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The UK Referendum – Challenges for Europe's Capital Markets

A legal and regulatory assessment

Association for Financial Markets in Europe
www.afme.eu

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Foreword

23 June sees the UK decide on whether to stay in or leave the European Union. The outcome of this once-in-a-generation referendum will shape the direction of Europe's capital markets for years to come.

To help inform the debate, AFME asked the leading law firm Clifford Chance to produce a report 'The UK Referendum: Challenges for Europe's Capital Markets: A legal and regulatory assessment'. This document provides a detailed, fact-based analysis of the issues European capital markets will face in the event of the UK leaving the EU.

In particular, the report focuses on 'passporting', which enable banks in one EU country to provide cross-border services to clients elsewhere in the single market. As the report highlights, in the event of a UK exit, global banks based in the UK would lose their rights as EU firms to 'passport' their services to the rest of the EU under existing legislation, such as MiFID and CRD. Any replacement trade agreement or 'third country' arrangement would have the potential to restrict cross-border trading.

This is a timely report and I would like to thank Clifford Chance for their considerable efforts. The referendum comes at a time when the European Commission is in the process of creating a Capital Markets Union. This project will harness capital markets to channel much-needed investment throughout Europe, creating jobs and growth in the process.

AFME believes that vigorous, integrated capital markets are vital for long-term growth in Europe. We hope that the report provides a solid platform for informed discussion in the run-up to the referendum on the regulatory and legal implications for Europe's capital markets of a decision to leave the EU.

Simon Lewis
Chief Executive
Association for the Financial Markets in Europe

Introduction and executive summary

Introduction

The referendum on the UK's membership of the European Union (EU) raises profound questions for Europe's wholesale capital markets. This paper assesses the legal and regulatory impacts of the exit of the UK from the EU (Brexit) on the EU's wholesale capital markets and the arrangements that might exist or be created to mitigate those impacts in the context of a new relationship between the UK and the C-EU. The assessment focuses on the potential impacts on the wholesale securities and derivatives and banking markets, including asset management. It does not consider the impact on insurance or reinsurance services.

The assessment focuses on the potential impact of the exit of the UK from the EU in the context of legislation specifically relating to financial services. It does not consider other areas, such as taxation, freedom of movement of workers or other cross-sectoral issues, even though these are also significant to intermediaries, investors and issuers and end-users of financial services.

The paper is structured as follows:

- The first section summarises the history of the development of the EU's single market for capital markets business.
- The second section reviews the legal and regulatory mechanisms used to integrate wholesale capital markets in the EU.
- The third section reviews the alternative Treaty frameworks for future cooperation between the UK and the continuing Member States of the EU (C-EU) following the exit of the UK from the EU.
- The final section addresses the extent to which the existing EU financial services legislation and the implementing UK legislation might mitigate the effects of the exit of the UK from the EU on the EU's wholesale financial markets, assuming that no alternative Treaty is agreed and summarises the practical impact that the exit of the UK from the EU might have on market participants..

Executive summary

A vote on 23 June for the UK to leave the EU would result in a radical change in the relationship between the UK and the continuing Member States of the EU (C-EU) which could fracture the integration achieved so far in these markets and forestall the future integration promised by the plans for an EU Capital Markets Union. This paper assesses the legal and regulatory impacts of the exit of the UK from the EU (Brexit) on the EU's wholesale capital markets and the arrangements that might exist or be created to mitigate those impacts in the context of a new relationship between the UK and the C-EU.

The development of the single market for capital markets business

There have been three distinct phases of the development of the EU's single market for capital markets business: the 1992 programme, the EU Financial Services Action Plan ending in 2005 and the continuing EU regulatory response to the global and eurozone financial crises, including the creation of a banking union for the euro area and the recent launch of the programme for Capital Markets Union under the new European Commission appointed in 2014. Each phase has expanded the scope of EU financial regulation and increased the level of harmonisation and integrationof EU capital markets.

Techniques for integrating EU capital markets

Throughout the development of the single market, the process of market integration has been accelerated by EU legislation harmonising legal and regulatory arrangements across the Member States and deepening institutionalised cooperation among EU regulators. However, the EU legislators have also built on this harmonisation and regulatory cooperation to create the most notable feature of the EU single market in financial services: the EU legislation granting banks and investment firms incorporated and authorised in one Member State a "passport" to establish branches in other Member States and, even more importantly, to provide cross-border services to clients and counterparties in other Member States without the need for additional local authorisations. This system of mutual recognition of and reliance on other Member States' regulatory arrangements is reflected in other rights and passports which also facilitate cross-border capital markets business within the EU. These rights are supported by fundamental principles of non-discrimination within the EU.

Passport rights have in particular enabled investment banking intermediaries to concentrate their capital markets business in hubs within the EU, notably in London, from which they provide services to clients and counterparties across the EU, and enabled certain funds business to concentrate in other centres, such as Dublin and Luxembourg.

Treaty alternatives to EU membership

From the perspective of financial services, the Treaty alternatives to UK membership of the EU fall into two main categories:

- *EEA membership:* the UK might seek membership of the European Economic Area (EEA) alongside the three EEA States that are members of the European Free Trade Association (EFTA) (Iceland, Liechtenstein and Norway);

- *Other free trade arrangements:* the UK and the C-EU might rely on multilateral arrangements, such as membership of the World Trade Organisation (WTO) and participation in the General Agreement on Trade in Services (GATS) or seek to negotiate bilateral arrangements, similar to the current arrangement between the Switzerland and the EU or a bespoke free trade agreement (FTA).

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Passport rights have enabled investment banking intermediaries to concentrate business in hubs within the EU
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UK membership of the EEA could preserve many of the key features of the single market in financial services. In principle, the EU single market legislation for financial services should extend across the whole of the EEA. However, in recent years, the process for the application of that legislation in the EEA-EFTA States has stalled as a result of the new powers given to the European Supervisory Authorities (ESAs) in which those EEA States do not participate. In addition, even if this process can be restarted, EEA-EFTA States currently have limited direct influence in the formulation of new EU legislation. This will be of particular concern in the context of wholesale financial markets where significant activity is clustered in the UK.

Other bilateral or multilateral free trade arrangements could achieve significant rights for firms from one contracting State to establish branches or subsidiaries in the other State's territory on terms that give national treatment. However, existing bilateral and multilateral treaties typically confer only limited rights with respect to cross-border services and do not provide anything like the EU passport for those services. Firms in one contracting State conducting cross-border activity with clients or counterparties in another can still face licensing requirements, even when dealing with clients or counterparties that are not retail investors. In any event, the contracting States reserve the right to regulate, i.e. the right to adopt or maintain measures for prudential reasons, including for investor protection or financial stability reasons. Even non-discriminatory licensing requirements can constitute an effective barrier to cross-border business, as they may require business to be conducted in a local branch or subsidiary or may impose capital or other requirements which duplicate or conflict with home state requirements.

The dynamic nature of financial services regulation makes it difficult to lock in rights of access while preserving the contracting States' right to regulate. Therefore, it is likely to be difficult to rely on bilateral or multilateral free trade arrangements to preserve the cross-border market access that exists today within the single market.

Impact of Brexit under existing financial services legislation

In recent years, EU legislation has increasingly incorporated "third country regimes" which allow non-EU entities market access to the EU, usually on condition that they are authorised in a State which has a regulatory regime equivalent to that in the EU and which provides an effective reciprocal mechanism offering access to EU firms. These mechanisms could provide an important means of mitigating the impact of the exit of the UK from the EU on continued cross-border business by UK and C-EU firms, because - at least at the outset following the UK's exit - the UK could ensure that its regulatory regime is equivalent to the regime in the C-EU by maintaining its existing regulatory regime implementing EU laws. Conversely, the UK could offer reciprocal access to EU firms.

In particular, the EU Markets in Financial Instruments Directive and Regulation (MiFID2/MiFIR) include a new arrangement which could allow non-EU firms from an equivalent jurisdiction a "third country entity passport" to provide cross-border investment services to "per se" professional clients and eligible counterparties across the EU. If activated this arrangement could significantly mitigate the impact of the exit of the UK from the EU on cross-border investment banking and asset management business between the UK and the C-EU. Other similar regimes could also at least partially mitigate other impacts, for example, on trading venues, central counterparties (CCPs), central securities depositories (CSDs) and other actors and activities.

Many of these third country regimes are as yet untested and there is a risk that political constraints may make it more difficult for the C-EU to extend their benefits to the UK as a close neighbour and significant competitor (and a former Member State of the EU) – especially if the UK seeks to abandon or alter other aspects of inherited EU legislation. There is likely to be a long period of uncertainty after the referendum vote before it is clear whether or not these regimes will be available to UK firms.

In addition, these regimes are largely conditioned on equivalence and effective reciprocity and, therefore, the UK may lose the benefits of these regimes unless it is prepared to maintain its existing regulatory regime implementing EU laws and to adapt its laws to reflect new EU laws as they develop over time - even though it would no longer have a direct means of influencing the development of those laws. In the past, EU laws have often imposed requirements going beyond minimum international standards and the UK may no longer be willing to accept this. In any event, the C-EU legislators would be able at any time unilaterally to amend or withdraw these regimes Therefore, in the longer term, these regimes may not provide a stable mechanism protecting market access if the UK and the C-EU take increasingly divergent approaches to regulation.

Moreover, these regimes do not cover all services and activities. For example, they do not cover firms' rights to access market infrastructure, lending, deposit-taking, foreign exchange or other banking services falling outside the scope of MiFID2/ MiFIR, payment services or retail investment services (including private wealth business). Future C-EU legislation may also extend the scope of the regulatory regime in ways that do not include corresponding protection for third countries. In addition, the Treaty and other protections under EU law against discrimination on the basis of location or currency would no longer apply to the UK.

Of course, the C-EU would have an interest in securing corresponding cross-border access to the UK market for its firms. However, the UK has traditionally had a reasonably open approach to cross-border business. In practice, it is more difficult for an international financial centre to restrict cross-border activity into its markets as this can simply deter clients and counterparties from seeking to use the services of actors in the financial centre.

Investment banking services, corporate banking, private wealth management and financial market infrastructure are most likely to be affected by restrictions on cross-border activity. In contrast, the impact on asset managers will depend on their particular business model. Issuers and investors may be affected if investment banking or asset management intermediaries are subject to new restrictions in the services that they can provide.

Even if it is possible to mitigate a large part of the immediate impact of the exit of the UK from the EU, changes to law or regulation over time in the UK and the C-EU could adversely affect the harmonised legal framework existing at the outset and put at risk the continued availability of equivalence determinations that help make the market work. In the longer term, it will be difficult to sustain the single market in the way that it operates today.

Key passport and mutual recognition regimes for capital markets

The following table summarises where, under existing EU legislation, EU firms or products benefit from a passport or mutual recognition regime that may cease to apply if the UK exits the EU and whether there is an existing third country regime available to equivalent non-EU firms or products that might mitigate the impact of that exit.

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The C-EU would have an interest in securing corresponding cross-border access to the UK market for its firms
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Legislation	Type of EU firms/ products	Passport right/mutual recognition	Third country regime for non-EU equivalent
MiFID2/MiFIR	Investment firms	Cross-border provision of investment services	Yes but only for wholesale clients and counterparties*
	Investment firms	Establishment of branches to provide investment services	Optional for Member States*
	Investment firms	Right to remote membership of market infrastructure	No
	Trading venues	Right to provide terminals on Member State territory	No
	Trading venues	Permitted execution venue for shares and OTC derivatives subject to trading mandate	Yes*
	Trading venues, CCPs	Non-discriminatory access to trading venues, CCPs, benchmarks	Yes*
	Data services providers	Single authorisation for EU	No
CRD	Banks	Cross-border provision of banking and investment services	No for banking services. See MiFID2/MiFIR for investment services
	Banks	Establishment of branches to provide banking and investment services	No for banking services. See MiFID2/MiFIR for investment services
EMIR	CCPs	Single authorisation for EU	Yes
	Trade repositories	Single registration for EU	Yes*
	CCPs, trading venues	Rights of non-discriminatory access to each other	No but see MiFID2/MiFIR
CSDR	Central securities depositories	Cross-border provision of services and branches	Yes*
Prospectus Directive	Prospectuses	Prospectus approved in a Member State can be used across EU	No
UCITS Directive	UCITS funds	Distribution in other Member States	No
	UCITS management companies	Cross-border provision of management and advisory services (and branches)	No
AIFMD	AIFMs	Can market EU AIFs across EU	No
	AIFMs	When "switched on", can market non-EU AIFs across EU	Yes*
	AIFMs	Cross-border provision of management and advisory services (and branches)	No
CRA Regulation	Credit rating agencies	Single registration for EU	Yes but may require an EU affiliate to endorse
Benchmark Regulation	Benchmark administrators	Single authorisation/ registration for EU	Yes*
CI(WUD)	Banks, some investment firms	Home state insolvency regime applies in other Member States	No
BRRD	Banks, some investment firms	Recognition of resolution action in other Member States	Yes*
SFD	Settlement systems	Protection from insolvency law in other Member States	No
Brussels Regulation	Judgments in a Member State	Enforceable in other Member States	No

* New regime, no examples of use to date

1. The development of the single market for capital markets business

1. The development of the single market for capital markets business

This section summarises the history of the development of the EU's single market for capital markets business. There have been three distinct phases of development:

- the 1992 Programme;
- the EU Financial services Action Plan ending in 2005; and
- the continuing EU regulatory response to the global and eurozone financial crises, including the creation of a banking union for the euro area and the recent launch of the programme for Capital Markets Union under the new European Commission appointed in 2014.

Each phase has expanded the scope of EU financial regulation and increased the the level of harmonisation and integration of EU capital markets.

The 1992 Programme

The Treaty of Rome – the founding treaty of the European Economic Community which became the EU - provided that:

"the Community shall have as its task, by establishing a common market and progressively approximating the economic policies of member states, to promote through the Community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an accelerated rising of the standard of living and closer relations between the states belonging to it"[1]

While the Community took significant steps to increase trade between Member States, there were still many barriers in place between them which prevented it from being a cohesive and competitive integrated marketplace. In 1985, Lord Cockfield presented a White Paper on behalf of the European Commission to the European Council on "Completing the Internal Market", which set out principles of mutual recognition and legislative harmonisation. It proposed 279 specific legislative measures to be brought into force by 1992, along with a raft of changes to the Treaty of Rome in order to advance the completion of the Internal Market. These changes were aimed at the removal of thousands of incompatible and divergent national regulations.

The Single European Act, which came into force in 1987, committed the EU to creating a functional Internal Market as described in the White Paper on Completing the Internal Market. This endeavour became known as the "1992 Programme".

The 1992 Programme was formally completed on 31 December 1992, by which time almost all of the original 279 measures provided for in the White Paper on Completing the Internal Market had become law.

In parallel to the 1992 Programme, the jurisprudence concerning the Internal Market was also developed through a number of important judgments of the Court of Justice of the European Union, building on the famous *Cassis de Dijon*[2] case which legally reinforces the principle of mutual recognition, having concluded that full harmonisation was not required for movement towards an internal market in all circumstances, particularly in respect of services.[3]

In the context of financial services, the 1992 Programme coincided with other developments which reinforced the importance of the measures taken to liberalise the internal market for capital market services.

1 European Union, Treaty Establishing the European Community (Consolidated Version), Rome Treaty, 25 March 1957, Article 2.

2 Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein (Cassis de Dijon) (Case 120/78) [1979] ECR 649.

3 See Case 427/85 *Commission v Germany* [1988] ECR 1123, Case 292/86 *Claude Gullung v Conseil de l'ordre des avocats du barreau de Colmar et de Saverne* [1988] ECR 111, and Case C-294/89 *Commission v France* [1991] ECR I-3591.

Exchange and capital controls can perform many of the same regulatory functions for financial markets as conventional prudential and market supervision and create significant barriers to cross-border capital markets activity. The UK abolished its exchange controls in 1979 and the remaining controls in the rest of the EU were gradually dismantled over the period of the 1992 Programme. The Council adopted a capital liberalisation directive in 1988, providing for the removal of all remaining exchange controls by mid-1990 for most of those countries maintaining this mechanism (subject to some transitional for Spain, Ireland, Portugal and Greece). As part of the drive towards Economic and Monetary Union, the freedom of capital movements gained the same status as the other Internal Market freedoms with the entry into force of the Maastricht Treaty. From 1 January 1994 not only were all restrictions on capital movements and payments between EU Member States prohibited, but so were restrictions between EU Member States and third countries. By the end of the 1992 Programme there had been a clear shift – not only in the EU, but also throughout other developed countries in the international financial system – to the increased use of prudential and markets supervision as a means for States to maintain control over their financial markets.

