

BREXIT AND FINANCIAL SERVICES: (YET) ANOTHER RE-ORDERING OF INSTITUTIONAL GOVERNANCE FOR THE EU FINANCIAL SYSTEM?

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Abstract

This article considers the potential impact of the withdrawal of the UK on EU financial services law and its institutional arrangements. While speculation is currently perilous, this article suggests that the impact of Brexit on EU financial governance will be contained and most likely limited. The greatest uncertainty relates to the EU's evolving supervisory/institutional arrangements. Brexit may be one of the factors which leads to a significant future empowerment of the European Supervisory Authorities, and in particular the European Securities and Markets Authority. But it is only one of a range of complex, dynamic and symbiotic political forces, institutional interests, legal constraints and functional challenges which must combine in the EU's governance reform crucible if material reform is to follow.

1. Scene setting

The 14-15 December 2017 decision by the European Council that the EU/UK withdrawal negotiations could move on to the second phase (“related to transition and the framework of the future relationship”)¹ opened the gateway to negotiations on the potential treatment of financial services under any new EU/UK settlement. In practice, the effects of the UK’s future withdrawal were already being felt in the financial services sphere. The 20 November 2017 decision by the General Affairs Council that Paris would be the new home of the London-based European Banking Authority² was widely reported as the first tangible step in the UK’s withdrawal from the EU, but there were already multiple indications of a changing regulatory and market environment. Regulated actors in the UK have been making contingency plans,³ including for the EU27 relocation.⁴ Warnings have been issued as to the risks to the EU27 and UK financial systems from a disorderly or hard Brexit which would leave the UK’s financial sector with limited access rights to the single market and which could disrupt EU/UK financial stability and funding capacity.⁵ The EU’s supervisory bodies, the European Central Bank within Banking Union’s Single Supervisory Mechanism, and the three European Supervisory Authorities within the European System of Financial Supervision, had produced guidelines on how UK firms and EU27 supervisors should

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¹European Council (Art. 50), Guidelines of 15 Dec. 2017, EUCO XT 20011/17, para 1.

²Council of the EU, “European Banking Authority to be relocated to Paris, France”, Press Release 689/17, 20 Nov. 2017.

³While industry preparations would have been expected, the UK regulators have required regulated actors to prepare contingency plans (letter from Bank of England Deputy Governor Woods to House of Commons Treasury Committee, 2 Aug. 2017) as have EU regulators (e.g. European Central Bank, Banking Supervision, “Brexit – an ECB Supervision Perspective”, 15 Nov. 2017).

⁴Some 13 banking groups are estimated to have chosen Frankfurt or Berlin as their new EU hub, while Ireland, Luxembourg, Belgium and the Netherlands look set to attract business, particularly in the asset management and insurance sectors: Jenkins, “How the city finally raised its voice over Brexit”, *Financial Times*, 3 Oct. 2017. One report has estimated the best-to-worst-case scenario for job losses in the UK financial sector across a spectrum from 3-4,000 to 65-75,000 jobs: “The impact of the UK’s exit from the EU on the UK-Based financial services sector”, (Oliver Wyman, 2016), p. 14.

⁵The Bank of England has warned of the potential for a fragmentation in funding sources which could generate risks for the EU as well as UK firms and households; a need for substitute sources of finance; and significant costs arising from a disruption to the “clearing” services which are essential to risk management in the derivatives markets; see Bank of England, Financial Stability Report, June 2017.

approach the relocation process.⁶ Brexit was beginning to leak into more long-term design decisions on the future shape of EU financial market governance. Brexit effects can be associated with the Commission's September 2017 Proposal to reform the European Supervisory Authorities⁷ as well as the Commission's June 2017 Proposal to reorder how the EU currently arranges the supervision of Central Clearing Counterparties (CCPs) – the arcane but systemically critical financial market infrastructures which support risk management in derivatives markets.⁸ Brexit may also be linked to the hints from the Commission in early 2017 that it would review more generally how it approaches the “equivalence” process which usually governs whether, and the extent to which, third country regulated actors can access the EU financial market on the basis of their home regulation and supervision.⁹

Since the December 2017 European Council, and although trade negotiations are yet to take place pending agreement on transitional arrangements, the indications that change is afoot continue to amass. The Commission's December 2017 Proposals to reform the prudential regulation of investment firms contain ambitious and far-reaching reforms to empower the ECB within Banking Union's Single Supervisory Mechanism to supervise Banking Union's largest systemic investment firms. These reforms can readily be associated with Brexit-related concerns to shore up EU supervisory governance.¹⁰ The late December 2017 decision by the Commission to grant Switzerland only a conditional, one-year “equivalence” period in relation to its regulation and supervision of stock exchanges, which has been contested by Switzerland, has also been related to Brexit effects, in the form of the signalling of an uncompromising EU approach towards third countries.¹¹

Markets are continuing to evolve. While early 2018 saw EU financial markets enter a new regulatory era with the coming into force of the massive new Markets in Financial Instruments Directive II regime - which required a behemoth industry implementation effort and is set to lead to some industry restructuring in the EU¹² - it also saw reports of strengthening competition in

⁶See for Banking Union, ECB Banking Supervision, Guidance on Relocating to the Euro Area, April 2017 and for the single market, the series of opinions on relocation adopted by the three European Supervisory Authorities, e.g., European Securities and Markets Authority, Opinion. General Principles to Support Supervisory Convergence in the Context of the UK Withdrawing from the European Union (ESMA42-110-433) (2017) and its related opinions on relocation for investment firms, asset managers and secondary markets (ESMA35-43-762, ESMA35-45-344 and ESMA 70-154-270, all 13 July 2017).

⁷COM(2017)536.

⁸COM(2017)208.

⁹Commission, “EU equivalence decisions in financial services policy: An assessment”, SWD(2017)102.

¹⁰COM(2017)790 and COM(2017)791. The ECB reforms (which are based on re-classifying large systemic investment firms as “credit institutions” and thereby bringing such firms, where they are based in Banking Union, into the ECB-overseen single supervisory mechanism). They are in part designed to update the EU's regulatory architecture to reflect the pivotal role played by UK investment firms in the EU financial market and the expected relocation by many of these firms of parts of their operations to the Banking Union zone: COM(2017)790, pp. 2-3.

¹¹Commission Implementing Decision (EU) 2017/2441 of 17 Dec. 2017, on the equivalence of the legal and supervisory framework applicable to stock exchanges in Switzerland in accordance with Directive 2014/65/EU of the European Parliament and of the Council, O.J. 2017, L 344/52. The Commission found that Switzerland's regulatory arrangements met the equivalence requirements, but a time limitation was imposed linked to Switzerland agreeing to “the establishment of a common institutional framework for existing and future agreements through which Switzerland participates in the Single Market” (recital 30). While related to ongoing EU/Swiss tensions concerning the institutional management of their bilateral relations, the conditional decision (which was not supported by the UK) was reported as having implications for the UK's access as a third country: Khan, “Switzerland hits out at EU ‘discrimination’ in finance dispute”, *Financial Times*, 21 Dec. 2017.

¹²Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014, on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, O.J. L 173/349 and Regulation 600/2014 of the European Parliament and of the Council of 15 May 2014 on financial instruments and amending Regulation 648/2012, O.J. 2014, L 173/84. The coming into force of the regime on 3 Jan. 2018 and its market impact was widely reported across the media and required last-minute interventions from Member State regulators as well as the European Securities and Markets Authority.

certain Member States for UK-located financial services business.¹³ Early 2018 also saw concern that reported difficulties in negotiating transition arrangements could lead to an agreement not being reached at the March 2018 European Council and generate industry difficulties and market disruption.¹⁴

This snapshot hints at the mosaic of short- and long-term effects which Brexit may have for the EU financial market and its governance. It also underlines the continuing high political, policy and market salience of EU financial services law and policy, even as the epochal crisis-era period recedes and its maturing institutional arrangements, notably the European System of Financial Supervision and Banking Union, bed in. This discussion considers why financial services are experiencing such high salience in the Brexit debate and whether and the extent to which Brexit is likely to have short- but also more long-term effects on EU financial governance.

