Barnabas Reynolds

Restoring UK Law

Freeing the UK's Global Financial Market

POLITEIA

Editor: Sheila Lawlor

A FORUM FOR SOCIAL AND ECONOMIC THINKING

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FOREWORD*

Sheila Lawlor

I

For a snapshot of how closely Britain's constitutional principles and its economic system are linked, there are few better places to look than London, the heart of the UK's financial services sector - and at how its many different businesses, which were often established to facilitate trade and shipping, have developed over centuries, operating under UK laws. By the end of the 18th century, London, a successful port and commercial centre since Roman times, had grown to 1 million people. Merchants came to the UK and joined others, such as shipowners and insurance underwriters, to establish banks and businesses. These included the Bank of England (1694), which began as a private corporation to finance the government's military campaign of that time; Lloyd's of London (1688), which provided marine insurance; and the London Stock Exchange, begun by stockbrokers. These last two had their origins in the coffee houses, where people met and did business and which had come to play a central part in London's cultural, business and social life since the 1650s. London overtook Amsterdam, the leading financial centre in the 17th century, and rivalled, then replaced, Paris at the end of the 18th century, following the French hyperinflation of the 1790s. But there was more to the story of remaining a pre-eminent centre, as the sector's evolution throughout the twentieth century was to reveal.

Economic historians have provided a rich and complex picture of change, as banking and finance adapted through the century, often with changes in the law. The first decades were punctuated by World War One, the 1930s depression, and World War Two, after which New York emerged as a leading global financial centre, at times to dominate, and invariably to rival, London. But it was after the Second World War that the sector's ability to contend with and adapt to change was particularly tested. High UK public debt between the later 1940s and 1970s had implications for other lending. The introduction of new technology from the 1980s put an end to long-established working practices. But it was from the EU that the winds of change were particularly keenly felt: the change in governance and a raft of legislation ushered in during the 1990s for the Single Market (by the Single European Act, 1986) and for EU political and monetary Union (The Treaty on European Union (TEU, Maastricht, 1992) and the Treaty on the Functioning of the EU which updated the founding EU treaty, the Treaty of Rome 1957). Further protracted regulatory change from the EU followed the financial crisis of 2007–2008, along with the international and UK response.

Perhaps more than at any other period before, the intensification of EU legislation in the wake of these developments put the spotlight on what politically would become increasingly problematic for the UK's electorate. It highlighted the very real differences in aims and expectations between the EU and many people in the UK. These differences were not only political and constitutional. They involved a clash of two economic systems, that of the UK's free market, competitive and entrepreneurial system and that of the EU, which continues to operate a model inspired by the French, centrally directed system, whose conceptual approach was integral to the founding project, the European Coal and Steel Community in 1951 (under the Treaty of Paris in 1951).

II

That precursor, which developed into the EEC with Italy and the Benelux countries under the Treaty of Rome in 1957, reflected the French desire, as conceived by Robert Schumann, the French foreign minister, to secure the country against the inevitable resurgence of Germany as a potentially hostile economic and military power. The plan was that Germany, subject to Franco-German cooperation and agreement, could rebuild as Europe's most powerful economic power, but peacefully and only under joint Franco-German control and cooperation. The arrangements governing future economic life for the EEC and later the EU followed those that had served the French state since the 17th century, with its *dirigiste* economy, protected and controlled centrally for the political and military aims of France. Today, few brands can be so potent a reminder of that fact than the Sèvres porcelain which graces Emmanuel Macron's refurbished Elysée. The French state has had a stake in its porcelain factory since

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* I am very grateful to Forrest Capie for his helpful comments, which I have used.

Louis XV moved it to Limoges, backed by the firepower of the state's finances and laws to promote the project and protect it from rivals, who were initially prohibited by law from decorating their wares with gold rims, in the style characteristic of Sèvres.

By contrast, Britain's economic arrangements have been of a different order, tending to reflect an economy built on competition, markets and trade and underwritten by a law that encourages such goals. Throughout its history, sectors have flourished and declined, as others take their place, facilitated and accelerated, on occasion, by popular support, with the law following. The popular and political movement to repeal the corn laws took off in the early decades of the 19th century, when political theorists and politicians, industrialists and the people themselves joined forces in a movement demanding an end to the corn laws, which protected the farming sector by imposing duties on imported corn, so preventing competition from cheaper imports. Repeal was won in 1846 when enough MPs joined forces with Sir Robert Peel in a parliamentary battle against the landed interest.

The momentum which developed in the decades before the 2016 referendum is reminiscent of that earlier movement, though with a different goal: to restore a system of freedoms, under clear, understandable and transparent laws made by MPs sent to Westminster who can be removed by those people who flocked to the meeting rooms and polling booths. They wanted to restore the right to determine the laws under which lives are led and businesses run rather than to accommodate the EU's highly centralised, precisely controlled and often counter-productive rules.

III

The focus of this analysis by Barnabas Reynolds is on the nature of the differences between the EU's centralised system and this country's common law tradition, and the implications for the financial services sector. This follows earlier proposals by Reynolds, who leads his City law firm's financial institutions practice, setting out the path for future UK-EU cross border trade under two possible options. The first is for both parties to trade under their own laws, with each party agreeing that the other's laws achieve equivalent outcomes, including the paramount aim of preventing systemic risk. This 'equivalence arrangement' would be enhanced to include mechanisms to give businesses greater certainty, *e.g.* so that the rules cannot be changed unilaterally or at short notice, and are subject to joint agreement. That proposal, which was broadly the basis for the UK's negotiating aim in the Brexit talks, is still on the table, and there remains all to play for. The second option, or 'Plan B', has already provided banks and businesses with a way forward, now that the EU passport arrangements have stopped. It shows how most businesses can continue to trade cross-border, without a formal trade treaty or chapter in a trade treaty, with different mechanisms available, which would not involve the setting up of a subsidiary in the EU.[1]

Reynolds addresses, for financial services, the conceptual differences between the EU's centralised approach and this country's common law approach. He considers how the different EU legal system has often been in conflict with the aims and means traditionally deployed under the common law to ensure the freedom of participants to develop their businesses in line with the rule of law and its evolution. In particular, he contends that EU law, as it has developed especially since the 1990s, has tended to supersede much of the UK's common law tradition for the sector. He explains how EU laws have developed and makes clear proposals for the UK to tackle the legacy of the inherited layers of EU law, which have been grafted onto the UK system, so as to restore UK law.

The message is clear. Now that the UK has emerged from the transition period during which the existing legal framework continued, the task for the Government is to address and reverse the legacy of EU law.

Sheila Lawlor,
Founder and Research Director, Politeia
8 February 2021

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1 See Barnabas Reynolds, *A Blueprint for Brexit: The Future of Global Financial Services and Markets in the UK* (2016) Politeia, and Barnabas Reynolds, *The Art of the No Deal: How Best to Navigate Brexit for Financial Services* (2017) Politeia.

THE AUTHOR

Barnabas Reynolds is an international financial services and regulatory lawyer. He is a London-based partner at Shearman & Sterling LLP, where he leads the global financial institutions practice and specialises in UK and EU law and financial regulation. He has been a member of the group of lawyers advising Members of Parliament on Brexit, having originated and developed the UK's proposed model for financial services trade with the EU after Brexit, in A Template for Enhanced Equivalence: Creating a Lasting Relationship in Financial Services between the EU and the UK (Politeia, 2017). He set out many of the legal structures now in use across all industry sectors in the City for no-deal Brexit planning, in The Art of the No Deal: How Best to Navigate Brexit for Financial Services (Politeia, 2017).

Other publications proposing and developing the options for the financial sector industry after Brexit include A Blueprint for Brexit: The Future of Global Financial Services and Markets in the UK (Politeia, 2016); Free Trade in UK-EU Financial Services – How Best to Structure a Brexit Free Trade Deal (Politeia, 2018); EU-UK Financial Services After Brexit – Enhanced Equivalence: A Win-Win Proposition (New Direction-Politeia, 2018). He co-authored Managing Euro Risk – Saving Investors from Systemic Risk (Politeia, 2020). He co-edits Sweet & Maxwell's *Journal of International Banking Law and Regulation*.

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Financial services, like other sectors, need the certainty that a strong system of law can bring, and the opportunity to innovate. Both features are to be found in the English common law system, under which the City of London has successfully developed to become a global centre.

1. **The world's two main legal operating systems for financial services are the common law system, based to a large degree on judicial precedent, and the civil law system, based generally on a French or German law code-based model.** *(See Chapter 1: The UK, the Financial Sector and the Common Law.)*

   The common law has proved itself to be the system of choice. The major international financial centres operate on the common law model. London and New York are the most preeminent. The clear trend for new financial free zones—bespoke jurisdictions designed to be magnets for economic activity—is to opt for a common law approach.[2]

   The reasons for this superiority of the common law are that:

   - Much of the law arises from case law precedent, which is attractive because it is *predictable*; *judge-made*; *based on decisions arising from real factual situations*; *bottom-up and incremental* in operation; and *constantly refreshing* and updating itself. The role of the judiciary means that there is dispersed control over much of the shape of the law.

   - Common law statutory drafting is generally clear and is used sparingly to address very specific points of policy, leaving much of the law to be developed through case law precedent. Statutes do not attempt to govern all possible future legal situations. Furthermore, they tend to deal in restrictions and liabilities rather than rights.

   - The common law is broadly liberal and permissive of innovation. Under the common law, everything is permitted unless expressly prohibited. This approach, together with the overall methodology of the common law, brings with it a progressive culture. The reasoning is pragmatic and practical, reflecting the judgements of reasonable people as to the application of the law to new circumstances as they occur. This fosters independence of mind and freedom of action.

   The flexibility of the common law has proved itself many times in the context of commercial developments. This can be seen *e.g.* in relation to netting, taking security, the separation of interests in investments through the law of trusts, and most recently, the law of cryptoassets. The result is that the UK has a comparative advantage in financial services from its common law operating system.

   By contrast, the civil law, code-based approach has very different features:

   - Civil law codes seek to be all-encompassing. The law is developed top-down, based on thinking at the time the code is made.

   - The general civil law approach is based on an assumption that basic principles adopted some time back (short or long) will work when applied to new situations. Because life and business are inherently dynamic, this is unduly ossifying. Codes often turn out to invalidate what are attractive and safe financial services and products. They then need constant refreshing, which occurs as developments arise and involves imposing new structure on those developments. Users are left waiting for updates of the operating system, as happens

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2 For instance, Abu Dhabi Global Market, Dubai International Financial Centre and Astana International Financial Centre.

with much current computer software. The process of amendment is lengthy and ponderous.

- A code also introduces unnecessary uncertainty because, as new situations arise which were not considered at the time the scheme was produced, there is often no easy way to predict how they are to be treated by the law. Furthermore, by setting out to prescribe rights as well as obligations, the method places them in tension with one another and narrows freedom of action under the code's pre-conceived scheme.

2. **EU law has introduced considerable elements of code-based, civil law thinking into the UK's financial services framework.** *(See Chapter 2: UK Financial Services and EU Law – The Conflict.)* From 1989 to 2020 it has pursued an ambitious federal project, seeking to impose harmonised rules across 28 different countries. In doing so, the EU has created a single financial services rulebook and a supervisory system for the whole of the EU. This continued to apply to the UK until the end of last year.

The EU's scheme has imported civil law style methodological weaknesses into UK law:

- **The legislative framework is prescriptive, inflexible, opaque and voluminous.** The approach is intrinsically restrictive—which arises in part because of the attempt to harmonise laws across 28 countries through pan-EU legislation and in part because of the use of the civil law method. One legislative measure alone, "MiFID II", has 1.7 million provisions.[3] The use of legislation of this type has reduced the flexibility and predictability of the common law and converted what should be financial regulations made by regulators on a dynamic basis, to manage financial risk, into ossified legal text.

- **The centralised method has dampened innovation.** The EU financial services project has an unresponsive legislator, poor quality legal drafting, bureaucratic centralised interpretative authorities and an intrinsically restrictive approach.

The resulting ambiguities inherent in EU law are resolved by the courts applying the civil law technique of interpretation. Given the nature of EU legislative text, this seeks to determine the application of a provision by focusing predominantly on the underlying purpose behind the provision—the *purposive method of interpretation*. The EU purposive method referred to is not the same as the general approach to statutory interpretation which goes by the same name in common law. Rather, it empowers officials to pronounce on what they perceive to have been the underlying purposes of regulation in the context of poorly drafted text and limited or conflicting sources as to what the purposes might be. They decide, in effect, what the law would have said, had the given situation been properly considered, rather than deciding (as the common law judge does) what the law does in fact say. The impact is aggravated because of the vast array of regulatory provisions, each with its own purposes. This has the effect of making the law inherently uncertain. The result is that the industry is constrained by the need constantly to consult officials on what is permitted, and is also adversely affected by the natural caution of those officials.

The uncertainties are further exacerbated by the fact that the CJEU has emerged as a supranational lawmaker, applying purposes which it identifies for the EU system as an entity.

After a number of central banks in both common law and civil law systems (including in the EU) failed to address systemic risk before the 2007-2008 financial crisis, the EU wrongly pointed the finger at the UK's arrangements, it now seems, to promote its own scheme. When extending EU law, it was implied by Michel Barnier[4] that somehow the common law can be dangerously

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[3] Philip Stafford and Peter Smith, *Europe begins countdown to Mifid II*, 1 January 2018, FT.com: www.ft.com/content/b8a9a634-e116-11e7-a8a4-0a1e63a52f9c.

[4] See, *e.g.*, Michel Barnier, Member of the European Commission for the Internal Market and Services *What financial stability for the future?*, 18 March 2010, Forum "Les Echos", Paris.

permissive and was responsible for that crisis. This is fundamentally flawed. In fact the central banks tasked with monitoring systemic risk at the time failed successfully to address that risk. This included the central banks in both common law and civil law systems, and in the EU itself. Since then, the UK (like others) has taken extensive steps to address matters of systemic risk.

The problematic EU system poses a danger in itself to stability in the system as a whole. This is particularly the case in relation to EU law's erroneous treatment of Eurozone member state debt as sovereign and risk-free, in breach of the intention behind the global regulatory standards established by the Basel Rules.[5] The result is that EU law creates vast amounts of unmanaged systemic financial risk. EU financial law has been made and implemented in ways that have been damaging to UK interests. Eurozone financial risk has to be mitigated by the UK regulators exercising supervisory discretion. The costs of that mitigation have been imposed on UK-based financial businesses by subjecting them to top-up capital charges. This is a step the EU's financial authorities choose not to mimic, saving the EU's financial firms the cost of doing so and leaving the Eurozone risk unmitigated within the EU.

Furthermore, the EU has demonstrated a willingness to use its law to attract business rather than to manage financial systemic risk. Recently, it sought to attract financial business from the UK after Brexit, first by creating an impression of a legal "cliff edge" whereby the continued performance of financial contracts between UK providers and EU customers, after the end of last year, would involve committing possible offences under EU law, with contracts also ceasing to be enforceable. This is in spite of international law and EU law case law protecting most such contracts, arising from previous instances in which empires or blocs have broken up. In addition, the EU has sought to offer only to grant recognition to UK financial laws, under the EU's equivalence framework, if the UK follows EU rulemaking. This is a false choice, and there are various, perfectly acceptable ways in which UK financial businesses can continue to service their EU customer base after Brexit without applying the unattractive EU rules.

3. **The current position is that the UK has accepted the legacy of a vast swathe of EU law. It is vital to the UK economy and the global market it serves that the UK's system is now reinvigorated by removing unnecessary layers of EU law and regulation.** *(See Chapter 3: Restoring the EU Approach to Law – Out of the EU, Into the Future.)*

As the only member state with a global finance centre, and the EU's most prominent common law system, the UK suffered disproportionately from **the incompatibility of the EU's civil law based approach**. The UK often found its attempts to advance its agenda as a financial services hub thwarted by politics, rather than economic or legal good sense. Its competitiveness has been damaged by laws to which it would never have been subject had it not been in the EU and under the EU's imperfect legal architecture. The effectiveness of the UK's financial services regime has, as a result, been undermined.

With the expiry of the Brexit transition period at the end of 2020, the UK is free to ensure that its financial (and other) markets can develop under the benefits of its own law. The focus should be on optimising our legal system, particularly because the common law tends to lead to superior economic results.[6] If liberated, the similarly pragmatic Scots law system is capable of comparable levels of performance. It is important that the UK now revitalises its legal order in anticipation of future trade deals, enabling them to operate on the basis of the UK's true, sovereign regime. Renouncing EU law and reviving the UK's own legal order would be compatible with any

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[5] See Barnabas Reynolds, David Blake and Robert Lyddon, *Managing Euro Risk: Saving Investors from Systemic Risk* (2020) Politeia.

[6] *E.g.* Cross, *Identifying the Virtues of the Common Law* (2007) 15 Supreme Court Economic Review 21; Graff, *Law and Finance: Common Law and Civil Law Countries Compared: An Empirical Critique* (2008) 75 Economica, New Series 60; Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, *The Economic Consequences of Legal Origins* (2008) 46 Journal of Economic Literature 285; and Mahoney, *The Common Law and Economic Growth: Hayek Might Be Right* (2001) 30 Journal of Legal Studies 503.

acceptable financial services trade deal with the EU that might be achieved in the future. This objective is more important than ever, given global economic developments.

The task, therefore, is to reclaim the benefits of the UK's legal heritage and unpick the undesirable elements of EU law from the UK's system. The UK should adopt the pure common law method across its legal and regulatory framework and address the EU-inherited approach of encrusting financial regulation in poorly drafted, statutory law by **taking the steps set out in Recommendations 1-4 in Chapter 3**, on the basis of the approach set out in that Chapter**.**

4. **Regulatory rulemaking and supervision have posed particular problems** under the EU regime. *(See Chapter 4: A UK Approach to Regulation - Predictability and Regulatory Restraint.)* The UK must radically reform the nature of regulation, how regulators operate and how they are held accountable for their rulings. Our regulators have been given powers to make rules, to judge whether EU regulations and also their own rules are followed, and to fine and impose other penalties on those they consider to have transgressed. In doing so they apply processes they have constructed themselves. Within the EU system, the regulators have been restricted by the EU's political process and by the detail of the EU rulebook, rendering them in many instances judges of fact as to a breach of regulation. Nevertheless, they have taken their rulemaking further than the common EU rulebook and have made additional rules, some of which are vague in nature, in order to provide in general terms for matters not covered by the EU rules. Furthermore, in exercising supervisory judgment their techniques have from time to time intruded on matters which might be seen as purely commercial.

The UK's regulators have benign intentions and are high quality and thoughtful, yet the overall situation gives rise to a lack of certainty. This results not only from the background of the EU's single rulebook, but also from the actions the UK regulators have taken to make the best of it. This has had a detrimental impact in restricting or slowing down what should have been seen as valid market conduct, and has led to unnecessarily increased costs for firms in their compliance. In certain ways the regulators have being operating under the EU regime in a manner at variance with the tradition of common law.

As the UK restores its own law making, UK regulation must change to reflect the country's revived approach for the sector. *(Chapter 4.)* The regulators' role will be to facilitate the operation of the UK's regulatory regime, and in an accountable, transparent way. Regulator rules which are clear and transparent should not need a layer of additional regulatory interpretation. Nor is there any basis for vague regulator rules to address gaps in the rulebook.

For that to happen, the regulators' role must change. Checks and balances are needed to ensure that the UK's regulators are seen to operate where possible by making clearly drafted regulations, and that they use the techniques of interpretation appropriate to common law statutes; they should intervene on a basis that is consistent and fair, and only where necessary to address a regulatory need; and they should function in a predictable manner consistent with the law and the newly restored UK system.

For this, the system must be rebalanced to make for greater accountability and oversight by a specialist Parliamentary committee, assisted by the necessary expertise. New mechanisms are required to ensure that regulatory supervision reflects common law practices, including the use of case law precedent. The drafting of regulator rules should be subject to Parliamentary oversight and judicial review, and the regulators' actions should be subject to legal challenge in the courts and Upper Tribunal, a superior court of record whose powers include the ability to exercise judicial review of the financial regulators. Adopting such an approach will restore the full benefits of the UK's traditional legal system, for customers, financial firms and the UK economy.

For the proposals on reforming the regulatory system the steps set out in Recommendation 5 in Chapter 4 should be taken, based on the reasoning set out in that Chapter.

INTRODUCTION

There are two main legal operating systems across the world. On the one hand there is the precedent-based common law system, which originated in England in the Middle Ages. It is a system of law declared by judges, derived from custom and precedent, and was called "common" because it applied equally across the whole country in contrast with diverse local customary law. In its developed form it operates on the basis of binding precedent, whereby courts follow, draw out and apply the principles and rules declared in previous cases decided by more senior courts (a method called *stare decisis*). Common law rules may of course be abrogated, superseded, replaced or modified by legislation, which takes precedence. On the other hand, there is the largely code-based civil law system arising from the eighteenth and nineteenth centuries, the basic notions of which are derived from Roman law. Civil law systems place much less emphasis on precedent than they do on the code or other legislative provisions from which their reasoning proceeds. In a civil law system, at least in theory, a judge merely establishes the facts of a case and applies remedies found in the code-based law.

The common law system is now used in North America and most of the Commonwealth jurisdictions. Code-based civil law is a more diversified approach used in continental Europe, most of the former colonies of continental European countries, and elsewhere, including Japan and (for the most part) China. The civil law system is further divided into two main branches—the Napoleonic and the Roman-Germanic—which date back particularly to nineteenth century codifications in France, with the Code Napoléon of 1804, and Germany, with its Civil Code, the *Bürgerliches Gesetzbuch* (BGB) of 1900. Each branch shares a reliance on codes but the approach differs in the structuring and use of those codes.[7] Further variations exist. In some instances, especially where the uncodified pre-Napoleonic civil law was adopted, there are combinations of the common law and civil law systems, the law displaying features of both.[8] Additional variants, seen in certain states particularly in the Middle East, include an additional theological element on top of the underlying regime,[9] or elsewhere a socialist law element.[10] However, the common law and civil law systems remain the two fundamental systems of legal thought and reasoning throughout the world. It might perhaps be seen as surprising that more systems have not been created, for instance in Asia and states that were never colonised. However, the difficulty in creating a scheme of legal thought is such that those countries voluntarily adopted one or other of these two systems.

An obvious question that arises, which has been debated by jurists for at any rate a hundred years,[11] is which system is better. At least in financial services, the answer is settled. Common law-based

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7 There is a further version of civil law that originates from Scandinavia. There are then hybrids of the Franco-German approaches, such as those found in the Italian and Swiss civil codes. The differences between the Napoleonic and the Roman-Germanic systems stem from the ways in which the systems have been codified. See JH Merryman and R Pérez-Perdomo, *The Civil Law Tradition: an Introduction to the Legal Systems of Europe and Latin America*, 3rd edn (2007), Stanford University Press, Chapter V, for an overview of their origins and characteristics, contrasting the essentially revolutionary, rationalistic and non-technical approach of the Code Napoléon (the French Civil Code) of 1804 with the more historically orientated, scientific and professional approach of the BGB of 1900.

8 For instance, Scotland, Jersey, South Africa, Sri Lanka and Mauritius all apply the common law mixed with elements of the civil law system. Scots law is a hybrid, or mixed, system containing common law and uncodified civil law elements. The civil law started being used directly in Scots law from around the 15th century, when Roman law was often adopted in argument in court, in an adapted form, where there was no native Scots rule to settle a dispute; and Roman law was in this way partially received into Scots law. Jersey law is based (when not on statute) by the customary law of the Duchy of Normandy pre-Code Napoléon, and has no clear doctrine of precedent. In South Africa, property, contract and delict remain based on Roman-Dutch law and those systems influenced by it. Sri Lankan law mixes Roman-Dutch law, Kandian law, Thesavalamai and Muslim law. While Mauritius is a mixed system, it differs from the others as it is code based and the mixture is different too: private law is code based, public law is common law and the judicial system is common law too. The Code Napoléon and the Code de Procédure Civil still apply in certain cases in Mauritius. Jersey and Mauritius have appeals to the Judicial Committee of the Privy Council. Scotland has appeals to the Supreme Court of the UK. See V.V. Palmer, *Mixed Systems Worldwide – The Third Legal Family*, 2nd edn (2012), CUP.

9 Sharia law applies in Islamic countries to a greater or lesser extent. Such states include Saudi Arabia, Egypt, (to a degree) Iran and the United Arab Emirates. In some states, such as Saudi Arabia, it is *the* law (see the Saudi Basic Law, article 23). In others, such as Egypt and the UAE, it is a "source of legislation" (a term that is Egyptian in origin).

10 The law in China comprises civil law mixed with Soviet Socialist law.

11 See, for instance, Peter J. Hamilton, *The Civil Law and the Common Law* (1922) 36 Harvard L Rev 180.

financial centres have clearly come out on top, providing the preferred legal environment for international financial marketplaces and best facilitating the constant innovation and development which financial products and services require. The world's two main international financial centres, London and New York, operate in common law jurisdictions.[12] There are then Hong Kong and Singapore, fifth and sixth in the league table, with their own common law systems, which have an appeal that extends significantly beyond their individual economies.[13] The legal and regulatory operating systems of both jurisdictions are seen to be attractive to international users in their own right. Of course, other factors are behind this success as well. New York is also driven by the power of the US economy. All four centres benefit from the English language. London benefits from its time zone. However, surveys indicate time and again the appeal of the legal framework that underpins each of them.[14]

By contrast, there are only two top civil law-based financial centres of note, Shanghai and Tokyo, at third and fourth in the world respectively. Tokyo operates under a mixture of the German and French civil code systems and benefits also from a common law (post-War, US) influence. However, its success largely reflects the success of the Japanese domestic economy and it mainly serves the Japanese market,[15] rather than constituting a magnetic marketplace in its own right, one in which participants from all over the world convene to conduct international financial business. The position is similar in Shanghai. The Chinese legal system to which it is subject evolved in the late 1970s after the end of the Cultural Revolution. It did so by adopting modified elements of the German code-based system, building on a method which was at that time rooted in Soviet Socialist law. China had long had an interest in the German branch of civil law, with the government at the end of the nineteenth century, during the Qing Dynasty, hiring Japanese legal experts to copy a legal system from Japan (which was in turn based on German judicial precedents) in order to modernise. These efforts were short-lived and largely ineffective. The modern Chinese law system is a recent creation, although the legacy of the socialist period means that Soviet Socialist law influences remain (for example, in its criminal and administrative law). Today the success of Shanghai is, like Tokyo, largely domestic, driven by the sheer size of the Chinese economy rather than any independent attraction to its legal or regulatory system for international market participants. Neither Tokyo nor Shanghai provide financial services to individuals and entities in other regions in the same manner or to the same extent as London and New York, or even Hong Kong and Singapore. Furthermore, Frankfurt and Paris, the home financial centres for the two main civil law systems in Europe, rank as sixteenth and eighteenth in world commerce[16]—

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12 *The Global Financial Centres Index 28, Report*, September 2020, published by Y/Zen. This Report was produced from the research of 121 financial centres and the use of 138 instrumental factors, provided by third parties such as the World Bank, the Economist Intelligence Unit, the OECD and the United Nations. The instrumental factors are merged with financial centre assessments, consisting of 54,509 assessments from 8,549 respondents to a GFCI online questionnaire. The UK is the world's leading net exporter of financial services, worth a total of $77bn, with the US a close second at US$60bn (*Key Facts About the UK as an International Financial Centre 2020, Report*, December 2020, TheCityUK). London is the powerhouse of the UK's financial markets, playing host to 250 foreign banks or branches, with 7.1% of total global foreign listings being made on the London Stock Exchange, as at the end of 2019. The majority of the UK's US$3.6 trn average daily foreign exchange trading turnover was transacted in London in April 2019. London is also the centre of the UK's professional services sector. Four of the 20 largest Global 100 law firms, based on number of lawyers in 2019/20, have their main base of operations in the UK.

13 The importance of the common law to the commercial success of Hong Kong was recently restated by Chief Justice Ma, *The dependency of business and finance on the common law in Hong Kong: a paradigm jurisdiction* [2019] LMCLQ, 549. However, the future of Hong Kong and the common law system applied there is currently uncertain: *e.g.* T Kinder and L Lewis, *Companies consider writing Hong Kong out of legal contracts*, 31 January 2021, Financial Times.

14 For example, evidence gathered for the September 2020 *Global Financial Centres Index 28, Report*, fn 12 above, indicated that "the regulatory environment is still seen as the central pillar needed for a successful financial centre. [The regime] must strike the right balance of regulation, to reduce corruption without stifling innovation and development and with greater transparency" (p. 11).

15 As recently as the September 2016 *The Global Financial Centres Index 20, Report,* published by Y/Zen, classed Tokyo as an "Established Transnational" financial centre (alongside others such as Chicago, Madrid and Stockholm), rather than a "Global Leader", despite being ranked the fifth most significant financial centre that year. According to CFA Society Japan, "this is because Tokyo appears to be more insular and less open to foreign talent than the international, cosmopolitan hubs of Hong Kong and Singapore. Tokyo is therefore less well connected with other centres than the other leading centres" (*Tokyo as an International Financial Centre*, July 2016, CFA Society Japan, p. 6).

16 See *The Global Financial Centres Index 28, Report*, fn 12 above. Since March 2020 they have both fallen 3 places in the rankings.

showing that London's success cannot solely be a product of its time zone or based on the size of the UK economy. Similarly, it can be said that the success of New York is not solely dependent on the domestic US economy.

In addition, for contractual matters English law and New York law are by far the most popular systems of choice. The common law covers 27% of the 320 legal jurisdictions around the world and approximately 30% of the world's population.[17] This arises from the size of the Commonwealth (including India) and US combined, and makes it the most prevalent legal system globally. English law is also the most popular governing law for cross-border contracts,[18] and is often used for contracts between parties who have little or no connection to the UK. Napoleonic law, based on the French system and used in countries such as Brazil and Egypt, applies to the largest share of the world's land mass (34%) yet it only covers approximately 23% of the world's population.[19] Roman-Germanic law is used in 10% of jurisdictions and by approximately 11% of the world's population.[20] China and Japan have civil law systems of mixed origin, which apply to approximately 25% of the world's population.[21] These other systems are far less frequently chosen by financial or commercial parties for their international transactions.

The attractions of the common law are no accident of history or empire. The latest fora to opt in to the common law approach, after the post-colonial settlements of the 20th Century, are the new "financial free zones", which are zones subject to regulation[22] on the common law method, to encourage economic activity. Most notable amongst those zones are the Abu Dhabi Global Market and the Dubai International Financial Centre.[23] Faced with a blank page and a desire to create a financial centre, lawyers in each of these zones turned to the common law. Even a jurisdiction with very few historical links with the common law world, Kazakhstan, has opted for common law for its new Astana International Financial Centre, which is intended to be a regional hub for finance in Central Asia.[24]

With Brexit, the UK left the EU system at the end of 2020 (when the transition period came to a close), which means it is now free to decide the shape of its future laws. The question arises as to whether the UK needs a radical change of direction and, if so, why; and what the areas of EU inherited law are that are particularly problematic. Many financial services practitioners dealing with the common and civil law systems will have noticed the shortcomings of EU law, but now the point comes to the fore.

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17 Philip Wood, *Maps of World Financial Law*, 6th edn (2008), Sweet & Maxwell.

18 *Legal Excellence, Internationally Renowned: UK Legal Services 2020, Report*, November 2020, TheCityUK.

19 *Maps of World Financial Law*, fn 17 above.

20 *Ibid.*

21 *Ibid.*

22 Financial free zones are being recognised as meeting high international standards. For example, the Abu Dhabi Global Market was recognised as being "fully compliant with international standards of cooperation and enforcement" by the International Organization of Securities Commissions (IOSCO) in 2017 (https://www.adgm.com/media/announcements/international-organisation-of-securities-commissions), and was recognised for having high standards in arbitration practices by Global Arbitration Review in 2020 (https://www.adgm.com/media/announcements/adgm-recognised-for-developments-in-arbitration-by-the-gar-awards-2020). The Dubai International Financial Centre was awarded ISO/IEC 27001 accreditation in Information Security Management Systems by the British Standards Institute in 2016: (https://penta.ch/blog/difc-awarded-isoiec-27001) and ISO 9001:2000 accreditation for quality management systems by the Lloyd's Register in 2016 (https://www.difc.ae/newsroom/news/difc-authority-achieves-iso-certification/).

23 The Abu Dhabi Global Market (ADGM) has adopted an "evergreen" approach to common law. It has passed a legislative measure for the zone which incorporates the English common law, as it stands from time to time, into its legal system. As a result, all subsequent developments in the common law case law automatically form part of ADGM law. See Barnabas Reynolds, *The Abu Dhabi Global Market – Legislative Framework, Approach and Methodology* (2017) 32 JIBLR 181. The Dubai International Financial Centre (DIFC) applies a codified version of the common law which makes reference to English law case law. Qatar Financial Centre is similar. Saudi Arabia is also establishing new zones, Neom and Red Sea (based on territories the size of Belgium), which benefit from elements of the common law, but in a different way. Each is seeking to be a hub for regional business.

24 Kazakhstan has adopted a codified version of the common law similar to DIFC. Kazakhstan is positioned geographically at the centre of China's Belt and Road Initiative and its economy has enjoyed a significant boost from oil and gas exports in recent years following the discovery of the Kashagan oilfield in 2016 (see Sir Rupert Jackson, *The Astana International Financial Centre: the court and the international arbitration centre* (2019) 35 Const LJ 489).

There are good reasons to return rapidly to our own legal position. The UK should recapture the full benefits of the common law method, making as few accommodations to EU and civil law methods as possible, consistent with upholding international standards. There is a consequential need to ensure the regulators are constrained in their use of rulemaking, supervisory and enforcement powers and that they operate within a carefully defined framework of law (as opposed to a regime arising from regulation of their own making). This paper highlights the context within which UK law has operated and some of the points that are striking from a practitioner's perspective which need reform. It is divided into four parts:

1. **The UK, the financial sector and the common law**
2. **The conflict that has arisen between UK financial services law and EU law**
3. **The next steps the UK should take to restore its laws—into the future and out of the EU**
4. **A revised approach for UK regulators—restraint in adopting rules and in supervision**

A Checklist of Recommendations is provided after the Conclusion. Further relevant materials are to be found in the Annexes to this paper.

PART I: THE "WHY" – CRITICAL BACKGROUND

CHAPTER 1

THE UK, THE FINANCIAL SECTOR AND THE COMMON LAW

The financial sector is a complex one, involving constant individual and collective innovation. Financial services and products are financial transactions made effective through law. There are numerous ways in which those services and products can turn out differently to expectations. The law is needed to allocate the risk of that happening. Law and regulation also ensure a fair and predictable marketplace and protect the entire financial system against systemic risk,[25] which private parties cannot entirely manage on their own since it arises from the interconnectivity of the system as a whole.

This Chapter explains:

1.1 The international financial system and the UK's financial centre;
1.2 The common law – pivotal to the success of a global financial centre;
1.3 UK regulation – the application of common law methodology;
1.4 Common law and code-based civil law: a problematic coexistence?
1.5 The legal foundations for success;
1.6 Practical examples of the common law's facilitation of new financial activity.

1.1 The international financial system and the UK's financial centre

The international financial system comprises a framework of agreements, regulations, rules, market practices and institutions within which international financial markets and investors operate. Financial transactions involve the buying and selling of financial services and products, and exchanging risk. Just as the common law underpins financial contracts, financial regulation provides for a predictable marketplace, restricting activities where they threaten the safety or soundness of the market, or the expectations of consumers. Although many of the institutions and arrangements underpinning the system were created after the Second World War, the modern system started emerging in its current form in the 1970s, with floating exchange rates and the removal of capital controls by the US, UK, Canada, Germany and Switzerland. This led to the rise in the 1980s and 1990s of an unprecedented, worldwide financial market, with investors chasing returns through financial centres, such as the UK's global centre, which were becoming more prominent across geographies and currencies. This worldwide market experienced further growth due to the incorporation of previously isolated economies such as those of China, India, Southeast Asia and the former Warsaw Pact countries into the global economy and its production, consumption and investment patterns.

How international financial centres work. International financial centres specialise in the provision of international financial services, and intermediate cross-border financial flows and transactions. They achieve that through the firms and infrastructures located in those centres. Financial firms cluster in the centres, particularly for wholesale business, because of external economies of scale, economies of agglomeration and network effects.[26] This fact, as well as continuing political and regulatory barriers, and localised incentives, has led to a market that can be divided into four groups: global centres (*i.e.*,

25 See fn 172 below.

26 Studies have shown that firms that locate in leading financial centres grow faster than rivals, their superior performance being attributable to the scale and scope benefits of clustering: A.J. Taylor, J.V. Beaverstock, G. Cook, N.R. Pandit and K. Pain, *Financial Services Clustering and its significance for London* (2003) Corporation of London, citing N.R. Pandit, G.A.S. Cook and G.M.P. Swann, *The dynamics of industrial clustering in British financial services* (2001) 21 The Service Industries Journal 33-61. More generally, see *The Art of the No Deal,* fn 1 above, at pp. 23-26.

London and New York), regional centres (such as Hong Kong, Singapore and Dubai[27]), domestic centres and offshore centres. The domestic centres, which exist across Europe outside the UK, serve local client bases, though typically they also host firms which have international connections. The offshore centres intermediate capital flows and have little connection with the country that hosts them.[28] These include the Cayman Islands, the Bahamas, the Netherlands Antilles and the Channel Islands. The term also includes much of the international financial activity conducted in Luxembourg and Switzerland, and some aspects of business in London (particularly in the context of the Euromarkets[29]).

There is no indication that modern methods of communication change these structural dynamics. Indeed, the quality of a financial market is driven by its liquidity, efficiency and scale of operations, leading to lower dealing costs and a diminished likelihood of market failure. The larger the number and greater the range of activities of financial firms located in a centre, the more new business opportunities and demand arise from other practitioners in the market. This also stimulates competition, which reduces prices and further cements the success of the centre. In addition, the economics of agglomeration accrue by reason of the ready availability of ancillary services and complementary activities that form part of the supply chain of finance, including sophisticated IT, accounting and legal services.[30] A further factor which has become essential for many financial firms is information and personal contact. The quantity and quality of information flows and relationships of trust in a centre enhance the competitiveness of many firms, and also attract new firms and business.

London's success. London is a pre-eminent international financial centre and has been so for at least two centuries. Although it briefly lost its role to New York after the Second World War, it recovered its position in the 1960s and 1970s, when it became the focus for the Euromarkets after the US introduced controls on capital outflows.[31] London grew more rapidly after that, seizing business as a result of these controls. In 1986, the UK also took various measures that liberalised the market and led to further business expansion, in the so-called "Big Bang". This involved the abolition of fixed commission charges and the distinction between jobbers (market makers) and brokers on the London Stock Exchange. The stock exchange also changed from open-outcry to electronic, screen-based trading. This dismantling of archaic restrictions transformed the City into a playing field for the large integrated international banks and investment houses. The result was to concentrate international financial services into a set of worldwide players operating out of global financial centres.[32] Although fewer people work in finance and insurance in London than in New York and Tokyo,[33] a higher proportion are engaged in international activities.

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27 Tokyo is also an established regional centre, while Shanghai and Mumbai are also striving to become regional hubs.

28 They emerged in the 1960s to service the rapidly expanding eurocurrency market and, in broad terms, intermediate financial flows between non-residents.

29 The Euromarkets are markets on which banks deal in a currency other than their own. For instance, Eurodollars are dollars held by banks outside the US. The prefix 'euro' refers to the fact that such deposits first appeared in Europe in around 1955.

30 In the UK's case its financial centre has widened beyond the City of London and is to be found across the country: *Exporting From Across Britain: Financial and Related Professional Services 2020*, November 2020, TheCityUK, states (at p. 33) "[a]round half of financial and related professional services exports came from outside London in 2018 and, based on our estimates, in 2019", https://www.thecityuk.com/assets/2020/Reports/45688b5f40/Exporting-from-across-Britain-Financial-and-related-professional-services-2020-v2.pdf.

31 The Eurodollar markets boomed in the 1960s after the US introduced controls which included the Interest Equalisation Tax Act, 1964, Public Law 88-563, adding Chapter 41 to Subtitle D to the Internal Revenue Code, 1954. This was intended to restrict European borrowing in the US capital market. Regulation Q, a Federal Reserve Board Regulation adopted in 1933, set ceilings on rates of interest paid on deposits by US banks.

32 See for example David Kynaston, *The City of London: The History* (2012) Random House, and Richard Roberts, *Inside International Finance* (1998) Orion.

33 In March 2020 London had 385,541 workers engaged in financial and insurance activities (data sourced from the Office of National Statistics, *Nomis "Workforce Jobs by Industry – Seasonally Adjusted"* tool *available*: https://www.nomisweb.co.uk/query/construct/summary.asp?mode=construct&version=0&dataset=130). In June 2020, New York City had 452,500 workers engaged in finance and insurance activities (data sourced from New York State Department of Labour, *NYC Current Employment Statistics (CES) Latest Month*, *available*: https://www.labor.ny.gov/stats/nyc/#:~:text=The%20city's%20seasonally%20adjusted%20unemployment,employed%20was%2047.4%20in%20June). The most recent available figures for Tokyo date from 2016, when 411,000 workers were

1.2 The common law – pivotal to the success of a global financial centre

A key element of London's attractiveness to investors is its legal framework, which underpins a flourishing commercial environment with the rule of law.[34] Market participants generally prefer good, predictable and permissive law and regulation, where they know what the rules are, that those rules will operate and be upheld, and there is confidence that the rules will not be subject to arbitrary change.

The legal system underpinning the London market lays down clear restrictions on permissible action with sufficient clarity for actors to be able to determine in advance whether what they do will be allowed. This is achieved through effective, just and predictable financial laws but also, importantly, because of a clear, predictable, flexible, yet sound legal system. The UK's laws facilitate commercial dealings in a manner which is safe for consumers and other market participants, as well as the system as a whole.

The common law system. The English common law system is a vital element in achieving this outcome. Having its roots in Medieval England, in its sophisticated form it derives from the approach developed in the seventeenth, eighteenth and particularly late nineteenth centuries. The system supports the financial system in ways that differ significantly from the methodology of the civil law systems in use around the world. The principal difference between the two is the embedding of freedom:[35] the common law's presumption that activities are lawful unless prohibited, the law being there to uphold the free choices of businesses and citizens. This derives from the fact that the common law arises from judicial precedent, based on decisions on individual cases brought before the courts, rather than from top-down prescription. Litigants apply to the court, seeking a remedy for perceived wrongs. The result is a system that is intrinsically *laissez-faire.*[36] It uses precedent to define restrictions and liabilities only, rather than permissions, except where there has been statutory or regulatory intervention (albeit this has become more frequent over time). In modern times, the common law system generally protects investors' monies through the law of contract, tort and restitution, the imposition of fiduciary duties, the use of equitable remedies, a somewhat limited statutory framework and through financial regulation which is made by regulators under certain defined statutory powers. It encourages innovation and allows for self-starting entrepreneurialism and commercial risk-taking. The approach to legislation and regulation is generally to provide for a framework within which desired activities can be conducted—a "yes, you can do it if you bear in mind the following risks and liabilities" not a "this is how it must be done" approach.[37] Furthermore, any specified statutory limitations on individual freedom are interpreted restrictively.[38]

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engaged in finance and insurance activities (data sourced from the Bureau of Industry and Labour Affairs, Tokyo Metropolitan Government, *Industry and Employment in Tokyo – a Graphic Overview 2019*: https://www.sangyo-rodo.metro.tokyo.lg.jp/toukei/c8cdaf213387cae120e1754b8d448c59.pdf).

34 Further analysis of the factors that contribute to the City's success generally can be found, for example, in the Briefing Document, *Vision 2025 – The Role of Financial and Related Professional Services* March 2017, TheCityUK. These include: lifestyle factors, tax environment, technology and infrastructure, access to skills, access to other markets, and domestic market size and nature.

35 Interestingly, Karl Friedrich von Moser, the eighteenth century German jurist, state journalist and politician, wrote in 1758, "[e]ach nation has its main characteristic. In Germany it is obedience, in England it is liberty, in Holland, trade, in France, the honour of the King", *Reliquien*, quoted by F. Meinecke, *Weltbürgertum und Nationalstaat* (1908) 2 Kap. See also WH Bruford, *British and German Ideas of Freedom*, in *German Life and Letters* (1947) Vol 1 for some interesting comments on the underpinnings of such an observation. A famous statement in Justinian's Digest is often cited, that the will of the Emperor has the force of law: *quod principi placuit legis habet vigorem*, Digest, I.4.1.1, Ulpian 1 Inst. Peter J. Hamilton, *The Civil Law and the Common Law* (1922) 36 Harvard L Rev 180, 187 further observed that the common law inherently recognised "individualism". In the US, the outrage following President Richard Nixon's assertion that "when the president does it, that means that it is not illegal" in the Nixon interviews (Part 3, aired 19 May 1977) is an indication of the distaste for sentiments such as those expressed in the Digest.

36 This term is said to have originated in a meeting in around 1671 between certain French businessmen and the Controller-General of Finances, and proponent of mercantilism, Jean-Baptiste Colbert. Colbert asked the businessmen how the State could best help them, to which the answer was "*laissez-nous faire*"—leave us to get on with it.

37 See Frank H Easterbrook, *Legal origins and securities fraud* [2019] LMCLQ 619, for an interesting discussion.

38 96 *Halsbury's Laws* 5th edn (2018) Statutes and Legislative Process, para 704.

The US system is similar to that of the UK[39] except in four key respects. First, its sanctions can be more punitive than our own. Very high, punitive fines can be imposed for breaches of regulations and as sanctions.[40] It also has the (albeit now reduced) risk of awards of punitive damages.[41] These features are seen as providing additional disincentives for misconduct. In addition, since the costs of litigation do not fall on the losing party, unlike the position in the UK, there is also a practice of suing corporations, particularly in class actions, for market price falls even where those might be seen as obviously not arising from any fault on the part of the institution. The claimants often settle these cases for the amount of the legal fees that a corporation would spend in defending against the claim. Finally, juries can be used in most financial and commercial matters in the US.[42]

The civil law system. The civil law code-based systems represent an attempt to adopt a rationalist or scientific method for the law.[43] The law is to a considerable extent set out in codes—civil codes,

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39 If anything it is in fact more focused on the application of the common law. For the US prizes judicial reasoning, which is a point that has been recognised as far back as the early 1830s by no less an acute observer than Alexis De Tocqueville, who stated that "[s]carcely any question arises in the United States which does not become, sooner or later, a subject of judicial debate": *Democracy in America* (ed. Frohnen, 2002) Regnery, p. 223.

40 See, *e.g.*, Cornerstone Research, *Securities Class Action Filings, 2019 Year in Review* (approximately 1 in 18 US exchange-listed companies was subject to securities litigation in 2019 and likelihood of being named in a litigation was around 5.5% in 2019), https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Filings-2019-Year-in-Review. In an anti-money laundering context, in 2019 the US regulators issued 25 fines at an average of approx. USD 91,000,000 per fine. By contrast, the UK regulators issued 12 fines at an average of approx. USD 32,000,000 per fine (data available: https://www.paymentscardsandmobile.com/8-14-billion-of-aml-fines-handed-out-in-2019-usa-and-uk-top-the-list/#:~:text=Regulators%20in%20the%20USA%20were,monetary%20fine%20was%20%245.1%20billion). See also the study referenced in this article on the comparative fines and penalties: https://www.corporatecomplianceinsights.com/global-financial-institutions-fined-26b-for-aml-sanctions-kyc-noncompliance-since-2008-financial-crisis/ ("The US Department of Justice is the most punitive regulator in the world when it comes to imposing financial penalties for noncompliance" with “know your customer” (KYC) requirements and sanctions). And: https://www.complianceweek.com/surveys-and-benchmarking/study-post-financial-crisis-fines-against-financial-institutions-hit-36b/28429.article.

41 Punitive damages are rarely available when claims are brought under federal law, and the Supreme Court has placed significant limits on punitive damages, whether awarded in federal or state courts, under the due process clause in the US Constitution: *BMW of North America v. Gore* 517 US 559 (1996) ("The Due Process Clause of the Fourteenth Amendment prohibits a State from imposing a "grossly excessive" punishment on a tortfeasor."). This case established criteria, focusing on the "reprehensibility" of the defendant's misconduct, for assessing where a punitive damages award is so "grossly excessive" that it violates due process. Criteria for assessing "reprehensibility" were set out in *State Farm Mut. Auto Ins. Co. v. Campbell* 538 US 408 (2003). While *State Farm* did not establish an explicit cap on the amount of punitive damages that can be awarded, the court did observe "in practice, few awards exceeding a single-digit ratio between punitive and compensatory damages . . . will satisfy due process" (*State Farm* at 425).

42 Douglas G. Smith, *Structural and Functional Aspects of the Jury: Comparative Analysis and Proposals for Reform* (1997) 48 Ala L Rev 441, 461 (noting that most civil law countries abandoned trial by jury a century ago). The use of juries will depend on the nature and basis of the claims and in what court the claims are proceeding. The right to a jury trial in certain cases, including in civil cases, is provided for federal courts in the Seventh Amendment to the Constitution (US CONST. amend. VII.) and for most state courts in provisions in each state's Constitution. Civil jury trials are widely used for commercial cases involving a monetary claim, at the election of either of the parties. Claims for non-monetary remedies (*i.e.* those remedies that were equitable in English law at the time of the framing of the Constitution) are decided by a judge in a federal court and in most state courts. For claims involving both monetary and non-monetary claims, the US Supreme Court has held that the right to a jury trial in a federal court still exists for the legal claim, which would be decided by a jury before the judge ruled on the equitable claim (*Beacon Theatres, Inc. v Westover* 359 US 500 (1959). Most state courts take a similar approach. See E.J. Hamilton, *Federalism and the State Civil Jury Rights* (2013) 65 Stanford L Review 851. In the UK jury trials can only generally be used in criminal proceedings: see fn 117 below.

43 For instance, the General State Laws for the Prussian States (*Allgemeines Landrecht für die Preußischen Staaten*) of 1794 were created in order to codify existing legal principles from different fields of law, such as contract law, property law, family law, and inheritance law, in a comprehensive, systematic, and accessible manner on the basis of new scientific principles (P. Hellwege, *Allgemeines Landrecht für die Preußischen Staaten, Handwoerterbuch des Europaeischen Privatrechts*: http://hwb-eup2009.mpipriv.de/index.php/Allgemeines_Landrecht_für_die_Preußischen_Staaten). At a later stage, the BGB was drafted mainly for the purpose of codifying different laws of German states (*e.g.* Prussia (above), Saxony, and Baden) as well as the *ius commune*, a well-known corpus of civil law not dissimilar, though derived from Roman law, to common law: see Haecker (2015) 131 LQR 24. In the course of the preparatory works, which took many years (the main discussions of the first commission (of two) started in October 1881, see W. Schubert, *Materialien zur Entstehungsgeschichte des BGB – Einfuehrung, Biographien, Materialien* (1978) Berlin/New York 45), the proved and tested rules from the different state law systems were assessed and in principle adhered to (for details on the work of the two commissions which were instituted in order to review the existing law and to prepare a uniform codification, see W. Schubert, *ibid.* p. 27 *et seq*. as well as p. 125 *et seq*. for historical materials). However, to some extent substantive rules

commercial codes, maritime codes and so on. The basic grammar, categories and habits of thoughts of the civil law family can be traced back to Roman law.[44] The principle is that law should be comprehensively written down so that people know where they stand.[45] The corpus of norms is set out at the outset in a code promulgated by a legislator, which means that the law is less dynamic and less able to change efficiently with the times.[46] In some versions of civil law the doctrine of *non liquet* means the code should be construed as being exhaustive.[47] However, whether or not this is the case, the answer to any legal question is, as a general matter, to be found in the relevant code. The code sets out legal propositions. Just as for the common law, legal concepts operate in juxtaposition to each other, with the application of rules being qualified by exceptions and needing to be interpreted in the context of other rules. There is no binding, case law precedent to demonstrate where the balance lies between relevant provisions of the code. This means that the system retains far more control, after any activities have occurred, in determining the legal implications at that point in time.[48]

In the civil law-based system, it therefore can be observed that the state and the legislator have greater powers and more reliance is placed on their role. Where code-based laws are absolute and rigid, which they typically are (since they cannot easily be changed), the power of justice rests with the legislators. The common law system provides for most aspects of private law and lacks the component of state involvement, allowing the system to evolve incrementally and (largely) apolitically. In the UK there are few checks on legislative power (other than occasional, high-level democratic ones), given the doctrine of Parliamentary sovereignty. However, the legislators, who are not naturally codifiers, do not take responsibility for the structure of private law principles. Instead they intervene in the markets or their mechanisms only when a political imperative requires a targeted change, with a particular practical objective in view. Overall, the common law approach reflects an intellectual preference for a pragmatic or empirical reasoning and governance—both in the courts and in the executive/legislature—over theoretical or systematic approaches.

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were developed further, for instance emphasising the legal concepts of private autonomy and freedom of contract in the BGB (see C. Schubert*, Muenchener Kommentar zum BGB*, 8th edn (2019) Beck, § 242, recitals 15 *et seq.* on the development of the principle of good faith (*Treu und Glauben*) pursuant to section 242 BGB).

44 Roman law also formed the conceptual basis for certain elements of the common law, as described by Bracton in *De legibus et consuetudinibus Angliae* (c. 1235), although how far he correctly outlined English law is disputed. Blackstone's *Commentaries on the Laws of England* (1765–9) followed the conceptual scheme for private law contained in Justinian's *Institutes* of 533 AD, but not the substantive Roman law.

45 In the French context, it has been observed that "Napoléon sought a code that was so clear, complete, and coherent that there would be no need for judges to deliberate publicly about which laws, customs and past experiences apply to new, evolving situations. Furthermore this approach required a high degree of procedural formalism to reduce the discretion of judges": Beck and Levine, *Legal institutions and financial development* (2003) World Bank Policy Research Working Paper no. 3136. The German approach was less immutable and designed more to evolve, rejecting the "revolutionary zeal and antagonism towards judges that shaped the Napoleonic code", Beck and Levine, *ibid.* Indeed, where statutes use broader and ambiguous terms, case law has developed over time (*e.g.* the requirement that contracts may not violate public policy, section 138 of the BGB).

46 Mahoney, *The Common Law and Economic Growth,* fn 58 below.

47 An interesting contrast arises between those states which, historically, accepted the Roman law concept of *non liquet* ("it is not clear")*,* which holds that where there is a gap or lacuna in the law the judge may abstain from granting judgment, and those which did not. The Prussian Civil Code of 1794 required judges to seek guidance from a legislative committee if the wording of the Code was indistinct. The Civil Codes of France and Switzerland reject such a possibility. Thus, for instance, Article 4 of the Napoleonic Civil Code provided that a judge who refused to pronounce judgment "under pretext of the silence, obscurity or insufficiency of the law" would be prosecuted for a denial of justice. This Article is still in force.

48 Unlike the common law, the codes are given timeless application, and judicial decisions seek always to apply the codes in any of the circumstances that arise. There is no rule of precedent, since the law is not intended to arise from judicial decision-making but from the code itself.

The code-based civil law's top-down approach provides for a deference to centralised authority.[49] As the situation has evolved,[50] the state is not there to uphold the free legal decisions of its citizens but is instead essentially there to direct them, and especially to direct the economy.[51] This thinking, which is reflected in the EU's financial services law system, was evident in continental Europe decades before the EU was formed, with concerns expressed as to the *laissez-faire* English system and the need for a more legally controlled economic arrangement.[52] In broad terms, the civil law system and the approach which underpins it can make for a controlled industrial economy.[53] Nowadays, the prescriptive nature of the civil law system for financial services law, which is a mixture of private law and regulatory law, makes for an unnecessarily restricted and ossified financial market. Thus, although the civil law system might be seen to work adequately for various areas of life, including the law of property (legal ownership), delict (legal wrongs) and other *ex post* remedies which seek to allocate losses after an event has occurred, it does not work so well in encouraging complex market commitments, particularly those where the participants wish to participate in the market in and of itself, detached from the underlying functioning of the rest of the economy. President Sarkozy of France expressed traditional civil law reasoning when he declared that the purpose of the financial markets was to assist broader economic activity.[54] He did not address their role in providing an efficient source and store of capital for whatever uses the participants demanded. The mismatch between such thinking and the pragmatic common law method could also be detected in the EU's approach to the Brexit negotiations with the UK over how to

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49 Apart from through the code-based approach itself, this can be seen in some of the sentiments expressed when the codes were produced. It has been said that "the political mechanism holds that the civil law has tended to support the rights of the State": Beck and Levine, *Legal institutions and financial development*, World Bank Policy Research Working Paper no. 3136 (2003). In procedural terms the ordinary courts in a civil law jurisdiction typically have no authority to review government action. In France, the relevant statute is unchanged from 1790: "[j]udges shall not, on pain of forfeiture, interfere in any manner whatsoever with the operation of the [government], nor shall they summon administrators to appear before them by reason of their functions": Law of 16 and 24 August 1790 on judicial organisation, Article 13 (original in French: "Les juges ne pourront, à peine de forfaiture, troubler, de quelque manière que ce soit, les opérations des corps administratifs, ni citer devant eux les administrateurs pour raison de leurs fonctions"). Substantive administrative law in a civil law system insists that the courts intrude as little as possible in the administration's pursuit of the public interest, albeit there are variations in degree to which this is the case. For instance, the administrative law courts intervene more in Germany than in France: Brown, Bell & Galabert, *French Administrative Law*, 5th edn (1998) Galabert, 46. The German administrative court system proceeds from a desire to subject administrators to external control. The German constitution provides for the independence of judges, who cannot be reassigned without their consent: *Grundgesetz*, Article 97. For that reason Hayek (fn 61 below) thought the German civil law system more conducive to individual liberty than its French counterpart.

50 German business law (based on a civil law code) initially had only a few, high level restrictions on what contracts would be permissible, eg a concept of fair dealing and a prohibition of violating other mandatory laws: Moritz & Kuhn, *Legal implications of flexibility in business contracting from the German perspective: Control of standard terms and conditions and the choice of law*, in *Flexibility in Contracting,* eds Nystén-Haarala, Barton, Kujala (2015) 2 Lapland Law Review 98, https://www.ulapland.fi/loader.aspx?id=aeeefda4-1780-4d88-8cbb-c100ac2fdd8a. Many of today's restrictions are derived from statutes and regulations that have been imposed on the original civil law system that in and of itself has not significantly changed.

51 It is possible that there are differences between the style of direction for those systems which are based on the German approach and those based on the French approach. Such considerations are beyond the scope of this publication.

52 The fact that this controlling approach is at odds with the *laissez-faire* English common law system was interestingly explained in the *Europäische Wirtschaftsgemeinschaft*, Berlin 1942, Funk, Jecht, Woermann, Reithinger, Benning, Clodius and Hunke. In this paper, Funk (pamphlet 1) attacked the Anglo-Saxon system as one which Germany (and others) had not in his view benefitted from, criticising the basis of the system (as he saw it) in the philosophy of Hobbes, Hume and Ricardo. See, for English translation: http://www.jar2.com/Files/Nazism/The_Europeische_Wirtschaftsgemeinchaft_Berlin_1942.pdf

53 In fact this is an embedded way of thinking, as was reflected in Funk's writings in 1942 (fn 52 above), when he said, under the heading "Directing of the Economy by the State and Work between the States of the Community", "[t]he objective remains to allow a particular achievement to be rewarded with an appropriate increase in profit and to stop cost wasting from taking its place." Of course the common law system could in principle be used for similar control, in that legislation can be passed which controls activity, which has happened to a degree for instance in the environmental sector (with the Environmental Protection Act 1990 and the Climate Change Act 2008, for example) and financial regulation (with the Financial Services and Markets Act 2000). Yet this is when legislation is deliberately crafted to do so in a manner thought fit at the time, reflecting a political decision emanating from the legislature of the day. If these restrictions are removed, the position reverts to the permissive default of the common law case law system.

54 In a speech at the French Embassy in New Delhi, M Sarkozy declared that "The point of a financial system is to lend money for economic activities, which, in turn, generate profits [...] it is not to go and speculate on different activities which create enormous flows and profits in a few hours": https://www.reuters.com/article/us-socgen-sarkozy-rules/finance-system-out-of-its-mind-frances-sarkozy-idUSL2666500320080126?sp=true.

provide for future trading relations[55] and an invisible border on the island of Ireland. The UK proposed various procedural solutions for the Northern Ireland border,[56] whereas the EU insisted on conceptual ones.[57]

Furthermore, the legal uncertainty implicit in the civil law method, because it is based on general principle rather than on precedent and practicality, does not go away once an activity has been carried out. The civil law systems accept innovations after the event and on their own terms through legislative change, but they do so slowly in comparison with the speed of business developments and in a way that addresses business practices current at the time of the legislation rather than those that subsequently evolve. It is a cumbersome method.

Which is better? There is evidence that, at least when properly applied, the common law correlates with better economic results and more developed and liquid financial markets, and hence more financing for the economy as a whole.[58] The cause of that could perhaps be its weighting towards

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55 The EU proposed that EU law (as interpreted by the CJEU) should apply to UK subsidisation and incentive policies (through the EU's State aid regime) and also to environmental and employment matters. These were contained in the so-called "Northern Ireland backstop" contained in the agreement between the government of Theresa May and the EU, prior to being amended by the subsequent government of Boris Johnson. Those arrangements applied to the whole of the UK and not just to Northern Ireland. Similar arrangements were also proposed by the EU negotiators for the future long-term relationship after the end of 2020, in discussions with the UK during the transition period: *e.g. Barnier shows controversial draft UK deal to EU members*, 13 March 2020, Euractiv.com, https://www.euractiv.com/section/uk-europe/news/barnier-shows-controversial-draft-uk-deal-to-eu-members/. This is despite the fact that as a matter of law such arrangements are entirely unnecessary. See, for instance, James Webber, *All Change? UK State Aid after Brexit: What Law? Whose Courts?* (2020) Politeia, https://www.politeia.co.uk/wp-content/Politeia%20Documents/2020/12.02%20James%20Webber%20All%20Change%3F%20State%20Aid/%27All%20Change%20UK%20State%20Aid%20after%20Brexit%20-%20What%20Law%20What%20Courts%27%2C%20James%20Webber.pdf.

56 The UK Government proposed "alternative arrangements" for an invisible border, based on existing customs and trade technologies: see *e.g.*, *Johnson proposes replacing backstop with alternative arrangements*, 19 August 2019, The Irish Times, https://www.irishtimes.com/news/world/uk/johnson-proposes-replacing-backstop-with-alternative-arrangements-1.3991208.