In addition, a number of Member States started on the long process of re-regulating capital markets business. The UK "Big Bang" and the Financial Services Act 1986 created an entirely new regulatory regime for capital markets business. In other countries, new legislation was somewhat less benign to cross-border activity. In particular, the Italian "SIM law" effectively required the securities intermediation services to be offered in Italy through an Italian incorporated and licensed entity (the Court of Justice declared this law contrary to the Treaty in 1996).[4]

The early EU measures established the framework for a system of passports for products and activities within the internal market for financial services. Under this framework, EU legislation harmonises minimum key elements of the conditions for the conduct of a particular activity and creates a system for cooperation between national supervisors in relation to supervision and enforcement. On that basis, each Member State is required to recognise the authorisations or approvals given to entities or financial products in other Member States and to allow those entities to conduct business, or to allow the offer of those products, in its territory without imposing its own requirements for authorisation or approval. Early examples of this system of minimum harmonisation, regulatory cooperation and mutual recognition included frameworks facilitating the cross border marketing of undertakings for collective investment in transferable securities (UCITS), the cross-border use of prospectuses for public offers of securities and the establishment of branches and the provision of cross-border services by banks and investment firms.

The Financial Services Action Plan

The 1992 Programme still left many barriers to the integration of EU financial markets and there were still significant weaknesses in the passports that had been created. The planned launch of the euro in 1999 gave renewed impetus to the creation of an internal market in financial services as a necessary counterpart to the single currency.

The 1998 Cardiff European Council called upon the European Commission:

"to table a framework for action... to improve the Internal Market in financial services, in particular examining the effectiveness of implementation of current legislation and identifying weaknesses which may require amending legislation".[5]

The Commission's response was set out in its 1999 paper, "Implementing the Framework for Financial Markets for Financial Markets: Action Plan",[6]which would later form the basis for its Financial Services Action Plan. This aimed to achieve four strategic market objectives:

- A single EU wholesale market – to provide for cheaper and more flexible financing arrangements for corporate borrowers and to remove legal and administrative barriers to creating EU-wide capital markets.

- Open and secure retail markets – to address the conditions under which financial products are sold to allow cross-border trading to flourish and to roll back unjustified conduct of business rules.

4 Case C-101/94, *Commission v Italy* [1996] ECR I-2691

5 Cardiff European Council of 15 and 16 June 1998, Presidency Conclusions, SN 150/1/98 REV 1.

6 COM(1999) 232, 11 May 1999.

- Prudential rules and supervision – to set rigorous standards for the EU financial sector, the development of EU-wide supervisory standards and identification of risks and mitigations of such risks as part of EU-wide rules and supervisory practices.

- Wider conditions to create an optimal single financial market – covering a range of issues from addressing disparities in tax treatment of financial services to promoting efficient and transparent systems of corporate governance.

To achieve these objectives, the Commission proposed 42 legislative and non-legislative measures which were largely adopted over the period to 2005. These included a range of measures in respect of wholesale markets:

- A new framework for the regulation of investment firms and markets in financial instruments (the Markets in Financial instruments Directive – MiFID) and harmonised rules on insider dealing and market manipulation.

- New rules for prospectuses and transparency obligations for listed companies, including the use of international financial reporting standards and more harmonised rules on prospectuses.

- Revisions to the UCITS directive.

- Consolidation and revision of the legislation on bank prudential supervision, including the implementation of the Basel II framework, and new rules on financial conglomerates.

- Harmonisation of rules related to the exchange of financial collateral, provisions to enhance the finality of settlement of securities and derivatives transactions and provisions on the winding up and reorganisation of banks (and insurance companies) to allow mutual recognition of these proceedings.

- Legislation on takeovers, company law and pensions.

- A new anti-money laundering directive.

However, the early stages of the Financial Services Action Plan had revealed weaknesses in the processes for the adoption and implementation of EU legislation. There had been concerns that the process for adoption of legislation was too slow and inflexible and that legislation was implemented in different ways across the Member States. At the request of the Council of the EU, a committee chaired by Alexandre Lamfalussy produced a report in 2001 recommending a new regulatory approach for legislation in the financial sector:

- Level 1 is the adoption of framework legislation by the European Parliament and Council of the EU. This legislation should set out the principles and conceptual framework but leave the detailed technical implementation to Levels 2 and 3. The legislation should be based on improved consultation.

- Level 2 envisaged that Level 1 legislation would be supplemented by detailed implementing measures adopted by the European Commission, advised by three new advisory committees (eventually established in 2004). These implementing measures would address technical details but should not make substantive political decisions.

- Level 3 envisaged improved cooperation and coordination in the implementation of EU legislation, in particular that the advisory committees would issue non-binding guidance to facilitate the consistent implementation of legislation in the Member States, effective cooperation between national supervisory authorities and convergence of their practices.

- Finally, Level 4 is enforcement of compliance with EU law, which is the primary responsibility of the European Commission.

This framework was influential in the eventual structure of many of the measures finally adopted under the Financial Services Action Plan, including MiFID and other directives.

Post-crisis regulation and reform

The 2008 global economic crisis and the eurozone crisis that followed triggered a renewed focus on financial sector regulation and reform. These have involved major changes to the institutional structure of supervision of firms and markets within the EU and regulatory cooperation, as well as significant legislative initiatives on the regulation of firms and markets, many but not all of which have been based on G20 initiatives.

The new European System of Financial Supervision

In October 2008, at the height of the financial crisis, the European Commission convened a group of experts, chaired by Jacques de Larosière, to analyse how the regulatory structure in the EU could be improved in response to the crisis. The group's report in 2009[7] concluded that the EU needed better coordination of both macro- and micro-prudential regulation to establish a more efficient, integrated and sustainable European system of supervision and also to reinforce cooperation between European supervisors and their international counterparts.

The report's recommendations resulted in the creation of a European Systemic Risk Board (ESRB) to act as a macro-prudential supervisory body, analysing information on the macro-prudential situation and monitor risk in all financial sectors and passing warnings and recommendations to micro-prudential supervisors to take action to mitigate those risks.

It also resulted in the creation of the European System of Financial Supervision (ESFS), involving the ESRB and national supervisors working with three new European Supervisory Authorities (ESAs): the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA). The ESAs were established in 2010 to replace the three former advisory committees created following the Lamfalussy report. At the same, the EU created a new Joint Committee of the ESAs to coordinate their work.

European Supervisory Authorities

The ESAs play a significant role in the new post-crisis regulatory and supervisory framework. Their responsibilities include:

- Developing draft proposals for technical standards under the Level 1 legislation adopted by the European Parliament and the Council of the EU. These are drafted by the ESAs and submitted to the European Commission for adoption. The ESAs also provide technical advice to the Commission on delegated and implementing regulations and directives where the Level 1 legislation gives the drafting lead to the Commission.

- Contributing to the consistent application of EU legislation and common supervisory practices. To this end, the ESAs can issue guidelines and recommendations and take other steps to coordinate implementation of EU legislation, e.g. through peer reviews and through published questions and answers (Q&A) on the application of the legislation.

- Investigating alleged failures by national supervisors to comply with or implement EU law. The ESAs can initiative investigations themselves or at the request of other institutions. The European Commission retains responsibility for enforcement but in some instances the ESAs may address individual decisions to market participants to address the non-compliance.

- Facilitating exchange of information and agreement between national supervisors, including by participation in colleges of supervisors. The Level 1 legislation may give the ESAs authority to provide binding mediation of disagreements between national supervisors in particular cases.

- Exercising direct supervisory powers where this is specified in the Level 1 legislation: currently ESMA directly supervises credit rating agencies and trade repositories.

- Co-ordination and some decision-making in emergency situations.

7 The High Level Group on Financial Supervision in the EU, 25 February 2009.

Banking Union

The eurozone crisis that followed the global financial crisis demonstrated that fragmentation of the banking sector could threaten the integrity of the single currency and the internal market. In particular, there were concerns about the need to break the negative feedback loop between weak banks and sovereigns by improving the supervision of euro area banks. The EU's response was to establish a Banking Union comprising the following elements:

- A Single Supervisory Mechanism (SSM) to ensure that the supervision of banks in the euro area is equally effective in reducing the probability of bank failures and preventing the need for intervention by deposit guarantee schemes or resolution funds. The European Central Bank (ECB) assumed direct and indirect supervision of some 6,000 banks in the euro area on 4 November 2014.

- A Single Resolution Mechanism (SRM), with the aim of ensuring the orderly winding-down of non-viable institutions, thereby protecting taxpayer funds. The Brussels-based Single Resolution Board (SRB) became operational on 1 January 2016 tasked with operating as the single resolution authority for the principal banks within the SSM, backed by a progressively mutualised single resolution fund based on contributions by banks.

- In November 2015, the European Commission put forward a proposal for a single European Deposit Insurance Scheme (EDIS) to strengthen the credibility of the existing deposit insurance arrangements within the SSM, initially operating by providing reinsurance to national schemes.

The Banking Union is open to participation by non-euro area Member States of the EU which establish "close cooperation" with the ECB so that their banks are supervised by the SSM (these participating Member States have a seat on the ECB's Supervisory Board, but not its Governing Council).

The post-crisis legislative programme

The crisis also set in train a series of legislative initiatives to address weaknesses in financial sector regulation. In relation to wholesale capital markets, the measures included:

Market regulation

- Replacement of MiFID with a new Directive and accompanying Regulation on markets in financial instruments (MiFID2/MiFIR).

- New rules on insider dealing and market manipulation, replacing the current directive with a new Regulation and a directive on criminal sanctions.

- A new regulation on short selling and credit default swaps.

- New rules for credit rating agencies, now embodied in a regulation.

- A new regulation on securities financing transactions and transparency of rights of reuse of collateral.

- New transparency obligations for issuers and investors in companies.

- A recently agreed regulation on financial benchmarks.

Derivatives and market infrastructure

- A regulation on OTC derivatives clearing, reporting and risk mitigation and central counterparties.
- A regulation on central securities depositories.

Asset management and funds

- A directive on alternative investment funds (AIFMD).
- A revision of the UCITS directive.
- Creation of a regime for European Social Entrepreneurship Funds, European Venture Capital Funds and European Long-term Investment Funds.
- A proposed regulation on money market funds.

Prudential regulation

- A new directive and regulation replacing the existing legislation for banks and implementing Basel III.
- A new framework for the recovery and resolution of banks and investment firms.
- A proposed regulation on the structural reform of banks.

Other

- New anti-money laundering legislation.
- Changes to the audit framework.

Capital Markets Union

The appointment of the new European Commission in 2014 marked the beginning of a new focus on EU capital markets for all Member States in the EU. The Commission aims to develop a more diversified funding system complementing bank financing, to unlock capital in Europe and internationally and put it to work in the economy and to establish a single capital market in the EU where investors and issuers can access opportunities irrespective of location. The immediate steps are legislative proposals to improve the rules on prospectuses and securitisation. In addition, the Commission will work with Member States and the ESAs on the need for a coordinated approach to debt raising by private placement. Other work streams include venture capital funds, crowd funding, access of small and medium sized enterprises to public markets, bond market liquidity and corporate insolvency.

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The appointment of the new European Commission in 2014 marked the beginning of a new focus on EU capital markets
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2. Techniques for integrating EU capital markets

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This section reviews the legal and regulatory mechanisms used to integrate wholesale capital markets in the EU.

Throughout the development of the single market, the process of market integration has been accelerated by EU legislation harmonising legal and regulatory arrangements across the Member States and deepening institutionalised cooperation among EU regulators. However, the EU legislators have also built on this harmonisation and regulatory cooperation to create the most notable feature of the EU single market in financial services: the EU legislation granting banks and investment firms incorporated and authorised in one Member State a "passport" to establish branches in other Member States and, even more importantly, to provide cross-border services to clients and counterparties in other Member States without the need for additional local authorisations. This system of mutual recognition of and reliance on other Member States' regulatory arrangements is reflected in other rights and passports which also facilitate cross-border capital markets business within the EU. These rights are supported by fundamental principles of non-discrimination within the EU.

Passport rights have in particular enabled investment banking intermediaries to concentrate their capital markets business in hubs within the EU, notably in London, from which they provide services to clients and counterparties across the EU, and enabled certain funds business to concentrate in other centres, such as Dublin and Luxembourg.

Harmonisation of laws

The previous section of this paper illustrates the extent to which EU legislation has shaped and continues to shape the legal and regulatory landscape within which the capital markets operate in the EU. The "single rulebook" now covers most areas of capital market regulation, including the prudential and conduct requirements for intermediaries, market infrastructure and other service providers, market structure, the rules for marketing and trading of securities, derivatives and funds, reporting requirements for intermediaries and investors and rules dealing with the failure or insolvency of key market participants.

The harmonisation or convergence of rules reduces differences between legal and regulatory regimes and thus in itself reduces or eliminates barriers and frictions to the operation of a single market. Market participants operating in different Member States can operate on the same or similar rules leading to more competitive equality. In addition, the existence of an EU legislative work stream often leads Member States or national supervisors to abandon or at least delay corresponding national initiatives that might have increased divergence between Member States (although sometimes Member States seek to "front run" EU initiatives with their own proposals with the aim of shaping the outcome). In many cases, the EU legislation will represent the EU implementation of international standards or initiatives, enabling market participants to operate on the basis of a single solution within the EU rather than multiple outcomes.

This harmonisation may be at a cost to market participants when the legislative or regulatory choice results in more burdensome regulation than that which might have been adopted independently by different countries. While many EU legislative initiatives are based on international standards or initiatives, on a number of occasions the EU legislators have chosen outcomes that go beyond or depart from international standards. Conversely, in some cases, Member States and their supervisors may have concerns that EU legislation constrains their ability to regulate as they see appropriate.

The level of harmonisation has significantly increased over recent years, in particular following the financial crisis, as a result of:

- The increasing volume and scope of the legislative framework at the EU level.
- In line with the recommendations of the de Larosière report, the increasing use of directly applicable Level 1 regulations instead of or accompanying directives and the increasing level of detail within directives, leaving less discretion to Member States as to the manner of implementation.
- A move away from minimum harmonisation of key elements of national regimes towards full or maximum harmonisation, in particular where the Level 1 legislation creates a new framework for the regulation of particular activities where few, if any, Member States have existing regimes (e.g., in the area of OTC derivatives, credit rating agencies or financial benchmarks).
- The reduction in the number of explicit national options or discretions within Level 1 legislation.

- The increasing inclusion of "third country regimes" in Level 1 legislation, specifying how the legislation must be applied in relation to cross-border activity involving non-EU entities or products, instead of leaving this to Member States to determine.

- As envisaged by the Lamfalussy report, the provision within Level 1 legislation for the creation of Level 2 rules specifying the detailed application of the Level 1 legislation - these may be in the form of regulatory or implementing technical standards drafted by the ESAs (which take the form of regulations adopted by the European Commission) or delegated or implementing regulations, directives or decisions adopted directly by the European Commission.

- Increased levels of Level 3 coordination of implementation, in the form of Q&A, guidelines, recommendations and other measures, thus reducing the scope for divergent national treatments or at least making differences of approach more transparent (e.g., as a result of national supervisors being required to provide an explanation if they do not comply with ESA guidelines or recommendations).

- Increasing harmonisation of the processes for supervision and enforcement of rules, including common forms, reporting templates and even the minimum powers that national supervisors must have in relation to supervision, investigation and enforcement as well as (more recently) the minimum type and level of sanctions and penalties that can be applied in the event of non-compliance.

- The responding shift by Member States to rely on EU law and not to add or overlay national regimes (and where implementing directives to "copy out" EU rules) and to rely on EU level interpretations of relevant rules.

Even though many national differences remain, this level of coordination does not have a ready parallel elsewhere. Even where other States are implementing agreed international standards, the form and content of rules differs markedly, particularly in the area of capital markets regulation where different States have different legislative, regulatory and supervisory arrangements and histories.

Institutionalised regulatory cooperation

The increasing harmonisation of capital markets rules through the “single rulebook” still leaves supervision and enforcement largely in the hands of national supervisors. However, the EU legislative framework increasingly provides a binding institutional framework for cooperation between national supervisors. This differs from the essentially voluntary frameworks for international cooperation between regulators in other States (or between the EU and other States), which largely rely on non-binding co-operation agreements or memoranda of understanding, voluntary participation in colleges of supervisors and other non-binding bilateral or multilateral arrangements.

The EU legislative framework for capital markets includes the following elements (the nature and scope of the provisions varies according to the individual legislative act):

- Obligations on national supervisors to cooperate with the ESAs and each other, including obligations to cooperate in investigation, supervision and enforcement activities (such as assistance for onsite inspections or investigations).

- Obligations on national supervisors to provide information to the ESAs and each other, in some cases subject to limited reasons for refusal. This may be in response to a request or in some cases may involve requirements to collect and distribute to other relevant national supervisors particular kinds of supervisory information (e.g., transaction data) or to volunteer information in some cases, e.g. about suspicions of non-compliance by relevant firms or when emergency situations arise.

- Obligations on national supervisors to notify or consult with the ESAs or each other before taking certain actions (in some cases, with prescribed time frames to allow a time to respond).

- Binding rules as to the allocation of supervisory responsibilities (e.g., for consolidated supervision within groups or group-wide resolution authority).

- Binding rules requiring joint supervisory decisions on certain matters and rules governing what happens in the event of disagreement.

