The FCA is a signatory to Appendix A of the IOSCO Multilateral Memorandum of Understanding and BaFin have entered into a memorandum of understanding with the Bank of England and the Financial Services Authority (as the PRA and FCA were then) in relation to banking supervision in 1995. The remaining condition that will need to be met for the UK Institution to continue as a clearing member of Eurex following Brexit will be (ii), namely that Eurex deems the UK regulatory standards to be equivalent to the applicable regulatory standards of the EU. The Eurex Clearing Conditions do not provide for how this process operates. In particular, the requirement is that Eurex determines the applicable regulatory standards to be equivalent, but in practice it is expected that Eurex would liaise to some extent with BaFin. Given the number and significance of UK clearing members of Eurex, it seems likely that an equivalence decision from Eurex would be in its commercial interests following Brexit, regardless of any equivalence decision at the EU level.

In the event that an impediment to the UK Institution becoming a clearing member of, or providing clearing services with respect to, an EU CCP does in fact arise because of the MiFID II Counterparty Prohibition or MiFID II Trading Prohibition, as locally interpreted, a possible solution might be for the UK Institution to clear trades at a UK branch of an EU CCP. This would involve the following factors:

- a. The relevant EU CCP being willing to establish a branch in the UK from the point of Brexit.

¹⁸⁵

The US Federal Reserve System and the AMF have entered into a cooperation agreement which permits EU branches of US banks to become clearing members of LCH.Clearnet SA.

- b. There would likely be administrative issues under EMIR that the CCP in question should consider if it does not already have a UK branch. The CCP would be required, without undue delay, to notify the competent authority of any material changes affecting the conditions for authorisation.¹⁸⁶ Depending on the nature of the activities and services provided in the UK and in the CCP's home state, it may also be required to apply to the competent authority for an extension of services.¹⁸⁷ Coincidentally Eurex has a UK branch already, so this would not be an issue for Eurex.
- c. The Bank of England would need to recognise the UK branch as a ROCH¹⁸⁸. In order for such recognition to be granted, the UK branch must satisfy certain requirements¹⁸⁹ which relate to investor protection, default management, information sharing and cooperation arrangements with the home regulator of the EU CCP. ROCH status also entails UK QCCP status. Following the introduction of EMIR, EU CCPs previously operating in the UK had their ROCH status removed as they became subject to pan-EU regulation under EMIR (e.g., Eurex had this status pre-EMIR but LCH.Clearnet SA did not). It is expected that EU CCPs already operating in the UK will be granted ROCH status without significant difficulties and those CCPs could deal with UK clearing members either under the overseas persons exclusion or as a ROCH.

Given that a UK branch would constitute the same legal entity as the relevant EMIR-authorised EU CCP, the EU CCP would continue to benefit from that EMIR-authorised status. As such, it would be possible to satisfy the EMIR Clearing Obligation (if the obligation arises) by clearing trades at the UK branch of an EU CCP, and the branch would also be an EU QCCP.¹⁹⁰

¹⁸⁶ Article 14(4), EMIR.

¹⁸⁷ Article 15(1), EMIR. The authorisation process for such extensions is outlined in Article 17, EMIR.

¹⁸⁸ Pursuant to Section 288 of FSMA.

¹⁸⁹ As set out in Section 292(3) of FSMA.

¹⁹⁰ See OTC Question 12, EMIR Q&A, 3 October 2017, ESMA.

(7) Reverse Solicitation

As mentioned in the subsection entitled *A. Trading* at the section entitled (1) *MiFID* above the activities of brokering trades with EU clients will likely result in the regulatory authorities of the Member State of the client regarding an investment service¹⁹¹ as taking place in the jurisdiction of the client. This will depend on the local regulatory perimeter for services and activities likely to be carried out, which include:

- a. execution of orders on behalf of clients;
- b. reception and transmission of orders;
- c. dealing on own account or as agent (depending on structures implemented); and
- d. investment advice (potentially).

Similarly, becoming a counterparty to the resulting transactions with clients will likely involve the MiFID service and activity of 'dealing in investments as principal'. This activity is likely to be deemed to take place at the place of business of the UK Institution. Many Member States are likely to regard the related service of dealing in investments for clients as occurring at the location of the client.

As a result, the UK Institution, which will cease to be a MiFID II authorised firm on Brexit, could be subject to the MiFID II Trading Prohibition and the MiFID II Counterparty Prohibition.

An exclusion from the MiFID II Trading Prohibition and MiFID II Counterparty Prohibition may be found in the concept of a 'reverse solicitation'. Under reverse solicitation, financial institutions are permitted to provide cross-border financial services to a client, without being registered or authorised in that client's Member State, provided that the services are provided at the exclusive initiative of the client.

MiFIR provides an EU-wide formulation of the exclusion in respect of eligible counterparties and *per se* professional clients which will enable third country financial institutions to provide MiFID II-regulated services to wholesale clients on a harmonised basis throughout the EU. The section entitled *Option 1 – Rely upon Reverse Solicitation Exclusion* in Chapter 10, *Investment Banking and Advisory Services*, sets out a full analysis of how this exclusion can be used for the MiFID II-regulated investment activities carried out by the UK Institution when its brokers trade with EU Clients.

The UK has long had a permissive view of the scope of its regime for most incoming business activity, reflected in its 'overseas persons exclusion', whereby persons who do not carry on a regulated activity (or offer to do so) from a permanent place of business in the UK are excluded from some of the requirements for authorisation where, in essence, they comply with the UK's financial promotions restrictions¹⁹² (e.g., by using one of the exemptions under the Financial Promotion Order).¹⁹³ The overseas persons exclusion falls within MiFID II's reverse

¹⁹¹ Set out in Section A to Annex I of MiFID.

¹⁹² Article 72(7), Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

¹⁹³ Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 SI 2005/1529. Notable exemptions include the exemption in respect of solicited communications (Article 14) and the intra-group communication exemption (Article 45).

solicitation exclusion. See section (5) *UK Regulatory Requirements* above for further discussion of the overseas persons exclusion.

It should be possible to structure carefully the arrangements described in the Agency Model or Give-Up Model, and reflect such arrangements across all documentation, so as to fall within the scope of the reverse solicitation exclusion under MiFID II. It would be possible to structure arrangements so that it is clear that there is a reverse solicitation from the EU Client to the UK Institution such that the EU regulatory perimeter is not breached. Assuming that a firm in the UK Institution's position in the models above has an affiliated EU Institution (or intends to establish one), it may be possible for the EU Institution to act as agent or introducer on behalf of its EU clients, at their request, to procure certain services from the UK Institution or provide local advisory, marketing and coverage for EU Clients to approach the UK Institution for particular services.

(8) MiFID II/MiFIR Trading Obligation

Article 23 of MiFIR will require MiFID II investment firms to ensure that trades in shares that are admitted to trading on an EU exchange are concluded on a regulated market, MTF, OTF, SI or equivalent third country trading venue (the '**Equities Trading Obligation**'). Article 28(2) of MiFIR will require financial counterparties and NFC+s that enter into certain derivatives trades with third country financial institutions to conclude those transactions on regulated markets, MTFs, OTFs or equivalent third country trading venues (the '**Derivatives Trading Obligation**').

A. Equities Trading Obligation

Some of the models set out in this Chapter 14, *Derivatives*, entail a back-to-back booking model in which trades entered into by the EU Institution with EU Clients (which may include trades that are subject to either the Equities Trading Obligation or the Derivatives Trading Obligation) are also combined with equivalent OTC transactions between the EU Institution and the UK Institution.

Article 23 of MiFIR provides an exemption from the Equities Trading Obligation in respect of trades carried out between eligible/professional counterparties which do not contribute to the price discovery process. The back-to-back trade between the EU Institution and the UK Institution would fall within this exemption as: (a) the EU Institution is (and will continue to be post Brexit) an eligible counterparty and the UK Institution will be a professional or eligible counterparty post Brexit, and (b) the price discovery process in respect of the trade will have already been completed when the EU Institution enters into the trade with the EU Client on the relevant trading venue. The back-to-back trade is therefore exempt from the Equities Trading Obligation.

B. Derivatives Trading Obligation

Under Article 28 of MiFIR, the Derivatives Trading Obligation does not apply in respect of trades in derivatives subject to the Derivatives Trading Obligation which are intragroup transactions for EMIR purposes. The back-to-back derivatives trade between the UK Institution and the EU Institution would likely be regarded as an intragroup transaction for the purposes of EMIR. An intragroup transaction in respect of a financial counterparty and another counterparty in its corporate group will arise where the following conditions are satisfied:

- a. the financial counterparty is established in the EU or in an equivalent third country;
- b. the other counterparty is a financial counterparty, a financial holding company, a financial institution or an ancillary services undertaking;¹⁹⁴
- c. both counterparties are included in the same consolidation on a full basis; and
- d. both counterparties are subject to appropriate centralised risk evaluation, measurement and control procedures.¹⁹⁵

Condition (a) above will be satisfied post Brexit as the EU Institution will be a financial counterparty established in the EU. The UK Institution will satisfy condition (b) either on the basis that the UK Institution will be a financial counterparty post Brexit because it is a credit institution, or on the basis that the UK Institution will be a financial institution post Brexit.¹⁹⁶

Both the EU Institution and UK Institution will be included in the same consolidation group, either for CRD IV purposes (on the basis of equivalence) or for accounting purposes (which will not require an equivalence determination). Although Article 3 of EMIR provides a narrow definition of consolidation which mandatorily counts for such purposes, this is not specified to be exhaustive. ESMA has confirmed that a contract between counterparties that are in the same group for accounting purposes but not consolidated under CRD IV is still eligible for the intragroup exemption under Article 3 of EMIR.¹⁹⁷ Therefore, even if the UK Institution and EU Institution are not in the same consolidation for regulatory capital purposes on the basis of the absence of an equivalence determination under Article 127 of CRD IV, the EMIR intragroup designation should still be applicable and condition (c) can be satisfied. Condition (d) is a factual question, and would be satisfied if, post Brexit, the UK Institution and the EU Institution are subject to a centralised risk function.

The back-to-back trade with the UK Institution can therefore constitute an intragroup transaction and so will be exempt from the Derivatives Trading Obligation.

¹⁹⁴ Financial holding company, financial institution and ancillary services undertaking are all defined terms under EMIR.

¹⁹⁵ Under Article 3(2), EMIR.