57 The EU negotiators insisted on applying EU law standards for goods and agriproducts in Northern Ireland and for EU State aid law to apply across the UK, in so far as it had an effect on trade across the north-south border on the island of Ireland. This law is to be interpreted by the CJEU. Other solutions were rejected, *e.g., EU rejects Boris Johnson's Brexit backstop plan*, 20 August 2019, Politico, https://www.politico.eu/article/tusk-slams-lack-of-realistic-alternatives-on-brexit-backstop/. The UK-EU Withdrawal Agreement of October 2019 (effective February 2020) applied this solution through a so-called "Northern Ireland Protocol". The strength of the desire for conceptual purity can be seen in the fact that the EU regarded its solution as acceptable even though it is inconsistent with UK sovereign rights over Northern Ireland (and it is therefore of dubious enforceability) as well as the democratic rights of the people of Northern Ireland, who would have no say in making or changing laws applicable to them, except every 4 years in retrospect. It is thus contrary to Article 3 of Protocol 1 of the European Convention on Human Rights 1950 (the right of people to participate in elections to their legislature) as Northern Ireland citizens will not have any voting rights in EU institutions - a point that was confirmed in a case involving Gibraltar: *Matthews v UK*, App. 24833/94. A proposal for the enforcement of each other's tariff and goods/agriproducts standards, behind the borders, has so far been ignored: see J. Webber, B. Reynolds *et al.*, *Replacing the Withdrawal Agreement: How to Ensure the UK Takes Back Control on Exiting the Transition Period* (2020) Centre for Brexit Policy, Chapter 2 ("Step 2"), https://centreforbrexitpolicy.org.uk/wp-content/uploads/2020/07/REPLACING-THE-WITHDRAWAL-AGREEMENT-How-to-ensure-the-UK-takes-back-control-on-exiting-the-transition-period-12-July-20.pdf and more generally. There is an old joke, often referencing German or French thinking, which goes: "that works very well in practice, but how does it work in theory?"

58 See Cross, *Identifying the Virtues of the Common Law* (2007) 15 Supreme Court Economic Review 21; Graff, *Law and Finance: Common Law and Civil Law Countries Compared: An Empirical Critique* (2008) 75 Economica, New Series, 60; Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, *The Economic Consequences of Legal Origins* (2008) 46 Journal of Econ Lit 285 and Mahoney, *The Common Law and Economic Growth: Hayek Might Be Right* (2001) 30 Journal of L Studies 503 which presents evidence that common law countries experienced faster economic growth than civil law countries during the period 1960–92, approving Friedrich A Hayek's observation (in *Law, Legislation and Liberty: a New Statement of the Liberal Principles of Justice and Political Economy* (1973) Routledge, at 94), that "the ideal of individual liberty seems to have flourished chiefly among people where, at least for long periods, judge-made law predominated". And see the *Commonwealth Growth Monitor*, showing higher growth data in the Commonwealth than the Eurozone during 1971–2016: https://www.worldeconomics.com/papers/Commonwealth_Growth_Monitor_0e53b963-bce5-4ba1-9cab-333cedaab048.paper.

freedom of contract,[59] its respect for contract and property rights,[60] its association with limited government,[61] its greater legal predictability (due to the use of the case law system of precedent),[62] its different regulatory approach including its protection of non-controlling investors,[63] or the fact that judge-made law tends to be more immune from the influence of interest groups and the detriments those can bring.[64] Economic research has also shown that the common law's decentralised judicial law-making power leads to more stable levels of fiscal inflation over time.[65] Furthermore, common law systems tend to spawn more innovative outcomes.[66] The phenomenal recent successes of US technology businesses such as Apple, Facebook, Amazon, Netflix and Google cannot be seen of themselves to be due to the common law, but the US's essentially common law framework is likely to have provided considerable support,[67] as in fact key business owners have attested.[68] In the UK, the role played by the common law in cementing London as the first global financial marketplace in the nineteenth century and in facilitating the Industrial Revolution in Great Britain in the eighteenth and nineteenth centuries, has yet to be fully investigated by scholars.

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59 See eg RH Coase, *The Nature of the Firm* (1937) 4 Economics (ns) 386; Coase, *The Problem of Social Cost* (1960) 3 Journal of Law & Econ 1.

60 Eg Daren Acemoglu and James Robinson, *Why Nations Fail: The Origins of Power, Prosperity, and Poverty* (2012) Crown. See also La Porta et al, *The Quality of Government* (1999) 15 Journal of Law, Econ & Org at 261–2. Cross, *Identifying the Virtues of the Common Law*, fn 58 above, notes (pp. 504–5) that the "English common law developed as it did because landed aristocrats and merchants wanted a system of law that would provide strong protections for property and contract rights and limit the Crown's ability to interfere in markets. French civil law, by contrast, developed as it did because the revolutionary generation, and Napoléon after it, wished to use state power to alter property rights and attempted to ensure that judges could not interfere." The strong emphasis on property and contract that characterises private law sometimes gives way in a civil law system's public law regime to a concern for preserving the government's freedom to pursue collective ends: Szladits, fn 151 below, at 176.

61 Various writers have attributed the common law's success to its association with limited government and through greater security of property and contract rights: eg Mahoney, *The Common Law and Economic Growth,* fn 58 above. See also Hayek, *Law, Legislation and Liberty,* fn 58 above, and *The Constitution of Liberty* (1960) University of Chicago Press, where he indicated that the common law was associated with fewer government restrictions on economic and other liberties, and it is superior to French law because of differing assumptions about the rules of the individual and the state—he saw the English model (derived from Locke and Hume) as emphasising the individual's freedom to pursue individual ends, and the French model (derived from Hobbes and Rousseau) as emphasising the government's freedom to pursue collective ends. See also La Porta et al, who noted that "[a] civil legal tradition… can be taken as a proxy for an intent to build institutions to further the power of the State… A common law tradition… can be taken as a proxy for the intent to limit rather than strengthen the State", *The Quality of Government* (1999) 15 Journal of Law Econ & Org 222 at 232. That said, it has been validly pointed out that Hayek's doctrine of spontaneous order does not necessarily lead to freedom—as Hayek himself accepted in *The Road to Serfdom* (1944) University of Chicago Press, and his lectures on *"The Political Ideal of the Rule of Law"* delivered in Cairo in 1955. Hayek's later theory of social evolution is contestable and may not be correct.

62 Cross, *Identifying the Virtues of the Common Law*, fn 58 above.

63 Eg Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *What Works in Securities Laws?* (2006) 61 J Finance 1; Priya P Lele & Mathias M Siems, *Shareholder Protection: A Leximetric Approach* (2007) 7 J Corp L Studies 17.

64 Mancur Olson, *The Rise and Decline of Nations: Economic Growth, Stagflation and Social Rigidities* (1984) Yale University Press.

65 Daniel Treisman, *Decentralisation and Inflation: Commitment, Collective Action or Continuity* (2000) 94 Am Pol Sci Rev 837.

66 J Huddleston, *Technological Mad Libs: How the Common Law Evolves to Embrace Disruptive Technology Despite Legal Technopanic*, 7 August 2017, the Technology Liberation Front (https://techliberation.com/2017/08/07/technological-mad-libs-how-the-common-law-evolves-to-embrace-disruptive-technology-despite-legal-technopanic/) suggests the gradual development of the common law has often produced better results over time for market participants.

67 See *e.g.* A. Chander, *How Law Made Silicon Valley* (2014) 63 Emory L Journal 639, who observes that "[j]ust as nineteenth-century American judges altered the common law in order to subsidise industrial development, American judges and legislators altered the law at the turn of the Millennium to promote the development of Internet enterprise." All of these companies are incorporated under Delaware law (except Apple, which is incorporated in California). One point which is interesting to note about Delaware is this dual benefit of stability (competent judges, deep precedent and so on) and flexibility (arising in part from the unique role of Delaware's Chancery Court, which is a rarity in the American judicial system, and the doctrinal flexibility it offers). See, for instance, https://courts.delaware.gov/chancery/history.aspx.

68 Chander, *op cit.,* fn 67 above, relates an anecdote involving Google's Larry Page and Sergey Brin, who noted that US law afforded significant flexibility, particularly in the area of intellectual property law, to their business. Such flexibility apparently could not at the time be found elsewhere to the same degree as in the US.

1.3 UK regulation – the application of common law methodology

Consistent with the common law approach to the financial markets, the UK's regulators have a bias towards permissiveness, and operate within a broad legal framework that has traditionally been fundamentally accommodating. They do not seek to control the market, or to prescribe particular business structures or operations. The market is seen as having a value in itself and is left to operate in its own manner so long as this is safe. The regulators can even go out of their way to help businesses get started or on new initiatives. For example, the Financial Conduct Authority (FCA) recently showed such leanings in leading the world in setting up so-called "sandboxes" for novel financial technology (FinTech) businesses. The FCA's regulatory "sandbox" provides firms with the ability to test new products and services in a restricted environment in which the FCA provides regulatory guidance, informal steers, waivers and no-enforcement-action letters, allowing firms to test new propositions out with customers in a less officious regulatory space.[69]

Now that we have left the EU the UK's regime has two different sorts of financial firm to consider. First, we have foreign operators, headquartered abroad, including within the EU, selling to or dealing with businesses or consumers in the UK. Those operators could be dealing with the UK cross-border or from local presences established here. The UK system treats those operators quite differently when they are dealing with UK businesses, whether regulated or otherwise, from when they wish to deal with UK consumers, who are carefully protected. Secondly, we also have UK firms selling to the EU and elsewhere.

For the dealings of UK financial firms with international businesses, an important feature of UK regulation is its openness. The UK regulates firms operating in the UK for all their client business, regardless of client location, but does not seek to regulate or restrict the clients themselves. Nor does it regulate market counterparties, located abroad, in their dealings with UK-based financial firms. Unless foreign countries impose their own restrictions, it is often only UK regulation that governs the business undertaken by regulated firms operating from the UK, in respect of customers or market counterparties based oversees, whether businesses or individuals. Other countries can of course apply their own restrictions on dealings with persons located there.

As for those seeking to provide services to UK customers from abroad, UK regulation refers to foreign firms or people as "overseas persons", and typically only requires them to comply with the UK's restrictions on financial promotions - which largely protect UK consumers.[70] The law seeks to ensure UK consumers are looked after and that only appropriate (*i.e.* less complex and risky) products can be marketed or sold to them. It does not otherwise seek to prohibit or restrict the activities of foreign providers, particularly for their cross-border wholesale market activities with UK-based financial firms. The regime is as a result particularly liberal for foreign firms. In fact, it is uniquely so, amongst major financial centres. The underlying notion is that businesses located in the UK, both regulated and unregulated, can look after their own interests in determining whether to buy foreign services or products.[71] This approach attracts an international client base for London firms, and facilitates wholesale cross-border business connections. It also allows capital to flow easily, which is sensible since the flow of money can be difficult to regulate, and global financial participants anyhow find ways

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69 See https://www.fca.org.uk/firms/innovation/regulatory-sandbox.

70 The overseas persons exclusion is provided for in Article 72(7), Financial Services and Markets Act 2000 (Regulated Activities) Order 2001. This provision allows all non-UK firms and individuals—be they EU or non-EU—to access wholesale markets located in the UK, and UK customers, on a cross-border basis without local regulation. The "overseas persons" exclusion applies to a broad range of sectors, including exchanges, clearing, settlement, brokerage, derivatives, agency business and advice. HM Treasury is currently consulting on the future application of the overseas persons regime: HM Treasury, *Overseas Framework: Call for Evidence*, December 2020, https://www.gov.uk/government/publications/call-for-evidence-on-the-overseas-framework..

71 In other words, firms that do not carry on a regulated activity (or offer to do so) from a permanent place of business in the UK are excluded from some of the requirements for authorisation where, in essence, they comply with the UK's financial promotions restrictions, contained in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (SI 2005/1529).

to service market demand.[72] Many countries try to impose restrictions, but these are often overdone, to the detriment of their businesses and consumers. The UK regime is permissive of legitimate business whilst providing a certain amount of protection. It is particularly robust in shielding UK consumers, and significant recent enhancements have been made in that regard.[73] Nevertheless, the lack of unnecessary restrictions means that financial services and products are cheaper for UK consumers.

By contrast, New York is more territorial in applying strong regulation for local activity, and strong restrictions on those seeking to access the US markets from abroad.[74] The position is also highly restrictive in civil law countries like France and Germany. Indeed, one of the reasons they have failed to be more successful in this field is a strong focus on the regulation of foreign service providers, which makes it very difficult even for the largest corporates based in those countries to conduct extensive cross-border business with financial institutions outside the EU.

Nevertheless, UK financial regulation can be prescriptive where it sees fit, particularly for safety and soundness purposes—as can be seen with the approach on some regulatory topics of the Bank of England and the UK's main regulators, the Prudential Regulation Authority (PRA) and the FCA. The UK has played a leading role, along with the US, in developing what became the Basel standards, which arose in 1988 out of a bilateral UK-US agreement (Basel I) designed to promote high standards of regulation and address declining capital ratios.[75] This was prompted by concerns in the early 1980s, with the onset of the Latin American debt crisis, that the capital ratios of the main international banks were deteriorating at a time of growing international risk. Those standards have evolved and form the bedrock for international bank regulation.

The UK's PRA regulates matters fundamental to the viability of banks, large investment firms, insurers, building societies and credit unions, again applying high standards. The UK's FCA[76] is primarily responsible for protecting consumers from malpractice in financial services and providing for specific disclosures to be made to customers, involving higher standards than would normally be required to prevent misstatements in general. In addition, the FCA conducts regular reviews of the financial services sector to identify emerging areas of concern for consumers.[77] Further safeguarding bodies, including the Competition and Markets Authority and the Payment Systems Regulator, oversee consumer protection in other areas of the market. Yet this approach operates within an environment that is instinctively permissive, which is what makes it so intrinsically attractive.

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72 See fn 31 above, in relation to US measures which pushed new "Eurodollar" business to the UK.

73 See Chapter 4, section 4.1 below.

74 *See, e.g., Morrison v. National Australia Bank* 561 US 247 (2010) (claims under Section 10(b) of the Exchange Act of 1934 and Rule 10b-5 can be brought only if investors participated in a "domestic transaction"). In 1993, the US Congress passed the Omnibus Budget Reconciliation Act, which established the principle of "national depositor preference", elevating the claims of domestic depositors on the assets of a failed bank over the claims of foreign depositors and general creditors. The intention of the legislation was to generate cost savings for the Federal Deposit Insurance Corporation (*see, e.g.* J.A. Marino and R.L. Bennett, *The Consequences of National Depositor Preference* (1999) 12 FDIC Banking Review 19).

75 This effort became the agreed international framework for financial regulation for systemically important banks and other financial institutions. It started tentatively to be created with the formation of the Basel Committee on Banking Supervision (Basel Committee) as an international standard-setting forum for central banks and regulators at the end of 1974. In fits and starts, this produced common rules, beginning in 1988 with Basel I, then continuing in June 2004 with Basel II (which was not fully implemented in the US) and now, after the 2007-2008 Global Financial Crisis, adopting Basel III. Basel III has achieved extensive harmonisation in financial regulation across the G20 and beyond. Its core rulemaking focus has necessarily been on banks.

76 The FCA is the prudential regulator for all firms not regulated by the PRA as well as the conduct regulator for all firms, including those prudentially regulated by the PRA. For the meaning of "prudential regulation", see fn 172 below. The FCA Handbook sets out the rules by which the FCA regulates financial services firms, and grants powers for the FCA to intervene and impose sanctions where it finds evidence of rule-breaking. See https://www.handbook.fca.org.uk/handbook.

77 See, for example, the FCA's 2020/2021 Business Plan, which identifies consumers' ability to make effective investment decisions and the operation of consumer credit markets as focus areas for the FCA over the next one to three years: https://www.fca.org.uk/publication/business-plans/business-plan-2020-21.pdf.

In an attempt to replicate the fact that, in the common law, principles which emerge from the case law assist in the application of common law rules arising from precedents, the UK regulators have defined in their regulations a handful of fundamental so called "Principles" of good conduct which they expect regulated firms to observe. The Principles are high level and comprise concepts such as "integrity", treating customers "fairly", "due skill, care and diligence", acting "in a prudent manner" and "proper standards of market conduct".[78] The approach was intended to assist in interpreting specific regulations and to fill in any obvious gaps between particular regulatory rules, so as to avoid the necessity for an exhaustive rulebook. These Principles, as they have come to be used, are to be contrasted with the wider range of principles arising from the common law case law, which generally only assist in applying the law and in developing common law rules. The regulators use their Principles liberally and often on a stand-alone basis in their enforcement actions, when determining and punishing inappropriate conduct by regulated firms. They regularly refer not to specific rules when bringing such actions, but instead to the Principles alone. It has to be admitted however that this technique of regulating and admonishing firms is not sufficiently certain and fails to draw sufficiently on the techniques of the common law. As explained in Chapter 4, section 4.2 below, the enforcement of the Principles on a stand-alone basis has introduced a level of uncertainty as to permissible action which has affected detrimentally the common law basis for the financial system. While the making and use of Principles is sensible, the approach to using them needs to be improved upon by the UK after Brexit, with a view to greater legal clarity for business. In addition, the drag of EU-made financial services law should be removed. But, despite this, the benefits of the overall UK system are clear. The general approach can be seen in a not dissimilar form in the US for regulators such as the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).[79]

1.4 Common law and code-based civil law - a problematic coexistence?

The differences in approach and method mean that although the common law and civil law codes coexist on a mixed basis in some states, they can be difficult to reconcile unless the areas in which each applies can in some way be separated. For although the common law and code-based civil law systems can achieve similar results, their method is different. The difference between the systems extends beyond their basic method to specific legal techniques. Furthermore, the underlying differences in philosophy mean there are constant and significant divergences of reasoning. The combining of the regimes is discouraged by the civil law's use of codification and the common law's use of judicial precedent. Each of the common law and civil law systems seeks to be comprehensive, using its own approach and method of reasoning throughout its autonomous structure. This can be seen in a limited number of jurisdictions in which major integration or change was attempted. So, for instance, Louisiana, which inherited the French civil law system,[80] refused to accept Article 2 of the Uniform Commercial Code (relating to sale of goods),[81] which was adopted by the other US states (who operate under the common law system and whose drafting is based on the common law approach). Moreover, an attempt in Louisiana to change from *jurisprudence constante* to the common law approach of *stare decisis*, which underpins the common law's system of judicial precedent, ended up failing.[82] Similarly, it is said that Quebec, which also operates a legacy French civil law system,[83] seeks to maintain the "entire integrity"

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[78] See the PRA's "Fundamental Rules" and the FCA's "Principles for Businesses".

[79] But the UK system has been compared favourably to that in the US: see the report by management consultancy McKinsey & Co, *Sustaining New York's and the US' Global Financial Services Leadership* (Jan 2007), pp 16–17, which makes the point that many regard the US system as less fair and predictable than the UK system, with frivolous litigation and penalties that are arbitrary and unfair. It observes that the UK system is regarded as superior, less complex, more measured, responsive, results orientated and effective than the US system: http://www.nyc.gov/html/om/pdf/ny_report_final.pdf.

[80] The Louisiana Civil Code was drafted locally and stems from the 1800 Draft of the Napoleonic Code.

[81] The Uniform Commercial Code is in part drafted taking into account the background of pre-existing common law and equitable principles. Its focus on commercial considerations and practicability also makes it more flexible than the continental European codes.

[82] *Jagers v Royal Indemnity Co* 276 So.2D 309 (La. 1973); A Tate Jr, *The Role of the Judge in Mixed Jurisdictions: The Louisiana Experience* (1974) 20 Loyola LR 231.

[83] The Civil Code of Quebec, originally adopted in 1866 and subsequently replaced in 1991, was largely based on and inspired by the Napoleonic Code of 1804.

of the Civil Code.[84] It is the codes that make integration difficult. Codes are also complemented and sometimes modified by statutes. Over time, more and more provisions tend to be added. The more detailed the provisions, the harder it is to change them. So the detailed provisions of the BGB on delictual liability made it difficult to change to stricter liability.[85] By contrast, in those cases such as that of Scots law, where the civil law element is uncodified and can be traced back historically to somewhat inaccessible and frequently contradictory old authorities, the benefits of stability were obtained through jurisprudence and a relatively strict rule of judicial precedent.[86] For them the assimilation of elements of the common law, sometimes with the benefit of statutory reform,[87] has been relatively easy.

1.5 The legal foundations for success

The common law achieves the delicate balance between permissiveness and legal certainty. It is not the common law's permissiveness alone which is responsible for its success with financial services. It would be possible in theory to draft and apply civil law codes in a highly permissive manner. For a successful legal framework, more is required. It must be possible for private sector practitioners to determine in advance, with considerable certainty, whether particular innovations are likely to be permitted or not. And they must be able to do so in a highly dynamic environment and in highly complex scenarios. At the same time, it is also critical that the law unfolds in a predictable and pragmatic fashion.

It is the methodology behind the common law that is in fact the principal reason for its success. Its predictable yet evolutionary approach, facilitates innovation; and this can be seen from practical examples of how the common law has facilitated new financial activity and innovations and continues to do so. The common law looks after things in its own way by placing its faith in individual judges. In the code-based civil law systems what you find is a sophisticated attempt to lay down clear legal principles and rules, but in the end even well-drafted codes cannot deal with all eventualities. The system leaves judges and academics to try to fill in the gaps, without allowing them to alter the underlying rules or statements of principle and despite the fact that the provisions can turn out to be at odds with a sensible outcome. The result is ultimately unstable for businesses and consumers.

The English common law - precedent and predictability, innovation and risk management

The common law has managed to meld business-friendly, pragmatic and predictable decision-making with an ability to evolve. It has done this through incremental law-making, a sophisticated judiciary which is empowered to develop the law, a willingness to allow contracting parties to create their own legal framework and a limited role for legislation, with clearly drafted statutes.

Precedent and predictability

The English common law operates by the development of precedent, which defines the law in specific, practical detail while allowing for incremental change.[88]

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84 R Cuming, *Perspectives On the Harmonisation of Law in Canada* (1985) University of Toronto Press 1–58.

85 Zweigert & Kötz, *An Introduction To Comparative Law*, trans Weir, 3rd edn (1998) OUP, chs 40-2.

86 See V.V. Palmer, *Mixed Systems Worldwide – The Third Legal Family*, fn 8 above.

87 Such as, in the case of Scotland, by the Sale of Goods Act 1893 and the Companies (Floating Charges) (Scotland) Act 1961. Both have been replaced by later legislation, but it was those Acts that brought about very significant changes that enabled Scotland to escape from its civil law principles and operate on level terms with England in what was then a UK single market. The fact that Scotland was able to absorb these changes without difficulty shows how very different its civil law system is from those jurisdictions that adopted the code-based system derived from the Napoleonic Code.

88 Many of the core elements of this methodology have been explained on numerous occasions, recently for instance in an article by Sir Philip Sales: *The common law: context and method* (2019) 135 LQR 47. The US common law system deploys looser reasoning and is less forensically precedent-based than the UK system, but is nevertheless based on precedent: see *e.g.* MNS Sellers, *The Doctrine of Precedent in the United States of America* (2006) 54 Am J Comp L 67.

Judicial decisions. Judicial decisions, arising from cases, cite and apply relevant areas of the law, deploying the principles and rules gleaned from decisions previously made (precedents) to the instances before the court. General principles and specific rules emerge from a cumulation of decisions. Judicial reasoning typically proceeds by identifying and applying those principles or rules that are seen to be inherent in the case law, or by reasoning by analogy from one decision to another. The accumulation of case law precedents provides a detailed understanding of the operation of the law. The cases arise from decisions on real-life situations, which promote predictability by showing in practical terms how the law operates. The decisions, including their reasoning, are recorded and published, serving as precedent for future cases.

The judiciary have a duty to seek for consistency. They examine previous decisions when deciding each case and apply "[t]he obligations imposed by precedent", which "underpin the obligation on judges to act impartially and the requirements of the rule of law that one treats like cases alike and different cases differently."[89] They often make wider comments about the architecture of the relevant areas of law. However, only the decision on the facts binds future first instance courts of equal or lower status—the so-called *ratio decidendi*. All other statements—*obiter dicta*—are non-binding and merely assist future courts, legal advisers and commentators in determining the potential future direction of travel of the law.[90]

Reasonableness. Predictability is enhanced by a number of further factors. These include the fact that the system seeks to achieve reasonable outcomes that are accepted by the parties to the disputes it resolves and by legal advisers and commentators. In a financial and commercial context this involves considering business expectations. In addition, decisions that are made benefit from the court having heard adversarial argument[91] on behalf of the parties themselves,[92] in a way that nevertheless means the system is still comparatively efficient, in that judges make relatively quick decisions[93] compared to those in many places elsewhere. Furthermore, the system generally operates in a manner which overrides any judicial idiosyncrasies. The cumulative weight of case law precedent, to which any single decision only generally contributes to a small degree, constrains individual judicial choice. So, although individual judges can have a significant impact on the evolution of the common law,[94] their power in applying and developing the law is limited by that of the other judges. As a result the law has no single architect.

Self-executing. The overall approach enables the law to be seen as largely "self-executing" in that financial market participants can determine with some accuracy the likely future decisions of the courts and the legal implications of proposed activities.

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89 Lord Hodge, Justice of the Supreme Court of the United Kingdom on 28 October 2019 at the Max Planck Institute of Comparative and International Private Law Hamburg, Germany. See also *June Medical Services L.L.C. v. Russo* 591 US __, 140 S.Ct. 2103, 2134-35 (2020) (Roberts, C.J. concurring in judgment) ("It has long been 'an established rule to abide by former precedents, where the same points come again in litigation; as well to keep the scale of justice even and steady, and not liable to waver with every new judge's opinion.'") (quoting W. Blackstone, *Commentaries on the Laws of England* (1765) Vol 1, 69.

90 Exceptionally, *obiter dicta* can be relied upon. So, the Court of Appeal held that the Supreme Court's repudiation of the test for dishonesty laid out previously by the Court of Appeal in *R v Ghosh* [1982] EWCA Crim 2, [1982] QB 1053, through *obiter dicta* of the Supreme Court in its decision in *Ivey v Genting Casinos (UK) Ltd* [2017] UKSC 67, [2018] AC 391, should bind the Court of Appeal, avoiding the need for an appeal to the Supreme Court: *R v David Barton and Rosemary Booth* [2020] EWCA Crim 575, [2020] All ER (D) 173 (Apr). This decision of the Court of Appeal in *R v Barton* is not without controversy, in that the Court of Appeal treated *obiter dicta* in the Supreme Court as if they had a quasi-legislative effect. Such an approach needs careful handling so as not to have adverse implications for *stare decisis*.

91 The common law's adversarial system "tends to result in the survival of efficient, and the demise of inefficient rules", Mahoney, *The Common Law and Economic Growth,* fn 58 above, p. 506.

92 Civil law systems leave the judges to assemble the record and determine the issues.

93 Civil systems are characterised by extensive interlocutory review.

94 Examples are numerous and include noted names such as Lord Mansfield, Lord Blackburn, Sir George Jessel, Lord Esher, Lord Reid, Lord Denning, Lord Diplock, Lord Wilberforce and Lord Bingham.

Innovation and risk management

Yet the system has an ability to evolve, which allows for developments that are rapid and responsive to facts when needed, and thoughtful and measured when circumstances develop more slowly. New decisions can mean that legal principles and rules are reformulated (by judges, in further cases, as well as legal commentators) to reflect the new precedents. Mechanisms for legal change also include the ability of senior courts to overrule earlier decisions[95] or allowing inefficient rules to fall into disuse. The publication of minority judgments (often absent from civil law systems[96])—and their potential persuasiveness—helps to create predictability in changes in judicial opinion over time.[97]

Evolutionary – the example of equity. One particular evolutionary technique has arisen through a body of case law known as "equity", which historically sought to mitigate what would otherwise be harsh results arising from the more traditional common law case law system. It developed alongside the traditional common law system after the Reformation.[98] Equity was initially administered in different courts, until the court system was fused in the 1870s.[99] It has produced concepts of critical utility to the financial markets such as the trust and the lesser "fiduciary duty".[100]

The trust. The law of trusts is particularly notable in that it currently plays a key function in commerce and many financial business structures, by allowing for the creation of different types of interest in property, which are then protected in an insolvency. Trusts originally developed as an addition to common law rules on property, and enable the beneficial interest in property to be separated from the legal interest in it. A key aspect of trusts is the ability to protect and limit the exposure of assets to creditors and other claimants in cases where either the settlor or the trustee becomes insolvent. Another aspect of the trust is that, by separating the legal interest from the beneficial interest and making beneficial ownership subject to rules set out in the trust instrument, the trust affords its users a great deal of flexibility in designing how and on what terms beneficial ownership is to be enjoyed. These features have resulted in the widespread use of trusts in mainstream financial commerce, for example in company pensions schemes (*e.g.* defined benefit pensions), funds (*e.g.* unit trusts in the UK) and

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95 Senior courts can overrule in explicit terms past decisions of subordinate courts and sometimes substitute their own decisions, which is a feature which has become more common in both the US and UK in the last three decades. *E.g.* in *Re Nortel; Re Lehman* [2013] UKSC 32, [2014] AC 209 the Supreme Court overturned precedents to decide that statutory pensions liabilities were provable debts in an insolvency, ranking alongside other unsecured, non-preferential, claims. Common law courts are not afraid to do this if the reasoning used is unacceptable or social circumstances have changed.

96 However, Spain has permitted dissenting judgments in the ordinary courts since 1985 and Germany allows it in some courts. Also, international courts, but not the CJEU, allow minority judgments, as do most arbitral tribunals. Until recent decades the Judicial Committee of the Privy Council insisted on a single court judgment.

97 A further advantage of minority opinions is that they contribute to focusing the analysis of the authoritative part of the judgment on the facts of the case and thus avoid the risk of negotiated statements of general principle by judges who disagree—with a damaging effect on the predictability of how they will be applied in practice.

98 The case law of both equity and the traditional common law are referred to here as comprising the "common law".

99 Supreme Court of Judicature Acts 1873 and 1875. Equity and the common law have been said to be now part of the same river: see *United Scientific Holdings Ltd v Burnley BC* [1978] AC 904, 924-5 (Lord Diplock). However, both remain substantively separate, although in most cases procedurally joined. In some jurisdictions, equity has retained more of a separate identity. New South Wales had an active Chancery Court until 1972, with a reform to the Supreme Court Act 1970 (NSW) that empowered both the Equity and Common Law Division of the Supreme Court of NSW to grant relief in either equity or common law. In 1972 New South Wales also adopted one of the essential sections of the Judicature reforms, which emphasised that where there was a conflict between the common law and equity, equity would always prevail. Delaware still has a chancery court, which "has jurisdiction to hear and determine all matters and causes in equity" (10 Del. C., 369).

100 In addition, equity provides remedies such as injunction and specific performance, used to stop a party from doing something or to direct a party to do a specific act, where the common law remedy such as damages could not provide a practical or adequate solution. These two equitable remedies give rise also to property interests, based on the reasoning that a party entitled to a particular remedy can in some circumstances proceed as if it had been granted. Thus an option is a contract that creates an equitable interest over land because the holder is entitled to specific performance of the promise to transfer even against people with whom they have no contract. An injunction can create a negative restriction binding land (restrictive covenant) because the beneficiary is entitled to enforce against a person with whom they have no contract but who ignores the restriction. (Neither remedy is enforceable against *bona fide* purchasers.) Some rights protected in equity in the three ways (trust, option, covenant) are quite like rights *in rem* in the civil law sense, and it is indeed arguable whether they should be so called.

asset securitisation structures. Another example of the use of trusts in financial services is the *Quistclose* trust, recognised in the eponymous case in which a bank which had lent monies to be used for a specific purpose was held to have a beneficial interest in trust in those monies requiring their application only for the specific purpose.[101] The financial services sectors under code-based[102] civil law systems are notably less flexible as a result of the lack of this structural tool.[103] In code-based civil law systems, there are concepts related to the trust, such as foundations, but they tend to be used mainly for preserving and managing family wealth, rather than in general commerce.[104]

A key role for the judiciary

Clarity as to the application and, on occasion, accretion of the common law rests on judicial decisions and the quality and cogency of the reasoning used in those decisions. The UK's approach to the common law is founded on a strong and respected judiciary.[105] Much of it has considerable business expertise and experience. For England and Wales there is a Commercial Court[106] that is well versed in financial and commercial cases. In 2015 a separate, specialist system was introduced—called the "Financial List"—to which complex financial markets cases in the High Court can be transferred when they are of high value or raise market issues. The list seeks to provide a faster and more efficient forum for financial dispute resolution, using specialist judges.[107] In addition, there is a deep pool of specialised practising lawyers with knowledge of the practicalities of financial business. They are trained and able reliably to predict likely judicial decisions in easy, complex and most difficult situations. A vibrant legal academy and press continually evaluate judicial decisions and subject them to scholarly and public scrutiny.

Judicial appointments are usually made from among the ranks of practising barristers and solicitors, affording a continuity of legal thinking between those practising and the bench. This approach enhances consistency in judicial thinking. It also ensures that judges and their law-making benefit from practical experience and are attuned to the realities of finance and commerce. The system avoids the criticism of a lack of neutrality which the sometimes quasi-political appointments in civil law jurisdictions can draw, especially, for instance, for the *Conseil Constitutionnel* (with its appointments of former politicians),[108] although the US Supreme Court is open to the same criticism to some degree. The UK's Constitutional Reform Act 2005 established a new "Judicial Appointments Commission",[109] intended further to protect against any politicisation of the appointment of judges.

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101 *Quistclose Investments v Barclays Bank plc* [1968] UKHL 4, [1970] AC 567.

102 The point does not necessarily arise for uncodified civil law systems. For instance, Scots law has the trust, and most results on Scots commercial law issues are not dissimilar to those of the English law system. The origin is somewhat obscure, if one is trying to find a civil law basis for the notion. *Fideicommissum*, a Roman doctrine, is a possibility. The contracts of mandate and deposit are others: see *Cuningham v Montgomerie* (1879) 6 R 1333 at 1337. But English influence has been there too. Attempts to define the trust in Scots law terms are regarded as not wholly satisfactory by some academic commentators. The concept was however recognised by judges by at least the middle of the 19th Century, and reinforced by statutes starting with the Trusts (Scotland) Act 1921. This is not the place to delve into why Scots law has not taken off to the same degree as English law on international matters.

103 Many civil law systems seek to achieve similar outcomes through their insolvency regimes. However, this is likely to be an after-the-fact adjustment which does not always provide the same protections. A further limitation is that a party has no choice over which insolvency regime will apply to a counterparty's assets since the law of the place of incorporation of the counterparty will ultimately prevail.

104 There are other, occasional constructs which mimic certain (but not all) functional aspects of the trust—for instance *la fiducie* in Luxembourg and the *Anstalt* in Liechtenstein, but again they are not put to widespread use.

105 Mahoney investigates this empirically and finds that common law nations have a judiciary that scores higher on an "efficiency and integrity index": *The Common Law and Economic Growth,* fn 58 above, at 519–521.

106 Formally a sub-division of the Queen's Bench Division of the High Court.

107 https://www.judiciary.uk/you-and-the-judiciary/going-to-court/high-court/courts-of-the-chancery-division/financial-list/. See also the Guide to the Financial List available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/644030/financial-list-guide.pdf.

108 The French *Conseil Constitutionnel* is exceptional for the number of former politicians who have been appointed to it over the years.

109 Section 61.

Overall, it is in the role of judges that is found one of the key differences between common law and civil law systems. In common law countries judges play a substantial and independent role in the evolution of the law and its enforcement in the context of the resolution of disputes. Officially, judges play no role in either context in civil law countries.[110] In common law countries, the autonomous judiciary limits government action by providing an independent check and balance. The law is shaped by multiple judicial decision-makers, each adding to the law or stopping particular developments.[111] The role of the judges in developing the law provides a check on the state, making it more difficult for any political grouping to align the entire system behind a single policy and bringing stability.[112]

The US system differs from that of the UK for judicial appointments and its use of jury trials. In the US, federal judges are appointed with life tenure. This is similar to the UK in that the UK's higher court judges are generally immovable, except in extreme circumstances.[113] However, not all US state court judges have life tenure and, following the Jacksonian revolution,[114] some state court judges may be elected. As a result, they can be influenced through approaches such as campaign contributions and the same electoral pressures that confront the legislators.[115] In addition, as has already been stated, juries can be used in most financial and commercial matters in the US.[116] Juries are not used in most civil proceedings in the UK.[117] Yet, despite these differences, as a general matter the US system is very similar to that of the UK.

The sanctity of contracts

An important feature of the common law for financial transactions is its emphasis on the protection of the expectations of the parties as determined by the wording of the contracts to which they have

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110 Members of the *Conseil d'État* in France have been consulted on prospective legislation.

111 Rafael La Porta, et al, *The Guarantees of Freedom* (2002) NBER Working Paper 8759, at tbl 12. In the US the Supreme Court is also empowered by the Constitution to disallow legislation, but this is of little relevance in commercial law matters.

112 Witold Henisz, *Political Institutions and Policy Volatility* (2004) 16 Econ & Pol 1, http://ssrn.com/abstract=513526. He also linked this inter-institutional government competition with higher levels of economic growth: Witold Henisz, *The Institutional Environment for Economic Growth* (2000) 12 Econ & Pol 1. Both the UK's Parliamentary system and the US's Presidential system follow the common law.

113 Under s. 11(3) of the Supreme Court Act 1981 both Houses of Parliament have the power to petition the Queen for the removal of a judge of the High Court or the Court of Appeal. This power has never had to be exercised in England and Wales, and has only been exercised once, when Sir Jonah Barrington was removed from office as a judge of the Irish High Court of Admiralty in 1830 for corruption (he misappropriated funds due to litigants). Judges who commit a criminal offence may be subject to an investigation by the Office for Judicial Complaints and may be subject to a disciplinary sanction in accordance with the relevant statutory provisions. The Lord Chief Justice and the Lord Chancellor are jointly responsible for considering and determining complaints about the personal conduct of all judges in England and Wales. There is "explanatory accountability" in that individuals can be asked to give an account as to why they have behaved in a particular way. Under Article III of the US Constitution federal judges can be removed from office (only) through impeachment by the House of Representatives and conviction by the Senate.

114 This resulted from a nineteenth century political philosophy originating with the seventh US President, Andrew Jackson. The Jacksonians demanded elected (not appointed) judges and rewrote many state constitutions to reflect the new values. Sandra Day O'Connor was the last Supreme Court justice to have previously been an elected state court judge, in Arizona. In *Williams-Yulee v. Florida Bar* 135 S. Ct. 1656 (2015), the US Supreme Court held that the First Amendment did not prohibit States from barring judges and judicial candidates from personally soliciting funds for their election campaigns since that specific restriction on a candidate's speech was deemed to be narrowly tailored to serve the compelling interest of keeping the judiciary impartial.

115 Daniel Barnhizer, *"On the Make": Campaign Funding and the Corruption of the American Judiciary* (2001) 50 Cath U L Rev 361 (commenting on the effects of campaign fundraising on judicial integrity on the states); Stephen J Ware, *Money, Politics and Judicial Decisions: A Case Study of Arbitration Law in Alabama* (1999) 15 J Law & Pol 645 (finding that Alabama state judges' source of campaign funds correlates closely with votes in arbitration cases).

116 See fn 42 above.

117 In England and Wales, juries are now in use principally for criminal law matters (including fraud, malicious prosecution and false imprisonment) and, at the discretion of the judge, in defamation— the Defamation Act 2013 (section 11) removed libel and slander from the list of matters subject to jury trial, unless the court orders otherwise. In Scotland, juries are used in certain civil cases, mainly for personal injury claims. Originally, the use of juries had been prevalent in the English courts even for commercial matters, but, in recognition that business people did not wish their rights and liabilities to be settled "according to the moral authority of a jury", the significance of jury trials declined from the beginning of the nineteenth century, with the growth of commerce and commercial litigation: *The Oxford History of the Laws of England* (2010) XII, OUP, 530.

agreed.[118] This permits and facilitates innovation by the private sector.[119] For business (as opposed to retail[120]) transactions, the law for the most part allows financial and commercial parties the freedom to choose the terms of their contracts. If those choices are ambiguous or non- or ill-defined, the courts will seek to work out what the choices were intended to be or would have been.[121] This technique recognises that it is a key to commercial activity that promises can be priced. It is for this overriding reason that English law and the law of the State of New York[122] are laws of choice for international transactions.[123]

Clarity in statutory drafting

UK statutes are generally more limited, focused and clearer than civil law codes or EU law (which in financial services had adopted a code-based approach). The style of financial legislation and regulation in the UK system reflects this underlying approach.[124] For a start, this is because statutes seek to be less ambitious than codes. They benefit from the fact that the common law legal framework is a constant, which underpins all laws, whether financial, commercial or otherwise. The UK Parliament has introduced statutory modifications and clarifications of the existing law.[125] Statutory measures take

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118 This may be traced back to the sixteenth century onwards. See, for instance, P.S. Atiyah, *The Rise and Fall of Freedom of Contract* (1979) OUP: "… we have seen that from the sixteenth century onward ideas were gaining currency, especially among the commercial community, which can only be described in terms of economic liberalism. They were, in origin, ideas favouring freedom – freedom of property, freedom to trade and to work, freedom to lend money at interest, freedom from monopolies and combinations, freedom to make one's own decisions for good or ill, freedom from governmental and legal intervention. There is some ground for thinking that the common lawyers were particularly receptive to these ideas, and that they gained a ready acceptance among the lawyers before they spread through the community at large." (p. 113).

119 The insurance and reinsurance market of Lloyd's of London was built on this notion. The market had its roots in marine insurance and was founded at a London coffee house in around 1686. The stated aim was the honouring of promises, under the motto *fidentia* (confidence). The market's operations were also closely associated with the concept of *uberrima fides*, or "utmost good faith", which represents the relationship between underwriters and brokers and reflects a saying sometimes used by participants, "my word is my bond". Insurance and reinsurance contracts are treated as *uberrimae fides,* requiring the highest standard of good faith during the disclosure of all material facts that could influence the decision of the other party. The idea was first recognised by Lord Mansfield in the case of *Carter v Boehm* (1766) 3 Burr 1905, in which he said: "Insurance is a contract of speculation... The special facts, upon which the contingent chance is to be computed, lie most commonly in the knowledge of the insured only. The underwriter trusts to his representation, and proceeds upon confidence that he does not keep back any circumstances in his knowledge, to mislead the underwriter into a belief that the circumstance does not exist... Good faith forbids either party by concealing what he privately knows, to draw the other into a bargain from his ignorance of that fact, and his believing the contrary." The concept remains to this day, although its application has recently been adjusted by the Insurance Act 2015.

120 The position is modified for consumers – individuals and very small businesses - who are taken not to be able to protect themselves and so are given enhanced protections by statute and by the FCA.

121 This approach is used cautiously: see *e.g. Arnold v Britton* [2015] UKSC 36, [2015] AC 1619 ("the reliance placed in some cases on commercial common sense and surrounding circumstances … should not be invoked to undervalue the importance of the language of the provision which is to be construed" - Lord Neuberger), *Wood v Capita Insurance Services Ltd* [2017] UKSC 24, [2017] AC 1173 (Lord Hodge reconciles the literal and contextual approaches) and the majority judgment in *Lloyds TSB Foundation for Scotland v Lloyds Banking Group plc* [2013] UKSC 3, [2013] 1 WLR 366 (necessary to construe the contract in the legal and accounting context at the time it was entered into). Occasionally the process can be somewhat artificial, as in *Sohio Supply Co v Gatoil (USA) Inc* [1987] 1 Lloyd's Rep 588, where the court presumed that a choice of English jurisdiction clause was intended to be exclusive.

122 Federal law, while potentially applicable, is not usually relevant to private law contract disputes.

123 In 2019, English law was the most common choice of law for contracts arbitrated or mediated before the International Court of Arbitration and International Centre for ADR, with 16% of contracts governed by English law. The laws of a US state were selected 10% of the time, with half of these being New York law. Swiss law was selected slightly more frequently than US law (12%), but this can in part be explained by the skew in the geographies of parties that sent filings to the ICC: 29.5% of filings were from North and West Europe, and only 9.1% were from the US International Chamber of Commerce, Report, *ICC Dispute Resolution 2019 Statistics*, p. 9 (*available*: https://file-eu.clickdimensions.com/iccwboorg-avxnt/files/2019iccdrsstatistics.pdf?m=7/16/2020%209:17:48%20AM&_cldee=ZnJhc2VyLnBhZG1vcmVAc2hlYXJtYW4uY29t&recipientid=contact-3610c52361d6ea11a813000d3abaad31-04b8a3939a0448f580fc09160e2efb1b&esid=db9db8fe-c0a6-4892-9960-17443d6b73df).

124 This is so even in cases where there are, or are intended to be, overarching internationally agreed standards.

125 There are numerous specific statutory modifications and clarifications, most of which were listed in the Schedule to the Application of English Law Regulations 2015, as amended, of the Abu Dhabi Global Market. The ADGM adopted the English common law in its entirety, for which it was necessary to specify the commercial law statutes since the Statute

different forms. There is a distinction to be made between those instances in which legislation has intervened to operate on the common law to make changes to its effect for policy purposes within its established sphere of operation (*e.g.*, the Unfair Contract Terms Act 1977[126]), the cases where attempts have been made at a limited form of systematisation based on pre-existing common law rules (*e.g.* the Sale of Goods Act 1979—consolidating an 1893 Act[127]), and the vast bulk of the legislation that has imposed a layer of rules on top of the common law (*e.g.* the Financial Services and Markets Act 2000 and its predecessors[128]). Separately, statute law has been required to give effect to international obligations, arising either as a result of treaties, or, more recently as a result of EU legislation. Statutory changes can also often be made further to recommendations made by the (independent) Law Commissions, as was the case, for example, with the Contracts (Rights of Third Parties) Act 1999.[129]

Where Parliament does intervene it is unfettered—*i.e.* sovereign—in its ability to legislate. Legislation is an expression of Parliament's sovereign will which is given full effect by the UK courts.[130] In enacting laws, Parliament does not intend the courts to be left to take any decisions on core policy matters. Statutes are not ordinarily drafted with a view to leaving open broad points of interpretation. Nor do they typically seek to delegate discretionary decision-making to the courts, though they do delegate certain rulemaking and supervisory authority to the regulators. Parliament intends to leave the courts merely to resolve factual disputes as to the operation of a statute – and, at the margins, disputes on difficult legal conflicts that arise under a plain reading of the statute, for instance between two pieces of legislative text. In certain exceptional instances Parliament may deliberately allow for judicial interpretation, for instance in the context of statutory purpose clauses providing for the exercise of a statutory administrative discretion.[131] However, this technique is not intended to be a mechanism for giving the courts a broad delegated discretion.

Thus, legislation is written for the purpose of adopting unequivocal rules or setting up regulatory schemes. It is designed to achieve acceptance for its effects by those who will not generally test its application in court. The drafting is traditionally very precise. Parliamentary counsel have the task of converting policy ideas and instructions into clear and coherent text. They seek to do so in a sparse manner on the basis that Parliamentary context should rarely be relevant to interpretation. An aphorism said to have emanated from Parliamentary Counsel holds that "excess matter in Bills, as in people, tends to go septic",[132] or that the use of any words more than those necessary gives rise to confusion and should be avoided. They would bring into question why such wording was not used in other places in the same statute or different statutes.

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of Frauds 1677 onwards as being adopted also. See also, Barnabas Reynolds, *The Abu Dhabi Global Market – Legislative Framework, Approach and Methodology* (2017) 32 JIBLR 181.

126 Other examples include the Consumer Rights Act 2015 and the Bribery Act 2010.

127 Or, in general terms, statutes based on pre-existing common law on various topics such as the Trustee Acts 1925 and 2000, the Insurance Act 2015 and its predecessors, the Bills of Exchange Act 1882 and the Partnership Act 1890.

128 Or *e.g.* the Companies Acts of 1985 and 2006, the Insolvency Acts of 1986 and 2000, the Hire Purchase Acts of 1938, 1954 and 1964, and the Competition Act 1998 (based on EU law).

129 Law Commission Report No. 242, *Privity of Contract: Contracts for the Benefit of Third Parties* (1996). The Law Commission for England and Wales is a statutory independent body established by the Law Commissions Act 1965 to review the law on a continual basis and to recommend reform. Of course, the decision as to whether and how to implement a Law Commission report is primarily, and in a representative democracy, properly, a political one. The Commission seeks to ensure the law is fair, modern, simple and cost effective. According to the Law Commission's website, more than two-thirds of the Commission's law reform recommendations have been implemented, and several are pending the Government's decision. Nevertheless, not all have been addressed, *e.g.* in response to the *Williams & Glyn's Bank v Boland* [1981] AC 487 decision of the House of Lords on overriding interests in land, in particular, the Law Commission's Report No 188, *Overreaching: Beneficiaries in Occupation* (1989) has been implemented only in part.

130 This would in principle be the case if Parliament were to have legislated contrary to the UK's international law obligations, *e.g.* those contained in Treaties. This was recently restated by the UK Supreme Court in *R (Miller & Anor) v Secretary of State for Exiting the European Union (Rev 3)* [2017] UKSC 5, pp 19-20, paras [55]-[58], [2018] AC 61 when it held that "UK legislation which alters the domestic Constitutional Status of EU institutions or of EU law is not constrained by the need to be consistent with EU law... such legislation will have domestic effect even if it infringes EU law."

131 *E.g.* sections 2A to 6 of the Communications Act 2003.

132 This aphorism was referred to in the House of Lords Select Committee on Constitution, Fourteenth Report, 2004. See also, *Why is there a Parliamentary Counsel Office?* (2005) 26 Statute L Rev 69 at 77.

The result is the UK's approach to the application and interpretation of statutes can be, and typically is, forensic. Parliament's method of communication is through the legislative text itself, so the courts apply in most instances a literalist or contextual interpretation of statutory wording.[133] If the meaning of a provision is unclear, the UK uses a purposive method of interpretation, but sparingly and in a context and manner quite different from the EU's purposive method of interpretation.[134] References to non-textual Parliamentary context should rarely be required. In conveying the intended statutory meaning the drafter takes into account relevant points arising from the common law case law where these enhance certainty,[135] for example for a right of entry or power of arrest, or to make a provision retrospective.[136] However, this is merely a point of convenience. Parliamentary sovereignty means it is unnecessary to use or adapt common law concepts. The case law has to reflect what is ultimately

[133] Sir Stephen Laws in *Parliamentary Sovereignty, Statutory Interpretation and the Supreme Court* (2020) 10 Supreme Court Yearbook (forthcoming), explains the basis of Parliamentary sovereignty for the judicial interpretation of statutes in the UK, how this contrasts with identifying the principle behind a common law precedent and why there should be no departure from such a basic constitutional precept. He dismisses any approach which might involve the courts determining the meaning of statutory provisions by use of a purposive construction under which the purposes would be determined by the courts rather than by the legislators and cites some examples of recent judicial overreach. In *R (Dolan, etc) v Secretary of State for Health* [2020] EWCA Civ 1605, the court approved a summary of the current approach by Lady Hale PSC in *R (Black) v Secretary of State for Justice* [2017] UKSC 81; [2018] AC 215, at para. 36: "The goal of all statutory interpretation is to discover the intention of the legislation ... That intention is to be gathered from the words used by Parliament, considered in the light of their context and their purpose." She went on to modify a statement of Lord Hobhouse in *R (Morgan Grenfell & Co Ltd) v Special Commissioner of Income Tax* [2002] UKHL 21; [2003] 1 AC 563, at para. 45, where he said that: "A *necessary* implication is one which necessarily follows from the express provisions of the statute construed in their context". Lady Hale said that that dictum "must be modified to include the purpose, as well as the context, of the legislation". This nevertheless contrasts with the CJEU's approach, since it represents an attempt to deduce Parliament's intention from the more limited and (typically) tightly drafted UK statutory wording itself, with limited recourse to records of Parliamentary proceedings (fn 134 below), rather than the more wide-ranging assertion of purposes determined by the CJEU in the context of the rich panoply of possibilities to be found in the hugely wide-ranging (and poorly drafted) EU financial services legislative "rulebook" and the (often vague or confusing) *travaux préparatoires* behind its creation: see *e.g.* fn 271 below and the surrounding text, and fn 273 below.

[134] The general principle of interpretation—subject to the exception discussed below—is that is it not permissible for the court to look to legislative reports to assist in construing the meaning of an Act (the so-called "exclusionary rule") (*Bennion on Statutory Interpretation*, 7th edn (2017) Section 24.11, Appendix 3). English law does adopt the purposive method of interpretation where the literal meaning of an enactment is obscure or ambiguous or leads to an uncertainty, and the court has available a statement in an official report that is (i) clear, (ii) made by the minister who promoted the Bill (or someone acting on their behalf) and (iii) discloses the mischief aimed at by the enactment or the legislative intention behind the Bill (*ibid.*). See *Pepper (Inspector of Taxes) v Hart* [1992] UKHL 3, [1993] AC 593. Invariably the "official report" used by the courts is *Hansard*, the official record of Parliamentary proceedings. It did not take long for some of England's most prominent judges—including some who had initially welcomed the decision in *Pepper v Hart*—to start to doubt its value. Many of these criticisms focused on the pragmatic difficulties of extracting clear, unambiguous statements of intention from a diffuse source such as Hansard (this was Lord Hoffmann's main point in his paper "*The Intolerable Wrestle with Words and Meanings*" (1997) 114 South African L Journal 656). Lord Millett went further, calling it a "regrettable decision", and called on Parliament to legislate to abolish the rule in *Pepper* (Lord Millett, *Construing Statutes* (1999) 20 Statute L Rev 107). These extrajudicial arguments were followed by statements in the House of Lords, with the most persuasive and influential being based on the basic inefficiency of attempting to deduce clear intentions from records of Parliamentary debates. Lord Hoffmann stated in *Robinson v Secretary of State for Northern Ireland* ([2002] UKHL 32 [40], [2002] NI 390) that Lord Mackay LC, who had dissented from the decision in *Pepper* exclusively on the basis of this inefficiency argument, had been "the better prophet". There is also a dubious temptation that arises from the case—always discouraged by drafters—which is that it provides an incentive to Ministers to "Pepper v Hart" a clarification for which they would previously have needed an amendment in the House of Commons.

[135] Legislation in common law systems tends to build upon (and indeed rely upon) the mechanisms of the common law. The common law has evolved causes of action, such as breach of statutory duty, which arose to ensure the proper operation of statute law. The style of drafting used in common law jurisdiction statutes as well as the principles of literal, as opposed to purposive, interpretation are an important common law check on the power of legislatures to alter legal rights and obligations through statutes. These protections have become eroded on account of the tendency in EU law systems for provisions in regulations and directives to be given an 'authoritative' interpretation by regulatory bodies by way of guidance (often issued only to limited constituencies and not publicised), without the usual accountabilities that attach to interpretative decisions in the common law system of statutory interpretation.

[136] See for instance, Sir Stephen Laws, *Plus ça change: Continuity and change in UK legislative drafting* (2009) 11 EJLR 139.

enacted. Where necessary, the case law then clarifies the extent of the application of statutory wording, enhancing its consistency and predictability.[137]

As explained later, in Chapter 2, section 2.2, EU financial services law has become in many ways akin to a civil law code. One exacerbating feature, discussed in section 2.2, is particularly noticeable: the law is more uncertain than it needs to be because of what is often poor drafting, the participation of multiple parties in the legislative process, and a purposive method of interpretation. This phenomenon could not arise to such a degree in a common law system and it is quite alien to the UK system. For a key feature of the UK legislative system is it has a single intellectual owner. Despite the fact that the legislative process results from a collaboration between government and the Houses of Parliament, the government retains control of the legislative text, normally making an initial "offer" by proposing legislative text to the Houses. This is generally then amended and ultimately accepted through debates and discussions which are intended to produce majority consensus as to the overall outcome. However, the governing party generally retains control over the wording of the legislation throughout the process[138] and accepts responsibility for the form and coherence of the final text. When political accommodations are made, Parliamentary drafters make appropriate changes to reflect the revised intent. Members of Parliament check that the text reflects that intent or that they are prepared to accept it. Rarely if ever is there a negotiation over wording. Indeed, consensus is not always achieved on why any change should be allowed or the benefits to society arising from the change. But as a result, the lack of clarity seen in EU law as a result of multiple drafters is not seen in the UK system.

This issue does not arise in the US context either, even though there are more parties involved in drafting US statutes than in the UK. In the US, the position stems from a rigid distinction between the executive and legislative branches of government and a less integrated process for drafting legislation. The executive does not "own" the conduct of the text through its legislative stages in quite the same way that the UK Government does. The result is that during its passage through Congress multiple parties can become involved in drafting the final version of the legislation. Members of Congress also often make competing statements about why a Bill is being passed. This means that the text has a less unified intellectual thread and can often contain ambiguities that need to be resolved more frequently than in the UK system. As in the UK, US judges initially look at the plain language of the legislation, applying ordinary and customary meanings, unless it is ambiguous, in which case they will look at the purpose behind the text. However, a determination of the meaning of the text will more often need to be supplemented by reference to its history than would be true in the UK. This process frequently includes an examination of the negotiation over particular provisions. Nevertheless, the level of uncertainty arising in the EU financial services law system finds no parallel here. The US texts are drafted with greater clarity and the interests of legislative parties are better expressed than occurs in the EU context. The EU position is explained in Chapter 2.

The civil codes – rights versus restrictions: a lack of certainty

Civil codes define rights as well as restrictions and obligations, putting them in tension with one another. One example is rights of private property, which are defined both positively[139] and negatively.[140] The

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137 For instance, in the context of amendments to case law, where a statute was passed to remedy a defect in the common law, the common law applies a "mischief rule" which involves determining the mischief which was sought to be addressed, the defect the statute in question set out to remedy, and what ruling would suppress the mischief and advance the remedy.

138 Even in the case of amendments in Parliament, the Government (as a collaborating partner in the production of legislation) accepts responsibility for the form and coherence of the final text.

139 For instance, in German law, section 903 of the BGB sets out the underlying character of property rights as in principle being absolute, i.e. with effect vis-à-vis everyone.

140 In German law, there are for example the claims of an owner pursuant to section 985 of the BGB in conjunction with sec. 986 (also called *rei vindicatio*, due to its roots in Roman law), sections 1004 (*actio negatoria*), and 1005 BGB. In addition, German law distinguishes between ownership (*Eigentum*) and possession (*Besitz*). The latter is protected against deprivation as well - see for example the claim pursuant to section 861 para. 1 in connection with section 858 para. 1 BGB; and also to ensure no other person holds a superior right with regard to the same property. See also C. Wendehorst, *Muenchener Kommentar BGB*, 7th edn (2018) Munich and Art. 43 EGBGB (Introductory Act to the Civil Code), recital 41; J. Gordley, *Common law und civil law: eine ueberholte Unterscheidung,* in ZEuP (Zeitschrift fuer Europaeisches

concepts are used in financial services in the context of the ownership of shares and other financial instruments.[141] Their practical application is in some cases unclear and subject to debate, particularly in novel situations such as cryptocurrencies.[142] The codes are interpreted in a similar way to legislative text in the common law system, on the basis of the wording, context and purpose of the text.[143] A long series of previous decisions can form *jurisprudence constante*, which is persuasive for applying a particular legal principle or rule but is not controlling in subsequent cases dealing with similar or identical issues of law. As has already been mentioned, there is in general no precedent to expose what the law is likely to be in new situations and where the line is to be drawn between rules and exceptions, and competing rules and principles. The fact that court judgments tend to be of lesser importance[144] in determining the law leaves a greater role to be played by academics to fill in any gaps or issue interpretations. This, the *"doctrine"* of civil law, is a recognised source of law.[145] The system has less predictability than the common law system in circumstances where the common law contains adequate case law precedent.[146] For civil law judges are tasked with interpreting what is often broad and generalised code-based law. Although there is often considerable consistency with prior decisions, and in the case of the CJEU (which also adopts a civil law approach) the court has so far rarely departed from its previous decisions,[147] the civil law method tends towards less certainty in that it relies more on theory than pragmatism and precedent. Changes in judicial approach can seem abrupt, a point which is exacerbated by the fact that minority opinions and reasoning are less frequently disclosed.[148]

Codes and contracts. In contrast to the common law, civil law systems may tend to be less willing to respect the sanctity of the promises that participants in a transaction have willingly accepted and are

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Privatrecht) (1993), p. 498 *et seq*., p. 510 *et seq*. From a comparative perspective regarding property laws in EU member states more generally, see also S. Heselhaus, C. Nowak, *Handbuch der Europaeischen Grundrechte*, 2nd edn (2020) Munich, § 36, recitals 15 *et seq*.). In the common law such points are left undefined and are instead determined by case law precedent which indicates when and how a court will provide for the protection and recovery of property.

141 Examples include the concept of joint ownership (*Miteigentum*) regarding securities in collective deposit (*Sammelverwahrung*), individual property rights such as co-ownership shares (*Miteigentumsanteile*) in relation to a global share certificate (*Sammelurkunde*/*Globalurkunde*), under sections 6 para. 1, 9a Securities Deposit Act (*Depotgesetz*, DepotG), the transfer of instruments payable to order (*Orderpapiere*), the additional element of an endorsement (*Indossament*) pursuant to section 364 para. 1 of the Commercial Code (*Handelsgesetzbuch*, HGB), which legitimises the new owner and thereby reinforces its position, or a trade settlement to which property law principles apply but whose details are not fully clarified in German legal doctrine.

142 The application of German property law principles to cryptocurrency is currently debated intensely among legal scholars in Germany and the different matters involved are highly disputed.

143 In the German code, the methods are: interpretation of the wording, the purpose of the provision, the history of the norm (becoming apparent *e.g.* from its drafting history or materials setting out the legislator's considerations), and its systematic context: Federal Court of Justice (*Bundesgerichtshof*, BGH), ZIP (*Zeitschrift für Wirtschaftsrecht*) (2018), p. 876 *et seq.,* p. 879, recital 34. The purposive method of interpretation is further explained in Federal Court of Justice (*Bundesgerichtshof*, BGH), case of 14 March 1990, case no. VIII ZR 18/89, juris, recital 41; see also J. Busche, in: *Muenchener Kommentar zum BGB*, 8th edn (2018), § 157, recital 47; D. Looschelders, in: T. Heidel, R. Hüßtege, H-P. Mansel, U. Noack, *Buergerliches Gesetzbuch: Allgemeiner Teil – EGBGB*, 3rd edn (2016), § 157, recital 22.