- Obligations on supervisors to agree coordination and cooperation arrangements for supervision.
- Obligations to use standard forms, templates or procedures specified in technical standards when cooperating in supervisory activities, on-site verification and investigations.
- Obligations on national supervisors to form colleges of supervisors involving supervisors from other Member States, with rules as to the operation of those colleges and the powers and rights of members in the event of disagreements.
- Provisions for binding mediation by an ESA in the event of disagreements between national supervisors on particular issues, allowing the ESA to substitute its decision for that of the relevant national supervisor.
- Mandatory protection for supervisory information shared between supervisors, including rules on disclosure or the type of use of the information.
- Requirements to notify the relevant ESA of sanctions or enforcement measures taken under the Level 1 legislation.
- Obligations to publish information about supervisory practices or arrangements.
- Requirements for the use of centralised information facilities, such as trade repositories, to gather reporting information, with national supervisors relying on rights of access conferred by the legislation.
- Procedures regulating the taking of decisions in emergency situations, including giving powers to ESAs to take such action.
- Rules centralising the powers to make decisions about the equivalence or other treatment of non-EU entities or situations either with the European Commission or the ESAs.

The ESAs themselves and the ESFS as a whole represent an institutional shift towards cooperation in policy making and supervision. In addition, supervision of credit rating agencies and trade repositories is centralised with ESMA and in the context of Banking Union supervision and resolution powers are centralised with the ECB and the SRB.

Passporting and mutual recognition

According to the case law of the European Court of Justice:

"the freedom to provide services may be limited only by provisions which are justified by imperative reasons relating to the public interest and which apply to all persons or undertakings pursuing an activity in the State of destination, in so far as that interest is not protected by the rules to which the person providing the services is subject in the Member State in which he is established. In particular, those requirements must be objectively necessary in order to ensure compliance with professional rules and to guarantee the protection of the recipient of services and they must not exceed what is necessary to attain those objectives"[8]

The progressive harmonisation of EU legislation and the institutionalisation of regulatory cooperation have allowed the EU legislators to build on these principles and to create a framework for mutual regulatory reliance within the EU in the form of the "passports" for financial services. These passports require each Member State to recognise the authorisations or approvals given to entities or products in other Member States and to allow those entities to conduct business, or to allow the offer of certain products, in its territory without imposing its own requirements for authorisation or approval. In effect, each Member State relies on the others to supervise and enforce the conditions for authorisation or approval.

8 Case C-76/90 *Säger v Dennemeyer & Co Ltd* [1991] ECR I-4211.

Subject to the third country regimes discussed in section 4 below, these passporting and mutual recognition regimes are generally only available to EU entities and products. In particular, non-EU entities do not benefit from the passports given to legal entities, even if operating through a branch in the EU (but see below in relation to the new third country regime under MiFID2/MiFIR).

The most notable examples are the provisions of the Capital Requirements Directive (CRD)[9] and MiFID (and from 2018, MiFID2/MiFIR)[10] that give banks and investment firms incorporated and authorised in one Member State (the home state) the right to establish branches and conduct cross-border business with clients and counterparties in other Member States (host states) without the need for additional local authorisation in those States.[11] The CRD passport covers a broad range of deposit-taking, credit and other banking business as well as securities and derivatives business while the MiFID passport is restricted to securities and derivatives business. However, both cover the core elements of the business of capital markets intermediaries including the reception and transmission and execution of client orders, dealing on own account, investment management and advice, underwriting and placing and the operation of trading platforms in relation to securities and derivatives, as well as the related ancillary services of custody, margin credit, foreign exchange, corporate finance advice and investment research services.

The right to establish branches is subject to the bank or investment firm providing prior notice to its home state supervisor which passes the notice to the host state supervisor(s). The home and host supervisors can only object to the establishment of the branch in limited circumstances. Prudential and related regulation, including recovery and resolution planning, remains the province of the home state, although there are mandatory requirements to consult host state supervisors in relation to certain matters affecting significant branches.[12] The host state supervisor can only impose a limited range of conduct requirements under MiFID in relation to securities and derivatives business conducted through a branch.[13] Bank branches may be subject to other rules in the interests of the "general good".[14] Banks and investment firms can rely on their home state depositor and investor protection schemes relating to their business in other Member States.

Banks and investment firms can access the passport for cross-border services by a simple notification to their home state supervisor which is passed on to the host state supervisor. The right to conduct cross-border business is not limited to particular types of client or counterparty. Since 2007, MiFID has made it clear that banks and investment firms can conduct cross-border securities and derivatives business with clients and counterparties largely on the basis of their home state rules by prohibiting the host state from imposing any requirements on a passporting firm that are within the scope of the directive.[15] In contrast, banks passporting banking and other services that fall outside the scope of MiFID may be subject to other rules in the interests of the general good.

It is these passporting rights for cross-border business which enable EU banks and investment firms to conduct their capital markets business from a single hub location in the EU with clients and counterparties across the EU. The European Commission has also interpreted these rights so that a firm incorporated and authorised in one Member State can rely on its passport rights to conduct cross-border business with clients and counterparties in other Member State from a branch in another Member State as well as from its offices in its home state.[16] This gives EU banks and investment firms freedom to conduct at least some of their EU wide business from hub locations in a different Member State (e.g., a number of EU banks conduct their EU-wide capital markets business from branches in the UK).

9 Directive 2013/36/EU.

10 Directive 2004/39/EC (being replaced by Directive 2014/65/EU and Regulation (EU) No. 600/2014).

11 CRD, Articles 35-39 and MiFID, Articles 31 and 32 (being replaced by MiFID2, Articles 34-35).

12 CRD, Article 51.

13 MiFID, Article 32(1) and (7), being replaced by MiFID2, Article 35(1) and (8)

14 CRD, Article 36(1).

15 MiFID, Article 31(1), being replaced by MiFID2, Article 34(1).

16 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).

These rights of EU incorporated and authorised banks and investment firms to conduct their securities and derivatives business from a single hub location in the EU are reinforced by the following:

- MiFID also gives EU banks and investment firms rights to gain access, including remote access, to memberships of regulated markets, central counterparties (CCPs) and clearing and settlement systems in other Member States on a non-discriminatory basis.[17]
- EU regulated markets and other trading venues regulated in one Member State under MiFID have the right to provide appropriate arrangements (such as terminals) on the territory of other Member States to facilitate access to and trading on their markets.[18] Regulated markets also have rights to obtain access to CCPs, clearing houses and settlement systems in other Member States for the clearing and settlement of trades on their systems.[19]
- The EU regulation on OTC derivatives and central counterparties (EMIR)[20] provides for EU CCPs and trade repositories to be able to obtain a single authorisation in their home state (or, in the case of trade repositories, registration with ESMA) which covers their activities across the EU regardless of the location of their participants.
- The EU regulation on central securities depositories (CSDR)[21] provides EU central securities depositories (CSDs) authorised in their home state with a passport under which they may establish branches and provide cross-border services in other Member States.
- EMIR and MiFIR also gives EU trading venues and CCPs non-discriminatory rights of access to each other and to certain financial benchmarks and related data.[22]
- MiFID2/MiFIR envisages that new data services providers will need to be authorised to act as approved publication arrangements (APAs) and consolidated tape providers (CTPs) for trade data and approved reporting mechanisms (ARMs) for transaction reports to supervisors. Again, the authorisation of the home state will cover their activities across the EU regardless of the location of their users.[23]

Looked at the other way round, these rights also facilitate the ability of EU trading venues, CCPs and other market infrastructure and service providers to compete for business across the EU from their home state without needing to set up local entities in other Member States.

Other important passports under existing EU capital markets legislation include the following:

- *Prospectus Directive:*[24] Where a prospectus is approved in one Member State, the prospectus can be used in other Member States to market the securities without the need for further approvals (and, at least for some debt securities, issuers have freedom to choose the place in which their prospectus is approved);

17 MiFID, Articles 33 to 35 (being replaced by MiFID2, Articles 36 to 38).

18 MiFID, Articles 31(5) and (6) and 42(6) (being replaced by MiFID2, Articles 34(6) and (7) and 53(6)).

19 MiFID, Article 46 (being replaced by MiFID2, Article 55).

20 Regulation (EU) No. 648/2012, Articles 14 and 55.

21 Regulation (EU) No. 909/2014, Article 23.

22 EMIR, Articles 7 and 8 and MiFIR, Articles 35-37.

23 MiFIR, Article 60.

24 Directive 2003/71/EC.

- *UCITS Directive:*[25] Where a UCITS has been established and authorised in one Member States, its units can be marketed in other Member States without new approvals and UCITS management companies also have a passport to establish branches and provide cross-border services in other Member States for the services for which they are authorised, including acting as manager of UCITS in other Member States and providing other investment management and related services;

- *Alternative Investment Fund Managers Directive (AIFMD);*[26] EU incorporated and authorised managers (AIFMs) of EU alternative investment funds (AIFs) can market those AIFs to professional investors across the EU without the need for additional approvals and also have a passport to establish branches and provide cross-border services in other Member States for the services for which they are authorised, including acting as manager of AIFs in other Member States and providing other investment management and related services;

- *CRA Regulation:*[27] EU incorporated credit rating agencies must be registered with ESMA but, once registered, their ratings can be used by supervised entities across the EU;

- *Benchmarks Regulation:*[28] Under the agreed text of this new Regulation, EU incorporated administrators of benchmarks must be authorised or registered in their home state but, once authorised or registered, their benchmarks can be used by supervised entities across the EU.

The principle of mutual recognition underlying the passports is also reflected in other EU legislation that is significant to capital markets such as:

- *Credit Institutions (Winding Up) Directive (CI(WUD)):*[29] this provides that only the home state of an EU bank (and now an investment firm) can open winding up or reorganisation proceedings in relation to the institution and provides that other Member States must apply the home state law in relation to those proceedings, with limited exceptions.

- *Bank Recovery and Resolution Directive (BRRD):*[30] this creates a common framework for the recovery and resolution of EU banks and investment firms and provides that other Member States must recognise and give effect to resolution actions taken by the home state resolution authority in relation to an EU bank or investment firm.

- *Settlement Finality Directive (SFD):*[31] this provides that Member States must ensure that their insolvency law does not prejudice the finality of settlement or the enforcement of collateral by settlement systems designated by them or other Member States and governed by the law of a Member State (as well as protecting the rights to collateral of members of the European System of Central Banks).

- *Brussels Regulation:*[32] this sets rules as to when Member State courts can take jurisdiction in relation to civil and commercial proceedings and provides that Member States must recognise and enforce judgments given by the courts in other Member States.

25 Directive 2009/65/EC.

26 Directive 2011/61/EU.

27 Regulation (EC) No 1060/2009.

28 Based on the agreed compromise text published by the Council on 4 December 2015.

29 Directive 2001/24/EC.

30 Directive 2014/59/EU.

31 Directive 98/26/EC.

32 Regulation (EU) No 1215/2012.

Non-discrimination principles

One of the foundations of EU law, as has been explained by the Court of Justice, is that equality and non-discrimination are fundamental principles both underlying the Treaties and in the court's application of EU law.[33] These principles are enumerated in the Treaties, specifically in respect of the freedom of establishment, free movement of services and free movement of capital. The approach taken in the EU is that restrictions on the lawful provision of services must be objectively justified and non-discriminatory.

These principles underlie a range of different provisions of EU legislation that protect the competitive equality of market participants across the EU, when similar protections are not afforded (or at least not automatically afforded) to non-EU market participants. Some examples are as follows:

- The standardised approach for risk weighting of credit exposures under the Capital Requirements Regulation (CRR) gives a specific risk weighting to exposures to any EU credit institution or investment firm. It only allows the same risk weighting to be applied to non-EU institutions if the European Commission determines that they are subject to equivalent regulation.[34]

- The UCITS Directive allows UCITS to have OTC exposures to EU credit institutions subject to specific limits but they would only be allowed to have a corresponding exposure to a non-EU credit institution considered by the national supervisor to be subject to equivalent supervision.[35]

- The anti-money laundering directive allow firms subject to its requirements to apply simplified due diligence when dealing with an EU institution but only to apply that level of due diligence to non-EU institutions which are subject to equivalent rules.[36]

These principles of non-discrimination have also been a significant factor constraining (if not eliminating) discriminatory national legislation or regulatory practices within the EU, in particular because of the overriding authority of EU law with respect to conflicting national requirements.

Furthermore, non-discrimination principles are enhanced in the context of Banking Union by the provisions that require that no action, proposal or policy of the ECB shall, directly or indirectly, discriminate against any Member State or group of Member States as a venue for the provision of banking or financial services in any currency.[37] The draft decision of the European Council annexed to the decision of the European Council concerning a new settlement for the UK within the EU (adopted at the meeting of the European Council on 18 and 19 February 2016) also provides that:

"Discrimination between natural and legal persons based on the official currency of the Member State or, as the case may be, the currency that has legal tender in the Member State, where they are established is prohibited. Any difference in treatment must be based on objective reasons."

33 Cases 117/76 and 16/77, *Ruckdeschel and Diamalt v Hauptzollamt Hamburg-St Annen* [1977] ECR 1753.

34 Regulation (EU) No. 575/2013, Articles 107(3) and 119.

35 Directive 2009/65/EC, Articles 50(1)(f) and 52(1).

36 Directive 2005/60/EC, Article 11.

37 Regulation (EU) No 1924/2013, Article 1.

Practical impact of passports

The ability of EU firms to passport services across borders and maintain branches in other Member States has shaped the way in which capital markets services are provided in the EU.

The passports have enabled EU firms to centralise their provision of capital markets services in a single hub location in the EU, notably in London, from which they provide services to clients and counterparties across the EU and from which they participate remotely in trading, clearing and settlement infrastructure in other Member States. This hub location may be their place of incorporation and authorisation. Alternatively, they may operate in the hub location through a branch and provide services from that branch across the EU.

The passports have made it easier for financial groups to reduce the number of EU legal entities in their group either by converting subsidiaries into passported branches of another EU entity or by ceasing to operate a local legal entity altogether and instead using the passport to provides services to clients and counterparties in the relevant Member State on a cross-border basis. There are substantial costs and inefficiencies in maintaining separately capitalised subsidiaries with their own governance and regulatory requirements. This process of "de-subsidiarisation" has been ongoing for many years.

The passports have enabled funds businesses to concentrate in centres such as Dublin and Luxembourg, on the basis that UCITS authorised in a single location can be sold across the EU. Listings of debt instruments are often in Dublin, London or Luxembourg because the prospectus can be passported across the EU.

Market infrastructures have also been able to compete on an EU wide basis, providing trading, clearing or settlement across the EU.

Finally, access to the passports is often a critical factor for non-EU groups when deciding how to operate in the EU. In particular, non-EU banks have often chosen to operate a significant part of their business out of EU incorporated subsidiaries that can make use of the passports, even though there might be substantial efficiencies in operating some businesses out of branches of the non-EU bank established in the EU. This is particularly important in relation to securities and derivatives business where there have been more significant barriers to cross-border provision of services by non-EU entities.

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3. Treaty alternatives to EU membership

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This section reviews the alternative Treaty frameworks for future cooperation between the UK and the C-EU following the exit of the UK from the EU and how they might preserve the benefits of the single market in financial services for investors, intermediaries and issuers and other end-users of services across the EU. From the perspective of financial services, the alternatives fall into two main categories:

- *EEA membership:* the UK might seek membership of the European Economic Area (EEA) alongside the three EEA States that are members of the European Free Trade Association (EFTA) (Iceland, Liechtenstein and Norway);

- *Other free trade arrangements:* the UK and the C-EU might rely on multilateral arrangements, such as membership of the World Trade Organisation (WTO) and participation in the General Agreement on Trade in Services (GATS) or seek to negotiate bilateral arrangements, similar to the current arrangement between the Switzerland and the EU or a bespoke free trade agreement (FTA).

EEA membership

Two additional treaties would have to be negotiated and ratified if the UK wished to leave the EU but remain a member of the EEA. First, the UK would have to join EFTA by acceding to the EFTA Convention, which would require the agreement of each of its members, i.e. Switzerland, Norway, Iceland and Liechtenstein. Second, the UK would have to join the EEA by acceding to the EEA Agreement. This would require the agreement of the contracting parties which are the EU and its Member States on the one hand and the EFTA countries of Norway, Iceland and Liechtenstein (not Switzerland) on the other hand.

Following the exit of the UK from the EU, UK membership of the EEA could preserve many of the key features of the single market in financial services. Annex IX on Financial Services of the EEA Agreement covers financial services. Therefore EU single market legislation for financial services should apply across the whole of the EEA and UK membership of the EEA should, in principle, ensure that the passports continue to operate across the current single market in much the same way as they do today.

However, since the establishment of the ESAs in 2010, the process for the application of EU financial services legislation in the EEA-EFTA States has stalled which, in principle, affects the participation of those States in the single market. This issue has arisen because the EEA-EFTA States do not participate in the ESAs but the ESAs directly supervise some entities (credit rating agencies and trade repositories) and have powers to take decisions that are binding on national supervisors and market participants in the single market. The EEA Agreement does not cater for this and, as a result, there is now a significant backlog of single market measures that have not been applied in the EEA-EFTA States.