2. The short and long(er) term picture: Trade/access arrangements and the high, but asymmetric salience of financial services

2.1. The UK – looking outward and building a new access arrangement

Since the June 2016 referendum, the fate of its prized financial services sector, a motor of the UK economy,¹⁵ has pre-occupied much of the UK debate on Brexit.¹⁶ Given the current uncertainty on the negotiations, speculation as to the outcome for financial services is perilous. Nonetheless, one legal outcome can be predicted reasonably safely. Prime Minister May's September 2017 "Florence Speech"¹⁷ affirmed that the UK will leave the single market and will not seek membership of the European Economic Area, and the Prime Minister's March 2018 "Mansion House" speech re-affirmed this position.¹⁸ Accordingly, on its withdrawal from the EU, the UK will become a "third country" and UK financial firms will lose their single market "passport." The December 2017 European Council has also noted the UK's intention not to participate in the single market after a (to-be-negotiated) transition period.¹⁹ This matters, as the "passport" allows financial firms to navigate one of the most heavily regulated sectors of the EU economy without incurring the costs of duplicate regulation and supervision.

The EU's single financial market is, in common with major financial markets globally, subject to dense regulation in the wake of the financial crisis, exemplified by the MiFID II/MiFIR leviathan. EU firms can navigate this market on the basis of a single licence or "passport." Under sectoral financial legislation, once authorized in its "home" Member State (typically, the State where the actor is incorporated or registered), a financial actor can operate through branches or

¹³Particularly in relation to asset management: Walter, "Spooked fund managers look at rivals to London", *Financial Times*, 17 Feb. 2018.

¹⁴Stafford, "Brexit anxieties grow over market disruption", *Financial Times*, 22 Feb. 2018.

¹⁵The sector generates some £190-205 billion in revenues; employs (directly and indirectly) in the region of 1.1 million people; generates some £60-67 billion in taxation; and contributes some £58 billion to the UK balance of payments: Wyman, *op. cit. supra* note 4, p. 2.

¹⁶See e.g. House of Lords, "Brexit the future of financial regulation and supervision", (2018) EU Committee, 11th Report of Session 2017-2019.

¹⁷Speech on "A new era of cooperation and partnership between the UK and the EU", 22 Sep. 2017, available at: <www.gov.uk/government/speeches/pms-florence-speech-a-new-era-of-cooperation-and-partnership-between-the-uk-and-the-eu>.

¹⁸ Speech on "Our future economic partnership with the European Union", 2 Mar. 2018, available at: www.gov.uk/government/speeches/pm-speech-on-our-future-economic-partnership-with-the-european-union. The speech also indicated that the UK will not seek an agreement based on the Canada agreement (EU-Canada Comprehensive Economic and Trade Agreement (CETA)), given that this would mean a significant reduction in market access, but would instead see a bespoke agreement which would, for services, "break new ground."

¹⁹European Council (Art. 50), Guidelines cited *supra* note 1, para 7.

cross-border service provisions based on home Member State regulation and supervision (in accordance with the EU's dense "single rulebook" and within the supervisory coordination arrangements of the European System of Financial Supervision). Third country actors, by contrast, do not benefit from "passporting" rights. Unless they become EU firms by using EU subsidiaries, their access is contingent on the EU's complex and partial "third country" regime, which provides only very limited access to the EU market and is usually dependent on the relevant third country's regulatory/supervisory arrangements being "equivalent" to those of the EU.²⁰ These third country/equivalence rules are a legally unstable and politically unpalatable basis for UK access to the EU for a number of reasons.²¹ From among the myriad functional and political difficulties for the UK, they cover only a limited number of financial sectors; they are contingent on a Commission decision, which can be withdrawn; they require that the third country regime remains equivalent into the future – notwithstanding the dynamism of financial regulation; and they are subject to the ECJ's oversight. The Commission's end 2017 conditional decision on the equivalence of Swiss stock exchange rules underlines the extent to which equivalence is controlled by the EU and is shaped by the EU's interests in protecting single market integrity.²²

With the UK exporting some 25 percent of its financial services to the EU,²³ concern as to the wider, destabilizing "network" effects of a withdrawal of capital and liquidity from the City of London into the EU and internationally, together with evidence that UK firms are planning to relocate parts of their operations to the EU27 to avoid the vagaries of third country equivalence,²⁴ there are calls being made in the UK for alternative access routes, which would form part of a new Free Trade Agreement (FTA).²⁵ Prime Minister May's March 2018 "Mansion House" speech underlined the importance of financial services in the negotiations, expressly referencing financial services and calling for an access arrangement based on a "collaborative, objective framework that is reciprocal, mutually agreed, and permanent and therefore reliable for business" and on the EU and UK maintaining the same "regulatory outcomes" over time.²⁶ Sophisticated new regulatory/access technology - typically based on the EU and UK "deferring" to each other's regulatory regimes on the basis of a minimum set of agreed standards arrangements for managing regulatory divergence, and coordination systems for supervision and for fiscal support in times of crisis (all a bespoke form of "mutual recognition") - which could provide the basis for such an

²⁰Other access routes are available, including "reverse solicitation" (which allows third country firms access the EU without being subject to EU law where the service follows an unsolicited client request) and delegation techniques (based on delegating/outsourcing services from an EU27 presence back to the UK firm). These are often regarded as insufficiently stable to support access, particularly in light of recent indications from EU regulators as to their hostility to UK firms operating through EU "letter boxes". See further Moloney, "The EU and its investment banker: Rethinking equivalence for the EU capital market", (2017) LSE Law Society and Economy Working Paper Series, WP No 5/2017, available at <www.ssrn.com/abstract=2929229>.

²¹See Alexander, Barnard, Ferran, Lang, and Moloney (Eds.), *Brexit and Financial Services. Law and Policy* (Hart Publishing, 2018); Moloney, op. cit. *supra* note 20; Ferran, "The UK as a third country in EU financial services regulation", 3 *Journal of Financial Regulation* (2017), 40; Armour, "Brexit and financial services", 33 *Oxford Review of Economic Policy*, (2017), S54.

²²See *supra* note 11.

²³Wyman Report, cit. op. *supra* note 4.

²⁴In Oct. 2017, the Ernst and Young "EY Brexit tracker for financial services" which monitors relocation statements by over 200 of the largest UK financial services companies reported that 30% of firms were considering moving operations.

²⁵To date, no FTA entered into by the EU (including the much-examined CETA) provides financial services access in any way similar to the passport. See further Lang, "The 'default option'? The WTO and cross-border financial services trade after Brexit", in Alexander et al, cit. *supra* note 20

²⁶ See *supra* note 18. In a follow-up speech on 7 Mar. 2018 the Chancellor of the Exchequer, Philip Hammond, called for a bespoke arrangement based on achieving "fully equivalent regulatory outcomes" and on "mutual recognition and reciprocal regulatory equivalence" (speech on "Financial Services" available at: <<https://www.gov.uk/government/speeches/chancellors-hsbc-speech-financial-services>>).

arrangement had earlier been suggested by industry groupings in the UK.²⁷ An extreme if nonetheless not atypical example of the concerns which are driving the UK's push for special treatment for financial services relates to central clearing counterparties (CCPs). Arcane though they may be, CCPs are the "nuclear powerhouses" of the EU financial market, standing at the epicentre of the behemoth EU derivatives market (which is essential to the stability and effectiveness of the EU financial market), "clearing" billions of euro value transactions in derivatives, by standing between, and providing risk management support to, counterparties engaging in derivative transactions.²⁸ The UK is the major centre for CCP services in the EU. Some 50 percent of all interest rate swap transactions - critical for interest rate risk management in the EU economy - are cleared in the UK,²⁹ while the four UK CCPs (LCH Clearnet, ICE Clear Europe, LME Clear, and CME Clearing Europe) together are a major provider of clearing services in derivatives to the EU 27: LCH.Clearnet, for example, is the market leader in euro-denominated clearing.³⁰ The dominance of the UK as the EU centre for the clearing of euro-denominated instruments has been a source of tension for some time, culminating in the UK successfully challenging the validity of the ECB's "location policy" for euro-denominated derivatives clearing (which required that such clearing take place in the euro area and be subject to ECB liquidity support).³¹ Since the Brexit referendum, these tensions have intensified with the prospect of euro-related clearing, a very significant element of its financial market, operating "offshore" in the UK.³² Much of the UK's Brexit planning efforts, which include facilitating access by EU27/EEA firms to the UK,³³ are focusing on the development of a bespoke arrangement for this specialist but highly valuable segment of its financial market,³⁴ even as the EU industry seeks to draw in clearing business from the UK³⁵ and as the EU develops measures to require the "relocation" of such business through regulatory fiat.³⁶

2.2. *The EU – looking inward and buttressing its internal arrangements*

²⁷Major industry contributions include UK Finance, "Supporting Europe's economies and citizens: A modern approach to financial services in an EU-UK Trade Agreement" (2017), available through <www.ukfinance.org.uk> and International Regulatory Strategy Group, "A New Basis for Access to EU/UK Financial Services Post Brexit" (2017). Special treatment for financial services in a new FTA has support from the leadership of the UK's regulators, see e.g. Speech by Bailey, FCA Chief Executive, "Free trade in financial services and global regulatory standards: Friends not rivals", 26 Jan. 2017 and Carney, Bank of England Governor, "A fine balance", 20 June 2017.

