KEY POINTS

- Important areas of EU commercial law cannot be preserved by the "Great Repeal Act" without continued UK/EU reciprocity. Examples are numerous, but include judgment enforcement, bank recovery, corporate insolvency, market abuse and financial collateral arrangements.
- Existing arrangements for granting financial services "equivalence" status to non-EU countries are unlikely to provide anything like the current level of access to the EU market in the near future.
- In the longer term, there are many reasons why it is in the UK's and EU's mutual interests to continue (or resume) co-operation and free trade in relation to financial services.

Author Andrew Henshaw QC

Reciprocity after Brexit

In this article Andrew Henshaw QC considers the problem of reciprocity in relation to EU law preserved after Brexit, and the desirability for all parties of maintaining mutual trading arrangements in the longer term.

THE "GREAT REPEAL ACT" AND RECIPROCITY

As is frequently pointed out, the title of the forthcoming Great Repeal Act (GRA) promises to be a misnomer. While repealing the European Communities Act 1972 (ECA) it will also, in the prime minister's words:

> "convert the 'acquis' – that is, the body of existing EU law – into British law … by converting the acquis into British law, we will give businesses and workers maximum certainty as we leave the European Union. The same rules and laws will apply to them after Brexit as they did before. Any changes in the law will have to be subject to full scrutiny and proper Parliamentary debate".

Something resembling the GRA is of course essential, and not merely because of the overwhelming volume of EU-based legislation (the House of Commons Library has estimated that 13.2% of UK primary and secondary legislation enacted between 1993 and 2004 was EU-related), which could not possibly be sifted through and where necessary unpicked or replaced during an Art 50 notice period of a mere two years. The GRA is also necessary to avoid the highly arbitrary effect that a simple repeal of the ECA would have: primary legislation implementing EU directives would remain, whereas secondary legislation made under the ECA would fall away; and EU Regulations – intended as the most definitive and directly binding category of EU legislation – would also disappear overnight.

However, the conversion of the *acquis* into British law cannot successfully replicate the pre-Brexit position in the many areas where the legislation assumes either:

- the intervention of EU agencies (eg ESMA's role in the formulation of Codes of acceptable market practice under the Market Abuse Regulation (596/2014)); or
- reciprocal action in EU member states: here, the purported retention of former EU law recast as UK law might be compared to the sound of one hand clapping or, adopting Richard Gordon's term, a "simalcrum" of EU law.[1]

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GOVERNING LAW, JURISDICTION AND JUDGMENTS

The problem is exemplified by the EU regimes for:

- governing law; and
- jurisdiction and judgments in civil and commercial cases.

The two Rome Regulations on the laws governing contracts and torts do not depend on reciprocity, and sometimes result in the selection of the law of a country outside the EU. They can continue to function perfectly happily after Brexit, both in EU member states' courts and (as a result of the GRA) in UK courts. By contrast, the rules on civil jurisdiction, now in the recast Brussels I Regulation 1215/2012, will in part cease to function. Whatever the GRA may provide, UK court judgments may no longer be entitled to enforcement in EU member states without a new reciprocal arrangement.

Some commentators argue that the Brussels Convention of 1968 – still operative vis a vis certain territories but "supersede[d]" by the Brussels I Regulation as between member states – will automatically spring back to life upon Brexit. That is a matter with which the EU Court of Justice may have to grapple. But suppose the answer is that the Brussels Convention was permanently superseded by the Brussels Regulation, leaving a void after Brexit? Even then there will remain a compelling case for reciprocal agreements – not for any reason connected with the internal market, but simply because it is plainly mutually advantageous for trading nations to recognise each other's judgments in civil and commercial matters. That is why, long before the Common Market was conceived, by the time of the Foreign Judgments (Reciprocal Enforcement) Act 1933 the UK had numerous bilateral agreements for the enforcement of such judgments, including agreements (which may well remain in force) with six major current EU member states: Austria, Belgium, France, Germany, Italy and the Netherlands.

FINANCIAL SERVICES

In other areas of law, the maintenance of reciprocity will be much more complicated. Whole tracts of regulation simply cannot function properly without mutuality within the EU (eg the laws governing medicines, food and aviation to mention but a few) and will need to be completely recast. To take one example from the sphere of financial services, the UK was a keen proponent of the Bank Recovery and Resolution Directive (BRRD), providing for the support and rescue of banks on a cross-border co-operative basis. An important facet of the scheme is "bail-in", under which investors and creditors accounting for 8% of a bank's balance sheet must in effect surrender their rights before other forms of stabilisation funding are accessed. BRRD Art 55 aims to make this work even as against most third country (non EU) investors and creditors, by requiring an enforceable bail-in clause in contracts not governed by an EU law, whereby the counterparty accepts bail-in. The UK might see some competitive advantage in freeing its banks from the obligation to ask third-country counterparties to agree bail-in clauses, recently criticised by Italy's finance minister as "an increase in instability, rather than stability". However, bearing in mind the considerations of mutual interest which led to the BRRD measures, and indeed the UK's pre-emption of some of them in the Banking Act 2009, the UK may take the opposite approach and continue to require UK banks to use contractual bail-in clauses, so as to replicate at least that element of the BRRD scheme. Even so, after Brexit the UK and EU member states would no longer be obliged to recognise each other's bank resolution measures; yet in the longer term, it would be clearly desirable on both sides for mutual recognition to be agreed.

