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ISSUES ON FINANCIAL MARKET REGULATION, BUSINESS DEVELOPMENT AND GOVERNMENT'S POLICIES ON GLOBALIZATION

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The "Law and Economics Yearly Review" is an academic journal to promote a legal and economic debate. It is published twice annually (Part I and Part II), by the Fondazione Gerardo Capriglione Onlus (an organization aimed to promote and develop the research activity on financial regulation) in association with Queen Mary University of London. The journal faces questions about development issues and other several matters related to the international context, originated by globalization. Delays in political actions, limits of certain Government's policies, business development constraints and the "sovereign debt crisis" are some aims of our studies. The global financial and economic crisis is analysed in its controversial perspectives; the same approach qualifies the research of possible remedies to override this period of progressive capitalism's turbulences and to promote a sustainable retrieval.

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RULES-BASED VS. PRINCIPLES-BASED REGULATION IN THE UK BANKING SECTOR. DOES BREXIT MATTER? *

Martin Berkeley ** - Andrea Miglionico ***

ABSTRACT: *This article examines the potential impact of Brexit in the context of the banking sector as it relates to UK credit institutions and the recognition measures for foreign banks. In doing so it seeks to analyse and put light upon the quest for coordinating these measures under practitioner lenses. This in turn is intended to aid reflection on how Brexit changes might best be adapted in UK banking regulation. The first part of this article addresses the regulatory approaches from a theoretical perspective, arguing whether it is still relevant to discuss the distinction between principles-based and outcomes-based regime. The second part of the article explores the effects of Brexit in practice, focussing primarily on investor protection and passporting arrangements. The article argues that the MiFID directive represents the legislative framework to achieve mutual recognition among banks and to avoid the risk of de-regulation in the UK financial markets. The article concludes with some observations on the potential divisive impact of Brexit on UK regions, particularly how Brexit might best be regulated if the UK remains within the European Economic Area.*

SUMMARY: 1. Introduction: the UK strategy and the EU approach. – 2. Market-based regime vs. risk-based regime within Brexit. – 3. From a principles-based regulation to an outcomes-based regulation: the potential effects of Brexit in the UK banking sector. – 4. Investor protection and resilience of banks in the aftermath of Brexit vote. – 5. The quest for passporting foreign banks in

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*This article is a result of joint reflections. Sections 1, 2 and 3 have been written by A. Miglionico. Sections 4, 5 and 6 have been written by M. Berkeley. Section 7 presents shared reflections on the subject matter.

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the UK. – 6. The risk of de-regulation in the UK financial markets. – 7. Conclusive remarks.

1. It is noteworthy that securities markets and capital regulation require transparency, fairness, equal access, competition and financial soundness. The corporate and banking collapses such as *Lehman Brothers* and *Northern Rock* showed that the financial industry has underestimated the value and importance of investor protection.[1] For instance, in the LIBOR scandal investors have suffered from a lack of transparency and information asymmetries which reflect a fundamental imbalance between market participants.[2]

The question at stake is how to reduce informational asymmetry in the financial sector and between market participants. The crucial issues of market confidence and management credibility are principal factors for the growth of the financial markets as is the integrity and competence of its members.[3]

Rapid changes affecting the regulatory structure of securities in the aftermath of 2007-09 global crisis and Brexit vote have revealed an important question, namely, how far is the financial market from safety and legality.[4] On the one hand, the UK system has responded with a series of measures reflecting a principles-based approach and tending to consider investor protection as the cornerstone of future regulatory developments. On the other hand, the Continental system, has sought to protect consumers through a series of directives that have introduced a form of mixed regulation (rules-based regime with the MiFID II and a

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[1]See SCHILLER, *The Subprime Solution* (Princeton University Press 2008) 87-88.

[2]See FIELDS, 'Common cause: institutional corruption's role in the Libor and the 4pm fix scandals' (2014) 8(1) *Law and Financial Markets Review*, 9-10.

[3]See BLACK, 'An Economic Analysis of Regulation: One View of the Cathedral' (1996) 16(4) *Oxford Journal of Legal Studies*, 699-700.

[4]See REYNOLDS and DONEGAN, 'Brexit—Opportunity for a Reboot of Financial Regulation' (2016) 31(12) *Journal of International Banking Law and Regulation*, 613.

mixed system of principles and rules with the Banking Union). The principles-based approach is implemented by a mechanism of voluntary provisions as firms and market participants have a responsibility to act in the interest of market growth and success, with a clear division of accountability and roles. As Sants observed, 'a principles-based approach does not work with individuals who have no principle'.[5]

The main challenge is moving from regulation based only on observable facts to regulation based on judgements about the future.[6] As the Paulson Report stated, 'a new regulatory architecture accountable to investors, with flexibility to adapt to changing markets and clarity of responsibility to interact with international counterparts to forge a seamless global market infrastructure, would inspire the confidence for the financial system to create prosperity in all sectors once again'.[7] Particular attention should be paid to the information gap to which business transactions are generally subject, the imbalanced relationship between managers and investors is principally determined by lack of financial knowledge and causes a distortion of consumers' choices at the time when the investment is executed.[8] However, the global financial crisis showed that customers were too trusting of banks with little understanding of the risks of commercial transaction. Market credibility can be measured in terms of intermediaries' accountability, not only from the point of view of the suitability of market actors, but also of effective enforcement. In this context, the role of internal controls such as the function of audit committees represents the best expression for the adoption of forms of self-regulation in terms of detailed duties and improved reputations.

In recent years, the financial markets can be considered as the major cor-

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[5]See THAL LARSEN and HUGHES, 'Sants signals more muscular regulatory era', *Financial Times*, 13 March 2009, 19.

[6]A simple principle must be accompanied by a strong judgement of the facts in short, moving to an outcomes-based regime is considered to be the most appropriate way of resolving the recent regulatory failures.

