



Law Society
of Scotland

Consultation Response

House of Lords EU Financial Affairs Sub-Committee
inquiry into the future of financial regulation and
supervision following Brexit

September 2017



Introduction

The Law Society of Scotland is the professional body for over 11,000 Scottish solicitors. With our overarching objective of leading legal excellence, we strive to excel and to be a world-class professional body, understanding and serving the needs of our members and the public. We set and uphold standards to ensure the provision of excellent legal services and ensure the public can have confidence in Scotland's solicitor profession.

We have a statutory duty to work in the public interest, a duty which we are strongly committed to achieving through our work to promote a strong, varied and effective solicitor profession working in the interests of the public and protecting and promoting the rule of law. We seek to influence the creation of a fairer and more just society through our active engagement with the Scottish and United Kingdom Governments, Parliaments, wider stakeholders and our membership.

The Society's Banking, Company and Insolvency Law Sub-Committee welcomes the opportunity to consider and respond to the House of Lords EU Financial Affairs Sub-Committee's call for evidence for its *Inquiry into the future of financial regulation and supervision following Brexit*.¹ The Sub-committee has the following comments to put forward for consideration.

Response to questions

1. What is your overall assessment of the EU's financial services regime, in light of its current application to the UK? To what extent is it effective, and for whom?

A large number of Scottish solicitors have financial services clients such as banks, investment companies, insurance companies and pension funds operating in the Internal Market. Both firms and in-house solicitors provide regulatory and other advice to financial services clients. Many solicitors therefore have in-depth expertise in dealing with financial services legislation which flows from the EU. The EU financial services markets are governed by EU regulations and at the same time are enabled by the founding freedoms as free movement services, capital² and people and also freedom of establishment underpin the Internal Market for financial services.

We note that the free movement of capital allows investment vehicles such as pension funds, insurance companies and investment trusts to diversify risks and exploit investment opportunities

¹ <https://www.parliament.uk/documents/lords-committees/eu-financial-affairs-subcommittee/financial-regulation-and-supervision/Final-call-for-evidence.pdf>

² As noted in our response to the Balance of Competences review, free movement of capital in practice has developed more slowly; for example the UK removed exchange controls some years after the UK joined the EEC in 1973.

across a wider market. It also allows UK companies to act as service providers for customers in other Member States. Furthermore, the free movement of capital is an integral aspect of foreign direct investment (FDI). The UK is one of the main beneficiaries of FDI from other countries within the Internal Market.

As a general rule the EU's financial services regime works well and succeeds in balancing the interests of financial services providers and consumers, although we note that the internal market for financial services is not yet complete.

One example where the EU has been active is in the field of card payment systems (direct debit and credit cards), and payments for small transactions to ease the flow of capital and to make payments by consumer easier. This is a good example of where action at the EU level has been particularly useful. However, we have previously identified retail financial services such as personal banking and retail insurance services as requiring further development.

In terms of facilitating business, the ability of financial services firms to create branches is considered to be an efficient way of ensuring that entities are regulated while making it easier for them to expand across borders. We also note that this has succeeded in reducing the requirement for businesses to comply with multiple sets of rules. This ability is underpinned by harmonised minimum standards to guard against regulatory and supervisory arbitrage and to protect consumers.

The need to comply with only one set of regulatory rules generates cost savings in terms of compliance – both in terms of internal operations and product creation. This is because within the EU companies are regulated by the regulator in their “home state” avoiding the need to report to a multiplicity of regulatory bodies in terms of structure and governance arrangements, leveraging, qualifications of personnel etc. At the same time, the rules governing products and services to be offered to customers (both business and consumer) are also standardised so that if a product can be sold in the UK, it can also be sold throughout the EU.

A key piece of financial services legislation in terms of providing benefits for consumers is the FSCS (Financial Services Compensation Scheme) which originates from EU legislation and is an important mechanism for protecting the private funds of ordinary citizens.

The UK has been an influential participant in creating the EU financial services regime and has helped steer the EU financial services policy and approach to regulation. We note that the UK has only very infrequently³ been overridden in the Council on financial services legislation. Indeed a number of pieces of legislation the EU legislation are similar to the system which was operating in the UK before it was introduced in the EU, for example many aspects of the proposed Rescue and Recovery Directive follow

³ The only incidence of which we are aware was the proposal to limit bankers' bonuses.

elements of the Banking Act 2009. This suggests that the approach taken at EU level has generally been acceptable or even beneficial to the UK.