²⁸CCPs manage "counterparty risk" in derivatives contracts by "clearing" transactions" - or acting as a seller to every buyer and as a buyer to every seller. CCP clearing guarantees the performance of derivatives contracts and thereby reduces the financial stability risk to the financial system. The requirement for CCP clearing is implemented in the EU under the EMIR Regulation (Regulation 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, O.J. 2012, L 201/1).

²⁹IMF, Oct. 2016 Global Financial Stability Report, p. 42.

³⁰Batsaikhan, Kalcik, and Schoenmaker, "Brexit and the European financial system: Mapping markets, players, and jobs", Bruegel Policy Contribution No. 4 (2017), p. 9-10.

³¹Case T-496/11, *UK v. European Central Bank*, EU:T:2015:133.

³²Some Member States have been reported as seeking the repatriation of euro-denominated clearing to the euro area: Reuters, "France wants right to veto Euro clearing in the EU after Brexit – EU sources", *Market News*, 6 Sept. 2017.

³³Towards the end of 2017, the UK Prudential Regulation Authority announced that, at least for the moment, "inbound" EEA firms seeking branch access can assume that it will regard EU requirements as equivalent to UK requirements for the purposes of UK authorization/access and will accordingly only require subsidiarization (and prohibit access through branches) where relevant conditions are met, including that material retail business is carried out: Prudential Regulation Authority, "Dear CEO letter. Firms' preparations for the UK's withdrawal from the European Union: Planning assumptions", 20 Dec. 2017.

³⁴E.g. International Regulatory Strategy Group, *CCPs Post Brexit* (2017).

³⁵Stafford, "Deutsche Börse eyes city of London Euro clearing crown", *Financial Times*, 20 Nov. 2017.

³⁶In summer 2017, the Commission proposed a new regime for "relocating" third country clearing into the EU (albeit when only a series of threshold conditions relating to systemic risk/financial stability are met): COM(2017)203.

The picture from the EU is different, with the EU adopting a more inward-oriented posture and buttressing its single market governance arrangements.

At first sight, the EU's preferences on financial services access arrangements should be aligned with the UK's as Brexit may lead to structural change to, and disruption within, the EU financial system if a reliable EU/UK financial services pipeline is not constructed. The EU financial system is predominantly bank-based: most funding to the EU economy is in the form of bank-provided credit.³⁷ EU financial governance has, however, long promoted market-based funding to diversify funding sources and thereby strengthen financial stability; the current Capital Markets Union (CMU) agenda, adopted in 2015 and the main pillar of the current EU financial regulation policy,³⁸ is only the most recent in a series of efforts to wean the EU from its dependence on bank funding. The UK is the primary EU location for market-based funding,³⁹ implying that a degree of EU market dislocation is inevitable in the absence of a bespoke EU/UK access arrangement. The UK hosts the largest fund management industry in the EU,⁴⁰ for example, with some 37 percent of assets under management in the EU managed in the UK.⁴¹ Similarly, more than half of all private equity funding raised in the EU is raised in the UK.⁴² Overall, some 35 percent of all wholesale financial services activity in the EU takes place in the UK.⁴³

The extent to which the EU financial market will be disrupted by Brexit is not clear and will not be for some time. The ECB appears relatively sanguine,⁴⁴ and the EU market can be expected to evolve without the UK pipeline and even in the absence of buffering trade agreements. Financial systems are innovative and also display an evolutionary bias to becoming more market-based, as advances in financial engineering, technological developments, and the globalization of funding markets give market-based funding a competitive advantage over bank funding.⁴⁵ Market-based funding, or at least greater reliance by banks on market sources for their funding and risk management, is growing across the EU.⁴⁶ This growth is likely to moderate the impact of Brexit, as will the steps being taken by UK firms to relocate their EU business to the EU27. The EU also appears determined to embed the CMU agenda and to develop substitutes for UK-based wholesale market business.⁴⁷ Nonetheless, an abrupt rupture between the UK and the EU27 could disrupt the EU financial market, generate financial stability risks, reduce the capacity of the EU financial

³⁷Commission, Economic Analysis Accompanying the Commission Communication on the Mid-Term Review of the Capital Markets Union Action Plan (SWD(2017)224), 36-37 and Commission, European Financial Stability and Integration Review (SWD(2016)146) 33.

³⁸The Capital Markets Union (CMU) agenda, adopted in Sept. 2015 (Commission, Green Paper, Building a Capital Markets Union (COM(2015)63)), is a predominantly regulatory agenda designed to liberalize capital markets in the EU and promote market-based funding.

³⁹E.g. Djankov, "The City of London after Brexit", (2017) *LSE Financial Markets Group Discussion Paper No. 762*.

⁴⁰IMF, "UK financial sector assessment program, financial system stability assessment", (2016) *IMF Country Report* 16/167, p. 9.

⁴¹Magnus, Margerit, and Mesnard, "Brexit: The United Kingdom and EU financial services", EU Parliament Briefing Paper, 9 Dec. 2016.

⁴²Commission, European Financial Stability and Integration Review, cited *supra* note 37, p. 28.

⁴³Wyman, op. cit. *supra* note 4, p. 2.

⁴⁴ECB, "Financial Stability in Europe", May 2017, pp. 28-30. For a similarly optimistic analysis see European Research Centre for Economic and Financial Governance, "Implications of Brexit on EU financial services", (2017), Study for the European Parliament ECON Committee, IP/A/ECON/2016-22.

⁴⁵FCA, "Market-based Finance: Its contributions and emerging issues", Occasional Paper 18 (2016).

⁴⁶As has been charted by, e.g. ECB, Financial Integration in Europe (2016).

⁴⁷See, e.g. Commission, "Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on the mid-term review of the capital markets Union action plan", (COM(2017)292).

system to fund the real economy, and threaten the achievement of the EU's flagship CMU policy agenda.⁴⁸

While the EU might therefore be regarded as having incentives to construct a new form of market access arrangement for the UK,⁴⁹ the technical design challenges are considerable. Mutual recognition/deference arrangements, on the lines being developed in the UK at the moment, are rare in international financial governance.⁵⁰ States internationally have limited incentives to adopt a liberal approach, given the absence of extensive international standards for financial regulation and of related arrangements for supervisory coordination and for risk-sharing in crisis conditions.⁵¹ Most "host" regimes, to which visiting "home" financial actors (registered/incorporated in the "home" State) seek access, require third country actors to follow - at least to a material extent - their domestic "host" rules. They only provide exemptions where the relevant "home" rules are "equivalent" to or can "substitute" for host rules; they also usually require third country actors to be registered and subject to some form of monitoring in the host State.⁵² The EU's third country arrangements follow this model, imposing EU host rules through the "equivalence" device, although many regimes internationally are more intrusive than the EU in requiring fuller host supervision than the EU usually requires.⁵³ The EU has also shown itself willing to tolerate access arrangements based on a pragmatic and outcomes-based approach to equivalence, rather than a formalistic treatment. For example, in 2016 the EU reached a hard-fought agreement, based on the EU's third country regime but reflecting the notion of outcomes-based deference, with the US authorities on the treatment of mutual access by CCPs to EU/US derivatives markets.⁵⁴ On the other hand, the recent Swiss experience, mentioned above, underlines the EU's commitment to protecting its single market institutions and regulatory arrangements.

Thus far, there are few signs that the EU - which, notwithstanding recent accommodations, has a long history of imposing its regulatory will through its third country rules⁵⁵ - is prepared to offer a bespoke access arrangement to the UK which would side-step the limitations of the third country rules and, at the same time, match single market access but without requiring the embedding of the UK within the immense superstructure of regulation and supervisory coordination which supports and manages risk within the single market in financial services. Access arrangements for financial services are expressly mentioned in the UK's "Article 50" letter.⁵⁶ They are not, by contrast, noted directly in the European Council's April 2017 negotiating Guidelines, and a reluctance to entertain bespoke arrangements can be implied in the reference in the Guidelines to the need for any future agreement to safeguard EU financial stability and respect its regulatory and supervisory regime; the draft negotiating Guidelines on the framework for the future relationship, proposed by European Council President Tusk on 7 March 2018, are similarly

⁴⁸On the potential costs see Sapir, Schoenmaker, and Véron, "Making the best of Brexit for the EU27 financial system, Bruegel Policy Brief, Feb. 2017.