[7]See PAULSON, 'Reform the architecture of regulation', *Financial Times*, 18 March 2009, 13.

[8]See PACCES, 'Financial intermediation in the securities markets law and economics of conduct of business regulation' (2000) 20(4) *International Review of Law and Economics*, 499.

nerstone of the EU's strategy in terms of policy efforts. What has been achieved ensues from the Banking Union[9] and the numerous financial directives that the EU Institutions have adopted with a view to reforming the banking and securities sectors.[10] It appears that the perceived need for better regulation and consumer protection has driven the EU's strategy, also under the influence of the real integration of the markets. Particularly, evidence of a desire to remove the existing national barriers as between Member States has marked certain directives, for example the MiFID Directive.[11] This assumption can be measured by the growing need for harmonised securities regulation, a common set of rules at international level has definitively replaced the former local rules and administrative burdens (costs of cross-border financial activities, such as permissions, licenses and authorities' approvals).

The effective consequence is the adoption of shared rules and forms of soft law,[12] the current activity of the financial markets has permitted the development of new methods of regulation, such as the principles-based regime and the outcomes-based regime.[13] These new forms of regulation have been reflected in a self-regulation regime[14] characterised by internal controls, best practices, compliance and "treat customers fairly" programmes.[15]

At first glance, the complexities of the regulatory system result in fragmentation and a substantive confusion of accountability, indeed, the principles

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[9]Communication from the Commission to the European Parliament and the Council. A Roadmap Towards a Banking Union COM(2012) 510 final.

[10]Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms.

[11]The fifth recital in the preamble to MiFID states that "it is necessary to establish a comprehensive regulatory regime governing the execution of transactions in financial instruments irrespective of the trading methods used to conclude those transactions so as to ensure a high quality of execution of investor transactions and to uphold the integrity and overall efficiency of the financial system".

[12]Soft law signifies a form of non-binding rules constituted by legal opinions, statements, guides, protocols, and commentaries. These forms have no legal force, but can influence the Courts and market participants.

[13]The Economist, 'Bolting the stable door', 21st March 2009, 35.

[14]See BLACK, 'Decentring Regulation: Understanding the Role of Regulation and Self-Regulation in a "Post-Regulatory" World', in M.D.A. Freeman (ed), *Current Legal Problems*, 2001, Vol. 54, 112-113.

[15]FSA, 'Treating Customers Fairly: Towards Fair Outcomes for Consumers', July 2006.

adopted to regulate the markets do not seem to operate in a clear manner. In the last few decades, rule-making (specifically normative activity) has been considered too slow to keep up with innovation in the sphere of financial instruments (as in the case of derivatives) and has been relegated to the same level as principles, with the inevitable confusion of their respective roles.[16] The former UK Financial Services Authority put greater stress on the use of principles-based regulation, while affirming that this kind of approach 'means moving away from dictating through detailed prescriptive rules and supervisory actions how firms should operate their business'.[17]

In addition, technological innovation and the transformation of the financial markets have brought about huge changes in terms of regulation, particularly in comparison between the EU and the UK strategies. On the one hand, the EU approach has laid the foundation for a new way of dealing with the securities sector, which is characterised by consumer protection and an investor-disclosure system. On the other, the UK approach has adopted the outcomes-based regime governed, not only by rules but also by principles. However, the Brexit vote has raised several questions such as how to regulate a single banking licence,[18] mutual recognition[19] and home country control. It also raised a question: how to regulate the EU requirements for equivalence determinations in the financial sector. In this context, several proposals have been launched such as co-operation agreements, bilateral agreements, reciprocity and substantive compliance, 'Norway model' based on the European Free Trade Association (EFTA), Member State of Reference and subsidiary v branch to establish common requirements for the recognition of

[16]E.F. Gerding, 'Code, Crash, and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis' (2009) 84(2) *Washington Law Review*, 132-133.
[17]FSA, 'Principles Based Regulation: Focusing on the Outcomes that Matter', April 2007.
[18]The single banking license was introduced by the Second Banking Directive (89/646/EEC) to provide access to EU financial institutions to do business with each other. In this way, credit institutions which are authorized to operate in any Member State are allowed to establish branches and to provide cross-border services throughout the community on the basis of the principle of home country supervision.
[19]Mutual recognition means harmonization of a managed regulatory system. It implies mutual trust and adoption of common rules.

third-country regulatory regimes.

Recital 41 in the preamble to MiFIR states that 'the equivalence assessment should be outcome-based; it should assess to what extent the respective third-country regulatory and supervisory framework achieves similar and adequate regulatory effects and to what extent it meets the same objectives as Union law'.[20] Articles 46(2)(a) and 47 of the MiFIR regulate the 'third-country firms' regime, and clarify that central to the requirements is the equivalence decision adopted by the Commission. Under Brexit, the UK will become a 'third country' within the current EU financial regulatory structure, this implies that future access to the EU's single market for UK-based financial institutions may be very limited.

The equivalence-based approach seems the way forward to maintain access to EU markets as it is unlikely to apply the passporting[21] solution because it would require concessions on UK sovereignty.[22] As observed, 'if the UK became a member of the EEA it would retain the right to assign "passports" to companies, but that would leave the UK having to comply with EU laws with no say in the decision-making process'.[23] If the UK will leave the EU, UK-based banks (including non-EU banks operating through UK subsidiaries) risk losing the passport regime.[24] If an EEA model is adopted in the outcome of Brexit negotiation, the UK will have an observer status, basically 'the UK will lose a channel for influencing interna-

[20]Regulation 600/2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 [2014] OJ L173/84.