Lastly we note that some of the UK financial services regulation which derives from EU Directives has a direct impact on the regulation of Scottish solicitors by the Financial Conduct Authority (FCA) under the Financial Services and Markets Act 2000 Part XX.⁴ The FCA recognises the Society as a Designated Professional Body under Part XX for our members who conduct exempt regulated activities (defined as incidental financial business under our Practice Rules). The Society Practice Rules in this area require to be approved by the FCA. The FCA has to be satisfied that any changes in financial services regulation from EU Directives which require changes to our Practice Rules are properly incorporated into these rules. The relevant legislation does not refer to EU institutions and therefore do not anticipate that any adjustments will be needed to take account of withdrawal from the EU.

2. Are current EU proposals on banking and financial services in your view positive for financial stability? How do you expect the EU's regulatory framework to evolve in the coming years?

We have no comments on how the EU's regulatory framework is likely to evolve in the coming years. However, as noted above the internal market for financial services is not yet complete and there are some areas in which we anticipate the EU might choose to take further action. One example is in relation to tax harmonisation where lack of harmonised treatment can create barriers to the Internal Market. One area where we have previously commented that this might be looked at is the series of UCITS Directives dealing with the regulated funds industry where the potential to exploit the advantages of the Internal Market is hampered by a lack of harmonised tax treatment concerning UCITS funds.⁵ Similarly it is often very difficult or impossible to transport pensions between Member States. Although agreement has been reached on legislation regarding the portability of pensions, the measures do not extend to transferability of pensions.

3. What are the key differences between financial regulation as agreed at the international, EU and UK levels, and where are the gaps? How important is it to maintain a level playing field for regulation?

One of the main differences with financial regulation when agreed at an international level is that international agreements do not benefit from the same enforcement mechanisms as EU or international law.

⁴ This relates to financial functions of solicitors as opposed to their professional obligations as Scottish qualified solicitors, which are regulated by the Law Society.

⁵ Cf the response of the Law Society of England and Wales to the Balance of Competences consultation on taxation (<http://www.lawsociety.org.uk/representation/policy-discussion/documents/balance-of-competences-review---taxation/>)

However, it is important to note that at present certain legislative initiatives are instigated by international organisations such as the Financial Stability Board (FSB) and G20 but enacted through the EU legislative processes. A good example of this is the implementation of the Basel III requirements in CRD IV.⁶ This provides a mechanism for ensuring that the EU Member States meet those obligations as the European Commission has effective enforcement powers, while also ensuring consistency.

The collective approach to implementation may also therefore mean that other international counterparts are less likely to question the UK's own implementation methods as the EU can draw on expertise from experts in multiple jurisdictions and the outcome is perhaps less likely to attract criticism.

Maintaining a level playing field for regulation is important, not only to ensure fair competition between businesses but also in the interests of avoiding regulatory arbitrage. At present participation in the Internal Market means that UK financial services firms are bound by essentially the same rules as their competitors based in EU Member States in terms of all business within the EU.

In the context of the Internal Market rules more generally we note that the competition regime is constructed to facilitate competition, including in relation to financial services. This allows the UK and UK businesses to build on its competitive advantage as a leading player in this field.

Following withdrawal the UK may choose to operate different regulatory rules. However, there is a risk that significant divergence from the EU rules could damage the ability of UK businesses to compete for EU business with companies based in the EU for as they would need to comply with two sets of rules. If the rules set very different requirements it might even be impossible to ensure compliance with both systems. The greater the variation, the greater the cost of compliance, both in terms of obtaining legal advice regarding changes in both systems and in making the necessary adjustments to ensure continued compliance with each set of rules.

4. Are there any particular legal or practical challenges related to incorporating the existing body of EU financial services legislation into the UK's domestic law, for example the PRA rulebook?

The two main sources of EU financial services legislation are directives and regulations with direction on how these should be interpreted stemming from other bodies responsible for financial services regulation and supervision in addition to judgments of the Court of Justice of the EU.