> After Brexit ... there will no longer be mutual facilitation of financial collateral arrangements to the extent that currently exists.

Another area of mutual benefit is corporate insolvency, where harmonised rules under the EU Insolvency Regulation (EUIR) and (for financial institutions) the EU Winding-up Directives for Credit Institutions and Insurance Undertakings have been implemented in the UK by regulations under the ECA. These would fall away unless preserved by the GRA, but even if preserved would not apply reciprocally without a new deal with EU member states. Failing that, the UK and EU member states would no longer *per se* be obliged to recognise each other's insolvency proceedings. A degree of mutuality would exist with the few member states who like the UK (in the Cross-Border Insolvency Regulations 2006) have implemented the UNCITRAL Model Law on Cross-Border Insolvencies: Greece, Poland, Romania and Slovenia. However, it would be mutually beneficial – again regardless of internal market considerations – for the UK and EC states to recognise each other's proceedings simply on the basis of comity.

A related topic is the Financial Collateral (No 2) Regulations SI 2003/3226, which implement Directive 2002/47/EC on financial collateral arrangements. Their broad effect is to disapply to such arrangements various statutory and common law rules requiring formalities (eg signature) or restricting enforcement in situations of insolvency, administration or voluntary arrangements with creditors. After Brexit, English law will still generally provide effective protection for insolvency for trust property, secured creditors and those with rights of set-off, but there will no longer be mutual facilitation of financial collateral arrangements to the extent that currently exists.

THE INTERNAL MARKET AND THIRD COUNTRY STATUS

On a broader plane, and perhaps most problematic of all for financial institutions, is the loss of "passporting" rights to establish branches and/or provide services in EU member states. The third country "equivalence" provisions in existing EU legislation seem highly unlikely to provide anything resembling the current level of access to the EU market in the short to medium term for at least three reasons.

First, the equivalence provisions are an incomplete patchwork created on a successive *ad hoc* basis for individual business sectors. For example, there are equivalence regimes – and equivalence determinations will be important – in relation to wholesale investment business and for central counterparties, but not in several other major business sectors. Most notoriously, the Capital Requirements Directive (CRD) contains no third country equivalence regime for banks and makes clear in recital 23 that branches of third country banks may not provide services in member states other than those in which they are established. There is merely a provision (Art 47) *allowing* the EU to make specific agreements to permit EU branches of third country credit institutions to trade cross border. Absent such agreement, banks must obtain separate authorisation in each member state. Moreover, under Art 127(3) member states can subject even an EU bank, owned by a UK financial holding company, to CRD IV or "other appropriate supervisory techniques", which might include having to establish an EU holding company. An overview of the existence or absence of equivalence regimes is given in the table opposite.

Second, politics may get in the way. It has recently been reported that the Commission is considering tightening the equivalence rules to make the approval process tougher.[2] More specifically, as Alastair Sutton has explained,[3] for many Europeans the City is to blame for the economic crisis of recent years, and a profound feeling of resentment will underlie any negotiation for a new relationship between the UK and the EU.

Third, the timescale is uncertain and likely to be protracted. For example, an equivalence decision under MiFIR Art 46 has to be taken under the committee procedure of "examination" under Art 5 of Regulation 182/2011, which in effect gives the member states represented on the committee a veto power, subject to an appeal process. Even with goodwill on both sides it seems almost impossible that new arrangements will be devised, negotiated

TABLE 1: AN OVERVIEW OF THE EXISTENCE OR ABSENCE OF EQUIVALENCE REGIMES

Sector	EU legislation	Third country equivalence provision?
Banking	CRD (2013/36)	No. Art 47(3) permits EU to make specific agreements
Investment business: wholesale	MiFIR (600/2014) (from January 2018)	Yes (Art 46)
Investment business: retail	MiFID II (2014/65) (from January 2018)	No: must establish separately authorised branches (Art 39)
Insurance (direct)	Solvency II Directive (2009/138)	No, save in limited respects: separate authorisations required to do business (Arts 162/167) unless specific agreement made (Art 171)
Reinsurance	Solvency II Directive (2009/138)	Yes for some purposes (Art 172) but does not provide passport: specific agreement required (Art 175)
Insurance intermediation	Insurance Distribution Directive (2016/97) (from February 2018)	No
Asset management: UCITS	UCITS Directive (2009/65)	No: treated as alternative investment funds
Asset management: AIFs	Alternative Investment Fund Managers Directive (2011/61)	Only partly: national private placement regimes apply; Arts 42 and 67(4) permit but do not oblige member states to allow third country firms to trade cross border (and do not cover MiFID-type activities)
Mortgage credit	Mortgage Credit Directive (2014/17)	No
Payment Services	Payment Services Directive II (2015/2366) (from January 2018)	No
Electronic Money	2nd Electronic Money Directive (2009/110)	No
Central Counterparties	European Market Infrastructure Regulation (EMIR) (648/2012)	Yes (Arts 13, 25, 75-77)

and implemented within the two-year Article 50 notice period. The long delays and difficulties in finalising the EU-Canada CETA deal provide a sobering precedent.