¹⁹⁶ The UK Institution will be a ‘credit institution’ for the purposes of the CRR if the view is taken that ‘credit institution’ includes deposit-taking institutions wherever they are established. Some commentators, however, have taken the different that ‘credit institution’ for certain CRR purposes only includes EU-established entities.

¹⁹⁷ See OTC Question 6, EMIR Q&A, 3 October 2017, ESMA.

15. Market Infrastructure

Impact of No Deal on UK Exchanges

Under the Financial Centre Model, exchange business within London will be unaffected. Cross-border access from firms in the EU into the UK will be possible for as long as the UK's overseas persons exclusion is maintained.¹⁹⁸ Maintaining this exclusion is solely within the control of the UK, and so far there have been no proposals to replace or amend this exclusion. Clearing of exchange trades within London will be similarly unaffected. Non-UK clearing members can rely on the overseas persons exclusion to carry out the regulated activity of dealing in investments as principal or agent in respect of their interactions with their UK clearing house. Major UK clearing houses do not require clearing members to be established in a particular jurisdiction. For instance, this is the case under the ICE and LCH Rulebooks. However, such access is typically subject to requirements that the clearing house may admit the member only if the local laws and in particular local insolvency laws are acceptable to the clearing house.

'Under the Financial Centre Model, exchange business within London will be unaffected.'

UK clearing houses would still be able to manage defaults under the Financial Collateral Directive, which protects EU and non-EU collateral takers equally. However, other steps such as porting and ensuring settlement finality are not currently supported for non-EU clearing houses under EU laws. It would be helpful to obtain some form of mutual recognition under the SFD to ensure further protections for settlement finality in the EU. However, non-EU clearing houses already operate without such protections and live with or manage this risk. UK clearing houses could also consider obtaining SFD protections for EU branches. Recognition of third country systems with EU places of business under the SFD is possible and has precedents such as X-Clear and CLS Bank. EU Member States may also apply the SFD to their domestic institutions that participate directly in non-EU systems.¹⁹⁹

London will doubtless continue to attract third country issuers to list locally. If listing standards diverge, issuers on London markets may need to comply with EU listing standards using an EU 'wrapper' and *vice versa*. This would consist of an EU listing rule-compliant template enclosing the UK issuer's original prospectus. Supplementing issuer disclosures and sections required to comply with EU listing rules can be added in to 'top up' the original prospectus.

Impact of No Deal on EU Exchanges

Cross-border exchange memberships of entities established in London will likely be unproblematic in the main jurisdictions – Germany and France. In these jurisdictions, proprietary trading is deemed to take place at the place of business of the exchange member and not at the location of the exchange. Proprietary trading carried out by UK firms on EU exchanges is therefore likely to be unaffected by the absence of a mutual recognition deal.

However, the MiFID II service of dealing in investments on behalf of clients is usually deemed also to occur at the location of the client. Where

¹⁹⁸ As set out in Article 72, Regulated Activities Order, see the section entitled *Reverse Solicitation*, in Chapter 8, *How Businesses Can Best Identify the Brexit Opportunities*, for further details of the overseas persons exclusion.

¹⁹⁹ As confirmed by Recital 17, SFD.

the client is located in the EU, a UK firm may be required to obtain authorisation in order to provide services to such clients, unless the arrangement can be structured as a reverse solicitation.

For issuances, if EU listing standards diverge from the UK's, a wrapper may become necessary to sell into the UK. The wrapper would contain any supplemental disclosures required to comply with UK listing rules. For issuers seeking to list in the EU after Brexit this will require a prospectus to be approved by the relevant regulator in the EU under the Prospectus Directive. The relevant regulator is that of the Member State in which the issuance is listed.

UK firms that are members of EU trading venues may provide access to these platforms to their clients through DEA. EU clients wishing to avail themselves of DEA through a UK-based member of a trading venue would be required to route the orders through an EU affiliate or restructure the arrangement as a reverse solicitation by the EU client as a result of the interpretation to Article 48(7) of MiFID II that has been issued by ESMA (see point (j) in the subsection entitled *Issues* and the subsection *B. Becoming Counterparty to the Resulting Transactions with Clients* and (5) *UK Regulatory Requirements* in Chapter 14, *Derivatives*).

Impact of No Deal on UK Clearing Houses

EU firms located in the EU may continue to be members of UK clearing houses on a cross-border basis under the overseas persons exclusion. The SFD will be grandfathered into UK law under the Great Repeal Bill and will continue as UK legislation alongside the UK Companies Act 1989. However, there needs to be EMIR recognition for the UK CCP in order for the UK CCP to be permitted to have EU clearing members.

EMIR recognition would also mean QCCP status for capital purposes for the UK clearing house, such that EU regulated members and EU regulated customers get a 0% or 2% capital treatment charge, rather than the higher counterparty risk charge that would apply if the UK clearing house was not recognised as a QCCP. Clearing at a UK CCP for an EU regulated customer or counterparty or for an EU customer or counterparty which is not regulated but is subject to the EMIR Clearing Obligation will not be economically viable unless the UK CCP is a QCCP. Obtaining QCCP status will require UK CCPs to obtain recognition under EMIR.²⁰⁰ This process will require the Commission to make an equivalence determination in respect of the UK. The UK will be implementing EMIR in national law such that EU and UK standards will be identical for the purposes of the equivalence determination.

It seems a remote possibility that UK CCPs will not be recognised under the existing EMIR equivalence regime since several other countries with quite different regulatory systems have been so recognised, and given the detrimental impact to the EU of severing access to UK-based clearing services. But if so, the business of EU clearing members and EU customers needing clearing will suffer. EU clearing members would need then to transfer memberships to UK entities. Most clearing members of UK CCPs are based in the UK or operate from UK branches, and are outside the EU's regulatory net.

²⁰⁰

Pursuant to Article 25, EMIR.

Impact of No Deal on EU CCPs

UK firms are likely in many cases to be able to continue their memberships of EU CCPs on a cross-border basis. This is because under EU law, the clearing service is deemed to be provided from the CCP (outbound from the EU), rather than from the clearing member inbound into the EU. The UK must recognise EU CCPs as QCCPs under the legislation replacing CRR post Brexit to ensure that UK firms that are exposed to EU CCPs are not subject to a prohibitively expensive capital charge on such exposures.

'... UK CCPs might consider the provision of lookalike products to those cleared in the EU to ensure business can carry on solely within the UK regulatory regime.'

When the UK transposes the CRR and EMIR, it should simultaneously issue its own equivalence determinations in respect of the main EU CCPs. This would neatly grant QCCP status to those CCPs to ensure UK clearing members' exposures to such CCPs are treated appropriately for capital purposes.

If recognition of UK CCPs under the existing EMIR equivalence regime is not forthcoming, or if there are any other barriers to access that the EU introduces, UK firms should still be in a good position to restructure themselves to ensure that they are not caught by the EU regulatory perimeter. In particular, UK CCPs might consider the provision of lookalike products to those cleared in the EU to ensure business can carry on solely within the UK regulatory regime.

Impact of No Deal on Underlying Trades of EU Customers

EU customers will need, absent an equivalence determination under MiFID II and absent reverse solicitation, to deal with an EU broker before their trades are put into clearing. There are several ways to achieve this and then to put the cleared trade back into the liquidity pool of the City and to avoid splitting the book. These include adopting indirect clearing models, or using the Split Clearing, Agency and Give-Up structures detailed in Chapter 14, *Derivatives*. As described above, the clearing leg of the trade executed by the EU entities should still be eligible for clearing in the UK. The previous sections of this publication describe the structures that may be adopted to ensure that clearing can still take place in respect of the EU market in all circumstances.

Impact of No Deal on Resolution and Recovery of Exchanges and CCPs

There will in due course need to be cross-border mutual recognition arrangements between the UK and EU to ensure that resolution arrangements, particularly in respect of CCPs, can be recognised on a cross-border basis. Fundamentally, the UK and the EU must determine whether the resolution and recovery arrangements will be recognised on the basis of a gateway, where each party will be able to determine that the other has properly operated its resolution and recovery framework, or on the basis of recognition which is largely automatic.

Impact of No Deal on Central Securities Depositories

Under the Central Securities Depository Regulation ('CSDR'),²⁰¹ central securities depositories ('CSDs') must be authorised in the EU, or be deemed equivalent under the third-country regime established in Article 25, CSDR. It is highly likely that, even in the absence of a wider Brexit

²⁰¹

Regulation (EU) 909/2014.

deal, the UK's CSD, CREST, would be recognised as equivalent, as failure to do so would risk disruption to security settlements in the EU-27, not least in the case of those Member States, particularly Ireland, that make use of the UK's CSD in the absence of their own.

It would make no sense for EU or UK to omit to recognise one another under CSDR, since this would restrict access to investors wishing to hold sovereign bonds or local issuers' securities, which could only have negative effects in pricing and liquidity. An EU attempt to cut off UK participant access to Euroclear and Clearstream would make it more difficult and costly for City participants to hold EU sovereign bonds, for example. Non-recognition is therefore only likely in the event of a political desire to punish the UK to such an extent that it means detrimentally impacting the ability of EU governments to raise debt and pricing of such debt, which seems implausible. Even if mutual equivalence is not established, local custodians in the UK and EU could intermediate access to their local CSDs, and use reverse solicitation, subcustody or other techniques to access end users on the other side of the Channel.

ANNEX 1 - Key Legal and Regulatory Factors Behind the City's Success

Use of Common Law and Focused Legislative Approach

The UK has traditionally had a strong but adaptable legal and regulatory framework. The common law is a flexible system that encourages and facilitates innovation. The UK's reputation for financial services is built on a foundation of robust regulation, starting (in the modern era) with the Financial Services Act 1986, which created the Securities and Investments Board (SIB) presiding over several self-regulatory organisations and the Banking Act 1987 which formalised certain powers for the Bank of England.

'... the common law system is a proven winner when it comes to the financial markets.'

The UK is generally quick to respond to developments in the market, and in particular has a faster process for legislating and amending or revoking legislation and rules than the EU. This is a result both of its processes, which are more flexible, often affording discretion and authority to on-the-ground regulators, and of the fact that the EU must operate across 28 separate legal jurisdictions and build political consensus through the Parliament and Council.