In late 2014, EU and EEA-EFTA Ministers of Finance and Economy reached an agreement to address these issues.[38] Under the agreement, the EFTA Surveillance Authority would take decisions addressed to the EEA-EFTA national supervisors and market operators on the basis of drafts prepared by the ESAs, with disagreements between the EFTA Surveillance Authority and the ESAs being referred to the EFTA Joint Committee. There would also be arrangements for the EFTA Surveillance Authority and EEA EFTA State national supervisors to participate, without voting rights, in the meetings of the Boards of Supervisors of the ESAs (with reciprocal arrangements for the participation of the ESAs in the work of the EFTA Surveillance Authority). However, at the time of writing, no significant progress has been made on the implementation of this agreement.

In any event, even if this issue is resolved, one feature of the EEA is that the EEA Joint Committee can only make decisions on the application of new legislation by unanimous agreement of all the EEA-EFTA States.[39] This can result in time lags of between six and 24 months before legislation is applied across the EEA-EFTA States.[40]

38 Council Conclusions on the EU and EEA-EFTA Ministers of Finance and Economy, 14 October 2015, available at http://www.efta.int/sites/default/files/documents/eea/eea-news/2010-10-14-EEA-EFTA-ECOFIN-joint-conclusions.pdf

39 EEA Agreement, Article 93(2).

40 What would out look like? McFaden and Tarrant, Policy Network, November 2015, p. 10.

How would the UK leave the EU?

The UK Government has indicated that, if the referendum vote is for the UK to leave the EU, it would start the process under Article 50 of the Treaty on European Union by notifying the European Council of the UK's intention to withdraw from the EU.

The UK and the EU would then seek to negotiate and conclude an agreement for the withdrawal of the UK "taking account of the framework for its future relationship with the Union". The European Commission would conduct the negotiations on the basis of guidelines from the European Council.

Any agreement would need to be approved by the Council acting by a qualified majority vote, after obtaining the consent of the European Parliament. The UK would not participate in the discussions of the European Council or the Council or the voting process.

If no agreement is reached within two years from the UK's notification to the European Council, then the EU Treaties would cease to apply to the UK at the end of the two year period, unless the European Council (acting unanimously) and the UK agree to extend that period. However, if the UK and the EU reach agreement on a withdrawal agreement, the Treaties cease to apply to the UK on the date that the agreement enters into force. This might be before or after the expiry of the two year period.

Until the time that the Treaties cease to apply to it, the UK would remain a Member State of the EU with the rights and obligations that entails. In particular, the existing EU legislation regulating the single market in financial services would remain in place, unless amended in the normal way. All Member States would continue to be required to give effect to that legislation through their domestic law.

It is very unlikely that the UK would follow the route of unilateral withdrawal (e.g., by repeal of the UK legislation giving effect to EU membership in the EU) as this would contravene the UK's international obligations and likely prejudice any negotiations between the UK and the C-EU on their future relationship. The Member States could amend the Treaties to give effect to the withdrawal of the UK but this would require unanimity.

In any case, negotiating the withdrawal agreement under Article 50 is likely to be only one part of the negotiations on the UK's exit from the EU. It seems likely that the UK and the C-EU would need separately to negotiate a future agreement between the UK and the C-EU on their long-term relationship after the UK exit. However, negotiations on long-term trade arrangements take time and there is a risk any long-term agreement would not be concluded by the time that the Treaties cease to apply to the UK under Article 50.

It is possible that the UK might seek to start negotiations in advance of the formal notification under Article 50 to delay the start of the two year period but other Member States may prefer to follow the process laid down in the Treaties. In any event, it seems unlikely, given the range and complexity of the issues to be resolved in the negotiations between the UK and the C-EU, that the UK would leave the EU within the two year period mentioned in Article 50, except if all the relevant parties agreed on an early entry of the UK into the EEA as an EFTA State as the framework for the ongoing relationship between the UK and the EU (even if only as an interim step). On that basis, the earliest reasonably plausible date by which the UK might leave the EU without some treaty arrangements to mitigate the impact would be in the summer of 2018.

Also, the EEA-EFTA States do not have direct influence over EU law-making in the area of financial services. They may participate in discussions and be consulted but they have no vote. This will be of particular concern in the context of wholesale financial markets where significant activity is clustered in the UK. The EEA Agreement requires the agreement of the EEA-EFTA States through the EEA Joint Committee to the application of new single market measures, but if agreement cannot be reached on how new EU legislation applies in the EEA-EFTA States, then the EEA Agreement provides for the provisional suspension of the relevant part of the EEA Agreement while negotiations continue on a mutually satisfactory solution.[41]

As a member of the EEA, the UK would no longer be subject to the jurisdiction of the Court of Justice of the EU. However, the EFTA court fulfils a similar role for the members of EFTA that are also party to the EEA agreement.

Other free trade arrangements

Other bilateral or multilateral free trade arrangements can achieve significant rights for firms from one contracting State to establish branches or subsidiaries in the other State's territory on terms that give national treatment (although this usually will not commit the host state to recognising the equivalence of the home state regime for any purpose). However, they typically confer only limited rights with respect to cross-border financial services and do not provide anything like the EU passport for those services.

Firms in one contracting State conducting cross-border activity with clients or counterparties in another can still face licensing requirements, even when dealing with clients or counterparties that are not retail investors. The contracting States reserve the right to regulate, i.e. the right to adopt or maintain measures for prudential reasons, including for investor protection or financial stability reasons. Even non-discriminatory licensing requirements can constitute an effective barrier to cross-border business, as they may require business to be conducted in a local branch or subsidiary or may impose capital or other requirements which duplicate or conflict with home state requirements.

The dynamic nature of financial services regulation makes it difficult to lock in rights of access while preserving the contracting States' right to regulate. Therefore, it is likely to be difficult to rely on bilateral or multilateral free trade arrangements to preserve the cross-border market access that exists today within the single market.

General Agreement on Trade in Services

Following the exit of the UK from the EU, the UK should at least retain its status as a WTO member outside the EU or the EEA-EFTA. Therefore, assuming that the UK can resolve its issues with regard to its Schedule of Commitments, the trade in financial services between the UK and the C-EU should at least be conducted within the framework of the WTO General Agreement on Trade in Services (GATS).[42]

The GATS is a multilateral trade agreement negotiated as part of the Uruguay Road of trade negotiations between 1986 and 1994. It applies to all WTO members. The main rules on financial services can be found in the GATS framework agreement, WTO members' Schedules of Commitments, the Annex on Financial Services and the Understanding on Commitments in Financial Services.

41 EEA Agreement, Article 102.

42 If the UK left the EU, it would need to update the terms of its WTO membership as the current Schedule of Commitments applies to the EU as a whole. The UK Government has said that this "would not be a straightforward process as, if we leave the EU, then we would need all other WTO Members to agree how the UK will take on the rights and obligations which we have formerly taken as a part of the EU. This would mean negotiating and agreeing updated UK schedules of commitments with all 161 WTO members. And until our schedule of commitments was updated, there could be questions surrounding our rights to access WTO members' markets, and our ability to enforce those rights." HM Government, The process for withdrawing from the European Union (Cmnd 9216, February 2016), page 15.

Trade in financial services takes place via four so-called "modes of supply."

- *Mode 1: Cross border supply.* This involves the supply of a service from one State to another.
- *Mode 2: Consumption abroad.* This involves a consumer of a service being in one State and consuming the service in another State.
- *Mode 3: Establishment.* This involves the supply of a service from one State to another through the incorporation of a commercial presence in that other State.
- *Mode 4: Presence of natural persons.* This involves a service supplier sending individuals from one State to another to supply a service in that State.

GATS Members are subject to certain general obligations, including obligations to ensure treatment services and suppliers from other Members no less favourable than that accorded to like services and suppliers of any other country and obligations with respect to transparency. However, commitments to market access and national treatment depend on the commitments made by GATS Members with respect to particular modes of supply and typically GATS Members make very limited commitments with respect to cross-border supply and consumption abroad of financial services. The understanding on commitments in financial services under the GATS only envisages that Members will permit non-resident suppliers to supply the following services on a cross-border basis to its residents on a basis that accords national treatment:

- insurance of risks relating to maritime shipping and commercial aviation and space launching and freight (including satellites), as well as risks relating to goods in international transit;
- reinsurance and retrocession;
- services auxiliary to insurance (such as consultancy, actuarial, risk assessment and claim settlement services);
- provision and transfer of financial information and financial data processing; and
- advisory and other auxiliary services, excluding intermediation, relating to certain banking and other financial services.[43]

This means that the GATS provides very limited cross-border market access or rights of national treatment in relation to capital markets services.

Even where there is a commitment to market access on the basis of national treatment, this does not require GATS Members to recognise the equivalence of home state regulation. Therefore, it is possible for GATS Members to impose licensing or other requirements that effectively preclude the non-resident supplier from conducting business because it may be difficult for them to comply with the requirements applicable to national suppliers at the same time as complying with any domestic legislation in their home state. For example, it may not be practical to comply with capital or other prudential requirements or requirements that affect business with all clients and counterparties which duplicate and possibly conflict with domestic regulation.

In any event, the GATS incorporates what is known as the 'prudential carve-out' which states that:

"*Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement.*"[44]

43 WTO Agreement 1995, Understanding on Commitments in Financial Services, paragraph 3.

44 WTO Agreement 1995, Annex 1B - General Agreement on Trade in Services 1994, Annex on Financial Services, paragraph 2.

This would give the UK and the C-EU very wide ability to retain or introduce regulatory provisions that have the effect of restricting cross-border services, including licensing requirements or requirements to carry on business through a local presence.

EU Preferential Trade Agreements

The EU has negotiated a number of Preferential Trade Agreements (PTAs) with third countries such as Korea and Singapore. These agreements have a similar structure to the GATS and like the GATS provide limited market access for cross-border financial services, although there are certain differences (for example Modes 1 and 2 are treated as a single mode of supply and the EU-Korea PTA does not even include reinsurance and retrocession in the commitments with respect to cross-border financial services).

In addition, these agreements include prudential carve-outs similar to the carve-out in the GATS. For example, Article 7.38 of the EU-Korea PTA states:

"1. Each Party may adopt or maintain measures for prudential reasons, including: (a) the protection of investors, depositors, policy-holders or persons to whom a fiduciary duty is owed by a financial service supplier; and (b) ensuring the integrity and stability of the Party's financial system.

2. These measures shall not be more burdensome than necessary to achieve their aim, and where they do not conform to the other provisions of this Agreement, they shall not be used as a means of avoiding each Party's commitments or obligations under such provisions.

3. Nothing in this Agreement shall be construed to require a Party to disclose information relating to the affairs and accounts of individual consumers or any confidential or proprietary information in the possession of public entities.

4. Without prejudice to other means of prudential regulation of cross-border trade in financial services, a Party may require the registration of cross-border financial service suppliers of the other Party and of financial instruments."

The proposed EU-Canada agreement goes somewhat further. The proposed text envisages a broader commitment by the EU to give national treatment to cross-border portfolio management services to professional clients, subject to an equivalence assessment, and, in the case of some smaller Member States, broader commitments to national treatment of a range of other cross-border financial services, but this would not preclude national authorisation or registration requirements.[45]

The Parties would also be required to allow persons located in their territory, and their nationals wherever located, to purchase financial services from cross-border financial service suppliers of another Party.[46] However, this obligation does not require a Party to permit those suppliers to do business or solicit in its territory and Parties are free to define what these terms mean (so long as they act consistently with the principle of national treatment).

In addition, there will be a Financial Services Committee to review and decide on the reasonableness of the use of the "prudential carve out".[47]

45 Proposed Comprehensive Economic and Trade Agreement between Canada and the EU (draft text made available for information purposes), Chapter 13 and Annex 13-A.

46 Ibid, Article 13.7.6.

47 Ibid, Annex 13-B.

Other bilateral or multilateral arrangements

Other bilateral and multilateral trade agreements have very limited provisions in respect of cross-border financial services and are unlikely to serve as a model for the relationship between the C-EU and the UK following the exit of the UK from the EU that would replicate the current passports for cross-border financial services within the EU.

EU-Switzerland

The bilateral Swiss relationship with the EU is founded on the Free Trade Agreement concluded by Switzerland with the European Economic Community in 1972 exclusively for industrial products. That agreement has been supplemented by two sets of bilateral sectoral agreements between Switzerland and the EU in 1999 and 2004. Those cover a wide range of issues from the free movement of person to technical barriers to trade (focused on industrial products), public procurement, agriculture, research, civil aviation, fraud, media and the environment. Apart from a 1989 agreement which covers the establishment of branches and agencies of direct (non-life) insurance companies, there is no sectoral agreement that covers financial services. Therefore, from a capital markets services perspective, the relationship between Switzerland and the EU is similar to that between other members of the WTO and GATS.

The EU-Swiss arrangement is managed by over fifteen joint committees but there is no institution that can give a single interpretation of the sectoral agreements. The European Council said in 2010 that "*the approach taken by Switzerland to participate in EU policies and programmes through sectoral agreements in more and more areas in the absence of any horizontal institutional framework, has reached its limits and needs to be reconsidered.*"[48]

The 1989 Swiss-EU agreement on branches and agencies of direct (non-life) insurance companies also illustrates the difficulties in using a bilateral Treaty to try to 'lock in' mutual recognition in relation to financial services, even in the context of branches, in the absence of an overarching institutional structure similar to the EU or the EEA. Article 39 of the Agreement deals with the evolution of the domestic legislation of the parties. The parties remain free to amend their respective domestic legislation, subject to the principle of non-discrimination. Where new legislation is incompatible with the agreement, there is a timetable to delay its implementation while a joint committee seeks to reach agreement on safeguarding the functioning of the agreement. However, if no agreement is reached, the agreement comes to an end.

Tran-Pacific Partnership

The Tran-Pacific Partnership (TPP) was signed in 2015 by 12 Pacific-rim countries including the USA, Canada, Mexico, Australia, Singapore and Japan. It took seven years to negotiate. The TPP does go somewhat further than the GATS in relation to the cross-border provision of services but it does not provide a model that would replicate the EU passports.

Annex 11-A to the chapter on financial services contains limited commitments by the Parties to give market access to a restricted range of insurance related services and financial data processing and related software relating to banking and other financial services and advisory and other auxiliary services. In a similar way to the proposed EU-Canada agreement, Annex 11-B includes a specific commitment to allow the cross-border provision of investment management and advice to local collective investment schemes. However, in both cases these obligations only require the national treatment of suppliers and access can be made subject to local registration or authorisation requirements.[49]

The Parties are required to permit persons located in their territory, and their nationals wherever located, to purchase financial services from cross-border financial service suppliers of another Party.[50] However, this obligation does not require a Party to permit those suppliers to do business or solicit in its territory and Parties are free to define what these terms mean (so long as they act consistently with the principle of national treatment).

Moreover, the TPP includes a broad prudential carve-out similar to that in the GATS.

48 European Council, Conclusions on EU relations with EFTA countries, 3213th Transport, Telecommunications and Energy Council meeting Brussels, 20 December 2012, paragraph 31.

49 TPP, Article 11.6.1 and 11.6.3.

50 TPP, Article 11.6.2.

Other

It is not yet certain whether the planned Transatlantic Trade and Investment Partnership (TTIP) under negotiation between the EU and the USA will cover financial services. The US position is not to include financial services in the scope of TTIP. However even the original EU proposal would have preserved each Party's right to regulate for prudential reasons.[51] Therefore, it is unclear that this will provide a model for the relationship between the UK and the C-EU on financial services.

The plurilateral Trade in Services Agreement (TiSA) being negotiated by 23 WTO members also is unlikely to provide significant additional access for each other's financial institutions to do business on a cross border basis.

51 European Commission, EU-US Transatlantic Trade and Investment Partnership (TTIP), Cooperation on financial services regulation (27 January 2014).

4. Impact of Brexit under existing financial services legislation

Legislating for Brexit

The exit of the UK from the EU would require C-EU and the UK to make changes to their legislation on financial services. However, there would be significant differences between the changes required in the C-EU and those required by the UK.

C-EU: EU legislation

The exit of the UK from the EU would require some changes to the Treaties to eliminate references specific to the UK. It would also require the C-EU to make some, but probably relatively few, changes to existing EU secondary legislation. References in EU legislation to Member States would cease to include the UK and the UK would be treated as a "third country" under relevant provisions.

Some legislation does contain specific references to UK specific situations. For example, Article 2(5) of the CRD provides that the CRD does not apply to certain bodies in the UK (such as the National Savings Bank). These would need to be deleted. However, there are relatively few examples like this in the main Level 1 legislative instruments relevant to capital markets.

It would still be necessary to address whether provisions that currently grant special treatment to certain third country entities should also be extended to corresponding entities in the UK or whether to create new third country regimes to address the position of the UK.