EU directives must be transposed by the Member States and as such are already part of UK domestic law although this is specifically confirmed in cl.2 of the European Withdrawal Bill. EU regulations are directly applicable without need for further legislation so these will need to be specifically incorporated into UK law, the relevant catch-all clause being cl.3 of the Bill. However, all EU laws are predicated on the assumption that they will apply in an EU Member State. This may present a major legal and practical challenge when it

⁶ The fourth Capital Requirements Directive

comes to transferring responsibility from the EU to the UK which cls.2 and 3 in themselves are not sufficient to overcome.

The biggest issue to be addressed is the fact that the legislation refers to EU institutions and bodies, including the supervisory authorities, of particular importance in a financial services context.⁷ From a legal perspective these references will need to be removed for the legislation: given the high volume of EU financial services legislation this may also be regarded as a practical challenge. In some cases, these references can be directly replaced with UK bodies: we anticipate that this will be the FCA or PRA in many cases and they are therefore likely to need additional resources. It may also be necessary to create additional domestic bodies to replace the functions of EU ones.

Another legal challenge is presented by the fact that the rules have been created for businesses operating in the Internal Market: where they relate to eg cross-border provision of goods or services, cooperation between regulators, or treatment of third country providers, they will not make sense.

Transition, equivalence and alignment

5. What would be the key priorities for a transitional arrangement, and how much continuity would you expect to see under such an arrangement?

As with all legal change, clarity is of key importance. In the interim the transitional arrangement should seek so far as possible to maintain the status quo. This will allow business to maintain their operations (and solicitors and other professionals working in the financial services sphere to continue advising their clients) in line with the existing rules so that a new relationship to be agreed if this has not already been achieved by the date of formal UK withdrawal.

In the longer term the arrangement should run for long enough to allow people to familiarise themselves with whatever relationship will follow on from withdrawal even if this is an absence of any special trading agreement. In practice many businesses will need to seek legal advice (be it internal advice from in-house teams or external advice from private practice) and lawyers themselves will need time to process the new rules to ensure they are best able to advise their clients. Businesses will then need to adjust their processes and contracts, and may also choose to restructure or move parts of their businesses, to ensure a smooth transition when the new relationship comes into effect.

⁷ For example the Directive 2014/65 EU on Markets in Financial Instruments (MiFID II - <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0065>). Article 24 sets out rules on general principles and information requirement. Art 24(11) states: "ESMA, in cooperation with EBA and EIOPA, shall develop by 3 January 2016, and update periodically, guidelines for the assessment and the supervision of cross-selling practices indicating, in particular, situations in which cross-selling practices are not compliant with obligations laid down in paragraph 1." However, following withdrawal it would need to be a UK body or bodies which produced such guidelines. Similarly the reference to the ability of the Commission to make delegated acts in this context is inappropriate. The implementing legislation (Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2017 (SI 2017/488) and Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2017 (SI 2017/701) will need to be amended accordingly.

The nature of these adjustments will depend on the form of any new relationship agreed with the EU in particular in relation to Internal Market participation. In the financial services sector, if the UK is regarded as standard third country then the arrangements or rearrangements will depend on whether the UK is granted equivalence.

6. In practical terms, how and when could a transitional arrangement be agreed and put in place? How long would such a transition need to last?

Legally the transitional agreement could be agreed at any time and come into effect whenever agreed but in practice it will be informed by political factors.

The transitional arrangement would need to be agreed before withdrawal from the EU to ensure continuity. The transition period should cover the period between formal withdrawal and the coming into effect of a new relationship. The first step is to obtain clarity as to what will follow on from the existing relationship, even if this means that the UK defaults to third country status and no special trading or other relationship can be agreed. There will then need to be a further period to allow both businesses and individuals familiarise themselves with the new rules and then carry out the logistical adjustments that will allow them to continue functioning under the new framework (to the extent that this is possible).

In particular, businesses which provide, or indeed receive, financial products and services to or from other EU countries, will need to work out if their operating model is still viable - for example in relation to recognition of qualifications or rules around financial services offerings whether they are actually permitted to continue providing those services.

Individuals may require to obtain those qualifications or businesses may need to restructure or open branches or offices within a remaining EU state. All of these things take time.

7. What are the benefits and drawbacks of seeking equivalence? What conditions are likely to be attached by the EU to any equivalence decisions?

Obtaining equivalence would minimise disruption to the flow of financial services between the UK and remaining EU. However, some changes would still be required as regulatory equivalence is not the same as Internal Market participation.