[21]The EU passport system means that if a financial services firm is authorized to carry out activities by one member state, it can freely trade in another member state. The UK benefits from the EU's 'passporting' arrangements which govern access to the single market in financial services. Under EU financial governance arrangements, subsidiaries are supervised in the relevant domestic market in which the subsidiary is registered. Branches and cross-border services are supervised through the home Member State from which these services operate.

[22]The passporting solution involves the following concerns: (1) rule-taking of EU regulations; (2) supranational bodies; and, (3) free movement and financial contributions.

[23]See MUGARURA, 'The "EU Brexit" implication on a single banking license and other aspects of financial markets regulation in the UK' (2016) 58(4) *International Journal of Law and Management*, 477.

[24]See SCHOENMAKER, 'Lost passports: a guide to the Brexit fallout for the City of London', Bruegel Blog Post, 30 June 2016, available at http://bruegel.org/2016/06/lost-passports-a-guide-to-the-brexit-fallout-for-the-city-of-london/.

tional financial governance'.[25] However, the EEA model may not be suitable for the fast-changing regulatory challenges of the financial sector, this means that if the UK seeks to join the EEA, it would need to ensure at least some mechanism to improve implementation speed for financial services measures.[26] The equivalence arrangements will give the possibility to remove and re-modulate EU laws: a solution that would allow the UK to establish a new regulatory framework or, as observed, a 'Financial Centre' model.[27] A new financial platform poses risks in terms of supervision as home supervised 'systemic branches' to the host market are all the greater where the branch is of a third country firm, such as a post Brexit UK firm, which operates outside the EU's supervisory governance and coordination requirements'.[28] This framework shows a grey area on which the City might continue to thrive as a global financial centre in Europe.[29] A scenario that demonstrates how Brexit will manifest more in form than in substance.[30]

The Brexit negotiation process can determine the relocation of some of banking activities to other financial centres in the EU.[31] The uncertainty created in the aftermath of this controversial vote is likely to affect any plans among international banking groups to expand their UK-based operations. Most interestingly there will be costs associated with the Brexit transition and 'most banks will be facing similar cost shocks, a large proportion of the additional costs are likely to be

[25]See MOLONEY, 'International Financial Governance, the EU, and Brexit: The 'Agencification' of EU Financial Governance and the Implications' (2016) 17 *European Business Organization Law Review*, 473.

[26]See ARMOUR, 'Brexit to the European Economic Area: What Would It Mean?' Oxford Business Law Blog, 19 July 2016, available at: https://www.law.ox.ac.uk/business-law-blog/blog/2016/07/brexit-european-economic-area-what-would-it-mean.

[27]See REYNOLDS, *A Blueprint for Brexit. The Future of Global Financial Services and Markets in the UK* (Politeia, London 2016) 27. The effect of a 'Financial Centre' model would be the development of an attractive, market-friendly regulatory framework, allowing banks and financial institutions to improve returns on equity.

[28]See MOLONEY, 'Brexit, the EU and Its Investment Banker: Rethinking 'Equivalence' for the EU Capital Market', LSE Law, Society and Economy Working Papers 5/2017, 12.

[29]See LANNOO, 'EU Financial Market Access After Brexit' (2016) (51)5 *Intereconomics*, 255.

[30]See RINGE, 'The Irrelevance of Brexit for the European Financial Market', Oxford Legal Research Paper Series 10/2017, April 2017, 36.

[31]AFME, 'Implementing Brexit Practical challenges for wholesale banking in adapting to the new environment', April 2017, available at https://www.afme.eu/globalassets/downloads/publications/afme-implementing-brexit-2017.pdf.

passed on to customers, rather than having a long-term impact on profitability'.[32] In addition, the impact of Brexit would affect transaction costs as banking regulation can diverge from the EU legislative framework. Compliance with different regulatory regimes can create additional costs for banks, which are likely to be passed on to customers and retail investors.

The equivalence model based on a mutually reciprocal arrangement can provide a fair agreement in providing access to the EU markets for branches in the UK of EU credit institutions. In this context, the European Securities and Markets Authority (ESMA) has published sector-specific principles in the areas of investment firms, investment management and secondary markets, aimed at fostering consistency in authorisation, supervision and enforcement related to the relocation of entities, activities and functions from the UK.[33]

The introduction of a third-country equivalence regime in the MiFID activities would ensure that UK banks would be able to carry on investment business activities—including wholesale investment services cross-border to professional clients and eligible counterparties—under an equivalence decision.[34] In terms of retail banking and private wealth management, UK banks will be able to carry on providing services which are MiFID activities to professional clients and eligible counterparties under the equivalence regime in MiFID II. However, the successful of the equivalence-based model faces some doubts because of different incentives of the UK and the EU: different public policy objectives (for instance to create a new Financial Centre) and uncertainties on supervisory powers are the main

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[32]See CORREIA DA SILVA, 'Leaving the EU: impact on bank customers', Oxford Law Faculty, Blog Series, 7 April 2017, 3 available at: https://www.law.ox.ac.uk/businesslawblog/blog/2017/04/brexitnegotiationsseriesleavingeuimpactbankcustomers.

[33]ESMA issues sector-specific principles on relocations from the UK to the EU27, ESMA71-99-526, 13 July 2017, available at: https://www.esma.europa.eu/document/esma-issues-sector-specific-principles-relocations-uk-eu27.

[34]The equivalence assessment may prove technically problematic because is subject to the Commission discretion. In addition, issues may arise in relation to the supervisory and enforcement aspects of the MiFIR equivalence decision.

concerns at stake.[35] As noted, 'many wholesale market activities will need to be relocated from the UK to the EU-27 so that financial firms can keep serving local customers within the single market: to address the supervisory risks, European leaders should reinforce the ESMA with significant additional resources and expanded responsibilities'.[36]

The next sections address the regulatory approaches from a theoretical perspective, arguing whether it is still relevant the distinction between principles-based and outcomes-based regimes in the UK banking sector. The second part of the article explores the effects of Brexit in practice, focussing primarily on investor protection and passporting arrangements. This article suggests that the MiFID directive represents the legislative framework to achieve mutual recognition among banks, and to avoid the risk of de-regulation in the UK financial markets. The article concludes with some observations on the potential divisive impact of Brexit on UK regions, particularly how Brexit might best be regulated if the UK remains within the European Economic Area.