C-EU: Member State legislation

Similarly, C-EU Member States will need to review their own legislation, regulations and rules to determine whether and how they need to be amended to address the new situation. However, as with EU legislation, it is likely that the exit of the UK from the EU would require relatively few changes to legislation, regulations and rules in C-EU Member States.

UK legislation

EU legislation on financial services is reflected in UK law by three main routes:

- In some cases, the EU requirements of directives may be reflected in UK law by virtue of an Act of Parliament or by the use of general powers under an Act of Parliament. For example, many requirements imposed by EU directives are implemented by rules made by the UK regulators under powers given by the Financial Services and Markets Act 2000 (FSMA).

- The requirements of EU directives may also be reflected in UK law by virtue of orders, regulations or other secondary legislation made under the powers granted to the Government by the European Communities Act 1972 (ECA). These powers may have been used to create "free standing" regulations (e.g., the regulations implementing the FCD) or to amend existing enactments to give effect to the requirements (e.g., the amendments to the Banking Act 2009 to implement BRRD and the amendments to the regulated activities order made under FSMA to implement MiFID) or to give additional powers to regulators to make rules to implement the relevant requirements.

- The directly applicable provisions of EU regulations apply in the UK without the need for further transposition by virtue of the ECA. Where EU regulations require the adoption of national measures to give effect to them (e.g. to designate the competent authority or to create penalty regimes), these provisions may be implemented in the UK in the same way as an EU directive.

The exit of the UK from the EU would involve the repeal or amendment of the ECA. The UK Parliament would need to make a legislative decision as to the impact on existing secondary legislation adopted under the powers granted by the ECA and whether (and, if so, how) to preserve the effect of directly applicable provision of EU regulations that currently have effect in the UK by virtue of the ECA. It seems likely that, at least at the outset, the legislative choice would be largely to preserve the existing regulatory framework implementing EU requirements and to leave it to subsequent Governments and Parliaments to decide on whether to repeal or replace parts of that framework.

However, this is only the first of the choices that would need to be made.

For example, FSMA alone includes approximately 525 references to rights and obligations of "EEA firms" or "EEA states", approximately 60 references to information sharing obligations between "Member States", 100 references to the "EU" (mostly as overrides or clauses enabling secondary legislation) and even 31 references to "ESMA" and its powers and relationships vis-à-vis UK firms and national supervisors. A legislative choice would need to be made as to how to address these references and the consequential impact. Similar issues would arise under other UK statutes and regulations and the rules of the UK regulators.

In addition, if a decision was made to preserve the effect in the UK of a directly applicable regulation such as EMIR, the UK legislator would need to consider how to apply the references to "Member States", the European System of Central Banks (ESCB), the European Financial Stability Facility and the European Stability Mechanism, the powers and responsibilities given to the European Commission to adopt delegated and implementing acts, monitor developments and to receive notices and make reports and the powers and responsibilities given to ESMA to receive notices, monitor developments, maintain and publish registers, register trade repositories and recognise third country CCPs (as well as the fact that many provisions address situations involving more than one Member State and national supervisor).

These are clearly not straightforward choices. A starting point for mapping these references might be to treat references to:

- the "EU" and "Member States" as references to the UK;
- "third countries" to mean States other than the UK (including the Member States of the C-EU);
- the European Commission's powers to adopt delegated or implementing acts as references to a power of the HM Treasury or the Secretary of State to make statutory instruments;
- ESMA and the EBA as references to the appropriate regulator under FSMA;
- the ESRB as references to the Financial Policy Committee;
- the ECB or the members of the ESCB as references to the Bank of England.

However, in the end, each individual law, rule and regulation would need to be reviewed to ensure that it is amended in a way that makes sense in the new context of the UK after its exit from the EU. Like the C-EU, the UK would also need to decide whether to create new regimes to recognise non-UK firms, including C-EU firms, as equivalent to UK firms for particular purposes.

4. Impact of Brexit under existing financial services legislation

This section addresses the extent to which the existing EU financial services legislation and the implementing UK legislation provide an alternative means to mitigate the effects of the exit of the UK from the EU on the EU's wholesale financial markets. It assumes that the UK leaves the EU without agreeing any special treaty arrangements and that the EU maintains its existing financial services legislation broadly unchanged so that the UK becomes a third country under that legislation. It also assumes that, at least initially, the UK retains the existing body of financial services regulation derived from its membership of the EU with amendments to treat other States (including C-EU Member States) in the same way that the EU treats third countries.

Third country regimes

The earlier EU financial sector legislation contained limited provisions in relation to the treatment of non-EU entities or financial products. The legislation focused on the free provision of services within the EU rather than the harmonisation of Member States' treatment of cross-border business between third countries and the EU.

However, in recent years, EU legislation has increasingly incorporated "third country regimes" which allow non-EU firms market access to the EU, usually on condition that they are authorised in a State which has a regulatory regime equivalent to that in the EU and which provides an effective reciprocal mechanism offering access to EU firms.

The adoption and implementation of these third country regimes has been the subject of considerable controversy. In some cases, they have been seen as restricting the ability of Member States to apply a more flexible approach to cross-border activity or as restricting the ability of EU firms to deal with non-EU counterparties or to invest in non-EU products. The implementation of these regimes has also raised questions as to the extent to which the EU requires other States to follow its regulatory approach as a condition of access to the EU market.

Nevertheless, these mechanisms could provide an important means of mitigating the impact of the exit of the UK from the EU on continued cross-border business by UK and C-EU firms, because - at least at the outset following the UK's exit - the UK could ensure that its regulatory regime is equivalent to the regime in the C-EU by maintaining its existing regulatory regime implementing EU laws. Conversely, the UK could offer reciprocal access to C-EU firms.

Many of these third country regimes are as yet untested and there is a risk that political constraints may make it more difficult for the C-EU to extend their benefits to the UK as a close neighbour and significant competitor (and a former Member State of the EU) – especially if the UK seeks to abandon or alter other aspects of inherited EU legislation. There is likely to be a long period of uncertainty after the referendum vote before it is clear whether or not these regimes will be available to UK firms.

In addition, these regimes are largely conditioned on equivalence and effective reciprocity and, therefore, the UK may lose the benefits of these regimes unless it is prepared to maintain its existing regulatory regime implementing EU laws and to adapt its laws to reflect new EU laws as they develop over time - even though it would no longer have a direct means of influencing the development of those laws. In the past, EU laws have often imposed requirements going beyond minimum international standards and the UK may no longer be willing to accept this. In any event, the C-EU legislators would be able at any time unilaterally to amend or withdraw these regimes. Therefore, in the longer term, these regimes may not provide a stable mechanism protecting market access if the UK and the C-EU take increasingly divergent approaches to regulation.

Moreover, these regimes do not cover all services and activities. For example, they do not cover firms' rights to access market infrastructure, lending, deposit-taking, foreign exchange or other banking services falling outside the scope of MiFID2/MiFIR, payment services or retail investment services (including private wealth business). Future C-EU legislation may also extend the scope of the regulatory regime in ways that do not include corresponding protection for third countries. In addition, the Treaty and other protections under EU law against discrimination on the basis of location or currency would no longer apply to the UK.

Of course, the C-EU would have an interest in securing corresponding cross-border access to the UK market for its firms. However, the UK has traditionally had a reasonably open approach to cross-border business. In practice, it is more difficult for an international financial centre to restrict cross-border activity into its markets as this can simply deter clients and counterparties from seeking to use the services of actors in the financial centre.

The UK and the C-EU may consider extending these third country regimes or creating new regimes to mitigate issues arising from the gaps in the existing regimes. However, the GATS would constrain the ability of the UK and the C-EU to create (or continue) preferential arrangements for each other, outside the context of a qualifying regional trade arrangement or comprehensive free trade agreement.[52] The GATS allows a Member to recognise prudential measures of other States for the purposes of the application of its financial services regulatory regime, either by an agreement or autonomously. However, the GATS Member granting recognition must allow other Members an adequate opportunity to accede to the agreement or arrangement, or negotiate comparable terms, in circumstances where there would be equivalent regulation, oversight, implementation of the relevant regulation, and, if appropriate, information sharing procedures.[53]

CRD and MiFID2/MiFIR: cross-border banking and investment business

A key concern of many UK banks and investment firms is that the exit of the UK from the EU would mean that they would no longer benefit from the CRD or MiFID passport and would be subject to similar restrictions as non-EU firms with respect to their cross-border business with clients and counterparties in the C-EU. This might compel them to relocate activities into the C-EU and thus undermine the benefits of being able to operate their business from a single hub in the UK. C-EU firms might have similar concerns as regards their cross-border business with clients and counterparties in the UK.

Application of existing licensing requirements to cross-border business by non-EU firms

Like their predecessors, neither CRD nor MiFID address the conditions on which non-EU firms may provide cross-border banking or investment services to clients or counterparties in the EU. Member States are free to define how their licensing regimes apply to non-EU firms providing cross-border services or establishing branches in their territory. However, a Member State must not treat branches of non-EU banks and investment firms more favourably than they treat branches of banks and investment firms from other Member States[54] and, even where a Member State does authorise a non-EU bank or investment firm to establish a local branch, that branch does not benefit from the passport to provide services in other Member States.

In practice this has led to a patchwork of differing approaches across the EU to cross-border business by non-EU firms in the areas regulated by MiFID and the CRD.

All Member States are required to impose licensing requirements on investment services and activities regulated by MiFID (but are free to decide on the extent that those requirements apply to ancillary services, such as custody, foreign exchange or margin lending). However, they take very different approaches to cross-border business by non-EU firms.

Some Member States, like the Ireland, Luxembourg and the UK, take a relatively liberal approach to non-EU firms conducting cross-border business and permit them to conduct cross-border business with local clients and counterparties without the need for local authorisation, at least when the clients are not retail clients. Some Member States, such as Belgium, Germany and the Netherlands, provide regimes under which non-EU firms are able to register, be licensed or exempted from licensing, and thus conduct business with at least some types of local clients, albeit subject to some local conduct of business or other rules.

Outside those specific cases, many Member States require a non-EU firm to obtain a local licence if it wishes to solicit business from local clients or counterparties, in many cases even if those clients or counterparties are institutional or wholesale investors or counterparties, and, in practice, it may be difficult for non-EU firms to obtain a local licence without establishing a local branch or subsidiary and conducting the business through that branch or subsidiary. Member States differ as to when they regard a non-EU firm as engaging in solicitation that triggers a licence requirement. There are also differences between the Member States as to whether a non-EU firm entering into transactions with local clients and counterparties still requires a local licence if an EU authorised and passported firm intermediates between the local client or counterparty and the non-EU firm by arranging the transaction and engaging in other client-facing activity.

52 GATS, Articles II and V.

53 GATS, Annex on financial services, paragraph 3.

54 CRD, Article 47(1) and now MiFID2, Article 41(2).

The CRD only requires Member States to impose licensing requirements on firms taking deposits or other repayable funds from the public. However, a significant number of Member States go beyond the minimum requirements of MiFID and the CRD to impose licensing requirements on a number of other wholesale banking services, e.g., lending, credit and guarantee business, financial leasing, payment services, custody services and foreign exchange business. Non-EU banks and other firms seeking to conduct cross-border business of this kind with clients and counterparties in the EU encounter a patchwork of different approaches to the licensing of cross-border business similar to that described above in relation to MiFID. In particular, a number of countries, such as Austria, France, Germany and Italy, have restrictive rules which can make it difficult for non-EU banks to make loans to borrowers in those countries.

Therefore, if the UK were to leave the EU, UK banks and investment firms would cease to have the benefit of a passport under MiFID or the CRD and would need to determine the extent to which they could continue their business with clients and counterparties in the C-EU taking into account this patchwork of regulatory restrictions. This would be a much more restrictive environment than they face today.

In contrast, C-EU banks and investment firms would not necessarily face similar issues continuing to conduct cross-border business with clients and counterparties in the UK. As already noted, the UK takes a relatively liberal approach to the treatment of cross-border business by non-UK firms with UK clients and counterparties, at least if those clients are authorised persons, large companies and trusts and other investment professionals. The FSMA provides an exclusion from licensing requirements for certain "overseas persons" that engage in cross-border business in securities and derivatives without infringing the rules on financial promotions (or in some cases with or through an authorised person under FSMA).[55] In addition, the restrictions on deposit-taking only apply to deposits accepted in the UK and the UK does not impose licensing requirements on lending, credit, guarantee or leasing business (outside the area of regulated consumer credit and residential mortgage business).

The "third country entity passport" under MiFIR

However, the implementation of MiFID2/MiFIR (expected in early 2018) will introduce a new arrangement which could allow non-EU firms from an equivalent jurisdiction a "third country entity passport" to provide cross-border investment services to wholesale clients and counterparties across the EU. If this arrangement is activated, it could significantly mitigate the impact of the exit of the UK from the EU on cross-border investment banking and asset management business between the UK and the C-EU.

MiFIR will allow a non-EU firm to provide cross-border investment services covered by MiFID2 (including ancillary services) to eligible counterparties and "per se" professional clients, without having to establish a branch in the EU, provided that the firm is registered by ESMA.[56] This registration is subject to the condition that:

- the European Commission has determined that the legal and supervisory arrangements of the relevant third country ensure that firms authorised there comply with legally binding prudential and business conduct requirements which have equivalent effect to those set out in MiFID2/MiFIR and the CRD;
- the European Commission has determined that the relevant third country has an effective equivalent system for recognition of investment firms authorised under third-country legal regimes;
- the non-EU firm has its head office in the relevant third country and is authorised in that jurisdiction to provide the relevant investment services or activities and is subject to effective supervision and enforcement in that third country; and
- ESMA has established cooperation agreements with the relevant national supervisor of that third country covering the exchange of information, notification of infringements and coordination of supervisory activities.

55 The Financial Services and Markets Act (Regulated Activities) Order 2001, Article 72.

56 MiFIR, Article 46.

Non-EU firms registered with ESMA are subject to limited additional requirements when providing services to EU clients and counterparties under this arrangement. They must inform clients and counterparties of the limitations on the scope of their activities and of the details of their home state national supervisor and must offer to submit disputes with clients to a court or arbitral tribunal in the EU.[57]

MiFIR provides that the European Commission may consider that the prudential and business conduct regime of a third country has equivalent effect where firms providing investment services and activities are subject to authorisation and effective ongoing supervision and enforcement, sufficient capital requirements, appropriate requirements applicable to shareholders and managers, adequate requirements regarding internal controls and appropriate conduct of business rules and the third country ensures market transparency and integrity by preventing insider dealing and market manipulation.

The European Commission should be able to determine that, after the exit of the UK from the EU, the UK has an equivalent and reciprocal regulatory regime if the UK has fully implemented MiFID2/MiFIR and the CRD and so long as the UK retains the existing body of financial services regulation derived from its membership of the EU (including MiFIR and the Market Abuse Regulation[58]). Similarly, if the UK creates a similar regime, it should be able to determine that the C-EU has an equivalent and reciprocal regime so long as the existing EU framework remains unchanged.

Therefore, this regime has the potential significantly to mitigate the impact of the exit of the UK from the EU on UK banks and investment firms conducting cross-border business with clients and counterparties in the C-EU and, to the extent needed, C-EU banks and investment firms conducting cross-border business with clients and counterparties in the UK. However, there may be a long period of uncertainty before it is confirmed that this regime will be available and even if it is available:

- For banks, this regime does not cover all the services and activities that are covered by the CRD passport and that fall outside the scope of the MiFID2 passport, in particular deposit-taking, lending, credit and guarantee business, financial leasing, payment services, custody services and foreign exchange business (in the case of credit and foreign exchange business, where not connected to investment services and activities).

- The regime does not confer on non-EU firms the rights conferred by MiFID2 on EU firms to gain access, including remote access, to memberships of regulated markets, CCPs and clearing and settlement systems in other Member States on a non-discriminatory basis.[59] However, EU legislation does not currently require market infrastructures to deny access to non-EU firms.[60]

- It does not cover business with retail clients, including municipalities, smaller companies and other retail clients that are eligible to be treated as professional clients.[61] MiFID2 specifically acknowledges that Member States may elect to require non-EU firms to establish a branch if they wish to provide investment services to these kinds of retail client.[62]

- In the event of the failure of a UK institution currently covered by the BRRD, the CI(WUD) would no longer apply and, therefore, the institution may be subject to local insolvency proceedings in the C-EU Member States in which it does business (e.g. if it has assets there). In addition, C-EU Member States would no longer be required to give effect to resolution actions by the home state resolution authority,[63] although local supervisors should be able to recognise UK resolution proceedings.[64] Similar issues will arise with respect to C-EU institutions operating in the UK. This may require the firm and third parties to re-evaluate legal opinions required, for example, for netting purposes or in relation to memberships of CCPs and payment systems and to reconsider its resolution plans.

