

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, NI, 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

Preliminary question

Regulatory decisions may affect the free choice of applicable law

- 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 depository'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 depository 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