⁴⁹And leaving to one side the WTO complications which might arise: see further Lang, *op. cit. supra* note 25.

⁵⁰For a review see IOSCO, Task Force on Cross Border Regulation. Final Report (FR/23/2015).

⁵¹Verdier, "Mutual recognition in international finance" 52 *Harv.Int'L.L.J.* (2011), 56

⁵²See further Moloney, *op. cit. supra* note 20.

⁵³The EU's current arrangements for third country CCPs e.g. are more "open" than those which typically apply internationally, in that the EU does not require close ongoing supervision of third country CCPs but relies instead on home supervision.

⁵⁴Commission Implementing Decision (EU) 2016/377 of March 2016, on the equivalence of the regulatory framework of the United States of America for central counterparties that are authorized and supervised by the Commodity Futures Trading Commission to the requirements of Regulation (EU) 648/2012 of the European Parliament and of the Council, O.J. 2016, L 70/32.

⁵⁵Quaglia, *The European Union & global financial regulation* (OUP, 2014).

⁵⁶Letter from UK Prime Minister May to European Council President Tusk, 29 March 2017, available at: <www.gov.uk/government/publications/prime-ministers-letter-to-donald-tusk-triggering-article-50>. The letter noted that the UK and the EU had regulatory frameworks that already matched and that the negotiations should accordingly prioritize how the evolution of regulatory frameworks could be managed and related disputes resolved.

austere, not referencing financial services but noting that there can be no “cherry picking” through single market sector-by-sector participation, and providing that an FTA in services generally would aim to allow market access under host state rules, consistent with the UK being a third country.⁵⁷ Similarly, the reference in the European Council’s December 2017 Guidelines on negotiating transitional arrangements to the UK not participating in EU agencies over any transitional period but being required to follow any changes to the *acquis* made by such agencies⁵⁸ implies a concern to protect current single market arrangements, given the importance of the three European Supervisory Authorities to the development of EU financial governance.⁵⁹ The European Parliament, in its April 2017 Brexit Resolution, made express reference to financial services, but only to underline that there can be no “cherry picking” and that the UK on withdrawal will become a third country, sitting outside the single market.⁶⁰ In the wake of the December 2017 European Council, the EU’s chief negotiator, Michel Barnier, warned that a special deal will not be available for financial services.⁶¹ Earlier in 2017, the Commission, in a delicately timed and frostily-toned report on the third country rules which apply to financial services (which does not mention Brexit but whose significance needs no underlining), warned that equivalence was not a market access device but a means for supporting EU stability; in a direction of travel which augurs ill for bespoke arrangements, it warned that jurisdictions of more systemic importance to the EU should receive closer attention in the equivalence process.⁶² The December 2017 Proposal to reform the regulation of investment firms reflects this direction of travel, materially strengthening the equivalence assessment which currently applies to investment firms, including by requiring a “detailed and granular assessment.”⁶³ At the supervisory/technocratic level, the ECB within Banking Union and the European Supervisory Authorities within the single market’s European System of Financial Supervision have over 2017, and as industry contingency planning got under way, adopted a robust posture on relocations of UK-based business to the EU, adopting guidelines which underline the need for adequate local structures and sufficient risk management capacity.⁶⁴

That the EU is proving, so far at least, unwilling to contemplate bespoke access arrangements and cleaving to its established third country arrangements, notwithstanding the potential market risks, is not surprising. The third country rules have, over time, been the subject of political contestation reflecting differing national positions on the desirability of a liberal access

⁵⁷European Council (Art. 50), Guidelines, following the United Kingdom’s notification under Art. 50 TEU, 29 April 2017, para 21 and European Council (Art 50) 23 March 2018) – Draft Guidelines, 7 Mar. 2018, para. 7.

⁵⁸European Council (Art. 50), Guidelines cited *supra* note 1, paras. 3-4. These Guidelines have been reflected in the Draft Withdrawal Agreement (28 Feb. 2018 TF50 (2018 33). Arts. 2, 122 and 126 together provide that the UK will be subject to acts adopted by the agencies of the EU, while Art. 6 provides that the UK will not participate in the decision-making and governance of agencies. The Draft Agreement provides, however, that the UK may (by invitation, on a case-by-case basis, and exceptionally, and without voting rights) attend agency meetings, but only where the discussion concerns individual acts to be addressed during the transition period to the UK (or to natural or legal persons residing or established in the UK) or the presence of the UK is necessary and in the interests of the EU, in particular for the effective implementation of EU law during the transition period (Art. 123(5)).

⁵⁹See further Moloney, *The age of ESMA: Governing EU financial markets* (Hart Publishing, 2018), (forthcoming).

⁶⁰European Parliament, Negotiations with the UK following its notification that it intends to withdraw from the EU, 5 April 2017 (P8_TA-PROV(2017)0102).

⁶¹Rankin, “UK cannot have a special deal for the City, says Brexit negotiator”, *The Guardian*, 18 Dec. 2017, reporting on Michel Barnier as stating “there is no place [for financial services]. There is not a single trade agreement that is open to financial services”.

⁶²Commission working document, cited *supra* note 9.

⁶³COM(2017)790, Art 61.

⁶⁴See *supra* note 6.

posture.⁶⁵ The Brexit-related competitive territory at stake for the Member States⁶⁶ makes it unlikely that a reconsideration of the third country regime - whether as a matter of horizontal legislative re-design for all third countries or for the UK specifically in an FTA - will be straightforward. Institutionally, the European Parliament appears sceptical of any bespoke EU/UK arrangement. It also appears increasingly suspicious of the Commission's role in international financial governance⁶⁷ and might be expected to resist any bespoke arrangement which strengthens the Commission's role – whether in relation to equivalence assessments, supervisory coordination, dispute resolution, or otherwise.

More fundamentally, since 2008 the EU has invested immense political, fiscal and institutional capital in the construction of the financial governance superstructure which supports the single financial market and which is designed to facilitate cross-border activity and at the same time contain the financial stability risks which, as the financial crisis exposed, can be transmitted cross-border to catastrophic effect. The “single rulebook” and the coordination of nationally-based supervisory governance for the single market through the European System of Financial Supervision, and Banking Union's distinct risk mutualization structures for the euro area banking sector, were not easy to construct, given the host of legal, political and institutional complexities. Not least among these is the high degree of political contestation which accompanies EU financial governance - in part linked to persistent underlying structural differences in national financial systems, and in part linked to the tensions which risk-mutualization and the sharing of the fiscal risks of supervision generate; how the different Member State interests, including those of the UK, have shaped current arrangements is noted in the following section.⁶⁸ The EU can be expected to protect this hard-won governance structure, including its third country arrangements, and to resist single market access which sits outside current governance arrangements. So far, all the indications suggest that any Brexit-prompted reforms to the third country regime are likely to be in the direction of a deeper embedding of the current legislative, single-market-based model. As discussed below, the Commission has proposed that the three European Supervisory Authorities be given additional powers to monitor ongoing compliance by third countries with equivalence conditions and, in the case of the European Securities and Markets Authority, be given direct supervisory powers over third country actors. There are few signs of any appetite for building a bespoke UK or an entirely new third country system - and many signs of the EU building an institutional capacity to supervise third country actors and monitor equivalence conditions within its single market structures.

3. The Long(er) term picture: The single rulebook

The withdrawal of the UK is also unlikely to have material effects on EU regulatory governance. Over and since the financial crisis era, the direction of EU financial regulation has been set by the

⁶⁵National preferences can vary depending on e.g. the exposure of a national market to the international market. See Quaglia, “The politics of ‘third country equivalence’ in post-crisis financial services regulation in the European Union”, 38 *Western European Politics* (2015), 167.

⁶⁶France's concern to capture financial services business from the UK has been well documented (e.g. Mooney and Thompson, “Europe's national regulators clash over delegation”, *Financial Times*, 8 Oct. 2017), while Frankfurt has also made overtures (Noonan, “Frankfurt offers ‘risk takers’ post- Brexit exemptions”, *Financial Times*, 3 July 2017).

⁶⁷European Parliament, ECON Committee, Report on the EU Role in the Framework of International Financial, Monetary and Regulatory Institutions and Bodies (A8-0027/2016) (2016).