Regardless of any personal preference for common law or civil law approaches, the common law system is a proven winner when it comes to the financial markets. It is notable that the top four financial centres in the world – London, New York, Hong Kong and Singapore – are all based on the common law approach to legislation and are all based on the clear legislative style of drafting adopted in the UK. Moreover, newer financial centres, such as the Dubai International Financial Centre and the Abu Dhabi Global Market, have also adopted the common law, in an attempt to leverage its business-friendly reputation to improve the fledgling centres' standing.

Robust Drafting and Straightforward Judicial Interpretations

English is the language of the international financial markets. In order to be effective, laws must be clear and well-drafted, and not result in the unintended consequences which can appear when laws are drafted by expansive committees. The common law has the advantage of decades – even centuries – of robust judicial interpretation by some of the world's leading judges in the English courts and what is now the UK Supreme Court. The English legal system, which is structured to avoid in-built jurisdictional protectionism and allow a fair hearing of written and oral evidence, continues to be the gold standard of judicial process globally.

Regulatory Philosophy of Focusing on Outcomes

The UK's regulatory approach has traditionally been based on requiring higher standards with less prescription. It has focused on the key outcomes required to keep taxpayers, markets and customers safe, whilst permitting innovation. The UK has welcomed cross-border institutional business and has made the establishment of local UK presences as easy as possible. Overly-prescriptive 'tick-box' or 'one-size-fits-all' approaches to regulation have been eschewed in favour of rigorous and intelligent oversight on a case-by-case basis by sophisticated regulators.

Highly-Skilled, Market-Experienced Personnel at Regulators, Exercising Real-Time Face-to-Face Judgment, Including in Rulemaking

UK regulators have historically been close to the market, enabling them to keep their ears to the ground and identify issues as they arise. They have applied the rules pragmatically and in accordance with a predictable and standard interpretation of the requirements of the relevant legal provision. If the laws or regulations omitted to capture a behaviour, then the legislature or the regulators (as rulemakers) would consult and amend the laws and rules respectively. This has provided for considerable immediacy, certainty, predictability and market friendliness, whilst generally keeping the markets safe.

ANNEX 2 – EU-Driven Erosion of UK Competitiveness in Financial Services

Civil Law Structures

Civil law systems are intrinsically less attractive for financial services than common law systems. The main global financial centres have flourished under the common law for a reason. The purposive method of interpretation in civil law systems, which has been adopted and pursued with vigour in EU law, means that the words on the page are often not given their literal meaning, but rather are to be interpreted and applied in accordance with the underlying purpose of the legislator or rulemaker, and – in the case of the EU – with judicial understandings of the purpose of the European project as a whole. This creates uncertainty and can detract from freedom of contract. The uncertainties that arise in a dynamically evolving environment have a detrimental effect on business and innovation.

One-Size-Fits-All Overly Prescriptive Laws and Regulations

‘Since 2008, there has been a civil law-based programme seeking to impose a codified blanket of regulation on the financial markets, specifying how business should be run in extraordinary detail.’

Both as a result of its civil law system, and as a function of attempting to create a single regulatory framework that would apply across 28 separate jurisdictions, the EU approach to regulation has been very prescriptive. Since 2008, there has been a civil law-based programme seeking to impose a codified blanket of regulation on the financial markets, specifying how business should be run in extraordinary detail. This programme has gone beyond many of the ideas originally underpinning the post-reform agenda, many of which actually emanated from the UK. Some of the post-crisis reform programme has been achieved through global cooperation under the FSB and IOSCO, but the EU has gone further than global standards in numerous ways. The UK played a significant part in moulding the new regulations implementing these global standards at the EU, as it did for those in effect prior to 2008, but this was as a committee member against the backdrop of an approach that was overly prescriptive because it was mistrustful of Member States and the City in particular.²⁰²

The EU has sought to map out in detail the practical application of the outcomes desired, instead of adopting the market-friendly and safe method of legislating for outcomes and leaving the regulators, using their expertise and discretion, to decide on the particularities. Huge manuals have been created for both regulators and participants, which layer on unnecessary and distracting compliance costs and processes to the industry (as discussed below), increasing costs and stifling innovation and competition. The purposive interpretation method has in turn soaked the blanket of EU laws and regulation in water, stifling creativity further.

²⁰²

For instance, MiFID II contains an extensive attempt to map out detailed rules for four different types of platform-type trading arrangement, which stem from an attempt to broaden the number and types of competing platforms across the EU away from exchanges – a project which commenced in the first MiFID directive. Its highly detailed provisions go significantly further than what is required to ensure clean and safe markets and represent to a large degree the implementation of a ‘single market’ objective across the EU, the price for which is a massive compromise on prescriptive rules as to how that market is to be broken down and regulated. It is, at best, unclear whether the four-way split was necessary for the UK’s markets or truly of benefit to them. The detailed prescription is in any event undesirable.

The overall effect has been to stifle innovation and dynamism. The rulemaking has been ill-focused – as evidenced by the fact that the UK's regulators have felt the need to impose higher standards in some key instances,²⁰³ whilst not being able to strip away misdirected prescription in others. The US regulatory approach has by contrast been focused far more on the efficacy of oversight by corporate boards, which brings the responsibility for safety back closer to the market itself and allows for more judgement-based and discretionary regulation.

Dangerous Splitting of Rule-Making and Supervision

This EU structural approach to regulation has removed key discretions from the national regulators. Instead of empowering those regulators to exercise good faith judgement and swiftly to amend the rules when issues are identified in a responsive and dynamic manner, the EU's institutional infrastructure, most recently augmented by the introduction of the ESAs in 2008, has meant that regulators have to consult with EU bodies on points of interpretation, second guess the ECJ on points of law, and seek to go back through the EU rulemaking and clarificatory procedures in order to effect changes to address market issues thrown up by poorly drafted, overly prescriptive EU laws.²⁰⁴

The civil law structure, which naturally relies less on guidance from regulators than in common law systems, coupled with the need to coordinate any guidance given across all EU jurisdictions between many involved parties, means that there is significantly less in the way of practice directions or guidance for firms to follow under EU law than (traditionally) in the UK.

This is uniquely stultifying in a top tier financial centre and has introduced considerable dangers into the UK's financial markets. It means that a very high degree of consensus needs to be achieved with numerous people far-removed from the market and the City in order to respond to market developments or issues arising. This point itself gives rise to significant systemic risk in a way that is little-understood, highly undesirable and difficult if not impossible to manage.

Uncertain and Politicised Rule-Making Processes

The EU legislative and consultative process is often political, as involved parties balance competing national concerns and the political project of the EU as a whole. This means that technical or expert consultation can often be less important than political considerations. This has resulted in some cases in regulatory requirements which are difficult to integrate into businesses on a practical level, and which can be unnecessarily costly²⁰⁵ or sometimes impossible to comply with where, for example,

²⁰³ Notably regulatory capital and senior management accountability.

²⁰⁴ For instance, there is a process whereby ESMA produces Q&As, the legal status of which is unclear, but which are designed to clarify – across the whole of the EU – points of uncertainty arising in regulations for which ESMA is responsible. This is the case for instance for the key area of derivatives regulation under EMIR. In that context the UK regulators need to deal with numerous uncertainties arising from EU drafting by going back through ESMA, rather than being in a position to rule on the matter in real time. This process is highly unattractive and introduces risk to the UK's markets and credibility issues for the UK's regulators in making determinations.

²⁰⁵ This is for instance the case in relation to the multiple overlapping trade reporting requirements that have been introduced after the credit crunch, which have introduced a hugely expensive set of requirements, many of which are unnecessary. For instance the details of many futures trades are already in the hands of clearing houses, and yet the EU is requiring the reporting of the same trades to trade repositories.

'As a result, since 2008, the UK and EU investment banking sector has fared noticeably worse than that in the US, where an approach more sensitive to commercial needs has been adopted.'

requirements introduced by different measures appear to conflict with each other.

As a result, since 2008, the UK and EU investment banking sector has fared noticeably worse than that in the US, where an approach more sensitive to commercial needs has been adopted. Given the unwieldy nature of the EU institutions, there has subsequently been an unwillingness on the part of the EU to revisit regulations to determine whether they achieve what was intended, or to remove or change regulations which have proven unnecessary or ineffective. The Commission only began to consider a re-evaluation of EU legislation in 2016 with the 'Better Regulation' agenda and Regulatory Fitness and Performance programme after the appointment of Lord Hill of Oareford by the UK as EU Financial Services Commissioner. Lord Hill also initiated the Action Plan for the Capital Markets Union. These are the first EU programmes for the removal of red tape and liberalising of business in financial services. Although the work appears to be continuing, it is likely to pursue with less vigour following Brexit and after the resignation of Lord Hill.

Competing Social Priorities, Designed to Promote a More Managed Economy

The EU, being a project based on larger socio-political considerations of 'ever-closer union' rather than a mere financial market, has pursued social policies which have not always prioritised the City's competitiveness, in particular since the financial crisis of 2007-2008 and the political dissatisfaction associated with the fallout from that.²⁰⁶ In an effort to centralise control, the EU has increased its grip over the legislative and regulatory framework for the City, generally from outside the City.

It has concentrated significant amounts of rulemaking in Brussels and also, more recently, in the ESAs in Paris (ESMA) and Frankfurt (Eiopa). The EBA is located in London, but is EU-run, and in any event many banking sector activities that one might expect it to regulate – such as clearing – have been consistently and deliberately given to ESMA in Paris.²⁰⁷ It also operates alongside, and is increasingly overshadowed by, the ECB, located in Frankfurt. Further, these bodies have no day-to-day regulatory functions. They just write rules. They are not close to the market. They do not operate fully in English and many personnel have no practical experience or expertise of working in leading financial markets.

²⁰⁶ For instance, the EU's highly politicised cap imposed on the amount bankers may earn by way of bonus goes against the UK's express wish to allow banks to compensate their employees very significantly in a contingent manner. The EU's approach makes banks less safe to run by lowering their fixed costs. It also prefers shareholders as recipients of profits over employees, so is questionable as a social policy in any event.

²⁰⁷ As noted in footnote 46, it may well be the case that more powers are awarded to the EBA once it has moved to Paris.

ANNEX 3 – MiFID II, MiFIR: EU Law Carve Outs – National Regulators

The table below sets out a summary of the powers of national competent authorities to waive, vary or otherwise affect implementation of requirements under MiFID II, MiFIR and the technical standards published thereunder.