2. The structure of financial regulation has been subjected to a new phase of regulatory regime, characterised by forms of a market-based and risk-based approach.[37] The market-based regime consists of the market evaluation of firms' profits with independent and external bodies supervising the effective working of governance (managers, intermediaries, investors). The risk-based approach involves, in general terms, an architecture in which self-imposed forms of regulation operate. In these terms, the market-based approach assumes a form of "merit regulation" where the sole judge of the regulatory system is the market.[38]

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[35] See MOLONEY (*supra* note 28) 43-44.
[36] See SHOENMAKER and VERON, 'Brexit should drive integration of EU capital markets', Bruegel Blog Post, 24 February 2017, available at: http://bruegel.org/2017/02/brexit-should-drive-integration-of-eu-capital-markets/.
[37] See BLACK, 'The development of risk-based regulation in financial services: just 'modelling through'?' in Black, Lodge, Thatcher (eds), *Regulatory Innovation - A Comparative Analysis* (Edward Elgar, Cheltenham 2005) 174.
[38] See KRAAKMAN, HERTIG and ROCK, 'Issuers and investor protection', in H. Kraakman, P.

To ensure complete merit regulation[39], the market should achieve adequate disclosure protection in terms of reducing agency problems (i.e. information asymmetries) by improving the flow of price information, expanding financial education and avoiding over-enforcement (i.e. the costs of additional regulation). However, the best way to achieve market quality could be afforded by self-induced disclosure, which brings in its train reputation and credibility of behaviours.[40] That would be based on the idea of a self-regulation regime in the sense of market confidence. In other words, the market's judgement would represent the primary evidence of a financial right activity, particularly through the assessment of information provided by firms. The banking and corporate failures need to be seen in terms of 'reputational value' on financial markets that means reputational risk and potential damages in the investment operations.[41] For example, the intermediaries' behaviours in financial transactions are not only enforced by law, through mandatory disclosure, but also by reputation efficiency as it determines the correct business operation. By the same token, the importance of self-regulatory measures—having their origin in confidence, trust and right culture—lies in the role that they can play in bringing about sound financial stability and "market efficiency", which requires a high quality of information together with a high degree of credibility on the part of the actors concerned.[42]

In substance, whilst the disclosure regime reduces the costs of capital and information, voluntary self-disclosure systems presuppose perfect alignment of manager and investor interests. To achieve allocative efficiency on the securities

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Davies et al. (eds), *The Anatomy of Corporate Law* (Oxford University Press 2004) 207.

[39]See BLACK, 'Rules and Regulators' (Clarendon Press, Oxford 1997) 215-216.

[40]See EASTERBROOK and FISCHEL, 'Mandatory Disclosure and the Protection of Investors' (1984) 70(4) *Virginia Law Review*, 669-670.

[41]See GOODHART, 'The regulatory response to the financial crisis' (2008) LSE Financial Markets Group Paper Series, Special Paper 177, p. 9 available at: http://www.lse.ac.uk/fmg/documents/specialPapers/2008/sp177.pdf.

[42]See GILSON and KRAAKMAN, 'The Mechanisms of Market Efficiency' (1984) 70(4) *Virginia Law Review*, 549.

market, firms should be fair and competing.[43] Finally, a system that enables direct action to be taken against persons involved in breaches of mandatory disclosure may help to promote substantive compliance according to the spirit of the law,[44] indeed, compliant persons ensure real enforcement of the management's fiduciary duties.[45]

In this context, the financial supervision has moved from an institutional and functional model towards an integrated approach where the role of national authorities is coordinated by one independent single network of financial supervisors in this manner, a clear distribution of roles and functions between financial regulators for integrity and uniformity of acts is manifest.[46] There has been a strong call at the EU level for an ongoing dialogue between institutions and a constant exchange of information amongst the individual supervisory authorities. Manifestly, this objective could be achieved with an integrated supervision approach under which the supervisory function should be effective, transparent and accountable to the political institutions. It can be noted that such a supervisory solution would supply a plausible, definitive solution to the risk of monitoring loopholes and provide a response to the emergent co-operation between national supervisors and European regulators. A strong improvement of risk management, together with the enforcement of internal compliant behaviours, should be implemented when tackling the new challenge of the reform of supervision.

The structure of EU financial supervision could be affected by the withdrawal of the UK from the EU and EEA that 'would lead to the loss of the automatic freedom to set up branches and offer services to customers in other Member States for UK based firms, and would be particularly alarming for the UK econ-

[43]See COFFEE JR., 'Market Failure and the Economic Case for a Mandatory Disclosure System' (1984) 70(4) *Virginia Law Review*, 734.
[44]See MCBARNET and WHELAN, 'The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control' (1991) 54(6) *The Modern Law Review*, 848.
[45]See FOX, 'Civil Liability and Mandatory Disclosure' (2009) 109 *Columbia Law Review*, 237.
[46]See BRIAULT, 'Revisiting the rationale for a single financial services regulator', FSA Occasional Paper Series No 16, London, 2002, 21-24.

omy as financial services accounts for a considerable part of UK exports'.[47] The exit strategy of the UK from the EU markets may result in a diminution of UK influence internationally and may also generate existential consequences for the current EU financial architecture, potentially leading to the construction of new platform through which cross-border relations will be coordinated under alternative regulatory structures.