⁶⁸For a recent assessment of the preferences and interests which shaped current financial governance arrangements see Burns, Clifton and Quaglia, “Explaining policy change in the EU: Financial reform after the crisis”, (2017) *Journal of European Public Policy*.

more interventionist group of “market-shaping” Member States,⁶⁹ and not by the UK. The UK can be associated with much of the technical rigour of the new rulebook,⁷⁰ but the overall direction and interventionist form of the rulebook reflects the dominance of the market-shaping coalition of Member States – though it is a result of the interplay of a host of drivers. The UK, as a member of the more liberal “market-making” coalition, was less influential.⁷¹ To the extent the UK’s influence was marked, notably in its espousal of a proportionate approach to regulation and a commitment to impact assessment, its legacy appears secure. Proportionality mechanisms, for example, now abound across the single rulebook, and the Commission appears committed to ensuring proportionality of rule design and application.⁷² Certainly, the absence of the UK will mean the removal of a friction against ever-intensifying harmonization and of a strong advocate for subsidiarity; harmonization can be expected to become more of a default option where questions as to the appropriateness of new EU regulatory intervention arise; the treatment of “fintech” may become a bellwether in this regard.⁷³ Overall, however, the absence of the UK as a political actor is unlikely to be determinative for the development of the single rulebook. This is not only a function of political dynamics, but also of the current nature of the single rulebook.

The single rulebook has, after years of wide-ranging, re-setting reforms, settled into shape as a mature regulatory system with few major gaps. This is not to suggest that the rulebook will remain static, but rather that its development is unlikely to be a function of intense political contestation over normative regulatory design choices. Instead, calibrating reforms and adjustments can be expected to shape the rulebook. For example, a horizontal “stock-take” of the entire regulatory landscape, directed to assessing the combined effect of the crisis-era reforms, has been carried out,⁷⁴ and a swathe of related technical reforms are in train. Similarly, all the crisis-era legislative measures have review clauses and will be reviewed over the short-to-medium term. This calibrating review/reform process is likely to be shaped by technocracy and not by political contestation, particularly given the increasing reliance by the Commission on the European Supervisory Authorities in carrying out reviews. The important December 2017 Commission Proposals on the prudential regulation of investment firms, for example, draw heavily on the technical support provided by the European Banking Authority.⁷⁵ Technocratic influence will be further embedded by the almost continual reforms being made to the highly technical and detailed administrative components of the single rulebook. These components are very dynamic, being in a state of almost permanent reform. To give only one example, while MiFID II/MiFIR came into

⁶⁹The classification of Member States into more interventionist “market-shaping” Member States and more liberal “market-making” Member States has been influential in the political economy discourse on the evolution of EU financial governance; for early articulations see Quaglia, “The ‘old’ and ‘new’ politics of financial services regulation in the EU”, 17 *New Political Economy* (2012), 15 and Quaglia, “Completing the single market in financial services: The politics of competing advocacy coalitions”, 17 *Journal of European Public Policy* (2010), 1007.

⁷⁰For analysis of where UK influence has been most marked, see City of London Corporation, “Shaping legislation: UK engagement in EU financial services policy-making”, Report by Norton Rose Fulbright (2016).

⁷¹See, from a legal perspective, Moloney, “Bending to uniformity: EU financial regulation with and without the UK”, 40 *Fordham International Law Review* (2017), 1335 and, from a political economy perspective, Howarth and Quaglia, “Brexit and the single European financial market”, 55 *JCMS* (2017).

⁷²A concern to ensure proportionate rule application is a recurring concern of the Commission’s major 2016 review of the crisis-era single rulebook: Commission, Call for Evidence – EU Regulatory Framework for Financial Services, COM(2016)855.

⁷³Crowdfunding, largely outside the current EU rulebook but an area of great current interest for national regulators in the EU, could be revealing. While the Commission has so far adopted a mutual learning/coordination-based approach, its recent “inception impact assessment” indicates that a legislative proposal is under consideration: Commission, Inception Impact Assessment. Legislative Proposal for an EU Framework on Crowd and Peer to Peer Finance (Ref. Ares(2017)5288649 - 30/10/2017).

⁷⁴Commission, Call for Evidence, cited *supra* note 72.

⁷⁵See *supra* note 10.

force only in January 2018, it is already being revised at the administrative level,⁷⁶ and in the immediate run-up to its application in January 2018 the European Securities and Markets Authority produced a host of soft guidelines on its application, designed to address issues of urgent industry concern.⁷⁷ Technocratic influence, exerted through the three European Supervisory Authorities, and not political contestation, is likely to be the dominant influence on the development of the single rulebook.

4. The Long(er) term picture: Institutional arrangements

4.1. The institutional setting and reform dynamics

Brexit can, however, be expected to shape institutional/supervisory governance for the EU financial market, at least to some extent. The EU's current institutional arrangements for the coordination of financial governance within the single market take two forms. First, the European System of Financial Supervision (ESFS) supports the development of administrative rules by the Commission and the adoption of soft law for the single market; it also provides the infrastructure for the coordination of supervision at national level, the supervisory management of cross-border risks, and the development of convergent supervisory practices across national supervisors. The ESFS is composed of: the Member States' national regulators (or "national competent authorities" (NCAs)) which provide the foundations of the system, supervising regulated actors in accordance with the EU's single rulebook; the three sectoral European Supervisory Authorities (ESAs),⁷⁸ which are charged with a range of quasi-regulatory and supervisory/supervisory co-ordination functions and their co-ordinating Joint Committee; and the European Systemic Risk Board (ESRB), which is charged with monitoring pan-EU system-wide risks and macro-prudential stability. The ESAs are designed to contribute to the development and consistent application of the single rulebook (including through the development of administrative rules and the adoption of soft law) and the promotion of supervisory convergence. Sitting uncomfortably alongside the pan-EU ESFS are the newer and distinct operational structures which relate to Banking Union and to the related mutualization of banking sector risk by its "participating" Member States. The Banking Union arrangements apply to euro area Member States (on a mandatory basis) and other "participating Member States" (on a voluntary basis) and to their deposit-taking institutions. The Single Supervisory Mechanism (SSM), operational since 2014, brings the supervision of the euro area's some 6,000 banks (non-euro area Member States may join the SSM on a voluntary basis, but have yet to do so), directly and indirectly, under the control of the ECB. The ECB has overall oversight of the SSM; is directly responsible for the supervision of 119 of the EU's most important banking groups ("significant banks"); and oversees the supervision of other euro area banks ("less significant banks") by their NCAs. The Single Resolution Mechanism (SRM), fully operational since 2016, brings the resolution of SSM-zone banks, directly and indirectly, within the control of Banking Union's Single Resolution Board (SRB) (like the ESAs, an agency set up under EU legislation) and includes a Single Resolution Fund to support resolution.

⁷⁶Over 2017 a series of administrative rule reforms were made to calibrate aspects of the regime. See e.g. Commission Draft Delegated Regulation (Ares(2017)3070825), which was subsequently adopted without objection from the Parliament or Council.

⁷⁷Including the Authority's Dec. 2017 "statement" allowing regulated actors a six-month transitional period during which the "Legal Entity Identifier" code, required under MiFID II/MiFIR for financial transactions, would not, subject to certain conditions, be required, given evidence of a lack of industry preparedness and concerns as to market disruption if transactions without the LEI were annulled or prohibited: ESMA Statement to Support the Smooth Introduction of the LEI Requirements, 20 Dec. 2017 (ESMA70-145-401).

⁷⁸The European Securities and Markets Authority (ESMA); the European Banking Authority (EBA); and the European Insurance and Occupational Pensions Authority (EIOPA).