Annex 3 – MiFID II, MiFIR: EU Law Carve Outs – National Regulators	
Article	Summary
MiFID II	
28(2)	<p><i>Client Order Handling Rules</i></p> <p>Competent authorities may waive the obligation on investment firms to make public a client limit order in respect of shares admitted to trading on a regulated market or traded on a trading venue which are not immediately executed under prevailing market conditions if the client limit order is large in scale compared with normal market size.</p>
MiFIR	
4(1)	<p><i>Waivers for Equity Instruments</i></p> <p>Competent authorities may waive the obligation for market operators and investment firms operating a trading venue to make public certain information including current bid and offer prices for:</p> <ul style="list-style-type: none"> a. systems matching orders based on a trading methodology by which the price of the financial instrument (including shares, depositary receipts, exchange-traded funds, certificates and other similar financial instruments) is derived from the trading venue where that financial instrument was first admitted to trading, or the most relevant market in terms of liquidity, where that reference price is widely published and is regarded as a reliable reference price; b. systems that formalise negotiated transactions; c. orders that are large in scale compared with normal market size; and d. orders held in an order management facility of the trading venue pending disclosure.
5(8)	<p><i>Volume Cap Mechanism</i></p> <p>Competent authorities may suspend the use of waivers for equity instruments (which allow market operators and investment firms operating a trading venue to waive the obligation to make public certain information). Competent authorities may suspend such waivers from the date of MiFIR's application (3 January 2018) and thereafter on a monthly basis.</p>
7(1)	<p><i>Authorisation of Deferred Publication</i></p> <p>Competent authorities may authorise market operators and investment firms operating a trading venue to provide for deferred publication of the details of transactions in equity instruments based on their type or size.</p>
9(1)	<p><i>Waivers for Non-Equity Instruments</i></p> <p>Competent authorities may waive the obligation for market operators and</p>

Article	Summary
	<p>investment firms operating a trading venue to make public information such as current bid and offer prices for:</p> <ul style="list-style-type: none"> a. orders that are large in scale compared with normal market size and orders held in an order management facility of the trading venue pending disclosure; b. actionable indications of interest in request-for-quote and voice trading systems that are above a size specific to the financial instrument, which would expose liquidity providers to undue risk and takes into account whether the relevant market participants are retail or wholesale investors; c. derivatives which are not subject to the obligation to trade on regulated markets, MTFs or OTFs and other financial instruments for which there is not a liquid market; d. order for the purpose of executing an exchange for physical; and e. package orders that meet certain conditions.
9(2a)	<p><i>Waivers for Non-Equity Instruments</i></p> <p>Competent authorities may waive the obligation to make public certain information including current bid and offer prices for each individual component of a package order. A package order is an order that is priced as a single unit either for the purpose of executing an exchange for physical or in two or more financial instruments for the purpose of executing a package transaction.</p>
9(4)	<p><i>Waivers for Non-Equity Instruments</i></p> <p>The competent authority responsible for supervising one or more trading venues on which a class of bond, structured finance product, emission allowance or derivative is traded may, where the liquidity of that class of financial instrument falls below a specified threshold, temporarily suspend the pre-trade transparency requirements for trading venues.</p> <p>The specified threshold is defined on the basis of objective criteria specific to the market for the financial instrument concerned. The temporary suspension shall be valid for an initial period not exceeding three months from the date of publication on the website of the relevant competent authority. The suspension may then be renewed for further periods not exceeding three months at a time if the grounds for suspension continue to be applicable.</p>
11(1)	<p><i>Authorisation of Deferred Publication</i></p> <p>Competent authorities may authorise market operators and investment firms operating a trading venue to provide for deferred publication of the details of transactions in non-equity instruments based on the size or type of the transaction.</p>
11(2)	<p><i>Authorisation of Deferred Publication</i></p> <p>The competent authority responsible for supervising one or more trading venues on which a class of bond, structured finance product, emission allowance or derivative is traded may, where the liquidity of that class of financial instrument falls below the threshold, temporarily suspend the post-trade transparency requirements for trading venues.</p> <p>The threshold shall be defined based on objective criteria specific to the market for the financial instrument concerned. The temporary suspension shall be valid for an initial period not exceeding three months from the date of its publication on</p>

Article	Summary
	the website of the relevant competent authority. The suspension may be renewed for further periods not exceeding three months at a time if the grounds for suspension continue to be applicable.
21(4)	<p><i>Post-Trade Disclosure by Investment Firms, Including Systematic Internalisers, in Respect of Bonds, Structured Finance Products, Emission Allowances and Derivatives</i></p> <p>Competent authorities may authorise investment firms to provide for deferred publication of post-trade disclosure, or may request the publication of limited details of a transaction or details of several transactions in an aggregated form, or a combination thereof.</p>
35(5)	<p><i>Non-Discriminatory Access to a CCP</i></p> <p>Competent authorities may decide that the non-discriminatory access to a CCP provisions do not apply in respect of transferable securities and money market instruments for a transitional period until 3 July 2020 to newly established and authorised CCPs, recognised CCPs or CCPs authorised under a pre-existing national authorisation regime for a period of less than three years on 2 July 2014.</p>
54(2)	<p><i>Transitional Provisions</i></p> <p>Competent authorities, taking into account the risks resulting from the application of the access rights under Article 35 (non-discriminatory access to a CCP) or 36 (non-discriminatory access to a trading venue) as regards exchange-traded derivatives to the orderly functioning of the relevant CCP or trading venue, may decide that Article 35 or 36 would not apply to the relevant CCP or trading venue, respectively, in respect of exchange-traded derivatives, for a transitional period until 3 July 2020.</p>
Commission Delegated Regulation (EU) 2017/583	
11(1)(b)	<p><i>Transparency Requirements in Conjunction with Deferred Publication at the Discretion of the Competent Authorities</i></p> <p>Competent authorities may, in conjunction with an authorisation of deferred publication of the details of transactions in non-equity instruments, allow the omission of the publication of the volume of an individual transaction for an extended time period of four weeks.</p>
11(1)(c)	<p><i>Transparency Requirements in Conjunction with Deferred Publication at the Discretion of the Competent Authorities</i></p> <p>In respect of non-equity instruments that are not sovereign debt, competent authorities may, in conjunction with an authorisation of deferred publication of the details of transactions in non-equity instruments, allow for an extended time period of deferral of four weeks, the publication of the aggregation of several transactions executed over the course of one calendar week on the following Tuesday before 09.00 local time.</p>
11(1)(d)	<p><i>Transparency Requirements in Conjunction with Deferred Publication at the Discretion of the Competent Authorities</i></p> <p>In respect of sovereign debt instruments, competent authorities may, in conjunction with an authorisation of deferred publication of the details of</p>

Article	Summary
	transactions in non-equity instruments, allow for an indefinite period of time, the publication of the aggregation of several transactions executed over the course of one calendar week on the following Tuesday before 09.00 local time.
16(1)	<p><i>Temporary Suspension of Transparency Obligations</i></p> <p>For financial instruments for which there is a liquid market, competent authorities may temporarily suspend the pre- and post-trade transparency requirements for non-equity instruments where for a class of bonds, structured finance products, emission allowances or derivatives, the total volume for the previous 30 calendar days represents less than 40% of the average monthly volume calculated for the 12 full calendar months preceding those 30 calendar days.</p>
16(2)	<p><i>Temporary Suspension of Transparency Obligations</i></p> <p>For financial instruments for which there is not a liquid market, competent authorities may temporarily suspend the pre- and post-trade transparency requirements for non-equity instruments where for a class of bonds, structured finance products, emission allowances and derivatives, the total volume for the previous 30 calendar days represents less than 20% of the average monthly volume calculated for the full 12 calendar months preceding those 30 calendar days.</p>

ANNEX 4 – EMIR, CRR/CRD IV: EU Law Carve Outs – National Regulators

The table below sets out a summary of the powers of national competent authorities to waive, vary or otherwise affect implementation of requirements under EMIR, CRR/CRD IV and the technical standards published thereunder.

Annex 4 – EMIR, CRR/CRD IV: EU Law Carve Outs – National Regulators	
Article	Summary
EMIR	
11(8)	<p><i>Risk-Mitigation Techniques for OTC Derivative Contracts not Cleared by a CCP</i></p> <p>An intragroup transaction in relation to a financial counterparty that is entered into by a counterparty which is established in the Union and a counterparty which is established in a third-country jurisdiction shall be exempt totally or partially from the requirement to exchange collateral with respect to OTC derivative contracts on the basis of a positive decision of the relevant competent authority responsible for supervision of the counterparty which is established in the Union provided that the following conditions are fulfilled:</p> <ul style="list-style-type: none"> (a) the risk-management procedures of the counterparties are adequately sound, robust and consistent with the level of complexity of the derivative transaction; and (b) there is no current or foreseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties.
11(10)	<p><i>Risk-Mitigation Techniques for OTC Derivative Contracts not Cleared by a CCP</i></p> <p>An intragroup transaction that is entered into by a non-financial counterparty and a financial counterparty which are established in different Member States shall be exempt totally or partially from the requirement to exchange collateral with respect to OTC derivative contracts on the basis of a positive decision of the relevant competent authority responsible for supervision of the financial counterparty provided that the following conditions are fulfilled:</p> <ul style="list-style-type: none"> (a) the risk-management procedures of the counterparties are adequately sound, robust and consistent with the level of complexity of the derivative transaction; and (b) there is no current or foreseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties.
89(2)	<p><i>Transitional Provisions</i></p> <p>In relation to pension scheme arrangements that are either occupational retirement provision businesses of life insurance undertakings or any other authorised and supervised entities, or arrangements, operating on a national basis that are recognised under national law and whose primary purpose is to provide retirement benefits, competent authorities may grant, until 16 August 2018 exempt the clearing obligation from applying to OTC derivative contracts that are objectively measurable as reducing investment risks directly relating to the financial solvency of the pension scheme arrangements.</p>