3. During the global financial crisis, the UK regulatory strategy has recorded evident failures in respect of legitimacy and accountability, indeed the bank collapses (*Bear Stearns*, *Royal Bank of Scotland* and *Halifax Bank of Scotland*) have revealed a lack of control by the supervisory authorities delegated to monitor and prevent financial risks. In response to those failures the regulators have made a significant switch from a principles-based regime towards a more intrusive and systemic regulatory approach.[48]

The principles-based regime represented the cornerstone of UK securities strategy. As noted in the Turner Review this structural break involved 'a radical shift in supervisory style from focusing on systems and processes, to focusing on key business outcomes and risks and on the sustainability of business models and strategies; a different approach to the assessment of approved persons, with a focus on technical skills as well as probity; an outstanding increase in resources devoted to sectoral and firm comparator analysis, enabling the FSA to better identify firms which are outliers in terms of risks and business strategies and to identify emerging sector wide trends which may create systemic risk'.[49]

The real shortcoming in the previous approach was determined by a failure to appreciate that "principles [do] not simply act in combination with more de-

[47]See KOKKINIS, 'The Impact of Brexit on the Legal Framework for Cross-Border Corporate Activity' (2016) 27(7) *European Business Law Review*, 973.
[48]See BLACK, 'Paradoxes and Failures: "New Governance" Techniques and the Financial Crisis' (2012) 75(6) *Modern Law Review*, 1042-1045.
[49]FSA, 'The Turner Review. A regulatory response to the global banking crisis', March 2009.

tailed rules, but ... play a more informing and influencing role in enabling and inducing compliance with the rules".[50] It has been argued that principles represent a form of soft law, albeit not readily translatable into a legal paradigm of reference.[51] Practices such as "treating customers fairly" or "[a] firm must pay due regard to the interests of its customers and treat them fairly, placing responsibility on firms' senior management to deliver fair outcomes for consumers and offering firms the flexibility to deliver these outcomes in the way which best suits their business"[52] do not make sense in the absence of a proper level of enforcement managed by compliance bodies which inculcate legal and ethical values into the corporate organisation and assume an active role in the day-to-day regulation of the firm.[53]

Principles are better understood as incentives to good faith and compliant behaviour in which corporate management assumes the role of regulator through its everyday conduct of the business.[54] In this regard, internal regulation could represent a social benefit for the company and not an onerous burden which is managed by rational regulators and improves the interests of market participants through an effective and efficient regulatory system (in terms of disclosure, allocation of resources and market success). The most important aspect is the legitimacy of the principles-based regime as a regulatory strategy: a principle itself does not ensure correct application of rules because, often, it is synonymous with escaping enforcement and lack of certainty.[55] Principles can yield effectiveness, durability, flexibility, accessibility, efficiency and congruence, provided that there are ade-

[50]See BLACK, "Which Arrow?": rule type and regulatory policy' (1995) 1 *Public Law*, 94-95.
[51]See SCHWARCZ, 'The "Principles" Paradox' (2008) Duke Law School Legal Studies Paper No 205.
[52]The "Treating Customers Fairly Initiative" represents the clearest example of the FSA's principles-based regime. It consists of a set of best practices by which firms are to ensure market confidence and consumer protection.
[53]See PARKER, 'The Ethics of Advising on Regulatory Compliance: Autonomy or Interdependence?' (2000) 28(4) *Journal of Business Ethics*, 346.
[54]See NELSON, 'Behavioural Evidence on the Effects of Principles-and Rules-Based Standards' (2003) 17(1) *Accounting Horizons*, 100-101.
[55]See BLACK, 'Using Rules Effectively' in C. McCrudden (ed), *Regulation and Deregulation* (Oxford University Press 1998) 101.

quate levels of monitoring and internal controls, they are not an alternative to detailed rules but represent a different method of regulation, deriving from management choices and not from statutory decisions.[56]

Finally, integrity and ethical conduct assume a central role in the outcomes-based regime if measured by the reputational risk: in this way, self-regulation measures take on the value of voluntary law enforcement, within the framework of a market-based regime, where the markets can be regarded as rule-makers and governance rules as a surrogate for statutory norms.[57] Regulation, defined as set of rules and principles governing a collective organisation[58], represents the challenge for financial stability and the investor protection system. In the context of EU, the Banking Union has imposed a new common ground of provisions, while adopting a practical and flexible approach to rule-making, particularly, all rule-making bodies adopting both binding and non-binding rules commit to 'regulatory self-restraint' which is consistent with the principles of better regulation.

Questions of legitimacy and accountability are linked to the utmost degree with consumer protection policy.[59] The UK system has set out in section 2(2) of the Financial Services and Markets Act 2000 (FSMA 2000) significant regulatory objectives such as market confidence, public awareness, consumer protection and reduction of financial crime, together with adequate consumer regulation.[60] Market confidence can be considered the key objective, in terms of investor protection, on account of its fundamental role of achieving soundness of the financial markets. A controversial question is whether the UK legislation affords an adequate level of consumer protection; indeed, it is argued that, whilst on the one

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[56]See POWER, 'Organized Uncertainty. Designing a World of Risk Management' (Oxford University Press, 2007) 48-49.
[57]See BLACK and ROUCH, 'The development of the global markets as rule-makers: engagement and legitimacy' (2008) 2(3) *Law and Financial Markets Review*, 223-225.
[58]See BLACK, 'Critical Reflections on Regulation', *Australian Journal of Legal Philosophy* (2002) 27(1) 21-22.
[59]See MOLONEY 'Confidence and Competence: The Conundrum of EC Capital Markets Law' (2004) 4(1) *Journal of Corporate Law Studies*, 11-12.
[60]See FISHER, BEWSEY, WATERS and OVEY, *The Law of Investor Protection* (London, Sweet & Maxwell 2003) 18.