144 Although in most civil law systems reports of cases are published and considered where a decision is significant, decisions are taken less seriously than in common law systems. French legal commentators pay regard to case law, as can be seen from publications such as the *Recueil Dalloz*, but nevertheless take it less seriously than those advising on the English common law. French commentators do not hesitate to criticise strongly whole lines of judicial decision-making that they consider to be improper. For example, strong criticism was made by French legal commentators of the case law on asymmetric jurisdiction clauses: see L. d'Avout, S. Bollée, *Droit du commerce international*, Recueil Dalloz (2015) 2031. The commentary of academics is given significant weight in determining the law.

145 Common law courts nowadays frequently cite the work of academics. However, academic literature has a far greater role in civil law systems. The civil law itself was the creation of Roman jurists and the European universities, whereas the common law, including the law of equity, is the creation of the courts.

146 Some civil lawyers might argue that the codes provide for greater predictability, but this would be a response based on theory not practice. The numerous practical instances in this paper (and many more) demonstrate that any such belief runs contrary to experience.

147 There is only one major CJEU case that expressly overruled a previous decision involving the same factual matrix (but not parties). This is the trademark case *HAG II* that overruled *HAG I* (Case C-10/89 [1990], CNL-SUCAL v HAG). There are other cases where the CJEU modifies its position. A recent example is the reformulation of the *Meroni* doctrine (one of its earliest cases) in the Short Selling case (Case C-270/12, *United Kingdom of Great Britain and Northern Ireland v European Parliament and Council of the European Union*).

148 See fn 96 above.

more prescriptive about the obligations participants must observe when transacting with each other.[149] At the highest level of generality, civil law systems can be more prone to make the decision for participants as to what they should have agreed to. So, for example, the civil law code-based system may on occasion intervene in relation to the conduct of pre-contractual negotiations and in respect of the performance of contracts in situations where a common law court would be less likely to do so.[150] This very fact leads to greater unpredictability in the application of the law.

How will the law be applied? The problem is that it is not possible, in a code (or any book) of manageable size, to deal in advance with every type of situation which may arise, even if those situations could be foreseen. So the approach taken is – and can only be - to set out a very small number of extremely high-level principles. From a practitioner perspective, this leaves market participants to try to interpolate or extrapolate how those principles apply to their situation, informed by academic writings and to some degree by prior cases. This approach is particularly restrictive for financial services and other intellect-based industries—such as technology and big data—which involve continuous innovation and relentless testing of the boundaries and application of law and regulation. In this area, the state cannot keep up with the pace of innovation and is left constantly trying to update legislation and regulation to catch up with the needs of the market.

The civil law systems and the professional civil service. In civil law countries, the judicial role is a professional civil service one, with appointments made after law school and promotions occurring through a hierarchy of judicial institutions; France's administrative law judges are trained at the administrative schools alongside the future civil servants whose decisions they will oversee.[151] Indeed, judges in civil law countries are essentially a part of the civil service[152] and may be under the indirect control of other branches of government, limiting their independence.[153] Sometimes the role of the adjudicators is mixed with executive functions, as in the French *Conseil d'État* (supreme administrative court).[154] It has been said that, in the French civil code nations, judges "are at the bottom of the scale

149 In French law, for instance, the section of the Civil Code on the law of contract was recently amended and restructured in its entirety (Ordonnance no 2016-131 du 10 février 2016 portant réforme du droit des contrats, du régime général et de la preuve des obligations, JORF no 0035 of 11 February 2016). The revised section came into force on 1 October 2016. Article 1104 provides that contracts must be "negotiated, formed and performed in good faith". This is described as "a matter of public policy." The 1804 Code simply stated that contracts should be performed in good faith. The reforms have codified case law that had extended the principle to the pre-contractual negotiations and formation stages. See S. Rowan, *The New French Law of Contract* (2017) 66 ICLQ 805. Although English law has been subject to modifications, especially recently, as a result of slight changes in attitude, there is no doubt that the French law position is likely to involve more intervention by the court.

150 See fn 149 above.

151 See Charles Szladits, *The Civil Law System* in 2 *International Encyclopaedia of Comparative Law*, ed. René David (1974) 15, 41.

152 Thus, "the cultural position of the civil law judge is different from its common law counterpart", since the "civil law judge is a civil servant and is far from being a cultural hero": Issachar Rosen-Zvi, *Constructing Professionalism: The Professional Project of the Israeli Judiciary* (2001) 41 Seton Hall Rev 760, 822.

153 See eg Carlo Guarnieri, *Judicial Independence and Policy-Making in Italy*, in Tate and Vallinder, eds, *The Global Expansion of Judicial Power* (1995) New York University Press 243, 247. He observed that in common law nations, the political branches of government "intervene only at the time of the judge's recruitment or in the rare cases of serious breach of conduct", while in civil law countries, the judge "remains subject to various forms of control that limit his or her independence". See also Beck, Demirguc-Kunt, and Levine, *Law and Firms' Access to Finance* (2015) 7 Am L & Econ Rev 211 at 213, which finds that common law judicial structures generally further judicial independence, and common law systems better enable national financial systems. Also, in civil law nations, judges may enjoy less "internal independence, vis-à-vis other judges", because selection is through examinations, professional training takes place within the judicial body and hierarchy controls promotion: *ibid.* at 245.

154 See https://www.conseil-etat.fr/en/the-members. It is also worth noting the special status of this court as one of *les Grands Corps de l'État*. A French official website states: "Un grand corps de l'État peut se définir comme **un corps de fonctionnaires de l'État doté d'une très forte unité et d'un grand prestige** car ses membres occupent des postes hiérarchiquement élevés dans l'administration (ex : inspecteur général des Finances, conseiller d'État)" (emphasis added): https://www.vie-publique.fr/fiches/20254-quels-sont-les-grands-corps-de-letat. The very idea of judges as *fonctionnaires* is quite different from the idea of common law judges.

of prestige among the legal professions"[155] and that this serves to "demean judges and the judicial functions" and reduce the judiciary to an almost clerical role.[156]

The civil code in France. This lesser role can also be seen in how the code-based civil law is less able to adjust to change. In France, the historical principle has been that judges, at least at the level of the *Cour de cassation* and *Conseil d'État*, must apply the law as though it were self-revelatory.[157] The case law does not cause the law to develop and become updated and more detailed in the same way as the common law.[158] It is noticeable that commercial law cases are used in a manner that allows the law to develop to some degree, but this is only within the confines of the code. In fact, the French Civil Code, as originally conceived, was much more than a simplification and codification of legal rules. As its principal drafter explained in 1801, it was also the expression of an "overriding desire to sacrifice all rights to political ends and no longer consider anything but the mysterious and variable interests of the State."[159] The jurisprudence in the French administrative courts is in practice more subtle than that, and the commercial courts are essentially independent on a day-to-day basis. Yet there is nevertheless a static conceptual framework and the contrast to the approach of the common law judiciary is marked.

1.6 Practical examples of the common law's facilitation of new financial activity

Financial dealings concern the taking of calculated risks against as certain as possible a legal backdrop in order to generate returns. The UK system has been demonstrably effective in providing a regime which participants in international commerce (including the cross border financial services sector) find attractive. This has been so since the eighteenth century, with the judgments of Lord Mansfield and his well known concern to fashion the law in accordance with the needs of merchants.[160] It has particularly been the case since the early nineteenth century, when the common law system started to take its modern form.[161] At root, it is the ability to evolve while providing for change, but nevertheless achieving what is commonly referred to as "legal certainty", that is so potent. Of course the system is not in fact

155 JH Merryman, *The French Deviation* (1996) 44 Am J Comp Law 109, 116.

156 *Ibid.*

157 Montesquieu first articulated this principle in his *Spirit of the Laws* (1748), Book XI, Ch. 6, when he said "[t]he national judges are no more than the mouth that pronounces the words of the law, mere passive beings, incapable of moderating either its force or rigour…" The status of French judicial decisions has since evolved and Nicole Stolowy and Matthieu Brochier argue that "[s]ince the end of the 20th century, the creative power of case law became well known in practice…" (Nicole Stolowy and Matthieu Brochier, *Reflections on the concepts of norms and sources of law in commercial matters* (2018) 3 Journal of Business Law 255). However, as noted by Stephen Brittain in his article *Justifying the teleological methodology of the European Court of Justice: a rebuttal* (2016) 55 Irish Jurist 134, it remains the case that "French judicial opinion remains strongly textualist and the style of judicial opinions continues to be magisterial and syllogistic".

158 This is not to say that civil law court decisions are not reasoned. French appellate decisions may be quite fully reasoned—for instance, this is true of the rulings of the Court of Appeal in Paris, the Conseil Constitutionnel, first instance and Court of Appeal commercial decisions in Greece and the German Federal Constitutional Court. The rulings of the latter Court, for instance, often exceed 100 pages with all dissenting opinions. However, decisions of the *Cour de cassation* and of the Paris Court of Appeal do not generally extend to this sort of length.

159 See Preliminary Address on the First Draft of the Civil Code, delivered on the occasion of the presentation of the draft of the government commission, on 1 Pluviôse IX (21 January 1801), reproduced in PA Fenet, *Recueil Complet des Travaux Preparatoires du Code Civil*, 465 (1968) (1827): "le désir exalté de sacrifier violemment tous les droits à un but politique, et de ne plus admettre d'autre considération que celle d'un mystérieux et variable intérêt d'État."

160 His idea most relevant to modern financial law is the recognition of the negotiability of certain instruments. *Eg. Miller v Race* 1 Burr 452, 97 Eng Rep 398 (K.B. 1758). See Holden, *History of Negotiable Instruments in English Law* (1955) The Athlone Press. Lord Mansfield's contribution was not universally welcome at the time – see for instance, the anonymous *Letters of Junius*, in which the polemicist Junius criticised Mansfield for creating uncertainty in the law. Recognition of corporations was hindered by the Bubble Act 1720 (passed under pressure from the South Sea Company, which made non-chartered companies illegal. From 1720 only companies incorporated by Royal charter or Act of Parliament were allowed to trade). See also W S Holdsworth, *The History of the Treatment of "Choses" in Action by the Common Law* (1920) 33 Harvard L Review 997.

161 It has been observed that "[u]ntil the 1830s, the approach of the judges was influenced by the ideas of a pre-industrial moral economy; after 1830, they were increasingly sympathetic to the approach of new political economists and utilitarian thinkers, which sought to encourage commercial enterprise, and free market individualism… Cases which came before the courts often involved significant fractures in the economic system, for which no solution had been anticipated by the legislation. Judges had, of necessity, to be social and economic policy makers, with policy made through the artificial prism of the case before them", *The Oxford History of the Laws of England* (2010) XII, OUP, 297–300.

completely certain. No system could be. Yet the term is used appropriately because the system is highly predictable. It makes constant efforts to achieve certainty[162] whilst adapting to change. It does so with astonishing degrees of success.

The result is that the UK's sophisticated yet ultimately commercially libertarian approach has allowed for phenomenal (but safe) innovation in financial services. Financial innovation, so long as it does not increase systemic risk or hidden risk to consumers, broadens the products and services offered to customers, allowing for a greater array of options. The recent innovations in the FinTech sector, spurred by the use of blockchain and distributed ledger technology, such as virtual currencies and novel types of transferable financial investment interests, are merely some of the examples of this phenomenon. Likewise, the use of big data has enabled the markets to reach an entirely new customer base directly, and to determine consumer preferences more accurately, allowing for better tailored product offerings.

On numerous occasions the law has evolved to facilitate the development of different types of financial activity and the use of what were initially novel techniques. It has often been the common law's judicial decision-making that has allowed the common law to end up supporting new but safe and fair ways of achieving those ends. Sometimes statutory provisions operating along with the common law have also been relevant to certainty. There are numerous examples of how the UK system has proved its ability to adapt to change and to facilitate market dealings. These include the following:

- *Netting of financial exposures to a contracting party* – through rules which allow for the termination of obligations under a contract on the default of the other party and their replacement with an obligation to pay a single net sum reflecting the net position resulting from combining the positive and negative replacement values for individual financial exposures between the two parties;

- *Custody of securities* – the common law facilitates the holding and safekeeping of securities by one party on behalf of another, through the trust concept which allows for legal title to be held by a custodian on behalf of client beneficiaries;

- *Client asset protections* – common law and statute law allows for the ringfencing of client assets held by a financial firm from its insolvent estate, so that they remain the property of the client and can easily be recovered in the event of the firm's insolvency;

- *The taking of security* – concepts such as the floating charge and an ability to take security over future property, as well as the avoidance of undue formality requirements, considerably enhance the options available for taking security;

- *The disintermediation and electronification of securities – through the "PRIMA" concept* – legislative measures outside the US implemented a pragmatic concept (which English common law had already begun to develop), that the governing law for securities holdings is the law of the place of the intermediary. This means that the law of the place of the account provider of a securities account applies to determine questions of property law that arise (such as the legal nature of the securities and issues of priority of interests in them), providing certainty in determining the applicable law for cross-border securities holdings;

- *Enabling the parcelling up of risk amongst different investors* – assisting with the development of securitisation and other varieties of modern capital-raising, which in some

[162] The UK's Financial Markets Law Committee, chaired by a former Lord Chief Justice, comprises a committee of senior legal practitioners, judges, former judges and General Counsel from HM Treasury, the Bank of England, PRA and FCA. The Committee has as its specific remit the identification of points of legal uncertainty in the financial markets and the making of proposals for the clarification of those uncertainties.

cases require the application of the law of equity by reason of the restrictions of assigning debt as a matter of common law;

- *Title transfer, including for collateral* – supporting the development of the securities financing markets through transactions such as "sale and repurchase" (repo), as well as derivatives clearing;

- *Predictability of the insolvency regime* – extensive case law supplementing UK statutory law which provides for *pari passu* distribution among unsecured creditors, anti-deprivation rules and numerous other rules around achieving equality of distribution on insolvency;

- *Certainty of commercial dealings* – the UK statutory and common law system robustly defends registered interests, for instance for the recently established registry system for EU emissions allowances,[163] providing the essential legal certainty that once property is transferred in the register it will be protected, even from claims from the victims of theft;

- *Cryptoassets and electronic signatures* – the common law has adjusted to numerous recent FinTech developments such as electronic signatures, and cryptoassets, the best known being Bitcoin;[164]

- *Misselling* – the common law has built a corpus of precedent over the last 25 years to the effect that in the wholesale markets there is a strong *caveat emptor* presumption, subject to the reservation that in the retail markets customers must be given adequate information; and

- *Privilege* – the common law has evolved to protect legal professional privilege in new circumstances, including the use of email.

Annex 1 below explains how the common law and UK statutes have achieved these results in each case.

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[163] Directive 2003/87/EC established the Emissions Trading Scheme in the EU and required each individual Member State to establish its own registry. The position was further harmonised in 2012, when Directive 2009/29/EC replaced these individual registries with a single Union Registry operated by the European Commission.

[164] See for instance *AA v Persons Unknown & Ors, Re Bitcoin* [2019] EWHC 3556 (Comm), [2020] 4 WLR 35, where the English High Court granted a proprietary injunction sought by the applicant insurance company over Bitcoin, on the basis that cryptocurrencies constitute property under English law and are therefore capable of being the subject of interim proprietary injunctions. This flexibility has also been evident in other common law systems, for instance with the decision of the Singapore Court of Appeal in *Quoine Pte Ltd v B2C2 Ltd* [2020] SGCA(I) 02, which by a majority upheld the trial judge's conclusion that the cryptocurrency exchange, Quoine, was liable to B2C2 for unilaterally reversing trades in Bitcoin and Ether, the token which trades on the Ethereum blockchain. See also the New Zealand case *Ruscoe and Moore v Cryptopia Limited (In Liquidation)* [2020] NZHC 728. Then compare *e.g.* the decision of the Tokyo District Court in a code-based civil law context in *Mt. Gox*, fn. 673 below. The UK Jurisdiction Taskforce, in its *Legal statement on cryptoassets and smart contracts* (November 2019), discusses the principles applicable under English and Welsh private law for determining when a cryptoasset will be considered property and when an enforceable contract is concluded through a so-called "smart contract", which is a self-executing contract with the terms of the agreement between buyer and seller being directly written into lines of code. While the *Legal statement* generally indicates that the common law in its current state of evolution is receptive to the concept of a cryptoasset, questions remain, particularly on issues of transferability. The *Legal statement* considers an arrangement whereby a unit of a cryptoasset is held by participants to represent an off-chain "real-world" asset, with the understanding that transfer of the cryptoasset effects transfer of title in the off-chain asset (in a manner analogous to the transfer of *documents of title* in traditional paper-based commerce). The existing theories of documents of title rely on the transfer of possession of the document: since (on the Taskforce's analysis) cryptoassets cannot be possessed, this arrangement would not fit easily into the theory of documents of title. The Taskforce does recognise however that the law is likely to follow mercantile practice in this area. In a telling passage, the *Legal statement* notes: "English law can and will adapt to meet the usages of commerce. Judges are alive to the fact that, in modern times, mercantile usages can develop relatively quickly" (at p. 28).

CHAPTER 2

UK FINANCIAL SERVICES AND EU LAW – THE CONFLICT

While within the EU, and until the end of 2020 when the transition period ended, the UK was subject to EU law-making. Some EU laws had "direct applicability" in domestic UK law without the need for any implementing legislation. These laws overrode whatever UK case law or statute law pre-existed the relevant measures. Other EU laws had "direct effect", which gave firms and individuals the ability to enforce rights derived from EU legislation directly in the UK courts. Further EU matters were set out in UK legislation or delegated legislation which implemented "directives" that EU law had required the UK to enact.

During the UK's membership of the EU, UK officials responsible for the UK's participation in the EU's legislative processes sought to address the UK's concerns over the content of EU law, in order that laws drafted by a committee of (then) up to 28 member states should be suitable for the UK. In this they had varying degrees of success, particularly after qualified majority voting for financial services was introduced when the Single European Act came into force on 1 July 1987. The fundamental methodology of EU law, and its operating scheme and style of reasoning, also became increasingly influential in the UK by virtue of the importation of EU law-making. For financial services, the effects have been marked. A sheer mass of EU law has been introduced. The overall approach of EU law has led to various civil law components being imported into the English common law system, partly because EU law itself follows civil law principles.

Many of the issues now presented by EU law arise from the far-reaching implications of imposing a different system, with different methods of thought, on top of the UK's regime. But there is another consequence, which could constitute a serious problem for the UK after leaving the EU unless it is addressed. This arises from the way in which EU law and regulation has created risk, derived from its treatment of the Eurozone, and the danger of cross-contamination of that risk into the UK sector unless action is taken. The matter is made more challenging because the EU system has demonstrated a willingness to prioritise its political interests over the management of financial risk.

With Brexit, and the UK rediscovering its ability to make its own laws, it is important to understand the extent to which EU law has changed the nature of the UK legal system; why this has undermined the important characteristics of the common law which make for successful global markets; how the EU law system creates systemic financial risk; and how EU law is being used in ways that endanger the UK and global financial markets. For this the following should be considered:

2.1 EU financial services law –far-reaching and overriding?
2.2 EU law – its nature and characteristics;
2.3 Protecting the euro – the impact, implications and risks;
2.4 The deployment of EU law - business generation versus risk management.

2.1 EU financial services law – far-reaching and overriding?

The first issue arises from the deluge of EU law-making in the financial sector and the structural overlay of EU authorities over the UK system.

How it happened

The EU's legal scheme has developed in a way that is fundamentally different from the common law method in four respects. It has been produced at a statutory level in an all-encompassing manner. A one-size-fits-all financial services rulebook has been adopted with a federal supervisory approach. The Court of Justice of the European Union (CJEU) plays a federalising role, applying its own view of the purposes intended by poorly drafted EU laws. And the overall result cramps business freedom and innovation.

The financial services laws of the UK (and other EU states) used to be national and were not overly affected by EU membership until the late 1980s. These laws served the UK very well. However, over the last 32 years the EU has embarked on a process of enacting a corpus of laws, applicable in the UK, which has developed into an all-encompassing, ever-expanding statutory financial services system. The process started in earnest in 1989, with the Second Banking Coordination Directive (2BCD).[165] This was quickly followed by the Capital Adequacy Directive[166] in 1993 and the Investment Services Directive (ISD), implemented in 1995.[167] Since then, the EU has legislated for financial services extensively, building a pan-EU rulebook. This rulebook now contains highly detailed regulation for capital markets offerings, insurance, derivatives, asset management, reinsurance, insurance intermediation, credit cards, payment services, e-money and various other topics. Tens of thousands of pages of rules have been published, with one regime alone (including its regulatory technical standards (RTS) and implementing technical standards (ITS)) containing 1.7 million provisions (the Markets in Financial Instruments Directive No. 2[168], and the Markets in Financial Instruments Regulation[169], together known as MiFID II).[170] Notably, none of this law is judge-made. It lays out prescriptive rule-based requirements for authorisation, approval and day-to-day regulation. Some elements of the approach in EU law arise from a perceived need to harmonise the laws across EU member states, creating the EU rulebook on a "one size fits all" basis. However, the method and volume of prescriptive rulemaking arises also in part because of the general, civil law method of legislating in code-based form that has been adopted by the EU, along with the reasoning that goes with that, which seeks to provide an answer in legislative text to every problem. To ensure consistency of application, the local "home state" supervisors, from the state in which firms are incorporated, have been placed under the oversight and control of pan-EU supervisors. The role of national legislation and rulemaking has largely been removed, with the EU for the most part applying an increasingly uniform scheme under which financial firms can operate across the EU.

Developing the one-size-fits-all EU financial services "rulebook", 1989-2020: the civil law method, federally applied, over Anglo-Saxon pragmatism

The unification of EU rules was intended to bring them under centralised control, and to facilitate a single market, allowing financial firms to be regulated just once, in the state where they are incorporated, avoiding unnecessary (and costly) duplicative regulation. It was thought that such a result could not be achieved in the context of the standards applied by EU member states, and the poor law-making, regulation and supervision prevalent across much of the EU (though not in the UK). The belief was that without a federal approach there was only limited ability for regulators in each member state to recognise the efficacy of actions taken by regulators in other states.

The pan-EU system was built in three steps, which sometimes overlap in terms of both period and scope.

First step, pan-EU directives. The first involved adopting numerous EU directives such as 2BCD and the ISD, from 1989 onwards, across the financial services sector in the EU, in part to allow for the

165 Second Council Directive 89/646/EEC of 15 December 1989.
166 Council Directive 93/6/EEC of 15 March 1993.
167 Council Directive 93/22/EEC of 10 May 1993.
168 Directive 2014/65/EU.
169 Regulation (EU) No 600/2014.
170 Philip Stafford and Peter Smith, 1 January 2018, FT.com: see fn 3 above.

mutual recognition of regulatory standards. The directives each set high-level standards, adopted through the normal EU legislative process, which involved approval by the EU Council and EU Parliament. Under EU law these directives were required to be implemented within each member state, generally two years after being passed at EU level.[171] Latitude was permitted for every state as to how that implementation was to take place, to take account of local legal circumstances and existing local laws. This framework then formed the basis for the mutual recognition of the locally implemented financial services laws and regulations, with EU member states each recognising the efficacy of each other's regimes.

The result was to introduce an early version of the EU "passport" for financial services – first in 2BCD and then the ISD, both of which set loosely-drafted standards without the detailed stipulations of today's directives and regulations. This approach was then adopted more broadly in subsequent directives. Regulation was split between the firm's home state, and the member state in which the service is provided, the "host state". The home state would address matters of prudential regulation,[172] governing whether the firm was properly capitalised and managed. The host state, in which they did business and serviced customers cross-border, addressed conduct of business regulation and sales matters. The measures were interpreted by the UK as applying to most types of cross-border business with customers of UK firms based elsewhere in the EU. The system was underpinned by the high-level standards set out in the directives, which the regimes of each of the home and host state were obliged to meet.[173] This approach enabled states to avoid the necessity of applying many of their own regulations, in duplication to those of another member state, to cross-border financial services activity emanating from that other member state. A regime was also introduced for the establishment of branches by financial firms in other member states, whereby reliance was to be placed by the regulators in the branch jurisdiction on the rules and oversight of the regulators operating in the firm's home state jurisdiction.

This initial method of EU financial services law-making already imported significant elements of the EU approach into UK law. That is because, over time, the UK typically adopted a "copy out" method for implementing EU directives which incorporated many of the civil law and other foreign features of the preliminary deluge of EU law.[174] This involved introducing in some cases foreign concepts and wordings alien to the English common law (and indeed the common law outside the US), such as the notion of "good faith" in consumer contracts.[175] The common law then struggled to incorporate these ideas, although subsequently good faith has started to become more of a mainstream concept.[176]

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171 However, in many states implementation often took place after that time.

172 Prudential regulation requires financial firms to control risks and hold adequate capital, by reference to capital requirements, liquidity requirements and limits for large exposures (and, more recently, concentration risk). It also includes reporting and public disclosure requirements and supervisory controls and processes. Within this, microprudential regulation focuses on the individual firms so that they can withstand financial shocks; macroprudential regulation (which was give particular attention in light of the 2007-2008 financial crisis, fn 183 below, and surrounding text) addresses risk arising from the whole financial system, including systemic risk.

173 So, for instance, the way the ISD operated was to provide rules for every member state to implement in the regulation of investment banking, rules which required states to achieve certain high-level standards in their laws. In return, it provided for mutual recognition based on those standards and the first version of the "passport" system.

174 Copy out was not the initial approach to EU obligations and in the early days was poorly regarded. However, the courts encouraged it and the developing doctrine of "direct applicability" made it in practice unavoidable.

175 See Gunther Teubner, *Legal Irritants: Good Faith in British Law or How Unifying Law Ends Up in New Divergences* (1998) 61 MLR 11, who considers the concept of "good faith" incorporated by Regulation 4 of the Unfair Terms in Consumer Contracts Regulations, SI 1994/3159, implementing the EU Directive on Unfair Terms in Consumer Contracts, Council Directive 93/13/EEC of 5 April 1993 (OJ L95, 21 April 1993, 29) and observes that "legal irritants […] unleash an evolutionary dynamic in which the external rule's meaning will be reconstructed and the internal context will undergo fundamental change" (p. 12).

176 For instance, the exercise of a contractual discretion may be subject to an implied obligation under which it is not to be exercised arbitrarily, capriciously, irrationally, or for an improper purpose. This has been referred to as the "*Braganza* duty", after the decision of the Supreme Court in *Braganza v BP Shipping Ltd* [2015] UKSC 17, [2015] 1 WLR 1661. In *Yam Seng Pte Ltd v International Trade Corp Ltd* [2013] EWHC 111 (QB), [2013] 1 All ER (Comm) 132, Leggatt J. recognised that it may be appropriate, even in relation to some commercial contracts where no fiduciary duty is owed, to imply a term that the parties will perform the contract in good faith. And see more recently *Sheikh Tahnoon Bin Saeed Bin Shakhboot Al Nehayan v Kent* [2018] EWHC 333 (Comm) (also Leggatt J.).

Second step: widespread harmonisation. Next, there was a process of widespread harmonisation of the main elements of EU member state financial services laws, from the turn of the century onwards. In 1999 the EU adopted a Financial Services Action Plan (FSAP), which comprised a series of 42 pan-EU measures designed to harmonise the member states' rules on securities, banking, insurance, mortgages, pensions and all other forms of financial transaction so as to create a single financial services market by 2005. A technocratic process was introduced for the implementation of the FSAP in the light of recommendations contained in a 2001 report of a "Committee of Wise Men", chaired by Baron Lamfalussy.[177] The process, still in use, comprises four "levels", each focusing on a specific stage of the implementation of legislation. At level 1, the European Parliament and Council adopt the basic laws proposed by the Commission, in the traditional EU co-decision procedure. Since this procedure is usually complex and time-consuming, the Lamfalussy report recommended using it only for setting out framework principles. At level 2, the Commission can adopt, adapt and update technical implementing measures with the help of consultative bodies composed mainly of the representatives of EU countries. This allows the Council and Parliament to focus on the key political decisions, while technical implementing details can be worked out afterwards by the Commission. At level 3, committees of national supervisors (now comprising pan-EU Supervisory Authorities, discussed below) are responsible for advising the Commission in the adoption of level 1 and 2 acts and for issuing guidelines on the implementation of the rules. At level 4, the report advocated a stronger role for the Commission in ensuring the correct enforcement of EU rules by national governments. At this second stage, nevertheless, many of the reforms effected through the process were introduced by way of EU directives at Level 1, which then had to be implemented into member state law, permitting some level of variation. The Market Abuse Directive[178] and the first Markets in Financial Instruments Directive[179] both originated in the 1999 FSAP.

Third step: federalism. The third and final stage of EU legislative reform involved the imposition of EU federal control and a single financial services rulebook across the EU, on a codified model.[180] The opportunity for this arose after the financial crisis of 2007–2008. Brussels believed (or key decision-makers claimed they believed) that the crisis had been caused by Anglo-Saxon finance[181] and, in particular, investment banking, which was seen as an Anglo-Saxon business activity. In fact the main contributory factor to the 2007-2008 crisis was potential and unchecked systemic risk,[182] arising particularly from US sub-prime bonds (most notably, from California, Florida and Nevada[183])—a risk that had been missed or at least left unaddressed by central banks around the world, including the

177 *Final Report of The Committee of Wise Men on The Regulation of European Securities Markets*, February 2001. The Committee was chaired by Baron Alexandre Lamfalussy, a Hungarian-born Belgian economist and banker, and the Report is generally referred to as the Lamfalussy Report.

178 Directive 2003/6/EC, since repealed and replaced by the Market Abuse Regulation (Regulation (EU) No 596/2014).

179 Directive 2004/39/EC, since repealed and replaced by the revised Markets in Financial Instruments Directive (Directive 2014/65/EU) and Markets in Financial Instruments Regulation (Regulation (EU) No 600/2014).

180 The EU Council first recommended the establishment of a single rulebook for financial services in its cover note to the 18/19 June 2009 Presidency Conclusions, 11225/2/09, REV 2, 10 July 2009.

181 After the 2009 G20 Summit in London, Nicolas Sarkozy, then President of France, said "the world has been living on a financial model, the Anglo-Saxon model – it is not my place to criticise it, it has its advantages – clearly, today, a page has been turned": *Sarkozy gives G20 news conference*, 2 April 2009, Reuters, https://uk.reuters.com/article/uk-g20-sarkozy-highlights-sb/highlights-sarkozy-gives-g20-news-conference-idUKTRE53150R20090402. Sharon Bowles, then MEP and Chairwoman of the European Parliament's Committee on Economic and Monetary Affairs, stated in 2012 that "In [the European Union's] eyes, [the United Kingdom is] responsible for everything they are suffering" and that "the rest of Europe thinks the contamination went into their countries, through the single market, from the UK" (L. Armistead, *Europe blames UK for the eurozone debt crisis, says MEP Sharon Bowles*, 1 October 2012, Daily Telegraph, https://www.telegraph.co.uk/finance/economics/9577166/Europe-blames-UK-for-the-eurozone-debt-crisis-says-MEP-Sharon-Bowles.html.

182 See the text that surrounds fn 449 below for a summary of the risks addressed by financial regulation.

183 These bonds arose from other states also. Note also the role of Fannie Mae and Freddie Mac, which are home mortgage companies created by the US Congress. They buy mortgages from lenders and either hold these mortgages in their portfolios or package the loans into mortgage-backed securities that may be sold. Lenders use the cash raised by selling mortgages to engage in further lending. Both organisations accepted Alt-A bonds (not quite sub-prime) and had been encouraged to do so by federal legislation.

European Central Bank (ECB).[184] They had mistakenly let the markets look after themselves for such matters, on the theory that market efficiencies would kill off poorly run businesses and practices dangerous to the system.[185] There was also excessive risk-taking by banks, which the early version of the EU passport had played a key role in allowing,[186] because of the lack of any centralised control over how, or whether, member states implemented EU directives. This enabled regulators in various member states (including Ireland and Luxembourg) to take a patchy approach, lowering (or offering to lower, or disapply) rules in order to attract financial business from the UK. The increased risk was not from any business conducted by banks in those states with the US, but instead it resulted from an attempt to take UK business by applying low standards under the EU law umbrella, in dubious compliance with the provisions of EU law. This in turn meant that the UK regulators had to respond. Yet, in doing so they were restricted by EU regulation, which they sought properly to apply. Using the passport, businesses could relocate to a country with lower standards and still provide their services across the EU (including the UK). This was a key driver in leading to an unlevel playing field and a race to the bottom in terms of financial regulation. The phenomenon had also led to a reduction in the essential management of financial systemic risk, which meant that the financial crisis caused unnecessary and avoidable damage to the UK economy - and the economies of other EU member states. EU law distorted the ability of the UK to manage financial risk, and removed some of its key regulatory levers.

Nevertheless, from a Brussels perspective, a new set of reforms was seen (or purportedly seen) as a necessary response to the crisis. The politics within the EU were such that the view took root that the markets needed now to be far more centrally controlled, and that the code-based method of regulation was the answer. Thus, for the first time, the member states organised that a non-UK Financial Services Commissioner - Michel Barnier, a former French Government Minister - should be appointed to the EU Commission for the next term, from 2010 to 2014. During his time he piloted the introduction of a far-reaching set of EU financial services reforms.

The original blueprint for the regulatory response to the crisis owed much to UK thinking,[187] but the ultimate shape and detail was built very much on the code-based model – and was federal in nature. It involved the roll-out of a hugely prescriptive set of rules in EU legislative text, comprising primary or secondary legislation, in order to achieve full control. Many of the new rules were created by way of EU regulation at Level 1, which has direct application in the law of member states, including in the UK at the time, rather than through directives which allowed member states the discretion on how the legislative measures were to be applied in local law and which were designed only to achieve regulatory harmonisation. In justifying the approach of using EU regulation with direct applicability in member state law to implement the reforms, legislators pointed to delays in the implementation of directives and their standards under the ISD, and other such regimes, in particular member states (though not the UK),

184 Under a 2006 Memorandum of Understanding for Financial Stability between HM Treasury, the Bank of England and the FSA, the Bank of England was responsible for "the system as a whole"; see also, the House of Lords, Economic Affairs Committee - Second Report, *Banking Supervision and Regulation*, 2009. The ECB had a similar responsibility and indeed was actively engaged in discussions on the very topic: *e.g. Fourth Joint Central Bank Research Conference on Risk Measurement and Systemic Risk*, 8-9 November 2005, published April 2007: https://www.ecb.europa.eu/pub/pdf/other/riskmeasurementandsystemicrisk200704en.pdf. This was a discussion that was hosted by the ECB, in cooperation with the Bank of Japan and the Board of Governors of the Federal Reserve System, and its stated goal "was to bring together the business, research and policy communities to foster active exchange on issues related to risk measurement and systemic risk" (p. 3).

185 The efficient market hypothesis is the theory that markets are efficient in reflecting information about both individual products and the marketplace. That is, that no one individual is in receipt of greater information than any other individual, at any one time because, when new information becomes available, it is distributed widely, such that the whole market is aware of the impact of that information, and in turn prices products and risk accordingly. As a result, the market would adjust for risky practices and bring down firms which engage in them before the situation gets out of hand. Lord Turner was requested to review the causes of the global financial crisis of 2008. In his report he stated that "the crisis also raises important questions about the intellectual assumptions on which previous regulatory approaches have largely been built. At the core of these assumptions has been the theory of efficient and rational markets." He went on to set out five propositions which have implications for a regulatory approach, including that "market discipline can be used as an effective tool in constraining harmful risk taking" and noted that these are now "subject to challenge": see *The Turner Review,* fn 362 below.

186 See *Managing Euro Risk*, fn 5 above, Chapter 11, for a discussion of the relevant points and the effects.

187 See *The Turner Review*, fn 362 below.

coupled with patchy interpretation and application of those standards. The UK was itself in favour of this method of adoption on the basis that it would bring into line those states who had a poor record in applying the EU standards.[188]

The UK was however outnumbered in objecting to the prescriptive and highly costly[189] manner in which the project proceeded.[190] The result was a process whereby measures which were previously directives were superseded, often expanded in scope, and reissued as regulations, so that they had direct applicability and did not permit for local discretionary interpretation (being instruments of EU law and so subject to interpretation, ultimately, by the CJEU). Key examples include the Market Abuse Regulation (which replaced the Market Abuse Directive)[191] and the revised MiFID II package, which comprises the MiFID II Directive and MiFIR (and which replaced the original MiFID I Directive).[192] The initial scheme of mutual recognition of standards was dropped. Cross-border business was now undertaken under home state supervision, applying a single rulebook which operated across the EU. This brought the commercial benefit that businesses need only consider one set of rules in conducting business across the EU. However, the "price tag" was an extraordinary blanket of prescriptive rules. These rules apply not just for financial services regulation but also in other areas of law, ancillary to financial services, such as data protection and employment law, which similarly restrict the markets and hamper innovation by adopting the civil law approach to the law, as explained in Annex 2 below.

There was then the question to be addressed as to how those rules should be interpreted and applied. In the first two stages of the programme, the national member state regulators were each left to perform that task for businesses established in their jurisdictions, answerable to their local political systems. To control this, institutional reforms were initiated, as part of this third stage, following the recommendations of a 2009 EU report by Jacques de Larosière's[193] financial support group. These reforms were intended to harmonise the approaches of the home state regulators and place them under federal EU oversight. The motive was control, including control of the City of London's regulatory regime.[194] As a result, in 2011, three pan-EU Supervisory Authorities (ESAs) were introduced, one for each of the following areas: securities and markets (the European Securities and Markets Authority (ESMA)[195]), banking (the European Banking Authority (EBA)[196]), and insurance and occupational pensions (the European Insurance and Occupational Pensions Authority (EIOPA)[197]). These bodies are located in Paris (in the case of ESMA and now, after Brexit, the EBA, which has relocated from London)

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188 For commentary on this point, see House of Lords EU Committee, *The post-crisis EU financial regulatory framework: do the pieces fit?* (2015), HL Paper 103, which discusses how the post-crisis framework still allowed Member States to compete with each other on different levels of regulation: https://publications.parliament.uk/pa/ld201415/ldselect/ldeucom/103/103.pdf.

189 The implementation of MiFID II has been estimated to cost the financial industry a total of $2.1 billion in 2017, including over $1 billion in costs for buy-side investment banks and asset management firms to adopt compliance systems and processes: MiFID II expected to cost buy-side over $1 billion, The Trade News, 29 September 2016. According to a report by Open Europe, a sample of the most significant 100 EU measures cost the UK £33.3bn in the 2014-2015 tax year. Among the costliest regulations were the CRD IV package (recurring cost of £4.6bn a year) and the Alternative Investment Fund Directive (recurring cost of £1.5bn a year): *Top 100 EU rules cost Britain £33.3bn*, 16 March 2015, Open Europe.

190 *E.g.* A. Barker, *Barnier vs the Brits*, 8 November 2011, Financial Times, https://www.ft.com/content/5471afde-096a-11e1-a20c-00144feabdc0.

191 See fn. 178 above.

192 See fn. 179 above. Other examples include the Benchmark Regulation (EU) 2016/1011, the Capital Requirements Regulation (EU) No 575/2013 (widely seen as overdone and a failure) along with the Capital Requirements Directive 2013/36/EU (which replaced the recast Capital Adequacy Directive and Banking Consolidation Directive, 2006/49/EC and 2006/48/EC, and the Prospectus Directive 2003/71/EC (which was replaced by the Prospectus Regulation (EU) 2017/1129).

193 *Report of The High-Level Group on Financial Supervision in the EU*, February 2009, Brussels, chaired by Jacques de Larosière de Champfeu, a former French central banker.

194 Christine Lagarde, French Minister of Finance when the ESAs were introduced, said at a conference the author spoke at in New York after the 2007-2008 financial crisis: "I can't tell you how much it means to me for the City of London to be regulated in Paris". This is because the main ESA is ESMA, which is based in Paris. Subsequent to Brexit, the EBA has moved from London to Paris also.

195 Regulation (EU) No 1095/2010.

196 Regulation (EU) No 1093/2010.

197 Regulation (EU) No 1094/2010.

and Frankfurt (in the case of EIOPA). This followed the introduction of a pan-EU systemic risk oversight body, the European Systemic Risk Board (ESRB), established in Frankfurt in 2010, which was designed to look across the EU's financial system for issues of systemic risk.[198]

The three ESAs were intended to ensure there was no difference in the supervision by national regulators of financial firms across the EU as a whole. To achieve this fully, a subsequent overarching regulation was adopted for each of the bodies, known as the ESAs Regulation,[199] which was designed to allow the bodies to make final determinations on the meanings of EU financial regulations within each of their mandates, ensuring a uniform approach to interpretation. The ESAs were given the powers to issue guidance on the interpretation and application of the EU's financial services regulatory regime and to recommend (to the European Commission) adjustments to or new level 2 rules.[200] The idea was that by this method there would be a uniform application of uniform EU legislative standards amongst the member state regulators. The ESAs were also given the power, *in extremis*, to step in and give directions to firms within member states, providing them with a level of federal supervisory authority.[201]

In the case of credit rating agencies and trade repositories, ESMA was given the role of exercising direct regulatory oversight of the relevant firms, creating an entirely federal EU supervisory regime for those firms.[202] The EU is now considering a further pan-EU supervisor for the oversight of financial firms in their anti-money laundering efforts as a result of recent failures of this area, which are being blamed on member state regulators and a lack of centralised coordination.[203] The centripetal forces are clear. In discussing the design of the system, EU officials often make comparisons to the system in the US, both in terms of its regulatory structure and also the specific rules.[204] Yet these comparisons are misguided and dangerous.

Not only is the comparison to the US common law based system erroneous, but the new EU regime contains a fundamental and unique flaw, which arises from the political necessities surrounding the

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198 The European Systemic Risk Board, ESRB (Regulation (EU) No 1092/2010). The UK has its own body, the Financial Policy Committee, established under the Bank of England Act 1998 by amendments made by section 4 of the Financial Services Act 2012. This body was set up in 2011 (when it met on an interim, pre-legislation basis, pending its statutory footing) to focus on identifying the macro-economic and financial issues that may threaten long-term growth prospects for the UK.

199 Regulation (EU) 2019/2175.

200 Thus, Article 8, Regulation (EU) 1093/2010 empowers the EBA to develop "draft regulatory and implementing technical standards, guidelines, recommendations, and other measures, including opinions", whilst Article 16 allows it to "issue guidelines addressed to all competent authorities or all financial institutions and issue recommendations to one or more competent authorities". Similar provisions are made in respect of ESMA and EIOPA in Regulations (EU) 1095/2010 and 1094/2010 respectively.

201 Articles 17(6) and 18(4), Regulation (EU) 1093/2010, Regulation (EU) 1094/2010 and Regulation (EU) 1095/2010.

202 ESMA's powers over CRAs are set out in the EU Credit Rating Agencies Regulation (Regulation (EC) No 1060/2009) and its powers over trade repositories are set out in EMIR (Regulation (EU) No 648/2012). The centralised supervision of credit rating agencies is discussed more fully in *Managing Euro Risk*, fn 5 above, at 64-65.

203 In its Communication from the Commission on an Action Plan for a comprehensive Union policy on preventing money laundering and terrorist financing (2020/C 164/06), the European Commission set out its intention to create a harmonised AML rulebook and an EU-level supervisor: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52020XC0513%2803%29. This followed on from two high profile instances of inadequate supervision across the EU. The first related to a Danish bank, Danske Bank: "Danish and Estonian financial regulators have publicly blamed each other for the Danske Bank Money Laundering scandal" and "[t]he EBA,…, opened a formal investigation into a possible breach of EU law by the two regulators over the Danske case": J. Gronholt-Pederson and F. Guarascio, *EU states force clearing of Estonian, Danish regulators over Danske Banke*, April 2019, Reuters, https://uk.reuters.com/article/uk-danske-bank-moneylaundering/eu-states-force-clearing-of-estonian-danish-regulators-over-danske-bank-idUKKCN1RT0WF. The second related to a German payment processor and financial services provider, Wirecard. Germany's regulator, BaFin, was criticised for its failure properly to oversee Wirecard: K Griffiths and J. Hurley, *Regulators under fire over Wirecard Scandal*, November 2020, The Times, https://www.thetimes.co.uk/article/regulators-under-fire-over-wirecard-scandal-f7tgwsp3z. See also fn 493 below.

204 For example, in its 2014-2015 Report, the House of Lords European Union Committee refers to evidence of this comparison being made, stating that "witnesses focussed in particular on a comparison of the EU and US approach"; it also quoted Sharon Bowles, former MEP and Chairwoman of the Committee on Legal Affairs, as saying that "the EU was largely in line with what the US and G20 were doing"; *The post-crisis EU financial regulatory framework: do the pieces fit?*, 5th Report of Session 2014-15, HL Paper 203, Chapter 5 (*The International Regulatory Agenda*), https://publications.parliament.uk/pa/ld201415/ldselect/ldeucom/103/103.pdf.

Eurozone project. As will be explained more fully in section 2.3 below, a vast amount of systemic financial risk arises from the way in which the single rulebook has been constructed in respect of the newly established euro currency arrangements. The 2007-2008 financial crisis had identified a key global shortcoming in financial regulation: that insufficient attention had been paid to the risks contained in the financial system as a whole. It was for this reason that the ESRB had been established, at the same time as that at which the UK set up a similar body, the Bank of England's Financial Policy Committee.[205] However, when it came to the making rules for the Eurozone, the Eurozone member states did not have, and still do not have, the political consensus required to take the necessary steps, nor to apply the expensive international standards that would ensure such arrangements are safe and sound for the financial markets. The result has been to allow the risk arising from the Eurozone to be disguised and dispersed, permitting the Eurozone to operate on the erroneous presumption that the euro currency has been properly constructed.

Another undesirable by-product of the federal regime has been a new element of bureaucracy. The system added further processes and delays to national supervisory controls, which means regulatory decisions can become bottlenecked in bureaucratic, centralised committees, as points of interpretation of the rulebook are debated by, and under the control of, the ESAs. This has inevitably slowed down regulatory processes within the UK, by requiring coordination on points of interpretation at an ESA level. Such a result is perhaps acceptable in a civil law environment in relation to less complex, domestic financial markets. There, the civil lawyer's instincts to control the markets and slow down developments may mean the process is found to be satisfactory. However, it is highly dangerous to fetter swift regulatory decision-making and rulemaking required for the UK's global market, which operates, as it does, on the common law method. It does not help that the UK is the host to the only global market in Europe and so committee-based discussions, under the auspices of the ESAs, with regulators of what are essentially domestic markets across the EU, have involved the UK being required to justify positions that are often only of principal relevance to itself, and to allow others to interfere in those policies in a manner that is not purely technocratic but can be political. Indeed, the EU has been uneasy with the UK's global role and various attempts have been made to change that. The introduction of the pan-EU passport regime[206] itself had been hoped by some to have done so in one swoop, by removing through harmonisation what was seen to be one of the UK's competitive edges, its superior law-making ability. This failed because of the competitive edge of the UK from its common law and the attractions of the market.

The implications of the pan-EU system

The EU system is managed on a centralised basis in a way which is at odds with the UK's traditional approach.

The CJEU – a federal, purpose-based court

The EU regime has been supported by the Court of Justice of the European Union (CJEU). The role of the CJEU has been more important in commercial and financial law matters than that of most courts in civil law systems, given its method of interpretation and the nature of the EU law system. This has been in evidence in several adverse financial services decisions relating to matters seen as important to the financial market and UK interests, many of which were not seen as predictable at the time, and were not predicted by the UK Government.[207] While occasional upsets may occur, this sequence of unanticipated results is not the hallmark of a predictable regime. Some proposals the UK successfully

[205] See fn 198 above.

[206] See section 2.1 above, for an explanation of the passporting regime and how it confers rights on certain financial institutions, allowing firms authorised in one EU member state (the "home state") to conduct business cross-border or through a branch in another member state on the basis of their home state authorisation. The rights are conferred under of EU directives and regulations, including the Alternative Investment Fund Managers Directive (2011/61/EU), MiFID II Directive (2014/65/EU) and the Capital Requirements Directive (2013/36/EU).

[207] George Osborne, Chancellor of the Exchequer at the time, told groups of Members of Parliament (MPs) that each case was one which the UK thought it would win.

opposed, such as the ECB's central counterparty (CCP)[208] location powers, but this dispute was won by the UK only on a technicality.[209] There were various others which it failed to prevent, including the more well-known bonus cap case where the Advocate General rejected the UK's challenge to the cap imposed on bankers' bonuses (in practice, principally on bonuses of UK bankers) by the EU, leading to the UK withdrawing its action;[210] the UK's unsuccessful challenge of the powers given to ESMA on short selling;[211] and its action against the proposed Financial Transactions Tax,[212] which was dismissed as premature.

The CJEU applies the civil law method of reasoning,[213] citing decisions it has rendered itself, often to meet the politics of particular financial services matters. It reinforces many other key—and alien—aspects of the civil law method which have been hard-wired into the EU law system and imported into the UK legal system over the years of the UK's membership of the EU. This point, and its implications, are discussed further in section 2.2 below.

In addition, the CJEU oversees the EU's exercise of supranational sovereign power, which extends to EU institutions and agencies.[214] The member states have an obligation to uphold the autonomy of EU law as interpreted by the CJEU.[215] There is also an obligation under the EU founding Treaties on member state courts to refer EU law matters to the CJEU.[216] The limits of this concept were recently disputed by the German Constitutional Court,[217] which purported to determine the proper application of EU law and stated that the German court could determine the *vires* of the actions of EU bodies (in this case the ECB) and whether they fell within the foundational treaties for the EU. However, it does not appear that the German judgment has had an immediate or material legal effect on EU action.

The CJEU's constitutional role gives its decisions, even in financial services matters, a particularly political hue. Indeed, the CJEU has been accused of making rather than interpreting the law, without restricting itself sufficiently to the wording of the founding arrangements agreed to by the member

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208 CCPs are also known as clearing houses.

209 *United Kingdom v ECB*, Case T-45/12.

210 *United Kingdom v Parliament and Council,* Case C-507/13. Alex Barker, *Osborne gives up on challenge to bank bonus cap*, 20 November 2014, FT.com, www.ft.com/content/12d1ba3a-7094-11e4-9129-00144feabdc0.

211 *United Kingdom of Great Britain and Northern Ireland v European Parliament and Council of the European Union*, Case C-270/12.

212 *United Kingdom of Great Britain and Northern Ireland v Council of the European Union*, Case C-209/13.

213 It does so in particular by generally citing the purpose of EU legislative provisions, and using teleological reasoning, as explained in section 2.2 below, as well as fns 218 and 260 and surrounding text. It should be acknowledged that the CJEU pays attention to previous decisions and cites its own decisions. This phenomenon is more marked in the opinions of the Advocate General. The Advocate General's opinions are almost always published and usually contain a detailed discussion of prior case law. Yet, the position of Advocate General is not a judicial one. It was modelled on the *commissaire du gouvernement*, the government's commissioner who advises the French *Conseil d'État* before it takes a decision on a pending case.

214 There is a general principle, known as the *Meroni* doctrine, arising from cases C-9/56 and C-10/56 (*Meroni v High Authority* [1957/1958] ECR 133), which provides that EU institutions may not delegate to agencies powers with a wide discretion. However, although this doctrine has not been overruled, it is seen by many as increasingly circumvented by reason of the growing complexity of EU competences, which have caused the supranational (federal) authority of EU bodies to expand steadily.

215 See *Flaminio Costa v ENEL* (1964) Case 6/64, *Van Gend en Loos v Nederlandse Administratie der Belastingen* (1963) Case 26/62, *Amministrazione delle Finanze v Simmenthal SpA* (1978) Case 106/77 and *Internationale Handelsgesellschaft mbH v Einfuhr- und Vorratsstelle für Getreide und Futtermittel* (1970) Case 11/70 which asserted that Community law took supremacy over the laws of all Member States, including the UK. The recent decision of the German Constitutional Court over the powers of the European Central Bank in the context of its asset purchase programmes was hugely controversial in identifying limits to this concept: see fn. 217 below.

216 Article 267 of the Treaty on the Functioning of the European Union.

217 BVerfG, Judgment of the Second Senate of 5 May 2020 - 2 BvR 859/15 -, paras. 1–237. There were previous judgments by the German Constitutional Court which adopted reasoning consistent with this dramatic decision: see *Managing Euro Risk*, fn 5 above, p. 82 for a summary. The UK House of Lords asserted the same prerogative in *R (Factortame Ltd) v Secretary of State for Transport (Nos. 1 and 2)* [1990] 2 AC 85 and [1991] 1 AC 603, and *R (HS2 Action Alliance Limited) v The Secretary of State for Transport* [2014] UKSC 3, [2014] 2 All ER 109, claiming that the application of the doctrine of the supremacy of EU law itself rested upon domestic (British) law.

states.[218] In the UK, the sovereignty of Parliament generally means that the UK's Supreme Court is not supposed to make such decisions of political policy within the UK's constitutional framework.[219] However, the UK gave effect to EU law while an EU member state, through the European Communities Act 1972. The UK Parliament has given further and ongoing effect to EU law (until the end of last year, and to a more limited degree thereafter) as a result of the European Union (Withdrawal Agreement) Act 2020, which implements the international law obligations of the UK-EU Withdrawal Agreement and its Northern Ireland Protocol. The UK's Supreme Court applies EU law, as interpreted by the CJEU, within the UK to the extent arising from those provisions. To this degree it has assumed what might be seen as a more politicised role than the UK system traditionally permits. The CJEU's own role is in fact more similar to that of the US Supreme Court and indeed there are often similar criticisms of political decision-making levelled at the US Court. However, unlike the democratically controlled appointments process used for the US Supreme Court, the CJEU's judges are not subject to scrutiny in respect of their political views at any time.[220]

Freedom, innovation and prescriptive rulemaking

The overall approach of EU financial services law has been to map out and prescribe the regime for virtually every aspect of financial services business, eliminating in many areas any deference to management judgement and the forces of competition. The law exists within an overall federal EU architecture and is interpreted on that basis. Furthermore, because the law virtually prescribes a mandatory end-to-end business model and *modus operandi* for many aspects of financial business, it rapidly becomes out of date, and hence risks making the industry uncompetitive.

Thus, a conflict has developed between the UK's approach to law and that of the EU, which has seeped into the UK financial system to the detriment of the UK system. This negative impact has gone beyond the mere methodology of EU law. In substantive terms, it has meant the imposition of laws and regulations which the UK would not itself have adopted. For instance, the UK would not have introduced the 1.7 million legislative provisions of MiFID II.[221] Nor would it have introduced the highly restrictive measures of the Solvency 2 Directive for the insurance industry, [222] or the Alternative Investment Fund Managers Directive for the wholesale funds industry. [223] Nor would it have accepted the bonus cap, which is a political measure that largely affects London[224] and which increases the fixed costs of firms, making them more risky not less – since it is vital to ensure firms are able to pay any star employees for outsized contributions to financial performance whilst retaining low fixed costs.

There are further substantive differences that are also emerging. The EU is also taking an increasingly controlling approach to the pricing of certain types of financial services. The UK and EU have

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218 See for example a paper presented by Professor Derrick Wyatt at an event of the British Institute of International and Comparative Law on 2 November 2015: https://www.biicl.org/documents/760_derrick_wyatts_paper.pdf. See also C Hansom, *Methods of Interpretation – a Critical Assessment of the Results*, Reports of a Judicial and Academic Conference, Luxembourg (1976); H Rasmussen, *On Law and Policy in the European Court of Justice* (1986) Martinus Nijhoff; T Hartley, *Constitutional Problems of the European Union* (1999) Hart; G Beck *The Legal Reasoning of the Court of Justice of the EU* (2013) Hart; and G Beck, *Judicial Activism in the Court of Justice of the EU* (2018) 36 University of Queensland Law Journal 333. See also the German Federal Constitutional Court (Bundesverfassungsgericht, BVerfG), decision that the CJEU judgment on the ECB's Public Sector Purchase Programme (PSPP) in *Weiss and Others*, C-493/17, EU:C:2018:1000 was *ultra vires* (BVerfG, Judgment of the Second Senate of 5 May 2020 - 2 BvR 859/15 -, paras. 1–237).

219 Note *R (Miller) v The Prime Minister; Cherry and others v Advocate General for Scotland* [2019] UKSC 41, [2020] AC 373, however, which strayed into constitutional matters in the limited context of a decision to prorogue Parliament.

220 The CJEU appointments (for judges and for Advocates-General) are made on the recommendation of member states, and in many cases, appointments go to government officials whose turn it is. The process for appointing US Supreme Court judges is very political, but the quality of the ensuing appointments is not identifiably worse for that.

221 See fn 3 above.

222 Directive 2009/138/EC.

223 Directive 2011/61/EU.

224 The UK had the largest population of high earners (i.e. individuals receiving more than €1m in annual remuneration) in the EU in 2017, representing 73.41% of the total number of EU high earners (see EBA Report on High Earners, 11 March 2019, available at https://eba.europa.eu/sites/default/documents/files/documents/10180/2551996/239d027f-07ae-43f7-b161-3f458d443f3c/Report%20on%20High%20Earners%202017.pdf?retry=1).

traditionally required fair, reasonable and non-discriminatory (FRAND) pricing for "natural" monopolies such as pharmaceuticals and some intellectual property rights.[225] More recently, the EU has applied the concept to financial infrastructure, so as to require FRAND pricing for access to exchanges,[226] CCPs,[227] settlement systems[228] and financial benchmarks[229] on the same terms. The EU has subsequently sought to impose FRAND in further areas, such as the provision by banks and brokers of clearing services[230] and pricing of trading data.[231] The EU is now seeking to define what FRAND means in the context of trading data in a way that would essentially import the approach to the regulation of prices changed by public utilities for those data. ESMA has indicated in a recent consultation that it interprets the provisions as requiring the prices for the sale of trading data to be largely based on the cost of producing the data, plus a margin,[232]instead of (for instance) by reference to the value of the data to the consumer, leaving the point to be determined by the normal forces of supply and demand. There are indications that the UK may follow the EU's thinking in this area.[233] Traditionally, the UK, like the US, has intervened on pricing matters only when there is a proven market distortion. In principle, any interference with competitive markets and the pricing they generate causes its own, anticipated and unanticipated, market distortions. It would provide a disincentive to innovation in data services and risk driving business offshore.

UK gold plating

The UK has often been accused of inflicting some of the negative effects on itself by "gold plating" EU laws.[234] In these instances the UK has thought fit to implement rules which go beyond those of the EU - so-called "gold-plating". Yet this has often been done because, despite its massive amount of prescriptive rules, EU law frequently falls short in addressing key points of systemic or individual firm (idiosyncratic) risk, such as regulatory capital. For instance, EU law has fallen short in implementing the Basel Rules[235] in the context of Eurozone risk, as explained in section 2.3, which means that the UK imposes top-up capital requirements in addition to the minima prescribed by EU law in order unilaterally to mitigate that risk. In the non-financial sector gold plating is often driven by a consumer protection objective. For financial services it is also, vitally, driven by the need to achieve a safe and sound market.

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225 *Unwired Planet International Ltd v Huawei Technologies Co Ltd* [2017] EWHC 2988 (Pat), [2017] RPC 19.

226 Article 36, MiFIR and Article 8, EMIR.

227 Article 35, MiFIR and Article 7, EMIR.

228 Article 33, Central Securities Depositories Regulation (Regulation (EU) No 909/2014.

229 Article 22, Benchmarks Regulation. See, also, fn 561 below and surrounding text.

230 Article 37(1), MiFID II. See also the ESMA final report with technical advice to the Commission on "FRANDT" (FRAND and transparent) commercial terms for clearing services, June 2020, in which ESMA proposed to impose certain conditions in order for clearing service providers' commercial terms to be considered FRANDT. These included a prescribed "Request for Proposal" process and public disclosure of commercial terms: https://www.esma.europa.eu/press-news/esma-news/esma-publishes-final-report-frandt-commercial-terms-clearing-services. This is another illustration of the over-prescriptive nature of the EU approach to regulation.

231 Articles 13, 15(1) and 18(8) of MiFIR and Articles 64(1) and 65(1) and (2) of MiFID II.

232 See the recent ESMA consultation paper on guidelines on the MiFID II / MiFIR obligations on market data, 6 November 2020: https://www.esma.europa.eu/sites/default/files/library/esma70-156-2477_cp_guidelines_on_market_data.pdf. This approach appears to be more restrictive than approaches elsewhere, as set out in a recent IOSCO Consultation Report, *Market Data in the Secondary Equity Markets*, CR03/2020, December 2020. On pp. 10-11, the Report states that standards around the world include that: market data is made available on a "reasonable commercial basis"; the fees do not impose an unreasonable condition to accessing the data; the fees do not permit unreasonable discrimination among clients, issuers and marketplace participants; the fees do not impose a burden on competition that is not reasonably necessary and appropriate.

233 In March 2020 the FCA issued a Call for Input with respect to the access and use of wholesale data: see the FCA's Call for Input regarding accessing and using wholesale data, 9 March 2020, https://www.fca.org.uk/publication/call-for-input/call-for-input-accessing-and-using-wholesale-data.pdf and https://www.fca.org.uk/publications/calls-input/accessing-and-using-wholesale-data-call-input#revisions. As a result of the COVID-19 pandemic, the deadline for responses was extended to 7 January 2021.

234 In EU terminology this practice is known as "super-equivalence". See the text surrounding fn 398 below, for examples of gold plating and how it has arisen.

235 See fn 75 above.

2.2 EU law – its nature and characteristics

However, the core concern with EU financial services law—and the EU legal backdrop for financial services more generally—is its approach, methodology and technique of reasoning. This hampers innovation and restricts activities unnecessarily, damaging the UK's financial markets. Although EU law has adopted the case law system of precedent to some degree, it has been built on the civil law model in ways that are often inappropriate or detrimental to the UK's common law system.[236] The problem has taken a number of forms.[237]

Defining rights, codifying rules

The very nature of the EU's civil law approach introduces inflexibility and uncertainty into its laws and regulations, by defining rights as well as obligations, adopting a code-based method of law-making, and eschewing precedent and the common law approach of incrementalism.

Rights and restrictions. First, on principle the EU approach to rights is generally the opposite of the common law approach, under which what is not prohibited is lawful. Both rights and restrictions are increasingly specified and therefore operate in interpretative tension with each other.[238] This is unnecessarily restrictive, adds complexity and leads to a reduction in precision in determining the application of the law, particularly to novel situations. The very fact of seeking to define the ambit of rights reduces flexibility, ossifies conceptual thinking and limits the evolution and operation of those rights as circumstances evolve.