The main drawback is that the UK would, broadly speaking, be bound to follow the EU's regulatory approach. However, as noted above, maintaining alignment with the EU system is likely to be of practical *advantage* to UK financial services businesses seeking to trade with the EU in any case.

Third country access has traditionally been of particular concern to the UK as its financial services markets are generally more open than those of many other Member States. Examples of legislation where this

issue has been raised include the AIFMD,⁸ EMIR and MiFID II⁹ but the rules will not necessarily go as far as UK companies would wish.

8. What alternatives may exist for maintaining alignment between the UK's and EU's regimes? What options could be considered for resolving disputes or arbitrating on such matters? What would be the barriers to a more bespoke arrangement?

The EEA presents an obvious example for alignment of approach to financial services regulation. However, we note that this is predicated on Internal Market participation and regulations are set by the EU Member States, with the EEA/EFTA countries bound to follow those rules without powers to set them. The EFTA Surveillance Authority works with the Commission to ensure compliance in this context but the EU rules remain paramount so there is no “dispute resolution” element in the traditional sense.

In the case of third country equivalence, companies from that third country are bound by the EU's rules for all financial products and services provided to EU customers. Again, EU law is paramount so considerations around dispute resolution/arbitration do not apply.

In a situation where there is a bilateral investment treaty or free trade agreement with investment provisions, this may be governed by the dispute resolution mechanisms set out in the original agreement but these allow individual companies to bring claims against the Member State in question and are not designed to maintain alignment between domestic and EU regulatory arrangements.

There would be no legal barriers to a more bespoke arrangement: whether or not this would be achievable would depend on political factors.

The future environment

9. What effect will the loss of the UK have on the development of the EU financial services framework and its capital markets?

We have no comment on this question.

10. Where is there scope for the UK to amend its regulatory regime? What precedents exist under current equivalence decisions for divergence to occur?

⁸ Alternative Investment Fund Managers Directive

⁹ Markets in Financial Instruments Directive II

We have no comment on this question.

- 11. What challenges will expected innovations in financial markets, for instance in the FinTech sector, present in respect of regulation and supervision post-Brexit? How can these challenges be overcome? Can the UK maintain a competitive advantage while adapting to a new regime? If so, how?**

We have no comment on this question.

- 12. Will leaving the EU affect the way that the UK represents itself in international fora? How can the UK continue to maintain influence when dealing with organisations such as the FSB and IOSCO in setting international standards?**

Leaving the EU means that the UK will represent itself in all international fora, including those where it would previously have negotiated or participated as part of the EU.

The EU has significant negotiating powers when concluding international regulatory agreements and may therefore be more effective in influencing negotiations than individual Member States acting alone. At the same time, if the UK is representing itself then it will be able to prioritise its objectives according to its own best interests.

As in other areas the UK will have complete autonomy in terms of the position it takes in international fora as it will not need to agree a joint position with other EU Member States and pursue this in negotiations. The UK will therefore be able to prioritise its objectives according to its own best interests without reference to the other Member State positions. However, we note that the UK's view on financial services was historically influential in informing the EU's overall position. The UK may have less influence if it is participating in international negotiations or dealing with international organisations as it is much smaller than the combined EU.

The UK should work to identify areas of common interest and build relationships with allies, which may include the EU, in order to maintain influence with organisations setting international standards.

Supervision

- 13. The Commission is currently conducting a review of the European Supervisory Agencies. What, in your view, are the key areas where reform should be pursued and what might be the impact of such reform on UK supervision?**

We have no comment on this question.

- 14. How could an enhanced role for ESMA and the ECB in respect of euro-denominated clearing work? What are the options for the UK to retain euro clearing in the light of the European Commission's recent proposals?**

We note that in 2011 the European Central Bank, with initial support from the European Commission, proposed to prohibit regulated clearing houses for euro-denominated financial

products from being located outside the Eurozone countries. As a Member State the UK was able to successfully challenge the legality of the proposal in the Court of Justice of the EU. This would not be the case following withdrawal.

15. How would supervisory cooperation (as envisaged for CCPs) work in practice? Are there any precedents? What are the potential risks?

We have no comment on this question.

For further information, please contact:

Carolyn Thurston Smith

Policy Team

Law Society of Scotland

DD: 0131 476 8205

carolynthurstonsmith@lawscot.org.uk