Article	Summary
CRD IV	
21(1)	<p><i>Waiver for Credit Institutions Permanently Affiliated to a Central Body</i></p> <p>Competent authorities may waive the following requirements for credit institutions which are permanently affiliated to a central body which supervises them and which is established in the same Member State:</p> <ul style="list-style-type: none"> (a) to include a programme of operations setting out the types of business and the structural organisation of the credit institution in its application for authorisation; (b) to hold separate own funds or initial capital of EUR 5 million; and (c) to have at least two persons who effectively direct the business of the applicant credit institution.
76(3)	<p><i>Treatment of Risks</i></p> <p>Competent authorities may allow an institution which is not considered significant to combine the risk committee with the audit committee.</p>
91(6)	<p><i>Management Body</i></p> <p>Competent authorities may authorise members of the management body to hold one additional non-executive directorship. This is in addition to the combinations determined under s91(3) which provides that members of a management body must not hold more than one of the following combinations of directorships at the same time:</p> <ul style="list-style-type: none"> (a) one executive directorship with two non-executive directorships; or (b) four non-executive directorships.
108(1)	<p><i>Internal Capital Adequacy Assessment Process</i></p> <p>For credit institutions which are permanently affiliated to a central body, competent authorities may waive the requirement for institutions to have in place sound, effective and comprehensive strategies and process to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of the risks to which they are or might be exposed.</p>
111(5)	<p><i>Determination of the Consolidating Supervisor</i></p> <p>If the application of the following conditions would be inappropriate, taking into account the institutions and the relative importance of their activities in different countries, competent authorities may, by common agreement, waive the following criteria and appoint a different competent authority to exercise supervision on a consolidated basis:</p> <ul style="list-style-type: none"> a. where institutions authorised in two or more Member States have as their parent the same parent financial holding company, the same parent mixed financial holding company in a Member State, the same EU parent financial holding company or the same EU parent mixed financial holding company, supervision on a consolidated basis shall be exercised by the competent authorities of the institution authorised in the Member State in which the financial holding company or mixed financial holding company was set up; b. where the parent undertakings of institutions authorised in two or more Member States comprise more than one financial holding company or mixed financial holding company with head offices in different Member States and there is a credit institution in each of those States, supervision on a consolidated basis shall be exercised by the competent authority of the credit institution with the largest balance sheet total; or c. where more than one financial institution authorised in the Union has

Article	Summary
	as its parent the same financial holding company or mixed financial holding company and none of those institutions has been authorised in the Member State in which the financial holding company or mixed financial holding company was set up, supervision on a consolidated basis shall be exercised by the competent authority that authorised the institution with the largest balance sheet total, which shall be considered as the institution controlled by an EU parent financial holding company or EU parent mixed financial holding company.
6(4)	<p><i>General principles</i></p> <p>Pending a report from the Commission, competent authorities may exempt investment firms from compliance with the liquidity obligations taking into account the nature, scale and complexity of the investment firms' activities.</p>
7(1)	<p><i>Derogation from the Application of Prudential Requirements on an Individual Basis</i></p> <p>For any subsidiary of an institution, where both the subsidiary and the institution are subject to authorisation and supervision by the Member State concerned, and the subsidiary is included in the supervision on a consolidated basis of the institution which is the parent undertaking, and provided that the following conditions are met:</p> <ul style="list-style-type: none"> a. there is no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities by its parent undertaking; b. either the parent undertaking satisfies the competent authority regarding the prudent management of the subsidiary and has declared, with the permission of the subsidiary, that it guarantees the commitments entered into by the subsidiary, or the risks in the subsidiary are of negligible interest; c. the risk evaluation, measurement and control procedures of the parent undertaking cover the subsidiary; and d. the parent undertaking holds more than 50% of the voting rights attached to shares in the capital of the subsidiary or has the right to appoint or remove a majority of the members of the management body of the subsidiary; <p>competent authorities may waive the application of the following obligations:</p> <ul style="list-style-type: none"> a. own funds; b. capital requirements; c. large exposures; d. exposures to transferred credit risk; and e. disclosure by institutions.
7(2)	<p><i>Derogation from the Application of Prudential Requirements on an Individual Basis</i></p> <p>Competent may also exercise the option outlined in 7(1) above where the parent undertaking is a financial holding company or a mixed financial holding company set up in the same Member State as the institution, provided that is it subject to the same supervision as that exercised over institutions.</p>
7(3)	<p><i>Derogation from the Application of Prudential Requirements on an Individual Basis</i></p> <p>For a parent institution in a Member State where that institution is subject to the authorisation and supervision by the Member State concerned, and it is included in the supervision on a consolidated basis, and provided that the following are met:</p>

Article	Summary
	<ul style="list-style-type: none"> a. there is no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment liabilities to the parent institution in a Member State; and b. the risk evaluation, measurement and control procedures relevant for consolidated supervision cover the parent institution in a Member State; <p>competent authorities may waive the application of the following obligations:</p> <ul style="list-style-type: none"> a. own funds; b. capital requirements; c. large exposures; d. exposures to transferred credit risk; and e. disclosure by institutions.
8(1)	<p><i>Derogation from the Application of Liquidity Requirements on an Individual Basis</i></p> <p>Competent authorities may waive, in full or part, the application of the liquidity requirements to an institution and to all or some of its subsidiaries in the Union and supervise them as a single liquidity sub-group provided that the following conditions are fulfilled;</p> <ul style="list-style-type: none"> a. the parent institution on a consolidated basis or a subsidiary institution on a sub-consolidated basis complies with the liquidity obligations; b. the parent institution on a consolidated basis or the subsidiary institution on a sub-consolidated basis monitors and has oversight at all times over the liquidity positions of all institutions within the group or sub-group, that are subject to the waiver and ensures a sufficient level of liquidity for all these institutions; c. the institutions have entered into contracts that, to the satisfaction of the competent authorities, provide for the free movements of funds between them to enable them to meet their individual and joint obligations as they become due; and d. there is no current or foreseen material practical or legal impediments to the fulfilment of the contracts referred to in (c).
8(2)	<p><i>Derogation from the Application of Liquidity Requirements on an Individual basis</i></p> <p>Competent authorities may waive the liquidity requirements, in full or in part, to an institution and to all or some of its subsidiaries where all institutions of the single liquidity sub-group are authorised in the same Member State and provided the conditions specified at 8(1) above are fulfilled.</p>
8(3)	<p><i>Derogation from the Application of Liquidity Requirements on an Individual Basis</i></p> <p>Where institutions of a single liquidity sub-group are authorised in several Member States, the waiver at 8(1) shall only be applied after following the joint decisions on the level of application of liquidity requirement procedure and only to those institutions whose competent authorities agree on:</p> <ul style="list-style-type: none"> a. their assessment of the compliance of the organisation and of the treatment of liquidity risk across the single liquidity sub-group; b. the distribution amounts, location and ownership of the required assets to be held within the single liquidity sub-group; c. the determination of minimum amounts of liquid assets to be held by institutions for which the application of the liquidity obligations will be waived; d. the need for stricter parameters than those set out in the liquidity obligations; e. unrestricted sharing of complete information between the competent

Article	Summary
	<p>authorities; and</p> <p>f. a full understanding of the implications of such waiver.</p>
8(4)	<p><i>Derogation from the Application of Liquidity Requirements on an Individual Basis</i></p> <p>Competent authorities may apply 8(1), 8(2) and 8(3) to institutions which are members of the same institutional protection scheme. Competent authorities shall in that case determine one of the institutions subject to the waiver to meet the liquidity obligations on the basis of the consolidated situation of all institutions of the single liquidity sub-group.</p>
10(1)	<p><i>Waiver for Credit Institutions Permanently Affiliated to a Central Body</i></p> <p>In accordance with national law, competent authorities may partially or fully waive the application of the following obligations:</p> <ul style="list-style-type: none"> a. own funds; b. capital requirements; c. large exposures; d. exposures to transferred credit risk; e. liquidity; f. leverage; and g. disclosure by institutions; <p>to one or more credit institutions situated in the same Member State and which are permanently affiliated to a central body which supervises them and which is established in the same Member State provided the following conditions are met:</p> <ul style="list-style-type: none"> a. the commitments of the central body and affiliated institutions are joint and several liabilities or the commitments of its affiliated institutions are entirely guaranteed by the central body; b. the solvency and liquidity of the central body and of all the affiliated institutions are monitored as a whole on the basis of consolidated accounts of these institutions; and c. the management of the central body is empowered to issue instructions to the management of the affiliated institutions.
10(2)	<p><i>Waiver for Credit Institutions Permanently Affiliated to a Central Body</i></p> <p>Where competent authorities are satisfied with the conditions set out in 10(1) above and where the liabilities or commitments of the central body are entirely guaranteed by the affiliated institutions, the competent authorities may waive the application of the following obligations to the central body on an individual basis:</p> <ul style="list-style-type: none"> a. own funds; b. capital requirements; c. large exposures; d. exposures to transferred credit risk; e. liquidity; f. leverage; and g. disclosure by institutions.
11(3)	<p><i>General Treatment</i></p> <p>Pending a report from the Commission and if a group comprises only investment firms, competent authorities may exempt investment firms from compliance with the liquidity obligations on a consolidated basis, taking into account the nature, scale and complexity of the investment firm's activities.</p>
15(2)	<p><i>Derogation from the Application of Own Funds Requirements on a Consolidated Basis for Groups of Investment Firms</i></p> <p>Competent authorities may waive the capital requirements obligations and the</p>