Code-based law-making – the implications. Next, the EU financial services law is highly code-based across all sectors, in contrast to some other contexts in which EU law has so far intervened only by legislation in specific areas, rather than by adopting broad codes. This approach has involved EU interventions across all areas of financial services, including in situations where the common law would generally adapt through evolution of precedent and consensus. The approach typically brings into play a single-minded legislative process that often involves creating a new scheme of law even before the industry has properly developed into the new area and before it is evident what scheme will be the most appropriate. The EU approach has therefore determined that new laws are needed for emerging developments, such as e-commerce[239] and e-money,[240] rather than leaving the legal and regulatory system to evolve to meet the requirements of those developments. By contrast, the common law is often able to cope with many aspects of novel market practice by accident or design, and is generally capable of being interpreted in a manner appropriate to the new forms of business.[241] The UK regulators typically wait for market activity to reach a certain degree of regularity before stepping in to make new regulations. Their Principles-based approach[242] allows for a more common law style, applying existing regulation to new techniques.[243]

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236 The only purely common law countries within the EU have been England, Wales and Northern Ireland and the Republic of Ireland—and now only the Republic of Ireland—so the resulting approach only includes limited elements that make accommodations for the common law. By contrast, in the US the American Restatement reflects tendencies in 49 states and the District of Colombia, which all have a common law basis. Diverging tendencies in Louisiana and Puerto Rico are diluted easily.

237 See, generally, Hansom, Rasmussen and Hartley, fn 218 above.

238 For EU protection of rights, see Coppel and O'Neill, *The European Court of Justice: Taking Rights Seriously?* (1992) 12 Legal Studies 227. Hansom and Rasmussen are classic critiques: fn 218 above.

239 Electronic Commerce Directive 2000/31/EC.

240 Second Electronic Money Directive 2009/110/EC, replacing the unsuccessful first Electronic Money Directive 2000/46/EC.

241 See Annex 1 below for examples. However, it has to be acknowledged that this is not always the case: New York's bitlicense for cryptocurrency drove exchanges and trading to other states as compliance was costly and cumbersome. Another example is the US tax legislation that resulted in the creation of the Euromarkets—see fn 31 above.

242 See fn 78 above and the surrounding text.

243 There are shortcomings to the Principles-based approach as currently formulated: see Chapter 4, section 4.2. However, section 4.3 of that Chapter shows how these shortcomings can easily be fixed.

Sometimes the new EU schemes head off burgeoning new industries into unanticipated directions (*e.g.*, MIFID II, which has interfered with market structures, shoehorning those structures into pre-defined categories) or kill off industries before they can get going (*e.g.,* General Data Protection Regulation, GDPR,[244] which has meant the EU does not have big data businesses matching those in the US). In other cases, new measures can turn out to be redundant entirely. So, for instance, the E-Money Directive[245] set out a scheme for e-money institutions that was hardly used, although it has recently had a renewed lease of life in the context of crypto payments businesses,[246] for which it was not originally designed.

In order to be sustained, the EU's approach requires the constant oversight and control of market change by the legislators and regulators. Once a new scheme is put in place, subsequent adjustments of a significant nature can become necessary. EU financial regulations are monitored and revised from time to time, through a similar process to that involved for the introduction of the original scheme. The approach to amendments is slow and ponderous, given the significance of any new regulation. Quick, agile fixes, as encouraged by the common law, are decried by many civil law practitioners as insufficiently thought through, lacking (as they do) the process of lengthy consideration, and detailed and complete exposition. As a result, the frameworks tend to be amended slowly and by accretion, as opposed to by dynamic adjustment through judicial decision-making. The end result is the constant accretive refinement of a textual scheme which is, in theory, sufficient to address all scenarios, at least in the minds of jurists who reject the concept of *non liquet* – the idea that there may be gaps in the codes, a concept rejected in French (and Swiss) legal theory.[247] Inevitably, the EU/civil law approach often lacks the ability to cope with novel contexts with the agility of the common law.

The civil law approach leaves EU legislators constantly struggling to keep up with market innovations. This is inherent in its method, leading to occasional jolts as the system is found to need radical adjustment. For instance, French and German law have struggled in financial services, showing themselves to lack permissive flexibility. This can be seen for example in their rules for the holdings of securities, which are less clear and reliable than those in the UK.[248] Or, for example, in 1989, German legislation had to be enacted to address a concern arising from a German federal court decision of 1970, which had built up over time. The legislation laid to rest (for the most part) the uncertainties identified in the federal decision and made clear that derivatives contracts are not caught by section 762 of the BGB, which provides that no obligations are created on the basis of gambling.[249] There were then major

244 Regulation (EU) 2016/679.

245 The first Electronic Money Directive 2000/46/EC, which was replaced by the second Electronic Money Directive 2009/110/EC.

246 The Electronic Money Directive is now used by businesses seeking to offer electronic payment services outside the more regulated structure of the Payment Services Directive (Directive (EU) 2015/2366). The key advantage of a business seeking a licence under the Electronic Money Directive is that it is able to transact in electronic money, that is, a digital form of cash stored on an electronic device.

247 See fn 45 above.

248 See section 1.6 in Chapter 1 above.

249 The concern with section 762 of the BGB is that "no obligation is established by gaming and betting. What has been paid due to such gaming or betting may not be demanded back on the basis that no obligation existed". Clearly, this would prove to be a problem in the context of derivatives transactions. In order to close out this potential issue, a change was made by the German Parliament (*Bundestag*) to the Stock Exchange Act in 1989 (formerly section 58 *Börsengesetz*, BörsG, *Bundesgesetzblatt,* BGBl (Federal Gazette) I at 1412 *et seq.*) and then, in 2002, it amended the Securities Trading Act (*Wertpapierhandelsgesetz*, WpHG) by providing the following wording in section 99 (of the WpHG): "Objections under section 762 of the Civil Code may not be made against claims arising from financial derivatives transactions involving at least one party that is an undertaking that enters into financial derivatives transactions on a commercial basis or on a scale that requires commercially organised business operations or that buys, sells or brokers financial derivatives transactions. Financial derivatives transactions within the meaning of sentence 1 and sections 100 and 101 mean derivatives within the meaning of section 2 (3) and warrants". It is the printed papers of the *Bundestag* which provide insight into the legislator's reasoning behind introducing section 99 of the WpHG (formerly section 37e WpHG), namely that "the regulation is necessary because certain forms of financial futures transactions which fall under the new Section 8, in particular open contracts for differences, can at the same time fulfil the objective elements of gambling within the meaning of section 762 BGB. As a rule, such transactions do not manifest a subjective element of gambling, since at least the company is not acting with the intention of gambling. However, it cannot be ruled out that the conclusion of a financial futures transaction by a company with a contractual partner who conducts the transaction solely for speculative purposes could be regarded as the conclusion of a game bet within the meaning of section 762 BGB" (printed papers of

issues in 2016 when a German court decided,[250] basing itself largely on academic writings, that all close-out netting provisions, including those on ISDA formats, were invalid because they did not follow the requirements of the German Insolvency Code. This led to a strong adverse reaction to reliance on German law by the derivatives market. In consequence the German regulator, BaFin,[251] was forced to issue a general administrative act[252]to deal with the issue, and a review was initiated of the German insolvency laws, which led to an amendment of Germany's Insolvency Code.[253] In Japan, which applies the civil law based on the German and French code-based method, a decision that Bitcoin is not property in the context of the Mt. Gox bankruptcy caused uncertainty which still lingers, despite regulatory legislation passed after that decision, in 2016.[254] Furthermore, the inherent unpredictability of the civil law method when confronted with new developments can be seen from the fact that, in China, which also applies the German civil law code technique, the Hangzhou Internet Court reached a different result on the point despite the law in question being very similar.[255] The common law judicial system is generally able to adjust more smoothly and predictably to these sorts of developments.[256]

The EU's governance structures are geared towards constant legislative activity. The European Commission, the EU body which proposes legislation, has a financial services staff who are tasked with just that. They are likely to step in as soon as novelties arise, in order to demonstrate their attentiveness. Unlike the UK's Parliamentary system, in which a drafting team deals with a piece of legislation and then moves on to whatever topic the government seeks next to address, the relevant staff is solely and permanently focused on financial services matters. When one regulation is completed they move on to another. Once proposals are made, they tend to be followed through, regardless of industry feedback. In addition, the fact that the law is heavily legislation based and not developed in part through decision-making by independent judges, unlike the common law, means that smaller interest groups are more able to influence the law than in common law systems, by lobbying for particular forms of words at legislative level. The approach also creates a tendency to find problems to solve when none exists – and even when evidence is presented that none exists. The point applies at the level of the EU's regulatory supervisory bodies just as much as for the European Commission. So, for instance, the EBA, the EU's banking supervisory authority, is engaged in ongoing monitoring of developments outside the regulatory perimeter in the FinTech space,[257] with a similar tendency towards constant intervention through new rulemaking. The measures are seldom deregulatory,[258] since the approach requires that all scenarios remain provided for in legislative text.

Precedent versus incrementalism. EU judicial decisions and the resulting case law are not binding on future courts. Judgments are typically short, at least compared to their common law counterparts, and do not contain the lengthy analysis and justification, particularly by reference to prior judicial decisions and reasoning, that is found in common law judgments. There are no dissenting judgments. One can sometimes get more of an understanding of the court's reasoning by considering the opinion of the

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the *Bundestag* (BT-Drs.) no. 14/8017, p. 96). Nevertheless, Reiner and Schacht in *Credit Default Swaps undverbriefte Kreditforderungen in derFinanzmarktkrise - Bemerkungen zum Wesenverbindlicher und unverbindlicher Risikoverträge*, WM 2010, 385 *et seq*. state that a considerable number of credit default swaps could qualify as gambling (at 395).

250 Federal Court of Justice (*Bundesgerichtshof*, BGH) of 9 June 2016, BKR 2016 324, IX ZR 314/14. See BGH NJW 2016, 2328 and *Kurzberg*, BKR 2016, 324.

251 *Bundesanstalt für Finanzdienstleistungsaufsicht*.

252 BGH NJW 2016, 2328 (decision of 9 June 2016, case no. IX ZR 314/14). For a short discussion of the decision, see B. Kurzberg, *(Un)Wirksamkeit von Netting-Vereinbarungen?*, BKR 2016, 324.

253 Act Amending the Insolvency Code and Amending the Act Introducing the Code of Civil Procedure dated 22 December 2016, Federal Law Gazette I, page 3147.

254 See fn 673 below.

255 *Ibid.*

256 See Chapter 2 above, and Annex 1 below.

257 See the *EBA Report on Regulatory perimeter, regulatory status and authorisation approaches in relation to FinTech activities*, July 2019.

258 An unusual example is the "Proposal for a Directive of the European Parliament and of the Council amending Directive 2014/65/EU as regards information requirements, product governance and position limits to help the recovery from the COVID-19 pandemic" (the "MiFID II Quick Fix"), which was really a response to Brexit and an effort to enhance the competitiveness of the EU's financial services laws, picking up on points which the UK had sought to change while within the EU system. In addition, there are adjustments made for points which prove to be impractical: see fns 276 and 279 below, and surrounding text.

CJEU's Advocate General.[259] However, even if individual lines of reasoning are consistently maintained (as is often the case), the basis on which this is achieved is not premised on the same approach as that which drives the common law system, which allows lines of innovation to be developed over time by way of precedent. Teleological reasoning can instead prevail, particularly where the EU's federal ambitions are at stake.[260]

In recognition of the benefits of the common law system, the CJEU has sought to adopt some elements of the common law: this has been noted by Koen Lenaerts, the President of the Court.[261] However, Mr. Lenaerts also acknowledged the incomplete nature of this adoption and the absence in EU law of a strict rule of precedent, or *stare decisis*, which is a vital underpinning for the common law's case law system. It may be observed that in practice the CJEU has so far tended to treat its prior case law more reverentially than many other civil law systems. However, the overall approach remains that the law is made top-down, with conceptual frameworks set by legislators rather than judges.

The application of law and the purposive method – the implications for trade

When it comes to interpreting EU law, the approach, as in the civil law systems, involves trying to identify how rules and principles adopted in the past will apply to new situations as they arise.[262] This can often present difficulties, because of the ever changing nature of the financial markets and the multiple individual initiatives constantly taking place, each of which is intrinsic to the fabric, success and attractiveness of the market. There can frequently be a tension that arises when it is sought to interpret the static legal text, conceived in circumstances often different to those sought to be considered. Crucially, an excessive use of the purposive method of interpretation, a key characteristic of the CJEU, has a dampening effect on legal certainty and freedom of action. This method, based on the civil law approach, allows the CJEU to determine what EU law provisions mean by looking at their underlying context and purpose. The full impact of the approach results from the EU's legislative process, in which the European Commission proposes initial legislative text but the European Council and European Parliament make extensive amendments of their own. Members of the European Parliament may also propose their own draft provisions. This system allows for decentralised drafting, which is itself then further amended through discussions in the European Council and European Parliament. Obviously, many of the wordings employed are not drafted by those whose native language is English. They are noticeably less precise and sophisticated than wording used in UK statutes. Furthermore, the final text is further translated into the 24 official languages of the EU, each of which has equal status, regardless of the obvious fact that nuances in one language may not create the same effect in another language. Indeed, lawyers in private practice frequently look across relevant texts in different languages to find meanings helpful to their interpretation. The CJEU's working language is French. Yet most market participants in fact rely in the first instance on English language versions of the texts.

As a result, there are obvious limitations on the CJEU's ability to engage in a literal, textual analysis by reference to syntax and common parlance. This is why the CJEU generally adopts a purposive method when engaged in matters of interpretation.[263] Such an approach not only involves looking into the

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[259] One of the CJEU's Advocates General will deliver a written opinion on most cases before the court. This opinion is typically followed by the court, but not necessarily on the basis of the reasoning set out in the opinion. Even when the court takes the same position as the Advocate General, the reasoning may not be assumed to have been approved.

[260] For instance, *Pringle v Government of Ireland* (2012) C-370/12, an EU law case which held the European Stability Mechanism was lawful, is a prime example of the use of teleological reasoning.

[261] Valedictory address in honour of Judge Christopher Vajda on the departure of the United Kingdom from the European Union, 12 February 2020: https://curia.europa.eu/jcms/upload/docs/application/pdf/2020-02/discours_president_lenaerts_-_depart_vajda_12_.pdf.

[262] However, the CJEU is more willing to be adaptive in its decision-making than perhaps French and German systems would be. For instance, the CJEU had no problem in considering the nature of Bitcoin in a ruling that the services of a Bitcoin exchange in exchanging Bitcoin for a traditional currency is exempt from VAT on the basis of a 'currency' exemption (*Skatteverket v David Hedqvist* Case C-264/14).

[263] For a general summary of the EU's interpretative method, see H. Rösler, *Interpretation of EU Law*, in J. Basedow, K. J. Hopt, & R. Zimmermann (eds.), *Max Planck Encyclopedia of European Private Law* (2012) OUP 979-982.

purposes behind particular provisions but also at the functional perspective chosen by the EU,[264] and trying to achieve the goals it sees as being determined in the primary law, such as the creation of a unified market or an ever-closer union among member states.[265] Such reasoning occurs particularly in the context of the euro currency and arrangements affecting that currency. However, this purposive approach makes what is already often unclear drafting even more unpredictable in meaning. The situation is exacerbated by the morass of EU provisions, each of which has its own purposes. The participants in the legislative process may have had very different purposes for any given provision or set of provisions. An amendment may have been proposed by Members of the European Parliament with one purpose but adopted by a majority of the European Parliament with another purpose entirely. Furthermore, evaluating the spirit and purpose of a provision as well as the comprehensive programme of the EU can be problematic when different purposes conflict, such as the single EU market, protection interests for employees and consumers, and interests of the Eurozone. The CJEU's judgments often add another ingredient, reflecting the notion of *effet utile*,[266] *i.e.* making the perceived practical effectiveness of EU law the objective of the court in its interpretation and development of law.

This approach has imported a lack of certainty into the UK's regime, only offset in part by the undesirable narrowing of financial and commercial freedoms provided by the restrictive detail of the EU single rulebook. Indeed, the uncertainty arises despite the controlling nature of EU law. The overall impact has been exacerbated by the UK's use of the "copy out" method, already discussed,[267] for adopting EU directives which the UK was required to implement in UK law. Industry criticisms of gold plating[268] led to a greater use of this approach, in order to ensure that the UK adopted EU law to the minimum stipulated extent. The idea was that it would then be clear when consideration would be needed to extend the coverage of EU law and to adopt additional requirements for UK purposes. However, the method was itself undesirable because it involves adopting poorly drafted EU provisions, without improvement, into UK regulation.

The situation is not helped by the fact that there are few comparative law references in CJEU judgments (as opposed to the opinions of the Advocate General, which can contain such references). This approach is intended to prevent the EU's autonomous legal texts from being undermined by references to particular legal systems. EU law is seen as an autonomous body of law, and in order to ensure that the rules and concepts of EU law are implemented consistently, their application must be seen to be independent of national preconceptions.[269] Yet, the overall outcome is that the system places unnecessary and unpredictable powers in the hands of the judiciary and erodes the judiciary's status as an impartial check on executive and legislative power.

The approach also has the practical effect that it requires the private sector to consult legislative drafts and process documents—*travaux préparatoires,* working papers for the official preparation of legislative texts—in order to try to discern what the purposes of the law might have been. This brings inefficiencies to the market. Further, and perhaps more dangerous, in view of the uncertainties that may still remain in the law, the private sector often then sees the need to consult regulators and governmental officials, who are perceived to have additional knowledge of those documents and are generally given deference as to what the regime is intended to permit in specific scenarios. This is a lengthy and often inconclusive process. For the more innovative aspects of financial services, such as those involving technology, market participants are typically wanting to test new proposals out with legal advisers

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264 *Ibid.*

265 The CJEU has pursued a fairly aggressive single market agenda. For example, the CJEU has not made any positive determinations on the basis of the treaty concept of "subsidiarity", which was designed to push powers back to member states, since that concept was introduced, partly at the behest of the UK, in 1993. By contrast, the CJEU has curtailed laws which were not made in accordance with the treaty concept of proportionality on several occasions. There is no reason for a practical distinction to be made in enforcing these parallel concepts, which exemplifies how the federalist instincts of the CJEU override the requirement to apply the treaty obligations faithfully in accordance with what was agreed to.

266 See fn 263 above.

267 See fn 174 above.

268 The notion of gold plating is explained above, text to fn 234.

269 See fn 263 above and surrounding text.

before acting. While it is possible to consult *travaux préparatoires*, such documents often fall short and do not cover the point at issue or do so only ambiguously.[270] It is also in principle possible to consult CJEU cases, even though these are not required to follow the rule of *stare decisis.* However, relevant decisions are generally few in number and often suffer from a lack of detailed reasoning that might enable a fully predictive effect. As a result, advisers often fall back on recommending the consultation of officials.

A further point to be contended with is that the purposes detected in the law are often themselves opaque and subject to change.[271] They can be newly identified and applied by courts and public officials after a relevant event has occurred. This is particularly true as a result of the realities of the EU's legislative process. Statements made during the legislative process are often calculated to target different political interests and to appeal to the different national audiences whose support may be necessary. There is unlikely to be any objective statement of overall legislative intent. Furthermore, at the CJEU level, there is sometimes a willingness to "find" a purpose despite the absence of apparent or objective purposes, or at least of purposes clear enough to be capable of accurate application to new facts, on face of the legislation. Although English law does allow the making of reference to legislative history when interpreting statutes, this is done relatively rarely,[272] and materials arising from Parliamentary debates and other discussions in the run-up to adopting a statute in its final form are treated with caution. There is no tendency to try to divine purposes behind what is normally clear statutory wording.[273]

The problem does not stop there. A compounding issue is that the officials are limited in number and have limited time. Many regulators refuse to engage on the basis of a hypothetical situation unless the market participant reveals their identity, which can make engagement more difficult since participants can often wish to remain anonymous and also generally desire that the fact a course of action is contemplated by them should remain a secret. The officials are also wary of regulatory capture[274] and aware of the need to retain a distance from those regulated.

In the civil law jurisdictions—and the EU itself—the purposive method of interpretation and reduced legal certainty in general exposes the weak knowledge of officials about the businesses they regulate and the low levels of responsiveness of officials as to the law's purposes and application.[275] Such an approach is particularly restrictive of individual entrepreneurialism and the wishes of individuals and businesses to act without engaging with a bureaucratic system. Bureaucrats are also typically risk-averse and often fail to understand the full benefits or implications of new initiatives, with the result that valid proposals may be prevented when, had matters been allowed to play out, the benefits would have become obvious.

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270 The use of *travaux préparatoires* is rare in CJEU cases. An exception is in the case of *Pringle v Government of Ireland* (2012) C-370/12.

271 The two level *telos* in *Pringle v Government of Ireland* (2012) C-370/12 is a good example. Compare the BvG's approach to intention with that of the CJEU (the German approach coincides with English law) – in *Weiss and Others*, C-493/17 the BvG expressly disagreed with the CJEU's purposive approach in determining the nature of economic measures taken by the ECB. In fact legislative history is rarely used by the CJEU, though it is recognised by the Vienna Convention on the Law of Treaties 1969 as a means of the interpretation of treaties.

272 *Pepper (Inspector of Taxes) v Hart* [1992] UKHL 3, [1993] AC 593. See fn 134 above.

273 There are nevertheless disagreements as to the approach at the margins. Lord Burrows, in his 2017 Hamlyn Lectures, *Thinking About Statutes: Interpretation, Interaction and Improvement* (2018) CUP, seems to take a view of the "purposive construction" of statute law which assumes that its usual subject matter is the common law, rather than - as it is in practice - public law, including the superimposition of regulatory regimes on transactions and markets operating using mechanisms deriving from the common law. For a critique, see Sir Stephen Laws, *Parliamentary Sovereignty, Statutory Interpretation and the Supreme Court* (2020) 10 Supreme Court Yearbook (forthcoming). Also, ancillary means of interpretation are expressly permitted by the Vienna Convention on the Law of Treaties 1969, and applied by English courts interpreting treaties. In addition, see fn 133 above.

274 See fn 534 below and surrounding text.

275 For more general commentary, see Gardella & Radicati di Brozolo, *Civil Law, Common Law and Market Integration: The EC Approach to Conflicts of Jurisdiction* (2003) 51 Am J Comp Law 611 and Zaphiriou, *Harmonization of Private Rules between Civil and Common Law Jurisdictions* (1990) 38 Am J Comp Law Supp 71.

Practitioners versus academic lawyers

Another critical point is that the EU legal system generally gives a greater role than the common law to academics. Academic and practitioner lawyers function differently. Practitioners have to take account of daily events, while academics operate more through theory. EU legislative proposals can be unduly influenced by academics. EMIR 2.1[276] is an example. The European Market Infrastructure Regulation (EMIR)[277] had to be amended in various ways to address numerous practical issues, which anyone familiar with derivatives markets could have probably have pointed out before the Regulation was made. (In fact many did so, during the consultation.) Yet as a general matter (and EMIR 2.1 was no exception), the EU bodies tend to press ahead on a political top-down basis, without adequate expert input. In doing so they can pursue policy objectives which are at worst impractical or at best ill thought through, and which lack input from experts with experience of the markets they regulate, such as persons who have worked in the City of London, the only global financial centre in the EU. The EMIR 2.1 amendments were made under the European Commission's Regulatory Fitness and Performance Programme (known as REFIT), launched in 2015. The changes included removing an impractical backloading reporting requirement, deleting the frontloading clearing obligation and requiring member states to bring their insolvency laws into line with the requirements of EMIR, for example, to allow account segregation, default management by CCPs and their clearing members, and "porting" and "leapfrog" payments to take place as envisaged in the original legislation. These changes were necessary and their extent highlights the shortcomings inherent in the initial EMIR scheme. Another example was seen when the Bank Recovery and Resolution Directive (BRRD)[278] had to be amended in BRRD II.[279] In addition. academic work may propose procedural or interpretative schemes which are principally the creature of academic thought.[280]

The problem is that academics do not tend to have current, practical commercial experience. Nor do they typically have active practices, so they do not know many of the topical issues or ways in which businesses operate and can end up providing hedged opinions. The academic views are generally subject to challenge only by the academic method. The academics are also, ordinarily, unable to adjust their theories with sufficient dexterity and accuracy to cater for developments in global market practices, since they have little daily interaction with the markets. In the same way, the EU and civil law courts can also demonstrate a lack of sensitivity to market practice. This was seen, for instance, in the 2016 German court decision[281] that all close-out netting provisions (including on ISDA formats) were invalid, which was a decision based on academic writings. Moreover, the reliance on academics has an impact on predictability. No single academic is the source of truth for the court system, so judicial decisions can differ between academic theorists. The court can also determine its own intellectual scheme and depart from the academic literature. Overall, although academic literature can be helpful, it is not a reliable source of law. It fundamentally lacks that which characterises and gives the common law its essence: a rooting in real-world legal disputes and controversies, and a hands on knowledge of the way cases develop as they are presented to actual judges for resolution.

Too many rules – too much risk?

The UK has sought to make the most of the situation, despite the shortcomings and obvious limits of the EU approach. In the UK external lawyers are generally still able to advise firms on what is or is not possible under large portions of the UK system. This is so even within much of the EU regulatory framework, since the UK's case law system of precedent and mode of reasoning provides a level of certainty not present in the underlying EU texts. The UK's regulators have also been able to help, since they are the supervisory and enforcement authorities within the UK system. In addition, the FCA led the way in addressing such needs for start-up firms less able to afford legal advice by being the first

276 Regulation (EU) 2019/834 amending EMIR (Regulation EU 648/2012).
277 Regulation (EU) No 648/2012.
278 Directive 2014/59/EU.
279 Directive 2019/879/EU amending Directive 2014/59/EU.
280 For example, the Lamfalussy Report, fn 177 above, and the de Larosière Report, fn 193 above.
281 See fn 250 above and the surrounding text.

regulator in the world to develop a "sandbox",[282] or safe regulatory space, within which firms can work with officials on entirely new developments and try out novel financial services and products. However, this was an accommodation made under the restrictions of the EU scheme, which can undermine the proper distance between the regulator and a firm. Furthermore, the now embedded EU method, and the federally controlled interpretation of EU law, through the ESAs, means that the unfurling blanket of EU law has been increasingly interfering with the UK's ability to operate a predictable regime. Were the UK to have remained in the EU, its superior system of law and rulemaking would have been continually eroded.

The ultimate destination is apparent from the day-to-day role of the law and the lawyers themselves. Because EU and civil law schemes for regulation are so prescriptive and often have purposes that are not obvious or are hard to discern, their rules are often not taken seriously by businesses and individuals subject to them.[283] Indeed, the rules themselves are typically treated as of comparatively minor significance. So, in the commercial sphere, as for individuals, the civil law method tends to reduce the sense of responsibility – in contrast to the common law's underpinning for self-reliant individualism. In addition, the nature of the advisory legal service is less important in the civil law: advisers have fewer answers to what the law requires, since they often need to seek input from officials.[284] There is only a limited parallel to the reliance and value placed on creativity and imagination for common law practitioners, in finding ways to navigate the system on behalf of financial parties. Another symptom of this fact is that many civil law systems have had lower standards for the protection of client confidentiality.[285]

The EU approach is also undesirable in the context of regulating a safe and sound financial market. The volume of prescriptive material to be consulted is so vast that it makes the financial markets more dangerous, introducing unnecessary risk. This risk arises because the law diverts the finite resource of intellectual capacity onto points of detail that are not necessarily important for the avoidance of systemic or individual firm risk, or to furthering consumer protection.[286] By ossifying processes and business structures the legal system prevents management from responding dynamically to events, and from focusing their attention (under the oversight of their board) on the matters of most importance at the time. Management becomes restricted by armies of people engaged in box-ticking in respect of lower-level details required by EU legislators.

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282 See fn 69 above.

283 The approach in certain Member States seems to have been simply to ignore the EU's rules. In the period 1952—2018, Member States were brought before the CJEU for failing to comply with EU law on 3,957 occasions. France, in many ways the EU's greatest champion, was responsible for 419 of those occasions. Only Italy, with 652 ECJ cases, was responsible for more. Germany, the other great advocate of the European project, faced the fifth most cases, with 293. The UK, long cast as a recalcitrant agitator, came a distant eleventh, with 143 (behind Austria, Portugal, Ireland and others). (Data from the Openpolis Foundation, https://www.openpolis.it/numeri/actions-for-failure-to-fulfil-obligations/).

284 This would not of itself necessarily be undesirable, if the officials had unlimited time, were prompt, expert and could be relied upon to be permissive, consistent and authoritative. However, as discussed below, this is not the case.

285 See Catherine A Rogers, *Fit and Function in Legal Ethics: Developing a Code of Conduct for International Arbitration* (2002) 23 Mich J Intl L 341, 366.

286 Corporates and financial institutions have made it clear that they find the EU's overregulation to be stifling. A number of trade bodies, including the European Banking Federation, the European Fund and Asset Management Association and the European Association of Corporate Treasurers, responded to a European Commission call for evidence in 2016. Respondents cited, among other matters: "unnecessary regulatory constraints on financing", an "unnecessary regulatory burden", "excessive compliance costs and complexity", "outdated rules due to technological change", "increased barriers to entry" due to the complex regulatory framework and a proliferation of "overlaps, duplications and inconsistencies" in the body of EU regulation (summary of the responses to the call for evidence: https://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/docs/summary-of-responses_en.pdf). It has been noted that overregulation of banking in particular, not least the capping of remuneration, has driven the most talented individuals into lighter-regulated firms and sectors. This "brain drain" from the banks can only increase the systemic risk in that industry: Edmund Parker and Mayank Gupta, *Too much regulation creates bank brain drain*, 18 October 2015, FT.com, www.ft.com/content/4dfc4190-719f-11e5-9b9e-690fdae72044.

2.3 Protecting the euro – the impact, implications and risks

As explained above, the EU legal and regulatory architecture for the Eurozone[287] is fundamentally flawed. It is constructed in a way which gives rise to huge amounts of (unmanaged) systemic financial risk,[288] which exposes the assets of savers and investors throughout the EU (and, by virtue of market interconnectivities, the rest of the world) to unforeseeable losses. This extraordinary situation arises from a lack of political consensus over whether and how to achieve the necessary integration entailed by the Eurozone project. At the core of the problem is the fact that the monetary aspects of the euro currency are dealt with centrally by the ECB but fiscal matters remain principally at member state level.[289] Member states have to raise monies (over and above their tax base) through issuing debt in the international capital markets. The split between federal monetary arrangements and national fiscal arrangements creates systemic risk because the Eurozone member states no longer have an ability to control the zone's central bank, the ECB, or order it to print more money if they needed help in repaying their debts. Instead, they depend on hoped-for cooperation from other members. This means that their debt is far riskier than that of, say, the UK or US.

Yet EU regulation ignores this crucial fact. International regulatory capital standards for systemically important banks and certain other large financial institutions are set by the Basel Committee.[290] Properly applied, in accordance with their intended purpose, these standards would treat Eurozone member state debt as sub-sovereign, in recognition of the fact that the risk of default of the member state issuers is far greater than that of a normal sovereign. Yet, instead, the single EU financial services rulebook treats the debt as risk-free and of sovereign quality,[291] allowing EU member states to raise capital by issuing debt on the financial markets as though nothing untoward was going on. So, under EU law and regulation, EU financial institutions can buy and hold that debt without attracting any regulatory capital requirement,[292] and can also treat it as a fully liquid instrument for liquidity purposes[293] and as of full value for collateral purposes.[294] Yet, there are in fact no Eurozone sovereign instruments that warrant this treatment.[295] The reason is of course simple: the Eurozone currently lacks the political will to mutualise its debts;[296] and it lacks the money to apply international regulatory standards.[297] A currency zone needs federalised funding, raising debt as a sovereign at the federal level,

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287 19 of the 27 current EU member states are in the Eurozone: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia Slovenia and Spain. Denmark has opted out, as had the UK before it left the EU. Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania and Sweden are not in the Eurozone.

288 See the text that surrounds fn 449 below for a summary of the risks addressed by financial regulation.

289 The recent decision to raise capital through pan-EU bonds in the context of COVID-19, agreed politically at the end of 2020 (https://ec.europa.eu/info/strategy/recovery-plan-europe_en), does not ameliorate the situation in any material way since the amounts are too small in the overall context.

290 See fn 75 above.

291 The way in which this occurs, how it is at odds with the intention behind the international Basel Rules, and the effects it gives rise to, are highly complex and technical matters. The position is set out in detail in the author's co-authored publication *Managing Euro Risk*, fn 5 above. The fundamental flaw is explained in Chapter 1. There are also further detailed points that exacerbate the situation, *e.g.* the ECB's TARGET2 system, the ECB's "quantitative easing" programme, the European Investment Bank Group and Eurozone bank non-performing loans: *ibid.,* Chapter 2.

292 See *Managing Euro Risk,* fn 5 above, Chapter 1, section 1.3.

293 *Ibid.,* Chapter 1, section 1.4.

294 *Ibid.,* Chapter 1, section 1.5.

295 *Ibid.,* Chapter 1, sections 1.6 and 1.7. The proposed COVID-19 capital raising (see fn 289 above) does not materially affect this point.

296 Member states could introduce joint-and-several Eurozone sovereignty and stand collectively behind each other's debt issuances. They would then benefit from each other's creditworthiness and, collectively, would effectively constitute a sovereign debt issuer that could exercise control over the ECB as the issuer of the euro currency. However, such a step would involve taxpayers in northern Europe accepting a level of political, economic and fiscal integration with the South and East that, so far, they have not been willing to accept. The German Finance Minister, Olaf Scholz, recently made relatively minor suggestions for integration – i.e., a Eurozone scheme to reinsure member state bank deposit guarantee schemes. Unfortunately, even his small suggestion (which in any case would have been only a minor fix) has been strongly resisted, not least in Germany itself. See O. Scholz, *Germany will consider EU-wide bank deposit insurance*, 5 November 2019, Financial Times; and then M. Khan and G. Chazan, *Weakened Scholz puts brakes on Eurozone reform*, 4 December 2019, Financial Times.

297 See *Managing Euro Risk,* fn 5 above, Chapter 8.

but this would involve member state taxpayers assuming liabilities across the zone, for which there is no political backing.

Systemic risk, mitigated but unmanaged

The point goes to the foundations of the EU financial system, creating risk which international rules are intended to protect against. This is because the international financial system treats genuinely sovereign debt (such as UK and US government debt) as the bedrock of the system – as the main asset that can always be relied on by financial firms in times of trouble. The debt is generally issued in the form of transferable bonds, so it can easily be offloaded for full value by financial firms which experience cashflow difficulties. As a result, it is the most dependable asset of the system. A true sovereign can be relied upon to have the ability to raise taxes and control the printing presses of its central bank, so its sovereign bonds are seen to comprise instruments that are akin to cash and so do not attract any regulatory capital requirements on the part of financial firms holding that debt. The bonds can also be used by those firms for full value as collateral and as an entirely liquid instrument which can be used at no notice to settle payment obligations.[298] However, by treating Eurozone member state debt in the same manner, the EU operates on a fiction that the Eurozone financial system's main asset is other than what it is. The EU system assumes that member debt is risk-free when it is in fact nothing of the sort. In the context of Basel Rules, Eurozone member state debt is more akin to debt issued by public sector entities (e.g., municipal bonds in the US). Such entities sit immediately below a sovereign. The holder of this debt runs the risk of a default on the part of the member state issuer, suffering any losses resulting from non-payment, where such an eventuality should not arise in the case of true sovereign debt.

EU law therefore creates dangerous systemic risk, arising from the very EU law system itself, since the EU system is operating on a false premise. The risk flows across the entire EU financial system as a result of the uniformity of the EU single financial services rulebook.[299] Furthermore, the interconnectivities of financial firms in their dealings, and the fact that the risk arises from pan-EU rulemaking, means that the risk is quickly dissipated throughout the EU financial system in a manner no one individual firm or participant can easily trace. Similar interconnectivities mean that the risk is then effectively offloaded to others, outside the EU, to the detriment of investors and savers in the UK and the global markets.[300] The result is that the EU is operating its financial system at the expense of the rest of the world, polluting other countries with financial risk – a phenomenon which will only cease with the proper integration of the fiscal arrangements for the Eurozone. The international regulatory standards set out in the Basel Rules would have required that Eurozone risks would be absorbed solely within the Eurozone. However, no doubt due to the obvious costs of doing so, the EU has chosen not to ringfence the risk whilst the Eurozone arrangements remain half-built.

Despite this, while in the EU and during the transition the UK used its supervisory powers to mitigate the risk for itself and the global market which it hosts through the application of discretionary top-up capital requirements to UK-incorporated banks as a result of annual Bank of England stress tests.[301] Notably, the EU does not do the same for itself nor (through the EBA[302]) for the Eurozone.[303] So the risk within the EU itself is unmanaged and unmitigated, because the Basel Rules are not properly applied to the source of the risk, and there is no supervisory counterbalance applied (unlike in the UK) to address the risk arising for EU financial institutions on a day-to-day basis. This is to be expected, since the EU lacks the political will to address Eurozone risk as a matter of financial regulation. It would be surprising if, having painstakingly produced financial rules which ignore international

[298] See fns 294 and 293 above, respectively.

[299] See *Managing Euro Risk,* fn 5 above, Chapter 4 for the scale of the problem. This is in addition to the other risks inherent in the Eurozone system, for instance that investors take the EU member states' budgetary constraints seriously and count on the ECB bailing out over-indebted states through the buying of their debt.

[300] See *Managing Euro Risk*, fn 5 above, Chapter 6.

[301] *Ibid.,* Chapter 7. The European Commission and France tried to put a stop to the UK's ability to do this. See A. Barker, *Barnier vs the Brits*, fn 190 above, and A. Barker, *UK in furious rejection of EU bank plan*, fn 307 below.

[302] Perhaps surprisingly, it is the EBA, a pan-EU body, which conducts stress tests for the Eurozone.

[303] See *Managing Euro Risk*, fn 5 above, Chapter 7.

standards and the risks they seek to manage, the EU were to override the benefits (to it) of those rules at a supervisory level. It is therefore the UK which is left to take precautions against this unmanaged risk. This is an action which benefits the global financial market which the UK hosts. The US does not do so, though there may be less of a need on the basis that most EU business that intersects with the global market is undertaken in the UK.[304]

Before the end of 2020, the costs of the UK's actions in mitigating Eurozone risk were thus forced to fall solely on financial institutions incorporated in the UK.[305] It was necessary for the UK's regulators to take action to protect their own market, and the global market, from Eurozone financial risk, imposing costs that would have been unnecessary had EU law been properly conceived. The UK fulfilled its mitigating role notwithstanding the fact that the single EU rulebook severely constrained its abilities.[306] EU rulemaking occurred through laws and regulations effective in the UK, but formed at a pan-EU level over which the UK had only a minority vote. The EU even sought at one stage to make rules preventing the UK from managing the risk entirely, by removing the necessary discretions (in the single EU rulebook) on which the UK authorities rely.[307] Meanwhile EU firms operated from EU member states cross-border into the UK or through a UK branch, under the passport, applying unmodified EU standards. EU law required the UK to treat EU firms equally with UK financial institutions, despite the fact that the EBA left the risk arising from the Eurozone unchecked for institutions incorporated within the zone.[308] The UK authorities had no jurisdiction to address the matter more broadly.

EU accounting standards and practices that are not in conformity with international standards and practices exacerbated the situation and were applicable in the UK.[309] For instance, under EU law banks may treat non-performing loans as partially performing, to a discounted percentage of the notional amount, without any renegotiation of the contracts;[310] and Eurosystem accounts do not list all public

304 *Ibid.,* Chapter 7, section 7.2.

305 The UK sought, with difficulty, in the attempted renegotiation of the UK's relationship with the EU by Prime Minister David Cameron in February 2016, to establish that the UK and sterling were independent of, equal to, and ring-fenced from the Eurozone and the euro. However, that amendment to the EU's architecture would have resolved only part of the problem for the UK under EU law in a post-Brexit environment: Letter by President Donald Tusk to the Members of the European Council on his proposal for a new settlement for the United Kingdom within the European Union, European Council, 2 February 2016, and David Cameron's statement on EU renegotiation: 3 February 2016.

306 An EU Parliament study, *The Impact of the UK's Withdrawal on EU Integration, Policy Department for Citizens' Rights and Constitutional Affairs*, June 2018, describes the UK's role, particularly in the euro's early years, as the "*de facto* banker of much of the Eurozone"; http://www.europarl.europa.eu/RegData/etudes/STUD/2018/604973/IPOL_STU(2018)604973_EN.pdf. The UK has nevertheless managed to mitigate Eurozone risk by imposing top-up capital requirements on UK-incorporated financial firms to counteract the risk in the UK, where the EU meets the global markets: see fn 301 above.

307 The EU sought to remove the UK's ability to adjust for risk uncaptured by the EU regulatory framework by attempting to block the UK's power to impose additional discretionary capital requirements (under Pillar 2 of the Basel Rules) on UK-incorporated firms: "To the delight of European banks – and the consternation of Whitehall – the Commission [and Michel Barnier, internal market Commissioner] in July [2011] proposed a limit on how much capital national regulators could force banks to hold. British ministers think this was deliberately aimed at undermining the flagship recommendation of the Vickers commission, which advocated ringfencing UK retail operations behind a higher capital buffer", A. Barker, *Barnier vs the Brits*, fn 190 above. Similarly, "The bad-tempered exchanges at a late-night meeting of European finance ministers risked scuppering agreement on a 600-page law to implement the Basel III international accord on bank capital. When some British demands to toughen up the text were rejected, Mr Osborne bluntly accused the European commission of offering concessions to French and German banks that breached the global agreement. 'We are not implementing the Basel agreement, as anyone who will look at this text will be able to tell you,' Mr Osborne told his stunned counterparts. 'I'm not prepared to go out there and say something that will make me an idiot five minutes later.' His sharp attack reflects the deep distrust marring relations between Brussels and London over regulation of the City... The 'polemic' drew an angry response from Michel Barnier, the French EU Commissioner overseeing financial services, who insisted his rules complied with Basel while taking account of European 'specificities'. Another flashpoint is the British and Swedish insistence that national regulators have the freedom to impose tougher rules on banks without EU approval – a move that Mr Barnier says will imperil the single market": see A. Barker, *UK in furious rejection of EU bank plan,* 2 May 2012, Financial Times, https://www.ft.com/content/82eab320-949c-11e1-bb0d-00144feab49a, which began with "Britain's poisonous relations with Brussels erupted on Wednesday as George Osborne, the chancellor, refused to defend watered-down EU bank rules that would make him 'look like an idiot'".

308 See fn 302 above.

309 See *Managing Euro Risk*, fn 5 above, Chapters 2 and 3.

310 *Ibid.,* section 2.4 of Chapter 2.

debt in the manner of other developed countries, such as the UK or US.[311] Both of these steps add risk to the system. In numerous ways the underlying legal flaw in the architecture of the Eurozone has been built upon by a multitude of pan-EU rules and regulations, top-down. The result is that the EU single rulebook creates risk, when the purpose of financial regulation is to remove or manage risk. That risk is then left unmitigated by the EU system.

Examples

The extensive list of legislative rulemakings, protecting the Eurozone, make for an interesting lesson in how the EU system, at least as it stands, has prioritised its perceived political interests over the management of systemic financial risk. Examples of additional EU rules which protect the Eurozone from the need to comply with international regulatory standards include:

- *Controlling adverse ratings of EU member state debt.* Through the Credit Rating Agencies Regulations the EU has empowered the pan-EU supervisor, ESMA, to oversee credit rating agencies, allowing it to control adverse credit ratings of members' debt when they are used across the EU as a whole.[312]

- *Controlling the downwards pressure created by short sellers on EU member state debt.* Through the Short Selling Regulation[313] the EU has introduced an ability for its regulators to ban short selling of EU government bonds, which has been used to reduce downwards pressure on the value of Eurozone bonds.

- *Encouraging central counterparties to accept Eurozone risk.* The EU has created a regulatory incentive for financial market participants known as central counterparties, or CCPs, to accept Eurozone risk.

    - CCPs are financial institutions which deal (principally) in the derivatives and equities markets as a passive counterparty to participants who are active in the markets. They seek to assume no risk of the default of their own counterparties, sitting in the middle between buyer and seller, acting as buyer to every seller and seller to every buyer in transactions which exactly mirror each other. A CCP automatically assumes such a role when a contract is entered into across an exchange, and it does so through a novation process when the contract is initially entered into bilaterally or "over the counter". CCPs are particularly important in the derivatives markets since they allow contracting parties to net off their trades across the market in an instrument "cleared" by a CCP because for all of those trades they will face the CCP. This makes the financial system safer by significantly reducing financial exposures and therefore systemic risk across the market as a whole. After the 2007–2008 financial crisis, the role of CCPs was bolstered, so as to require the clearing by a CCP of certain liquid derivatives contracts:[314] this reflected an enhanced understanding of the importance of CCPs.

    - EU law regulates EU CCPs, and also non-EU CCPs recognised by the EU as legitimate venues for EU customers to use for their clearing (which now includes

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311 *Ibid.,* Chapter 3. The system runs four different sets of accounts, but, when consolidated, it assumes the amounts owing between national central banks (NCBs) and the ECB can be netted, thereby disregarding the intrasystem gross exposures. It is unclear whether this assumption is legitimate, even under EU law: *ibid.*

312 Regulation (EC) No 1060/2009.

313 Regulation (EU) No 236/2012.

314 This was pursuant to a G20 agreement after the 2007-2008 financial crisis to address some of the systemic risk issues identified as having arisen, by requiring the clearing of liquid financial instruments (and where possible also to force trading onto exchanges, to ensure the most transparent pricing): see the Leaders' Statement from the G20 Pittsburgh Summit in September 2009. This was rightly seen to reduce systemic risk in the financial markets. Absent clearing, financial institutions have exposures on derivatives, repos and other long-term contracts to each other on a bilateral and gross basis, whereas a CCP allows individual firms to treat their cleared exposures on a net basis.

UK CCPs, from the end of last year). CCPs are only permitted to accept cash or certain government bonds—including EU member state bonds, and UK and US government bonds—as collateral.[315] CCPs may themselves determine which issuers to accept. Some CCPs will not accept all EU member state issuers' bonds as collateral. EU law also requires the investment of cash held by CCPs into such assets and other high-quality "sovereign" debt instruments, but again CCPs may choose between these instruments when making their decisions.

- Revisions to EMIR, known as EMIR 2.2,[316] enhance the ECB's role in the regulation of CCPs and include regulatory restrictions and processes for CCPs to change the kinds of sovereign debt that they will accept as collateral. This allows an EU-based CCP's college of regulators to prevent a CCP from changing accepted collateral classes on risk grounds,[317] and can be used to encourage CCPs to accept Eurozone member state bonds (which are treated as sovereign for these purposes) as collateral at a higher value than that attributed to them by the financial market as a whole. This risk is then effectively borne by a CCP's members and, through them, the global markets.

- *Offloading retail risk into the global market.* The EU has used bank regulation to offload risk for member state retail (and other) depositors and investors into the global market. This has been effected through the Bank Recovery and Resolution Directive[318] regime and its equivalent for ECB-regulated banks, the SRM.[319] When EU banks are seen to be "failing or likely to fail", these regimes give the EU authorities the power to "bail-in" creditors, *i.e.* incrementally to write off a bank's equity holdings and write down its subordinated debt, and then its senior debt, up to a point where this allows the bank to continue in business, while ensuring the protection of retail depositors up to a limit of €100,000 in their accounts.[320] In practice, the authorities have sought to manipulate the application of this regime with the effect of targeting international wholesale investors by bailing-in their debt and avoiding the strict application of some of its rules to minimise the bail-in for local member state depositors as well as for local taxpayers and retail investors who hold some of the bank equity or debt.[321]

- *Discouraging cross-border intra-Eurozone bailouts.* There is a lack of permitted or encouraged cross-border intra-Eurozone bank mergers and acquisition activity. This is because cross-border mergers could expose the acquirer, along with other financial firms which contribute to the deposit guarantee scheme of the acquirer's country, to the non-performing loans and any partiality in the application of law and regulation for the target bank.[322]

- *Permitting transactions which obscure Eurozone bank risk.* The EU has permitted banks to securitise non-performing loans and repackage them, with guarantees by the relevant Eurozone

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315 European Market Infrastructure Regulation (EMIR), article 46, read with the related Regulatory Technical Standards (Commission Delegated Regulation (EU) No 153/2013).
316 Regulation (EU) 2019/2099 amending EMIR.
317 See *Managing Euro Risk*, fn 5 above, Chapter 5, Factor 3.
318 Directive 2014/59/EU.
319 Regulation (EU) No 806/2014.
320 Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, under which retail depositors with less than €100,000 are to be paid out by way of the national deposit guarantee scheme which each member state is supposed to have and to fund, so that the resolved bank would be liable to the national deposit scheme as the only creditor, with the bailed-in depositors becoming shareholders with shares that reflect how much in excess of €100,000 they had in their accounts. So far there have been no pay-outs from the national deposit schemes and this template has not been fully followed.
321 So, for instance, there has been a failure to apply a rule requiring the write-down of 8% of bank liabilities upon receipt of public monies (State aid) in numerous cases of EU bank resolution or recapitalisation, spanning Greece, Italy, Cyprus, Germany and elsewhere: see *Managing Euro Risk*, fn 5 above, Chapter 5, Factor 1.
322 For instance, when the EU and Eurozone authorities considered the rescue of depositors in the Co-op Bank of Cyprus, difficulties under Cypriot law in recovering local mortgage debt through repossession were seen as a risk that other Eurozone member states and the financial institutions located there should not accept.

member state where the borrowers are located. The originating banks are allowed to treat themselves as no longer exposed to those non-performing loans. EU law then permits EU banks to hold the securitised loans at a level reflecting a risk-free, sovereign treatment of the Eurozone member state guarantee, not taking into account the true credit risk arising from that guarantee. The approach was pioneered by Italy[323] and was subsequently used by Greece in the "Hercules" programme.[324] Yet in these cases the relevant member state providing the guarantee was itself only ranked as investment grade (Republic of Italy) or speculative grade (Republic of Greece) in its creditworthiness.[325]

- *Proposed sharing of Eurozone risk by global financial sector.* A further mutualisation of Eurozone risk across the global financial sector is proposed through a European Deposit Guarantee Scheme (EDIS),[326] which would mutualise the effects of a failure of a Eurozone bank by sharing losses for local deposit-takers across the banking community operating within the Eurozone as a whole. The Scheme would be pre-funded by the EU subsidiaries of global firms, alongside local firms.

These examples are explained in further detail in Annex 3 below.

An absence of scrutiny?

It can therefore be seen that one key feature of EU financial services law is the fact that many of the financial regulations embed deep-seated and little-examined political choices of considerable magnitude. These choices can arise from the political rather than the purely legal sphere and have undermined the exercise of UK sovereignty and the common law method. Most notably, certain of the rules have sought to further the vital (but unique) interests of a subset of the EU, the Eurozone. As a result, numerous financial regulations have been prompted not by technocratic reasons to further the proper aims of financial regulation in the UK—something the UK might have accepted under the shared sovereignty arrangements of the EU, if properly executed. Instead, they have sought to protect the Eurozone's legal architecture, and to offload the risks and indirect costs of the Eurozone onto international investors.[327]

It is difficult to believe a judicially based common law system could have carried off the creation of such an extraordinarily embellished web of rules, based as they are on a false premise, that Eurozone member state debt is risk-free, which is an assumption at odds with international standards.[328] It is also odd that the point has not been fully identified and examined in the European Parliament during the process of the promulgation of these rules.

2.4 The deployment of EU law - business generation versus risk management

Furthermore, it is notable that the politically-driven approach of the EU system creates systemic risk, borne throughout the world, and that this appears to be seen as an acceptable price (for others) to pay.

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323 The Republic of Italy agreed to provide €12 billion of guarantees to assist with securitisation of non-performing loans. See *Italy: Liquidation of Veneto Banca and Banca Popolare di Vicenza*, 12 July 2017, Economic Research Department, BNPParibas, https://economic-research.bnpparibas.com/html/en-US/Liquidation-Veneto-Banca-Banca-Popolare-Vicenza7/12/2017,30109.
See also https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr170623.en.html.

324 See https://europa.eu/rapid/press-release_IP-19-6058_en.htm.

325 https://tradingeconomics.com/greece/rating.

326 Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme, COM(2015) 586 final, 24/11/2015.

327 See *Managing Euro Risk,* fn 5 above, Chapters 4 and 6. There are other consequences to this architecture, over and above those relating to financial risk, involving potential breaches of WTO law on trade, through dumping of artificially underpriced goods (particularly from the northern Eurozone) and unfair trade subsidisation, both of which can be counteracted by the imposition of tariffs and duties (as self-help remedies) by countries outside the EU: see David Collins, *How to Level the EU's Playing Field: Trade Remedies for a Trade Deal* (2020) Politeia. See also David Blake, *The UK is the Eurozone's dumping* ground, April 2020, Briefings for Britain, for a discussion of the economic distortions arising from the effects of the Eurozone's structure at the level of specific Eurozone member states.

328 See *Managing Euro Risk,* fn 5 above, Chapter 7, section 7.4.

EU law has been crafted for the political purposes of the Eurozone. More recently, during the Brexit negotiations the EU authorities, including EU regulators, have attempted to pull financial business from the UK into the EU (so that it becomes subject to EU law), regardless of (and apparently oblivious to) the implications for Eurozone risk.[329] As has been shown in section 2.1, there is precedent for the use of EU law to grab business. In 2007-2008 the EU developed a narrative that the financial crisis was caused by the Anglo-Saxon approach, justifying the imposition of EU law over the UK's markets, partly in the hope of attracting business away from the UK. Now, the EU system is yet again seeking to prioritise its political interests over the management of systemic risk as a result of Brexit.

The latest EU strategy

The EU's strategy to acquire financial business has operated in two ways.

The myth of the "cliff edge". First, financial services businesses in the UK were encouraged to believe that, unless the UK agreed a financial services trade deal on the EU's terms (which did not occur), they needed to move their EU customer contracts to EU financial firms. This was required in order for UK businesses to avoid committing offences under EU law and regulation after the UK left the transition period (as extended) which resulted from the falling away of the EU passport as a result of the UK's notice to leave the EU.[330] The proposition was that there would be a "cliff edge" at that time for any financial services contracts that were in the process of being performed between UK financial firms and EU customers or contracting counterparties. Without the passport, the perimeter of EU regulation would spring up and UK businesses operating then from outside the EU would find that their contracts, which had been initially valid, were no longer legal to perform. The ongoing provision of services by UK businesses, cross-border, would breach EU rules and would entail the commission of offences by those firms, and the potential unenforceability of their contracts. This was said to be so despite the fact that those contracts were generally providing benefits to EU businesses and citizens. UK firms were then led to believe that, to avoid huge penalties from the EU, they should set up new EU financial subsidiaries, or expand existing ones, to take on those contracts so that the obligations under them could continue to be performed.[331] In a further attempt to drive business into the EU, the pan-EU regulatory

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329 J. Crisp, *Brussels draws up hit list of UK financial services as row over EU rules after Brexit intensifies*, 22 January 2020, Daily Telegraph. These relate to the 40 areas where the EU has equivalence arrangements with third countries: Equivalence in the Area of Financial Services, Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, COM(2019) 349 final, 29 July 2019, European Commission, https://eur-lex.europa.eu/legalcontent/EN/TXT/?uri=CELEX:52019DC0349. France, in particular, had ambitions to establish itself as a leading EU financial centre, in apparent disregard for the systemic risk implications and costs to EU businesses and consumers, based on the following narrative: "Until 1914, France was Europe's banker, even if London was the world's banker. Brexit is perceived as the best opportunity in a century to regain that pre-eminence, what a French Senate report called its 'age-old ambition'. …The prospect of Paris dethroning London is perceived, on the other side of the Channel, as within France's grasp. It has snaffled the [EBA] on repatriation to the Eurozone from London in the wake of the Brexit Referendum, denying Frankfurt its natural home. Macron manoeuvred deftly to get Christine Lagarde, French former Centre-Right Finance Minister to replace Mario Draghi as head of the ECB. In a France Info radio interview on 27 January, France's highly ambitious and powerful Finance Minister, Bruno Le Maire, repeated the line that Paris was about to overtake London as Europe's prime financial centre. He went on to say that in the Brexit negotiations France can benefit 'if we are firm'" (J. Keiger, *Macron's new post-Brexit negotiating position*, 30 January 2020, Briefings for Britain; https://briefingsforbritain.co.uk/macrons-new-post-brexit-negotiating-position/). France has also tried to use long-term tax breaks to tempt UK-based bankers to move to Paris (A. Dawber, *Sarkozy woos City bankers with promise of Paris tax break*, 23 August 2010, The Independent; https://www.independent.co.uk/news/business/news/sarkozy-woos-city-bankers-with-promise-of-paris-tax-break2059472.html).

330 Under Article 50 of Treaty on European Union this notice period was 2 years. Notice to leave the EU was served by the UK on 29 March 2017, but the exit period was then extended and, under the UK-EU Withdrawal Agreement 2019, EU law continued to apply in the UK until the end of 2020.

331 There were high level statements to the contrary, but without sufficient legal certainty to provide a basis for leaving contracts in place: *e.g.* Huw Jones, *EU says no cliff-edge risk from Brexit for derivatives*, 18 October 2018, Reuters, which stated "Britain is taking legal steps to ensure contract continuity, but the EU has so far declined to mirror these moves. [The EU Financial Services Commissioner, Valdis] Dombrovskis told a Politico event that the clearing of derivatives is one area of concern, but the private sector could take action to mitigate risks, such as shifting contracts from London to the EU before March. Asked about concerns over derivatives in a no-deal Brexit, Dombrovskis' top civil servant, Olivier Guersent, said: "There is no cliff. On 30th of March... nothing happens," Guersent said, adding that contracts would be

bodies, the ESAs, then issued various "opinions" indicating that the subsidiaries needed to be staffed and operated locally to a more significant degree than firms had proposed (within EU law).[332] The EU authorities and member states also put considerable further regulatory pressure on firms to bolster the size of their offices in the EU.[333]

The UK authorities accommodated this business grab,[334] in part because the UK's regulators were still operating under EU law and the oversight of EU bodies, including the ESAs. The UK regulators asked UK firms for details of their plans to move affected contracts to EU affiliate entities.[335] Many such moves took place.[336] Yet, as has been shown in section 2.3 above, any financial contracts which contain (as many do) exposures to elements of the Eurozone are much safer if they are with UK financial firms, and held in the UK, where Eurozone risk is mitigated. UK firms that hold those assets are safer counterparties and custodians for those assets. Even other assets, which do not involve taking on financial exposures to any elements of the Eurozone, are also better protected in the sophisticated UK system, because of the availability of the common law, including the law of trusts, as explained in Chapter 1, sections 1.5 and 1.6, and Annex 1. Were the EU system to be a normal one in seeking to avoid, manage, or (failing that) mitigate financial risk, it would not operate in this way. Eurozone risk is safely mitigated for financial assets in London but not in the EU, and the regulatory system has an interest in ensuring London is where business takes place.

Moreover, many of the moves encouraged by the EU were entirely unnecessary. In this whole episode the possibility was overlooked of placing reliance upon the protections afforded to contracting parties under provisions on "acquired rights" and rights to property under international law and EU law itself,[337] which protect the parties in their entitlements under valuable contracts, once entered into, regardless of intervening events such as Brexit. These is case law to that effect, including from previous break-up of empires and the former Soviet bloc.[338] The point even appears eventually to have been accepted by the European Commission, which stated that it did not see a general issue over the continuity of contracts at the point of the UK's departure from the EU scheme.[339] Yet, EU law was used to lever the transfers of business to the EU despite this fact, and despite the increase in risk that arose from the EU laws underpinning the Eurozone, which aggravates the risks for savers and investors arising from EU law and the Eurozone.

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dealt with on a case-by-case basis." Clearly this was inadequate in providing any meaningful comfort that specific contracts did not need to be moved and that no action would be taken by the EU if they were left with UK firms. The piece continued: "banks say Brussels is slow to deal with potential contract disruption in order to pile pressure on them to staff new hubs in the EU before March and shift the contracts to them."

332 See the opinions and other papers issued by the three ESAs, the first of which were: Opinion of the European Banking Authority on issues related to the departure of the United Kingdom from the European Union, EBA/Op/2017/12, 12 October 2017; General Principles to support supervisory convergence in the context of the UK withdrawing from the EU, 31 May 2017, ESMA42-110-433; and Opinion on supervisory convergence in light of the United Kingdom withdrawing from the European Union, EIOPA-BoS-17/141, 11 July 2017.

333 *E.g.* Paul Clarke, *City banks under pressure to strengthen Brexit hubs in Europe*, 20 January 2020, Financial News.

334 See *e.g.,* Caroline Binham, *Banking watchdog warns of risks from cliff-edge Brexit*, 9 August 2017, Financial Times. The Financial Policy Committee discussed these concerns in its meeting of 20 September 2017.

335 *E.g.* Madison Marriage, *Regulator demands detailed Brexit plans from UK asset managers*, 31 May 2017, Financial Times. Or, see https://www.fca.org.uk/firms/considerations-firms-after-transition-period.

336 *E.g.* Mike Starling, *Brexit exodus: 7,500 UK finance jobs and £1.2trn in assets move to Europe*, 1 October 2020, The Week.

337 For a discussion of how the right to property under the European Convention of Human Rights (ECHR) and the EU Charter of Fundamental Rights, and the doctrine of "acquired rights" under public international law, protect contractual rights, see: *Continuity of Contracts and Business on a "hard" Brexit: Human Rights and Reverse Solicitation to the Rescue"*, 31 October 2017, Shearman & Sterling LLP.

338 *Ibid.*

339 See the Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions and the European Investment, "Preparing for the withdrawal of the United Kingdom from the European Union on 30 March 2019", COM (2018) 556, 19 July 2018, in which it stated "[i]n relation to contracts, at this juncture, there does not appear to be an issue of a general nature linked to contract continuity [because] in principle, even after withdrawal, the performance of existing obligations can continue."

EU law for access. Secondly, the EU has indicated that in future it will only grant easy access to its customers for UK-based financial businesses in their cross-border sales if the UK does not diverge from EU financial laws and regulations in a manner the EU finds unacceptable.[340] There are various ways in which UK-based businesses can continue servicing existing and new EU customers going forward, some of which are cheaper for those customers than others. None requires the UK to follow EU law. The one which is selected will depend on the extent to which the EU acts in the best interests of its businesses and citizens in recognising UK standards. The default is the most expensive (for EU customers, since the costs are likely to be put back onto them). This involves UK firms offering certain services and products through EU financial subsidiaries, or EU financial middlemen, when EU law requires it. These entities will have to be capitalised and staffed up separately in order to intermediate the sales. This is the traditional way of selling into a particular country, but operating on this basis would be to ignore one of the benefits (to the EU) of provisions of EU law that enable easier and cheaper access. These provisions state that where the law of a third (*i.e.,* non-EU) country is equivalent to EU law, firms in those countries can operate across the EU in reliance on their own, equivalent laws. The EU has made unilateral equivalence decisions for tens of countries around the world, including the US, Mexico and Singapore.[341] The EU is now considering whether to make equivalence decisions for the UK.