hand section 5(1) of FSMA 2000 ensures "an appropriate degree of protection for consumers" on the other, section 5(2) provides that "in considering what degree of protection may be appropriate, the Authority must have regard to (d) the general principle that consumers should take responsibility for their decisions". It has been observed that 'an evident lack of certainty and clarity underscores the limits of the UK consumer protection system'.[61] By contrast, the EU legislation with MiFID has imposed a stringent assessment of investor guarantees through "the fair presentation of investment recommendations and the disclosure of conflicts of interest".[62] Broadly, legitimate and accountable regulation prevents the potential risk of confidence failure and promotes a clear understanding of consumer protection law. An innovative challenge has been set by the Office of Fair Trading, a government agency appointed to improve the consumer protection legislation through informative leaflets or booklets, guidance and publications of best practices.[63] In this context, the English Courts have made appreciable advances in terms of consumer and investor protection by confirming the tendency to consider consumers as an active part of financial markets, particularly in the banking sector.[64]

4. The decision of the United Kingdom to leave the EU was largely unexpected and markets reacted immediately signalling their dismay.[65] The consternation was compounded, as it appeared there was little or no planning in place for Brexit to actually happen.[66] The Prime Minister David Cameron resigned and after a short leadership campaign, Theresa May was installed as the new conservative Prime Minister, completing a swift *volte-face* from her previously moderately pro-

[61]See BENJAMIN, *Financial Law* (OUP: Oxford University Press 2007) 590.
[62]MiFID Directive Level 2 (2006/73/EC) recital 28.
[63]See HARVEY and PARRY, 'The Law of Consumer Protection and Fair Trading' (Butterworths, London 2000) 50-51.
[64]See *Office of Fair Trading v Abbey National and others* [2009] EWCA Civ 116.
[65]See BLITZ, 'The Brexit vote and UK Markets one year on', *Financial Times*, 22 June 2017.
[66]See FAULCONBRIDGE, 'Disputed memo says Britain has no Brexit plan', *Reuters*, 15 November 2016.

EU position to appearing to be a hard line 'Brexiter'. Further confusion was sown with her now infamous statement of 'Brexit means Brexit'.[67]

The chaotic situation has resulted in uncertainty for the financial services industry, but the phrase *Brexit means Brexit*, may contain clues as to the consequences for banks in the UK and investor protection. In summary, it may be that the UK will start to cleave away from its regulatory grounding in the EU and start to define new standards as the situation for the UK financial sector becomes clearer. Alternatively, the opacity of the phrase could be seen as symptomatic of the uncertainty of Brexit – no one is quite sure what it means.

UK banks and investors do not and will not operate in a vacuum hermetically sealed from external influences. Capital is highly liquid and is not restricted by the physical borders provided by the English Channel. Individual investors are possibly less mobile and the majority of UK investors will remain in UK as they do not have an easy manner or wish to move abroad, however, a small minority may move their investments to more favourable regimes but this may be for tax advantages rather than for investor protection purposes.

The unanswered question is what does Brexit mean for UK investor protection? In the short term there will probably be little change. The UK's principles based regime is largely based on EU legislation and more recent investor protection measures are being incorporated into UK regulation (for example MiFID II). The UK's Common Law based legal system, whereby case law is based on precedent will most likely ensure the stability of investor protections. However, it is possible that new cases may set new precedents that could initiate the move of consumer protection away from the current EU based standards. This could be either a positive or negative development depending on the direction taken. If the UK were to move to become effectively an offshore tax haven, this could result in

[67]Then Home Secretary Theresa May launching her leadership bid for the Conservative Party, 30 June 2016, Birmingham.

a laxer regulatory regime, with greater opportunities for innovation.[68] Historically looser regulatory regimes, often found in 'offshore' centres have less stringent consumer protection in place. The financial services industry regularly complains of over regulation and a laxer regime may be welcomed by the financial services industry, but at the expense of consumers.[69]

There is likely to be a significant human capital cost of Brexit. The City of London and the financial services sector employ 2.2 million people directly or in related services.[70] Many different nationalities work together and the various diaspora give it strength and local knowledge when trading internationally.[71] Deep networks are formed and bankers that return to their home countries have an intimate knowledge of how a global financial centre such as London functions.[72]

5. A major concern for UK based financial institutions post Brexit is the potential loss of the ability to frictionlessly trade cross border. The concept of passporting is essentially that of regulatory equivalence. If a firm satisfies the regulatory requirements in one EU state, it is able to trade 'passport' its services cross border with minimal local country compliance requirements.

London has been an attractive location for many global banks to establish their European headquarters. Accidentally being between the Asian and American time zones means trading books often pass through London intraday. Additionally, the benign regulatory and legal regimes, English as the modern global language of trade and the network effect of many collocated banks have made London an at-

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[68]The Economist, 'If Britain became "Singapore-on-Thames". The British economy if the country crashes out of the European Union', 13 July 2017.

[69]See BINHAM and PARKER, 'Banks step up fightback against wave of UK regulation', *Financial Times*, 5 June 2015.

[70]The City UK, *Key facts about UK -based financial and related professional services,* April 2017, p. 4.

[71]It is not uncommon to find team members of different nationalities using their language and cultural skills to the benefit of their banks.