The establishment of the ESFS initially and Banking Union subsequently reflects the confluence and interaction of a host of preferences – political, institutional and technocratic in the main – which were shaped by the exigencies of equipping the EU with a functioning risk management and fiscal support capacity in the wake of the initial financial crisis and subsequent euro area crises.⁷⁹ Both arrangements are, reflecting their complex origins, still “works in progress.” Banking Union is bedding in, but has yet to be completed. Progress on the missing legs of Banking Union, the European Deposit Insurance Scheme and the “fiscal backstop,” remains slow,⁸⁰ reflecting material political contestation on the extent to which risks should be further mutualized and EU regulation to reduce risks strengthened. The three ESAs, the key components of the ESFS, have been in place for longer but are also works in progress. Their powers are being continually extended by incremental legislative grant,⁸¹ but also by means of judicious and at time entrepreneurial application by the ESAs of their array of soft powers.⁸²

In the absence of some form of resetting shock, akin to the shocks which attended their construction, an incremental bedding in and expansion of the powers of the ESAs might have been expected over the next few years, not forgetting that these powers are shaped but also checked by the different preferences, interests and legal constraints which played a role originally. Similarly, Banking Union might have been expected to develop in accordance with the evolution of preferences relating to risk-mutualization and risk-reduction. Brexit, however, might be regarded as providing something of a resetting shock by removing the UK as a potential friction against their institutional development. From the outset, the UK resisted any transfer of direct supervisory powers to the three ESAs, typically calling in aid the *Meroni* prohibition on agencies exercising discretionary powers without appropriate conditionality.⁸³ It also sought to ensure that single market interests were not trumped by Banking Union/euro area preferences on questions of institutional design, fighting against any encroachment of Banking Union, or similar new structures, on the single market and against EMU needs driving EU supervisory arrangements.⁸⁴

4.2. Banking Union and Brexit

Initial indications suggest that Brexit is likely to have most relevance for the ESAs, and specifically ESMA. Banking Union, while still incomplete and not without contestation,⁸⁵ is

⁷⁹An extensive political economy literature examines the forces which have shaped the ESFS and Banking Union. On Banking Union, e.g. see Howarth and Quaglia, “Internationalized banking, alternative banks, and the single supervisory mechanism”, 39 *West European Politics* (2016), 438.

⁸⁰For a recent progress report see Commission, Completing the Banking Union, COM(2017)592. The 2018 Bulgarian Presidency has prioritized the completion of Banking Union, placing a “strong emphasis” on the completion agenda: Programme of the Republic of Bulgaria for the Presidency of the Council of the European Union (2018), pp. 24-25.

⁸¹Almost every sectoral financial legislative measure adopted since the 2011 establishment of the ESAs has conferred on them additional mandates and tasks.

⁸²Moloney, “Institutional governance and capital markets union: Incrementalism or a ‘big bang’?”, 13 *European Company and Financial Law Review* (2016), 376.

⁸³Case C-9/56, *Meroni v. High Authority of the European Coal and Steel Community*, EU:C:1958:7. The extent to which *Meroni* still represents a material obstruction to agency development is contested, in light of the *Short Selling* ruling (Case C-270/12, *UK v. Parliament and Council* EU:C: 2018:18); see also *infra* note 120.

⁸⁴Well-illustrated by the pre-referendum “new settlement” negotiated by then Prime Minister David Cameron which sought to protect single market financial governance: Decision of the Heads of State or Government Meeting Within the European Council, Concerning a New Settlement for the United Kingdom with the European Union, European Council Meeting, 18 and 19 Feb. 2016, EUCO 1/16 (Annex 1).

⁸⁵The SSM has faced criticism, most notably over summer 2017 in relation to the State-aid-supported liquidation of certain Italian banks, which led to disapproval of the SSM for failure to intervene earlier. The European Parliament is also proving an assertive interlocutor, challenging the SSM on, e.g. the proportionality of its action and, most recently as to its competence (in relation to the SSM’s contested Guidelines on the treatment of non-performing

becoming normalized and there are few indications that it will be destabilized by Brexit. Brexit is also unlikely to accelerate the completion of Banking Union, given that euro area preferences on risk mutualization and risk reduction will dictate the speed at which Banking Union is completed.⁸⁶ This is not to say that there will not be effects. Preferences on risk mutualization/reduction may be shaped by Brexit-related effects, particularly if stability risks arise, while Brexit is providing the ECB with opportunities to embed its authority within the SSM and Banking Union (including by monitoring the preparedness of banks for Brexit and adopting positions on relocation to the Banking Union zone). The Commission's December 2017 Proposals to empower the ECB to supervise within the SSM large systemic investment firms, as well as banks,⁸⁷ can be directly related to Brexit, being designed to address the supervision of the UK investment firms which dominate in the EU investment firm sector and which are likely to relocate part of their operations to the EU. The fate of the Commission's Proposals is at present uncertain, particularly as the Treaty competence for the reform is not entirely clear.⁸⁸ At the very least, however, the Proposals indicate a Commission appetite for further empowering the ECB within the SSM, and they may yet come to represent the "wedge" opening the way to the ECB's supervisory competences within Banking Union being significantly extended. Overall, however, the completion and subsequent development of Banking Union can be expected to depend on the complex interaction of political and institutional forces which shaped its establishment and is unlikely to be materially shaped by Brexit.

4.3. *The ESAs and Brexit*

Brexit effects may be more pronounced in relation to the ESAs. The ESAs are also becoming normalized, being used more and more frequently by the Commission and the co-legislators to deliver EU financial policy and to support integration, and thereby extending their distinct transnational influence.⁸⁹ Since 2011 they have experienced an incremental if ever intensifying accretion of formal and informal powers and a strengthening of their related capacity to exert technocratic influence over EU financial governance.⁹⁰ In September 2017, however, the Commission presented its ESA Reform Proposal⁹¹ which may lead to more punctuated change and to an acceleration of the "agencification" of EU financial governance which is already underway. The Proposal suggests changes to the governance of the ESAs (by diluting the power of the decision-making Board of Supervisors (composed of the 28 (soon:27) NCAs and locating certain decisions, particularly those where the Board may be in conflict, in that they relate to action against an NCA, within a new, bureaucratic Executive Board); funding reforms (by injecting an industry-funded component in to the ESAs' funding model which is currently based on EU/Member State funding); and a strengthening of the ESAs' soft coordinating/convergence powers, including by

loans, see, e.g. Guarascio, "EU Parliament says ECB goes beyond its mandate on bad loan plans", *Reuters*, 8 Nov. 2017).

⁸⁶See further Moloney, "EU financial governance after Brexit: The rise of technocracy and the absorption of the UK's withdrawal" in Alexander et al, op. cit. *supra* note 21, p. 61.

⁸⁷See *supra* note 10.

⁸⁸The reform is achieved by revising the definition of "credit institution" which applies under EU banking legislation and which is "borrowed" to define the scope of the SSM in the SSM's founding Regulation. Whether or not reform to an "ambulatory definition" in a different piece of legislation adopted under Art. 114 TFEU is sufficient to meet Art. 127(6) TFEU, which provides the legal base for the SSM and which gives decision-making power to the Council only, is not clear.

⁸⁹Moloney, op. cit. *supra* note 82.

⁹⁰See e.g. Zeitlin, "EU experimentalist governance in times of crisis", 39 *West European Politics* (2016), 1073; Ferran, "The existential search of the European banking authority", 17 *EBOR* (2016), 285 and Moloney, op. cit. *supra* note 59.

⁹¹COM(2017)536.

means of a new binding/hard power to request information directly from regulated actors and to impose sanctions for non-compliance.⁹²

The timing alone of the Proposal, and the relative speed with which it followed the earlier February 2017 Commission consultation, suggests a link to Brexit. Further, the Commission's February 2017 ESA Consultation had identified a "need to reflect carefully about "supervisory arrangements" given Brexit,⁹³ and its June 2017 review of the Capital Markets Union agenda argued that Brexit "strengthens the need for future integration of supervision at EU level."⁹⁴ The imprints of Brexit can certainly be identified fairly easily in the Proposal, notably in relation to the suite of proposed new ESA powers directed to third country actors. The Proposal suggests that the ESAs be empowered to monitor and review NCA decision-making where NCAs authorize EU-based financial actors who delegate operations to a third country; this new power relates directly to the earlier summer 2017 opinions issued by the ESAs on the management by NCAs of relocations from the UK to the EU,⁹⁵ and represents a hardening of the ESAs' ability to police NCAs in this regard. The Proposal also embeds the ESAs more fully in the third country regime. Currently, the ESAs provide technical advice to the Commission on equivalence decisions. The Proposal would extend the ESAs' role to monitoring the ongoing status of third country jurisdictions, reporting to the Commission where concerns arose, and entering into agreements with third country authorities which enhance supervisory coordination between the ESAs and relevant third country supervisors. These powers can be characterized as "tooling up" the EU to manage the UK as a third country actor, but they are also likely to have the long-term effect of empowering the ESAs in an area of significant political and market salience and of affording them the opportunity to deepen their influence and authority more generally. EU relations with third countries hosting major financial markets, including the US but also the major Asian economies, can be expected to become more sensitive as the EU adjusts to the UK as a major offshore financial centre; the sensitivities associated with the equivalence of Switzerland are already clear.⁹⁶ The ESAs have already proved adept in deploying their advisory powers in relation to the third country regime, and their coordinating role in international financial governance generally, to strengthen their institutional position within EU financial governance.⁹⁷ The Proposal's reinforcement of the ESAs as pivotal technocratic actors in what can be expected to be a sphere of ongoing significance to EU financial governance policy can be expected to further embed them within EU financial governance.