A Declaration made contemporaneously with the new UK-EU Trade and Cooperation Agreement 2020 states that the UK and the EU will by March 2021 agree a Memorandum of Understanding which provides, *inter alia*, for transparency and appropriate dialogue in the process of adoption, suspension and withdrawal of equivalence decisions. However, this Memorandum will not be legally binding and the EU has not committed to the instances in which it will grant equivalence-based access to EU businesses and consumers. Furthermore, the provisions themselves allow the European Commission to determine equivalence, and to withdraw any favourable determination on (typically) one month's notice.[342] It would appear likely that there will now be a period during which the EU attempts to grab business from the UK by dangling the possibility of granting or withdrawing equivalence decisions over various segments of the UK financial market. The UK has inherited the EU's equivalence framework and has so far made various declarations in favour of the EU. The UK also has a more open perimeter which allows for far more business to be conducted cross-border from the EU into the UK than the other way around,[343] although cross-border business from EU firms into the UK can still be prohibited by EU law itself since this applies to the EU counterparty to a UK trade.

It would also be possible for the EU to provide for a more certain, and wider, form of access by making relatively small changes to the existing equivalence framework, in an arrangement known as Enhanced Equivalence.[344] This option is set out in section 1 of Annex 4. It would be the optimum outcome and could well be arrived at once the politics settle down. However, in the meantime, if equivalence declarations are not forthcoming, UK financial businesses will need to provide services to some EU customers from places of business in the EU. By introducing this annoyance, the EU has sought (and

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340 See the European Commission's Questions and Answers document on the UK-EU Trade and Cooperation Agreement, dated 24 December 2020, which states that equivalence determinations will need to take into account "how the UK will diverge from EU frameworks after 31 December", which is a point which the UK has only just started to consider. See also S. Payne, C. Giles, J. Brunsden, *Boris Johnson admits Brexit deal is limited for financial services*, 27 December 2020, Financial Times. The EU has consistently adopted this approach: see, *e.g.* J. Brunsden, S. Fleming and P. Stafford, *EU chief issues Brexit warning over City of London access: Dombrovskis says UK could be cut out if it diverges from Brussels standards*, 2 December 2019, Financial Times, https://www.ft.com/content/59569142-12c9-11ea-a7e6-62bf4f9e548a.

341 See *A Blueprint for Brexit,* fn 1 above, especially Annex A.

342 Examples of such equivalence regimes are set out under: Article 47 of the Markets in Financial Instruments Regulation (Regulation (EU) No 600/2014), Article 25 of MiFID II, Articles 35, 36 and 39 to 42 of the Alternative Investment Fund Managers Directive (Directive 2011/61/EU), Articles 2a, 25 and 75 of the European Markets Infrastructure Regulation (Regulation (EU) No 648/2012), Article 5 of the Credit Rating Agencies Regulation (Regulation (EC) No 1060/2009), Article 25 of the Central Securities Depositories Regulation (Regulation (EU) No 909/2014), Article 19 of the Securities Financing Transactions Regulation (Regulation (EU) 2015/2365) and Article 30 of the Benchmarks Regulation (Regulation (EU) 2016/1011).

343 See fn 70 above and surrounding text.

344 See Annex 4, section 1.

continues to seek) control over the shape of UK financial regulation, despite the UK no longer having its key role (within the EU) in determining and restraining the detail of that regulation.

The need for risk management

The UK (driven initially by the Bank of England) has rightly rejected the idea of following EU law[345] and has offered a looser relationship that would benefit both parties and leave the UK free to regulate to protect the financial market.[346] Any acceptance of EU regulation in the UK would be highly dangerous, given that the EU law system ignores Eurozone risk. The wish of the EU authorities to take business after Brexit comes with too heavy a price tag in terms of the risk created to the global market and the UK economy. It has already been seen in section 2.1 above how the financial crisis of 2007-2008 arose in large part as a result of unmanaged systemic risk. The UK cannot allow itself, its taxpayers, or the global market to be exposed to risk resulting from the EU law arrangements for the Eurozone. The EU's forced moves only increase the exposures within the EU system to the implications of the flawed rules outlined in section 2.3 above. The EU's actions in the context of Brexit can be seen as reckless for the world's savers and investors. This is quite apart from the fact that EU law is overly prescriptive in a manner uncomfortably at odds with the traditional UK method of regulation. It also misdirects attention onto points of lesser significance, forming a distraction from points of much greater importance. Now the UK has left the EU system, the UK need no longer operate its regulatory regime within the inherited EU law framework. The UK needs to remain free to take the steps in Chapters 4 and 5 below to purge itself of the unattractive elements of the inherited EU rulebook and the EU law method, and to reinstate the traditional UK method of law and regulation.

Any future trading arrangements for financial services should accommodate this need. The idea that there is a choice to be made by the UK between having no access for UK financial firms to EU customers or following EU law and regulation is false. Any proper recognition of UK standards under the equivalence mechanisms in EU law should be on the basis of the EU law system of recognition, which makes reference to high-level outcomes. This interpretation is provided for in EU law itself, as Michel Barnier, the EU negotiator on Brexit, has previously indicated.[347] Worldwide standard-setting bodies, such as the Basel Committee, have already done most of the work in identifying the key outcomes for global regulation. The UK has committed to the EU to uphold international standards,[348] and indeed it would do so anyway as a member of the relevant standard-setting bodies. So the EU has no valid reason to doubt that UK law and regulation will be satisfactory for equivalence purposes at all times. As such, a denial of equivalence-based recognition of UK standards by the EU can only be seen as a political measure aimed at trying to grasp business.

The UK should take steps to improve its laws in the manner outlined in this work, and leave the EU to determine how it wishes to interact with the global financial market. It is for the EU to decide how to satisfy the need for EU businesses and consumers to have access to the broadest and most efficient financial services offerings. Unless the EU allows for a stable future arrangement with the UK, based on mutual recognition of regulation, there will have to be new counterbalancing measures from the UK in mitigating Eurozone risk for the UK itself and on behalf of the global financial market. The UK authorities will need to adopt new methods to mitigate Eurozone risk, including the risk arising from

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345 See the evidence of Andrew Bailey, Governor of the Bank of England, to the Treasury Select Committee, 6 January 2021. The Bank of England has been consistent in this view: *e.g.* George Parker and Chris Giles, *Treasury and BoE clash over City of London regulation after Brexit,* 28 May 2018, Financial Times; Caroline Binham, *Top banking regulator stresses UK should not be 'rule taker' post-Brexit*, 16 May 2019, Financial Times.

346 For a general discussion of the point and how any future access arrangements can be constructed, see Annex 4, section 1 below.

347 See, *e.g.*, Recital 41 of MiFIR, which states that an "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". Furthermore, such an interpretation was supported by Michel Barnier when, as European internal market Commissioner, he was promoting the equivalence concept to the US in 2013: *The European Commission and the CFTC reach a Common Path Forward on Derivatives*, 11 July 2013, European Commission.

348 See Article SERVIN.5.41 of the UK-EU Trade and Cooperation Agreement 2020, fn 751 below.

EU financial institutions (and EU financial subsidiaries of UK financial institutions) which operate cross-border within the UK or through a branch in the UK from their headquarters in the EU, and are subject to the EU regulatory regime and supervision.[349] If the US is to apply global standards it should follow suit. Through the application by the UK (and US) of the Basel standards to UK (and US) financial firms in their exposures to EU financial firms, the seepage of Eurozone risk outside the Eurozone itself can be significantly reduced and some of the costs of the risks created by the zone can be put back onto EU financial firms.[350] The measures would involve imposing regulatory capital charges on UK financial firms and heightened rules on collateral and liquidity for their dealings with EU financial firms.[351] This would be expensive for the EU's financial sector and would mean that EU businesses and consumers would be incentivised to bypass EU financial middlemen (and the adverse implications of EU law) in accessing the global financial markets, as they are allowed to do,[352] in reliance upon an EU law concept known as "reverse solicitation", or by establishing tiny presences in the UK from which to receive UK services more cheaply.[353] In each case only UK regulation would apply to the services. EU customers could thereby seek out their financial services and products directly from UK (and US) providers, thus depriving the EU of the benefits it seeks from its actions.[354] In this way, the costs of Eurozone risk can to some degree be put back onto EU financial institutions, addressing (though only in part) the shortcomings of EU law.

However, whatever position the EU takes, any further facilitation of moves of financial business to the EU should be resisted by both the market and the UK (and global) regulators. Such steps would merely exacerbate the risks arising from the Eurozone, since any additional EU financial business would operate under the flawed EU regime. The UK needs to ensure any steps made do not allow for any increase of risk in the UK's own market. Annex 4, section 1 discusses in further detail the choices facing the EU which are compatible with the UK's sovereignty and the UK's ability to mitigate Eurozone risk, and the various factors at play in how the EU is likely ultimately to exercise its choice.

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349 See *Managing Euro Risk,* fn 5 above, Controlling Eurozone Risk by Law, section IV, pp. 12-16.

350 *Ibid*.

351 See Chapter III of *Using Negotiating Leverage to Achieve a Sovereignty Compliant Exit from the Transition Period*, September 2020, Centre for Brexit Policy, written by the author.

352 See fns 349 above and 766 below.

353 For further discussion of these and other ways in which such business can occur, see *The Art of the No Deal,* fn 1 above.

354 *Ibid*.

PART II: A REVIVED SYSTEM OF LAW, REGULATION, AND REGULATORY RESTRAINT

CHAPTER 3

RESTORING THE UK APPROACH TO LAW – OUT OF THE EU, INTO THE FUTURE

The position as we leave is that we have taken on a vast body of EU law. Yet it has been seen in the earlier Chapters that the code-based civil law approach is not suited to international finance. Laws can go stale and the present approach, and method of application, of the law involves unnecessary state interference on the freedom of contract and business. Despite all the advantages of the common law method, elements of the UK's approach have been supplanted during the UK's membership of the EU. Developments have occurred (not just for EU-related reasons) that take away some of the common law's strengths.

In the first instance the task now is to unpick those features of the EU's legal regime that have reduced the UK's attraction for business and can be argued actually to import risk into the otherwise secure UK trading arrangements. The UK must also consider the extent to which inherited EU law for the financial sector may need reform. It is important that the opportunity is seized and the UK seeks to revive the substance, structure and method of its own laws.

The situation should be addressed rapidly. From the beginning of this year, the UK has regained the power to make its own laws and regulations. Operating under a legal regime at odds with the UK's intrinsic approach is undesirable. In addition, there may be at least a short term downturn as a result of Brexit, as services into Europe may decline. A key way for the UK to innovate and address needs as they arise, and to take advantage of Brexit, is to restore the culture of the common law system and to recover those aspects of the UK's traditional legal operating system that have worked successfully.

The problem requires significant intervention. The UK has retained almost all EU-inherited law,[355] as well as the EU's interpretation of that law, from the point of Brexit, save that the UK's appellate courts are empowered to depart from EU interpretations thereafter. Under the European Union (Withdrawal) Act 2018,[356] this power is given to the UK's Supreme Court, and Scotland's High Court of Justiciary, in limited circumstances. Following a Ministry of Justice consultation,[357] the UK granted the same power to the Court of Appeal (or equivalent) level.[358] However, the UK's appellate courts cannot on their own address the inherited EU methodology, the results of which are highly unattractive. Nor can they address the substance of EU law.

This Chapter explains what needs to be done to take full advantage of the UK's method for financial services, by identifying how the UK should now proceed, outside the EU's legal regime. This involves taking steps to move back to clearer, simpler and more efficient rules using the traditional UK approach to the law, so that commercial parties have the benefits of predictability from that system. The expertise of the UK's regulators must be harnessed, not to introduce new laws but instead to remove and rewrite EU-inherited laws. This must take place under appropriate supervision by elected politicians, properly equipped to engage in detailed and technical challenge. There should at the same time be the

355 See fn 359 below.
356 Section 6(4).
357 *Response to the consultation on the departure from retained EU case law by UK courts and tribunals*, October 2020, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/926811/departure-eu-case-law-uk-courts-tribunals-consultation-response.pdf.
358 See the European Union (Withdrawal) Act 2018 (Relevant Court) (Retained EU Case Law) Regulations 2020 (SI 2020/1525).

introduction of greater certainty than can be provided through better rulemaking alone, which will involve more judicial decision-making, more Parliamentary and legal oversight of the regulators (discussed in Chapter 5) and placing a renewed reliance upon common law techniques. The necessary steps involve tackling the legacy of rules presently applicable and setting the new direction that allows for a less meddlesome and finicky approach, as follows:

3.1 Tackling the legacy - move back to a common law based approach to legislative and regulatory drafting;

Which leads to:

3.2 *Recommendation 1:* transfer as much as possible of the EU rulebook to the UK regulators, empowering them to replace and improve most inherited EU regulation, under the oversight of a Parliamentary Committee.

At the same time, further measures need to be adopted, as follows:

3.3 Setting the new direction - more case law precedent and precedent-based reasoning, and using common law techniques to bring daylight into the shadow of financial services law;

Which in turn leads to:

3.4 *Recommendation 2:* move to ensure more judicial decision-making;
3.5 *Recommendation 3:* place reliance on the common law operational method, allowing for a less controlling approach;
3.6 *Recommendation 4:* secure that the purposive approach to interpretation as operated under EU (and civil) law is rejected.

3.1 Tackling the legacy - move back to a common law based approach to legislative and regulatory drafting

The current system of financial services law and regulation must change; and the opportunity that Brexit brings must be seized to deliver the thorough overhaul that is needed, so that the new structure, substance and techniques used can more effectively govern the UK's financial services sector. As explained, the EU's system is excessively prescriptive across the sector. As an overall matter, the UK must therefore reinvigorate its competitiveness by moving as quickly as possible back to its traditional common law approach.

What must change?

The UK's regulatory regime now comprises retained EU legislation, and inherited EU technical standards, both of which have been "onshored", principally by adopting them into UK law through Statutory Instruments.[359] In addition, it contains domestic legislation and regulator rules made under the Financial Services and Markets Act 2000 (FSMA).

The regulator rules are important. The law for financial regulation is unusual. Outside the EU scheme, it tends to be neither entirely statute, nor case law, based. It has evolved to work effectively for the sector, where changes can be too fast-moving and complex to be capable of being effectively governed solely by statutory rules and case law precedent. Many financial market exposures are long-term and depend on firms being around in the future to honour their promises and look after financial assets.

[359] The European Union (Withdrawal) Act 2018 preserves all EU-derived domestic legislation, such as legislation implementing EU directives, and transfers directly applicable EU law (*e.g.* EU regulations) onto the UK statute book.

Court decisions are too rare and often made after the event. Technological and market developments are too rapid to be capable of being addressed through statute alone. So Parliament delegates the managerial task of regulating a safe market to the financial regulators, whose main task is to make rules for and supervise financial firms, in order that firms are not able to run unnecessary risks at the expense of customers or the market as a whole. The role and presence of the regulators can also enable customers and the market more generally to rely on their investments, savings and future payments.

The approach of the inherited EU regime has reduced the flexibility of UK's regulators to make rules and is at odds with the traditional common law method. It is dampening growth, opportunity and innovation. It is important that steps are taken immediately so that as soon as possible during this year the inherited EU laws and regulations are subject to a profound re-evaluation and that an approach more consistent with the common law starts to be adopted. This means removing any unnecessarily prescriptive provisions, removing provisions which do not make sense for the UK (for instance because they relate to EU single market arrangements[360]), clarifying what is often poor drafting (because it is unclear) and reformulating provisions that can be better and more concisely expressed. Such steps do not necessarily involve "de-regulation", but require instead better-drafted, clearer and more targeted regulation, removing unnecessary elements and clearing out the cobwebs with a common law broom. It is also important that the new system is subject to proper judicial and other oversight.

Since EU law has played a significant role in the UK's system of financial regulation, extricating the UK from the detrimental effects of EU intervention in the UK's system (explained in Chapter 2) will be a complex task. In recent years the UK has been so focused on the operations of the EU system itself that other aspects of the UK's regulatory regime have been subject to less scrutiny than is warranted. So the task is not only one of extrication but also the re-evaluation of various aspects of the current UK system.

The direction for renewal

The ultimate destination should be the system of market-friendly regulation traditionally preferred and successfully used by this country.[361] This generally involves specifying principles and outcomes rather than highly prescriptive regulation – an approach often referred to as "principles-based regulation". This (uncapitalised) term refers to regulation on the basis of a permissive, common law approach involving high level rules and principles. It is to be distinguished from Principles-based regulation, discussed throughout this paper, which refers to supervision and enforcement on the basis of vague regulator rules, requiring conduct to match up to concepts such as "integrity" and treating customers "fairly". As will be explained in Chapter 4, section 4.2, the current Principles-based approach now needs to be adjusted for the purposes of legal certainty in the new UK regime, because the use of the regulators' Principles on their own is generally undesirable.

The extent of the problem

In achieving this change, two aspects of the existing corpus of law should be reconsidered.

First, there is the EU-inherited approach. The EU-inherited regime needs to be re-evaluated in its structure, substance and technique. Much of it was introduced to address perceived needs, which now need to be re-examined. In particular, the regulatory response to the financial crisis of 2007-2008 is especially significant in the regime we have today. Many aspects of the inherited EU framework arising

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[360] These include provisions providing for regulatory harmonisation or mutual recognition within the EU, or competition within the EU single market. See also *A Blueprint for Brexit*, fn 1 above, pp. 5-6.

[361] *E.g.* "The reason we've invested in the UK for so long is that it's the centre of global markets and the UK regulators have a deep understanding of the importance of frictionless access to them," said Ben Jackson, President of Intercontinental Exchange. "There's an opportunity for the UK to stand up and focus back on what made their market successful, namely principles-based regulation," he said: Philip Stafford and Stephen Morris in London and Jim Brunsden *Europe's finance sector hits 'peak uncertainty' over Brexit*, 26 November 2020, Financial Times.

from that event were conceived by the UK and then introduced at a global level.[362] However, as can be seen from Chapter 2, the EU went further than the UK recommended or was necessary, introducing a bureaucratic and prescriptive structure. This complexity creates material risks of inadvertent breaches and of adjustments to the structure of businesses, services or products not for any regulatory or commercial reason, but merely to avoid details of particular rules. It also stifles competition by restricting differences between firms' business models. For instance, MIFID II provides for four different types of market structure for trading platforms—an exchange; a multilateral trading facility; an organised trading facility; and a "systematic internaliser" (*i.e.*, an investment firm which has arrangements for systematically executing client orders against its own account, in a manner that does not amount to one of the other three types of platform[363]). This prescription of different possible arrangements, with their consequences, is alien to the common law approach and unnecessarily restrictive. The EU has also shaped new regulations in a way that ignores the risks of the Eurozone, as explained in Chapter 2, section 2.3. In addition, areas of EU law that are ancillary to the EU's single financial services rulebook have detrimental implications for financial services business. Annex 2 below considers two particularly relevant areas of EU law—data protection and employment law—and shows how these exhibit many of the same flaws present in the single EU rulebook itself. They need reconsideration. So one strand of reform should involve re-thinking structural and substantive aspects of the system inherited from the EU.

Then there is the global reaction. The reaction of the world's legislators and regulators to the 2007 – 2008 financial crisis in terms of rulemaking was also overdone in various ways, and now needs to be rationalised. Many of the changes were coordinated at a global level, through bodies such as the Financial Stability Board (FSB), which is an international organisation, established in April 2009 after a G20 summit in London to monitor and make recommendations about the global financial system. In the US, the Dodd-Frank Act, enacted in 2010,[364] introduced approximately 2,300 pages of legal provisions in response to the crisis covering many—but by no means all—of the same areas of the financial markets as those adopted by the EU.[365] It is detailed, and indeed some of the EU's reforms were heavily informed by the US provisions. However, unlike the EU material, it is drafted and interpreted on the common law method and so forms a more relevant starting point when considering a rationalisation of the state of the art. The US regime is also subject to constant testing under the US legal system, which is more akin to the UK system. It does not seek to mask systemic risk, in contrast the approach of EU's single rulebook in disguising the risks of the Eurozone.[366] The Dodd-Frank Act is nevertheless interventionist. It introduced new regulatory bodies[367] and structural reforms for the

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362 The core architecture and analysis was in fact conceived and undertaken in the UK. See, for example, *The Turner Review: A regulatory response to the global banking crisis*, March 2009, the FSA, https://webarchive.nationalarchives.gov.uk/20090320232953/http:/www.fsa.gov.uk/pubs/other/turner_review.pdf, which made recommendations for regulation on bank resolution, capital requirements (such as the introduction of countercyclical buffers), deposit insurance and central clearing of over-the-counter (OTC, *i.e.* not exchange traded) derivatives. In addition, Paul Tucker, Deputy Governor of the Bank of England from 2009 to 2013, was central to the development of the concept of bail-in (his speeches from 2009 to 2013 are available at https://www.bankofengland.co.uk/news/speeches).

363 Article 4(1)(20) of MiFID II provides that systematic internalisers are investment firms which, on an organised, frequent, systematic and substantial basis, deal on own account when executing client orders outside a regulated market, multilateral trading facility organised trading facility without operating a multilateral system.

364 Dodd-Frank Wall Street Reform and Consumer Protection Act 2010. It was named after its sponsors, Senator Christopher J. Dodd and Representative Barney Frank.

365 Some of the US reforms were influenced by *The Turner Review*, fn 362 above.

366 See Chapter 2, section 2.3 above.

367 Notably, the Financial Stability Oversight Council, established to monitor the financial stability of major financial firms whose failure could have a serious negative impact on the US economy (*i.e.* companies deemed "too big to fail"); the Federal Insurance Office, tasked with identifying and monitoring insurance companies considered "too big to fail"; the Orderly Liquidation Fund, set up to assist with the dismantling of financial companies that have been placed in receivership; the Consumer Financial Protection Bureau (CFPB), established to prevent predatory mortgage lending; the SEC Office of Credit Ratings, charged with ensuring that credit rating agencies provide meaningful and reliable credit ratings in respect of the businesses, municipalities, and other entities they evaluate; and the Office of Financial Research, charged with providing data and support related to risks in the financial system to relevant government agencies.

industry.[368] In addition, it introduced new restrictions on global financial institutions accessing US "discount window" programs, through which the Federal Reserve, the central bank, provides emergency liquidity to US banks and the US branches and agencies of non-US banks.[369] The new rules required large-scale international banking firms to have a separate US ("intermediate") holding company through which the Federal Reserve Board, the main bank regulator, can supervise and regulate more meaningfully than before.[370]

Many of the safety belt measures introduced for the main financial markets—the UK and US—though laudably designed to protect the economy and individual financial firms from the effects of market turmoil and systemic risk, were made in a manner that brought overlap and duplication.[371] There has been criticism of the reforms, both in the UK[372] and US,[373] for going too far for small and medium sized firms, and for restricting liquidity, particularly in the bond markets. The US had already begun to move in reconsidering its regulatory framework, both in the substance of that framework and its application.[374] With the new President it remains to be seen whether that trajectory will continue. However, in

368 Notably, the "Volcker" rule, named after the former Chairman of the Federal Reserve, Paul Volcker. The rule restricts the ways in which banks can invest for their own account and limits their dealings with most hedge funds and private equity funds. The rule reinstates some of the thinking behind the US's Glass-Steagall Act of 1933, which first recognised the dangers inherent in financial entities conducting commercial and investment banking business at the same time. The UK's Vickers reforms attacked these risks from a different angle, by curtailing exposures between large retail and investment banks operating in the same group: see fn 399 below.

369 https://www.frbdiscountwindow.org/pages/general-information/the%20discount%20window.

370 See https://www.govinfo.gov/content/pkg/FR-2014-03-27/pdf/2014-05699.pdf, p. 17269; and https://www.govinfo.gov/content/pkg/FR-2012-12-28/pdf/2012-30734.pdf. pp. 76637 and 76642.

371 It has been suggested that key aspects of the reforms relating to regulatory capital went too far: *e.g.* Tim Congdon, *Should Banks Take More Risks?* (2018) City View; Steve Hanke, *The Basel rules and the banking system: an American perspective*, in Tim Congdon (ed.), *Money in the Great Recession: Did a Crash in Money Growth Cause the Global Slump?* (2017) Elgar; Jason Douglas, *BOE's Carney Says Bank Regulation May Have Gone too Far*, 11 November 2015, Wall Street Journal. Another criticism is that the global standards introduced regulatory fragmentation, leading to conflicting and overlapping requirements being set by different jurisdictions e.g. ISDA, *Regulatory Dirven Market Fragmentation*, January 2019.

372 See fn 371 above. Some of the criticism of the UK reforms was levelled by those responsible for reform in the US. Paul Volcker is reported to have informed the Parliamentary Commission on Banking Standards that "[t]he concept that different subsidiaries of a single commercial banking organisation can maintain total independence either in practice or in public is difficult to sustain": P. Jenkins, *Volcker criticises UK banking reforms*, 17 October 2012, Financial Times, https://www.ft.com/content/6d605922-1883-11e2-8705-00144feabdc0.

373 In the US, complaints have been made that the regulatory compliance requirements are unduly burdensome for community banks and smaller financial institutions, despite the fact that they played no role in causing the financial crisis: A. Hayes and T. Brock, *Dodd-Frank Wall Street Reform and Consumer Protection Act*, 1 September 2020, Investopedia, https://www.investopedia.com/terms/d/dodd-frank-financial-regulatory-reform-bill.asp. See also the high profile letter of 23 February 2012 by Robert G. Wilmers, Chairman and CEO of M&T Bank, who noted that regional and community banks "did little or nothing to cause the financial crisis – and were, in fact, in many ways victims" of the excessive risk-taking and irresponsible behaviour of the largest US banks: https://newsroom.mtb.com/2011-annual-report-message-to-shareholders. Notable market participants have also argued that, while each institution is safer due to the capital constraints imposed by Dodd-Frank, the constraints also make for a more illiquid market overall, particularly in the bond markets, where all securities are not mark to market (*i.e.* they are not subject to the accounting method that values them at their current market level) and many bonds lack a constant supply of buyers and sellers: Investopedia, *supra*. The higher reserve requirements that were introduced also mean that banks must keep a higher percentage of their assets in cash, which decreases the amount they are able to hold in marketable securities and limits the market-making role that banks have traditionally undertaken for bonds: *ibid.*

374 President Trump pledged, when campaigning for and after being elected President, in 2016, to repeal Dodd-Frank. In May 2018, the Trump administration signed a new law, the Economic Growth, Regulatory Relief, and Consumer Protection Act 2018, rolling back significant portions of it. This followed concerns over the impact of Dodd-Frank, some of which are still subject to debate. For example, in April 2017, the then (Republican) Chairman of the House of Representatives financial services committee, Jeb Hensarling, proposed extensive reforms to the US financial regulatory system, saying the Dodd-Frank regulations introduced under President Obama had been a "bureaucratic nightmare," strangling banks in red tape. These proposals were not themselves adopted, but in its paper *Who Regulates Whom? An Overview of the U.S. Financial Regulatory Framework*, 10 March 2020, the Congressional Research Service highlighted that "[m]any observers believe that the structure of the regulatory system influences regulatory outcomes. For that reason, there is ongoing Congressional debate about the best way to structure the regulatory system." Available at https://fas.org/sgp/crs/misc/R44918.pdf.

addressing the legacy of EU law there is a need to consider whether the global regime can be improved upon for the new UK structure.

Shedding the EU's structural approach – how to regain the common law benefits in full

The main point to address of course is EU law. It has been estimated that the EU's *acquis communautaire* still in force in December 2015 was 168,349 pages long.[375] Up to date figures are not available but the length is now likely to be materially greater. In the financial services context there are vast areas of inherited law, as can be seen from the volume of laws described in Chapter 2. It is plainly the case for instance that the areas sought to be regulated in MiFID II can be addressed more concisely than they are in the 1.7 million provisions which that regime contains.[376] The EU has introduced much of its regulation in a manner which has required the UK to adopt it by way of primary or secondary legislation. Too many of the detailed EU provisions have been taken on by way of statute or statutory instrument and not in regulatory rules.[377] The result is a patchwork in which EU legislation covers many key areas of regulation, including the prudential[378] regulation of banking, insurance and investment firms, and broad swathes of financial markets activity and infrastructure. The juxtaposition of the UK's own, common law based regime has added further complexity. The UK regulators have then had broad policy discretion in rulemaking and supervision in areas not covered by the EU regime, as a result of the framework in the FSMA, within which they operate. The Principles-based approach to regulation is an example.[379] There are also provisions in statute and delegated legislation requiring major UK banking groups to operate a ring-fence which separates their retail 'utility' banking businesses from their investment banking and corporate finance activities.[380] Additional powers have been granted to the regulators by statute to supervise, individually, the senior managers of firms,[381] and they have written further rules for this purpose.[382] The regulators have created a particularly far-reaching set of Principles and rules for senior managers.

Reforms to EU-inherited law should begin with a change to the way in which that law has been created. Much of the EU's financial rulemaking has been at the legislative level, made through pan-EU regulation or directive, which has direct applicability in UK law or requires UK legislative enactment,

375 *Red Tape filled EU rule book is now nearly as tall as Nelson's Column*, 30 December 2015, The Sun.

376 See fn 3 above.

377 For example, the Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2017 (SI 2017/701) (partially) implement the EU MiFID II Directive (Directive 2014/65/EU) and the Capital Requirements Regulations 2013 (SI 2013/3115) implement part of the CRD4 (Directive 2013/36/EU) provisions.

378 See fn 172 above.

379 See fn 78 above and surrounding text.

380 See fn 399 below. See also the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 (SI 2014/1960).

381 The UK's Senior Managers regime was introduced after the 2007-2008 crisis to ensure there was a clear line of command and responsibility for regulatory breaches. It was a response to Parliamentary and public criticism that there had only been a few successful prosecutions and regulatory enforcement actions against individuals after that series of events: see the report of the Parliamentary Commission on Banking Standards, *Changing Banking for Good*, June 2013. The Commission also recommended changes to the rules on the remuneration of bankers: see the Remuneration Code (Senior Management Arrangements, Systems and Controls sourcebook, FCA Handbook; and Remuneration, PRA Rulebook). These rules are now highly prescriptive as to compensation arrangements for senior managers. These rules were made in view of the apparent "heads I win, tails you lose" result for various senior executives after the financial crisis, where shareholder assets were wiped out, firms went down and yet the executives were left untouched, with their overall compensation packages intact. In the regime first proposed (FCA CP14/13) original sections 64B(5), 66A and 66B of FSMA imposed a controversial "presumption of responsibility" on senior managers. They were to be liable for misconduct unless they could show they had taken all steps reasonable for someone in their position to avoid it happening. Statements of responsibilities and responsibilities maps would identify those who could be asked to prove their innocence. Five months before SMCR's initial implementation (and in response to papers submitted by the author, amongst others), the government backtracked. FSMA was amended and the presumption of responsibility replaced by a duty of responsibility. Statements of responsibility and responsibility maps remained, but the burden of proof was moved back onto regulators, as is normal for prosecutorial matters.

382 For example, the FCA Handbook contains SYSC: Senior Management Arrangements, Systems and Controls.

respectively.[383] However, the Parliamentary process is ill-suited to the making of detailed financial services regulation, in that it is slow and unable easily to distinguish between necessary and unnecessary rules in an area that requires particular expertise. It is better that the regulators make most day-to-day regulations and that they are supervised in their role by Parliament. The EU's approach, whilst perhaps defensible in the context of seeking the harmonisation of rules across the EU as a whole, is not defensible for a properly flexible regulatory regime. It reduces the role of the regulators in many instances to that of an arbiter of fact, on the basis that once a regulator is satisfied that a specified set of circumstances exists, a specified treatment applies. It also incentivises market participants to restructure their operations and to adjust their actions to fit into the legal categories created in advance by the legislators, rather than leaving the law to buttress valid and safe business activity in the way in which the participants have conceived it.

Furthermore, through the normal Parliamentary processes, it could take decades to re-conceive the inherited EU measures and to strip out unnecessary rules. Addressing the need to change and improve the inherited laws currently contained in primary or secondary legislation would take up valuable Parliamentary time. As a result, a special method is needed for achieving this in the next two or three years, so that the UK can achieve one of the key benefits of Brexit. For that, the task would be dramatically simplified if as much detail as possible is immediately devolved to the UK's regulators, who are in a position (more quickly) to assess its worth and the quality of drafting. The regulators can then embark on a programme of improvement and refinement as set out here without the need for scarce Parliamentary time, in way more conducive to the need for managerial regulatory oversight.[384] In the European Union (Withdrawal) Act 2018, the UK has already delegated to its regulators the taking forward of several regulatory technical standards.[385] The UK's implementation of Basel III will predominantly be effected by way of regulatory rules.[386] This is a good first step but far more needs to be done. The approach needs to be adopted more systematically.

The step that must be taken is to break up the inherited *acquis*, leaving the minimum amount in statutory form and addressing the bulk of the measures required through statutory instruments and regulatory rules. Some matters will need to be maintained in statute as a matter of constitutional propriety. These include for instance defining the scope of the concept of regulation; preventing the regulators from extending their remit unilaterally; defining the borderlines of criminal offences; and applying regulatory requirements to people outside the system (which requires topics such as market abuse to be addressed in legislation rather than regulatory rules).[387] Subject to this point, as much as possible of the inherited

383 This applies even to more operational matters such as capital standards. The EU's approach of formulating financial rules in primary legislation or subordinate legislative instruments makes them too ossified. The instruments can only be changed through the bureaucratic EU process involving typically three (but sometimes only two) legislative bodies.

384 See Lon L Fuller, *The Forms and Limits of Adjudication* (1978-9) 92 Harvard L Review 353 for a discussion of the limits of adjudication and the need for managerial direction in circumstances which he terms "polycentric"—ones involving a dynamic set of inter-related and inter-dependent considerations, any of which could be put at the heart of the decision. Such decisions can be addressed by the legislature, by the markets themselves or, where appropriate, by regulators in a managerial fashion. Judicial-type processes and reasoning can address some of these situations, but may be too slow and the situations too unique to merit such an approach.

385 European Union (Withdrawal) Act 2018, schedule 4, paragraph 20 and 21 and the Financial Regulators' Powers (Technical Standards etc.) (Amendment etc.) (EU Exit) Regulations 2018/1115, Regulation 3 and Regulation 7. However vast swathes of law which before the EU's financial services action plan (see fn 177 above and surrounding text) were in the UK located in the regulatory rulebook are now found in primary EU legislation and have been on-shored in the UK in a manner requiring Parliamentary intervention to amend them. Although this may have been expedient in reaching the end of 2020 with a functioning regime, the position is undesirable and requires a further and significant delegation of powers to the regulators.

386 The Government position is set out clearly in the Explanatory Notes to the Financial Services Bill as introduced in the House of Commons on 20 October 2020 (Bill 200). The Bank of England and PRA are spearheading the implementation of Basel III, and have published extensively on their intended approach – see https://www.bankofengland.co.uk/prudential-regulation/key-initiatives/capital-requirements-directive-iv. See fn 75 above for an explanation of the Basel Committee and Basel Rules.

387 There is an important balance to be struck in that it is not helpful for the regulators alone to decide where they need discretion and when they think their discretions should be constrained by rules. The mechanisms for ensuring that any rules are formulated after proper consultation and with independent input can be enhanced, but there also needs to be democratic political accountability for the rules.

rulebook should be transferred straight away from the legislative arena to the PRA and FCA, the primary regulators, so that they can fine tune the application of general legislative principles, are empowered to remove unnecessary rules and re-write what remains, and can consult upon and make new rules. There is already framework legislation, the FSMA, which allows for this.[388] Redundant or poorly conceived (or drafted) rules should be immediately obvious to the UK's sophisticated regulators, particularly in consultation with industry. They can also revise the inherited rules on a dynamic basis. This approach is also desirable for the regulatory environment that will arise after this task has been accomplished.

Pruning and sharpening the substantive regime inherited from the EU

In addressing the changes required, it is important to recall that although some of the regulations in the inherited EU rulebook (now to be found principally in "onshored" provisions in UK statutes and statutory instruments) may contain desirable elements, even then they can often be poorly drafted. Other EU regulations are entirely unnecessary in that they are needlessly prescriptive, verbose or imprecise.[389] Indeed, EU-inherited financial services law is too all-encompassing and prescriptive. In regulation, as with EU law itself, it would be best to pare down the inherited EU law regulatory regime to a leaner and more efficient set of rules. In some areas of regulation, such as regulatory capital and reporting requirements, a prescriptive approach could be tolerated. But, this technique does not operate successfully in respect of areas of financial activity in which hard and fast rules can less easily be produced, for instance when regulators are seeking to restrict improper behaviour by firms, or the taking of commercial judgements that involve too much risk, prejudicing customers, the market or the system as a whole. As a practical reference point, it is worth observing that the supervisors typically supervise on the basis of capital, governance, systems and controls, and risk. Much effort has been spent, both by the regulators and by the industry, in elaborating rules in other areas. But little effort is made, certainly by the regulators, subsequently to supervise compliance with them, which calls into question the necessity for many of those rules. In addition, the EU's formulaic—and ultimately damaging—method of writing everything down about how every kind of financial business should operate under a single model, should now be dropped, on the basis that this is unnecessarily restrictive of market choice. Such reforms need not compromise the rule of law or safety and soundness concerns. It will still be possible to ensure a safe and fair market, adequate consumer protection, certainty and consumer choice.

Misdirected resistance?

Some firms may resist the removal of EU-inherited red tape or the better and clearer drafting of EU-inherited rules. They may argue, as some have already done, that they would prefer to have a single set of requirements for their European business, rather than two sets, even if the purely domestic UK requirements might be better than those in the EU. However, acceding to such thinking would mean ignoring the benefits of superior law and regulation, and adopting policy choices made for an entirely different set of circumstances. The EU markets are not global but domestic. The Eurozone brings with it issues of serious risk and difficulty which are not relevant to the UK, except in so far as the UK needs to ensure that its own regulatory regime protects its markets from any risk created by the EU law framework for the Eurozone. Regulations are made in the EU to implement public policy choices around local industries and economies which are not relevant to the UK's global markets. They are also interpreted and applied in a less predictable manner, involving unarticulated policy choices and purposes. So, although superficially attractive, this suggestion is misdirected.

There are some who will argue that the proposed approach creates unnecessary uncertainty for the *acquis communautaire*, the inherited body of EU-made law. However, the benefits to be derived from shedding weight from the inherited EU corpus of law are so important that tolerating some transitional uncertainty is desirable. EU methods of interpretation should also be dropped (see Recommendation 4 in section 3.6 below). The UK's courts and legal profession can swiftly derive new legal certainty from

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[388] HM Treasury has suggested that those inherited rules which fall within the regulators' powers under FSMA should be delegated: see the *Regulatory Framework Review – Phase II*, fn 448 below. This is a sensible approach.

[389] See Chapter 2, sections 2.1 and 2.2.

interpreting inherited provisions in a more common law fashion, pending the upgrade of those provisions which remain to the UK's superior style of drafting. Ultimately, however, the responsibility has been given by the electorate to the government to execute the democratic decision taken in 2016 and endorsed in the general election of 2019. In so doing it will take account of different interest groups but must both honour its electoral mandate and govern in the UK's national interest—that of the whole economy, nationally and internationally.

3.2 *Recommendation 1:* Transfer as much as possible of the EU rulebook to the UK regulators, empowering them to replace and improve most inherited EU regulation,[390] under the oversight of a Parliamentary Committee

When considering potential action, the priority for the sector must be to restore rapidly the inherited UK approach to the law (which includes not only the English common law approach but, in Scotland, the uncodified Scots law approach), for the reasons discussed above. The steps outlined in the previous section may seem vast. However, much of the task involves the removal of unnecessary laws, regulations and rules.

Devolving the acquis – tapping the expertise of the UK regulators. The inherited *acquis* should be broken up so as to leave the minimum amount in statutory form,[391] leaving the vast bulk to be addressed through statutory instrument amendable by negative resolution (where Parliamentary oversight is appropriate) or rulebooks at a regulatory level.

Pruning and re-writing. A project should then be established to prune and re-write the inherited *acquis* under the oversight of, say, a small joint committee of HM Treasury and the Department of Business, Energy and Industrial Strategy (BEIS).[392] The joint Parliamentary committee, in the case of statutory instruments, and the regulators (supervised by the joint committee), in the case of rules, would then pilot a programme of simplification and re-writing, to remove unnecessary rules and adopt the common law style.

The method for tackling the corpus of inherited relevant financial services (and ancillary) statutes as well as statutory instruments and regulatory rules, on an expedited basis, should include:

- ensuring that Parliamentary Counsel upgrade the inherited EU drafting of statutes—this will have to take place over time given the volume of EU-inherited legislation;
- adopting a formal process for the Treasury Solicitors to upgrade relevant statutory instruments;
- repealing unnecessary EU legislation and statutory instruments that harm the competitiveness of London as a financial centre or inhibit flexibility to promote financial innovation and secure financial stability;
- rewriting financial regulations so that they are more focused on financial risk,[393] misconduct and damaging forms of behaviour;
- removing statements of rights and focusing on restrictions and liabilities; and

[390] See fn 375 above and surrounding text.
[391] See section 3.1 above for some of the limitations that should be observed when doing this.
[392] There will need to be coordination with other Parliamentary committees in this task, including the European Scrutiny Committee, given its extensive knowledge of inherited EU law.
[393] See the text that surrounds fn 449 below for a summary of the risks to be addressed by financial law and regulation.

- removing superfluous wording and condensing law and regulation into what is necessary.[394]

For the regulators specifically, unnecessarily prescriptive rules and regulations should be removed (without of course leading to over-reliance on Principles), particularly as to business methodologies. Steps should be taken to move to adopt a clear specification of rules for the industry, showing what is required for the future. To accomplish this task, the regulators could be given two to three years to eliminate superfluous red tape and to replace any remaining provisions with new versions drafted along common law lines. The process would occur under the oversight of the proposed joint Parliamentary committee. This would involve adopting a common law style of drafting, as for the law, and looking again at the financial regulatory rulebooks. Many of the shortcomings of EU law and regulation were the subject of discussion and debate when those laws were made, and these can provide the signposts for some of the changes now required. The industry is already engaging in the process of examining UK regulatory reform and would benefit from reforms that reinstate the traditional, pragmatic UK system, based on the following:

- *Outcomes-driven rulemaking.* The focus should be on desired outcomes, adopting guidance rather than rules where possible—and, even then, restricting guidance to situations where it is absolutely necessary. The revival of the UK's practice of allowing reliance on voluntary industry codes should be considered for some areas.[395] Mechanical tick-box compliance processes should be eschewed except where such requirements are essential for a particular industry sector, for instance in the context of certain aspects of regulatory capital, which can involve the application of somewhat prescriptive international rules. For those areas which remain mechanistic in nature, the UK's regulatory system would also benefit from a certain degree of automation,[396] or at least the examination and recognition of automation. So, for example, the standard methods of calculating regulatory capital could be automated. Even perhaps the approval of regulatory capital models may be capable of being automated. Similarly, the decision-taking of the Financial Ombudsman as regards clear-cut breaches and certain fines imposed by the FCA, for example for the

[394] When determining what falls into this category it may be sensible to retain in some form provisions of EU law which address points that would normally be expected to be determined by the common law, but where EU law has made an intervention before the common law has had a chance to settle the matter. For instance the 2014 Regulation on electronic identification and trust services for electronic transactions in the internal market and repealing Directive 1999/93/EC (EU) No 910/2014 provides for the effectiveness of electronic signatures (Article 25). This is a point for which case law would normally have been expected to provide reassurance, on its own. It may be advisable to retain a provision of this nature. Many other aspects of the law on signatures have of course been settled by case law, as summarised in the Law Commission's Report No 386 *Electronic Execution of Documents* (2019).

[395] In particular, consideration could be given to the placing of reliance on voluntary industry codes in novel areas where the merits of regulation are still unclear. The regulators are already doing this, for instance for standards produced by the FICC Markets Standards Board, which often have input (through not endorsement) from the regulators. There is a lot to be said for regulators acting as approvers of rules made by market participants for themselves—bottom up—which was the traditional approach to much financial regulation in the UK. As noted in a discussion paper published by the Institute of Economic Affairs (P Booth, *Regulation without the State*, June 2019): "Before the so-called 'Big Bang' in 1986, securities markets were generally regulated by private stock exchanges except for occasional primary legislation and Companies Acts which imposed very specific and limited requirements on those trading in securities as well as on publicly listed companies. The extension of statutory regulation to the mortgage market is more recent still. The sale of mortgages continued to be regulated only by consumer protection law until 2004. The same was true of general insurance until 2005. Furthermore, until recent times, the UK insurance industry was regulated by a regime known as 'freedom with publicity'—essentially the approach was: 'do what you like as long as you say you are doing it' […] Pension funds were also largely unregulated by the state until the Pensions Act 1995". A powerful defence of self-regulation is offered in A. Ogus, *Rethinking Self-Regulation* (1995) 15 Oxf J Leg Stud 97.

[396] The UK is already the world centre for many aspects of FinTech: G. Michael, *Tech Nation: 'the UK is a fintech centre of excellence'*, FinTech Magazine, https://www.fintechmagazine.com/venture-capital/tech-nation-uk-fintech-centre-excellence, with world-class local expertise available for the development of automated regulatory methods. HM Treasury has floated the idea of introducing machine-readable rules in some areas: see the *Regulatory Framework Review – Phase II,* fn 448 below, p. 23.

late filing of returns and other straightforward matters, could be automated in many instances.[397]

- *Better drafting.* Replacing the opaque style of drafting of EU measures with the more precise, common law style. Centralised Government legal support should be made available for drafting the slimmed down replacement rules, as soon as those have been formulated by the relevant regulators.

Oversight and approvals. Primary legislation would be amended by Parliament in the usual way. The joint committee would oversee the re-writing of any remaining provisions of secondary legislation and the regulatory rules. This process requires adequate support and day-to-day oversight, including by legal drafting teams. There should be an advisory committee of experts, reporting to the Parliamentary committee, which should contain adequate lawyer membership to evaluate the changes to regulation proposed, for consistency and compliance with the rule of law.

Gold plating – tackling the consequences. There should also be a thorough review of the instances where the UK has thought to gold plate EU law.[398] Removal of gold plating can however be more difficult than the removal of unnecessarily prescriptive EU rules, for the following reasons:

- When the UK gold plated a provision of EU law, this was sometimes because it needed to identify important points that had been left unaddressed by EU regulation—often because EU thinking related to its members' largely domestic financial markets, and the UK's global markets had different regulatory needs. Where this has occurred, a more limited redrafting may be appropriate, or none at all.[399] However, there should nevertheless be fresh consideration of the matter. Admission to listing is a case in point. When the listing authority conducted a "fundamental" review of the listing rules, the FSA suggested dropping the additional requirements which the FSA (as listing authority) had put on top of the EU rules.[400] Listed companies indicated however that they preferred to retain the additional requirements as a hallmark of quality in corporate governance.[401] Nevertheless, despite this, the UK is not always a listing venue of choice, especially for third–country issuers or funds, who may regard the additional standards as unnecessary.[402]

- In some cases the UK has implemented a directive against a background in which it already had such requirements, and the gold plating simply amounted to the retention of them.[403] This was the case, for instance, for the UK's Regulated Activities Order,[404] which was satisfactory before the EU promulgated its own versions of these UK provisions. The UK

397 Further cases could potentially be decided by the application of an appropriate algorithm. This would allow for sophisticated debate and scrutiny over the algorithm rather than over individual decisions.

398 The notion of gold plating is explained above, text to fn 234.

399 An example of an instance where no change is likely to be required is the UK rules requiring retail banks to be split off, financially, from the wholesale banks which own them. Since January 2019, the largest UK banks have had to ring-fence their retail banks from their investment banking business. These measures were introduced through the Financial Services (Banking Reform) Act 2013 following the recommendations in 2011 of the Independent Commission on Banking (chaired by Sir John Vickers). The rules were not influenced by EU law. (The EU considered adopting a similar regime but rejected it.) These provisions should only need a brief review.

400 See *Amendments to the Listing Rules, Prospectus Rules, Disclosure Rules and Transparency Rules* (2012) CP12/2.

401 In *Enhancing the effectiveness of the Listing Regime and feedback on* CP12/2 – *Supplementary consultation on proposed changes to the Listing Rules resulting from the implementation of the Alternative Investment Fund Managers Directive*, the FSA stated at page 112 that the "standard segment should accord as closely as possible to the standards imposed by the various applicable European Directives without gold plating via further super-equivalent requirements": see https://www.fca.org.uk/publication/consultation/cp12-25.pdf.

402 On 19 November 2020 the Government appointed Lord Hill to review the UK listings regime with a view to making recommendations to the Government and UK regulators on how to encourage more high-quality UK equity listings and public offers: https://www.gov.uk/government/publications/uk-listings-review/terms-of-reference-lord-hills-review-on-listings.

403 The EU requirement may have been designed to produce a similar result to pre-existing UK regulation, but with a more limited scope, and using different words.

404 Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544).

maintained its own regime and layered it with the EU's additions, making for undue complexity. In other cases the UK could have been gold plating merely to clarify the EU drafting and making the concept fit better with the UK's pre-existing system. In yet more cases it may have made sense to apply the new provisions across the full scope of the previous UK provisions, rather than only to those within the scope of the actual EU requirement. This was the case, for example, in regard to the FCA's client money regime, which clearly gold plates the provisions of MiFID II, but is also widely regarded as important. If the UK had only applied the directive provisions within the scope of the directive, it would have ended up with a much weaker law, or two different sets of provisions applying to different businesses within the same institution. The anomalies would also have been particularly difficult because the UK client money regime builds on the law of trusts and provides for structures which protect client funds and procure that they will be unaffected by a firm's insolvency. Under the law of trusts assets held for clients do not form part of the insolvency estate. The civil law regimes across the EU do not have such a clean way of extracting client assets from those of an insolvent bank.[405]

Meeting other commitments: ensuring that international trade arrangements do not fetter UK rulemaking or supervisory abilities. As part of the process of reformulating the UK's regime, it will be important to ensure that attention is paid to any international commitments for the mutual recognition of regulatory standards in the context of international trade in financial services to which the UK agrees for business purposes (whether with the EU or others). Furthermore, it is vital that none of the benefits from a revitalised UK system are given away as part of any future trading arrangements. Annex 4, section 1 below explains how those arrangements can be made to fit with the common law (and Scots law) system, UK sovereignty and the need for the UK to make its own rules appropriately. It addresses how this can be achieved in a manner that does not affect the UK's recognition of international standards, nor its ability to enter into mutual recognition arrangements with other regulatory regimes for cross-border business. There is also a need to have a superior system for applying any agreements, once they have been entered into, to ensure that they are not breached. The precise interpretation of those deals would need to be scrutinised to ensure that any requirements in them are not actually over-interpreted in such a way as to avoid any possibility of dispute.[406] It is important that the UK remains free to take interpretations which may then (if necessary) be tested in a dispute resolution body, so as not unnecessarily to restrict the UK's freedom of action. Section 1 of Annex 4 below sets out some of the potential pitfalls and how they can be avoided.

3.3 Setting the new direction – more case law precedent and precedent-based reasoning, and using common law techniques to bring daylight into the shadow of financial services law

Going forward, it is also important for the UK's legal system to facilitate and reinvigorate the evolution of the common law in this area and re-engage with the system of case law precedent, allowing for greater predictability in the law and more extensive reliance on the ability of commercial parties to manage (most of) their own risk.

The advance of common law legal analysis depends to some degree on published court judgments, but these are becoming increasingly unusual in financial disputes because many financial institutions are reluctant to litigate their disputes with the regulators and other authorities in public. This is in fact surprising since competition law fines are commonly litigated even where the merits of the case are slim. Also the English courts do not apply the "reasonable agency" interpretation operative in the US,

405 See Annex 1 below.

406 Of course, preserving maximum flexibility for the UK should be a driving factor in the negotiation of those arrangements. They should only require the UK to have standards which achieve agreed high level outcomes: see Annex 4, section 1 below. How those outcomes are achieved should be a point which the UK is free to decide upon.

an interpretation which dampens the possibility of successfully suing regulators in that country.[407] However, there are several factors which hamper the development of case law for financial services.

Unwanted exposure of damaging facts, and uncertainty. Financial firms generally have an aversion to public hearings and so have avoided disputing matters in court, resorting instead to settling disputes with the regulators out of court. The modern regulatory framework was introduced with the enactment of the FSMA. With that Act, the system moved to a full statutory regulator, the Financial Services Authority (FSA), operating under Parliamentary oversight. The FSA became the principal regulator across banking, investment business and insurance.[408] Provision was made for the ability for challenge to the FSA in court.[409] Rules governing hearings before the Financial Services and Markets Tribunal (now the Upper Tribunal[410]) provided that all judicial hearings into disputes between regulators and financial firms should, subject to certain exceptions, be held in public, consistent with the approach across the court system as a whole and defensible in principle on the basis of open justice.[411] However, the process has been little used. This remains the case under the new regulatory framework, which was created in April 2013 by the Financial Services Act 2012. The 2012 Act abolished the FSA and separated its responsibilities between the FCA (responsible for policing the financial activities of the City and the banking system), the PRA (under the Bank of England, which would carry out prudential[412] regulation of financial firms)[413] and the Bank of England itself (which would supervise CCPs, and monitor systemic risk and financial stability through its Financial Policy Committee).[414]

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407 This stems from *Chevron USA, Inc. v. Natural Resources Defense Council, Inc* 467 US 837 (1984), which provides for courts to defer to agency interpretations of statutes in many circumstances if the statute is ambiguous and the agency's interpretation is reasonable and within the agency's expertise.

408 The transfer of responsibility for banking supervision from the Bank to a reformed single regulator arose from the collapse of BCCI (see fn 522 below) and Barings Bank (see fns 523 and 524 below) (Bank of England Bill, Bill 62 of 1997/98, Research Paper 97/115, House of Commons Library, 1 November 1997). The Bank of England Act 1998 transferred the Bank of England's responsibility for the supervisory and surveillance of banks to the FSA, which was at the time the renamed Securities and Investments Board (as of 28 October 1997). The FSA started to exercise its statutory powers under the FSMA on 1 December 2001. The reforms aimed to simplify the existing regulatory architecture, as explained by the then Chancellor Gordon Brown's statement before Parliament on 20 May 1997: "The current two-tier system splits responsibility between the Securities and Investments Board and the self-regulatory organisations, together with the recognised professional bodies. This division is inefficient and confusing for investors, and lacks accountability and a clear allocation of responsibilities. Reform is long overdue to simplify the delivery of financial services regulation" (Bank of England and Financial Regulation, HC Deb 20 May 1997 vol 294 cc 507-24).

409 Various provisions in FSMA provided for a reference to be made to the Financial Services and Markets Tribunal. For example, a firm that did not agree with an FSA decision on authorisation could make a referral under section 55, FSMA. Section 67(7) of the Act allowed for a reference where a firm was subject to a FSA disciplinary process. The current version of FSMA includes the same provisions.

410 See fn 615 below.

411 Section 17 of the Financial Services and Markets Tribunal Rules 2001, S.I. 2001/2476. The Tribunal was able to allow a hearing to be held in private on an application by all of the parties or on the application of one party in the interests of morals, public order, national security, the protection of the private lives of the parties, or of any unfairness to the applicant or prejudice to the interests of consumers. In these situations, a private hearing would only be permitted if the interests of justice were not prejudiced as a result. The Supreme Court has recently reiterated the importance of open justice in *Khuja v Times Newspapers Ltd* [2017] UKSC 49, [2018] 1 Cr App R 1 and *Cape Intermediate Holdings Ltd* v *Dring* [2019] UKSC 38, [2020] AC 629.

412 See fn 172 above.

413 The PRA is the prudential regulator for banks, large investment firms, credit unions, insurers and building societies. The FCA is the prudential regulator for all other firms and the conduct regulator for all regulated firms. UK regulated firms are referred to as dual-regulated (PRA as prudential regulator and FCA as conduct regulator) or solo-regulated (FCA as both prudential and conduct regulator).

414 The new arrangement was one in which the PRA and FCA, the main regulators, oversaw complementary areas of activity, under an approach dubbed "twin peaks". This contrasted with the previous single regulator structure where the FSA was the sole main regulator. After the financial crisis of 2007-2008 it was thought that the FSA's functions could at times be conflicting, and that the competing roles led to potential overemphasis of one aspect of the role at the expense of the other. As a result, it was decided that the regulators should be separated out in this manner, with one body (the PRA) charged with the maintenance of financial system stability, and the other (the FCA) charged with market conduct and consumer protection.

Market perceptions and relationships. Firms are also concerned at the drawn out process involved in litigating against the UK's regulators and the potential effect it might have on their market value, relationships with the regulators and also with clients.[415]

The power of the regulators. There is a view in the industry that the regulators have now become so powerful[416] that they are all-controlling and that their views cannot be objected to without possible adverse consequences. This arises in part from the over-general nature of Principles-based regulation.[417] As a result, firms typically settle matters, and their interactions with regulators are therefore more limited and less meaningful and reasoned than they would otherwise be. There is now a need to show that the regulators are being kept in check, given the fact that they will obtain more power. Chapter 4 sets out how this can be achieved. However, there is an initial problem which we need to tackle, which is to reclaim the full predictability that arises from the UK's approach to law, including to case law.

The Ombudsman's ability to decide on "fairness" grounds. FSMA also introduced the Financial Ombudsman Service, to resolve disputes as a free alternative to the courts.[418] As a result, the use of the industry-funded Ombudsmen for low-value[419] consumer and small business[420] claims has reduced court cases and the creation of precedents. As shown in Chapter 4, section 4.2 below, the Scheme has also been used for mass claims in a way that is inconsistent with a thorough system of justice. The separate, voluntary scheme which is being piloted, heightens the concern.[421] While the Ombudsman Scheme has arguably improved outcomes on a case by case basis for numerous victims of financial services malpractice, this is at the cost of having considerable amounts of dispute resolution of broader market relevance addressed in non-judicial proceedings, which lack the same status or detailed discussion as arises in court judgments under the common law system.[422] If costs are brought into consideration this

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415 See fn 616 below for a description of the limited use of judicial review in this context. In addition, claims are not brought against the FCA and PRA because both are exempt from liability in damages (see Annex 6, section 2 below). As a result, even if a claim is successful, a claimant stands to gain little besides a publicised victory and costs. A firm is only likely to consider bringing a claim if it seeks a remedy other than damages. Such cases are rare. The introduction of the Focused Resolution Agreement is likely to lead to an increase in the number of challenges by firms. Those who have used the process so far – Linear Investments, Carphone Warehouse, Standard Chartered – have achieved the same result or better: see fn 616 below.

416 Proposals for regulatory accountability after Brexit have been made, for instance, in *The architecture for regulating finance after Brexit: Phase II*, IRSG/Linklaters, January 2020: https://www.thecityuk.com/assets/2020/Reports/87f3a48c7e/The-architecture-for-regulating-finance-after-Brexit-Phase-II.pdf.

417 See fn 78 above and surrounding text, and Chapter 4, section 4.2 below. The FCA has enormous discretion though, for the most part, it has used that discretion wisely.

418 The Financial Ombudsman's powers are derived from Part XVI of the FSMA, as well as the Alternative Dispute Resolution for Consumer Disputes (Competent Authorities and Information) Regulations 2015 and the Alternative Dispute Resolution for Consumer Disputes (Amendment) Regulations 2015, which implemented the EU's Directive on Alternative Dispute Resolution, 2013/11/EU, in the UK.

419 In 2020, the FCA also increased the Financial Ombudsman's compensation limit from £150,000 to £355,000 (for complaints made on or after 1 April 2020), in part to align the new compensation thresholds with the expansion of the Ombudsman scheme to larger SMEs. See https://www.fca.org.uk/publications/policy-statements/ps19-8-increasing-award-limit-financial-ombudsman-service.

420 In December 2018, the FCA introduced rules expanding the scope of the Financial Ombudsman Scheme to accept complaints from SMEs, in addition to the individual consumers and micro-enterprises whom it had previously protected, partly in response to complaints regarding the exorbitant cost of litigation for SMEs. These changes are intended to provide SMEs with an alternative to redress through the courts. The Financial Ombudsman Scheme is now available to SMEs with an annual turnover of not less than £6.5m which employ either fewer than 50 persons or have a balance sheet total or less than £5m. See https://www.fca.org.uk/publications/policy-statements/ps18-21-sme-access-financial-ombudsman-service-near-final-rules.

421 A Business Banking Resolution Service (BBRS), a non-profit organisation comprised of business groups and financial institutions, is being piloted in 2020 to consider complaints dating from 1 April 2019 onwards from small and medium sized enterprises (SMEs) with a turnover of up to £10m, total assets of up to £7.5m and which are ineligible for the Financial Ombudsman Service. The BBRS will also operate a "historical scheme", designed to deal with complaints dating from 1 December 2001 to 31 March 2019 for SMEs with a maximum turnover of up to £6.5m per annum and total assets of up to £5m (*i.e.* those SMEs that would now be covered by the FCA's revised Financial Ombudsman Scheme compensation limits).

422 Concerns have been expressed about the ability of voluntary ombudsman schemes to deal adequately with more sophisticated disputes, and about the removal of this work from business and property courts, preventing the courts from

system operates at the expense of the industry and broader society in the sense that the development of case law is curtailed. In addition, the Financial Ombudsman has an ability to decide on financial services disputes by considering what is fair and reasonable in all the circumstances of the particular case, rather than imposing a solution based on the letter of the law.[423] As a result, the Ombudsman, as currently conceived, is incapable of creating judicial precedents upon which future reliance can be placed.