57 MiFIR, Article 46(5) and (6).

58 Regulation (EU) No 596/2014.

59 MiFID, Articles 33 to 35 (being replaced by MiFID2, Articles 36 to 38).

60 See e.g., MiFID2, Article 53(3) relating to membership of a regulated market.

61 Under MiFID2, Section II of Annex II.

62 MiFID2, Article 39(1).

63 BRRD, Article 66.

64 BRRD, Articles 94.

CRD and MiFID2/MiFIR: branches

The exit of the UK from the EU could also have a significant impact on UK banks and investment firms with branches in the C-EU and C-EU banks and investment firms with branches in the UK.

UK firms with branches in the EU

UK banks and investment firms with branches in the C-EU are currently subject to limited host state regulation in relation to the branch. As noted above, EU rules limit the extent to which the host state can impose regulation on the firm's activities, in particular because prudential regulation, including recovery and resolution planning, is the province of the home state.

The exit of the UK from the EU would mean that the host state supervisors would need to re-consider the regulation of these branches, in particular as the relationships between home and host state supervisors would no longer be subject to the institutionalised framework of regulatory cooperation established by EU legislation. This may be a particular concern for banks with significant local branches if host state supervisors were to seek to restrict the operations of the branch or require other measures to address local systemic risks. In any event, even if the host state supervisor recognises that the UK prudential regime continues to be equivalent to EU requirements and puts in place appropriate cooperation arrangements with the UK regulators, the host state may impose branch capital, liquidity or reporting requirements that do not currently apply to branches of UK banks in the EU.

Branches of UK banks in the euro area would no longer be subject to direct or indirect supervision by the ECB under the regulation establishing the SSM and instead would be directly supervised by national supervisors.[65]

UK banks and investment firms may also be required to join local depositor or investor protection schemes. Institutions subject to the BRRD would potentially now be subject to secondary local insolvency or reorganisation proceedings as CI(WUD) would no longer apply in the same way. In addition, the host state would no longer be required by the BRRD to recognise home state resolution action in relation to the firm.[66] However, local supervisors should be able to recognise UK resolution proceedings in relation to the branch or, failing that, to take independent resolution action in relation to the branch under the local provisions implementing the third country regime under the BRRD.[67] This may require the firm and third parties to re-evaluate legal opinions required, for example, for netting purposes or in relation to memberships of CCPs and payment systems and to reconsider its resolution plans.

In addition, currently, UK banks and investment firms can rely on the CRD or MiFID passport to conduct cross-border business from a branch with clients and counterparties in other Member States. In principle, if the UK left the EU, this right would cease and the firm could face barriers to conducting cross-border business in other Member States from the branch similar to those faced by non-EU firms conducting cross-border business into those Member States from outside the EU.

However, MiFID2 establishes an optional regime for third country firms that could affect the treatment of these branches. If an EU Member State exercises its option under MiID2 to require a non-EU firm providing investment services to retail clients to establish branches, then MiFID2 regulates the conditions for the authorisation of the branch, including a requirement for initial branch capital and specifies the conduct of business and market integrity rules that must be applied to the branch.[68]

65 Regulation (EU) No 1024/2013, Recital 28.

66 BRRD, Article 66.

67 BRRD, Articles 93 to 98.

68 MiFID2, Articles 39 to 41.

In addition, if the branch of a non-EU firm is authorised in a Member State under this new MiFID2 regime and the European Commission has made an equivalence determination under MiFIR in relation to the equivalence regulation of the non-EU firm in its home state, the branch will have a "third country branch passport" under which it can provide investment services to eligible counterparties and "per se" professional clients in other Member States, without being required to establish additional branches or require additional authorisations in those other Member States.[69] This passport could significantly mitigate the impact of the exit of the UK from the EU on UK firms with branches in the C-EU, although it is subject to similar limitations to those discussed above in relation to the third country entity passport for cross-border business under MiFIR.

C-EU firms with branches in the UK

For similar reasons to those discussed above, UK regulators may re-evaluate their regulation of C-EU banks and investment firms with branches in the UK, particularly where those branches are significant. For example, the UK Prudential Regulation Authority (PRA) has an established policy on supervision of international banks with a branch in the UK which states its "risk appetite" in relation to those branches.[70]

Those banks and investment firms would have to participate in the UK depositor and investor protection scheme. As for UK banks with branches in the C-EU, these banks and investment firms and their counterparties may need to evaluate the change to the applicable insolvency and resolution regimes as CI(WUD) and the BRRD would no longer apply to them in the same way.

In addition, currently, EU banks and investment firms with branches in the UK can rely on the CRD or MiFID passport to conduct cross-border business from that branch with clients and counterparties in other Member States. There is some uncertainty as to how MiFID2 and the CRD apply in relation to branches outside the EU and thus as to whether this right would be recognised as continuing if the UK left the EU. This issue would not be mitigated by the MiFIR "third country entity passport" discussed above.

CRD and MiFID2/MiFIR: groups

In many cases, individual EU banks and investment firms are members of wider groups of companies, including both EU and non-EU entities. The treatment of the individual entities in the UK or the C-EU under CRD and MiFID2/MiFIR is discussed above.

However, the exit of the UK from the EU may have other implications in relation to the supervision of a group that includes entities in both the UK and the C-EU.

For example, such exit may result in changes to the consolidating supervisor of the group or sub-groups within the wider group under the rules in the CRD (which would also affect the identity of the group-level resolution authority under the BRRD).[71] Where a UK institution or financial holding company or mixed financial holding is the parent undertaking of a C-EU institution, the CRD may require the supervisor of the C-EU institution to determine whether the institution is subject to consolidated supervision by a UK regulator which is equivalent to that under the CRD.[72] The regulator of a UK institution with a C-EU parent may also be required to make a similar determination. Similar issues may arise in relation to groups covered by the Financial Conglomerates Directive (FICOD).[73]

In addition, the supervisors of a group which includes both UK and C-EU entities may need to establish new supervisory cooperation arrangements as the relationships between UK and C-EU supervisors would no longer be subject to the institutionalised framework of regulatory cooperation established by EU legislation.

69 MiFIR, Article 47(3).

70 PRA, Supervising international banks: the PRA's approach to branch supervision – PS8/14 and SS10/14 (September 2014).

71 CRD, Article 111 and BRRD, Article 2(1)(44). For example, under current rules, if a Luxembourg holding company owns banking subsidiaries in France, Germany and the UK, the UK regulator may be the consolidating supervisor of the group if the UK bank is the largest bank. After the exit of the UK from the EU, the C-EU application of CRD would direct that the ECB would be the consolidating supervisor, acting through the French or German supervisors, in accordance with the rules establishing the SSM.

72 CRD, Article 127.

73 Directive 2002/87/EC.

Funds and asset management

The exit of the UK from the EU would affect the way in which UK and C-EU firms distribute funds and provide asset management and investment advisory services.

UCITS

UK UCITS would no longer be eligible for distribution in the C-EU and C-EU UCITS would no longer be eligible for distribution in the UK under the passport arrangements provided by the UCITS Directive. Instead, they would be treated in the same way as non-EU AIFs under the AIFMD.

In particular, this would mean that UK UCITS could only be marketed in the C-EU under the national private placement regimes of C-EU Member States.[74] A number of C-EU Member States currently do not allow marketing of non-EU AIFs to retail investors or impose additional restrictive conditions on marketing to retail investors.[75]

Similarly, C-EU UCITS could only be marketed in the UK under the UK national private placement regime, which requires compliance with the financial promotion restrictions and would restrict the marketing of unrecognised schemes to retail investors (assuming that the UK retains its existing legislation but treats other States, including C-EU Member States, in the same way as it currently treats third countries).[76] However, the UK might use the powers under the FSMA individually to recognise a C-EU UCITS as a recognised overseas scheme in relation to marketing in the UK to facilitate marketing in the UK.[77]

These restrictions on marketing UK UCITS to retail investors in the C-EU could continue even if the C-EU "switched on" the passport regime under AIFMD for non-C-EU AIFs and AIFMs.[78] For similar reasons, if the UK retained its existing legislation but treats other States, including C-EU Member States, in the same way as it currently treats third countries, these restrictions on marketing C-EU UCITS to retail investors in the UK could continue even if the UK "switched on" the corresponding passport regime for non-UK AIFs and AIFMs.

UK and C-EU management companies would also have to consider whether they would be subject to licensing requirements as a result of marketing or selling their UCITS in the C-EU or the UK respectively, in particular as regards marketing and sales to retail investors. UK management companies may not be able to benefit from the MiFIR "third country entity passport" referred to above, which may not apply to managers of collective investment undertakings acting as such[79] and in any event does not cover the provision of services to retail investors. Similarly, C-EU management companies may not benefit from any reciprocal arrangements under MiFIR or the "overseas persons" exclusion with respect to marketing to retail investors in the UK.

UK management companies would no longer be able to act as managers of C-EU UCITS and C-EU management companies would no longer be able to act as managers of UK UCITS under their passport rights under the UCITS Directive. It is likely to be necessary to establish new management companies in the C-EU and the UK for this purpose, although the new management companies should be able to delegate portfolio management to the existing management company subject to compliance with the requirements of the UCITS Directive on delegation to non-EU managers. Existing delegation arrangements between the C-EU management companies and UK portfolio managers and between UK management companies and C-EU portfolio managers may need to updated to reflect these requirements.

UCITS may not invest more than 30% of their assets in non-UCITS collective investment schemes.[80] This would affect the ability of C-EU UCITS funds of funds to invest in UK UCITS and UK UCITS funds of funds to invest in C-EU UCITS.

74 AIFMD, Article 42.

75 AIFMD, Article 43.

76 UK Alternative Investment Fund Managers Regulations 2013.

77 FSMA, sections 272–277A.

78 AIFMD, Article 67.

79 MiFID2, Article 2(1)(i).

80 UCITS Directive, Article 55(2).

AIFs

The exit of the UK from the EU would mean that UK full scope AIFMs would no longer have the benefit of the marketing passport under AIFMD when marketing C-EU and UK AIFs managed by them into C-EU Member States.[81] Instead, they would have to comply with the national private placement regimes in those States for marketing to professional investors (and any national restrictions on marketing to retail investors).[82] Some C-EU Member States have not implemented a private placement regime and in other C-EU Member States the conditions for private placement regimes are very restrictive. Small UK AIFMs may be in a different position.

However, UK AIFMs may benefit from the new arrangements to the extent that they market non-EU AIFs to professional investors in C-EU Member States. Currently, they have to comply with the national private placement regimes in those States[83] but would still have fully to comply with the AIFMD requirements (except that they are not required to comply with the full rules on depositories in relation to the AIF but must comply with limited substitute "depo-lite" requirements).[84] There would be a benefit for a UK AIFM to the extent that, following the exit of the UK from the EU, the UK regime regulating AIFMs is less burdensome than the AIFMD regime (such as not imposing depositary requirements).

If the C-EU "switched on" the passport regime under AIFMD for non-C-EU AIFs and AIFMs,[85] a UK full scope AIFM could have the benefit of the AIFMD marketing passport for marketing to professional investors in the C-EU of C-EU, UK and non-EU AIFs managed by it. However, it would have to be authorised in a C-EU Member State of reference, comply with the full requirements of AIFMD (except those where compliance incompatible with compliance with an equivalent UK rule) and maintain a legal representative in the C-EU. It would also still have to be authorised in the UK and to comply with any requirements of the UK regime even if duplicative of or going beyond the C-EU requirements.

UK AIFMs would also have to consider whether they would be subject to licensing requirements as a result of marketing or selling AIFs in the C-EU. UK AIFMs may not be able to benefit from the MiFIR "third country entity passport" referred to above, which may not be available to managers of collective investment undertakings which would fall within an exemption under MiFID2.[86]

UK AIFMs that do not market their AIFs in the C-EU (except on a reverse enquiry basis) may benefit to the extent that, following the exit of the UK from the EU the UK regime regulating AIFMs is less burdensome than the AIFMD regime. However, it is possible that maintenance of the current regime may be a condition of the marketing passport being available to UK AIFMs to market in the C-EU (if the AIFMD is interpreted or amended so that the passport is only "switched on" in relation to equivalent jurisdictions).

The exit of the UK from the EU would also affect C-EU AIFMs when marketing C-EU, UK and non-EU AIFs managed by them into the UK in a corresponding way to that described above. However, they would be less likely to see a benefit from the change in position in relation to the marketing of non-EU AIFs unless the C-EU chose to relax the requirements of the AIFMD as well. C-EU AIFMs are also less likely to be affected by UK licensing requirements when they market their AIFs to professional investors in the UK because they are likely to be able to rely on the overseas persons exclusion under UK legislation referred to above.

Existing delegation arrangements between C-EU AIFMs and UK firms and between UK AIFMs and C-EU firms may need to updated to reflect the burdensome requirements that apply under the AIFM in relation to delegation outside the EU.

C-EU AIFs would not be able to use UK banks as depositories.[87] Similarly, UK AIFs would not be able to use C-EU banks as depositaries.

81 AIFMD, Article 32.

82 AIFMD, Articles 42 and 43.

83 AIFMD, Article 36.

84 AIFMD, Articles 21 and 36(1)(a).

85 AIFMD, Article 67.

86 MiFID2, Article 2(1)(i).

87 AIFMD, Article 21(3).

ELTIFs

The exit of the UK from the EU would mean that European long-term investment funds (ELTIFs) established in the UK and regulated under the ELTIF Regulation would no longer be eligible for distribution in the C-EU and C-EU ELTIFs would no longer be eligible for distribution in the UK under the passport arrangements provided by the ELTIF Regulation.[88] Instead, they would be treated in the same way as non-EU AIFs under the AIFMD. C-EU ELTIFs could only invest in UK undertakings and UK ELTIFs could only invest in C-EU undertakings if certain conditions are met, including a relevant tax agreement between the ELTIF's home state and the State of the investment.[89]

Portfolio management and investment advisory services

The exit of the UK from the EU could affect the ability of UK UCITS management companies and AIFMs to provide segregated account portfolio management services and investment advice to clients in the C-EU. The UCITS Directive and AIFMD do not contain a third country regime enabling firms from non-EU States to provide those services into the EU but UK UCITS management companies and AIFMs may not be able to benefit from the MiFIR "third country entity passport" referred to above in relation to these services (although they may be able to provide services on a "reverse enquiry" basis depending on the relevant national rules). Where a UK investment firm provides portfolio management and investment advisory services, it may be able to benefit from the MiFIR "third country entity passport" referred to above to provide those services into other Member States.

UK UCITS management companies, AIFMs and (to the extent that they cannot rely on MiFIR) investment firms would need to determine the extent to which they could continue their business with clients and counterparties in the C-EU taking into account the patchwork of regulatory restrictions on cross-border activity discussed above.

C-EU UCITS management companies and AIFMs may be able to provide portfolio management and investment advice to clients in the UK without requiring a licence in the UK under the "overseas persons" exclusion referred to above, at least if the clients are professional clients.

However, clients may be subject to regulatory requirements or requirements in their investment mandates which restrict the extent to which they can delegate services outside the EU.

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The exit of the UK from the EU could affect the ability of UK UCITS management companies and AIFMs to provide services
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88 Regulation (EU) 2015/760, Article 31.

89 ELTIF Regulation, Article

Prospectuses

The exit of the UK from the EU would affect the treatment of securities offerings under the Prospectus Directive.

For example, prospectuses approved in the UK could no longer be passported into C-EU Member States for public offers or admission to trading in other Member States. [90] This could affect issuers' choice of the UK as a venue for initial listing of their securities. The fact that the UK would no longer be a C-EU Member State may also affect the question of which C-EU Member State is an issuer's "home state" for the purposes of both the Prospectus Directive[91] and the Transparency Obligations Directive.[92] However, C-EU supervisors would be able to approve a prospectus for an offer to the public in the C-EU or for admission to trading on a C-EU regulated market of securities of a UK issuer drawn up in accordance with UK law on the basis of a determination by the European Commission that UK law is equivalent to the requirements under the Directive.[93]

Corresponding issues would arise with respect to use of prospectuses approved in the C-EU for passporting into the UK.

See below as to the impact on government and public securities.

Market infrastructure and service providers

Market infrastructure and other service providers play a critical role in the functioning of the single market. However, the exit of the UK from the EU could affect their ability to provide their services or the ability of market participants to make use of their services. In most cases, existing legislation provides an equivalence arrangement or similar mechanism to allow for current arrangements to continue, but in some cases new arrangements might need to be made to avoid adverse impacts on the market.