Article	Summary
	<p>prudential supervision principles if the financial holding companies holds a lower amount of own funds than either of the following:</p> <ul style="list-style-type: none"> a. the sum of the full book value of any holdings, subordinated claims and instruments in investment firms, financial institutions, asset management companies and ancillary services undertakings which would otherwise be consolidated; and b. the total amount of any contingent liability in favour of investment firms, financial institutions, asset management companies and ancillary services undertakings which would otherwise be consolidated; <p>but no lower than the sum of the own funds requirements imposed on an individual basis to investment firms, financial institutions, asset management companies and ancillary services undertakings which would otherwise be consolidated and the total amount of any contingent liability in favour of investment firms, financial institutions, asset management companies and ancillary services undertakings which would otherwise be consolidated.</p>
78(3)	<p><i>Supervisory Permission for Reducing Own Funds</i></p> <p>Where an institution reduces, redeems or repurchases Common Equity Tier 1 instruments in a manner that is permitted under applicable national law and the refusal of the redemption of Common Equity Tier 1 instruments is prohibited by applicable national law, competent authorities may waive the following conditions:</p> <ul style="list-style-type: none"> a. earlier than or at the same time as the reduction, redemption or repurchase, the institution replaces the Common Equity Tier 1 instruments with own funds instruments of equal or higher quality in terms that are sustainable for the income capacity of the institution; or b. the institution has demonstrated to the satisfaction of the competent authority that the own funds of the institution would, following the reduction, redemption or repurchase exceed certain requirements. <p>The competent authority may waive these conditions provided that it required the institution to limit the redemption of such instruments on an appropriate basis.</p>
79(1)	<p><i>Temporary Waiver of Deduction from Own Funds</i></p> <p>Where an institution holds capital instruments or has granted subordinated loans that qualify as Common Equity Tier 1, Additional Tier 1 or Tier 2 instruments in a financial sector entity temporarily and the competent authority deems those holdings to be for the purposes of a financial assistance operation designed to reorganise or save that entity, the competent authority may temporarily waive the provisions on deduction that would otherwise apply to those instruments.</p>
83(1)	<p><i>Qualifying Additional Tier 1 and Tier 2 Capital Issued by Special Purpose Entity</i></p> <p>Where the competent authority considers the assets of the special purpose entity other than its investment in the own funds of the parent undertaking or subsidiary thereof that is included in the scope of consolidation to be minimal and insignificant for such an entity, the competent authority may waive the condition that the only assets of the special purpose entity in its investment in the own funds of a parent undertaking or a subsidiary thereof that can be included fully in the consolidation are Additional Tier 1 instruments and Tier 2 instruments.</p>
84(5)	<p><i>Minority Interest Included in Consolidated Common Equity Tier 1 Capital</i></p> <p>Competent authorities may waive the application of Article 84 (minority interest included in consolidated Common Equity Tier 1 capital) to a parent financial holding company that satisfies all of the following:</p> <ul style="list-style-type: none"> a. its principal activity is to acquire holdings; b. it is subject to prudential supervision on a consolidated basis;

Article	Summary
	<ul style="list-style-type: none"> c. it consolidates a subsidiary institution in which it has only a minority holding by virtue of a control relationship; and d. more than 90% of the consolidated required Common Equity Tier 1 capital arises from the subsidiary institution referred to in point (c) calculated on a sub-consolidated basis.
129(1)	<p><i>Exposures in the Form of Covered Bonds</i></p> <p>After consulting the EBA, competent authorities may partly waive the application of the following requirement:</p> <ul style="list-style-type: none"> a. covered bonds shall be collateralised by exposures to institutions that qualify for the credit quality step 1. The total exposure of this kind shall not exceed 15% of the nominal amount of outstanding covered bonds of the issuing institution. Exposures to institutions in the Union with a maturity not exceeding 100 days shall not be comprised by the step 1 requirement but those institutions shall as a minimum qualify for credit quality step 2. <p>In partially waiving this requirement, the competent authorities will allow credit quality step 2 for up to 10% of the total exposure of the nominal amount of outstanding covered bonds of the issuing institution, provided that significant potential concentration problems in the Member States concerned can be documented due to the application of the credit quality step 1 requirement.</p>
157(5)	<p><i>Risk-Weighted Exposure Amounts for Dilution Risk of Purchased Receivables</i></p> <p>Competent authorities shall exempt an institution from calculating and recognising risk-weighted exposure amounts for dilution risk of a type of exposures caused by purchased corporate or retail receivables where the institution has demonstrated to the satisfaction of the competent authority that dilution risk for that institution is immaterial for this type of exposures.</p>
395(1)	<p><i>Limits to Large Exposures</i></p> <p>Competent authorities may set a lower limit than EUR 150 million for exposures and shall inform the Commission and the EBA thereof.</p>
396(1)	<p><i>Compliance with Large Exposures Requirements</i></p> <p>Where the exposure amount of EUR 150 million is applicable, the competent authorities may allow on a case-by-case basis the 100% limit in terms of the institutions eligible capital to be exceeded.</p>
400(2)	<p><i>Exemptions</i></p> <p>Subject to certain conditions, competent authorities may fully or partially exempt the following exposures:</p> <ul style="list-style-type: none"> a. certain covered bonds; b. asset items constituting claims on regional governments or local authorities of Member States where those claims would be assigned a 20% risk rate and other exposures to or guaranteed by those regional governments or local authorities, claims on which would be assigned a 20% risk weight; c. exposures, including participations or other kinds of holdings, incurred by an institution to its parent undertaking, to other subsidiaries of that parent undertaking or to its own subsidiaries, in so far as those undertakings are covered by the supervision on a consolidated basis to which the institution itself is subject or with equivalent standards in force in a third country; d. asset items constituting claims on and other exposures, including participations or other kinds of holdings, to regional or central credit institutions with which the credit institution is associated in a network in accordance with legal or statutory provisions and which are

Article	Summary
	<p>responsible, under those provisions, for cash-clearing operations within the network;</p> <ul style="list-style-type: none"> e. asset items constituting claims on and other exposures to credit institutions incurred by credit institutions, one of which operates on a non-competitive basis or provides or guarantees loans under legislative programmes or its statutes, to promote specified sectors of the economy under some form of government oversight and restrictions on the use of the loans, provided that the respective exposures arise from such loans that are passed on to the beneficiaries via credit institutions or from the guarantees of these loans; f. asset items constituting claims on and other exposures to institutions, provided that those exposures do not constitute such institutions' own funds, do not last longer than the following business day and are not denominated in a major trading currency; g. asset items constituting claims on central banks in the form of required minimum reserves held at those central banks which are denominated in their national currencies; h. asset items constituting claims on central governments in the form of statutory liquidity requirements held in government securities which are denominated and funded in their national currencies, provided that, at the discretion of the competent authority, the credit assessment of those central governments assigned by a nominated ECAI is investment grade; i. 50% of medium/low risk off-balance sheet documentary credits and off medium/low risk off-balance sheet undrawn credit facilities and subject to the competent authorities' agreement, 80% of guarantees other than loan guarantees which have a legal and regulatory basis and are given for their members by mutual guarantee schemes possessing the status of credit institutions; j. legally required guarantees used when a mortgage loan financed by issuing mortgage bonds is paid to the mortgage borrower before the final registration of the mortgage in the land register, provided that the guarantee is not used as reducing the risk in calculating the risk-weighted exposure amounts; and k. asset items constituting claims on and other exposures to recognised exchanges.
422(9)	<p><i>Outflows on Other Liabilities</i></p> <p>Competent authorities may waive the condition that the institution and the depositor be established in the same Member State for the purpose of determining whether the criteria for specific intragroup treatment are met.</p>
425(5)	<p><i>Inflows</i></p> <p>Competent authorities may waive the condition that the institution and the counterparty be established in the same Member State for the purpose of determining whether the criteria for specific intragroup treatment are met.</p>
429(7)	<p><i>Calculation of the Leverage Ratio</i></p> <p>Competent authorities may permit an institution not to include in the exposure measure exposures that can benefit from the prior approval of the competent authorities to decide not to apply the calculation of risk-weighted exposure amounts to the exposures of that institution to a counterparty which is its parent undertaking, its subsidiary, a subsidiary of its parent undertaking or an undertaking linked by a relationship. Competent authorities may grant the permission only where the following conditions are met:</p>

Article	Summary
	<ul style="list-style-type: none"> a. the counterparty is an institution, a financial institution or an ancillary services undertaking subject to appropriate prudential requirements; b. the counterparty is included in the same consolidation as the institution on a full basis; c. the counterparty subject to the same risk evaluation, measurement and control procedures as the institution; d. the counterparty is established in the same Member State as the institution; and e. there is no current or foreseen material or practical legal impediment to the prompt transfer of own funds or repayment of liabilities from the counterparty to the institution.
429(14)	<p><i>Calculation of the Leverage Ratio</i></p> <p>Competent authorities may permit an institution to exclude from the exposure measure exposures that meet all of the following conditions:</p> <ul style="list-style-type: none"> a. they are exposures to a public sector entity; b. they are exposures to public sector entities treated as exposures to the central government, regional government or local authority in whose jurisdiction they are established where in the opinion of the competent authorities of this jurisdiction there is no difference in risk between such exposures because of the existence of an appropriate guarantee by the central government, regional government or local authority; and c. they are exposures that arise from deposits that the institution is legally obliged to transfer to the public sector entity referred to in (a) for the purposes of funding general interest investments.

Article	Summary
471(1)	<p><i>Exemption from Deduction of Equity Holdings in Insurance Companies from Common Equity Tier 1 Items</i></p> <p>During the period from 1 January 2014 to 31 December 2022, competent authorities may permit institutions to not deduct equity holdings in insurance undertakings, reinsurance undertakings or insurance holding companies where the following conditions are met:</p> <ul style="list-style-type: none"> a. the financial sector entity is an insurance undertaking, a re-insurance undertaking or an insurance holding company; b. the institution has received the prior permission of the competent authorities; c. the holdings in the entity belong to one of the following: <ul style="list-style-type: none"> i. the parent credit institution; ii. the parent financial holding company; iii. the parent mixed financial holding company; iv. the institution; or v. a subsidiary of one of the above entities that is included in the scope of the consolidation; d. the competent authorities are satisfied with the level of risk control and financial analysis procedures specifically adopted by the institution in order to supervise the investment in the undertaking or holding company; e. the equity holdings of the institution in the insurance undertaking, reinsurance undertaking or insurance holding company do not exceed 15% of the Common Equity Tier 1 instruments issued by that insurance entity as at 31 December 2012 and during the period from 1 January 2013 to 31 December 2022; and f. the amount of the equity holding which is not deducted does not exceed the amount held in the Common Equity Tier 1 instruments in the insurance undertaking, reinsurance undertaking or insurance holding company as at 31 December 2012.
473(1)	<p><i>Introduction of Amendments to IAS 19</i></p> <p>During the period from 1 January 2014 until 31 December 2018, competent authorities may permit institutions that prepare their accounts in conformity with the international accounting standards adopted in accordance with the procedure laid down in Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of the international accounting standards to add to their Common Equity Tier 1 capital the applicable amount in accordance with the following:</p> <ul style="list-style-type: none"> a. the applicable amount is calculated by deducting from the sum derived in accordance with point (i) below the sum derived in accordance with point (ii); <ul style="list-style-type: none"> i. institutions shall determine the values of the assets of their defined pensions funds or plans. Institutions shall then deduct from the values of these assets the values of the obligations under the same funds or plans determined according to the same accounting rules; and ii. institutions shall determine the values of the assets of their defined pension funds or plans. Institutions shall then deduct from the values of those assets, the values of the obligations under the same funds or plans determined in accordance with the same accounting rules; b. the amount determined in accordance with (a) shall be limited to the amount not required to be deducted from own funds prior to 1