The encouragement of Alternative Dispute Resolution (ADR). Furthermore, there has in recent years been a use of incentives introduced by the court system[424] and more generally[425] for parties to settle their cases through ADR and the use of arbitration as a resolution mechanism. These do not routinely lead to the publication of judgments, and have provided alternative means of dispute resolution which are less desirable from the perspective of the creation of precedent.[426]

3.4 *Recommendation 2:* Move to ensure more judicial decision-making

It would be beneficial over time to move to more disputes being resolved in court. Use of the Ombudsman, ADR and arbitration systems involves sacrificing the opportunity for the development of the law to the parties' own benefit and to that of future market participants by losing the certainty of precedent that a published court judgment could bring. Changing this situation would involve a number of steps, as follows:

- *Encouragement of court hearings.* A sensitive way of handling the publicity surrounding financial hearings should be considered. The starting point in both civil and criminal proceedings is that hearings should be held in public.[427] However, there are various mechanisms available to the courts to limit the access to proceedings, the information that may be provided to non-parties and the reporting of proceedings. One idea would be to restrict the reporting of cases until liability has been determined, particularly when the allegations being made are akin to those involving the criminal law, in that they could result in significant reputational harm, substantial fines and individuals no longer being able to work in the industry. This approach might even be considered where a firm is taking a risk in bringing an action in order to clarify a matter of regulatory uncertainty. This approach would allow case law to become more prominent for most of the sector's activities. It is an approach that could be adopted both for the financial firm concerned and any staff caught up in the matter. It would not prevent open court hearings from taking place and could remain the exception rather than the rule—invoked only when the interests of justice

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ensuring consistency and fairness, and thereby developing case law (and predictability) in these areas. See the record of the Financial Markets Law Committee (FMLC) meeting on 31 January 2019, http://fmlc.org/wp-content/uploads/2019/04/Minutes-of-FMLC-meeting-31-January-2019.pdf. The same concern arises for the Financial Ombudsman Scheme itself.

423 FSMA, section 228(2).

424 The Civil Procedure Rules 1998 include a number of measures designed to encourage alternative dispute resolution (ADR). The Rules require parties, at various stages before and during litigation, to consider whether ADR might be appropriate as a means of settling their dispute. In November 2018, the Civil Justice Council, in its report *ADR and Civil Justice*, made recommendations as to how ADR could be further promoted, including in relation to costs sanctions for refusing to mediate: https://www.judiciary.uk/wp-content/uploads/2018/12/CJC-ADR-Report-FINAL-Dec-2018-2.pdf.

425 In the consumer context, the Alternative Dispute Resolution for Consumer Disputes (Competent Authorities and Information) Regulations 2015 and the Alternative Dispute Resolution for Consumer Disputes (Amendment) Regulations 2015 were introduced to facilitate the resolution of disputes outside the court system and to enhance consumers' ability to obtain redress.

426 Indeed, the parties to such proceedings are principally interested in the outcome, not the reasoning behind it. Arbitration is generally selected to avoid publicity. Awards can be and often are published, though this is generally determined by the parties. See Annex 4, section 2 below for further discussion.

427 For civil proceedings, see Rule 39.2(1) of the Civil Procedure Rules (CPR). For criminal proceedings, see the common law principles discussed in *Attorney-General v Leveller Magazine Ltd* [1979] AC 440, and s. 121(4) of the Magistrates' Courts Act 1980.

require it.[428] The civil and criminal courts also have the power to restrict the publication of names and other matters.[429] Such provisions could be used to protect witnesses, particularly whistle-blowers or those subject to bullying, harassment or similar misconduct. The system of course needs to be seen as fair, and a balance will need to be struck that takes into account the circumstances of each case. Secret justice merely to protect privacy violates a fundamental principle of the common law. Exceptions exist, for instance when publicity would defeat the object of the hearing or to protect national security, but parties are rarely able to rely on their right to privacy to limit access to, or publication of, proceedings.

- *Replacing or restricting the Financial Ombudsman Service.* There should be a re-evaluation of the widespread use of the Ombudsman scheme and of similar, voluntary schemes. Two possible steps should be considered:

    - *More judicial precedent – the use of junior judges for small claims.* Whilst the notion of having swift justice for smaller claims is a good one, the court system involving junior judges (on the model of District Judges in the County Courts) and lawyers expert in the financial markets should now form the basis for the way forward for many claims.[430] For it would be preferable to settle many of the disputes at present resolved under the Ombudsman Scheme by way of a proper dispute resolution process involving legal scrutiny. Lower-level courts can be used for smaller decision-making, particularly for any decisions of individual or repeat significance, but in a way that provides for and develops judicial precedent. This should be done in a manner that ensures a far greater number of published case law precedents on financial topics. It would mean empowering lower-level judges with the ability to render swift judgments, largely on the spot, which need comprise no more than two or three pages of text. The publication of judgments would shine daylight on awards. Further adjustments could be considered to ensure swift and cheap justice, including rapid strikeouts of unmeritorious claims or defences. Oral hearings would be subject to time restrictions to ensure that a large volume of claims could be handled. Judges could be specially trained to ensure familiarity with the subject matter.[431] The rule that the loser to the litigation pays the winner's costs[432] should be overridden for such cases, so as to ensure that a lack of funds (particularly in the context of an unequal ability to obtain legal assistance) does not prevent access to justice. If judicial resource is an issue, arrangements could be considered such as requesting all financial services lawyers in the City to give a couple of hours of their time a week, *pro bono*, to act as judges and get the system up and running.[433] These arrangements, though involving more lawyer time, would replace the Financial Ombudsman Service for those matters. They would

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428 Section 4(2) of the Contempt of Court Act 1981 permits courts to order the postponement of reporting of proceedings or a part of proceedings "where it appears to be necessary for avoiding a substantial risk of prejudice to the administration of justice in those proceedings or in any other proceedings pending or imminent".

429 See, generally, s. 11 of the Contempt of Court Act 1981. Specific provisions also prevent the naming of certain parties in proceedings (e.g. children, or complainants in criminal cases involving sexual offences). In exceptional cases, courts may allow a witness to give evidence anonymously. However, it is very rare for a court to withhold the identity of a witness from the parties to proceedings even if it makes an anonymity order. For the position in civil proceedings, see CPR 39.2(4) and *Kalma & Others v African Minerals Limited & Others* [2018] EWHC 120 (QB). For the position in criminal proceedings, see Part 3 of the Coroners and Justice Act 2009. The provisions relating to anonymity should not be confused with "special measures" – the provisions that allow a witness to give evidence behind a screen or by video link in criminal proceedings in order to limit direct contact with a defendant. In such cases, the identity of the witness is known to all parties; the judge, jury and legal representatives are still able to see the witness.

430 Consideration could alternatively be given to a revised approach which converts the Ombudsman into a form of specialised tribunal which operates along common law lines. This may allow it to deal with the privacy issues more sensitively. However, one way or another a properly legalistic approach is required.

431 See fn 618 below.

432 Civil Procedure Rules 44.2(2).

433 They would clearly need to be prohibited from making decisions where they had a conflict of interest.

ultimately be fairer and better than buying off consumer and small and medium-sized enterprise (SME) claims through Ombudsmen.

- *Judicial oversight of Ombudsman - no arbitrary decision-making even for small claims.* Furthermore, any remaining role of the Financial Ombudsman Service should be reduced, and made subject to judicial oversight. For, if the Financial Ombudsman Service is to be allowed to continue to deal with low-level claims in any form it needs to be subject to appropriate supervision. The Ombudsman has been able to take too broad-brush an approach to a mass of mis-selling cases, as is discussed in Chapter 4, section 4.2 below. Where decisions are of wider significance, it should be possible for those affected to appeal to the courts for a binding ruling. A process involving judicial oversight and public consultation also needs to be introduced for situations in which the Ombudsman is making multiple decisions of a similar nature across the financial market. This would ensure that such decisions are not taken solely by the Ombudsman but are overseen through a system that ensures the proper testing of proposed action, and is based on formal analysis, providing the opportunity for formal argument. In addition, consideration should be given to requiring the Ombudsman to apply normal legal principles, employ legally qualified staff, and not merely to rely on what it regards as "fair". Finally, there are also various ancillary features of the Financial Ombudsman and Financial Services Compensation regime, arising from the role of claims management companies, which need attention.[434]

- *Encouraging the international recognition of UK court judgments.* Internationally, the UK should seek to enhance existing arrangements for the recognition and enforcement of UK court judgments abroad. A superior system for the recognition of judgments in the financial services sphere would facilitate the use of judicial dispute resolution rather than arbitration,[435] which is typically private in nature. However, this needs to be nurtured. The relevant regimes, and their relative merits, are considered in Annex 4, section 2 below.

3.5 *Recommendation 3:* Place reliance on the common law operational method, allowing for a less controlling approach

The other aspect of the codified approach to regulation in the EU should also be overridden, which comprises the use of rules in an attempt to control the market. In addition to the adoption of an improved

[434] There needs to be consideration of certain undesirable practices that arise in the context of the Financial Ombudsman Service and FSCS. There has been a rise of claims management companies, particularly in the wake of the PPI scandal. This saw those companies rush to offer their services, often in exchange for large percentages of customers' damages awards. This phenomenon has triggered regulatory concern: *e.g.* an FSCS website page discouraging use of claims companies: https://www.fscs.org.uk/how-we-work/customer-info/cms/; an FCA website page about unscrupulous claims companies: https://www.fca.org.uk/ppi/claims-companies; and a 21 April 2020 release by FSCS relating to scams targeting London Capital & Finance Plc (LC&F) investors over claims management: https://www.fscs.org.uk/failed-firms/lcf/. For further discussion of LC&F, see fn 826 below and surrounding text. Following a review of the claims management company market (by Carol Brady, *Independent review of claims management regulation*, March 2016), the UK Government moved the regulation of claims management companies from the Ministry of Justice's Claims Management Regulation Unit to the FCA from 1 April 2019 (Financial Services and Markets Act 2000 (Claims Management Activity) Order 2018). As regulator, the FCA has taken steps to promote better standards of conduct within the sector and to improve consumer protection. Further action may be necessary to address undesirable practices such as spam emails, texts and cold calling, as well as other breaches of privacy: these practices are being clamped down on, for instance with a fine by the Information Commissioner for nuisance texts on PPI: https://ico.org.uk/about-the-ico/news-and-events/news-and-blogs/2019/05/ico-fines-ppi-claims-company-120-000-for-millions-of-nuisance-texts/. The question is whether more action may be necessary.

[435] Most major financial institutions would prefer judicial adjudication to arbitration. The use of arbitration tends to be in circumstances where the recognition of arbitral judgments is superior, for instance in the emerging markets, Russia and the Middle East. See Annex 4, section 2 below.

regulator rulebook, this would involve changing the approach to regulation so as to facilitate free choices by market participants. This involves adjusting for the following concepts.

- *Caveat emptor.* New rulemaking should place more reliance on the autonomous choices of market participants, using a *caveat emptor* approach, except for those who are clearly unable to protect themselves.[436] Protective regulation designed to supplant business and individual choices and to impose a one-size-fits-all protective overlay on sales of financial services and products is at odds with the UK's tradition. For most financial services and products, customers should be left to make their own choices; but in instances where those choices have long-term implications that could be regrettable, the regulators could step in for the protected class and impose sales restrictions or very clear requirements of disclosure, as well as outright prohibitions on the sale of the most dangerous products. The definition of those consumers who are protected in this way needs to be carefully formulated and limited in scope, so that there are mechanisms for excluding those towards the edge of the protective threshold who believe they are able to look after themselves and wish to opt out of the protective system and to make their own choices, including where they prefer to do so with less formal processes and disclosures.[437]

- *Disclosure.* There should also be a renewed emphasis on disclosure by market participants, so that other participants can rely on those disclosures and make evaluations of risk based on them. This brings with it considerable economic efficiencies. It has been found that "the development of stock markets is strongly associated with extensive disclosure requirements and a relatively low burden of proof on investors seeking to recover damages resulting from omissions of material information from the prospectus… The benefits of common law appear to lie in its emphasis on private contracting and standardised disclosure and in its reliance on private dispute resolution using market-friendly standards of liability."[438] This of course relates to an area where regulation already focuses on disclosure and is one for which, in the US, class actions are widely used. However, the more general application of the principle is valid, and individual proceedings brought by victims of wrongful disclosure (as is more the norm in the UK) provide adequate redress. Further uses should therefore be considered for the requirement of disclosure, since it allows more freedom for individuals to shape their actions on the basis of their own evaluation of their options.

  Disclosure mechanisms can be both private and public. Participants can to some degree require private disclosure by a contracting counterparty in advance of any dealings, and then bolster any disclosed facts by making them contractual assumptions. However, reliance predominantly on contractual provisions and on the other contracting party for redress is not always satisfactory. In some instances the counterparty may not have enough money to compensate for losses caused. Moreover, certain types of market participant cannot protect themselves. Nor can participants require disclosure from all other market participants. The regulations can achieve this instead, by ensuring that all market participants operate against a certain backdrop and can draft their contracts in a way that

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436 There are precedents for this in the financial services sector, where, for products which are difficult to comprehend and which have extended life-cycles, the financial regulators seek to ensure the products are generally accretive and attractive or are well-explained to retail investors. Highly dangerous—generally, highly speculative—products are prohibited from sale to such customers.

437 This is achieved through wealth or sophistication thresholds. Such concepts should be considered for products presenting high-risk, long-term or significant exposure. A good example is the UK investment funds regime, where certain products deemed unsuitable for retail investors due to, for example, long redemption periods or light-touch diversification rules (most notably the "Qualified Investor Scheme") are only marketable to defined classes of professional or otherwise eligible investors (see FCA Handbook, COBS 4.12).

438 See Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *What Works in Securities Laws?* (2006) 61 J Finance 20 at 28.

sets out their expectations. Participants can rely on disclosures made and subsequent behaviour of other participants on the basis of those disclosures.[439]

Of course, reliance on disclosure is in some instances inadequate. The law in turn ensures that if counterparty or market disclosures do not turn out to be true or honest, a remedy is provided. Regulated bodies need to be overseen to ensure they are run in a predictable manner. There also need to be swift remedies if disclosures are partial or misleading.[440] Otherwise the fact that a business was regulated might be taken to have been itself misleading, implying a level of oversight, verification and probity that had not been there.[441]

The common law provides additional forms of non-contractual protection against wrongdoing. There is the law of fraud, which was a feature of the common law long before statute intervened. There is also the doctrine of breach of fiduciary duty, the "proper purpose" doctrine of company law as well as the wrongs of "knowing receipt" and "knowing assistance".[442] Approaches to applying such notions vary somewhat amongst common law jurisdictions. For instance, the Australian courts have pushed the fiduciary concept slightly further than the English courts.[443] Yet the general conceptual framework has been found to be broadly satisfactory across the common law world in ensuring that assumptions of proper conduct are met and that, where this is not so, adequate remedies exist.

3.6 *Recommendation 4:* Secure that the purposive approach to interpretation as operated under EU (and civil) law is rejected

In addition, the restoration of clarity should be assisted by providing by statute for the UK courts to adopt their traditional methods of interpretation, based on the UK's method of communication through clear language. The UK should therefore drop the EU methods of interpretation,[444] instead returning to the pre-EU status quo of determining the intention of the law largely from the words used. An amendment to the Interpretation Act 1978 may be needed, to make absolutely clear that the EU's purposive and other methods of interpretation should not be applied by the UK courts, particularly in the context of inherited EU law.[445] The EU's purposes and aims are no longer relevant to the UK, and the UK's courts have a superior method of interpreting any law.

Finally, there is a further tension that is worth bearing in mind in this context. This arises not from EU law but from the testing of Parliament's legislative intent against the value-laden principles of the

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439 Otherwise, there would be a concern that no contract will ever be fully complete and capable of covering in clear provisions every possible aspect of malpractice by those upon whose performance the contract depends, whether or not they are a contracting party: Frank H Easterbrook, *Legal origins and securities fraud* [2019] LMCLQ 619, 622.

440 In the US, Bernie Madoff, the former NASDAQ chairman and founder of the Wall Street firm Bernard L. Madoff Investment Securities LLC, admitted in December 2008 that the wealth management arm of his business was an elaborate multi-billion-dollar Ponzi scheme. His investors suffered huge losses. Many of those investors were sophisticated market participants who made inquiries of Madoff and relied on his statutory disclosures. Those disclosures were clearly inadequate. Moreover, Madoff's activities behind the scenes were fraudulent. The US SEC was criticised for not investigating Madoff more thoroughly. Questions about his firm had been raised as early as 1999.

441 *Cf.* the recent case of LC&F, described in fn 827 below.

442 *Bowstead and Reynolds on Agency*, 21st edn (2018) Sweet & Maxwell, arts 43, 96. In the UK there is in addition a blanket of consumer protection law, which is an EU concept. The traditional common law approach of addressing fraud and unfair trading is different, as can be seen by comparing the US and Australian systems.

443 A. Black, *Fiduciary duties in a commercial context: comparing English and Australian approaches* [2020] LMCLQ 401. There is also the Australian Competition and Consumer Act 2010, formerly the Trade Practices Act 1974, which provides additional protections and remedies of a quite different nature.

444 As Sir Patrick Neill argued in a paper presented to a House of Lords Select Committee that the CJEU "is a 'court with a mission', namely pushing the Community [...] forward towards the goals enshrined in the [...] various treaties. With this aim it has gone far beyond literal interpretation", and as such any interpretive principles it adopts cannot be suitable for use by UK courts (Sir P Neill, *The European Court of Justice – A Case Study in Judicial Activism*, HL Paper 88, Session 1994-95, 18th Report, 218-245).

445 See fn 133 above for a statement by Sir Stephen Laws of how the UK system should operate.

Human Rights Act 1998. This statute, as it has come to be applied, is similarly in danger of undermining Parliament's sovereign decision-making authority,[446] and its application in a post-Brexit UK should be subject to ongoing, watchful consideration.[447]

Overall, the UK's system, with the courts applying and developing the private law, while interpreting and applying Parliamentary legislation, has stood the test of time and is demonstrably superior to the system more recently introduced by the EU. Paradoxically perhaps, for the UK at least, the old system is the best.

[446] The judicially developed principle of legality, which is the idea that Parliament does not mean to legislate contrary to human rights (now contained in the Human Rights Act 1998) unless it uses express language or necessary implication, could be used to allow dangerous judicial interference with Parliamentary sovereignty in this regard. An early (and clear) articulation of the principle was Lord Hoffmann's judgment in *R (Simms) v Secretary of State for the Home Department* [1999] UKHL 33, [2000] AC 115. See Sir Stephen Laws, *op cit*, fn 133 above.

[447] The Government has launched an inquiry into the current application of the Human Rights Act 1998, led by Sir Peter Gross, a former Court of Appeal judge: https://www.gov.uk/government/news/government-launches-independent-review-of-the-human-rights-act.

CHAPTER 4

A UK APPROACH TO REGULATION – PREDICTABILITY AND REGULATORY RESTRAINT

Taking the steps set out in Chapter 3 will not be enough, however. The issue that then arises is how to ensure that the regulators operate predictably and with restraint within a reordered UK system. Unlike the position across the legal system as a whole, financial services regulation provides the regulators with considerable discretionary power. Any reforms to the UK regime need to address the issue of how its regulatory approach should now operate. Just as the EU's rulemaking methods are unsatisfactory, so too are the EU's methods for regulating and overseeing the national regulators. The EU's controlling approach permeates its system. In the UK, the industry has found that the regulators in recent years have interfered in commercial decisions in a way that is hard to justify. This is partly because of the panoply of EU regulation. But in addition, it must be acknowledged, it is in part because of how the UK's own approach to regulation has added a further layer of constraint and uncertainty. It is unclear whether this additional lawyer itself arises because of the EU method and the shortcomings of EU law for the UK's global markets. However, regardless of the explanation, the phenomenon is clearly observable.

A new approach is needed. The EU approach to regulatory supervision is flawed. It is premised on the idea that prescribing the role of the regulators means prescribing the exercise of their powers so that they are in large part arbiters of fact as to whether or not a particular codified provision, made at a legislative level, is broken. Furthermore, no code can ever be drafted in a manner that is complete. The open-ended wordings of various aspects of the EU's single rulebook, and the EU's purposive method of interpretation (which was increasingly seeping into the UK system because of the federal, interpretative role of the ESAs), then gives the officials arbitrary power in declaring the application of the provisions as matters evolve. The approach gives rise both to unpredictability and also a curious sense of inflexibility in the rules from the perspective of a market user. This is not the best way of approaching regulation. It is perfectly possible—and indeed desirable—to operate a system where the sphere of competence of the regulators is established, but the way in which they exercise their powers within that sphere is subject to an appropriate level of discretion, properly overseen so as to ensure predictability. For this, the UK's own approach also needs attention in that it creates an additional layer of regulatory uncertainty.

The system must be carefully recalibrated to ensure two key outcomes are achieved. First, the UK's regulators must be empowered to use their judgment, expertise and experience to regulate and supervise the financial sector in a pragmatic and market-sensitive manner, moving away from the process-driven, tick-box approach that results from the EU's regime. Secondly, the powers of the regulators must be carefully circumscribed, to ensure that they do not overreach, or unnecessarily expand their role into commercial areas, or stifle innovation. The law also needs to ensure that the regulators operate predictably. These are not contradictory goals. There are grey areas for businesses in their decision-making, and the same is true for regulation. But for law and regulation, it is best to allow for any judgements which are reached to be based on precedent, guidance and reasoning by analogy. They should also be subject to restrictions on scope and process and should ultimately be capable of being tested under a system of case law, so that the regulators apply (and are seen to apply) legal and regulatory standards in the manner expected. For law or regulation which is intrinsically liberalising will not be so if those who are regulated are frightened of applying it themselves, or from challenging what they see as improper interpretations on the part of regulators. In such circumstances, regulated firms cannot accurately judge what the regulator will do, so many will not try to do so, which will dampen activity and innovation. The principle that should be adopted is to apply the law in a manner that is adequately permissive, without posing a risk to the system or allowing improper risk to be incurred for investors' assets. The aim of regulation should also be that the law works well and without delays.

The need for change is urgent and clear. Otherwise the result could be an improved regulatory regime in terms of the applicable rules, which benefits from the liberating effects of the common law method, but where many of the benefits are lost as a result of uncertainties arising from the exercise of regulatory powers. The Treasury Select Committee and HM Treasury have been consulting on the future regulatory framework for financial services.[448] No action can be calibrated appropriately without an understanding of the origins and extent of the problems to be fixed. The common law method shows the way. The following matters should be considered:

4.1 Aims and role of regulation – principle and practice;
4.2 What is wrong with the current regulatory system?

And this leads to -

4.3 *Recommendation 5:* Apply lessons from common law in providing certainty and constraining and overseeing the regulators in the exercise of their delegated functions.

4.1 Aims and role of regulation – principle and practice

A strong regulatory system should allow the market to function freely under the law, enabling businesses to make commercial judgements while the regulators supervise regulated firms to ensure customers have trust in the system. They also need to manage the financial risk which cannot be left to be managed by the firms themselves, particularly the risk arising from the system as a whole. The way this is achieved is through financial regulation, which is a form of law–making that needs careful handling. For financial regulation is not a natural part of the legal system, and the regulators have a special role. They can act as law-maker, judge and executioner. Their task is a complicated one. The ever-changing nature of financial services means that financial regulation needs both to be aware of the marketplace and to look ahead, observing how it changes. The regulators must address instances of non-compliance and consider the adjustments needed in the regulatory system. To work well, financial regulation needs to be effective, fair, flexible, efficient and resilient; yet it must also encourage innovation and be capable of operating alongside other (*i.e.,* foreign) legal and regulatory systems. Furthermore, the complexity of the financial markets mean that financial regulation is often quite technical, which can pose a challenge for oversight and commentary on the efficacy of the regulatory system.

[448] On 20 November 2020, Parliament's Treasury Select Committee announced a consultation on the future shape of UK regulation: https://committees.parliament.uk/committee/158/treasury-committee/news/132741/future-of-financial-services-inquiry-launched/. HM Treasury issued its own consultation, *Financial Services Future: Regulatory Framework Review - Phase II Consultation*, in October 2020. As part of an effort to gear up for a new regulatory framework after Brexit, action has been taken, following a HM Treasury consultation, to improve co-ordination between the UK regulators. This involves the implementation of a "Grid", managed by the Financial Services Regulatory Initiatives Forum, comprising the Bank of England, PRA, FCA, Payment Systems Regulator (PSR), CMA, and HM Treasury. The "Grid" will be published twice a year and will set out joint timetables for regulatory initiatives.

A focus on risk

The main role of the regulatory system is to manage risk, ensuring, broadly, the safety and soundness of the financial system,[449] and safe markets.[450] There are three main areas of focus for the regulators—idiosyncratic risk, systemic risk, and market and consumer risk. Idiosyncratic risk can arise in the businesses of individual firms. It involves the risk that a particular firm misbehaves, or is run in a risky way with the result that it may not be able to deliver on its promises when the time comes, or the assets or savings which it holds are tied up in such a way as to require a lengthy process to recover them if the firm runs into difficulties. Secondly, there is systemic risk, where a risk arises to the system as a whole, often because of the cumulative effects of activities of firms across the market, a problem which has been exacerbated in recent years by globalisation. In both cases the management of risk is a cross-border matter, involving cooperation (principally) between the global regulators in the US and UK. Thirdly, there is market and consumer risk, the risk that the financial markets are seen overall as unfair or unpredictable to participants or the consumer, undermining the ability or willingness of borrowers, investors and savers to use those markets. The first two forms of risk are matters which are subject to prudential regulation.[451] Such matters are predominantly overseen by the PRA,[452] which regulates the more significant (and therefore risky) financial institutions for prudential matters. The third form of risk is subject to regulation by the FCA, which oversees the conduct of financial business (and exercises prudential supervision over smaller firms).[453]

The activities of the financial regulators take place in the highly complex, technical and dynamic area of financial services and markets. Ultimately, however, they are just markets, like any other. The point of risk management is not to prevent failure, but to ensure that failures, and their consequences, occur (when they do) in a manner acceptable to the system. For this, the regulators need to pay constant attention to the markets themselves and to individual firms. It must be recognised that financial firms can fail, just like firms in other sectors. There can also be wrongdoing. The extent to which this is uncovered varies according to the efficiency of the regulators and enforcement bodies. The results can be seen to differ between the UK,[454] US[455] and EU,[456] but the UK's record is relatively strong. There

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449 Section 2B(2) FSMA 2000 sets out the PRA's general objective, which is "promoting the safety and soundness of PRA-authorised firms". This is then complemented by an insurance-specific objective found in section 2C FSMA 2000. The general rule-making powers of the PRA are contained in Part IX A of FSMA 2000. Section 137G(1) enables the PRA to "make such rules applying to PRA-authorised persons – (a) with respect to the carrying on by them of regulated activities, or (b) with respect to the carrying on by them of activities which are not regulated activities, as appear to the PRA to be necessary or expedient for the purpose of advancing any of its objectives".

450 Section 1B(2) FSMA 2000 sets out the FCA's strategic objective, which is "ensuring that the relevant markets function well". Section 1B(3) sets lists its operation objectives, which include consumer protection, integrity, and competition.

451 See fn 172 above.

452 Systemic risk is subject to separate, specialised scrutiny by the Bank of England’s Financial Policy Committee: see fn 198 above and the text surrounding fn 205 above.

453 See fn 414 above and surrounding text for a further explanation of the split between the roles of the PRA and FCA, and the “twin peaks” approach to regulation.

454 The UK has successful enforcement arrangements (see *e.g.* fn 458 below, and the footnotes immediately following that).

455 The US approach is slightly different. It can be seen to benefit from having multiple different, and overlapping, regulators and enforcers – all empowered to enact rules and bring enforcement actions, which has created something of a tapestry that, over time, has operated in a way that balances out the different approaches involved. For example, individual US states have their own securities laws, enforced by state securities regulators and criminal authorities – both District Attorneys at the local level and Attorneys General at the state level. In general, US state securities laws complement US federal securities laws, as do their enforcement action. And the inherent variation resulting from so many different regulators and enforcers results in something of an ever-present system of trial and error, whereby regulators, financial institutions and capital markets participants learn from experience and gravitate to the most predictable and efficient systems of rules and regulations. Of course, there have been times in the US where the variation in rules has led to challenges, or improper piling-on of punishment (in May 2018, the US Department of Justice enacted a Policy on Coordination of Corporate Resolution Penalties in response to such concerns, explicitly designed to avoid "piling on:" https://www.justice.gov/opa/speech/file/1061186/download), but over time it has led to positive development of the law. Enforcement efforts across the EU have been more mixed.

456 A comparison of the FCA's enforcement statistics with those of the major EU member state regulators – BaFin in Germany and the Autorité des marchés financiers (AMF) in France – shows that, in the number of investigations carried out and total value of financial penalties imposed each year, the FCA is significantly ahead. BaFin imposed a higher total number of fines, but the overwhelming majority were very low in value. Of course, the UK has a far larger financial services market, and BaFin and the AMF operate models under which criminal wrongdoing is referred to other agencies, but it is

have been numerous failures or failings of regulated financial firms in each of these jurisdictions and indeed elsewhere.[457] They include instances of individual fraud or other financial crime,[458] money laundering,[459] mis-selling,[460] poor commercial decision-making,[461] poor lending decisions[462] and inadequately managed systemic risk, most notably in the context of the 2007 – 2008 financial crisis which led in some cases to bail-outs, recapitalisations and the (unacceptable) need for government funding.[463] The costs to the UK industry and its shareholders as a result of compensation claims, litigation and regulatory fines arising from breaches of law and regulation can run into the tens of billions.[464] The UK financial services industry is very large and the management of the risk of these occurrences involves ensuring that business failures occur in a way that causes minimal disruption to the economy, the market and consumers, and no exposure to losses for UK taxpayers.[465]

Systemic risk – the lessons of the financial crisis. A painful lesson was learned in the 2007 – 2008 financial crisis. As explained in Chapter 3, this crisis arose from a misplaced faith in the efficient market hypothesis, that the market itself would operate to close down risky practices.[466] As a result, inadequate attention was paid to systemic risk by the world's central banks and regulators.[467] The EU law framework exacerbated its effects in Europe.[468] When the risk crystallised through a trigger event in the US, the result washed through the global financial system.[469] What this episode has brought home is that systemic risk, wherever it arises (including abroad), is a key element of risk that needs to be managed. This is so whether the risk arises from the Eurozone (as described in Chapter 2, section 2.3)

safe to say that the UK has been more proactive than its European neighbours, especially in recent years, as evidenced by the significant increase in FCA enforcement investigations since 2015. Source: the Annual Reports of the various regulators across Europe.

457 In the US, the Federal Deposit Insurance Corporation (FDIC) keeps a list of failed banks since 1 October 2000 – there have been 562, most of which are smaller firms. See https://www.fdic.gov/resources/resolutions/bank-failures/failed-bank-list/. There has been nothing like this list of failed institutions in the UK, but that in part is due to the international, wholesale nature of the UK market.

458 *E.g.* Wirecard (EU/2020); Deutsche Bank (EU/2020); Wells Fargo (US/2016); Kweku Adoboil / UBS (UK/2011); Jerome Kerviel / Societe Generale (EU/2010); Madoff (US/2008, fn 440 above); AIG (US/2005); Freddie Mac (US/2003); John Rusnak / Allied Irish Banks (UK/2002); Enron (US/2001) and the Natwest Three (UK/2001); Morgan Grenfell (UK/1999); Griffin Trading Company (UK/1998); Barings Bank (UK/1995, fns 523 and 524 below); Nordbanken (Nordea) (Sweden/1992); BCCI (UK/1991); Barlow Clowes (UK/1988, fns 514 and 515 below); LIBOR: Barclays (UK/2012), UBS (Switzerland/2012), Rabobank (EU/2014), Deutsche Bank (US/2015); RBS (US/2012) and fn 563 below and surrounding text; FX: Citicorp (US/2015), JPMorgan (US/2015), Barclays (US/2015), RBS (US/2015), UBS (US/2015). Fines have also been imposed in respect of sanctions violations, *e.g.* BNP Paribas (US/2015); Standard Chartered (US/2019); UniCredit (US/2019).

459 *E.g.* Danske Bank (EU/2017-18); Nordea (EU/2016); Deutsche Bank (EU/2015); Standard Chartered (UK/2007-8); Wachovia Bank (US/2006).

460 *E.g.* Pensions: Royal Sun Alliance (UK/2013); Equitable Life (UK/2010). PPI: 1990-2010 (UK): Lloyds; Barclays; RBS; HSBC; Yorkshire/Clydesdale; Bank of America; Santander; Citibank (Egg); Northern Rock; Cooperative Bank and others.

461 *E.g.* Equitable Life (UK, fn 525 below); UBS, three Icelandic banks, (Kaupthing, Landsbanki and Glitnir); Lehman Brothers (US/2009); RBS (UK/2009, fn 536 below); Lloyd's of London (UK) Reconstruction and Renewal Plan (UK/1996) / Equitas (fn 536 below).

462 *E.g.* Piraeus Bank (EU), Eurobank (EU), National Bank of Greece (EU), Banca Populare di Vicenza (EU), Veneto Banca (EU), Kaupthing (EU), Landsbanki (EU), Banco Espirito Santo (EU), HSH Nordbank (EU), Heta (EU), Cooperative Bank of Cyprus (EU), ING (EU), UBS (EU), Anglo Irish Bank (EU), Banco Popular Español (EU), ABN AMRO (EU), Hypo Real Estate (EU), Fortis (various EU), Banco Popolare (EU), SNS Reaal (EU) and ABVL (EU). The EU bank failures arising from the 2007-2008 financial crisis are recorded in the *Failed Bank Tracker*, Open Economics, https://openeconomics.net/failed-bank-tracker/.

463 *E.g.* Freddie Mae (US); Freddie Mac (US), Northern Rock (UK, fn 540 below); HBOS (UK), RBS (UK/2009); Lloyds TSB. Participants in the US bail-out scheme for the effects of the 2007-2008 financial crisis, the Troubled Asset Relief Programme (TARP), included Citigroup, Bank of America, JPMorgan Chase, Morgan Stanley and Wells Fargo, amongst others. Note: a few of these incidents also relate to management failings and poor commercial decisions.

464 See *e.g.* Dominic Lindley, *The top 10 retail banking scandals: 70 billion reasons why shareholders must play a greater role in changing bank culture*, originally 11 April 2016, updated to 2019/2020, New City Agenda, https://newcityagenda.co.uk/the-top-10-retail-banking-scandals-50-billion-reasons-why-shareholders-must-play-a-greater-role-in-changing-bank-culture/.

465 See fn 470 below.

466 See fn 185 above.

467 See fn 184 above.

468 See fn 186 above and surrounding text.

469 See fn 183 above.

or elsewhere. Calming the financial crisis of 2007 – 2008 required the UK to put its entire balance sheet at risk in order to ensure that numerous financial firms could maintain operations and not become immediately insolvent.[470] The Government at the time, and Parliament, enacted many of the post-crisis reforms with that in mind, with a view to ensuring that never again would taxpayer monies be exposed to the financial markets in this way.[471] There were similar commitments made in the US, including a provision added to the Dodd-Frank Act 2010[472] to make clear that this should not happen.[473] Systemic risk oversight is now an essential part of financial regulation.[474] However, this form of oversight also involves paying more attention to the conduct of firms, both in themselves and in their relations with other market participants.

What the regime cannot address. It is important to identify the various points which the regulatory regime cannot address. In particular, there are limitations on the ability of regulators to prevent individual misconduct or poor decision-making in individual businesses. Such matters arise from time to time across all industry sectors. No regulator can guarantee to identify and prevent financial crime by rogue employees. Nor can the regulators always prevent failures of commercial decision-making. The regime can ensure that any such occurrences are discovered swiftly, and it can constrain and minimise their consequences. The answer cannot be to prevent desirable market activity. If the regulators were to restrict commercial action unduly, the market would shrink and economic growth would be adversely affected. The financial market needs to be allowed to operate just like any other market, which contains successful and less successful participants. The question is how to allow that to happen safely. The results of untended systemic risk meant that the 2007 – 2008 financial crisis, when it came, triggered existential problems for so many financial firms that the Government could not rely on its insolvency regime and the other tools then available. The general approach of central banks and regulators is to allow firms to fail so as to prevent "moral hazard", which is the risk that otherwise a firm has an incentive to increase its exposure to risk because it does not bear the full costs of that risk.[475] However, this approach proved inadequate in the case of the system-wide events of 2007 – 2008,[476] which is why systemic risk is now understood to require particular attention, and new structures, described below, have been put in place to protect consumers and the proper, continued functioning of the market.

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470 The National Audit Office (NAO) estimated that total guarantees added up to over £1 trillion at peak support during the financial crisis: *Taxpayer support for UK banks: FAQs, https://www.nao.org.uk/highlights/taxpayer-support-for-uk-banks-faqs/*. See also *Bank rescues of 2007-09: outcomes and cost*, 8 October 2018, House of Commons Briefing Paper No 5748.

471 In 2011 the UK Government published *The Government response to the Independent Commission on Banking*, in which the "British Dilemma", was described as, "[h]ow Britain can be the home of some of the world's leading banks, without exposing the British taxpayers to the unacceptable costs of those banks failing" (December 2011, CM 8252, at p. 3, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/31585/govt_response_to_icb_191211.pdf). The report further stated "the UK cannot afford to let banks be underwritten by the British taxpayer, putting the broader economy at risk. Reform of financial regulation is needed to make banks more resilient, to allow banks that still fail to do so safely without cost to the taxpayer, and to improve the stability of the financial system" (p. 14).

472 See fn 364 above.

473 See section 214 of the Dodd-Frank Act 2010, 12 USC § 5394.

474 See fn 198 above.

475 This system had worked even in times of extreme stress, for instance when the Lloyd's of London market suffered huge losses of approximately £8 billion between 1988 and 1992, largely as a result of claims related to asbestosis and pollution and the practice at the time of reinsuring excess risk within a small group of Lloyd's syndicates, which led to the final resting place of the risk becoming unknown, an effect that became known as the London Market Excess of Loss spiral. These large losses ultimately led to an array of litigation by Lloyd's "Names" (the underwriters of risk) against other participants in the Lloyd's market, and the losses also forced many Names to cease underwriting. The outstanding debts also adversely affected the solvency and liquidity of the entire Lloyd's market. In 1996, Lloyds of London implemented a complex market restructuring under which it reinsured the 1992 and prior years of business underwritten by its Names into Equitas, a UK authorised reinsurance fund, through a process known as Reconstruction and Renewal. However, the experience was not left unaddressed. It formed part of the reason for subsequent legislative provisions which placed of the regulatory function of Lloyd's of London under the oversight of the FCA and PRA: see fn 506 below.

476 See fn 540 below.

Powers and resource

Financial regulation in the UK arises from broad powers granted by Parliament by statute. The regulators operate under delegated authority from Parliament and are empowered to make day-to-day rules and to supervise firms, within defined parameters. They authorise firms to conduct regulated activities. They have the power to remove a firm's authorisation, prohibit individuals from undertaking regulated activities, withdraw permissions (permanently or temporarily), impose requirements, issue public censures, seek various court orders, including injunctions, restitution orders, winding-up and similar insolvency orders, and impose financial penalties.[477] They set out the processes around the exercise of these powers in their own rules.[478] They may also act as the prosecuting authority for various criminal offences[479] and have the power to institute civil proceedings.[480] The regulators are exempt from liability in damages in the proper performance of their tasks.[481] They are nevertheless subject to the ongoing oversight of HM Treasury and Parliament, including the Treasury Select Committee,[482] as well as of the courts through judicial review (under a branch of law called administrative law[483]). The regulatory rules exist in conjunction with the common law and statute.

To fulfil these functions, the UK's regulators have become significant enterprises. Nowadays, the FCA employs around 3,600 people.[484] It is the conduct regulator for nearly 60,000 financial services firms and markets in the UK and the prudential supervisor for 49,000 firms, setting specific standards for 19,000 firms.[485] The PRA has around 1,250 employees[486] and supervises around 1,500 financial institutions.[487] The PRA is part of the Bank of England. Both bodies located close to the main activity of the financial market, so as to be readily apprised of market developments and behaviours. The PRA's offices are located in the City of London; the FCA's offices are located in Stratford, just outside the City.

Modern regulation – the fundamental method

In managing financial risk, there are certain basic principles upon which all financial regulation rests. There are certain points which require constant attention in ensuring that the market can operate freely but in a stable and safe manner. These points also protect the safety and soundness of the system itself and its ability to withstand shocks. They include the safeguarding of customer assets; the management of risk arising from regulated firms; and ensuring a level of trust in the market through the predictable behaviour of firms. There is also a need to ensure sufficient market transparency for the market to operate smoothly. Market participants have no right to expect the absence of failures on the part of firms with which they deal, but as a general matter the market should operate in a manner which allows participants and customers to deal with others on the basis of the words of others, set out in contracts and public disclosures, and to have confidence that as a general matter the businesses with which they

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477 The majority of the regulators' powers are set out in the FSMA. They are afforded additional statutory powers to deal with particular types of misconduct, *e.g.* Part 9 of the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017.

478 For the FCA, see the FCA Handbook generally and the Enforcement Guide. For the PRA, see the PRA Rulebook and the Approach to Enforcement.

479 See sections 401 to 403 of FSMA and the Supreme Court's decision in *R v Rollins* [2010] UKSC 39, [2010] 1 WLR 1922.

480 By way of example, see sections 359, 367, and 380 to 383 of FSMA.

481 See Annex 6, section 2 below.

482 *E.g.*, for the FCA, see: https://www.fca.org.uk/about/reporting-treasury-parliament.

483 See Annex 6, section 3 below.

484 In 2018-2019, the FCA employed 3,655 full time equivalents: *Regulation Overview 2019,* National Audit Office, March 2020.

485 https://www.fca.org.uk/about/the-fca.

486 https://www.bankofengland.co.uk/freedom-of-information/2020/number-of-members-of-staff-at-the-prudential-regulation-authority-as-at-end-march-2020. Figures up to date as at end of March 2020.

487 https://www.bankofengland.co.uk/knowledgebank/what-is-the-prudential-regulation-authority-pra#:~:text=with%20swipe%20gestures.-,What%20is%20the%20Prudential%20Regulation%20Authority%20(PRA)%3F,including%20banks%20and%20insurance%20companies.

deal are operating in the way in which they purport to be. These objectives are achieved in a variety of ways.

The basics – protecting the system and customer funds

First and foremost, the system itself needs to be protected, for which purpose attention focuses on its key elements. After the experiences of 2007 – 2008 a number of steps were taken. The safety and soundness of banks was buttressed in the UK by a statutory requirement for the ringfencing of retail banks and payment systems.[488] The US adopted measures designed to achieve a similar degree of protection: banks are restricted in the ways in which they can invest for their own account and are subject to limitations in their dealings with most hedge funds and private equity funds.[489] The EU, interestingly, has declined to adopt any such measures.[490] The UK also introduced new powers for the Bank of England to resolve failing banks,[491] described in the following paragraph. These were measures followed in the EU.[492]

In addition, the regulators need to manage the legal and regulatory framework so as to protect customer funds. The regulators need to ensure the firm's systems and controls are strong, and that they (and the firms they supervise) respond quickly as soon as shortcomings or anomalies are found to arise, so as to protect consumer assets and allow (in the case of the collapse of a firm) for the swift return or transfer of those assets to a successor firm so that consumers can continue to have access to them.[493] In the UK, the use of trust law and the client money and assets regime ensures client monies and assets are ring-fenced from a firm's own assets, including on its insolvency.[494] However, these protections cannot deal with situations in which client monies and other assets have been fraudulently squandered, nor with the need to recover those assets quickly so that consumers can carry on trading, and thereby be insulated from the failure of their firm. To address the first point, there is an industry-funded Financial Services Compensation Scheme (FSCS) which guarantees that retail customers of UK banks which fail are covered up to the first £85,000 of any losses on their deposits and investments (and more in unique circumstances, such as the proceeds of the sale of a house).[495] The Scheme also protects consumers

488 See fn 307 above, and the criticisms of Paul Volcker: fn 372 above.

489 See fn 368 above, and the Volcker Rule, which is a modern approach to restricting any cross-contamination of risk between the various financial industry sectors, protecting the banking system in particular. An earlier US measure, the Glass-Steagall Act of 1933, had sought to address this problem in a different manner, by requiring the separation of investment banking businesses from those businesses engaged in retail banking. The US repealed elements of Glass-Steagall with the Gramm–Leach–Bliley Act of 1999.

490 In October 2012, the EU high-level expert group on reforming the structure of the EU banking sector, chaired by Erkki Liikanen, a Finnish politician and former governor of the Bank of Finland, published its recommendations for, among other things, ring-fencing retail banks from the proprietary trading activities of the group. The model was the UK's Vickers reforms: see fn 399 above. In January 2014, the European Commission adopted a formal legislative proposal to implement the Liikanen recommendations, but which went further by proposing an outright ban on proprietary trading (Proposal for a Regulation on structural measures improving the resilience of EU credit institutions (COM/2014/043 final - 2014/0020 (COD)). The EU withdrew the proposed Regulation in July 2018. The rationale given for withdrawal of the proposal was that no political agreement by the member states was foreseeable. The proposal had made no progress since 2015. Furthermore, in the meantime, it was claimed that the financial stability objective of the proposed Regulation had been met by other regulatory measures in the banking sector, notably the entry into force of the Banking Union's supervisory and resolution arms, comprising the supervision of the ECB (known as the Single Supervisory Mechanism) and the resolution powers adopted from the UK (see fn 362 above, for the Bank of England's development of bail-in, the BRRD in fn 318 above and the precursor UK regime, the Banking Act 2009). However, none of these measures address the structural ring-fencing of risk achieved by the UK and US reforms.

491 See fn 500 below.

492 See fns 725 and 726 below.

493 An extraordinary example of failings in this role can be found in the case of Wirecard. The German regulator, BaFin, tried to brush away serious questions raised by investigative journalists from the Financial Times over the fraudulent German payments provider, Wirecard, launching criminal complaints against those journalists and barring sceptical investors from betting that the company's share price would fall, by imposing a short selling ban, before the company ultimately collapsed, causing significant losses: Patrick Jenkins, *Why Germany should Shut Down BaFin*, 21 December 2020, Financial Times.

494 See Annex 1.

495 https://www.fscs.org.uk/. For deposits, see the Deposit Guarantee Scheme Regulations 2015 (SI 2015/486) (as amended, in the context of Brexit, by the Deposit Guarantee Scheme and Miscellaneous Provisions (Amendment) (EU Exit) Regulations 2018, SI 2018/1285). EU banks are similarly covered for the first €100,000 of any losses on deposits: see

who hold insurance policies underwritten by a UK-authorised insurer (or who receive insurance advice or brokering services from such a firm) for 90% of their claims on an unlimited basis, if the firm becomes insolvent, with compulsory policies being protected in full; and it protects claims arising from bad mortgage advice for up to £85,000.[496] To address the second point, the UK has developed a statutory scheme for transferring failing bank businesses to other institutions, or recapitalising a bank using creditor money, in order to protect customer deposits.[497] It has refined its insolvency regime to allow for a quicker return of customer assets.[498] There are also mechanisms for transferring assets from a clearing member of a CCP which is in trouble to another clearing member.[499] Furthermore, assets are recorded in electronic or paper form and evidence of ownership can sometimes be required. There are therefore detailed record-keeping requirements which are overseen by the regulators.[500] The key is that customers are able to continue accessing their deposits and their financial assets are not "lost" but can be recovered easily.

In regulating the complex wholesale markets, the guarantee fund is unavailable, on the basis that wholesale customers can play a role in looking after their own interests. This coincides with the fact that there is more of a concern in the wholesale context of moral hazard, since the number of market participants is greater. Also, the wholesale market is more global and the interactions of some of those participants are less easily addressed through regulatory coordination. The regulatory approach in this area therefore revolves more around the maxim *caveat emptor*[501] and the presumption that the market will weed out fraudulent operators. However, this approach still coexists with regulatory oversight, since even sophisticated parties can fall victim to systematic fraud.[502]

Tackling market complexity – making and applying rules

The complexities of the financial markets and the risks they involve have meant that the regulators need to operate by making and applying rules. The modern markets have meant that the style of regulation traditionally adopted in the UK has had to be updated. Market participants no longer all operate within walking distance of the UK regulators, particularly with the online provision of many services. The method of regulatory communication must therefore be through published regulations and guidance. The rules need to capture the key aspects of financial risk which are the subject matter of regulation. Market complexities mean that the process of rulemaking is a painstaking one. It is not practicable to make an exhaustive set of rules, as the EU experience demonstrates.[503] In addition, experience has shown that regulatory supervision of compliance with those rules now needs to involve more day-to-day intrusion into business practices than was traditionally thought appropriate.

The origins of the modern UK method. Prior to the enactment of FSMA, Self-Regulating Organisations (SROs) conducted the rulemaking and supervision of investment businesses under the oversight of the

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fn 320 above (the UK amount represents the sterling equivalent since the EU regime was implemented in the UK, while within the EU). There are limitations to the member state deposit guarantee schemes, and there is a (controversial) proposed industry-funded pan-EU guarantee scheme: fn 738 below and surrounding text, and *Managing Euro Risk,* fn 5 above, footnote 136.

496 *Ibid.* EIOPA has called for the harmonisation of insurance guarantee schemes across the EU: *Opinion on the 2020 Review of Solvency II*, 17 December 2020, p. 93 *et seq.*

497 Banking Act 2009.

498 See the Investment Bank Special Administration Regulations 2011, as amended following the recommendations of Peter Bloxham in his *Review of the Investment Bank Special Administration Regulations 2011*, April 2013.

499 UK and EU law provide for a mechanism known as "porting" under which client positions and assets held at a CCP can be transferred on the default of a clearing member to another clearing member designated by the client. The CCP must uphold the client's request, without the consent of the defaulting clearing member. See EMIR, Recital 64 and Articles 4, 39 and 48 , and "UK EMIR" as onshored by the European Union (Withdrawal) Act 2018 and amended by Regulation 42 and 49 of the Over the Counter Derivatives, Central Counterparties and Trade Repositories (Amendment, etc., and Transitional Provision) (EU Exit) Regulations (SI 2019/335).

500 *E.g.* FCA Handbook, SYSC 9.1.

501 See Chapter 3, section 3.5 above.

502 See *e.g.* the experience of customers of Bernie Madoff, fn 440 above, some of whom were sophisticated investors.

503 See Chapter 2 above.

statute-based Securities and Investments Board (SIB).[504] In particular, conduct of business regulation was comparatively light. The UK's Bank of England exercised discretionary supervision over banks operating in the UK.[505] Insurers were subject to very light touch regulation, first by the Department of Trade and Industry and subsequently by the Treasury, focused largely on their risk profiles and solvency.[506] The traditional form of regulation of the Bank of England focused principally on prudential[507] matters, and the joke went that the test was whether the Governor of the Bank of England would raise his eyebrows if he heard about a particular situation or activity.[508] However, this mischaracterised what was a system of pretty stringent oversight, with sanctions rapidly enforced. It operated with only a small number of highly-skilled supervisors, who were able to sit around a single table. As a result, the supervisors focused on what they believed to be significant and were generally limited to addressing only the most important points of the day; they did not engage in lower level oversight of compliance. Senior executives were called in to the Bank to explain any troubling situation.[509] The method was justifiable in the environment at the time, in which the financial markets were less complex than they are now.[510] For regulatory capital, this highly discretionary approach was broadly how the UK regulators operated when implementing the Basel Rules,[511] right up until the adoption of the EU's Capital Requirements Regulation (CRR).[512] However, such methods of regulation can now be seen as old fashioned and under-developed for the complex, modern markets.[513]

In addition, the main stick under the old regime, of removing a firm's authorisation, is seen as no longer sufficient, particularly when this will be subject to judicial challenge. This was one of the reasons Barlow Clowes International Ltd, a fraudulent "bond-washing" operation,[514] whose fraud and collapse caused an accounting scandal in 1988, was able to continue in operation for longer than it should have been able to do and after valid concerns had been raised about its probity.[515] The modern approach to

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504 This was provided for in the Financial Services Act 1986.

505 Banking Act 1987.

506 Lloyd's of London used to regulate itself, but under the FSMA, the regulation of the Lloyd's market by Lloyd's Corporation was placed under the oversight of the FSA (and now the FCA and PRA, its successor bodies in this respect).

507 See fn 172 above.

508 (All Governors to date have been male.) The power of the Governor's raised eyebrows was well known. For instance, it was said that "the most powerful force in the City of London is, proverbially, the Governor of the Bank of England's raised eyebrows" and that the small and close-knit group of people able to govern in this way wielded "an authority based on custom, respect, and mutual convenience, rather than any force of law": C. Fieldes, *The Governor's Eyebrows*, 28 November 1981, The Spectator, p. 16, http://archive.spectator.co.uk/article/28th-november-1981/16/the-governors-eyebrows.

509 The former Deputy Governor of the Bank of England, Baroness Shafik, referenced the historically informal way in which executives may have been called to explain any troubling situation by stating "Governors' eyebrows and fireside chats are no match for a clearly communicated framework in which information will be gathered and decisions made": C. Binham, *Bank of England banishes 'fireside chats'*, 26 February 2015, Financial Times, https://www.ft.com/content/d6fff9f4-bddc-11e4-9d09-00144feab7de.

510 Interesting comments on the transition from that world to the new one are to be found in Lord George's paper, *Banking on Stability: A framework for economic success* (2018) Politeia.

511 See fn 75 above.

512 Discretionary regulatory policy played an important role in the UK's implementation of capital requirements, with UK regulators imposing bank-specific minimum capital requirements on top of those set by Basel. The FSA became the supervisor of UK banks in 2001 and issued individual capital guidance based on supervisory assessments, which applied on an individual firm basis. Capital requirements later became set under Basel II. In the aftermath of the 2007-2008 financial crisis, the FSA imposed an enhanced regime upon those banks that had undergone government-supported recapitalisations. In 2013, the FSA's bank supervisory powers were transferred to the Prudential Regulation Authority, which abandoned the previous supervisory framework and instead required the major UK banks to adhere to the Basel III minimum common equity tier 1 capital ratio as well as a Tier 1 leverage ratio that was implemented through the direct application and transposition of the EU law provisions in CRR and CRD respectively.

513 They were not however the cause of the 2007-2008 financial crisis: see fn 185 above and fns 587 and 589 below and surrounding text.

514 Government bonds were purchased and sold to create tax advantages, with investors believing their money had been invested risk-free when instead much of it had been used to fund the lifestyle of the company's co-founder, Peter Clowes.

515 The Department of Trade and Industry gave the company a licence in 1985, and renewed it in both 1986 and 1987. It has been alleged that the DTI knew by the mid-1980s that Barlow Clowes was trading without a licence. Sir Peter Emery alluded to this point in a speech to the House of Commons on 5 July 1988, when he asked the Minister for Corporate and Consumer Affairs "[w]ill the Minister let the House know how many official complaints or intimations of concern were received by his Department about Barlow Clowes from 1985 to 1988?".

regulation needs to be more nuanced. The regulators need multiple levers short of the withdrawal of authorisation.

Furthermore, the previous approach relied upon extensive use of guidance, including for matters of regulatory importance. The extent of this reliance is at odds with the increased need for predictability and the rule of law in matters of financial regulation, which arises to a greater degree than ever before because of the complexity of the modern financial markets. Additionally, many of the regulatory standards are now more hard wired and in many cases agreed internationally. The issue is how to ensure that regulations are applied fairly and consistently, so that businesses do not find themselves subject to discretionary oversight that could quickly become arbitrary.[516]

The contrasting EU method. In recalibrating the UK's modern approach the inherited EU approach does not form a particularly useful benchmark. Indeed, it is notable that the EU single rulebook has not proved to be any more effective than regimes elsewhere, to say the least. The 2007 – 2008 financial crisis arose for the UK within the EU's rulebook structure, with all its distortive effects of forcing the UK to accept inbound business which was not properly regulated in its home state.[517] Under its regulatory regime at the time, the UK did not fall victim to the 1929 Wall Street Crash in anything like the same way as the US, and it has generally managed through the ups and downs of market cycles. The EU's scepticism of Anglo-Saxon methods and of investment banking arises because the EU does not have strong investment banking businesses (operating within the EU itself, as opposed to within the UK) and instead benefits from those businesses (including those incorporated in the EU) providing their essential services out of the UK and US. In addition, as has been shown in Chapter 2, section 2.3, the EU has in fact created systemic risk through its legal and regulatory architecture for the euro currency, which is fundamentally flawed and highly dangerous. Many of the EU financial crises affecting individual firms have arisen, and continue to arise, from problems with the Eurozone, including for example from the economic state of affairs within the zone and crippling non-performing loans.[518]

Engendering trust in the system – regulatory managerialism

In addition to thoughtful rulemaking, the UK regulators need to engage in careful supervision. Supervision of compliance with the rules is necessary so as to ensure there is broad compliance with the rules themselves, and that firms are managed in ways which meet market expectations. Regulations are not enough on their own. The rules, if properly drafted, will address key points which would give rise to risk that the system seeks to prevent or manage. However, the consequences of non-compliance with those rules are to introduce risk into the system which, if the risks materialise, may give rise to losses. The supervision is not in order to protect the investors in the firms, since they can be left to look after themselves. It is instead to protect the participants in, and users of, the markets. For the financial markets are based on trust. Financial firms need to honour their word and be around for the long haul, so that they can deliver on the promises they make.

The regulators play a vital part in ensuring market predictability for participants and users. A particular focus is on ensuring that those whose dealings with the market are infrequent, and who are therefore less able to distinguish between good and bad providers, are able to place their trust in the system. As already explained, this does not mean ensuring that regulated firms can never fail, since that would be to cut across the need for competitive forces to ensure that the market operates efficiently. However, it does mean providing for a certain predictability in the behaviour of those businesses. For this, the regulators need to act in a managerial capacity, responding dynamically to the market. The modern markets require a sophisticated approach in supervising the behaviour of individual firms, which manifests itself in two forms.

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516 Of course one misconception which must be avoided is the notion that that requires there to be a law governing every stage of a transaction. Rather, there should in general terms be transparency about the consequences of failure, and consistency in the imposition of those consequences.

517 See Chapter 2, section 2.1 above.

518 See Chapter 2.3 above and fn 462 above which has examples of firms failing because of the Eurozone crisis.

Judgement-based supervision. First, financial regulators have a continuous, non-judicial role. Some elements of regulation do need to be conducted on a discretionary basis, within the boundaries of the regulators' statutory authority and the rules which they have already made. The vast and ever-changing complexity of the financial markets means that the regulators need to be able to make judgements on matters in situations in which the facts are uncertain. There will be complexities in market operations that will require the exercise of dynamic judgement of the risks and abilities of market participants. This was seen, for instance, in the case of Long-Term Capital Management (LTCM), a US hedge fund set up in 1994, which engaged in a complex investment strategy based on mathematical modelling, which was overseen by two Nobel prizewinning economists.[519] This strategy turned out to be fundamentally flawed, causing huge losses.[520] It is unlikely that any regulator at the time could have readily challenged the modelling used by LTCM. However, a sceptical assessment could have been made of the risks involved. So it is necessary for the regulators to retain an element of discretion and the ability to exercise their own judgement.[521] This extends to cross-border structures, where the regulators need to be careful to ensure that those bits of the firm which they do not oversee are properly regulated elsewhere.[522]

Overseeing management as well as firms themselves. Secondly, inadequate management can cause huge, unexpected losses and systemic damage. This was seen in the case of Nick Leeson, a rogue trader in Barings Bank, the UK's oldest merchant bank. In 1995, Leeson racked up extraordinary losses in its Singapore operations, without the knowledge or control of the bank's London management.[523] This led to the collapse of the bank.[524] It became clear then that there needed to be greater regulatory oversight of management in its supervision of complex financial market activity.[525]

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519 LTCM was advised and run by highly distinguished market practitioners, including two Nobel prizewinning economists, Myron Scholes and Robert Merton (who had developed, in 1997, a method to determine the value of derivatives). LTCM ran an investment strategy based on highly analytic thinking, using computer models which sought to take advantage of minute price differences to be found across the market. In order to maximise returns, LTCM borrowed large amounts to enhance the profit from those small differences in price.

520 LTCM's strategy was was initially very successful, with annualised return of over 21% (after fees) in its first year, 43% in the second year and 41% in the third year. However, when Russia defaulted on its debt in August 1998, LTCM was holding a significant position in Russian government bonds. Despite the loss of hundreds of millions of dollars per day, LTCM's computer models recommended that it continue to hold its positions, which gave rise to huge losses. In 1998 LTCM lost $4.6 billion in less than four months due to a combination of high leverage and exposure to the 1997 Asian financial crisis and 1998 Russian financial crisis. The fund liquidated and dissolved in early 2000. This led to a bailout by many of the main international banks, organised by the US Federal Reserve, and ultimately to the liquidation of the fund.

521 For instance, they retain – and need to retain – the discretion to set additional capital requirements for particular firms on a dynamic basis to respond to sudden risks arising in those firms or in the market as a whole. This cannot be achieved solely on a rules-based approach.

522 This lesson was learned in the 1980s as a result of the case of Bank of Credit and Commerce International (BCCI), which was established in such a way that no regulator had adequate oversight of its operations. BCCI was founded in 1972 by a Pakistani financier. The Bank was registered in Luxembourg with head offices in Karachi and London. In the early 1980s, BCCI had over 400 branches in 78 countries and assets in excess of US$20 billion, making it the seventh largest private bank in the world. During the 1980s, concerns arose that BCCI was poorly regulated, and it came under the scrutiny of financial regulators and intelligence agencies. Investigations then revealed that BCCI was involved in large-scale money laundering and other financial crimes, and had illegally gained the controlling interest in a US bank. In 1991, customs and bank regulators in seven countries raided its branch offices. UK and US investigators found that BCCI had been "set up deliberately to avoid centralised regulatory review and operated extensively in bank secrecy jurisdictions. Its affairs were extraordinarily complex. Its officers were sophisticated international bankers whose apparent objective was to keep their affairs secret, to commit fraud on a massive scale, and to avoid detection": J. Kerry, H. Brown, *The BCCI Affair: A Report to the Committee on Foreign Relations* (1992) US Senate, at p. 60. Deloitte & Touche, the liquidators, sued the bank's auditors, Price Waterhouse and Ernst & Young, who settled for $175 million in 1998. By 2013, Deloitte & Touche recovered about 75% of the creditors' lost money.

523 Nick Leeson was a derivatives trader based in the Singapore operations of the bank. He executed and cleared derivatives transactions on the Singapore Exchange (SGX). He began making unauthorised trades, initially making large profits for Barings. Although he was supposed to be managing a cash neutral business, he was in fact using the bank's money to bet on the market, trying to recoup his trading losses.

524 At the beginning of 1995 his losses rose to £827 million, twice the bank's available trading capital. After a failed bailout attempt the bank declared bankruptcy in February 1995.