RECIPROCITY IN THE LONGER TERM

As a result, there is almost bound to be considerable dislocation in the next few years. It is usually assumed that the UK financial services business will be the main loser from this. Sutton notes that given the history there is no reason why EU countries should feel the need to grant "favourable treatment" to the UK, especially when their own access to UK markets at least for manufactured goods is guaranteed by WTO agreements. However, considerations of reciprocity may well remain significant at least in the medium to longer term, and the UK should not necessarily be in the position of seeking favours from the EU.

At the most basic level, the services UK financial institutions currently provide within the EU are presumably services their EU customers need and are willing to pay for. To view the London financial markets as synonymous with overpaid bankers is to overlook important quotidien functions such as insurance/reinsurance, fund management (overall an estimated 57% of UCITS and AIFs are marketed on a cross-border basis) and the economically vital capital markets for corporate funding, in each of which the UK's financial sector plays a very significant role.

Removal of the UK service-providers from such markets would reduce competition within the EU, to the ultimate detriment of service-users, unless additional capacity arises within the EU, eg by UK entities relocating parts of their business. The latter cannot, however, always be assumed. In relatively lean times for banks, the costs may simply be too high. As the Oliver Wyman report notes, for some institutions the cost of relocation and the ongoing inefficiencies associated with a more fragmented environment could instead cause them to close or scale back parts of their business. Relocation away from the UK does not necessarily mean migration to an EU location.

In addition, EU financial institutions have an interest in reciprocal free trade. The Financial Conduct Authority's letter of 17 August 2016 to the House of Commons Treasury Committee indicates that 5,465 firms use at least one "outbound" passport to provide services in the EU, but 8,008 firms use at least one "inbound" passport to provide services in the UK. Inbound passports exceed outbound passports in relation to the CRD (banking), Solvency II (insurance/reinsurance), insurance mediation and UCITS. These figures do

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not indicate the extent of use made of each passport, but still underline the reciprocal nature of access to the financial markets.

Such considerations help explain the existence of the third country equivalence regime, and why equivalence determinations have been made for a variety of non-EU countries, including smaller nations probably lacking enormous political or economic "clout" but with thriving financial institutions whose services EU customers value. These include (in relation to various business sectors) Switzerland, Australia, Mexico, Bermuda, Jersey, Guernsey, Hong Kong and Singapore.

Further, it cannot be assumed that non-financial services entities in the EU have nothing to lose from a "hard" Brexit. A pure WTO position would be disadvantageous for EU member states as well as the UK because it could involve sizeable tariffs on manufactured goods (most famously, 10% on cars).

Some parts of the UK financial services sector may continue to benefit from EU business outside the internal market, for example UK fund managers acting as delegates to EU-based UCITS or AIF managers, and UK reinsurers reinsuring liabilities of EU-based insurers.

There could also be some positive aspects for the UK financial services industry outside the EU internal market. There might be competitive advantage in not adopting some facets of the EU regime, such as the BRRD Art 55 bail-in requirement discussed above. A previous article in this journal[4] noted that chief executives of seven "challenger" banks in June 2016 called on the UK government post CRD IV to take a more proportionate approach to the regulation of smaller banks, especially as regards capital requirements. It is even possible, given Wall Street's recent bonus spree, that the UK sector could benefit from liberation from CRD IV restrictions on bonuses and discretionary pension payments, which go beyond anything required by Basel III (by which the UK will remain bound post Brexit).

Looking further afield, the Wyman report cites work by TheCityUK highlighting opportunities in relation to emerging markets wealth management, masala bond trading and issuance, green finance and FinTech. The UK sector may benefit from greater freedom to pursue opportunities in such economically thriving areas.

None of this means the transition will be in any sense easy or loss-free. However, considerations of the kind outlined above suggest that it would be mutually beneficial not to slam the door on the UK financial services sector, and that after the initial throes of a likely "hard" Brexit, the brighter future lies in the resumption of co-operation and free trade. ■

[1] The UK courts after Brexit (2016) 9 JIBFL 511.

[2] Market Movements (2016) 11 JIBFL 690.

[3] The City of London and Brexit: threat or opportunity? (2016) 6 JIBFL 323.

[4] Brexit and Basel III: an invitation for more or for less? (2016) 8 JIBFL 478.

Further Reading:

- Brexit and Basel III: an invitation for more or for less? [2016] 8 JIBFL 478.
- The UK courts after Brexit [2016] 9 JIBFL 511.
- LexisNexis Loan Ranger blog: Brexit – how does it impact LMA facility documentation?