Brexit cannot easily be identified, however, as a determinative influence on the Commission's 2017 Proposal overall or as driving major long-term reforms to the ESAs; it forms part, but only a part, of a complex matrix of causative effects. The 2017 ESA Reform Proposal has been in gestation for some time and can be traced back to the initial 2013-2014 review of the ESAs and its suggestions for reform.⁹⁸ It can also be associated with the current CMU agenda. The Commission had, from the adoption of the CMU agenda in 2015, linked the achievement of CMU to stronger supervisory coordination through the ESAs, while the Council had also called for enhanced supervisory convergence, through the ESAs, as essential for CMU.⁹⁹ The 2017 ESA

⁹²The Sept. 2017 Proposal is at a very early stage of its legislative journey and given the degree of political and institutional contestation it is likely to generate (the Bulgarian Presidency has committed only to "start substantive discussions" on the Proposal), discussion here can only be highly tentative and preliminary.

⁹³Commission, "Consultation on the operations of the European Supervisory Authorities", (2017), p.15.

⁹⁴Commission Communication, cited *supra* note 47, p. 8.

⁹⁵See *supra* note 6.

⁹⁶See *supra* note 11.

⁹⁷Moloney, "International financial governance, the EU, and Brexit: The agencification of EU financial governance and the implications", 17 EBOR (2016), 451.

⁹⁸Commission, Report on the Operation of the European Supervisory Authorities and the European System of Financial Supervision, COM(2014)509.

⁹⁹E.g. ECOFIN Council Conclusions, 10 Nov. 2015, Press Release 791/15.

Consultation and Reform Proposal both directly link the reforms to a CMU-need to strengthen supervisory convergence,¹⁰⁰ while a separate Commission Communication, issued alongside the 2017 ESA Reform Proposal, has tied a strengthening of supervisory coordination under the reforms to the strengthening of CMU and to an acceleration of financial integration.¹⁰¹

The completion of Banking Union and of EMU can also be identified as influences on the 2017 Proposal. The Commission located the 2017 ESA Reform Proposal within these two ongoing projects, linking the supervisory reforms to Banking Union's support of financial stability, as well as to the 2015 call by the "Five Presidents" for EMU to be supported by a "Financial Union" (operating alongside Banking Union) which would be supervised by a single capital markets supervisor.¹⁰² Certainly, the ESA reform process has provided the Commission with the opportunity to use the ESAs as a means to buttress the EU against Brexit-related risks, and the absence of the UK has cleared the political pathway, to a certain extent, for additional empowerments. Nonetheless, the ESA reform process should be located in the wider set of preferences and interests and policy agendas which drive institutional reform to EU financial governance.

4.4. ESMA and Brexit

Brexit may prove to have long-term effects on institutional design in one respect, however, in that it can be associated with the proposals to materially strengthen one of the ESAs – ESMA – by means of additional direct supervisory powers.

ESMA, alone among the three ESAs, has direct supervisory powers but these are limited and circumscribed and apply to two sets of regulated actors only - EU credit rating agencies and trade repositories (in essence, massive data repositories for derivatives market data). The ESAs, by sharp contrast with the ECB within the SSM, are not designed as executive supervisors with binding powers, but as coordinating bodies. The legal difficulties aside,¹⁰³ direct supervision represents a significant incursion into Member States' autonomy; it can, particularly in a rescue/resolution context, lead to the imposition of fiscal costs back on Member States or require the mutualization of risk; and it can limit Member States' ability to wield economic levers, particularly where supervision impacts on sovereign borrowing costs or limits liquidity which disrupts the market's funding capacity. Member States also have often starkly different preferences in relation to the centralization of supervision, reflecting deeply rooted economic and financial system models. These were sharply exposed by the Banking Union reforms and the related centralization of supervision and mutualization of risk, but they have also coloured the development of the ESAs' supervisory powers as primarily coordinating powers, given resistance across many Member States to the centralization of supervisory powers.¹⁰⁴

Over 2017, however, the June 2017 CCP Supervision Proposal and the September 2017 ESA Reform Proposal proposed a material strengthening of ESMA's supervisory powers. The CCP

¹⁰⁰ESA Consultation, cited *supra* note 93, at p. 1 and ESA Reform Proposal, cited *supra* note 7, at p. 2.

¹⁰¹Commission Communication, Reinforcing integrated supervision to strengthen Capital Markets Union and financial integration in a changing environment, COM(2017)542.

¹⁰²ESA Reform Proposal, cited *supra* note 7, 2 and ESA Consultation, cited *supra* note 100, at p. 2. The Five Presidents' Report, (Completing Europe's Economic and Monetary Union (2015)) and the ECB (2016 Financial Integration Report (2016), p. 97) called for a "single European capital markets supervisor" to support EMU.

¹⁰³Empowering the ESAs as direct supervisors faces the challenges posed by the *Meroni* conditions on discretionary action by agencies as well as those posed by the limitation of the Art. 114 TFEU competence (which is used to empower the ESAs) to harmonizing measures. See further Moloney, *EU Securities and Financial Markets Regulation* 3rd ed. (OUP, 2014), pp. 993-1003.

¹⁰⁴On the preferences which shaped the development of the ESAs, and the political interests of the Member States see Quaglia, Howarth, and Liebe, "The political economy of European capital markets union", (2016) *JCMS*, 185 and Moloney, *op. cit. supra* 103, at pp. 960-964.

Proposal proposed that ESMA be conferred direct supervisory and enforcement powers over third country CCPs. The ESA Reform Proposal proposed that ESMA be conferred supervisory powers (based on the legal and operational template developed for rating agencies and trade repositories) over a limited set of sectors (with relatively small regulated populations) with distinct and strong cross-border settings: certain funds with EU regulatory “labels”; data service providers; benchmark administrators; and certain prospectuses oriented towards the professional fund-raising markets. What is perhaps more revealing is what the Proposal hints at. The Commission located these limited empowerments within a wider movement “towards a single capital markets supervisor,”¹⁰⁵ characterized them as “the first concrete steps towards a Single European Capital Markets Supervisor,”¹⁰⁶ moreover, it had earlier, in 2017, in the context of the completion of EMU, linked the 2017 ESA reform process to the “first steps” to be taken in the direction of a single supervisor as a support to EMU as well as to the single-market-wide CMU.¹⁰⁷ While allowance must be made for institutional opportunism and kite-flying, and while the Commission was at the same time careful to refer to subsidiarity constraints and functional realities,¹⁰⁸ the Commission nonetheless appears committed to a clear direction of travel.

The two Proposals can be regarded as forming part of the EU’s financial integration project more generally and not as entirely Brexit-driven developments. As noted above, the 2017 ESA Reform Proposal is closely tied to the EU’s ongoing efforts to deepen financial integration and related to the process of completing EMU and Banking Union – Brexit receives only cursory reference.¹⁰⁹ Nonetheless, the Proposals cannot be dissociated from Brexit. The Brexit imprints are clearest in the case of the 2017 CCP Supervision Proposal which gives ESMA supervisory powers over third country CCPs, given the political and market salience of the potential “offshoring” of euro clearing in the UK. With the 2017 ESA Reform Proposal, it is difficult to entirely disentangle its reforms from Brexit, particularly as the absence of the UK removes a significant political road-block to empowerments to ESMA. The confluence of Brexit and CMU seems to have led to a material change to the Commission’s position, as the Commission has historically been reluctant to propose any significant empowerment of the ESAs and sensitive to the restrictions imposed by the *Meroni* ruling. Further, ESMA, as predicted by the political economy literature on agency development,¹¹⁰ has proved an astute and entrepreneurial actor, carefully deploying the opportunity represented by Brexit to reinforce its position. Over 2017, ESMA repeatedly called for a strengthening of its powers in relation to third country firms and for supervisory powers over third country actors;¹¹¹ proposed an adjustment and toughening of its current third country-related powers;¹¹² used its supervisory convergence powers to seize the Brexit agenda, examining the risks to the EU financial market from a “cliff edge” hard Brexit and

¹⁰⁵Commission Communication, cited *supra* note 101 (accompanying the 2017 ESA Reform Proposal).

¹⁰⁶*Ibid.*, p. 4.