525 A similar lesson was learned in the insurance context at the turn of the century, with poor management decision-making at The Equitable Life Assurance Society. Equitable Life was a UK life insurance company, founded in 1762. In the

4.2 What is wrong with the current regulatory system?

There are various concerns arising from these features of the regulatory system that need to be addressed in any new regulatory regime. Unfortunately, the UK's system has become unnecessarily limiting. The present UK approach has emerged over recent years simultaneously with the upsurge of EU regulation. The regulators have had to fight against the problems created by EU methodology, sometimes by adding gold plating to EU requirements.[526] Our regulators have often tried to make clear in Brussels that our approach is different, but with only limited success. The situation we have now arises (at least in part) from EU law and procedure, and from the prescriptive nature of the EU system and the way in which this drives disputing parties towards reliance upon officials. It also has to be acknowledged that the UK regulators have added their own unsatisfactory elements, such as those arising from the way in which they use vague regulator Principles, discussed below. However, regardless of the precise origins of the situation, it needs to change. Now that we can lift off the EU single rulebook (and, with it, EU methods), we can see that there are some dangers in the role of the regulators, as this operates at present, which need to be avoided for the future. We need to get back to an approach in which the law is open and not too controlling. This will mean clearer, more efficient laws and more accountable regulatory supervision. Chapter 3 shows how the laws themselves can be improved, and how predictability for financial institutions can be regained, including through more case law. However, the additional problem is that we have not only inherited the EU laws and regulations but we also have a concern with the nature of our own supervision.

The chill of supervisory intrusion against a backdrop of regulatory uncertainty

As things stand, the UK's supervisory approach is not good for transparency, clarity and business. The shortcomings of the EU law hitherto dominant and the difficulty in identifying what is good risk mean there are too many grey areas. The regulators' task is almost impossible. They are being asked to fill in the grey areas in provisions produced largely at a legislative level. The result is that the EU approach almost stops people from taking risk. However, this approach does not lead to safer markets, since it leads to other problems arising in the regulatory scheme. Concerns arise in various categories.

Insufficiently lawyer-based. First, in their discretionary action, including the interpretation of their own Principles, the regulators need to observe general principles of fair dealing. Yet, for this task, the majority of those involved in regulation are not legally trained and are unlikely to apply judicial reasoning to their decision making. In the common law system, predictability is in part achieved through the legal community, who apply a developed form of shared reasoning. It is notable that there is at present only a limited role for lawyers in running the system. The vast majority of the FCA's staff are non-lawyer professionals. The legal division is of high quality but very small (in 2016 it was around 80 in number[527]). The FCA's Regulatory Decisions Committee, which takes certain key decisions on behalf of the FCA, including for enforcement and supervisory actions, and applications by firms for authorisation as well as by individuals for approval as senior managers, has 18 members, 6 of whom are lawyers.[528] The Bank of England has a legal directorate for the whole Bank, including the PRA.

1990s, it had grown to have 1.5 million policyholders with funds worth £26 billion under management. However, it had allowed large unhedged liabilities to accumulate, guaranteeing fixed returns to investors without making provision for adverse market changes. Many policyholders lost half their life savings, and the company came close to collapse. It closed to new business in December 2000 and reduced payouts to existing members. Lord Penrose's 2004 Equitable Life Inquiry found that the company had made over-generous payouts leading to it being under-funded. A 2007 European report concluded that regulators had focused on solvency margins and failed to consider the increasing risk of accrued terminal bonuses. In 2010, the UK Government announced that it would make compensation payments to policy-holders of £1.5bn.

526 The notion of gold plating is explained above, text to fn 234.

527 https://www.lawgazette.co.uk/people/interview-sean-martin/5058855.article. Up-to-date public data is unavailable. There are other legally trained FCA staff, operating as lawyers and recognised as such, for instance in the enforcement division.

528 FCA Annual Report and Accounts, 2019/2020.

On a recent count, there were around 150 lawyers in the legal directorate.[529] The Enforcement Decision-Making Committee of the PRA has 6 members, 2 of whom are lawyers.[530] This is in contrast to the position in the US, where lawyers are more central to the regulatory functions. This means that UK regulators can (and do in practice) operate in a manner that is less predictable than it should be, and that their interpretations are from time to time challenged and found to be incorrect, irrational or inappropriate in the circumstances.[531]

Unpredictable interpretations. The interpretations of financial regulation have been in some instances unpredictable. This arises particularly from the fact that much EU financial regulation is statutory in nature so cannot easily be changed. The UK's regulators have been forced to operate as best they can, construing rules in a flexible manner that achieves their desired outcome but in ways which have created an environment of uncertainty. The ESAs, which are in charge of interpretations of the pan-EU rulebook, have provided their own dynamic. Given the fact that most of the staff of the ESAs are from member states which apply civil law codes (since this is the legal system of the vast majority of member states[532]), the civilian lawyer's approach and reasoning are all-pervasive. The overall result is that our regulators have often been unable to address matters head on, by making swift changes to the drafting of the rule or quick adjustments to interpretations. Moreover, because of the shortcomings of EU law, the UK's regulators have been less able to apply the rules in a way that is clearly warranted by their wording.[533] The result is to introduce uncertainty into the application of regulation. The new style of rulemaking recommended in Chapter 3 will need a proper application of rulemaking powers and the predictable application of those rules in accordance with the text itself. This can require rapid adjustments to be made to the rules when unexpected situations arise. The way in which regulation is developed can be intensive and swift, but that is merely a feature of good regulation. Steps need to be taken to identify cases where there is a need for change and to facilitate the making of new rules. Properly done, this will remove many elements of discretions whose exercise can at present sometimes be seen as arbitrary or dependent on the quality of relationships between firms and their regulators.

Danger of undue deference to regulators. An additional problem stemming from the present background is a build-up of undue deference to regulators on the part of the industry. Something similar seems to have occurred in the US. In considering the revised system it is vital to appreciate and understand the implications of this deference and its negative consequences. The powers of the regulators are wide-ranging, and industry participants are thus generally loath to challenge them. It is now necessary to redress the balance of power within the UK system and encourage more formal challenge. This must address the current symptom of over-submissive behaviour of financial institutions, whilst still permitting appropriate regulatory oversight. Although to some degree similar concerns may be levelled at the US regulatory regime, in the US there is an environment of greater political and legal challenge. As explained in Appendix 5, the checks and balances in the two jurisdictions are broadly similar, but the detail of how they work is different.

Heightened regulatory "challenge" of firms. At root, the current notion of regulatory "challenge" operates in a single direction, by regulators of firms, with no real counterbalance. It comes as a reaction to what was seen to be an over-accommodating approach to supervision by the regulators prior to the

529 https://www.inhouselawyer.co.uk/profile/profile-sonya-branch-bank-of-england/. The figure of 120 is cited in an official publication, but this appears to be out of date: https://www.bankofengland.co.uk/-/media/boe/files/careers/legalcareers.pdf.

530 https://www.bankofengland.co.uk/prudential-regulation/pra-statutory-powers/enforcement-decision-making-committee, which also states that a panel of at least three committee members hear each contested enforcement case; and, in addition to hearing specific cases, the committee meets as a whole committee to discuss matters of broader interest.

531 The Gloster Report, prepared by a former Justice of Appeal, is an example of a serious instance of regulatory failure: see text to fn 625 below. Or see, for example, the Report of the regulatory failings in relation to Equitable Life: *Equitable Life: a decade of regulatory failure*, Parliamentary and Health Service Ombudsman, 16 July 2008, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/248490/0815.pdf.

532 Now the UK has left, only Ireland has a common law system. Cyprus and Malta have mixed common law and code-based systems.

533 This results from the tensions between meaning and purpose explained in Chapter 2, section 2.2 above.

2007 – 2008 financial crisis.[534] However, the response to those events was not coupled with measures to ensure that there was no lessening of the efficiency or predictability of regulation. The main problem that had been identified, that the market was not "efficient" in addressing matters of systemic risk and certain aspects of idiosyncratic risk,[535] was correct. Most of the elements of the post-crisis regime arose from that realisation and aimed to ensure that the regulators had the powers which they needed and adopted a sufficiently sceptical approach to challenge firms and their management over their activities. This challenge can be to large-scale commercial decisions, challenges which have been justified on the basis that significant failures of decision-making were to be blamed for aspects of the financial crisis.[536] It can also be to decisions at a lower level, or indecision over matters of business culture,[537] since poor culture within organisations has also been seen as partially responsible for the crisis.[538] The traditional regulator approach of allowing firms to fail, in order to avoid moral hazard,[539] could not operate properly during the crisis since systemic risk had not been sufficiently managed.[540] For that, individual firms also needed to be better managed.[541] The result of this reaction has been seen in governance changes at financial firms, overseen and in many cases instigated by the regulators, along with significant effects on business culture.[542] The removal of the requirement for the regulators to consider the UK's international competitiveness, when making rules and in the exercise of their supervisory powers, may

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534 This impression was exacerbated by incidents such as that in the US in which the New York Federal Reserve was accused of being too lax in its supervision, firing a bank examiner (Carmen Segarra) who alleged that this was because she was too tough in her approach: see *Ex-regulator releases secret Goldman Sachs tapes in bid to win legal fight*, 26 September 2014, The Guardian, https://www.theguardian.com/business/2014/sep/26/us-regulator-ray-rice-tapes-finance-goldman-sachs.

535 See fns 185 above, and fn 449 above and surrounding text.

536 For instance, the decision of RBS (along with Fortis and Santander) to acquire ABN Amro in October 2007 is widely seen as a mistake, even though RBS was engaged in a competitive auction for the business with Barclays Bank. *E.g.* Nils Pratley, *What was RBS board thinking when it backed ABN Amro takeover? It wasn't*, 12 December 2011, The Guardian.

537 In 2014, the PRA published a Statement of Policy outlining its approach to addressing cultural failings in firms: *The use of PRA powers to address serious failings in the culture of firms*, June 2014, https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/statement-of-policy/2014/the-use-of-pra-powers-to-address-serious-failings-in-the-culture-of-firms.pdf?la=en&hash=D5A8F467D255274681EC7C1A3C5D1C8D46D65637. Culture also fell to be addressed through the Senior Managers' regime, which was introduced in 2016 (see fn 381 above) with the intention of holding senior members of staff accountable for failings of the firm. Improving the culture of financial services firms is an ongoing priority for the FCA (https://www.fca.org.uk/firms/culture-and-governance) and a focus on culture and governance is one of the key supervisory principles identified in the FCA's *Approach to Supervision*, April 2019, https://www.fca.org.uk/publication/corporate/our-approach-supervision-final-report-feedback-statement.pdf. The FCA's 2019/2020 report, *'Messages from the Engine Room' 5 Conduct Questions*, https://www.fca.org.uk/publication/market-studies/5-conduct-questions-industry-feedback-2019-20.pdf gathers responses to questions it posed from the wholesale banking sector and offers the FCA's insights on cultural challenges. The FCA has also considered the need for firms to have a meaningful purpose in driving their culture, prompting its recent Discussion Paper, *Transforming Culture in financial services: Driving Purposeful Cultures* (DP20/1), https://www.fca.org.uk/publication/discussion/dp20-1.pdf, which features a collection of essays by industry representatives on the importance of having an appropriate purpose in financial services.

538 For instance, the culture within Lehman Brothers and what is now seen by many as undue deference to the Chairman and CEO, Dick Fuld, is seen as having played a significant part in the collapse of the bank: *e.g.* Larry McDonald, *Crash of a titan: The inside story of the fall of Lehman Brothers,* 7 September 2009, The Independent. Similar concerns were raised over the undue deference given by the board of Royal Bank of Scotland to its CEO Fred Goodwin: *e.g.* Jill Treanor, *Fred Goodwin: FSA's history of concern over 'assertive' management style,* 12 December 2011, The Guardian; or the CEO of Halifax Bank of Scotland, Andy Hornby, whose prior experience had been at the supermarket ASDA and who subsequently became CEO of The Restaurant Group, after HBOS collapsed under his stewardship in 2008: Rob Davies, *Andy Hornby: reinvention of man with infamous role in banking crisis*, 2 May 2019, The Guardian; or to the flawed business model of Northern Rock, a UK building society which almost collapsed in 2007: *Northern Rock - who's to blame?*, 27 September 2007, MoneyWeek.

539 See fn 475 above and surrounding text.

540 See Chapter 2, section 2.1 above. When the Northern Rock crisis unfolded in 2007 and queues started to form outside the branches of the bank, Mervyn King, the Governor of the Bank of England, declared that no assistance would be provided, following the principle of avoiding moral hazard, only to back down later because there was otherwise no system at the time available adequately to protect the bank depositors: Scheherazade Daneshkhu, *King defends role in Northern Rock crisis*, 20 September 2007, Financial Times.

541 See fn 538 above.

542 The UK financial services industry has been at the forefront of corporate cultural change since the 2007/2008 financial crisis and the establishment of the UK Banking Standards Board in 2015: e.g. *Taking the measure of good corporate culture*, 6 December 2018, Financial Times.

have to some extent caused over-correction in the activity of the regulators.[543] As indicated above, it can also be noted that in most cases the challenge has been from the regulators to the industry. Challenges from the industry to the regulators are much less common. There now needs to be more challenge of the regulators themselves so as to provide a proper counterbalance. The regime will otherwise have the unintended consequence of stifling innovation, which could lead to a financial industry that falls behind that of other countries.

Dual control of commercial decisions. There is also a danger that the regulators can become too involved in the purely commercial sphere. Indeed, the lack of a check on regulatory challenge has meant that the regulators have sometimes come be involved in commercial decision-making. Lack of clarity in regulation has led firms to seek the approval or non-objection of the regulators for significant decisions in advance of any action. The regulators have then become, by reason of risk aversion, less responsive to industry and less prompt in completing regulatory approval processes. There is insufficient adjustment of approach for the wholesale markets, despite their special characteristics. As a result, the process for regulator approval of proposed action, or tacit non-objection, can take longer than is commercially desirable in the context of the global markets. There has come to be a regulatory lock on many significant commercial decisions—on top of the need for management or board approval. This can involve interference in the commercial realm without objective justification. It has also meant that firms can accept legally wrong or questionable, or even economically damaging proposals or requests from their regulators, on the basis of some notion of "relationship". Regulatory challenge has led to firms not taking action that was perfectly valid, and has encouraged the reliance on a precautionary approach to interpretation, which dampens objectively acceptable forms of business. The result has been that in recent times the UK has, in effect, weakened its position as the ideal destination for launching new products or businesses. The lack of litigation on such matters against the regulators over the necessity for individual rules, their responsiveness to industry comment and evidence, and the application of the rules in accordance with their wordings has made the situation more acute since there is hardly any properly reasoned judicial precedent available. Parliament's Treasury Select Committee currently exercises only limited restraint in practice.[544] This situation can be contrasted with that of the US, as explained in Annex 5 below, where there is more challenge in the courts and from Congress.

The lack of definition over regulators' roles. Part of the problem is the lack of definition as to the regulators' roles. The results they are to seek are defined in general terms only and the methods of getting there are left to the regulators to determine for themselves. The regulators' roles now need to be clarified and tightened, with a clear remit to make rules and supervise the market, but in a manner that is consistent, predictable and subject to expert legal and other scrutiny.[545] The result should be to avoid mechanical tick-box compliance processes except where such requirements are a pre-requisite across a particular industry sector (which is likely to be rare). For this, there need to be changes to regulatory practices and adequate challenge of the regulators to ensure the need for such changes is not overlooked. Only a more legalistic approach would ensure this, and reduce unnecessary challenging of firms by the regulators and permit authorised firms properly to engage in challenging the regulators.

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[543] This was a required objective of the regulator, then the FSA, under the FSMA, but it was then removed after the financial crisis: see fn 578 below and the surrounding text.

[544] There are various other statutory powers that are in theory relevant to oversight, but they do not provide - are not used as – much of a adequate check or balance in practice. For instance, the Treasury may appoint an independent person to conduct a review of the economy, efficiency and effectiveness of the FCA's use of resources (FSMA, section 15). The Treasury may direct the PRA and FCA to carry out investigations into regulatory failures and other matters in the public interest (section 77 of the Financial Services Act 2012). The Treasury may direct the PRA or FCA to take action, or refrain from taking action, necessary in order to ensure that the UK meets its international obligations (section 410 of FSMA). The Treasury may require the PRA or FCA to comply with certain statutory provisions on the keeping of accounts and audit (Schedules 1ZA and 1ZB of FSMA). In reality, day-to-day oversight is exercised by the Treasury Select Committee under its ordinary powers, which involves interviewing senior management, reviewing reports and so on. The Committee does not currently engage in regular investigation or challenge on an own initiative basis.

[545] Various parts of the financial services industry have already been proposing amendments to the governance of the regulatory regime and for the oversight of the regulators. For instance, *The architecture for regulating finance after Brexit*, IRSG/Linklaters, December 2017, and *The architecture for regulating finance after Brexit: Phase II,* IRSG/Linklaters, January 2020.

There will need to be greater scrutiny from the Treasury Select Committee and the judiciary so that the regulators do not have the last word. For this, there needs to be an adjustment to the statutory remit of the regulators in order to ensure that the regime achieves clarity and predictability, and in the most efficient manner. The common law system automatically achieves such outcomes in other contexts. For financial services, with its complex overlay of financial regulation, the use of common law thinking and reasoning in the process of rulemaking and supervision needs to be deliberately embedded. The controlling mechanism for this will require to be contained in statute. The regulators should generally be required by statute to operate by making clearly drafted regulations and applying them using the techniques of interpretation appropriate to common law statutes.

In addition, the political oversight needs to provide for a steady approach. The regulators operate in the political arena and can become scapegoats for the failures of individual firms that they supervise, or for financial crises or depressions. There is always the spectre of "regulatory failure", which is the risk of their being assessed in retrospect by the public or politicians as having failed to oversee a safe and fair market. In addition, the media continually examine the performance by regulators of their role, particularly in terms of retail clients or matters which affect the "real" economy, such as pensions. This means there is a danger that the regulators become politicised, or otherwise influenced by the press agenda of the day. The system needs to be sufficiently robust to resist ill-focused pressures that may arise.

Undue challenge to senior managers. The UK's senior manager regime[546] means that the regulators approve all senior appointments to a firm and oversee the behaviour of senior managers as well as firms. This parallel scheme of regulation – of the individuals as well as the firm itself – is a development spearheaded by the UK. The US does not have a separate regulatory regime for senior managers. The US regulators seek to hold boards accountable for the actions of the firms they supervise. Challenges to the boards can be significant. Regulatory interactions with firms can also be particularly challenging. However, the regulators do not delve so much into individual decision-making at executive level. In the UK, the senior manager regime applies to many board members[547] as well as executive positions. The UK regulators address individual behaviour at both levels. They often take a different view from the board, which may mean that a board has to try and second guess what the regulators have in mind. The same is true at executive level. The regulatory scheme for senior managers has become a key tool for supervision. Instead of verifying that the required minimum standards of expertise and probity are met for core appointments and behaviours, the regulators are sometimes reported as making general comments to firms about their senior managers such as "We think you could do better", or as intervening in management decisions, overturning or modifying them to accommodate the judgement of individual officials. Notably, when the tables are turned, the regulators are unwilling to subject themselves to similar levels of accountability.[548]

In order to revert to the less controlling, common law approach, the regulators should be addressing any perceived limitations of individual capabilities through their oversight of systems and controls rather than by replacing the judgement of individual senior managers with their own. The senior managers

[546] See fn 381 above.

[547] For example, the chief finance officer (SMF 2), chief operations officer (SMF 24) and the chairs of the risk committee (SMF 10), audit committee (SMF 11), remuneration committee (SMF 12) and nomination committee (SMF 13) (FCA Handbook, SUP 10C.4.3).

[548] The Gloster Report into the failure of LC&F, fn 625 below (and surrounding text), noted this point on pp. 25-26: ".. a number of participants in the representations process asked the Investigation not to make findings about individual responsibility for the FCA's deficiencies in regulating LC&F. For example, the Investigation was asked "to delete references to "responsibility" resting with specific identified/identifiable individuals". Similarly, the Investigation was told that criticism of senior managers within the regulator, who were recruited to overcome structural, cultural or institutional difficulties, was "likely to have the undesirable consequence of discouraging people from taking on and tackling difficult and vital roles within public bodies". The findings in this Report are certainly not intended to have that effect. In any case, it is difficult to see why an individual's willingness to take on challenging tasks in public bodies should absolve that person from accountability. A further comment was that "it is neither necessary nor… appropriate for individuals to be identified as bearing particular responsibility for the matters which are the subject of the criticisms in the draft Report". The Investigation does not agree with these suggestions for the reasons set out..."

should then rightly take the risk of being held responsible for wrongdoing or if they cause something to go wrong.

Perceived "bandwidth" limitations for regulators. There is a further phenomenon which has crept into regulatory relationships. There is an unhealthy culture of thinking among compliance professionals that regulators have only a certain amount of "bandwidth" to deal with new business developments and other initiatives (or difficulties) requiring review, and that these must therefore be prioritised and scaled back where possible. A particular concern is that the regulators are unwilling to take risks and will rarely be helpful in approving novel propositions.[549] This thinking holds that even incorrect determinations or requests of regulators should not be challenged if it can be avoided.[550] It also maintains that as few as possible requests should be made of regulators in unusual situations. The thesis is based upon a perception that there is some sort of unwritten credits system, where credits are used up by such requests and therefore need to be retained for use on topics of the highest priority.

The same can be seen in regulatory consultation processes, as part of the current culture of legislative reform in the EU, and to a lesser degree in the UK. Many sub-optimal proposals or poor pieces of legal drafting go unchallenged during these processes, by reason of a wish by industry and market associations to reserve discussion for what they regard as key points. Drafters of statute-based (EU style) regulations often produce entirely unworkable, impracticable, undesirable or unnecessary proposals based upon limited or no, practical, industry or market experience. The industry can become exasperated by such proposals, but focus on complaining about what they regard as the most egregious points in consultation responses. The proposals are indeed often later dropped or scaled back.[551] However, this focus on the most objectionable or impractical aspects of proposals during consultations results in a lack of focus on the technical and other aspects of the same proposals, which may sail through without challenge or sufficient focus on their drafting. Consultations should have a greater involvement of industry before their publication, which would make consultations more efficient and useful in focusing on those details of the proposals that will survive consultation.

The current approach adopted by compliance professionals and respondents to consultations can be said to have a doubtful or even no legal basis yet risks stifling innovation and efficient markets. Without some form of indication as to the existence (or not) of principles of "bandwidth" and "goodwill", this approach will continue to apply in practice, to the detriment of markets, participants and consumers.

The problems in regulating behavioural complexity – the Principles: uncertain, unpredictable and difficult for enforcement

Particular concerns arise over the general regulatory approach to behaviour, given the complexities of the financial markets. In order to maximise the efficiency of the system, it is important that the

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549 In response to the FCA's 2014 "Project Innovate" consultation, members of the financial services industry commented that "the regulatory regime does not provide innovators with sufficient legal certainty" and that "[t]hese problems were said to substantially reduce business' appetite to innovate." Similarly, "[u]ncertainty as to whether or not digital currencies such as Bitcoin will be regulated in the UK was repeatedly said to prevent businesses from experimenting with related technologies that could benefit consumers": https://www.fca.org.uk/publication/feedback/fs-14-2.pdf. The FCA's 2019 report on Project Innovate suggests progress has been made and that "[f]eedback from firms tells us our work is having a positive impact on their perception of the FCA's activities to facilitate innovation", although the FCA acknowledges difficulties in measuring the impact of the Project on firms: https://www.fca.org.uk/publication/research/the-impact-and-effectiveness-of-innovate.pdf.

550 There are occasional public challenges to regulators or prosecutorial authorities, some of which have been successful. For instance, in 2017 charges were levelled against Barclays Plc and Barclays Bank Plc by the Serious Fraud Office over how the bank raised capital from Qatar during the financial crisis in 2008. Those charges were dismissed by the Crown Court in May 2018. The High Court rejected the SFO's application to re-instate them in October 2018 and refused permission to appeal to the Supreme Court. Cases were also brought against various senior executives, including the former CEO of Barclays. These cases were dismissed or those accused were acquitted, in April 2019 and February 2020 respectively. However, such challenges have been few in number.

551 See fns 276 and 279 above, and surrounding text.

regulators (and Ombudsmen, if these are continued in any form[552]) operate in a context which controls their discretions and maximises predictability. What is needed is certainty and an ability to adapt the rules rapidly for new circumstances and products. Otherwise the regulators themselves will create impediments to predictability. There is also a need to avoid unnecessary rulemaking, since this adds unwarranted cost for the industry. However, navigating a successful path for the prevention of damaging behaviour can be difficult. The complexities of the market mean that highly thoughtful rulemaking is required, and there is still the risk of conduct taking place which would not have been permitted had those making the rules known of the possibility at the time. There is therefore a temptation for the regulators to seek to circumvent the necessity for continuous discipline in observation and updating the rules, and to use catch-all and other generic language when drafting the rules, so as to protect against the unforeseen. Yet an open-ended approach of this nature does the market, and the industry, a disservice. Loosely drafted rules reduce the effort up front, but then leave unchecked power in the hands of the supervisors and expose future conduct (including conduct which can be seen to be in good faith and ultimately benign) to unnecessary dispute.

This problem is inherent in the current system and is best illustrated by the present approach to Principles-based regulation.[553] Given a wish to operate within the prescriptive EU system with as much predictability as possible on the basis of the wording of the rules made, whilst avoiding the making of even more prescriptive rules on top, it has been necessary for the UK regulators to place an emphasis on certain general Principles, made by the regulators themselves, such as treating customers "fairly" and the like. As a result, Principles-based regulation, which is discussed below, sits alongside more detailed rules. Some of these Principles are vague or potentially subjective. Without ancillary precedents, an interpretation of appropriate general standards of behaviour can be asserted by regulators in a manner that may appear simply to be the exercise of a discretion. Moreover, unlike the common law system, what is required cannot so easily be gleaned from good sense, honesty and other such values—although these notions are still important because the rules are based on common sense and collective interest.

Whilst principles-based or outcomes-based regulation is in principle the desirable path for UK regulation, the way in which the UK regulators currently use the rules which they call Principles, discussed in the following paragraph,[554] would benefit from refinement. In fact, lessons can be drawn from this area as to how to ensure that a successful move is made to true principles-based regulation. Rules protecting customers and enforceable by them need at all times to be clear, and predictable in meaning. Market participants should not be subjected to the judgement of over-cautious bureaucrats operating in a precautionary manner by reference to vague principles. Decisions made by regulators themselves need to be based on sufficiently cogent, published reasoning for the system to be able to operate at its best in this area. For this, there needs to be a serious re-evaluation of the UK's use of Principles-based reasoning and current enforcement under it.

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552 As explained in Chapter 3, section 3.4, in such circumstances the Ombudsmen need to apply, or be subject to oversight on the basis of, legal and judicial reasoning.

553 See, also, fn 78 above and the surrounding text, for the meaning of the term.

554 See also fn 78 above and the surrounding text.

The problem – laws or guidance, and Principles

The UK regulators have adopted a Principles-based approach[555] to regulation since the Financial Services Act 1986. Particularly in recent times, this has been over-applied,[556] to the detriment of legal certainty. The Principles are made by the UK regulators and require firms to observe certain high-level values. They are used in setting the general standards for regulation. Principles-based regulation was originally designed to absorb specific rules within the framework of an overarching set of principles of good conduct, so that firms cannot cite the absence of a specific rule as an excuse not to do something that is obviously not intended to be permitted. The Principles include such unobjectionable criteria as "integrity", "proper standards of market conduct" and treating customers "fairly". Their current usage is not the result of EU law, but is instead due to the holes in the blanket of what is now EU regulation and a desire to ensure proper standards of behaviour, particularly in the complex and fluid wholesale markets which are prevalent in the UK but not the EU. Yet the use of the Principles has evolved and brought uncertainty to firms in their compliance efforts, dampening financial activity. In 2007 the FSA announced that it was adjusting its approach to enforcement by giving more prominence to the Principles, including regularly taking enforcement action for breach of a Principle alone.[557] The Principles are now often relied on for such enforcement actions, in the absence of specific rules. For instance, in Citigroup's 2004 – 2005 Euro MTS manipulation case,[558] Citigroup's trading strategy involved building up and rapidly exiting substantial long positions in the Euro MTS market. This was conduct that no specific rule or legislation prohibited. The FSA's position was that the Principles nevertheless prohibited such conduct and constituted requirements imposed in and of themselves on authorised firms and that these restricted Citigroup's activities despite the absence of a specific rule. The result, when compared to other FSA settlement decisions of a similar era which were also based on Principles, is a situation in which the precise scope of the regulatory prohibitions is unclear. For instance, in the Euro MTS settlement, Citi accepted a breach of Principles 2 (lack of due skill, care and diligence) and 3 (failures in systems and controls). Relatively shortly after that, Deutsche Bank settled with the FSA (Scania) on the basis of Principles 2 (lack of due skill etc) and 5 (observing proper standards of market conduct).[559] It is debatable as to what could be understood from the facts of Citi about Principle 3 and the facts of Deutsche Bank about Principle 5. The answer is not much. These were simply the results of negotiations. Citi preferred to accept a Principle 3 breach. Deutsche Bank

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555 In the 1986 Act reliance was placed on the SIB and various SROs, adopting a set of high level principles. After FSMA came into force, the principles were promulgated by the then sole (statutory) regulator, the FSA. The SROs were abolished. Since then, it has been said that the UK regulators have "elevated principles-based regulation to a regulatory art form": J. Black, *The Rise, Fall and Fate of Principles Based Regulation*, 21 November 2010, LSE Law, Society and Economy Working Papers, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1712862. The financial crisis prompted the FSA to rebrand its approach slightly, calling itself an "outcomes-based regulator"; the Discussion Paper that accompanied *The Turner Review* (fn 362 above) stated: "The FSA has always considered itself to be principles-based in carrying out its supervisory work, preferring, where appropriate, a high-level articulation of what is expected of regulated firms over prescriptive rules. This enables firms to decide how to align their business objectives with the specified regulatory outcomes. The focus is not on the principles themselves but on judging the results of the actions of the firms and the individuals that the FSA supervises. In this way, a better articulation of the FSA's philosophy is that it is an outcomes-focused regulator, firmly committed to a risk-based and proportionate approach" (*A Regulatory Response to the Global Banking Crisis*, FSA Discussion Paper 09/2, 3 March 2009, para. 1.64). Despite this assertion, Principles-based regulation has been and has remained a core element of the regulatory approaches of the FSA and its successor agencies, the PRA and FCA.

556 See, for example, the FCA Handbook, Principles for Business and the PRA Fundamental Rules.

557 See https://www.handbook.fca.org.uk/handbook/document/eg/EG_20070828.pdf, where it was stated that "[t]his will have the benefit of providing further clear examples of how the Principles work in practice." However, this has not proved to be sufficient. The current version of the FCA Handbook states that if a firm breaches the principles, it could face enforcement action. See https://www.handbook.fca.org.uk/handbook/SIFA/4/1.html?date=2005-01-01&timeline=True.

558 See the FSA Final Notice issued to Citigroup Global Markets Limited on 28 June 2005, https://www.fca.org.uk/publication/final-notices/cgml_28jun05.pdf.

559 See the FSA Financial Notice issued to Deutsche Bank AG on 10 April 2006, https://www.fca.org.uk/publication/final-notices/deutsche.pdf.

preferred to accept a Principle 5 breach. The FSA had no principled way of distinguishing between the two.[560]

More recent settlements based on the Principles have done little to clarify matters. For instance, cases arose involving the manipulation of the LIBOR (London Inter-bank Offered Rate) benchmark. LIBOR is an interest rate in widespread use (*i.e.* a "benchmark"), representing the rate at which major global banks lend to one another in the international interbank market for short-term loans.[561] It was at the time calculated solely from submissions made by panel banks. These cases involved manipulative behaviour in relation to panel bank submissions for the benchmark, which was at the time outside the strict purview of the regulators. In June 2012 the FSA imposed its largest fine on Barclays Bank for breaches of Principles 2, 3 and 5 in relation to manipulation of LIBOR and EURIBOR,[562] the reference to Principles 3 and 5 involving a particularly vague application of those concepts – in what was an area not subject to regulation. The real problem was that insufficient attention had been paid to where the perimeter of regulation should lie. Contributing to and administering UK benchmarks has since then become a matter for UK regulation.[563]

The problem is that there is an overall weakness of the Principles in the context of enforcement action. They leave too much discretionary power in the hands of officials, which (as has already been shown in the context of EU law) reduces the freedom of the market to innovate. They are, on their own, in many respects vague, which makes enforcement based solely on the Principles insufficiently predictable. Given banks' reluctance to litigate, objections also arise from the use of Principles to force settlements. The Principles are often capable of being construed in several different ways in complex financial situations. There is often little usable guidance as to how the regulators would expect them to be applied. It is therefore extremely difficult to devise plans which are sure to avoid their application. For instance, the terms "customer" and "fairly" in the FCA's Principle 6, which requires firms to treat customers fairly, are sufficiently wide that all sorts of expensive protections can be implied into a situation without the regulators having to be put to the trouble of defining in advance what they wish to prevent, for which they would have been subject to Parliamentary oversight. As a result, the Principles-based approach strays outside the perimeter of practicable Parliamentary control and leads to firms having to develop and apply their own conceptual framework with a view to certifying compliance before often quite junior regulatory officials. Firms can become over-dependent upon the interpretations of those officials, just as under the EU law single rulebook; and as with the EU system, the officials can be prone to adopting precautionary interpretations in an effort to be seen to "challenge" the firms that they supervise. Therefore, relying only on Principles for enforcement weakens the market's acceptance of regulation and adds unnecessary expense to compliance efforts. It is notable that the US regulatory system tends to be less Principles-based and more prescriptive than the UK's approach—albeit the US system is sometimes criticised by market participants for its approach.

Rules versus market practice? What can happen in practice? The problem can be exacerbated by an absence of rules in key areas where market practice has developed. This has allowed a sense of safety

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560 These examples illustrate not only the problem of relying on Principles, but also the weakness in developing a jurisprudence based on settlements, unless they are precisely reasoned and legalistic in nature.

561 LIBOR, and other interest rate benchmarks currently in operation and known as "IBORs", are due to cease being used by the end of 2021, as provided for by the regulators. The financial services industry is taking steps to transition from LIBOR to using alternative, risk-free interest rates. The transition is being assisted by industry-led working groups. In the UK, the FCA and the Bank of England are driving the transition for the sterling markets from LIBOR to the Sterling Overnight Index Average (SONIA), which is the effective overnight interest rate paid by banks for unsecured transactions in the sterling market.

562 FSA press release, "Barclays fined £59.5 million for significant failings in relation to LIBOR and EURIBOR" (27 June 2012) and Final Notice, https://www.fca.org.uk/publication/final-notices/barclays-jun12.pdf.

563 This followed the recommendations the Wheatley Review of LIBOR, September 2012, when the UK addressed the lacuna in the regulatory perimeter and introduced legislation to bring benchmark administration and the contribution to benchmarks within the scope of regulation. These changes were introduced by amendments to FSMA 2000 and the FSMA (Regulated Activities) Order 2001 (SI 2001/544). In addition, although initially the FCA was only made responsible for regulating LIBOR, following the recommendations of the Fair and Effective Markets Review of June 2015 (which was established to consider steps to enhance confidence in the wholesale Fixed Income, Currency and Commodities (FICC) markets), the scope was extended in 2015 to seven other benchmarks.

in numbers to arise on the basis of perceived validity in "market practice". This has on occasion then turned out to be misplaced. Such a phenomenon has been particularly apparent in the retail sector and can be seen to have arisen in the context of the mis-selling of payment protection insurance (PPI)[564] in the early part of this century, which led to a market-wide breach of law and regulation. It became clear in 2005 that PPI had been widely mis-sold, and that the volume of claims being made through claims management companies (companies that handle the making of a claim on an individual's behalf in return for a fee) threatened to swamp the Financial Ombudsman Service, which was seeking to provide redress. If there had been more detailed regulations at the outset, when PPI products were being developed, firms could have built automated systems around these rules to ensure that they complied with them. Instead, they were left to interpret the Principles for themselves;[565] and reliance by the regulators on the treating customers "fairly" Principle was in practice used to establish more detailed rules in retrospect. After the scandal broke, the regulator at the time, the FSA, put in place an informal industry-wide redress scheme which set detailed principles as to when redress must be paid, which were described as derived from the treating customers "fairly" Principle. Some in the industry challenged the FSA's scheme in court, without success.[566]

What lessons? One can derive many different lessons from this episode, but key ones in the present context are that the system is too vague as between guidance and law, too often applied retrospectively, and too uneven in redress and in how it deals with different questions. Examples follow:

- *Use of powers – laws or guidance:* the FSA chose not to use its specific powers to require industry-wide redress, but rather, to issue guidance on how firms should handle complaints under existing complaint-handling rules.[567] This was a legitimate approach, but it would have been better if legal powers had been used. This is an example of the current trend of the regulators to do things informally rather than by use of law.

- *Retrospective?* Guidance, articulated as based on the Principle of treating customers "fairly", in fact came close to detailed rules, applied in retrospect. No one had attempted to consider rigorously in advance what treating customers "fairly" might require in a range of different situations: furthermore, the Principle was treated by the regulators as through it were only capable of being clearly applied after the fact. This was clearly an unsatisfactory way of proceeding, although it is arguable that each of the requirements subsequently identified by the FSA as having arisen could have been identified by firms in advance of any action, with a fair degree of approximation, on a common sense basis. The problem was the lack of clarity over which processes would reliably be beyond criticism, and the balancing need to assess the cost of any systems which might subsequently be seen to have been required.

- *Uneven in redress – compensation rapid and unthinking*

  (a) Compensation: there was and perhaps still is a failure of the policy-making process when the regulator establishes a redress scheme. The nature of the issue to be addressed is often not publicly analysed, with action instead moving swiftly from a high–level description of the problem to proposed rules to address it, which are then responded to by the industry primarily by attempting to make them easier to comply with. Better would

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564 PPI is a form of insurance which covers the policyholder in the event they are unable to make repayments on borrowings (for example, a loan or mortgage). The FSA at the time found that PPI was often mis-sold to policyholders.

565 For example, the FSA highlighted in a policy statement of 2010 that one of the main criticisms being levelled at the FSA at that time was that "firms could not have known what they were supposed to do under the Principles in the context of PPI selling, because [the FSA] did not explain [its] expectations (e.g. of what 'clear, fair and not misleading' meant)": *The assessment and redress of Payment Protection Insurance Complaints*, August 2010, FSA Policy Statement 10/12, https://www.fca.org.uk/publication/policy/ps10_12.pdf.

566 *R (on the application of the British Bankers Association) v Financial Services Authority and another* [2011] EWHC 999 (Admin), [2011] Bus LR 1531.

567 *The assessment and redress of Payment Protection Insurance complaints*, August 2010, https://www.fca.org.uk/publication/policy/ps10_12.pdf.

have been a judicial process permitting rigorous challenge as to the nature of the problem and the best way to address it.

(b) A different practice for Competition: in contrast, the competition regulators undertake a thorough and independent analysis as to the nature of the problem involved,[568] and in particular whether there is a significant failure of competition, before they start to look for remedies. On significant matters, the FCA should be required to do something similar.

There is, therefore, good reason to move to a more certain, law-based arrangement.

It would be desirable in future to build out the power for the regulators to obtain restitution orders in court, under which the PRA or FCA may apply for an order for restitution to reimburse those who suffer financial loss in circumstances in which other remedies may not be readily available.[569] The court may order that the person concerned pays the regulator, who in turn distributes the sums to those qualifying for recompense.[570] The current mechanism could be subject to minor adjustments and form the basis for establishing individual firm redress schemes. Or there could be a new requirement for any scheme agreed between the regulator and a firm to be approved by a court. In this way interested parties would be given an opportunity to have their arguments properly heard.[571] It would minimise the validity of any subsequent criticisms that the interests of claimants were not properly taken into account, since it would allow the representatives of claimants to be present in court. The UK's regulators are of a high quality, yet the addition of a court process would add further protections around decisions of this sort of magnitude, to the general benefit. In addition, as mentioned above, when there are system-wide situations of this nature handled by the Ombudsman, that official should not be allowed to exercise their extensive existing powers, unfettered by legal process, legal reasoning and the possibility for the industry to engage in reasoned challenge within the court system.[572]

Overall, trust in the markets themselves relies on a level of predictability on the part of the regulators as well. For that, it is vital to ensure that the regulators are subject to sufficient legal oversight. It is sometimes said that the regulators cannot be subject to constant judicial oversight or to the threat of lawsuit if a regulator does not do what claimants demand. Certainly, assessments by the regulators of whether an individual or group of individuals is managing a regulated firm appropriately involve the application of judgement across several areas of a complex and dynamic environment. Furthermore, the urgency with which these assessments often need to be undertaken and the fluidity of the markets mean that regulatory judgments are typically not susceptible to the application of the judicial process[573] on a sufficiently swift basis to be capable of being challenged. The assessment of the regulators often cannot easily be undone without prejudicing the position of other market participants or disrupting the market itself. Nevertheless, there does nevertheless need to be an independent legal check on their power since it is otherwise insufficiently fettered, to the detriment of the overall system.

568 The Competition and Markets Authority (CMA) follows a highly detailed procedure in cases under the Competition Act 1998, and there is provision for a full merits review by the Competition Appeal Tribunal. There must be "sufficient evidence of an infringement" before the CMA receives representations from parties and comes to a conclusion. See *Competition Act 1998: Guidance on the CMA's investigation procedures in Competition Act 1998 cases*, 18 January 2019: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/771970/CMA8_CA98_guidance.pdf. In addition, market studies and investigations carried out under the Enterprise Act 2002 have a detailed and highly transparent procedure, and give reasoned decisions, albeit the evidentiary burden on the CMA and the extent of judicial protection is substantially lower than in Competition Act cases.

569 FSMA, section 382 enables the court on the application of the relevant regulator to make an order for restitution by way of procuring that the person concerned pay the regulator, and in turn providing for the relevant regulator to distribute such sums to qualifying persons (as defined in section 382). FSMA, section 383 provides for the same in respect of breaches of the Market Abuse Regulation.

570 *Ibid.*

571 Another example is the process for obtaining a court-approved banking business transfer, contained in sections 104 and 111 of FSMA.

572 See Chapter 3, section 3.4 above.

573 See Annex 6, section 3 below.

4.3 *Recommendation 5:* Apply lessons from common law in providing certainty and constraining the regulators in the exercise of their delegated functions

The main argument of this book is to bring back the UK's traditional approach to the law, and then to make it operate more effectively in the financial sector. The theme of this Chapter is that the current arrangements for regulation do not give certainty and predictability. Now we are in charge, we can make things much clearer. For this, the rule of law should be enhanced in a number of key respects. Chapter 3 has shown how to make the laws and regulations more predictable. It also shows how we need to take advantage of the clarity brought by the common law in the financial sector, by placing a renewed emphasis on case law. The position for financial transactions should be largely taken care of by the Recommendations in that Chapter. By bringing back into full operation the English case law system, more clarity and certainty will be achieved and, with it, a surge in market activities. For revitalising the common law approach will be highly beneficial in and of itself. The thinking behind the approach is that the law should be clear but not a straightjacket. It has already been shown how the common law system is highly versatile and innovative in its response to developments in the financial markets.[574] The rise of FinTech, Bitcoin, blockchain, big data and other market innovations are examples of the continued need to develop the law, in this case on proprietary interests and entitlements, choice of law and other issues arising from the modern environment. The courts provide the best resource for such developments. In the fast-moving world of the financial markets the EU has tried to fill the uncertainty with its codes, and also to control new market activity by determining at an early stage how it should operate in the interests of the system. This approach brings with it certain drawbacks. We no longer need to place our faith in EU codes. Our system is different and needs to be allowed to operate in an optimal way.

There also needs to be sufficient predictability in the regulatory regime, and for that there need to be adequate checks and balances on the regulators. It is only in this way that adequate certainty can be provided as to what the regulators will do. Under the proposed approach, based on longstanding UK methods, there should be less regulation, enabling more firms to be willing to make the most of the opportunities from expanding markets. Through the process proposed in Chapter 3, the regulators will be given far more rulemaking power. This is because, although there will be less regulation overall, the bulk of the regulation that does exist will be made by the regulators themselves. For the system to work well, there then needs to be a more structured legal environment within which the regulators can operate. For it is only through a proper legal framework that lines can be drawn and applied. The UK regulators are high quality and can be relied upon to exercise a level of restraint, but this is not enough to provide legal certainty. We need to ensure that the law under which the regulatory regime operates is restructured and fully deployed so that the regime operates within a more clearly defined legal architecture. The assumption must be that the regulators follow the law just like businesses. If differences of view arise, the clarity of the law, of the regulator rules and of regulatory discretions can be tested in court.

The operation of regulatory powers should therefore be enhanced in a number of key respects. As a general matter, we can develop further an approach based on the thinking behind the case law system and place more reliance on the judicial function. When markets are fast-moving and changing, regulatory decisions will sometimes need to be tested in court. There will always be grey areas left by the rules where someone wants to take an opportunity which is not clearly forbidden by regulation. For these, market participants need to be able to act in accordance with a reasonable interpretation of the law. Otherwise there will be a chilling effect on business, by which the action will not be taken or it will be taken only after private discussions with officials, on the EU method, which undermines the rule of law and fairness for everyone else who is not privy those private determinations. That approach also gives the officials too much power. The regulators need to be subject to appropriate checks and balances, and should operate in a manner that is required to be predictable and transparent. To achieve this, the use of regulation should now be re-examined, particularly in the context of enforcement actions, so as to reintroduce key aspects of the common law method and ensure the system is predictable, self-

574 See Chapter 1, sections 1.5 and 1.6 above, and Annex 1 below.

executing and clear – and also free from individual interpretative whim or after-the-fact policy-making. More broadly, it is important that compliance professionals within firms and regulators do not merely 'tick the box' on rulebook compliance, but also consider whether their systems or behaviour are in principle acceptable. A change of approach is needed in order to make the new system work properly. Commercial pressures will then ensure that regulated firms adapt their methods, when it becomes clear what the law requires and the law is less mechanistic in its application. This will require consideration to be given to the following adjustments.

A new framework for success

First, it is important that the powers of the regulator are redefined to ensure that the regulators operate this new system as intended. This would involve introducing a new legislative framework for the regulators, which sets out their powers, and the restrictions within which they operate, in more detail than now. It will enable their activities to be overseen more effectively by Parliament and the courts.

New statutory objectives

For this, the way in which the regulators exercise their powers should be considered. Regulators are already required by statute to seek to achieve certain defined objectives.[575] There are also various statutory principles which they are required to apply,[576] but it is their objectives which are the most important. These form benchmarks for the assessment of the performance of the regulators by Parliament and the courts. The objectives need adjustment to embed the new way of acting. There need to be new objectives for the regulators, requiring the approach for which they are then overseen.

- *Requirement for clarity and predictability.* First, regulation needs to be clear and applied in a predictable manner. New statutory objectives should be adopted for the regulators, requiring them to seek "clarity" and "predictability". The wording should be framed so as to ensure that the regulators are generally required to operate by making clearly drafted rules and applying them predictably, using techniques of interpretation appropriate to common law statutes. Consideration should also be given to adding other goals such as support of innovation, market growth and profitability, as well as transparency of risk. These objectives need to be couched in such a way as to require the results set out here.

- *International competitiveness.* In addition, consideration should be given to reinstating the statutory requirement for the regulators to seek the "international competitiveness"[577] of the UK's system in their rulemaking and supervisory activities. This means that the rules must not be so extensive that they clog the machinery and make London unattractive, providing of course there is no danger of creating risk in the system. Nor should supervision be so exhaustive as to have a similar effect. This statutory competitiveness objective was removed after the 2007 – 2008 financial crisis. In its former guise it required the UK regulators to "have regard to"" the international competitiveness of the UK when exercising their rulemaking and supervisory functions.[578] There has recently been evidence of an

575 See fns 449 and 450 above, for the PRA's and FCA's objectives respectively.

576 These are contained in section 3B of FSMA. They include using resources efficiently, ensuring any regulatory burdens are proportionate, recognising the desirability of sustainability of growth in the UK economy over time, and recognising that consumers should in principle take responsibility for their decisions. However, these principles are not used for the purposes of accountability, except in the very broadest sense.

577 See fn 578 below.

578 Under section 2(3)(e) of FSMA 2000, as originally enacted, the then regulator, the FSA, was required in the course of discharging all its general functions to have regard to "the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom". This provision was repealed by the Financial Services Act 2012, in light of media and political criticism that it might have played a role in causing the crisis by incentivising the regulators to apply "light touch regulation". This was misguided, as explained in fn 582 below and surrounding text. The Chancellor of the Exchequer, Rishi Sunak MP, stated in the House of Commons on 23 June 2020, when addressing the ways in which the UK's prudential financial services regulatory requirements will be updated after Brexit: "[t]he Government intends to … [update prudential requirements] by delegating responsibility for firm

appetite for reinstating such an objective. This would be helpful. Its removal took place on the basis of media and Parliamentary concern at the "light touch" approach to regulation applied by the regulator of that time, the FSA.[579] The concern was that the regulators had operated to attract business rather than to manage the system properly for the purpose of safety and soundness, and also that the competitiveness objective had made them accountable if business was lost to the City as a result of regulation.[580] However, criticism at the time was insufficiently nuanced. As has been explained in Chapter 2, section 2.1, the public narrative was heavily influenced by an EU need to find an excuse to seize control of financial regulation at a federal level. Neither the competitiveness objective (as a subordinate objective to systemic risk[581]) nor light touch regulation are in themselves problematic, so long as regulation is thoughtfully constructed and applied.[582] If there are two different ways of achieving a regulatory outcome and one of those is more pro-competitive, there is nothing wrong with selecting that option. Furthermore, the UK approach was in many ways inappropriately described as "light touch", since the UK was at the time gold plating[583] EU directives, having led the way in applying restrictions in the size of banks' exposures to a particular counterparty,[584] top-up capital requirements over and above the recommended Basel base level,[585] and a market abuse regime (which was subsequently copied by the EU),[586] amongst other matters.

The real issues with regulation at the time were twofold. There was an assumption that the market was efficient and would root out businesses that were poorly run, including those which took too much risk.[587] This was flawed in that the market is not equipped to address issues of systemic risk (including some elements of idiosyncratic risk for third party firms),[588] as opposed to the risk arising from particular contracting counterparties. In addition, problems arose from the way in which other EU countries were failing to apply EU standards of the day, in order to attract financial business from the UK.[589] As explained in Chapter 2, section 2.1, the then EU system required EU standards to be adopted by implementing high level EU directives, with no real oversight of how that was done, rather

requirements to the relevant regulator – the Prudential Regulation Authority (PRA) or the Financial Conduct Authority (FCA) – subject to an enhanced accountability framework to ensure that the regulators have regard to competitiveness and equivalence when making rules for these regimes" (https://questions-statements.parliament.uk/written-statements/detail/2020-06-23/HCWS309). On 9 November 2020, the Chancellor gave an updated statement to the House which anticipated equivalence being used as a key tool in the UK's future relationship with the EU, which is a method that will permit the UK to ensure it is competitive internationally: see Annex 4, section 1.

579 For example, in 2007 the former Chief Executive of the FSA, Hector Sants, was reported as favouring light-touch regulation in the face of criticism of that approach, *FSA chief committed to light-touch regulation*, 17 October 2007, Reuters, https://uk.reuters.com/article/uk-fsa-regulation/fsa-chief-committed-to-light-touch-regulation-idUKL1756080220071017.

580 *E.g.* Brooke Masters, *Regulator's 'light touch' led?to failure*, 12 December 2011, Financial Times.

581 See fns 185 above, and fn 449 above and surrounding text.

582 In 2015 one of Mr Sants' predecessors (fn 579 above), Sir Howard Davies, defending his reputation as a proponent of light-touch regulation, said that "[t]he big problem during the crisis was that banks didn't have enough capital. It had nothing to do with light-touch regulation", *New RBS chairman defends his record as regulator*, 23 March 2015, Reuters, https://uk.reuters.com/article/uk-rbs-chairman-idUKKBN0MJ21R20150323. The capital shortfall arose from a lack of precaution against systemic risk, which had not been fully identified or understood. This point is often lost in modern debate: see, *e.g.* HM Treasury's *Regulatory Framework Review – Phase II*, fn 448 above, para 2.45.

583 The notion of gold plating is explained above, text to fn 234.

584 The Bank of England had developed and adopted a "large exposures" regime, largely as a result of the lessons learned from the failure of Johnson Matthey Bankers, a banking, gold bullion and commodity trading entity, in 1984. The 1987 Banking Act contained a statutory requirement that there should be limits to a bank's exposure to a single counterparty of 25% of its available capital resources. This approach was subsequently adopted by the Basel Committee in 1991, and then followed by the EU in 1992 with the Large Exposures Directive (92/121/EEC).

585 See fns 75 and 307 above.

586 The UK was already operating a market abuse regime through FSMA 2000 and the Criminal Justice Act 1997 by the time the proposed EU Market Abuse Directive (2003/6/EC) was introduced. The Market Abuse Directive was subsequently repealed and replaced in 2016 with the Market Abuse Regulation (Regulation (EU) 596/2014).

587 See fn 185 above.

588 See fns 185 above, and fn 449 above and surrounding text.

589 See Chapter 2, section 2.1 and the mention of Ireland and Luxembourg.

than through EU regulation with direct application. EU "passporting" laws then forced the UK to accept incoming EU business activity on the presumption it was properly regulated under EU equivalent standards, when this was not the case. While it might be argued that competitiveness should be subordinate to other objectives, such as the reduction and management of systemic risk, it would nevertheless be desirable as a statutory objective, since it is only then that there is a Parliamentary instruction to achieve regulatory aims in a manner that involves the least possible intervention in the market.

A revised method of rulemaking and supervision

Next, in practical terms, the regulators should also seek to adopt a more refined method of rulemaking and supervision, operating under their newly accountable powers. This will involve a number of steps, as follows.

The basics

Since regulation and regulatory supervision are ultimately outworks of the legal system, the regulator rules, guidance and decisions need to have a sufficient legal basis, for which they need adequate legal involvement. In addition, regulatory focus should be on the areas of market activity that pose the most risk to consumers, market participants and the system as a whole. This requires the following to be considered afresh.

- *Necessary legalism.* If the regulators are to have the power to regulate the industry they should have adequate involvement of legally qualified persons and more judgments should be made by the courts. There is a question as to whether the FCA and PRA are sufficiently lawyer-driven to operate the new UK regulatory system fairly and predictably. An immediate form of improved predictability could be achieved if supervisory and enforcement teams within the regulators included a practising lawyer and an accountant, along of course with persons possessed of management and other market skills. Internal structures that avoid unnecessary hierarchy and bureaucracy would allow the regulators to operate with fewer people, while maintaining their quality. These people would draft clear rules and apply those rules (and the regulators' Principles) using common law techniques to ensure predictability, in the manner here discussed.

- *An approach calibrated by regulatory activity.* An approach to regulation should be required and adopted which varies the degree of prescriptive rulemaking in accordance with its area of operation. The approach for the wholesale (as opposed to retail) markets should change radically to make the rules more risk-based and proportionate (to risk). Overall, subject to minimum standards of governance being achieved, the focus of regulators should principally be on regulatory capital, and systems and controls. Conduct of business regulation should operate through highly specific rules which focus on identifying particular (unwanted) behaviours.

- *Practical discipline for regulatory rulemaking.* There needs to be a greater practical discipline and checks and balances around regulatory rulemaking. There are already certain obligations in place. Regulators are bound by clear laws when they wish to make or change rules. The FCA and PRA both have a duty, under the Financial Services and Markets Act 2000, to consult on changes to their rules or guidance.[590] They also have to undertake a cost benefit analysis, which will be paramount in properly validating any new regime.[591] However, unlike the position in the US, where there are various ways in which proposed

[590] FSMA, sections 1M and 2L. In the US, federal administrative agencies (including the SEC and Federal Reserve) have to go through a procedure of providing public notice and soliciting public comment on regulatory proposals before adopting final regulations under the Administrative Procedure Act, 5 U.S.C. ch. 5 (2006).

[591] FSMA, sections 138I(2)(a) and 138J(2)(a).

rules can be challenged in court, both in terms of their substance and how they are made, the regulatory powers and obligations operative in the UK, including those to consult and conduct a cost benefit analysis, are rarely a source of legal challenge by the financial industry.[592] They are currently insufficient to temper the uncertainties arising from the inherited EU system. Lessons can be learned from the US financial regulatory system in identifying points where enhancement of the relevant provisions, along with more judicial oversight, is desirable. A summary of that system is contained in Annex 5 below.

- *Waivers.* The statutory provisions providing for the use of waivers should be considered afresh. Waivers[593]—and "no action letters",[594] used in the US and now the EU[595]—vary the rules or bar the regulators from taking any regulatory action against a firm once they have "signed off" on a particular matter. In general terms, the deployment of waivers by the regulators should be tightly constrained so that they can be subject to adequate judicial oversight, ensuring that they are truly one-off.[596] Any changes of a more general nature should be effected through changes to the wording of the relevant regulations themselves and subject to the consultation and cost benefit analyses that come with that.[597] Details of the current use of waivers by the UK's regulators, and considerations for improvement, are contained in Annex 6, section 1 below.

Control over open-ended regulation

In addition, open-ended regulation chills market activity and should be avoided as far as possible. For this, the regulators should be required to change how they seek to apply some of the more open-textured rules in current use, such as their Principles,[598] and adopt common law reasoning based on precedent and analogy. The original insight which led to the introduction of the regulators' Principles was correct, because the financial markets are too complex to be capable of regulation solely through detailed rules. The law itself operates in part by identifying principles which underpin the rules. The common law system of precedent has over the centuries demonstrated its ability to operate predictably and yet evolve, based on principles. Financial regulation should learn from its methods.[599] In regulation (as has occurred in the law itself), the rules should be sufficiently digestible and limited in number, and then interpreted against the background of regulator Principles.

For this to be a reality, the Principles, when applied, must be construed by reference to specified rules, prior decisions and other materials. This must occur through predictable, interpretative and precedent-based reasoning or by analogy from particular regulator rules, decisions or materials (when those rules, decisions or materials are not directly pertinent and there is no immediate precedent). The reasoning used should be that deployed throughout the common law. This would provide for the predictable application and incremental development of the application of the regulator Principles, and avoid lawmaking by inconsistent regulatory diktat. There should be detailed published decisions or guidelines on the Principles which are given the status of precedent, similar to that in the common law's system of case law. The approach of the regulators could be that of the Supreme Court, which is free to change its mind—although no two cases are ever identical anyway. Such an approach nevertheless of course needs to be subject to careful control, through a proper process for the making of new regulator rules

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592 Essentially, a cost benefit analysis seems always to fit any desired result, and there is no independent verification of the process.
593 See Annex 6, section 1 below.
594 See Annex 6, section 1 below, and fn 810 below.
595 See fn 821 below.
596 See Annex 6, section 3 below for a discussion of judicial review.
597 See fn 591 above and surrounding text.
598 See fns 78 and 554 above and the surrounding text.
599 Lon L Fuller's paper *The Forms and Limits of Adjudication* (1978–9) 92 Harvard L Review 353 contains an exposition of the judicial method.

and following appropriate consultation, when the regulators decide to take a different approach and depart from the precedent created in a particular area.[600]

This can be achieved relatively easily if written materials and decisions of the regulators, which are already publicly available, are treated as having the effect of precedent and as providing guidance in the interpretation of the regulatory regime. An approach to the more open-textured rules should be adopted which seeks to create more predictability without restricting the ability of the regulators to change their minds and establish a new line of analysis. This would involve:

- enforcing regulator rules only where their purport is clear; this is a particular need in the context of the high–level Principles, which are used too liberally in the enforcement context, leading to considerable uncertainty, but the point is of general application. On the one hand, it is important to preserve the ability for the regulators to operate in a managerial manner and not to be too restricted by legal process. But, on the other hand, fairness and predictability of result are important too;

- collating all published guidance, speeches and other materials on the regulators' websites, alongside the provisions upon which they seek to expand. The regulators should ensure that they publish an up to date, integrated set of rules, decisions, and related commentary and exposition so that the market has available in an easy form all of the relevant rules, decisions and guidance. All of these materials should be given legal relevance and should be capable of being used in determining the scope of permitted action and any legal evaluation of future regulatory actions;

- requiring such materials to be taken into account in the reasoning of enforcement (including settlement) decisions;

- requiring more detailed enforcement (including settlement) decisions from the regulators, using common law, judicial reasoning, capable of being used subsequently as precedents or by analogy.

Ensuring predictable enforcement

Predictable enforcement and better regulation require that general standards like those contained in the Principles should be accompanied by a more detailed elaboration of what they require. Until that has been provided by established case law, rules or guidance by the regulator, Principles should not be used, in and of themselves, to found enforcement cases. The point is not that previous Principles-based enforcement actions were misconceived. It is instead that many of them were insufficiently founded on an application of careful rulemaking, and this makes the law less predictable. In order to assist with a more rigorous approach, the concept of precedent can be deployed expansively, based on the steps in the preceding paragraphs. The terms of regulatory settlements could be drafted more in the manner of court judgments, in a way that will withstand judicial scrutiny. They need not be lengthy. Also, the UK regulators' carefully worded speeches could be treated as generating interpretative guidance of a similar nature to precedent and could form the basis of future decision-making. The common law-based technique of applying rules and precedents, where they exist, or reasoning by analogy when they do not, provides much-needed flexibility, and publications and speeches can clarify or adjust previous determinations. Through a careful balance between rules, decisions and examples, and well-publicised statements, the regulator can provide clear and sufficiently detailed guidance on the application of prescribed Principles. A transition to this method should not be too onerous. The basis for such an approach already exists in that the UK's regulators already provide clear, well-written guidance, both on their webpages and in separate materials that set out their approach to regulation and supervision of the different sectors within their remit. What is currently missing is that the regulators are not using

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600 See fn 591 above and surrounding text.

this material in constructing legally-reasoned decisions which can, over time, be understood (along with the decisions themselves) on a basis similar to precedent in identifying what is or is not permitted.

Respect for commercial activity

In addition, the regulators will need to act in a way that maximises the ability of the market to address the risk which it creates itself, and to intervene only in cases where there is suspicion that this may not be taking place. Such an approach will involve a re-evaluation of which activities take place within the truly commercial sphere, and how to intervene in the least intrusive manner so that market actions are allowed—whether they succeed or fail, so long as they will fail safely. This means that the following should take place.