[72]If Brexit results in an exodus of talent to new markets, the knowledge drain could potentially be very damaging to the UK. Many bankers are international in outlook and if the UK is no longer a welcoming or attractive place to work and appealing offers are available in other locations, the migration of talent could represent an immediate and significant threat to banks.

tractive European headquarters. The result is London is a major global financial centre and the largest and most significant financial centre in the EU. Brexit may profoundly change this if passporting rights are lost. Many banks are advanced in their contingency planning – not wishing to risk the apparent indecision of the politicians, office space has been taken in other European financial centres that area keenly promoting themselves, not only as bases for European operations, but also as part of a wider strategy to win key lines of business from London.[73]

Brexit will not affect all banking markets or banks equally. Those that are domestically focussed on the UK will potentially feel less impact, at least initially. However, if their funding model is not based on deposits and requires use of the capital or money markets, the further is possibly less certain. 'Traditional' lending banks that accept deposits and lend locally do not have the need to raise liquidity on the markets. Customers will still require credit, and depositors will continue to look for returns on cash. If interest rates raise, this may stimulate deposits, though of course, have a consequently negative impact for borrowers on margins.

In respect of international funding and cross border transactions the future is less certain. A weakened pound and more attractive interest rates could lead to capital inflows. However, if international trade is depressed as the UK endeavours to strike new trade agreements, capital may seek higher returns elsewhere.

The financial impact of Brexit has been estimated to range from a 'best case' scenario where the UK retains effectively full market access via passporting rights to resulting is a reduction in tax revenues of ~£0.5Bn annually, which EU related business declining by ~£2Bn (2%) annually, the impact of jobs being a loss of up to 4000 jobs.[74] A 'worst case' scenario, where the UK only has third country status and has to rely on World Trade Organisation rules, would result in up to a

[73]For example, Deutsche Bank is reportedly planning to move parts of its trading and investment banking operations to Frankfurt: S. Arons, W. Canny, D. Griffin and R. David, 'Brexit: Deutsche Bank said to be switching from London to Frankfurt', *The Independent*, 6 July 2017.

[74]See WYMAN, *The Impact of the UK's Exit from the EU on the UK-Based Financial Services Sector*, 2016.

50% reduction (~£20Bn in annual revenue) in trade with the EU with direct job losses being up to 35,000.[75] The accurate costs of Brexit are less certain and will not become clear until the true impact has percolated through the economy. Any negative impacts, may be counterbalanced by new trading opportunities.[76]

In terms of guaranteeing access to the EU markets post Brexit the choice appears quite straightforward. Banks cannot wait for a political settlement and an uncertain future in respect of passporting. They must have sufficiently large operations within the EU to ensure free market access.

6. A consequence of Brexit may be the divergence of British Law. The choice of the words British Law is intentional as we are also starting to experience a divergence of law between the constituent parts of the United Kingdom. Scotland already has a separate (though similar) legal system and there are differences in some law in areas of the United Kingdom with regional parliaments such as Northern Ireland and Wales having law making powers.[77] If Brexit has a centrifugal effect on the regions of the British Isles, there may be increased pressure for further differentiation in the laws of Scotland, Wales and Northern Ireland.[78] What direction these laws takes post Brexit remains to be seen, but it is not inconceivable that a regional legislative body may wish to align its financial regulatory framework more closely with the EU in order to facilitate trade, investor protection or even passporting. Alternatively, a more liberal approach could be taken to create offshore centres, such as those that already exist within the British Isles (The Channel Islands or the Isle of Man).

There are reports of discord between the UK Government and the Scottish

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[75] *Ibid.*
[76] Woodford Investment Management, *The Economic Impact of Brexit,* February 2016, Capital Economics, Para 4.3, pp. 21-22.
[77] These are wide and include diverse areas such as health, education and economic development, see Government of Wales Act 2006 and the Northern Ireland Act 1998.
[78] For example, there exists an on-going debate for a separate legal system in Wales, recently expressed by the Welsh Counsel General Theodore Huckle QC, *Why Wales needs its own legal jurisdiction*, 7 April 2016, The Institute of Welsh Affairs.

and Welsh regional Governments over the 'Great Repeal Bill' as this proposes to transfer EU law to the UK Government and not regional assemblies.[79] Financial services are not currently devolved matters, but given the uncertainty of a fragile government in a post Brexit scenario, it is not impossible that lobbying and political pressure may effect a change in this direction.[80] If a divergence of law were to occur this would potentially give rise to disagreement as to which law was applicable. Would it be the law where the product was sold, manufactured or sited for regulatory purposes? Such conflict is clearly undesirable and potentially expensive. Even if disagreements about applicable law were not to occur within the UK, it may occur in disputes between the UK and EU.[81]

It is possible the potencies unleashed by Brexit may have consequences beyond the United Kingdom. The British Overseas territory of Gibraltar is currently treated as Special Member State Territory within the EU and voted overwhelmingly to remain in the EU.[82] It is highly dependent on immigration and is a major financial centre. [83] The issue of sovereignty with Spain has been historically contentious and the EU Brexit negotiating guidelines have suggested that any agreement with the UK does not apply to Gibraltar, stipulating any agreement must include an agreement between the UK and Spain.[84] This has unsurprisingly increased political tensions and furthered the possibility that Gibraltar may have to establish a new and unique relationship with the EU.[85] Being physically part of the European mainland and the immediate impact of Brexit on Gibraltar could drive the need for pragmatic and swift realignment with the EU to ensure contin-

[79] *Joint statement from the First Ministers of Wales and Scotland in reaction to the EU (Withdrawal) Bill*, 13 July 2017.

[80] See CRAMB, 'First Ministers of Scotland and Wales threaten constitutional crisis over Great repeal Bill', *The Telegraph*, 13 July 2017.

[81] There is already disagreement between the UK and EU as to where and how disputes will be resolved; see S. Bodoni, *Why EU Court of Justice is a key Brexit Battleground*, 27 July 2017 Bloomberg.

[82] Gibraltar voted to remain in the EU by 96%: source Electoral Commission.

[83] See HENLEY, *Rocked by Brexit vote, Gibraltar lays plans for new kind of EU relationship*, 22 October 2016.

[84] See House of Lords, *Leaving the European Union: Status of Gibraltar*, 2 May 2017.