¹⁰⁷Commission, Reflection Paper on the Deepening of the Economic and Monetary Union (2017), noting that the gradual strengthening of the supervisory framework should lead to a single European capital markets supervisor and identifying the 2017 ESA Review as the “first steps” in that direction (at pp. 20-21).

¹⁰⁸*Ibid.*, p. 9.

¹⁰⁹See *supra* note 7, Explanatory Memorandum, p. 2-4.

¹¹⁰On the influence which agencies, as technocratic actors and by developing epistemic networks of peer regulators, can exert on their operating environment, see Thatcher, “The creation of European regulatory agencies and its limits: A comparative analysis of European delegation”, 18 *Journal of European Public Policy* (2011), 790.

¹¹¹See e.g. ESMA, Response to the Public Consultation on the Operations of the European Supervisory Authorities (ESMA03-173-194) (2017); and speeches by ESMA Chairman Maijor, e.g. Speech to Futures Industry Association IDX Conference, London, 7 June 2017; and Speech to ALDE Seminar, European Parliament, 8 Feb. 2017.

¹¹²Notably in relation to ESMA’s approach to the “endorsement” of ratings from third country rating agencies and its proposal of a more intrusive approach to the related assessment of the quality of third country supervision: ESMA, Consultation Paper (ESMA33-9-159) (2017).

preparing possible mitigating action;¹¹³ and took the lead in addressing “race to the bottom” supervisory risks posed by Brexit-related competition¹¹⁴ by adopting robust guidelines, contained in its series of opinions on Brexit-related relocation of UK entities.¹¹⁵

The fate of both Proposals is at present a matter of speculation and the Commission’s position cannot be taken as a reliable indicator of future centralization of supervisory power within ESMA. To take only one set of interests – political interests – contestation may be significant. The empowerments proposed in the 2017 ESA Reform Proposal relate to a limited set of actors who do not post material fiscal risk, but they can be expected to be challenged. Earlier, the CMU agenda, around which Member States interests have, for the most part coalesced, had not prompted political enthusiasm for direct supervision.¹¹⁶ While the 2015 Five Presidents’ Report suggested institutional support for centralized capital market supervision within the euro area, it is not clear that there is euro area political support for such a change – much less single-market-wide support, given persistent differences in capital market structures across the Member States and related divergences in preferences relating to supervisory organization. Brexit may unleash competitive forces which lead to Member States resisting any further loss of supervisory autonomy. France, for example, has been pushing for stronger ESMA-located oversight of the EU funds industry, but Luxembourg, a major centre for funds regulation, has been strongly opposed.¹¹⁷

More generally, while the direct supervisory empowerments proposed for ESMA relate to regulated actors unlikely to generate fiscal risk, they may establish a material precedent which may not be palatable politically. Political interests will be shaped by industry preferences which, as the 2017 ESA Consultation indicated, can be marked. While the 2017 ESA Consultation saw some industry support for a strengthening of ESMA’s supervisory convergence role, it also produced a broad consensus that the ESAs were currently fit for purpose, and exposed hostility to any expansion of ESMA’s direct supervision powers, a concern to protect NCA discretion/autonomy, and calls for ESA restraint in relation to soft law and for the ESAs to respect the limits of their mandates.¹¹⁸ The specific CCP-related powers can also be expected to be questioned. Member States are unlikely to be sanguine as to the prospect of ESMA exerting direct supervisory powers over third country CCPs, given the precedent it establishes for locating direct supervisory power over systemically significant actors, without fiscal responsibility, at ESMA level – even allowing for the reality that in practice fiscal burdens are most likely to fall on the third country home supervisor. This is all the more the case as the CCP Supervision Proposal at the same materially strengthens ESMA’s role in relation to NCAs’ supervisors of EU CCPs by, in effect, conferring on ESMA approval/veto powers over CCP supervision, notwithstanding that the acute fiscal risk associated with CCP supervision remains at national level.

If the two Proposals emerge from the negotiations in anything close to their current form, a material strengthening of ESMA’s direct supervisory powers which can be associated, at least to some extent, with Brexit, will follow. The impact on EU financial governance should not, however,

¹¹³On ESMA’s pre-emptive, market monitoring agenda see ESMA Chairman Maijor, Speech on ‘ESMA View Point – Priorities for 2018’ 16 Nov. 2017 and Opening Statement, ECON Committee, 2 Oct. 2017 (ESMA22-105-239).

¹¹⁴Which were identified at ESMA’s first Board of Supervisors Meeting after the UK referendum: 12 July 2016 (ESMA/2016/BS/201).

¹¹⁵See *supra* note 6.

¹¹⁶ECOFIN Council Conclusions, 10 Nov. 2015 (Press Release 791/15) and ECOFIN Council Conclusions, 11 July 2017 (Press Release 460/17).

¹¹⁷Mooney and Thompson, “Europe’s national regulators clash over delegation”, *Financial Times*, 8 Oct. 2017.

¹¹⁸Commission, Feedback Statement on the Public Consultation on the operation of the European Supervisory Authorities (2017). Many respondents highlighted the need to respect subsidiarity, proportionality and NCA discretion; there was an “overwhelming majority” against increasing ESMA’s powers in relation to financial reporting; and with the exception of CCP supervision, there was little support for further direct empowerments given the merits of local supervision: at p. 6, 11 and 13.

be overplayed. The combined effect of the 2017 CCP Supervision Proposal and the ESA Reform Proposal will not change ESMA's essential characterization as a coordinating network actor, exerting primarily soft powers within the ESFS. The two Proposals may, however, mark the start of a second evolutionary trajectory, which may ultimately terminate in the centralization of direct capital markets supervision. For that to happen, a host of political, institutional, legal and functional frictions will need to be removed, and multiple and difficult institutional design decisions will need to be made and executed in a politically acceptable, functionally effective, and legally resilient manner. Not least among the legal and functional challenges are: the Treaty competences available to support such an institutional reform;¹¹⁹ *Meroni* restraints, assuming an agency model is used;¹²⁰ the ability of EU administrative law to protect third party rights against maladministration by powerful supervisors;¹²¹ and whether, and if so how, centralized supervisory responsibilities should be split across the ESAs within the ESFS and/or the ECB within Banking Union, in relation to which a bewildering array of potential design choices arise, with related legal complexities. Brexit alone will not provide the resetting shock which makes the removal of these frictions and the successful execution of these design choices a likely prospect.

5. Conclusion

Speculation is perilous in the current environment. Nonetheless, it is not unreasonable to suggest that Brexit's impact on EU financial governance will be contained and most likely limited. Current indications do not suggest material changes to the EU's third country access arrangements beyond the "tooling up" of the EU's institutional capacity to deal with third country actors. The single rulebook is unlikely to depart from its current developmental trajectory, which is being powered, for the most part, by technocratic ESA influence. As has long been the case in EU financial governance, the greatest uncertainty relates to the EU's evolving supervisory/institutional arrangements. Here, Brexit may be one of the factors which lead to a significant future empowerment of the ESAs, and in particular ESMA. Brexit is only one, however, of a range of complex, dynamic and symbiotic political forces, institutional interests, legal constraints and functional challenges which must combine in the EU's governance reform crucible if materially more supervision is to be located at EU level.

¹¹⁹The legal resilience of Art. 114 TFEU, which underpins the ESAs, has been subject to close evaluation in light of the A.G.'s finding in the *Short Selling* ruling (which was not followed by the ECJ) that Art. 114 TFEU could not support ESMA's direct intervention powers (Case C-270/12, *Short Selling*). See Bergstrom, "Shaping the new system for delegation of powers to EU agencies: United Kingdom v. European Parliament and Council (*Short Selling*)", 52 CML Rev. (2015), 219; Van Cleynenbruegel, "*Meroni* Circumvented? Art.114 TFEU and EU regulatory agencies", 21 MJ (2014), 64; and Howell, "The European Court of Justice: Selling us Short", 11 *European Company and Financial Law Review* (2014), 454.

¹²⁰Even allowing for the apparent relaxation of *Meroni* by the *Short Selling* ruling in which the ECJ found that ESMA's discretion to exercise emergency intervention powers in relation to short selling was appropriately confined, despite the generality of the related legislative and administrative conditions, it remains a material friction on agency organization. See e.g. Craig, *UK, EU and global administrative law* (Cambridge University Press, 2015), pp. 532-544.

¹²¹Chiti has critiqued the related deficiencies in EU administrative law, in particular its failure to mature in line with the burgeoning of EU agencies and of their powers to affect third parties: Chiti, "Is EU administrative law failing in some of its crucial tasks", 22 ELJ (2016), 576.