Trading venues

EU legislation categorises trading venues for financial instruments as regulated markets, multilateral trading facilities (MTFs) and, when MiFID2/MiFIR are implemented, organised trading facilities (OTFs). Market operators can operate regulated markets, as well as MTFs or OFT (under MiFID2/MiFIR). Banks and investment firms can operate MTFs or OTFs. All of these systems effectively bring together third party interests on a platform which results in binding transactions for financial instruments. Current EU legislation provides that only systems which are authorised in a Member State can be treated as trading venues. As a result, the exit of the UK from the EU would have a number of potential effects on trading venues operated by UK firms:

- UK trading venues would lose their rights under MiFID2 to provide arrangements in the territory of the C-EU to enable remote users, members or participants to trade on those markets[94] and may face licensing restrictions on providing cross-border access to C-EU firms. UK banks and investment firms operating an MTF or OTF may be able to benefit from the MiFIR "third country entity passport" discussed above to provide cross-border services into the C-EU but there is some uncertainty as to how this would operate in relation to platforms operated by non-EU firms given that the definitions of MTF and OTF assume that the platform is operated "in accordance with" Title II or III of MiFID2 which apply to EU operated platforms.[95]

90 Prospectus Directive, Article 17.

91 Prospectus Directive, Article 2(1)(m).

92 Directive 2004/109/EC, Article 2(1)(m)

93 Prospectus Directive, Article 20(1).

94 MiFID2, Articles 53(6), 34(6) and 34(7) respectively.

95 MiFID2, Article 4(1)(22) and (23).

- UK trading venues would lose their right under EMIR to non-discriminatory access to C-EU CCPs to have financial instruments cleared, including access fees and collateral.[96] A UK trading venue would only be able to request access to a C-EU CCP if the European Commission has adopted an equivalence decision with respect to the UK's regulatory regime for trading venues and may only make use of access rights if the UK's legal and regulatory framework provides an effective equivalent mechanism for foreign trading venues to gain access to UK CCPs.[97]

- UK trading venues would lose their right under MiFIR to fair, reasonable and non-discriminatory access to price and data feeds for, information on and licences to C-EU benchmarks.[98] A UK trading venue would only be able to request a licence and that access right to a C-EU benchmark if the European Commission has adopted an equivalence decision with respect to the UK and if the UK provides an effective equivalent mechanism for foreign trading venues to gain access to UK benchmarks.[99]

- C-EU banks and investment firms would not be able to undertake transactions on UK trading venues in shares admitted to trading on a C-EU regulated market or traded on a trading venue in the C-EU unless the European Commission has assessed the UK trading venue as equivalent under the regime provided in the Prospectus Directive.[100]

- Counterparties subject to the C-EU trading mandate for OTC derivatives would not be able to execute their trades in OTC derivatives within the scope of the trading mandate on UK trading venues unless the European Commission has adopted an equivalence decision for the UK and the UK's legal and regulatory framework provides an effective equivalent mechanism for C-EU trading venues to trade derivatives declared subject to a trading obligation in the UK on a non-exclusive basis.[101]

- Derivatives traded on UK trading venues would be considered "OTC derivatives" for the purposes of the C-EU rules under EMIR (e.g., when non-financial counterparties have to determine whether their positions in OTC derivatives exceed the clearing threshold under EMIR) unless the European Commission determines that they are equivalent to EU trading venues.[102]

- The fact that a UK market would no longer be a regulated market or trading venue for the purposes of EU legislation may have other effects, for example, on the question of which State is the home state within the C-EU under the Prospectus Directive[103] or the Transparency Obligations Directive,[104] the question of which supervisory authority is competent in relation to a takeover under the Takeovers Directive[105] or the application of the Market Abuse Regulation to conduct in the C-EU in relation to instruments traded on UK venues.[106]

96 EMIR, Article 7 and MiFIR, Article 35.

97 MiFIR, Articles 28(4) and 38(1).

98 MiFIR, Article 37.

99 MiFIR, Article 38(2) and (3).

100 MiFID2, Article 23.

101 MiFIR, Article 28.

102 EMIR, Articles 2(1)(7) and 2a.

103 Prospectus Directive, Article 2(1)(m).

104 Transparency Obligations Directive, Article 2(1)(m).

105 Directive 2004/25/EC, Article 4.

106 MAR, Article 2

- Under the Short Selling Regulation, C-EU disclosure requirements and limits on uncovered short sales would apply to persons in the UK (and elsewhere) if shares are admitted to trading on a trading venue in the C-EU, even the shares are also traded in the UK.[107] These would duplicate the UK requirements. The Short Selling Regulation would provide an exemption where the relevant C-EU supervisor determines that the principal venue for the trading of the shares is in the UK.[108] However, the UK and the C-EU supervisors may need to put in place arrangements to share information on private disclosures. The Regulation also provides a market making exemption from certain requirements that would be available for UK firms that are members of a trading venue in the UK if the European Commission determines that the legal and regulatory framework governing that venue are equivalent to EU requirements.[109]

In a similar way, if the UK retained the existing EU legislation but treated other States (including C-EU Member States) in the same way as the EU treats third countries, C-EU trading venues would lose corresponding rights of access to the UK, unless the relevant UK authority made a corresponding equivalence assessment. The UK legislation may also need to address some of the other issues referred to above, e.g. the application of the Market Abuse Regulation to conduct in the UK in relation to instruments that are traded on C-EU venues or the exemptions from UK short selling requirements where the principal venue for trading shares is in the C-EU.

Central counterparties

The exit of the UK from the UK would have a number of effects on UK CCPs:

- Unless UK CCPs are recognised by ESMA under EMIR, they would no longer be able to provide clearing services to C-EU clearing members or trading venues,[110] counterparties subject to the C-EU clearing obligation under EMIR would not be able to clear mandatorily clearable trades on those CCPs[111] and C-EU institutions subject to CRR would not benefit from the preferential regulatory treatment accorded to transactions cleared on qualifying CCPs (QCCPs).[112] In order to obtain recognition, the European Commission would need to adopt a decision as to the equivalence of the UK regime and determining that the UK regime provides an effective equivalent mechanism for the recognition of foreign CCPs. In addition, ESMA would have to establish cooperation arrangements with the UK regulators and the UK would have to be recognised as having equivalent systems for anti-money laundering and combating the financing of terrorism.[113]

- UK CCPs would lose their right under EMIR to non-discriminatory access to trade feeds for financial instruments traded on C-EU trading venues.[114] A UK CCP would only be able to request access to a C-EU trading venues if the European Commission has adopted an equivalence decision with respect to the UK's regulatory regime for CCPs and may only make use of the access rights if the UK's legal and regulatory framework provides an effective equivalent mechanism for foreign CCPs to gain access to UK trading venues.[115]

- UK CCPs would lose their right under MiFIR to fair, reasonable and non-discriminatory access to price and data feeds for, information on and licences to C-EU benchmarks.[116] A UK CCP would only be able to request a licence and that access right to a C-EU benchmark if the European Commission has adopted an equivalence decision with respect to the UK and if the UK provides an effective equivalent mechanism for foreign CCPs to gain access to UK benchmarks.[117]

107 Regulation (EU) No 236/2012, Articles 5, 6 and 12.

108 Short Selling Regulation, Article 16.

109 Short Selling Regulation, Article 17.

110 EMIR, Article 25.

111 EMIR, Article 4(3).

112 CRR, Articles 305(2)(d), 306(1)(a) and 310

113 EMIR, Article 25.

114 EMIR, Article 8 and MiFIR, Article 36.

115 MiFIR, Articles 28(4) and 38(1).

116 MiFIR, Article 37.

117 MiFIR, Article 38(2) and (3).

In a similar way, if the UK retained the existing EU legislation but treated other States (including C-EU Member States) in the same way as the EU treats third countries, C-EU CCPs would lose corresponding rights in the UK, unless the relevant UK authority made a corresponding equivalence assessment and recognised those CCPs for UK purposes.

Central securities depositories

The exit of the UK from the EU would also have an effect on UK central securities depositories authorised under the CSDR:

- UK central securities depositories would lose their right to provide their services to market participants in the C-EU by way of a branch or through the cross-border provision of services.[118] The CSDR would allow UK central securities depositories to offer services to entities within the C-EU. However, if they wish to provide certain services relating to securities constituted under the law of a C-EU Member State or to establish a branch in the EU, the UK central securities depository would have to be recognised by ESMA.[119] For a UK central securities depository to be recognised by ESMA, a number of conditions would have to be met, including the European Commission adopting a decision determining that the legal and supervisory arrangements in the UK ensure that the central securities depository is subject to equivalent requirements to those under the CSDR. Co-operation arrangements would also have to be established between ESMA and the relevant UK regulator.

- C-EU central securities depositories could link to UK central securities depositories [120] but it seems that UK central securities depositories would no longer have rights to link to C-EU central securities depositories or rights of non-discriminatory access to transaction feeds from C-EU CCPs or trading venues.[121]

In a similar way, if the UK retained the effects of the existing EU legislation but treated other States (including C-EU Member States) in the same way as the EU treats third countries, C-EU central securities depositories would lose corresponding rights of access to the UK, unless they were recognised for UK purposes.

UK issuers would no longer have a right to issue their securities in C-EU central securities depositories (nor would C-EU issuers have a corresponding right in UK central securities depositories).[122]

Settlement finality

The exit of the UK from the EU could affect the protection afforded by the SFD to UK payment and securities settlement systems. C-EU Member States would no longer be required to ensure that their law protects payment and settlement systems governed by the law of a part of the UK and designated by the UK under the SFD from the impact of insolvency proceedings in the C-EU on the finality of settlement and the enforcement of collateral. Similarly, C-EU Member States would no longer be required to ensure that their law protects UK systems from the effect of certain resolution powers under the BRRD.[123] This may affect the ability of UK systems to continue to admit participants from C-EU Member States. The SFD does not currently include a third country regime that would mitigate the impact of this on UK systems.

Similarly, the UK would also no longer be required to ensure that its law protects systems governed by the law of a C-EU Member State which might affect the ability of UK firms to continue to be participants of C-EU systems. The UK could unilaterally decide to extend this protection to C-EU systems by extending its insolvency and resolution legislation[124] to cover those systems, possibly even if the C-EU did not reciprocate.

118 CSDR, Article 23.

119 CSDR, Article 25.

120 CSDR, Article 25(2).

121 CSDR, Articles 50 and 53.

122 CSDR, Article 49.

123 BRRD, Articles 69(4)(b), 70(2) and 71(3).

124 UK Financial Markets and Insolvency (Settlement Finality) Regulations 1999 and the Banking Act 2009.

Transparency and reporting

The exit of the UK from the EU could also have an impact on transparency and reporting arrangements:

- Unless the UK changed the approach to implementation, UK firms subject to the transparency and reporting requirements under MiFIR would not have to provide pre- or post-trade transparency or report transactions to the UK regulator if the transactions related to financial instruments that are only traded or admitted to trading on C-EU trading venues (and not on UK trading venues).[125] Similarly, C-EU firms subject to those requirements, would not have to provide pre- or post-trade transparency or report transactions to their C-EU supervisors if the transactions related to financial instruments that are only traded or admitted to trading on UK trading venues (and not on C-EU trading venues). This might significantly diminish the volume of information published and reported. The UK and C-EU supervisors might change their rules to impose wider transparency and reporting obligations but then would need to establish new supervisory cooperation arrangements to share that information with each other.

- If UK trading venues continue to admit C-EU firms as participants, the UK trading venue would also have to report the transactions on the venue to the UK regulator, which would duplicate reports made by the C-EU firm to its supervisor.[126] Similar duplication would arise where UK firms are participants in C-EU venues.

- C-EU firms with branches in the UK may have to report transactions by their UK branch to the UK regulator in addition to reporting to their home state supervisor.[127] Similarly, UK firms with branches in the C-EU may have to report branch transactions both to the host state supervisor and to the UK regulator. There may be similar duplication of reporting under the Securities Financing Transactions Regulation (SFTR) which also contemplates reporting by branches of non-EU entities in the EU or by non-EU branches of EU firms, although the use of common trade repositories could reduce the impact of this (and SFTR also contains provisions allowing for relief from reporting where the counterparties comply with equivalent obligations of a third country where one of the parties is established in that third country).[128]

- UK firms authorised to act as data reporting services providers (approved publication arrangements, consolidated tape providers and approved reporting mechanisms) [129] would cease to be able to provide their services to C-EU entities as MiFID2 provides that these must be entities established and authorised in the EU. There is no provision for recognition of third country entities. Similarly, C-EU entities which are authorised to act as data reporting service providers would cease to be able to able to provide their services to UK entities.

- UK firms registered with ESMA as trade repositories under EMIR and SFTR would cease to be able to receive reports from C-EU counterparties subject to obligations under EMIR or SFTR unless they were recognised by ESMA.[130] UK trade repositories may be recognised under EMIR if the Commission has determined that the UK has an equivalent regulatory and supervisory arrangement, there is a binding international agreement in place between the EU and the UK covering supervision and the exchange of information and ESMA has entered into cooperation arrangements with the UK regarding to access to information. Similar requirements apply under the SFTR except that there is no requirement for an international agreement, but recognition could only be granted if the UK imposed legally binding obligations on its trade repositories to give direct and immediate access to data to the relevant C-EU authorities. Similarly, C-EU firms registered with ESMA as trade repositories under EMIR and SFTR would lose their rights to receive reports from UK counterparties subject to obligations under EMIR or SFTR unless they were recognised in a corresponding way by the relevant UK regulator.

125 MiFIR, Articles 14, 18, 20, 21 and 26.

126 MiFIR, Article 26(5).

127 MiFIR, Article 26. ESMA has indicated that it expects EU firms to report transactions in the UK to their home state regulator.

128 Regulation (EU) 2015/2365, Articles 2(1)(a), 4 and 21.

129 MiFID2, Article 59, 64, 65 and 66.

130 EMIR, Articles 9, 75, 76 and 77 and SFTR, Articles 4 and 19.

Credit rating agencies

The exit of the UK from the EU could mean that C-EU supervised entities would no longer be able to use ratings produced by UK credit rating agencies or produced by non-EU affiliates of a UK credit rating agency and endorsed by the UK credit rating agency for use in the EU.[131] However:

- If the UK credit rating agency has an affiliated credit rating agency in the C-EU which is registered with ESMA, the C-EU affiliate may be able to endorse the ratings produced by the UK credit rating agency and its non-EU affiliates so that they can be used in the C-EU but only if certain conditions are met. In particular, there must be an objective reason for the rating to be produced outside the C-EU and the UK and non-EU credit rating agencies' activities fulfil requirements at least as stringent as requirements under the CRA Regulation (or that the European Commission has recognised the equivalence of the UK's legal and regulatory framework) and cooperation arrangements would need to be in place between ESMA and the relevant UK regulator.[132]

- Where a UK credit rating agency produces credit ratings that are not of systemic importance in the C-EU, supervised entities in the C-EU would be able to use those ratings if the credit rating agency is certified under the CRA Regulation. Certification would be subject to additional conditions including the requirement that the European Commission has recognised the equivalence of the UK's legal and regulatory framework and that cooperation arrangements would need to be in place between ESMA and the relevant UK regulator.[133]

In a similar way, if the UK retained the effects of the CRA Regulation but treated all other States (including C-EU Member States) in the same way as the EU treats third countries, UK supervised entities could cease to be able to use ratings produced by C-EU credit rating agencies or produced by non-EU credit rating agencies and endorsed by those C-EU agencies for use in the EU, unless those ratings were endorsed by a UK credit rating agency or the C-EU credit rating agency were certified under the UK provisions reflecting the provisions of the CRA Regulation discussed above.

Benchmarks

The exit of the UK from the EU could mean that C-EU supervised entities would no longer be able to use benchmarks provided by a UK administrator or benchmarks provided by non-EU administrators and endorsed by a UK supervised entity for use in the EU under the Benchmarks Regulation.[134] However:

- C-EU supervised entities could use benchmarks provided by a UK administrator if the European Commission determines that the UK legal framework and supervisory arrangements are equivalent to those under the Benchmarks Regulation and cooperation arrangements between ESMA and the relevant UK regulator are operational.[135]This regime may also be available in relation to a non-EU administrator instead of relying on the endorsement of a UK administrator, but few other non-EU States currently have equivalent regimes.

- The UK administrator or the non-EU administrator could seek recognition from a national supervisor in the C-EU or arrange for a C-EU supervised entity to endorse its benchmarks under the other parts of the third country regime under the Benchmarks Regulation, although there may be practical issues in using these regimes (e.g. identifying the Member State of reference whose national supervisor must recognise the benchmarks).[136]

In a similar way, if the UK retained the effects of the Benchmarks Regulation but treated all other States (including C-EU Member States) in the same way as the EU treats third countries, UK supervised entities could cease to be able to use benchmarks provided by C-EU administrators or provided by non-EU administrators and endorsed by C-EU supervised entities for use in the EU, unless those benchmarks were qualified for use in the UK under the retained provisions of the Benchmarks Regulation.