[85] *Ibid*: Henley 2016.

ued market access. It is unclear what form this could take, but it possibly some sort of associate status territory or perhaps more speculatively an economic or political union with a closely allied state. Malta, for example, shares a British heritage, buoyant financial services sector and will remain in the EU. A close alliance or partnership with Malta could resolve Gibraltar's predicament, though this is unlikely to be welcomed by Spain. It is possible that radical realignments of British territories may embolden other constituent parts of the United Kingdom to follow a similar path.

There exist other systemic risks to the UK banking sector outside the EU. It may be tempting to embrace laxer capital adequacy rules and other financial stability measures in order to remain competitive. By attempting to avoid the stricter requirements under Basel IV, UK banks would endeavour to remain more competitive,[86] though the Basel Committee is unlikely to be content with having the UK banking industry outside the framework designed to protected against global systemic risk. The UK will have to become more innovative and agile within global regulations, not only to take advantage of new opportunities in wider markets, but to rapidly fill the gap that may appear if a 'hard' Brexit effectively closes the door to the largest trading block in the world.

7. Effective reform of financial market behaviours will entail a radical change in the securities system. In this perspective, the law-making process consists of a merit-based regime, which signifies judging self-regulation against self-induced norms. Indeed, the market becomes the test for verifying that principles are functioning properly. Consequently, the statutory norm takes on a marginal role in the regulation process because the securities market, with its own corpus of principles and rules, acts as a surrogate for it. This new way of regulation would require responsive behaviour of market participants and would involve forms of

[86]See OUDÉA, 'New Basel banking rules' impact on European economy', *Financial Times*, 28 November 2016.

self-enforcement however, it would introduce a concept of responsible management characterised by capability and the ability to combine "the versatility and flexibility of voluntary self-regulation, avoiding many of the inherent weaknesses of voluntarism".[87]

To achieve more participative regulation on the part of market actors, the compliance culture should facilitate less intrusive statutory intervention. As has been argued, "governments may achieve greater compliance by engineering a regulatory system in which they themselves play a less dominant role, facilitating the constructive regulatory participation of private interests, and relying on more or less naturally occurring regulatory orderings".[88] The effectiveness of internal controls can allow action to be taken against behaviours amounting to misconduct and can permit a sound system of risk management to be applied.[89] Principles improve voluntary norms and self-enforced behaviours and provide an incentive for the daily mechanisms of management control. A possible path of financial reform could consist in improving effective fairness in respect of business conduct so as to reduce the reputational risk of the firm. This means better regulation[90] in terms of substantive compliance culture and an active role on the part of market participants.

The movement towards a risk-management culture, based on voluntary forms of regulation, has changed the regulatory strategy of securities governance.[91] The implementation of moral corporate practices, under the compliance watchdog, has altered the spirit of the principles-based regime: from ethical and

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[87]See AYRES and BRAITHWAITE, *Responsive Regulation. Transcending the Deregulation Debate* (New York, Oxford University Press 1992) 106.
[88]See GRABOSKY, 'Using Non-Governmental Resources to Foster Regulatory Compliance' (1995) 8(4) *Governance: An International Journal of Policy, Administration and Institutions*, 543.
[89]Financial Reporting Council, 'The Combined Code on Corporate Governance, June 2008, 16; Financial Reporting Council, 'Internal Control. Revised Guidance for Directors on the Combined Code', October 2005, 3-4.
[90]FSA, 'Better Regulation Action Plan', CP 05/10, December 2005; FSA, 'Better Regulation Action Plan. Progress Report', June 2006.
[91]See ALFIERI, 'The Fall of Legal Ethics and the Rise of Risk Management' (2006) 94(6) *Georgetown Law Journal*, 1933-1934.

formal behaviours to enforced effective norms of conduct. The successful use of principles over rules has raised an important question: how to provide an adequate enforcement measure to counter the legal risk[92] of a failure of internal controls. In this connection, the system of members' credibility has proved to be inefficacious for ensuring that fairness and good faith are properly applied. Principles have resulted in a self-regulation law-making process characterised by management choice and market participants' actions (intermediaries conduct and senior management responsibility).

The global financial crisis has revealed all the distortions involved in managing securities products, but, at the same time, it has altered the prevailing sentiment with regard to regulation into a recognised need for a mixed regime (principles plus rules). Predictability, legitimacy, accountability, certainty: these concepts constitute the benchmarks of an efficient market where consumer confidence and investor protection are the fundamental corollaries of transparent behaviours however, a certain amount of effectiveness is lost if there is no proper regulatory system. The current financial architecture has put in place a strict relationship between two elements, namely the principles-based regime and the rules-based approach.

The principles-based regime consists of a set of second-level norms such as standards, guidance, voluntary codes, ethical and moral values, and best practices enhancing forms of self-induced legislation. The rules-based approach reflects the EU strategy, which institutionalises the principles-based regime within the statutory rules, whereas the principles are implemented under the legal basis of Community law.

The EU framework for financial markets has introduced a mixed system of rules and principles which are integrated into the provisions, however the potential impact of Brexit in the UK banking sector could open room for different regula-

[92]See WHITTAKER, 'Lawyers as risk managers' (2003) 18(1) *Butterworth Journal of International Business and Finance Law*, 5-6.

tory scenario. As with any predictions, the accuracy of implications about Brexit and the effect on the UK banking sector are difficult to gauge. Without doubt Brexit matters, not only to the British banking sector, but also the wider economy in the UK, mainland Europe and globally. Exactly how the challenges manifest themselves is yet unclear. It is certain there will be unexpected challenges, but there also may be unforeseen opportunities. Banking is a worldwide enterprise and a key question is whether the British banking sector will able to recover quickly enough from the damage of Brexit to not just keep up with other global players, but to regain its preeminent position.