Article	Summary
	<p>January 2014, under the national transposition of measures under Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, insofar as those national transposition measures would be eligible for the additional filters and deductions treatment in the Member State concerned;</p> <p>the capital applicable amount calculated in accordance with points (a) and (b) is multiplied by the factor applied in accordance with the following:</p> <ul style="list-style-type: none"> a. 1 in the period from 1 January 2014 to 31 December 2014; b. 0.8 in the period from 1 January 2015 to 31 December 2015; c. 0.6 in the period from 1 January 2016 to 31 December 2016; d. 0.4 in the period from 1 January 2017 to 31 December 2017; and e. 0.2 in the period from 1 January 2018 to 31 December 2018.
495(1)	<p><i>Treatment of Equity Exposures Under the IRB Approach</i></p> <p>Until 31 December 2017, the competent authorities may, by way of derogation, exempt from the IRB treatment certain categories of equity exposures held by institutions and EU subsidiaries of institutions in that Member State as at 31 December 2007.</p>
496(1)	<p><i>Own Funds Requirements for Covered Bonds</i></p> <p>Until 31 December 2017, competent authorities may waive in full or in part, the 10% limit for senior units issued by French <i>Fonds Communs de Créances</i> provided that:</p> <ul style="list-style-type: none"> a. the securitised residential property or commercial immovable property exposures were originated by a member of the same consolidated group of which the issuer of the covered bonds is a member, or by an entity affiliated to the same central body to which the issuer of the covered bonds is affiliated, where that common group membership or affiliation shall be determined at the time the senior units are made collateral for covered bonds; and b. a member of the same consolidated group of which the issuer of the covered bonds is a member, or an entity affiliated to the same central body to which the issuer of the covered bonds is affiliated, retains the whole first loss tranche supporting those senior units.
499(3)	<p><i>Leverage</i></p> <p>During the period from 1 January 2014 to 31 December 2017, competent authorities may permit institutions to calculate the end-of-quarter leverage ratio where they consider that institutions may not have data of sufficiently good quality to calculate a leverage ratio that is an arithmetic mean of the monthly leverage ratios over a quarter.</p>
500(5)	<p><i>Transitional Provisions – Basel I Floor</i></p> <p>After consulting the EBA, competent authorities may waive the following requirement:</p> <ul style="list-style-type: none"> a. that, until 31 December 2017, institutions calculating risk-weighted exposure amounts and institutions using the Advanced Measurement Approaches for the calculation of their own funds requirements for operational risk shall hold own funds which are at all times more than or equal to 80% of the total minimum amount of own funds that the institution would be required to hold; <p>provided that all the requirements for the IRB Approach or the qualifying criteria for the use of the Advanced Measurement Approach, as applicable, are met.</p>

Article	Summary
Commission Delegated Regulation (EU) No 241/2014	
30(2)	<p><i>Content of the Application to be Submitted by the Institution for the Purposes of Article 77 (EU) No 575/2013</i></p> <p>The competent authority shall waive the submission of some of the following information where it satisfied that this information is already available to it:</p> <ul style="list-style-type: none"> a. a well-founded explanation of the rationale for reducing or repurchasing Common Equity Tier 1 instruments or calling, redeeming or repurchasing Additional Tier 1 or Tier 2 instruments; b. the information on capital requirements and capital buffers covering at least a three year period, including the level and composition of own funds before and after the performing of the action and the impact of the action on the regulatory requirements; c. the impact on the profitability of the institution of a replacement of a capital instrument; d. an evaluation of the risks to which the institution is or might be exposed and whether the level of own fund ensures an appropriate coverage of such risks, including stress tests on main risks evidencing potential losses under different scenarios; e. any other information considered necessary by the competent authority for evaluating the appropriateness of granting a permission for reducing own funds.

ANNEX 5 – Financial Market Infrastructure: EU Law Carve Outs – National Regulators

The table below sets out a summary of the powers of national competent authorities to waive, vary or otherwise affect implementation of requirements under MiFID II, MiFIR, EMIR and the technical standards published thereunder relevant to FMI.

Annex 5 – Financial Market Infrastructure: EU Law Carve Outs – National Regulators	
Article	Summary
MiFID II	
28(2)	<p><i>Client Order Handling Rules</i></p> <p>Competent authorities may waive the obligation on investment firms to make public a client limit order in respect of shares admitted to trading on a regulated market or traded on a trading venue which are not immediately executed under prevailing market conditions if the client limit order is large in scale compared with normal market size.</p>
MiFIR	
4(1)	<p><i>Waivers for Equity Instruments</i></p> <p>Competent authorities may waive the obligation for market operators and investment firms operating a trading venue to make public certain information including current bid and offer prices for:</p> <ul style="list-style-type: none"> a. systems matching orders based on a trading methodology by which the price of the financial instrument (including shares, depositary receipts, ETFs, certificates and other similar financial instruments) is derived from the trading venue where that financial instrument was first admitted to trading, or the most relevant market in terms of liquidity, where that reference price is widely published and is regarded as a reliable reference price; b. systems that formalise negotiated transactions; c. orders that are large in scale compared with normal market size; and d. orders held in an order management facility of the trading venue pending disclosure.
5(8)	<p><i>Volume Cap Mechanism</i></p> <p>Competent authorities may suspend the use of waivers for equity instruments (which allow market operators and investment firms operating a trading venue to waive the obligation to make public certain information). Competent authorities may suspend such waivers from the date of MiFIR's application (3 January 2018) and thereafter on a monthly basis.</p>
7(1)	<p><i>Authorisation of Deferred Publication</i></p> <p>Competent authorities may authorise market operators and investment firms operating a trading venue to provide for deferred publication of the details of transactions in equity instruments based on their type or size.</p>
9(1)	<p><i>Waivers for Non-Equity Instruments</i></p> <p>Competent authorities may waive the obligation for market operators and investment firms operating a trading venue to make public information such as current bid and offer prices for:</p> <ul style="list-style-type: none"> a. orders that are large in scale compared with normal market size and orders held in an order management facility of the trading venue pending disclosure;

Article	Summary
	<p>b. actionable indications of interest in request-for-quote and voice trading systems that are above a size specific to the financial instrument, which would expose liquidity providers to undue risk and takes into account whether the relevant market participants are retail or wholesale investors;</p> <p>c. derivatives which are not subject to the obligation to trade on regulated markets, MTFs or OTFs and other financial instruments for which there is not a liquid market;</p> <p>d. order for the purpose of executing an exchange for physical; and</p> <p>e. package orders that meet certain conditions.</p>
9(2a)	<p><i>Waivers for Non-Equity Instruments</i></p> <p>Competent authorities may waive the obligation to make public certain information including current bid and offer prices for each individual component of a package order. A package order is an order that is priced as a single unit either for the purpose of executing an exchange for physical or in two or more financial instruments for the purpose of executing a package transaction.</p>
9(4)	<p><i>Waivers for Non-Equity Instruments</i></p> <p>The competent authority responsible for supervising one or more trading venues on which a class of bond, structured finance product, emission allowance or derivative is traded may, where the liquidity of that class of financial instrument falls below a specified threshold, temporarily suspend the pre-trade transparency requirements for trading venues.</p> <p>The specified threshold is defined on the basis of objective criteria specific to the market for the financial instrument concerned. The temporary suspension shall be valid for an initial period not exceeding three months from the date of publication on the website of the relevant competent authority. The suspension may then be renewed for further periods not exceeding three months at a time if the grounds for suspension continue to be applicable.</p>
11(1)	<p><i>Authorisation of Deferred Publication</i></p> <p>Competent authorities may authorise market operators and investment firms operating a trading venue to provide for deferred publication of the details of transactions in non-equity instruments based on the size or type of the transaction.</p>
11(2)	<p><i>Authorisation of Deferred Publication</i></p> <p>The competent authority responsible for supervising one or more trading venues on which a class of bond, structured finance product, emission allowance or derivative is traded may, where the liquidity of that class of financial instrument falls below the threshold, temporarily suspend the post-trade transparency requirements for trading venues.</p> <p>The threshold shall be defined based on objective criteria specific to the market for the financial instrument concerned. The temporary suspension shall be valid for an initial period not exceeding three months from the date of its publication on the website of the relevant competent authority. The suspension may be renewed for further periods not exceeding three months at a time if the grounds for suspension continue to be applicable.</p>
21(4)	<p><i>Post-Trade Disclosure by Investment Firms, Including Systematic Internalisers, in Respect of Bonds, Structured Finance Products, Emission Allowances and Derivatives</i></p> <p>Competent authorities may authorise investment firms to provide for deferred publication of post-trade disclosure, or may request the publication of limited details of a transaction or details of several transactions in an aggregated form, or a combination thereof.</p>