131 CRA Regulation, Article 4.

132 CRA Regulation, Articles 4(3) to (6) and 5(6).

133 CRA Regulation, Article 5.

134 Benchmarks Regulation agreed text published on 4 December 2015, Articles 19 and 21b.

135 Benchmarks Regulation, agreed text published on 4 December 2015, Article 20.

136 Benchmarks Regulation, agreed text published on 4 December 2015, Articles 21a and 21b.

UK and C-EU supervised entities may cease to benefit from rights to access licences of and information relating to critical benchmarks provided by a C-EU administrator, for example, where these are not "used" in financial instruments traded on C-EU trading venues (or a UK administrator, for example, where these are not "used" in financial instruments traded on UK trading venues).[137]

Central banks and governments

A number of EU directives and regulations provide special treatment for the ECB, other EU central banks that are members of the ESCB and EU Member States. In some cases, the legislation does not provide for that treatment to extend, or to extend automatically, to non-EU central banks and States. For example:

- The Prospectus Directive does not apply to non-equity securities of EU Member States, their regional and local authorities and members of the ESCB (as well as public international bodies of which one or more Member States are members and securities guaranteed by a Member State or by one of a Member State's regional or local authorities).[138] There is no corresponding exemption for offering of securities of non-EU States or central banks (or other public international bodies). The Transparency Obligations Directive also has exemptions for Member States and their regional or local authorities which do not extend to non-EU States or their authorities.[139]

- MiFIR provides exemptions from reporting requirements for certain transactions of members of the ESCB but the European Commission can extend this to non-EU central banks.[140]

- EMIR and SFTR provide exemptions to members of the ESCB and EU public bodies that are charged with intervening in the management of public debt but the European Commission can extend some of these exemptions to non-EU central banks and public bodies.[141]

- The SFD requires Member States to protect the right to collateral security provided to members of the ESCB against insolvency proceedings.[142] The SFD does not contain provisions requiring Member States to extend this protection to non-EU central banks.

The C-EU would need to decide whether to apply these special treatments to the Bank of England and the UK. Similarly, the UK would need to decide whether to apply treatments to the continuing members of the ESCB and C-EU Member States. If the C-EU and the UK do not do this, it would affect offerings of UK public sector debt securities in the C-EU and offerings of C-EU public sector debt securities in the UK and could affect the acceptability of UK and C-EU firms as counterparties to the continuing members of the ESCB or the Bank of England.

In other cases, EU legislation provides special treatment that is available equally both to EU and non-EU central banks and governments. For example, the CRR provides reduced risk weights for central banks and governments under the standardised approach which apply equally to EU and non-EU central banks and governments,[143] the BRRD requires Member States to provide protections from certain resolution powers to all central banks[144] and the agreed text of the Benchmarks Regulation also provides exemptions for central banks and public authorities providing benchmarks that are not expressed to be limited to EU central banks or public authorities.[145]

137 Benchmarks Regulation, agreed text published on 4 December 2015, Article 13b.

138 Prospectus Directive, Article 1(2)(b) and (d).

139 Transparency Obligations Directive, Article 1(3).

140 MiFIR, Article 1(6) to (9).

141 EMIR, Article 1(4)(a) and (6) and SFTR, Article 1(2) to (4). The SFTR does not give the European Commission powers to extend the exemptions allowing counterparties not to report transactions with members of the ESCB to non-EU central banks.

142 SFD, Article 9

143 CRR, Article 114.

144 BRRD, Articles 69(4)(b), 70(2) and 71(3).

145 Benchmarks Regulation, agreed compromise text published by the Council on 4 December 2015, Article 2(2)(a) and (b).

Other impacts

There would be a range of other impacts resulting from the exit of the UK from the EU. For example:

- Additional equivalence determinations may be necessary under EU legislation, for example, to recognise the equivalence of rules on clearing and margining of OTC derivatives under EMIR[146] or on the reporting of securities financing transactions under the SFTR[147] (for other examples, see "Non-discrimination principles" in Section 2 above).

- The Brussels Regulation would no longer require courts in the C-EU to recognise judgments of the UK courts, even where there is a submission to the jurisdiction of those courts. Similarly, UK courts would no longer be required to recognise judgments of C-EU courts. The courts may still be able to recognise judgments but the process may be less straightforward. The UK and the C-EU could enter into a new convention on jurisdiction or the recognition of judgments in civil and commercial matters to address this gap. Alternatively or additionally, the UK might accede to the 2005 Hague Convention on Choice of Court Agreements to which the EU is already a party. This would ensure that the courts in the UK and the C-EU would recognise contractual agreements conferring exclusive jurisdiction on the chosen courts, but would not address the issues relating to non-exclusive jurisdiction clauses common in financial agreements.

- C-EU institutions subject to the BRRD would need to include clauses recognising bail-in powers in contracts governed by English law.[148] Conversely, UK institutions subject to BRRD would need to include clauses recognising bail-in powers in contracts governed by the law of a C-EU Member State. Similar issues may arise under UK or C-EU national rules requiring the inclusion of clauses recognising resolution action in contracts.

- Unless the ECB changes its guidelines, the exit of the UK from the EU and the EEA could affect the eligibility of some classes of securities as collateral for Eurosystem credit operations, such as asset-backed securities issued by UK SPVs or with underlying assets representing claims on UK obligors or governed by UK law.[149] In any event, the ECB would have to assess the acceptability of a UK listing for securities to be used as collateral (because UK markets would no longer be regulated markets under MiFID) and, in relation to UK issuers of securities used as collateral, whether UK law appropriately protects the rights of the ECB.[150] The Bank of England would need to decide whether to continue to treat C-EU asset backed securities, securitisations, covered bonds and corporate debt securities in the same way for collateral purposes as corresponding UK securities.[151]

- There would be impacts under other cross-sector legislation, such as data protection laws, where there may be similar issues about whether cross-border data transfers between the UK and the C-EU can continue based on the equivalence of their regulatory regimes.

- There would also be a need to review contracts to ensure that continued performance is not dependent on authorisations that are no longer available or that they do not inappropriately refer to legislation and concepts that are no longer relevant.

- There may be additional consequences under national law where local legislation in a Member State currently distinguishes between the treatment of EU and non-EU firms or situations.

In addition, UK and C-EU supervisors would need to build a framework of non-binding cooperation arrangements to replace, so far as practicable, the institutionalised regulatory cooperation embedded in EU financial legislation.

146 EMIR, Article 13.

147 SFTR, Article 21.

148 BRRD, Article 55.

149 Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (ECB/2014/60), Articles 66, 70(5), 75 and 76.

150 Ibid, Articles 68(1) and 70(6).

151 Bank of England, Sterling Monetary Framework – summary of collateral eligible for the Bank's operations (August 2015), available at:http://www.bankofengland.co.uk/markets/Documents/money/publications/summary_collateral.pdf

Transitional arrangements

Existing EU legislation would only allow relevant equivalence determinations to be made and other steps to be taken to mitigate the impact of the exit of the UK from the EU after the UK has ceased to be a Member State. Therefore, the UK might seek to negotiate arrangements as part of the withdrawal agreement to ensure that the mitigations described above take effect in the C-EU immediately at the time of withdrawal (or other appropriate transitional arrangements). The UK could pass legislation enabling reciprocal mitigating action as part of its legislation relating to the exit from the EU.

As the EU will have already recognised a number of other third country CCPs before the exit of the UK from the EU under the provisions discussed above, the UK would need to determine whether to apply transitional provisions recognising those CCPs for the purposes of the EU legislation retained in the UK. This would be likely to require the UK regulators to establish new cooperation arrangements with the relevant third country supervisors to replicate the existing cooperation arrangements with ESMA. Similar issues will arise in relation to:

- non-EU credit rating agencies certified under the CRA Regulation;
- non-EU trading venues, CSDs or trade repositories recognised in the EU before the exit of the UK from the EU under MiFIR, CSDR, EMIR and SFTR;
- non-EU benchmarks qualified for use in the EU before the exit of the UK from the EU under the Benchmarks Regulation.

In any event, both the C-EU and the UK would need to consider the treatment of the many different types of case where the exit of the UK from the EU would affect existing arrangements. For example:

- Market participants conducting cross-border business in other Member States in reliance on passport rights may have existing relationships with clients and counterparties that cannot readily be stopped even if continued cross-border business would not be permitted under the licensing regime that would exist after the exit of the UK from the EU. It may be appropriate to grandfather existing relationships and provide time for firms to cease taking new business.
- Market participants that have established branches in other Member States in reliance on passport rights may need time to close the branch or to prepare for the change in the regulatory regime resulting from the exit of the UK from the EU.

The withdrawal arrangements should provide appropriate transitional arrangements for these and other similar situations.

Acquired rights

Leaving aside any negotiated solution, the ability under international law to continue to use rights after a change in law is dealt with by the doctrine of what is called "acquired rights", with the premise being that rights which have already been executed and had their effect acquire an existence independent of any treaty which created such rights and that termination will not affect them.[152] While these are strong statements of principle, it is still not clear that there is an internationally recognised concept of what and how acquired rights should operate (or whether they even exist at all as far as private actors are concerned – as opposed to between state actors).[153] In addition, in determining the extent to which rights under specific legislation can be modified, the European Court of Justice generally recognises the broad freedom of the legislator to modify the regulatory framework for the future, even if the new rules negatively affect existing relations.[154]

In absence of any agreed transitional measures, it is difficult to conclude with any confidence that either the Court of Justice or the domestic courts of the UK or the C-EU Member States would recognise the continued ability of financial services firms to operate on the basis of their current situation under the doctrine of acquired rights.

152 Lord McNair, *The Law of Treaties*, 2nd edition, 1961, pp 531-532.

153 See Sornarajah, M., *The International Law on Foreign Investment*, 2nd edition, 2004, p 445.

154 See Case C-60/98 Butterfly Music Srl v Carosello Edizioni Musicali e Discografiche Srl, [1999], ECR I-3939, paras. 24-25.

Legal redress

The question of standing and legal redress would be an important issue for the relationship between the UK and the EU following the exit of the UK from the EU, particularly for financial services. As the UK may continue to be the main financial centre for the C-EU, albeit "offshore" and outside its direct jurisdiction, the UK would continue to be significantly affected by legislation or policies adopted by the C-EU but would have no standing to challenge them even if they contravene the EU Treaties.[155] Conversely, the C-EU would be significantly affected by legislation and policies adopted by the UK, but would have no standing to challenge them either. This may be subject to the terms of any withdrawal agreement or ongoing agreement between the UK and the C-EU which provides a dispute settlement mechanism. However, trade agreements are likely to impose limited constraints on action taken by the C-EU or the UK for prudential purposes.

Individuals and businesses do not generally have any direct standing to bring challenges before the Court of Justice, unless action is directly taken against them by way of decisions (for example, by the ECB as banking supervisor).[156] However, they would be able to take action in national courts in the C-EU, which can seek an interpretation from the Court of Justice in Luxembourg.

Practical impact on market participants

UK banks and investment firms that use the UK as a hub location to provide cross-border investment banking, corporate banking and private wealth management services to clients and counterparties in the C-EU are likely to be significantly and adversely affected by new restrictions on cross-border business following a UK exit from the EU. However, the MiFIR "third country entity passport" (if activated) could be an important mitigant allowing UK banks and investment firms at least to provide cross-border investment services to wholesale and institutional clients and counterparties in the C-EU.

However, MiFIR would not assist in relation to other cross-border services, in particular deposit-taking, lending and credit and foreign exchange or private wealth management. It may be necessary to relocate some activities to branches or entities based in the C-EU in order to continue to access clients and counterparties there. The extent of relocation is likely to be significantly increased if the MiFIR "third country entity passport" is not available or if uncertainty as to its eventual availability means that firms feel constrained to act to relocate business in advance of the final position becoming clear. Relocation of activities is likely to involve significant time, work and expense in capitalising entities and putting in place systems and controls and staffing to enable them do business.

In contrast, C-EU banks and investment firms providing investment banking and corporate banking services to clients and counterparties in the UK are less likely to be affected, at least for institutional and wholesale business. However, they are likely to encounter new restrictions on providing cross-border private wealth management services into the UK, but may be able to do so through a branch (or subsidiary). In addition, C-EU banks and investment firms that currently use branches in the UK to service clients and counterparties in the C-EU may no longer be able to rely on their CRD or MiFID2 passport, as those passports may not be available to non-EU branches.

The impact on asset managers will depend on their particular business model. Some asset managers could be adversely affected by new restrictions on marketing UK UCITS funds to C-EU investors or, unless the UK relaxes its rules, C-EU UCITS funds into the UK. UK asset managers could also be adversely affected if they manage UK or C-EU AIFs that are marketed in the C-EU or if their business involves providing segregated account portfolio management or investment advisory services to C-EU clients. The MiFIR "third country entity passport" may not mitigate the impact on their segregated account portfolio management or investment advisory services unless they are investment firms. C-EU asset managers could also be significantly affected if they manage C-EU or UK AIFs and market them in the UK.

155 Compare e.g. Case T-496/11 United Kingdom v European Central Bank concerning the location policies of the ECB.

156 TFEU, Article 263 only provides that a natural or legal person may only institute proceedings "*against an act addressed to that person or which is of direct and individual concern to them*".

In contrast, asset managers are unlikely to be significantly affected by new restrictions if they manage assets from the UK but do not market their funds in the C-EU and do not provide segregated account portfolio management or investment advisory services to C-EU clients. Also, UK AIFMs marketing non-EU AIFs into the C-EU may be able to make use of national private placement regimes without some of the restrictions that currently apply.

UK and C-EU trading venues, CCPs and central securities depositories and their users would be significantly affected by new restrictions unless these infrastructures are recognised as equivalent in respectively the C-EU and the UK. Even so, UK and C-EU trading venues may be subject to some new restrictions on the provision of their services or their ability to place terminals or other facilities in respectively the C-EU and the UK. The resulting change to the insolvency law treatment of clearing and payment systems and banks and investment firms may cause firms or their counterparties to re-evaluate their relationships.

UK and C-EU credit rating agencies and benchmark administrators would need to evaluate whether they can make use of the third country regimes under the relevant regulations.

Issuers and investors may be affected if investment banking or asset management intermediaries are subject to new restrictions in the services that they can provide.

Both the UK and the C-EU would have an interest in making the market work following the exit of the UK from the EU. For example, many C-EU banks have significant operations in the UK and C-EU issuers and investors are likely to continue to wish to access investment banking and other services in the UK. However, these interests are not the same and there are risks that political constraints may obstruct the use of third country mechanisms to mitigate the exit of the UK from the EU.

In any event, even if it is possible to mitigate a large part of the immediate impact of the exit of the UK from the EU, changes to law or regulation over time in the UK and the C-EU could adversely affect the harmonised legal framework existing at the outset and put at risk the continued availability of equivalence determinations that help make the market work. In the longer term, it will be difficult to sustain the single market in the way that it operates today.

Appendices

Glossary of terms

AIF	Alternative investment fund
AIFM	Alternative investment fund manager
Brexit	Exit of the UK from the EU
CCP	Central counterparty
C-EU	The EU and its continuing Member States after the exit of the UK from the EU
CRA	Credit rating agency
CSD	Central securities depository
EBA	European Banking Authority
ECA	UK European Communities Act 1972
ECB	European Central Bank
EDIS	European Deposit Insurance Scheme
EEA	European Economic Area
EFTA	European Free Trade Area
EIOPA	European Insurance and Occupational Pensions Authority
ESA	European Supervisory Authority (EBA, EIOPA, ESMA)
ESFS	European System of Financial Supervision
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
FTA	Free trade agreement
G20	Group of 20
GATS	General Agreement on Trade in Services
MTF	Multilateral trading facility
OTF	Organised trading facility
PTA	Preferential Trade Agreement
SRB	Single Resolution Board
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TiSA	Trade in Services Agreement
TPP	Trans-Pacific Partnership
TTIP	Transatlantic Trade and Investment Partnership
UCITS	Undertaking for collective investment in transferable securities
WTO	World Trade Organisation

Table of selected EU legislation relating to capital markets

Accounting Directive	Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings
AIFMD	Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers
AML Directive	Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing
Bank Structural Reform Regulation*	Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions COM(2014) 43
Benchmarks Regulation*	Proposed Regulation on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds, 2013/0314(COD)
BRRD	Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms
Brussels Regulation	Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters
CI(WUD)	Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions
CRA Regulation	Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies
CRD	Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms
CRR	Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms
CSMAD	Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse
CSDR	Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories
EDIS Regulation*	Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme 2015/0270(COD)
ELTIF Regulation	Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds
EMIR	Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories
EuSEF Regulation	Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds
EuVECA Regulation	Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds
FCD	Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements
FICOD	Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate
IAS Regulation	Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards

MAR	Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse
MiFID	Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments
MiFID2	Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments
MiFIR	Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments
MMF Regulation*	Proposal for a Regulation of the European Parliament and of the Council on Money Market Funds 2013/0306 (COD)
PRIIPs	Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs)
Prospectus Directive	Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading
Prospectus Regulation*	Proposal for a Regulation of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading (replacing the Prospectus Directive) 2015/0268(COD)
Securitisation Regulation*	Proposal for a Regulation of the European Parliament and of the Council laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation 2015/0226(COD)
SFD	Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems
SFTR	Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse
SRM Regulation	Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions
SSM Regulation	Regulation (EU) No 806/2014 2012 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund
Short Selling Regulation	Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps
Takeovers Directive	Directive 2004/25/EC of the European Parliament and of the Council of of 21 April 2004 on takeover bids
Transparency Obligations Directive	Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market
UCITS Directive	Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)

* Not yet in force

Notes

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