Transition Brexit – EU in Financial Regulation

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Two significant transition issues

- **Equivalence** of UK regulation with EU regulations as a condition for accessing markets

- **Relocation** and delegation: how secure that UK firms will be present in the EU, as fully engaged entities, and not as “letter box” companies
Equivalence

- **Equivalence:** third countries can only access EU markets if their legal and regulatory regimes are equivalent
- Normally: condition for access by firms
- More widely: condition for distributing products/services
- Inward/ outward equivalence:
  - Inward: UK investment firms in the EU
  - Outward: access of EU orders to regulated markets – CH Swiss Exchange case
  - Sanction: in both cases: UK cut off
- **Transactions violating equivalence requirement:** e.g. clearing on a non-equivalence CCP?
  - Nullity? Depends on national law - variety of systems
  - Disciplinary sanctions: probably yes
Relocation +delegation-outsourcing

• UK firms can **continue to access** the EU markets if they establish a genuine EU financial services firm; especially subsidiaries

• Conditions: are applicable to **all** third country firms + some additional conditions for UK firms - some stricter monitoring

• Main EU concern: **letter box** companies, “brass plate” entities; “empty shell” entities
  • Here delegation and outsourcing are key techniques; but also back-to-back transaction; invoicing centers; reverse solicitation, a.o.
  • Basic concept: you cannot at the same time be in and outside the EU

• Legal basis: existing regulations + ESA interpretations
Choice of law question

• Principles is freedom of choice is upheld: including choice for UK law or any other third country
• Will decisions by UK jurisdictions be executable in the EU.? Agreements on enforcement of judgments may be necessary.
• Arbitration may be the only valid alternative
• Some Member States adopt the use of English language / law in domestic litigation
  • Use of English language in Fr, Nl, Germ if all parties agree
    • Final decision in Dutch, proceedings in English
  • Aachen Cologne Bonn: special chambers
  • The International Chamber of the Paris Commercial court for English – written procedures
    • Lay Judges in French – English- Spanish law
• English common law applies in ICC, HK and Singapore: international arbitration courts

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Preliminary question
Regulatory decisions may affect the free choice of applicable loi

• Pre-Brexit: regulatory decisions are deemed identical in all MS.
  • Same legal basis; often reference to UK law
  • Recourse before the ECJ – binding for all parties
• Generally, EU regulations contain no direct requirement relating to the choice of the applicable law
• Indirect requirements may be due to regulatory – supervisory conditions
• EU Financial supervisors may become hesitant for dealing with business activities based on UK law and impose reference to EU law:
  • For reasons of investor protection: UCITs model
  • For reason of prudential risk assessment and monitoring
  • For reason of systemic risk: See the CCP case.
• 4 Examples
1 - UCITS

• UK UCITS will become Alternative Investment Funds: no direct access for lack of AIFM equivalence
  • the UCITS brand is reserved to EU domiciled funds: few UK UCITS (OEIC-Unit trusts
  • Most UK UCITS located in Ireland or other EU places

• UK asset managers will have to set up subsidiaries in EU for managing copies of UK fund: EU private law will become applicable

• Delegation of asset management to UK parent will be restricted: how much? Depends on justification for delegation.

• Distribution: remains free if subsidiary form; as a branch: limited to one EU state – distribution contract for retail: EU local law.
1- UCITS : Securities depositary’s role and liability

• “Ensure that the sale, issue, repurchase, redemption and cancellation of units of the UCITS are carried out in accordance with the applicable national law and the fund rules or instruments of incorporation”;

• Delegation and subdelegation are allowed but expose the initial depositary to strict liability.
  • Except “External event beyond its reasonable control”
  • Would apply to UK AIF, former UCITS, if allowed for distribution in EU
**2- Investor protection**

• Several restrictions imposed by regulation
  • ESMA role prohibiting/ restricting certain activities for securing orderly functioning or stability of the financial system (article 9)
  • May include exclusive reference to EU law
  • National restrictions for accessing non-EU markets: equivalence test - see trading on non-EU markets

• Prohibitions: strict disclosure regime: e.g., no CfD in some states;
• Standardising derivatives for clearing by EU authorities
  • Reference to EU law + ECJ review may be necessary for euro derivatives
  • But no outright prohibition: more expensive e.g. for banks’ own funds
3- UK Firms’ Access to EU markets

• UK credit institutions prefer subsidiary form: passport
  • Implies choice for EU legal regime in daily operations, governance, risk management and internal models; retail activities: implies reference to EU legal system +ECJ
  • Does not extend to UK produced products or services, especially if recognised as equivalent: e.g. lending, investment banking
  • But use in EU – e.g. for collateral recovery, repos – might imply reference to EU law – also implies ECJ jurisdictions
  • Under Mifid II: article 39: extraterritorial regime for branches – EU law not applicable – EU supervisors not competent
  • Asset management, investment advice, depositary: EU law + ECJ
  • Reverse solicitation, Private placement: under EU law + ECJ for ambit of the regulatory exemption, not for contract itself – restrictions to be expected
4- Resolution

- Will UK resolution decisions be recognised in EU? And EU to UK?
  - Especially for bail-in tool – “contractual regime” would not work
  - EBA: “inherent legal uncertainty caused by Brexit”
  - EU-UK Agreement needed- financial back-up for systemic cases
- Resolution is public order: private law generally set aside
- Some exceptions motivated by other priorities: article 44
  - Liabilities which cannot be bailed-in
Conclusion

• The reference to UK law will not directly be affected by Brexit: free choice of law will be the generally accepted standard

• Indirectly, regulatory pressure will reduce the field where UK law will prevail
  • Mostly in the retail business
  • Affecting supervisory action, i.a. financial stability risks
  • The absence of ECJ review will weaken references to UK law for EU firms

• This is part of the wider issue:
  • Regulatory pressure reduces free decision making, for the choice of law subject, but also for investors’ free choice