Article	Summary
35(5)	<p><i>Non-Discriminatory Access to a CCP</i></p> <p>Competent authorities may decide that the non-discriminatory access to a CCP provisions do not apply in respect of transferable securities and money market instruments for a transitional period until 3 July 2020 to newly established and authorised CCPs, recognised CCPs or CCPs authorised under a pre-existing national authorisation regime for a period of less than three years on 2 July 2014.</p>
36(4)	<p><i>Non-Discriminatory Access to a Trading Venue</i></p> <p>The competent authority of the trading venue or that of the CCP shall grant a CCP access to a trading venue only where such access:</p> <ul style="list-style-type: none"> a. would not require an interoperability arrangement, in the case of derivatives that are not OTC derivatives pursuant to Article 2(7) of Regulation (EU) No 648/2012; or b. would not threaten the smooth and orderly functioning of the markets, in particular due to liquidity fragmentation and the trading venue has put in place adequate mechanisms to prevent such fragmentation, or would not adversely affect systemic risk.
54(2)	<p><i>Transitional Provisions</i></p> <p>Competent authorities, taking into account the risks resulting from the application of the access rights under Article 35 (non-discriminatory access to a CCP) or 36 (non-discriminatory access to a trading venue) as regards exchange-traded derivatives to the orderly functioning of the relevant CCP or trading venue, may decide that Article 35 or 36 would not apply to the relevant CCP or trading venue, respectively, in respect of exchange-traded derivatives, for a transitional period until 3 July 2020.</p>
Commission Delegated Regulation (EU) 2017/583	
11(1)(b)	<p><i>Transparency Requirements in Conjunction with Deferred Publication at the Discretion of the Competent Authorities</i></p> <p>Competent authorities may, in conjunction with an authorisation of deferred publication of the details of transactions in non-equity instruments, allow the omission of the publication of the volume of an individual transaction for an extended time period of four weeks.</p>
11(1)(c)	<p><i>Transparency Requirements in Conjunction with Deferred Publication at the Discretion of the Competent Authorities</i></p> <p>In respect of non-equity instruments that are not sovereign debt, competent authorities may, in conjunction with an authorisation of deferred publication of the details of transactions in non-equity instruments, allow for an extended time period of deferral of four weeks, the publication of the aggregation of several transactions executed over the course of one calendar week on the following Tuesday before 09.00 local time.</p>
11(1)(d)	<p><i>Transparency Requirements in Conjunction with Deferred Publication at the Discretion of the Competent Authorities</i></p> <p>In respect of sovereign debt instruments, competent authorities may, in conjunction with an authorisation of deferred publication of the details of transactions in non-equity instruments, allow for an indefinite period of time, the publication of the aggregation of several transactions executed over the course of one calendar week on the following Tuesday before 09.00 local time.</p>
16(1)	<p><i>Temporary Suspension of Transparency Obligations</i></p> <p>For financial instruments for which there is a liquid market, competent authorities may temporarily suspend the pre- and post-trade transparency requirements for non-equity instruments where for a class of bonds, structured finance products, emission allowances or derivatives, the total volume for the previous 30 calendar</p>

Article	Summary
	days represents less than 40% of the average monthly volume calculated for the 12 full calendar months preceding those 30 calendar days.
16(2)	<p><i>Temporary Suspension of Transparency Obligations</i></p> <p>For financial instruments for which there is not a liquid market, competent authorities may temporarily suspend the pre- and post-trade transparency requirements for non-equity instruments where for a class of bonds, structured finance products, emission allowances and derivatives, the total volume for the previous 30 calendar days represents less than 20% of the average monthly volume calculated for the full 12 calendar months preceding those 30 calendar days.</p>
EMIR	
11(8)	<p><i>Risk-Mitigation Techniques for OTC Derivative Contracts Not Cleared by a CCP</i></p> <p>An intragroup transaction in relation to a financial counterparty that is entered into by a counterparty which is established in the Union and a counterparty which is established in a third-country jurisdiction shall be exempt totally or partially from the requirement to exchange collateral with respect to OTC derivative contracts on the basis of a positive decision of the relevant competent authority responsible for supervision of the counterparty which is established in the Union provided that the following conditions are fulfilled:</p> <ul style="list-style-type: none"> a. the risk-management procedures of the counterparties are adequately sound, robust and consistent with the level of complexity of the derivative transaction; and b. there is no current or foreseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties.
11(10)	<p><i>Risk-Mitigation Techniques for OTC Derivative Contracts Not Cleared by a CCP</i></p> <p>An intragroup transaction that is entered into by a non-financial counterparty and a financial counterparty which are established in different Member States shall be exempt totally or partially from the requirement to exchange collateral with respect to OTC derivative contracts on the basis of a positive decision of the relevant competent authority responsible for supervision of the financial counterparty provided that the following conditions are fulfilled:</p> <ul style="list-style-type: none"> a. the risk-management procedures of the counterparties are adequately sound, robust and consistent with the level of complexity of the derivative transaction; and b. there is no current or foreseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties.
89(2)	<p><i>Transitional Provisions</i></p> <p>In relation to pension scheme arrangements that are either occupational retirement provision businesses of life insurance undertakings or any other authorised and supervised entities, or arrangements, operating on a national basis that are recognised under national law and whose primary purpose is to provide retirement benefits, competent authorities may grant, until 16 August 2018 exempt the clearing obligation from applying to OTC derivative contracts that are objectively measurable as reducing investment risks directly relating to the financial solvency of the pension scheme arrangements.</p>

ANNEX 6 – Glossary of Terms Used

This table sets out definitions of the key terms and abbreviations used in this book.

Legislation	
AIFMD	Alternative Investment Fund Managers Directive (Directive 2011/61/EU)
BRD	Bank Recovery and Resolution Directive (Directive 2014/59/EU)
Charter	EU Charter of Fundamental Rights
Convention	European Convention on Human Rights
CRD IV	Capital Requirements Directive (Directive 2013/36/EU)
Credit Institution Winding-Up Directive	Directive 2001/24/EC
CRR	Capital Requirements Regulation (Regulation (EU) 575/2013)
CSDR	Central Securities Depository Regulation (Regulation (EU) 909/2014)
EMIR	European Market Infrastructure Regulation (Regulation (EU) 648/2012)
Financial Promotion Order	Financial Services and Markets Act 2000 (Financial Promotion) Order 2005
FSMA	Financial Services and Markets Act 2000
GATS	General Agreement on Tariffs and Trade
IDD	Insurance Distribution Directive (Directive 2016/97)
MiFID I	Markets in Financial Instruments Directive (Directive 2004/39/EC)
MiFID II	Markets in Financial Instruments Directive (Directive 2014/65/EU)
MiFIR	Markets in Financial Instruments Regulation (Regulation (EU) 600/2014)
PSD	Payment Services Directive (Directive 2007/64/EC)
PSD II	Second Payment Services Directive (Directive 2015/2366)
SFD	Settlement Finality Directive (Directive 98/26/EC)
Solvency II	Solvency II Directive (Directive 2009/138/EC)
SSM Regulation	SSM Regulation (Regulation (EU) 1024/2013)
Treaty	Treaty on European Union

Other Definitions	
AIFM	Alternative Investment Fund Manager
AMF	<i>Autorité des Marchés Financières</i>
Basel Committee	Basel Committee on Banking Supervision
BaFin	<i>Bundesanstalt für Finanzdienstleistungsaufsicht</i>
CCP	Central counterparty
Commission	The European Commission
Council	Council of the European Union
DEA	Direct Electronic Access
EBA	European Banking Authority
ECB	European Central Bank
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
Eligible counterparty	Under MiFID I and MiFID II/MiFIR, EU Credit Institutions, EU Investment Firms, insurers, asset managers, funds, other institutional investors, other EU regulated firms, national governments, central banks, supranational organisations and non-EU equivalent regulated entities as well as commodity dealers and large companies consenting to be treated as an eligible counterparty
ESA	European Supervisory Authorities
ESMA	European Securities and Markets Authority
EU	European Union
EU-27	The Member States of the EU post Brexit
EU CCP	A CCP established in the EU-27
Eurex	Eurex Clearing AG
FCA	Financial Conduct Authority
FMI	Financial market infrastructure
FSB	Financial Stability Board
IAIS	International Association of Insurance Supervisors
IOSCO	International Organization of Securities Commissions
Most Favoured Nation Principle	The general principle under GATS that countries cannot grant certain trading partners favourable investment without extending such treatment to all WTO members

MTF	Multilateral Trading Facility
OTC	Over-the-counter
OTF	Organised Trading Facility
Per se professional clients	Under MiFID I and MiFID II/MiFIR, EU Credit Institutions, EU Investment Firms, insurers, asset managers, funds, commodity dealers, other institutional investors, non-EU equivalent entities; national and regional governments, central banks, bodies managing public debts, international and supranational institutions; large companies and other institutional investors whose main activity is to invest in financial instruments including those that mostly securitise assets and finance transactions
PRA	Prudential Regulation Authority
QCCP	Qualifying Central Counterparty
RCCP	A Third Country CCP that is recognised in the EU
ROCH	Recognised overseas clearing house
RTS	Regulatory Technical Standards
SI	Systematic Internaliser
SEPA	Single Euro Payments Area
TARGET2	Trans-European Automated Real-time Gross settlement Express Transfer system
Third country	A country other than the EU-27 post Brexit
Third Country CCP	A CCP established in a third country
UCITS	Undertakings for Collective Investment in Transferable Securities
UK	United Kingdom
UK Institution	A credit institution established and regulated in the UK
US	United States of America
WTO	World Trade Organisation

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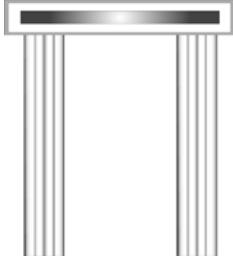
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For the UK's financial services, the goal after Brexit is to ensure that businesses can continue to flourish and grow, trading both with the EU and globally. There are two ways of reaching this goal, and the UK Government needs to keep both in play, says Barnabas Reynolds, the author of *The Art of the No Deal: How Best to Navigate Brexit for Financial Services*. The first option is to pursue free trade, on the basis of mutual recognition of laws and standards (by enhancing the EU's equivalence concept or developing a new method for recognition), and the second is a 'no deal' outcome, preparations for which should also be pursued.

In this volume, Reynolds, who leads his City law firm's global and EU financial regulatory and advisory practice, explains that for the financial sector a no deal outcome has much to recommend it.

With the right preparations the no deal result can bring many benefits, and could be an inexpensive and attractive basis for business. If there were no deal for financial services, businesses currently operating under the EU passport would not need to relocate to an EU capital to serve EU customers, because legal structures and approaches can be adopted to avoid any expensive moves. The author details the ways in which this can be done, taking advantage of the synergies and savings in doing business in the UK's global financial centre. In a checklist addressed to different sorts of business, from insurance and banking to investment business and derivatives, he explains the steps they should now take to avoid moving, prepare for the different contingencies and to provide to EU customers the benefits of the cheapest possible access to capital from the global financial centre in this timezone.

Provided the Government has the right legal framework, the benefits that London enjoys as a leading world financial centre will not be lost after Brexit. The author explains how best the UK Government should proceed and that, with the right legal framework, the gains will be significant for the UK's financial services.

Leaving behind EU civil law with its process-driven regulation, which stifles enterprise, will help the sector as the UK returns to its common law tradition, the principles of which support competition, freedom and markets. Businesses will be in a position to continue servicing financial business across the EU from London. They can also advise on the changes our Government should now make. Such benefits more than outweigh the advantages of the passport, not needed for most cross border transactions, but for which alternative arrangements can be substituted without friction. In these ways the UK, freed from EU rulebook, should be able to move swiftly to introduce a more business-friendly regulation and tax regime.