- *Deference to commercial decision-making.* The regulators should cease their current practice of applying their own judgement for commercial matters, and leave the boards of financial institutions to manage performance. However, the regulators should of course remain free to exercise discretion in relation to systems and controls, and financial soundness; for banks, this would be in conformity with the discretions embedded in the international financial regulatory system through Basel's Pillar 2 standards.[601]

- *Deference to firms in appointments and performance management.* There also needs to be more deference to the judgement of firms over the recruitment and performance of their own employees. The regime for the appointment and supervision of senior managers[602] of firms should be reframed so as to apply minimum standards, leaving firms free to form their own commercial judgement as to whom to employ and the quality of their performance. The day-to-day approach to supervision[603] should be recalibrated to require an assessment of a minimum level of skills for those in their positions. On their initial appointment or any appointment to a new role, the burden of proof could be on the firm to show that those thresholds are met. But on an ongoing basis, the burden of proof could be on the regulator to show that the minimum standards had been transgressed. Use could be made of the service of the Banking Standards Board, which seeks to provide guidance for firms on ethical and other behavioural issues for bankers.[604] The idea would be for the oversight to be more limited than at present, leaving firms and the market to weed out inferior management. Similarly, compensation packages should be left for firms to decide upon, subject to far less prescriptive, overarching guidelines than those operative at present.[605] The principal focus would be on ensuring symmetry of outcome for those who bear the consequences of their own misjudgment, whereby they could make whatever profit the market permits if they succeed, but would equally be penalised for failure in both their role and withdrawal of financial benefits.[606] There could also be an adjustment to the current, intrusive, approach, to require that prior approvals by regulators of senior appointments are needed only for the Chairman, Chief Executive Officer, Finance Director and Risk Officer. Lesser procedures could be considered for a limited list of further roles, such as the Senior Independent Director, and the Chairmen of the Audit, Risk and Remuneration Committees.

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601 See fns 75 and 307 above.

602 See fn 381 above.

603 *Ibid*.

604 Established in 2015, the Board is a private sector body funded by membership subscriptions and open to all banks and building societies operating in the UK: https://bankingstandardsboard.org.uk.

605 There should be a reframing of the Remuneration Code to be less prescriptive and leave more room for the exercise by firms of their discretion.

606 This is in conformity with the purpose of the remuneration regime: SYSC 19A.1.6: "The aim of the Remuneration Code is to ensure that firms have risk-focused remuneration policies, which are consistent with and promote effective risk management and do no expose them to excessive risk": https://www.handbook.fca.org.uk/handbook/SYSC/19A/1.html.

Top-down challenge – providing the check and balance

In order to bolster the respect by the regulators for the commercial sphere, there needs to be an element of Parliamentary and judicial oversight of the regulators to ensure that the system operates smoothly. The regulators engage in a form of law-making through their promulgation of regulation and in their use of supervisory discretion. In doing so, they should of course themselves operate in accordance with the law. The market itself cannot constrain the regulators by bringing actions for damages for losses suffered as a result of regulatory action. The regulators have statutory immunity from suit in the performance of their functions when acting in good faith, as explained in Annex 6, section 2 below. In order to provide an adequate constraint, there need to be further mechanisms to ensure that the regulators operate within a legal framework that ensures fairness and predictability. These should involve:

- *Enhanced Parliamentary oversight.* The Treasury Select Committee could draw on a permanent panel of independent experts (including lawyers and those with market knowledge and other relevant expertise[607]) to help oversee the regulators.[608] The fact that the Treasury Select Committee constantly renews itself and is subject to democratic forces should be replicated by the committee periodically renewing its expert advisory panel. Market expertise is important. Proper oversight involves a consideration of a complex matrix of regulatory decisions and procedures, and determining whether they are operating appropriately, in line with the objectives set for the regulators by statute. A sub-committee that includes members of the Treasury Select Committee, as well as the panel, would report to the full Committee, and could be given (by the Committee) the role of overseeing whether the day-to-day actions of the regulators fall within their statutory remit. The Treasury Select Committee is not itself in a position to engage on such matters at a suitable level of detail. The sub-committee, with its panel of independent experts, would have no decision-making powers. It would however have an inquisitorial role and the power (as proxy for the Treasury Select Committee[609]) to require the regulators to appear before it and to provide evidence. There would also be a process for spot checks by the expert panel on the regulators' decisions. In addition, consideration could be given to the adoption of a statutory regime, equivalent to the US Congressional Review Act, that would allow Parliament to review and overrule new financial rules made by the regulators: see Annex 5 below, for a discussion. None of these steps would damage the independence of the regulators, which is important to maintain. Political interference in matters of financial regulation has been shown to cause economic damage.[610] Instead, it would involve holding

[607] This would mean the committee is in a position to evaluate without extensive research the suitability of regulatory rulemaking and the exercise of regulatory discretion.

[608] There will also need to be oversight of other matters. For instance, the new Private International Law (Implementation of Agreements) Act 2020 allows international agreements to be adopted by secondary legislation, without full Parliamentary scrutiny. There is a risk that agreements are adopted which are inconsistent with the common law method or which overturn long-standing common law rules or principles without adequate consideration. For instance, it would permit the new UNCITRAL Model Law on the Recognition of Insolvency Related Judgments (2018) to be taken on this way. If the Model Law were left unadjusted, it could overturn the English common law rule determining law which law governs how a debt is to be extinguished: *Antony Gibbs & Sons v La Société Industrielle et Commerciale des Métaux* (1890) LR 25 QBD 399.

[609] For this, one or more members of the Treasury Select Committee may have to attend the inquisitorial hearings. Standing Order 152 of the House of Commons provides the Treasury Select Committee with the power (a) to send for persons, papers and records, to sit notwithstanding any adjournment of the House, to adjourn from place to place, and to report from time to time; (b) to appoint specialist advisers either to supply information which is not readily available or to elucidate matters of complexity within the committee's order of reference; and (c) to report from time to time the minutes of evidence taken before subcommittees, and to lay upon the Table of the House the minutes of the proceedings of subcommittees; and the subcommittees appointed under this order have power to send for persons, papers and records, to sit notwithstanding any adjournment of the House, to adjourn from place to place, to report from time to time the minutes of their proceedings, and shall have a quorum of three.

[610] M. Quintyn and M.W. Taylor, *Should Financial Regulators Be Independent?* (2004) 32 International Monetary Fund Economic Issues, which shows how political intervention in matters of financial regulation damages the efficiency of the market, raising the cost for taxpayers of a financial crisis.

the regulators to account and ensuring they exercise their powers in a way which is predictable and necessary.

- *Judicial oversight of enforcement.* The Upper Tribunal,[611] which has jurisdiction to hear appeals against decisions of the FCA, PRA, Bank of England and the Pensions Regulator to penalise a firm or individual by limiting or removing a permission to provide financial services, should be more used for the review of regulatory decisions. The framework of administrative law, discussed in Annex 6, section 3 below, should be used. Thought should also be given to whether it would be an improvement if the FCA, PRA and Bank of England were required always to pursue enforcement cases before the Upper Tribunal, rather than allowed to take decisions themselves through the Regulatory Decisions Committee (RDC),[612] for the FCA, and the Enforcement Decision Making Committee (EDMC) for the PRA and Bank of England.[613] Of course, even if this were to be done, we would still need to get over the fact that firms wish to avoid publicity and seek in most instances to settle cases rather than fight them.

- *Expanding the use of judicial review of supervisory decisions.* More oversight by the courts, through their powers of judicial review,[614] is also desirable. Mechanisms should be considered to ensure that financial firms feel able to challenge regulatory decisions in the Upper Tribunal[615] and in the court system.[616] The detailed position of judicial review needs to be evaluated in this context as part of any steps taken in light of the Faulks Review.[617] As mentioned above, thought should be given to making the regulators test all proposed enforcement actions of any magnitude by means of proceedings in the Upper Tribunal. A facility for bringing test cases against the regulators should also be considered. In addition, consideration should be given to the lessons that may be learned from the US system of judicial review, including from elements of the US Administrative Procedure Act and its underlying jurisprudence and methodology. The US approach appears to lead to more regular (and successful) challenge of regulatory action, including of rules made by the regulators and of enforcement actions. Thought should also be given to the merits of the various checks and balances in the US enforcement regime more generally, and a comparison of the efficacy of this regime with that of the UK. See Annex 5 below, for a

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611 The Upper Tribunal was established under the Tribunals, Courts and Enforcements Act 2007. It has equivalent status to the High Court, allowing it to set precedent.

612 The Regulatory Decisions Committee is an independent committee of the FCA's Board. The RDC's process is administrative rather than judicial and it is not a tribunal (DEPP 3.2.11G). It takes decisions with respect to certain enforcement as well as supervisory actions. The FCA's explanation of the role of the Regulatory Decisions Committee can be found at https://www.fca.org.uk/about/committees/regulatory-decisions-committee-rdc.

613 The Enforcement Decision Making Committee was established in 2018 and has powers to decide contested enforcement cases across prudential, financial market infrastructure and resolution matters.

614 See Annex 6, section 3 below.

615 See fn 611 above.

616 There have been very few UK court cases involving judicial review of the financial regulator, other than in the enforcement context: a search of Westlaw reveals only a handful of judicial review cases involving the FCA, although only cases in which permission to bring proceedings was granted or a refusal to grant permission was challenged are in the public domain. Most applications for judicial review are considered without a hearing and refused on the papers. Nevertheless, the figure is low. This is because there are review mechanisms built into the FCA's and PRA's processes (see fns 612 and 613 below) and a claim for judicial review can only be brought if a party has no other adequate means of challenging a decision (see Annex 6, section 3 below). Even claims challenging enforcement decisions are quite rare. It is possible that the situation could change as a result of the FCA's introduction, in 2017, of "focused resolution agreements", which allow parties subject to regulatory enforcement action to agree a position on one or more, but not all, of the issues. The remaining issues are litigated before the RDC or Upper Tribunal. By entering into such an agreement, a firm can enjoy a penalty discount of up to 30% under the FCA's Early Settlement Discount Scheme. To date, firms who have entered into these agreements, such as Linear Investments, Carphone Warehouse and Standard Chartered Bank, have agreed the facts and accepted liability, but disputed the penalty. None of the firms have had the proposed penalty increased and some have secured a significant reduction. For example, the RDC reduced the financial penalty against Standard Chartered Bank proposed by the FCA from £155 million to £102 million. See, also, Recommendation 2 in section 3.2 above, for possible ways to address the concerns of the financial industry over the potential for drawn-out publicity arising from court hearings, which is an additional factor behind the lack of cases in this area.

617 See fn 833 below.

discussion of the US system. In addition, attention should be given to the need for enhanced judicial training in financial services[618] and, potentially, for designated judges to deal with certain types of cases.

However, whatever the refinements, judicial review has its limitations. It does not provide any systematic review of regulatory action (or inaction). It does not permit the day-to-day oversight of supervisory power by the regulators. It involves a point-in-time assessment of whether a specific regulatory decision was exercised in conformity with the regulator's statutory powers. As such it only provides a (valuable but) limited constraint on regulatory action. The role of the Treasury Select Committee is therefore critical. For a broader discussion of judicial review and possible adjustments in this context, see Annex 6, section 3 below.

More remedies through private litigation

The private sector can assist in ensuring that the regulations are enforced. There is a role for legal actions taken by those adversely affected by a firm's breach of regulatory rules when such actions are designed to address malpractice and customer detriment.[619] The system should facilitate litigation by private participants (and therefore evaluation by a court), since those affected by malpractice are often those best placed to take action for redress. Presently, this form of redress is restricted in that private individuals alone (not corporates) may sue a firm under FSMA for a breach of FCA or PRA rules where the person suffers loss. Certain breaches are excluded, including breaches of rules of conduct, of rules requiring a firm to hold financial resources, of the "threshold conditions",[620] and of the listing rules and rules relating to the provision of information by parent firms.[621] These restrictions should be reconsidered. Consideration should be given to allowing all private market participants (and not just private individuals) to use the court system for remedies for regulatory breach, particularly where there is no contractual relationship in place that would have allowed the affected party to protect itself through specific contract terms. This would:

- in many sectors provide a further framework for the rules specifying particular standards to be much simplified, on the basis that the standards set need to be particularly clear and readable so that the court system can be relied upon to monitor the satisfaction of those standards and to impose liability accordingly;

- encourage the enforcement of regulatory rules which are designed to prevent malpractice, and ensure there is a clear route to litigation by private market participants, and therefore to the evaluation by a court of any breaches of those rules. There could be a statutory filter to ensure that multiple failures are dealt with collectively and other restrictions ensure that market participants are not harassed by individual litigants in connection with purely technical contraventions.

The regulator could be asked to give evidence as to the meaning of the rule concerned, although the regulators will probably not want this to take up too much of their time and in any event the meanings should be capable of being deduced objectively, without external input.

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618 The FMLC already provides training of this nature: see *Bridge to the judiciary,* http://fmlc.org/about-the-fmlc/. This could be further embellished.

619 There is a balance to be struck. Care needs to be taken to ensure that regulators do not produce rules that transfer the task of regulation to customers by conferring remedies on them. Instead they must retain oversight of the operation and application of the rules so that their effectiveness is not distorted by the willingness of particular customers to resort to litigation.

620 See fn 818 below.

621 FSMA, section 138D.

Ensuring that the implications of the surrounding legal system are foreseen and addressed

Finally, the nexus between the common law and financial regulation must be taken into account. There should be ongoing monitoring by the regulators of instances where unexpectedly large changes of regulatory and financial outcome could result from a court decision on a widespread market practice. Problems can arise where large financial exposures have been built up through multiple sales across the market, particularly in the retail context. The regulators, let us assume, have regarded those sales as perfectly legitimate. The products turn out not to perform as anticipated, causing significant losses. Subsequently a court decides that the sales were unacceptable, whether for reasons of law or regulation, and awards redress to the purchasers. This happened, for instance, in relation to the sale of interest rate swaps to local authorities, which led to a series of court cases in the 1990s. In the main decision, the House of Lords declared that local authorities had no power to engage in interest rate swap agreements, because they were beyond the local authority's borrowing powers, and that all the contracts were void.[622] Such a decision has financial consequences because of its application to vast numbers of transactions which may have already taken place on the basis of a different view of the law and regulation. It also means that some financial products become a one-way bet: if they are profitable, they continue unchallenged, but if they make losses, the investors seek to void the contract.

A second example concerns consumer contracts made with a firm which is not authorised for financial activities when the law requires it to be, or the firm is regulated and its behaviour might be taken (wrongly) to be supervised by the regulators, and retail customers assume (with some degree of justification) that they will be protected by the regulatory system. A particular problem arises if the firm fails, since the statutory compensation scheme, the FSCS, will be unavailable.[623] This exposes the taxpayer to the need to compensate those who have moral rights to compensation where they are seen to have been misled by the financial regulatory regime. The problem can be seen in the recent case of London Capital & Finance plc (LC&F),[624] which was authorised for other activities, but not for the ones which caused consumer losses. LC&F engaged in the widespread issuance (£237 million) to retail investors of "income bonds" and investment savings account (ISA) bonds. The FSCS took the position that this activity was unregulated and therefore not covered by its compensatory scheme, for highly technical (and debatable) reasons which relied upon an unusual non-transfer clause in the bonds which the FSCS said resulted in the instruments being issued outside the regulatory perimeter. The decision is presently the subject of a judicial review.

The subsequent wrongful behaviour and falling into administration of LC&F caused significant losses, with investors only receiving 2.5% returns in the administration, since many of its assets had been dissipated to connected persons. LC&F was regulated for credit brokerage, investment advice and "arranging". Its FCA licence and ISA manager status were referred to prominently in its advertising, which were facts on which consumers may have placed justifiable reliance. A Report by the Rt Hon Dame Elizabeth Gloster (the Gloster Report)[625] criticised the conduct of the FCA in relation to its oversight of LC&F, and concluded that there had been a serious instance of regulatory failure. The Government has announced that it is setting up a scheme to consider compensating investors to whom FSCS or other redress is not available, using taxpayer funds.[626]

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622 *Hazel v Hammersmith and Fulham LBC* [1991] 2 AC 1. This decision spawned a number of other decisions on consequential points of law, perhaps most notably *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] AC 669, which dealt with whether the local authorities had to return the sums they had received under the swaps contracts with simple or compound interest – holding that only simple interest was payable.

623 See fn 495 above.

624 For a fuller summary of the facts of LC&F, see fn 826 below.

625 *Report of the Independent Investigation into the Financial Conduct Authority's Regulation of London Capital & Finance plc*, 23 November 2020.

626 John Glen MP, the Economic Secretary to the Treasury, announced on 17 December 2020 that the Treasury would set up a compensation scheme to protect certain bondholders who would not otherwise receive compensation: https://questions-statements.parliament.uk/written-statements/detail/2020-12-17/hcws678.

The potential lack of enforceability of the contracts of unauthorised financial firms against their customers may ordinarily be seen as an important incentive for firms to become authorised when the FSMA regime requires this.[627] Otherwise, there is the risk of their dealings with clients becoming one-way bets in favour of the clients. This is because the clients would be able to walk away from positions that turned out to be loss-making.[628] However, this incentive cannot be assumed always to have such an effect. Furthermore, in the particular case of LC&F, the contracts were not rendered unenforceable by the FSMA, since LC&F had an FCA licence but was not supervised for the portion of its business in question,[629] which the FCA believed fell outside its scope of authorisation.[630] The Gloster Report referred to the importance of the FCA considering the activities of authorised financial firms as a whole, regardless of whether those activities are themselves regulated or unregulated, on the basis that FCA authorisation implies a badge of respectability. There needs to be continuous oversight of the system so as to ensure that those whom the market and consumers expect to be authorised are indeed authorised for the relevant activities, and that regulation is adopted and applied in such a way that there are no instances in which *vires* or other arguments could lead to such a level of financial upheaval if transactions are challenged in court.

[627] FSMA, section 19 provides that a firm may not carry out a regulated activity without being authorised or exempt from authorisation. Section 20 provides that an authorised firm may only undertake the activities for which it is authorised. Sections 26 to 27 provide that contravention of section 19 will render contracts unenforceable.

[628] See fn 627 above.

[629] The unenforceability provisions referred to in fn 627 above do not apply to transactions or contracts entered in breach of section 20 of the FSMA.

[630] The question of whether these contracts might be void or voidable as a result of fraud or misrepresentation has yet to be considered by the courts. Some parts of the LC&F arrangements, involving connected persons, have already been replaced or declared void.

CONCLUSION

For many people who assumed the UK's position within the EU was satisfactory, Brexit was an unwanted event. The EU's approach to the law tended to be seen as being a matter for academic debate over technicalities rather than being about anything more serious. Indeed, the UK's position within the EU legal construct was generally seen in broad brush. The method of EU law, and its implications, were unexamined. Commerce appeared to carry on unhindered. The laws for financial services business elicited grumbles from the industry but were generally accepted. Concerns were brushed aside when the problems associated with the harmonisation of member state laws in the EU's developing legal structure, member state politics and the introduction of the Eurozone prompted more laws and rulemaking (as in MIFID II and the highly political bonus cap[631]), adding increased burdens of compliance and costs on generally well run UK businesses. There appeared to be a tendency to treat discussion of the topic as hostile to the EU project itself and its member states, and as involving no more than a debate about political preferences, rather than a debate over legal systems.

By contrast, this analysis considers the implications of EU law for this country's common law system and the consequences for financial sector businesses, suggesting that there are important legal as well as economic reasons to take advantage of the tried and tested common law system and its benefits. The reasoning underpinning the common law approach represents a deeply embedded way of legal thinking in the UK; and the uncodified Scots law approach is in many ways similar. Both English and Scots law differ starkly in their reasoning from that which goes hand in hand with the code-based civil law systems. These are not matters purely for lawyers. Such reasoning can often permeate the entire discourse of the state, and legal reasoning permeates the societies in which it operates.

The common law (and Scots law) approach of reasoning by tentative steps and subject to change contrasts with the grand intellectual schemes of the continent and the EU itself, one aim of which is to seek solutions in advance of every problem. The laws made in the national parliaments of the EU represent the political choices of an electorate to govern the arrangements of their daily life and commerce. In the same way, financial rules aim to govern the arrangements which cover transactions in the sector, and to determine which risks are acceptable and which are not in a manner which takes account of the wider good - of the economy and society. For key members of the EU, the purpose of the markets is seen to be predominantly that of assisting the industrial economy. The free market is not seen as having value in its own right.

The UK approach to financial law is different, reflecting the different priorities of the society in which it is placed. The legal system is built around commercial and individual freedoms. Lawyers analyse and advise on complex new situations, for which their reasoning can be nuanced and inventive. They do so in the expectation that they are engaged in what is essentially a collaborative endeavour with others, particularly the regulators and judges, to apply the law in a sophisticated way to new circumstances. The shared understanding is that the law is to be applied so as to allow activity that has not been deliberately restricted. Unlike the position in code-based systems, points are settled iteratively, by judicial or regulatory decision, so that further arguments can build from this new starting point. As a result, the law builds out to a degree of subtlety that no systematiser can contemplate and no industry of advisers can replicate within a system in which the code reigns supreme.

The approach of the common law system, which is used the world over and works well for the financial sector, is to reflect the changes that occur over time, rather than seeking to anticipate every possible eventuality at the moment of its creation. The system takes account of evolutionary change and the unpredictability of life and business. There is no one solution to govern future circumstances, no path by which lawmakers can foresee the whole, rather than assess each case on its own merits. This involves the largely unglamorous, but intellectually challenging, job of constantly assessing how principles and

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631 See fn 210 above and surrounding text.

rules apply to new situations, and whether those principles and rules need reformulation to cope with new facts. For there are always novel situations which emerge that those seeking to formulate the law had not been aware of or appreciated. Such circumstances can be inconvenient to grand schemes, throwing up new legal problems requiring new solutions.

The valiant attempts of the nineteenth century to codify laws and set out answers to legal problems in a systematic form reflect the values and approach of different societies to our own. The code-based response involves proceeding by updating the schematic operating system iteratively, to meet failings as they become apparent and assuming they will recur in the same form. In the meantime the codes are applied as best they can be. The application of the law to practical experience is treated as more automated than is true under the common law and as something which largely requires an application of rules designed to meet each possible transgression. Yet this approach is potentially ill-equipped to deal with a given, particular circumstance. The EU experience demonstrates that for the fast-moving financial services sector this system involves a constant shaping and refining of a vast corpus of laws in an attempt to impose centralised order on activity that is by nature decentralised and disordered. By contrast, the common law system, as it applies to commercial arrangements, does not assume the nature of transactions entered into to be static. No solution is assumed to be permanent. The law, instead, underpins the framework. No one person or group of people is regarded as omniscient and the market, as it has evolved under law, is respected. The method is therefore in practice broadly permissive of commercial activity. It seeks to buttress the choices of market participants and to address transgressions and their consequences, unlike the continental approach in which a theoretical system is given pre-eminence over matters beyond the knowledge, comprehension or prediction of any group of individual lawmakers or regulators.

The result in the financial sector is a divergence not only between styles of law-making but also between the respect accorded to individual and business liberty. The EU trend is towards central control. Those used to operating within a common law system find it difficult to comprehend the civil law code-based method and approach. The converse is of course also true, and the EU, applying the civil law method to codify financial services law, in an accelerating trend after the 2007-2008 financial crisis (with some of the worrying consequences discussed above), remains intrinsically suspicious of the common law's methodology and faith in market freedoms.

The codified system entwines economics, finance, politically focussed policy and the law. The approach tends towards assumptions and a mistrust of participants. It also seeks to apply political and economic policy through its codified scheme in a way that is sometimes ill-conceived and morally questionable. That has helped lead to the EU's codified regime, as it has evolved, facilitating the introduction of a complex financial system, which lacks transparency and is constructed around the as yet half-built Eurozone, which creates and then masks vast amounts of systemic risk. This may be partly the result of the Eurozone's political aims and practical indecision, together with the levels of popular concern and weak democratic support for the integrationist project.

In comparison, the common law approach can in this area actually be said to bring more legal certainty, and achieves high levels of legal predictability. It is in addition intrinsically linked to its notions of individual and commercial liberty. Certainty, and the knowledge that practical and legal argumentation will be respected, is liberating. The law deploys reasoning that respects individual decision-makers and decision-making, allowing them (at least in the UK's version) to deploy arguments before the courts in a way that is given equal weight to those arguments when used by the state itself. By contrast, the code-based civil law approach is more sceptical of individual motives and retains permanent control for the system over individual behaviour, so that it can often decide after the event whether to permit activity, rather than allowing for predictability in advance by private individuals or businesses which the system then upholds.

Now that the UK is no longer operating within the EU's legal architecture it needs, in respect of financial law, to recapture its traditional form of reasoning. For that, it needs to renounce EU law, and its code-based methods, and restore the role of the common law and its system of reasoning. Fortunately, this task is surprisingly easy. The English, Welsh and Northern Irish system is based on the common law. In Scotland it is based on an uncodified system which is very similar in this respect. In this area (even if not in all areas) reasoning still proceeds on an uncodified basis. As a result, recapturing the benefits of the traditional UK system should swiftly become possible, so long as the right steps are taken now. Those steps involve a rapid repudiation of code-based methods, the cutting out of inherited, code-based EU law and a reinstatement of the legal pragmatism that is embodied in the common law and Scots law systems.

In addition the UK, since joining the EU, has introduced very powerful statutory regulators who can be said to operate in the financial sector as legislative bodies, as well as judge, jury and executioner. These bodies already have many of the main ingredients to operate within a revitalised UK system. But adjustments are needed for them to do so in a manner complementary to the new UK system. The adjustments require a new framework which provides for the necessary certainty of UK law which underpins regulation and its predictable operation. The regulators need to operate within a newly defined set of parameters, so as to allow for greater review by the courts of the exercise of their powers, and in particular their rulemaking and supervisory processes. They also need to be overseen more proactively by Parliament, with expert assistance. This would provide challenge to the activities of the regulators themselves, counterbalancing the challenge they make of regulated financial institutions. These changes should be relatively easy to implement.

The opportunity now arises for the UK to shed the legacy of codified EU financial services law, and recapture its historical legacy of law-making and implementation, for general economic benefit. The UK's future success will involve placing renewed trust in individual and commercial actors to organise their own affairs, rather than assuming they need to fit into the arrangements of a state which is determined to play a role alongside them. Quite apart from the merits of liberty, the top-down state-driven approach to law-making and its intrusion in activities more properly for individuals and business decisions, as seen in Continental Europe and within the EU, leads to inferior economic outcomes.[632] Change in the financial sector occurs rapidly and UK law is best equipped to accommodate this. For instance, it is increasingly apparent that, with technological innovations, many financial services and products can be acquired remotely, online or through smart devices, empowering customers throughout the world to seek out the services and products they wish to acquire. The location of property interests is becoming harder to define using traditional legal methods as new developments such as blockchain, which compiles cryptographic records ("blocks") without any single identifiable legal location for the chain, become adopted. The common law can rise to accommodate such things.

The opportunity could not therefore be better for the UK to rediscover its free trade roots and the benefits of the common law, allowing those people located within its jurisdiction, whether or not domiciled here permanently, and those elsewhere who wish to access it, to benefit from an environment which is optimised to permit the greatest possible levels of (safe) innovation. EU firms or individuals can benefit from such a transformation and join the many global investors who already locate business activities here in the UK. They will be able to sell services and products cross-border in an increasingly virtual world of financial services provision, to all those around the world who seek superior service, fairness and opportunity. Global consumers are increasingly empowering themselves to shape and drive commerce, and the trust engendered by the UK's "gold standard" legal and regulatory framework should prove to be a considerable attraction. Over time, whatever happens elsewhere, the UK's permissive, non-controlling approach will win out – it is underpinned by a law that gives certainty to business, reassurance to customers and protection to the country from systemic risk.

632 See fn 6 above.

CHECKLIST

Strip out EU law approach from UK statute book, removing unnecessary laws and regulations (including those which hamper the UK's competitiveness), upgrading drafting, moving most day-to-day regulatory provisions to the regulator rulebooks.

Reframe and enhance the regulator rulebooks, removing unnecessary rules and clarifying drafting of those which remain.

Adopt common law approach to drafting, focusing on outcomes, restrictions and liabilities.

Reinforce focus on disclosure and appropriate use of *caveat emptor*.

Seek Parliamentary oversight for above changes, with expert input.

Do not fetter rulemaking or supervisory activities in international arrangements; enhance recognition internationally of UK court judgments for financial services matters.

Take steps to encourage more court hearings – consider publicity issues.

Use junior judges for small claims, in place of Ombudsman role. Ensure Ombudsman operates under judicial oversight and on basis of common law in any residual role.

Replace EU's purposive approach to interpretation, including of inherited EU law.

Introduce new statutory objectives for the regulators and redefine their roles and powers, so as to enhance the ability for judicial and Parliamentary oversight.

Require more legalism in exercise of power by the regulators, to enhance predictability. Focus and limit use of waivers.

Ensure regulatory supervision occurs through precedent-based reasoning, and reasoning by analogy. Control open-ended regulation.

Promote use of Parliamentary committee, with expert panel forming part of sub-committee, to oversee regulatory rulemaking and supervision, and to ensure adequate checks and balances. Ensure respect for commercial activity.

Procure ongoing consideration of surrounding legal system to ensure public appreciation of what is and is not regulated, and the implications.

ANNEX 1: EXAMPLES OF THE COMMON LAW'S FACILITATION OF NEW FINANCIAL ACTIVITY

The following are some examples of the ways in which the common law and the UK legal system have facilitated financial activity, referred to in section 1.6 of Chapter 1.

Netting

In the financial markets, there is often a process which contracting parties agree to, known as "netting", which involves offsetting the value of multiple positions or payments due to be exchanged between the parties. Close-out netting occurs when two parties agree to combine their various obligations into a single net payment following a default. The rules relating to close-out netting, particularly in a derivatives context, have been critical to the development of sophisticated markets. These rules allow for the termination of obligations under a contract with a defaulting party and subsequent combining of positive and negative replacement values into a single net payable or receivable. The existence of these rules allows for regulated financial institutions to account for their net rather than gross exposures to their individual counterparties.

The English common law has long recognised the ability of collateral takers, particularly those who take title to assets, to enforce against those assets and offset the assets against any related losses. However, in many civil law countries, such notions were either not facilitated or were restricted by requirements to register collateral. The financial industry's standard form derivatives agreement, the ISDA master agreement, is an internationally agreed standard document published by the International Swaps and Derivatives Association. This document is based on the English common law's netting principles—as indeed it has been since it was first published in 1987. As the financial markets have globalised, civil law jurisdictions have, of course, adapted their legal regimes to allow for netting, not least in Europe as a result of the EU's Financial Collateral Directive of 2002,[633] which effectively adopted English law across the EU as regards the enforceability of collateral and related close-out netting. However, making these adjustments across other jurisdictions has in many cases required additional specialised legislation to promote enforceability.[634] Even as recently as 2016, a German court disrupted the use of standard ISDA master agreements when it declared that a netting provision widely used in such agreements was invalid as it did not comply with the German Insolvency Code.[635] The provision purported to result in a deemed termination of contracts entered into under the master agreement, prior to insolvency, and the subsequent set-off of amounts owing under those contracts. The German legislature had to amend its Insolvency Code to remedy the issue.[636]

Custody of securities

Although custody arrangements, or their equivalent, can be established in civil law jurisdictions, common law concepts of equity[637] and the trust facilitate the custody and safeguarding of assets arrangements more straightforwardly. Common law countries are therefore the jurisdictions of choice

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633 Directive 2002/47/EC.

634 Even in common law systems some adjustments have been required, for instance to limit other developments in the law which would have encroached on the recognition of close-out netting. Thus, US bankruptcy law prohibits so-called *ipso facto* clauses and has done so since the enactment of the US Bankruptcy Code in 1979. These clauses provide for a contractual termination right which arises solely as a consequence of an insolvency process. The UK recently outlawed non-financial *ipso facto* clauses in the Corporate Insolvency and Governance Act 2020. In both countries, there are important exclusions to permit close-out netting and the enforcement of collateral and, in the UK, for most kinds of financial institution creditors.

635 See fn 250 above.

636 See the text relevant to fns 252 and 253 above for more detail on this case and its impact. BaFin's announcement discussing this issue and legal interventions to fix it is available at: https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2017/fa_bj_1701_Netting_Klauseln_en.html.

637 See fn 100 above and related text.

for this key plumbing of the global markets. Luxembourg and Belgium have enacted legislation effectively recognising the trust for the purposes of facilitating the Clearstream[638] and the Euroclear systems.[639]

Client asset protections

The trust—a peculiarly common law concept—underlies the development of modern client asset regimes, including the UK's revamp of its FCA client asset sourcebook following the 2007–2008 financial crisis. Client asset protections that are based in statute (including insolvency laws) or regulations in common law jurisdictions often reflect the influence of the trust concept. Civil law jurisdictions have emulated aspects of such regimes by way of contractual provisions and changes to insolvency law (recognising a preference for client assets at the time of insolvency), and concepts that are arguably trust-like have developed,[640] though participants in practice generally prefer the authentic common law structures. For example, in many civil law jurisdictions, such as the Netherlands, administrative segregation—whereby securities are clearly registered in the books of an intermediary as held for the account of a given client—does not give rise to the same extent of segregation as is available under trust law, especially in the event of insolvency of the intermediary.[641] Under English law, administratively segregated securities may be designated as subject to a trust interest. In the case of the Lehman insolvency, where some client assets had not been segregated, the UK Courts addressed client asset issues and certain linked issues in a sophisticated manner.[642]

The taking of security

There are various areas where English law security has been—or at least is perceived by market participants to have been—more flexible and user-friendly than civil law systems in adapting to novel techniques. Examples include: (a) the concept of the floating charge as developed under English law; (b) the general ability under English law (and other systems based on English law) to take security over future property (only effective in equity); and (c) the fact that civil law jurisdictions often require significantly more formalities than common law regimes, including expensive notarisation requirements. Legislative structures have been introduced in civil law jurisdictions to compensate for these deficiencies, for instance to address the lack of a floating charge[643] or the ability to take security over future property.[644] However, these typically have the consequence that the regime as a whole

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638 Law of 1 August 2001 on the circulation of securities, as amended, https://www.cssf.lu/wp-content/uploads/files/Lois_reglements/Legislation/Lois/L_010801_CircSec_upd010319.pdf.

639 Royal Decree No. 62 of 10 November 1967 on the deposit of fungible financial instruments and the settlement of transactions in respect of these instruments.

640 For example, the *stichting*, or civil law foundation, was introduced in Liechtenstein in 1926 (and is based on English law with differences); there are similar concepts elsewhere. The introduction of a trusts law is currently being considered in Switzerland.

641 M. Haentjens, *European Harmonisation of Intermediated Securities Law: Dispossession and Segregation in Regulatory and Private Law*, in L. Gullifer and J. Payne (eds.) *Intermediation and Beyond* (2019) Hart, 268–270.

642 An interesting summary is to be found in Lord Briggs, *The Lehman insolvency and beyond* [2019] LMCLQ 603. The author of this paper expressed doubts at the time, as set out in Reynolds, Ali, Donegan, Ahmad, *What's broken with the UK's client asset and money protections and how to fix it* (2010) 11 JIBLR 529; but various improvements to the UK regime were subsequently made, including the creation of the Investment Bank Special Administration Regulations 2011 (as amended by the Investment Bank (Amendment of Definition) and Special Administration (Amendment) Regulations 2017), and the common law system proved robust.

643 While they do not have a floating charge, lenders often take Dutch security in a debenture-like document called an omnibus pledge that covers all assets other than shares and real estate. In France, there is a pledge over business as a going concern that captures goodwill, intellectual property, equipment, machinery, and so on.

644 In the Netherlands, security over future property is permitted other than registered property (real estate, ships and aircraft); in Germany it is generally possible to grant security over future assets provided the assets are described in a non-ambiguous manner; in Switzerland, a security interest over future assets is possible under the condition that such assets are clearly determined or at least sufficiently determinable at the time of granting the security; in Luxembourg, pledges can be granted over future assets, including, for example, future claims, future shares or future bank accounts, but not mortgages; in Spain, security may be granted over future assets, subject to fulfilling certain conditions, such as these being sufficiently determinable; in France, a pledge over future assets is permitted as long as the assets are determinable as to their nature, quality and quantity.

becomes more rigid. They also lead to significantly more distinctions around the type and nature of security than are found under English law, a fact which renders discussion and analysis more difficult, particularly in an international context. In 2002 the Financial Collateral Directive[645] improved registration and enforceability matters considerably for financial markets players across the EU, but it is notable that the common law had been able to adjust when such practices arose, without legislative intervention.[646]

The disintermediation and electronification of securities – the "PRIMA" concept

Recent private international law treaties[647] and some European legislation[648] have furthered the "place of the relevant intermediary approach", PRIMA, as the governing law for securities holdings. This means that, in relation to securities holdings, the law of the place of the account provider of a securities account applies to determine property law questions, such as the legal nature of the securities and issues of priority of interests in them. The common law had begun to develop such an approach.[649] It then became clear that, given the international, cross-border nature of securities holdings (and of the transfer of those holdings), intervention was needed to accelerate the process and harmonise with the approach in civil law jurisdictions.[650] Common and civil law jurisdictions previously employed various different approaches to such matters, leading to significant legal uncertainty. These included the law under which the securities are issued, the law of the place where the paper securities are located, the law of the place where the initial electronic record is made, the law of the place of business of the customer, the law of the court hearing the dispute or the law of the contract governing related (but different) contractual law questions arising between the parties. The introduction of the PRIMA, or variants, as a global standard therefore required legislative intervention.[651]

Enabling the parcelling up of risk amongst different investors

From the earliest days of sale of goods law, the courts sought to reflect the practice of merchants in respect of issues such as the passing of risk or property. The principles of equity[652] and their application have generated an even more sophisticated framework that has facilitated numerous innovations in financial activity. Equitable principles have assisted the development of securitisation and other varieties of modern capital-raising, which require the application of equity by reason of the restrictions on assigning debt under common law.[653] Such approaches allow for the offloading of financial risk

645 Directive 2002/47/EC.

646 That said, even many of the common law jurisdictions (eg US, Canada, Australia, New Zealand) have adopted some sort of legislative framework bolstering security interests. Catering for the complexities of such interests and the demands of the markets has required adjustments. Nevertheless, the English law experience shows the superiority of the bottom-up approach in providing the intellectual foundations for dealings in security.

647 Convention on the law applicable to certain rights in respect of securities held with an intermediary (the Hague Securities Convention), 2006.

648 The EU adopted the PRIMA approach in modified form, with Article 9(2) of the Settlement Finality Directive and, subsequently, Article 9 of the Financial Collateral Directive. The Commission originally planned for the EU to accede to the Hague Convention but this was blocked by some member states.

649 See, for instance, *Macmillan Inc v Bishopsgate Investment Trust plc (No 3)* [1995] EWCA Civ 55, [1996] WLR 387 in relation to the *lex situs* of shares. See also *Eckerle v Wickeder* [2013] EWHC 68 (Ch), [2014] Ch 196 and *Secure Capital SA v Credit Suisse AG* [2017] EWCA Civ 1486; [2017] 2 Lloyd's Rep. 599. The case law across other common law jurisdictions was in the early days limited.

650 The overall PRIMA concept, which built from the common law foundation, was set out in a paper by R. Guynn, *Modernizing Securities Ownership, Transfer and Pledging Laws: A Discussion Paper on the Need for International Harmonization* (1996) International Bar Association; in various academic publications including an article by R. Goode (*The Nature and Transfer of Rights in Dematerialised and Immobilised Securities*) in F. Oditah (ed) *The future for the global securities market: legal and regulatory aspects* (1996) OUP; in J. Benjamin, *The Law of Global Custody*, 1st edn (1996) Butterworths; and was subsequently recognised by the then latest edition of Dicey & Morris, *The Conflict of Laws*, Sweet & Maxwell. Many later academic texts support it. The whole question is currently subject to a study by the Law Commission, which published a scoping paper on 11 November 2020 setting out the issues and potential solutions. Formal recommendations for refinements are still under consideration.

651 See fn 648 above.

652 See fn 98 above.

653 For instance, Standard and Poor's noted in RatingsDirect, August 2008: "Civil law jurisdictions, with the formality of their civil codes, the inability to rely on equitable principles, and the scarcity or uncertainty of case law applicable to the

onto willing counterparties, mimicking the assignment of debt. Partnerships, frequently the vehicle of choice for fund and other investment managers, are also in large part governed by equitable principles. Commercial property, such as commercial aircraft, and the land on which offices and hotels are built, is often owned in equity by means of trusts. In general equity undoubtedly plays a significant role in modern commercial disputes, disputes which can often require an element capable of creatively and flexibly dealing with their complex and highly specific nature.[654]

Title transfer, including for collateral

English law has not had difficulty in supporting the development of the repo[655] and other securities financing markets. The legal technique underpinning these markets often involves the use of "title transfer collateral" – whereby legal and beneficial title to financial collateral are transferred on terms that title to equivalent financial collateral will be transferred back to the collateral-provider when it discharges its obligations to the collateral-taker. These markets are critical in ensuring a liquid financial system, enabling securities owned by financial institutions to be used to raise cash or manage portfolios. The technique is also important to the taking of collateral in the context of many derivatives clearing arrangements. It is particularly popular because of difficulties arising from the use of security collateral, including registration and formality issues, as well as enforceability questions and the legal risk that arises from security arrangements.

Predictability of the insolvency regime

The common law has had an important part to play in ensuring that the UK's insolvency regime operates efficiently.[656] For instance, UK insolvency legislation has for many years provided a statutory regime for achieving an equal, *pari passu* distribution among unsecured creditors. This principle has been supplemented by the common law reaching beyond the pure application of the legislation. In the seminal case of *British Eagle*,[657] the House of Lords struck down a contractual arrangement (an airline clearing house arrangement) which sought to vary the statutory order of distribution in an insolvency. This has generated a rich vein of case law which declares it to be against public policy to displace insolvency law by contractual provision or transaction - for example a term that, in the event of one party's insolvency, a specified asset (which is not otherwise subject to security) becomes the property of the other. This is the so called "anti-deprivation rule",[658] which plays an important part in the realisation of the insolvent estate's assets. There are legitimate ways by which creditors can agree to

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financial sector, pose special challenges to securitisation" (page 5). Of course, formalities can be required in common law systems. Section 136 Law of Property Act 1925, which sets out the formal requirements for an assignment to be a legal assignment and not merely an equitable assignment, is fairly prescriptive.

654 For example, where a dividend has been paid unlawfully, there is a statutory basis to recover the amount paid from a member who knew (or had reasonable grounds to believe) that it was unlawful (Companies Act 2006, section 847(2)). Equity goes further in such circumstances and under equity the recipient, if in possession of the facts that made the distribution unlawful, may be held to be a constructive trustee of the amount paid and liable to account to the company accordingly (*Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1986] Ch 447). The role of the common law in this context and the difficulty in codifying the flexibility of equity is evidenced by the express preservation of all other obligations imposed on that member through section 847(3).

655 This term is market shorthand for a sale and repurchase transaction, whereby securities are sold on the basis they will be subsequently bought back, allowing for short-term use of cash, collateralised by the taking of ownership of the securities by the lender.

656 See Philip Wood, *Why English law?* 29 January 2019, https://primefinancedisputes.org/files/2019-03/why-english-law-philip-wood-cbe-qc-hon-.pdf?439c9efb7f, for some interesting perspectives, including on English finance law more generally.

657 *British Eagle International Airlines Ltd v Compagnie Nationale Air France* [1975] 1 WLR 758 HL.

658 See the Supreme Court decision in *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* [2011] UKSC 38, [2012] 1 AC 383 which addressed the so called "flip" provisions in a security enforcement process relating to a medium-term note (MTN) securitisation programme (which allows the issuer to offer its MTNs from time to time without producing extensive legal documents at the time of each issuance of notes). See also the application of the anti-deprivation rule in the context of Football League clubs being penalised for entering administration until their debts are paid in full, *Revenue & Customs Commissioners v Football League Ltd* [2012] EWHC 1372 (Ch), [2012] Bus LR 1539.

subordinate their claims to others, and the common law has been important to determine what is or is not acceptable.[659]

The common law has similarly contributed to other rules around achieving equality of distribution. Examples that may be given are the rule against double proof, the rule of hotchpot in relation to the application of recoveries from multiple local and foreign insolvency proceedings over the same debtor and even the laws of contribution and subrogation in relation to guarantee claims and marshalling in relation to security enforcement. Particularly in the insolvency context, the common law has provided significant guidance (and protection) around the core areas of set-off, security and trusts which are so important to the operation of a predictable and efficient financial market.

In addition, the common law has contributed a deep seam of legal decisions in the area of cross-border insolvency. Where specific insolvency regimes do not apply (for example, the Recast EU Regulation on Insolvency Proceedings[660]), the common law has quickly filled the gaps to address the principles on which foreign insolvency proceedings will be recognised in the UK and to address which parts of the UK's insolvency regime are deemed to be mandatory and should apply notwithstanding a contrary provision in a foreign insolvency process.[661]

The law of unjust enrichment also has an important part to play in insolvency, often determining whether a putative creditor has a valid claim (for example arising out of a mistaken payment or a wrong) and, in certain circumstances, whether that claim should be given some proprietary status and therefore rank above the claims of other unsecured creditors. Whilst some aspects of unjust enrichment in the insolvency context can be said to be derived from statute (for example, the laws around transactions at an undervalue and preferences[662]) many aspects have been derived from the common law, including important cases regarding the scope and extent of the remedial constructive trust and its impact on established property rights.[663]

Furthermore, even the conduct of insolvency office-holders in the discharge of their functions, their treatment of creditors, and what is expected of them as officers of the court can be said to have been determined in large part by common law.[664]

Certainty of commercial dealings

In another context central to the financial markets, that of registered interests, English law robustly defends the *bona fide* purchaser principle: the good faith purchaser of the legal title for value, without notice of any other party's claim against the property, defeats prior interests.[665] This provides vital

659 *Re SSSL Realisations (2002) Ltd* [2006] EWCA Civ 7, [2006] Ch 610.

660 Regulation (EU) 2015/848.

661 See for example the House of Lords decision in *BCCI (No 8)* [1998] AC 214, declaring that the UK's statutory set-off in insolvency is mandatory; *Cambridge Gas Transport Corp v Official Unsecured Creditors of Navigator Holdings plc* [2006] UKPC 26, [2007] 1 AC 508 where the Privy Council held that a universalist approach to cross-border insolvency recognition should apply; and *Rubin v Eurofinance SA* [2012] UKSC 46, [2013] 1 AC 236 where the Supreme Court rolled back on the universalist approach.

662 See sections 238 and 239 of the Insolvency Act 1986.

663 See earlier cases including *Neste Oy v Lloyds Bank plc* [1983] 2 Lloyd's Rep 658, *Re Japan Leasing Europe plc* [1999] BPIR 911, *Re Farepak Food & Gifts Ltd* [2006] EWHC 3272 (Ch), [2007] 2 BCLC 1 and [2009] EWHC 2580 (Ch), [2010] 1 BCLC 444, various Lehman cases, for example, *Re Lehman Bros International (Europe), CRC Credit Fund Ltd v GLG Investments plc* [2012] UKSC 6, [2012] Bus LR 667 and *Bailey v Angove's PTY Limited* [2016] UKSC 47, [2016] 1 WLR 3179 in which the Supreme Court sought to limit, albeit in *obiter dicta*, the scope for remedial constructive trusts to apply in common law and further affect established property law concepts.

664 See for example the seminal and oft quoted case *James Ex p: Re Condon* (1873-74) LR 9 Ch App 609. Similarly, the common law has articulated the duties of a receiver or mortgagee in disposing secured property (including the duty to obtain a proper price), establishing important protections for both the secured creditor and debtor providing the security, see *Medforth v Blake* [2000] Ch 86 and *Silven Properties Ltd v RBS* [2003] EWCA Civ 1409, [2004] 1 WLR 997.

665 English law starts with the doctrine of *nemo dat quod non habet* (a transferor of goods cannot pass on a better title than he possesses). The civil law has a similar concept (*nemo plus iuris ad alium transferre potest quam ipse habet*): see Justinian, *Digest*, 50.17.54 (Ulpian, 46 *Ad Edictum*). In the UK, this concept is sometimes allowed to be applied liberally. So the Sale of Goods (Amendment) Act 1994 abolished the medieval English law "market overt" exception under which,

certainty to the markets. The protection arises after property is transferred in the register.[666] Once that happens, the new registered holder's interests may defeat even a victim of crime. Collateral takers are treated as purchasers for these purposes. One result of this approach is that English law and other common law systems are often the law of choice for asset transfers, especially in a financial and maritime setting. This is because of problems that can arise because a good faith purchaser may end up being trumped by a victim of crime in many (but not all) civil law countries, often without clear rules as to when this is so. An example arose with a scandal over "phished"[667] EU emissions allowances that resulted from fraudulent emails sent to owners of those allowances, asking them to re-register their allowances on fraudulent websites. The websites asked for account and other confidential details which, when provided, allowed those behind the scam to steal the allowances. There were questions that arose in numerous civil law jurisdictions over whether EU emissions allowances recorded on registers in countries which protect victims could still be used or traded.[668] One of the main European auction platforms for emissions, ICE Futures Europe, felt it necessary to ban transacting in emissions allowances, other than through the UK, German, Spanish and Netherlands registries,[669] since only those countries respected the *bona fide* purchase principle in such situations and so provided certainty as to ownership of allowances traded in the market.[670]

Cryptoassets and electronic signatures

The common law has been more easily able to adjust to numerous recent FinTech developments such as cryptoassets[671] and the use of electronic signatures,[672] with limited need for new statutory (or other code-based) intervention with all of the complexity which that creates in terms of having to map out in one shot all aspects of a future regime. The flexibility is crucial for situations where novel legal questions arise, such as with cryptoassets. One can compare for instance the Tokyo court's ruling that under the Japanese code Bitcoin was not property, with the result that the creditor of collapsed Bitcoin exchange Mt. Gox had no remedy.[673]

Misselling

Over the last 25 years, there have been a number of prominent UK cases in which banks have been sued for misselling. This is an area which has shown the common law to work well. Each case builds on the other and reinforces the law that in the wholesale markets, there is a strong *caveat emptor*

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if goods were openly sold in designated markets between sunrise and sunset, provenance could not be questioned and effective title of ownership was obtained. Or, the general protection of current rights from theft is exemplified in the Sale of Goods Act 1979, which provides that where goods are sold by a person who is not their owner, or without the authority or consent of the owner, the buyer acquires no better title to the goods than the seller has. However, this does not address equitable interests.

666 The UK has established several important registers to protect key asset classes, such as, in the context of securities, central securities depositories and custodians, or more generally, the Land Registry and a registry of motor vehicles.

667 "Phishing" is a term which describes a particular type of internet crime where fake internet websites are established, whose appearance is almost identical to the legitimate one. Unsuspecting customers are directed to the website where they are requested to enter personal information, in which case their financial information and passwords may then be stolen. This information can then be used illegally to transfer assets (or money).

668 *Guide to Carbon Trading Crime*, June 2013, Interpol.

669 At the time of the phishing attacks (2009-2010), the EU emissions trading system was based on national registries for EU allowance ownership. Since 2012, the registries have been consolidated into a pan-EU registry, run by the European Commission.

670 ICE Futures Europe Circular, Reintroduction of the ICE EUA Daily Futures Contracts and ICE CER Daily Futures Contract, 12/173, 4 December 2012.

671 See for instance the Singapore Court of Appeal decision in *Quoine*, the English High Court decision in *Re Bitcoin*, and the New Zealand case *Ruscoe and Moore v Cryptopia*, and the comments of the UK Jurisdiction Taskforce, fn 164 above.

672 *Golden Ocean Group v Salgaocar Mining Industries PVT Ltd* [2012] EWCA Civ 265, [2012] 3 All ER 842.

673 *Mt. Gox,* Judgment of Tokyo District Court, Civil Division 28 of 5 August 2015 (Year of Heisei 27). In response to the Mt. Gox scandal, Japan amended its Payment Services Act and Fund Settlement Law to make cryptocurrency legal tender and to require "virtual currency exchange platforms" like Mt. Gox to register with authorities. In China, the Hangzhou Internet Court has also legally recognised Bitcoin as "virtual property". And recently, the Shenzhen Futian District People's Court in Guangdong Province declared ethereum legal property in China. These Chinese decisions come despite general governmental antipathy towards cryptoassets. All are first instance decisions.

presumption, whilst in retail markets, customers must be given adequate information. In the business-to-business context, it was decided that whilst a bank negotiating and contracting with a party does not owe a duty to explain the nature or effect of the proposed transaction, if it does give an explanation or tender advice, it will then owe a duty to give that advice fully, accurately and properly.[674] In the business-to-consumer context, the Supreme Court decided that a failure to disclose to a client a large commission payment on a single premium payment protection insurance (PPI) policy made the relationship between a lender and the borrower unfair under the relevant consumer protection statute.[675] There is nothing like this clarity in continental European systems. We should however note that the FSA (the predecessor to the FCA and PRA) made this area somewhat more challenging with its Treating Customers Fairly (TCF) regime, which introduced requirements based on its general Principle that required firms to treat customers "fairly".[676] The issue with this concept is that fairness is in the eye of the beholder. The TCF regime now adopted by the FSA's successor, the FCA, is based on six consumer outcomes that the FCA expects firms to achieve for their retail customers, more detailed rules being set out in the FCA Handbook. The FCA is able to take enforcement action for breach of a particular rule, and also uses failure to achieve the six outcomes as a basis for regulatory action. Chapter 4, section 4.2 above explains how the UK regulators' adoption of the requirement to treat customers "fairly" has been applied in a manner that needs to be improved upon, but the point of comparison with civil law regimes over the clarity provided by the common law case law on misselling still stands.

Privilege

There have been several common law cases in the important area of legal professional privilege in the last few years, including the *Three Rivers* case,[677] which refined the scope of the privilege and applied it to new situations such as those involving email.[678] The concept is perhaps less significant in civil law jurisdictions since it evolved alongside the common law practice of disclosure of relevant documents in a dispute. Civil law systems generally do not require disclosure in the same way. Most will simply require the parties to provide those documents on which they respectively rely. This means that, although there are some analogous principles in civil law systems (lawyer-client correspondence will generally be subject to confidentiality obligations for example) they do not deal with quite the same considerations and challenges as common law doctrines of privilege. Furthermore, even in that context it is notable that civil law concepts of confidentiality with respect to client-lawyer correspondence do not generally extend to in-house lawyers, which can be seen to reflect a failure on the part of civil law regimes to reflect an increasing reliance by businesses on in-house counsel.[679]

As shown in many of these examples the common law is typically more reliable, more adaptable and more effective than when similar issues are addressed in civil law contexts.

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674 *Bankers Trust International Plc v PT Dharmala Sakti Sejahtera (No.2)* [1995] 12 WLUK 29, [1996] CLC 518.

675 *Plevin v Paragon Personal Finance Limited* [2014] UKSC 61, [2014] 1 WLR 4222, which related to section 140A of the Consumer Credit Act 1974.

676 The concept of treating customers fairly (TCF) appeared in the UK's Financial Services Act 1986 (now repealed). However, the FSA TCF initiative began in earnest in 2006, with the publication by the FSA of its paper, *Treating Customers Fairly - towards fair outcomes for consumers*. The EU's ISD of 1993 also included principles about firms acting fairly, but not on treating customers fairly in a manner which focuses on the outcomes achieved. The FCA focuses on outcomes as well as method.

677 *Three Rivers District Council & Others v The Governor and Company of the Bank of England* [2003] EWCA Civ 474, [2003] QB 1556.

678 See, for instance, *CAA v Jet2.com* [2020] EWCA Civ 35, [2020] QB 1027, *Sports Direct v FRC* [2020] EWCA Civ 177, [2020] 2 WLR 1256, which provided guidance on the application of privilege in the context of multi-party email correspondence copied to various recipients, as well as the correct approach when considering whether privilege attaches to emails and their corresponding attachments.

679 The English courts have recently, in the Business and Property Courts, launched a new pilot scheme for disclosure, in which the default position is much closer to that found in civil law jurisdictions—*i.e.* parties disclose only those documents on which they rely and which are necessary in order for the other party to understand the case against them: *see* Practice Direction 51U of the Civil Procedure Rules. That is not to say that the traditional approach to disclosure is no longer available, but any order for such 'extended disclosure' must now be justified by the parties: Practice Direction 51U, paragraph 6.

ANNEX 2: ANCILLARY AREAS OF EU LAW ADVERSELY AFFECTING THE FINANCIAL SECTOR

It is not just in the field of financial services regulation that the EU's approach contrasts with the common law approach and is detrimental to the financial markets. Ancillary areas of law are having a damaging effect on the financial system. Two of them will be considered here, data privacy and employment.

1. Data privacy law – common law versus civil law thinking

A particularly notable example is data privacy. The differences between civil law and common law systems are very much in evidence in the contrasting data privacy laws of the EU, based on a civil law approach, and those of California, which is probably the most comprehensive regime in the US and whose system is based on the common law. Both followed an internationally agreed attempt to set out various principles for data privacy, in 1980, under the auspices of the international Organisation for Economic Co-Operation and Development (OECD).[680] In the EU, the General Data Protection Regulation (GDPR) reflects a codification of the continental European focus on privacy from a perspective of principles and human rights.[681] In the US, the California Consumer Privacy Act of 2018 (CCPA) is the only data privacy law that is comparable to GDPR, and in fact has been called the "American GDPR." However, a closer look at the two laws reveals significant differences in approach and effects, which reflect differences between the legal systems from which these privacy laws developed.

The conceptual approach embodied by GDPR reflects a top-down approach that is usual in civil law systems.[682] It focuses on principles related to the processing of personal data.[683] It expressly embraces a "fundamental right" in the "protection of natural persons in relation to the processing of personal data".[684] So, derived from these starting points, GDPR imposes obligations on businesses in numerous ways. Instead of being free to use personal data in the absence of restrictions, businesses subject to GDPR (as "controllers" of personal data) must have a lawful basis for all their data processing activities.[685] The law grants various rights and protections to individuals (as "data subjects"), which may be exercised by way of requests to businesses, which businesses must respond to and accommodate.[686] It imposes requirements on businesses to keep personal data protected by a level of security that is appropriate to the risk to the data subjects.[687]

GDPR also affects the internal operations of businesses in several ways. In particular, businesses must not only comply with GDPR but must also be able to demonstrate their compliance.[688] Further, certain businesses are required to appoint a data protection officer, who must be involved in all issues relating to the processing of personal data, and who must monitor compliance with GDPR, among other

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680 OECD Guidelines on Data Protection, 1980. The Council of Europe, an international organisation, distinct from the EU, which has 47 member states and was founded in 1949 to uphold human rights, democracy and the rule of law in Europe, subsequently adopted the Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data ("Treaty No. 108"), 1981. This Convention has been subsequently updated and a new instrument on artificial intelligence has been added.

681 It was preceded by the Data Protection Directive 95/46/EC.

682 By contrast, under English law, breach of confidence evolved into a privacy tort – *i.e.* civil wrongdoing – prior to GDPR.

683 Listed at GDPR, Art. 5(1) and (2), the principles relating to processing of personal data are: (a) lawfulness, fairness and transparency, (b) purpose limitation, (c) data minimisation, (d) accuracy, (e) storage limitation, (f) integrity and confidentiality, and (g) accountability.

684 GDPR, Recital 1, referring to the fundamental rights provided in the Charter of Fundamental Rights of the European Union, Article 8(1) and the Treaty on the Functioning of the European Union, Article 16(1).

685 GDPR, Art. 6; see also Art. 9.

686 GDPR, Arts. 15-22.

687 GDPR, Art. 32.

688 GDPR, Art. 5(2).

responsibilities.[689] For multinational businesses, GDPR prohibits the transfer of personal data from the EU to countries outside the EU, unless certain conditions are met or adequate safeguards are provided for in the receiving jurisdiction by approved means.[690]

Under GDPR, businesses must also embrace data protection by designing their compliance systems to achieve the specified data protection principles[691] (taking into account a number of factors including the "state of the art"), and ensuring that, "by default", only personal data which are necessary for each specific purpose of the processing are processed.[692] Firms must also perform data protection impact assessments for data processing activities involving a high risk to data subjects.[693] Based on the results of a data protection impact assessment, a business may be required to consult with a supervisory authority, which is empowered to take pre-emptive actions against activities that it determines would infringe GDPR if carried out.[694] This represents, under GDPR, a possibility for administrative agencies to prevent businesses from acting, based on perceived risks to individual privacy.

As a result, collectively, the GDPR's requirements result in significant burdens on financial and other businesses operating in the EU and for businesses that wish to enter the EU market. The EU response to GDPR critics, which is a most notable reaction in Germany, is the response of a society that spent many decades under totalitarian dictatorships (Nazi and Communist). This history has had a profound impact on EU society in the present, leading to a high value being placed on protecting individual privacy. Many Europeans, especially Germans, would say that the way in which GDPR impinges on business is a small price to pay for the protections that it provides for privacy and individual freedoms.

In California, the CCPA, by contrast, reflects a less prescriptive, more business friendly approach that is more usual in common law systems, and its development—and later refinement—demonstrates an awareness of and sensitivity to commercial needs. The privacy protections embodied in the CCPA were originally proposed by individual activists, who sought to present the original version of the CCPA directly to California voters as a ballot measure[695] in November 2018. The activists reached a deal with the California legislature, which drafted and passed the CCPA with various changes from the original.

Similar to GDPR, businesses subject to the CCPA must respond to consumers' requests to exercise individual rights that are granted under the CCPA. However, overall, the CCPA imposes fewer requirements on businesses. Although it recognises that businesses have a duty to implement and maintain reasonable and appropriate security procedures and practices to protect personal information,[696] the CCPA does not directly require businesses to implement data security measures and does not impose prescriptive requirements as to how businesses go about implementing security or privacy compliance measures. The CCPA is not a wide-ranging law, unlike the GDPR. The CCPA is more specifically focused on providing certain consumer protections, such as by requiring disclosures to consumers regarding a business' personal information practices, rights to access or delete one's personal information, and a right to opt-out of the sale of one's personal information.[697] In addition, in contrast to the holistic application of GDPR to all or nearly all businesses, the CCPA recognises and exempts businesses in certain commercial sectors that are already subject to (what are seen as) adequate US data protection laws.

689 GDPR, Arts. 37-39.
690 GDPR, Arts. 44-49.
691 See fn 683 above.
692 GDPR, Art. 25.
693 GDPR, Art. 35.
694 GDPR, Art. 36.
695 Under California law, citizens can propose new laws to be voted on by ballot. The proponents of an initiative begin by circulating a petition. Once the requisite number of signatures is obtained and "qualified" by the Secretary of State, the proposed measure is approved to appear on an upcoming ballot. If the ballot measure is approved by California voters, the matter becomes state law.
696 Cal. Civ. Code § 1798.150(a).
697 See, generally, Cal. Civ. Code §§ 1798.100 to 1798.120, 1798.130 and 1798.135.

For example, firms that provide personal financial services, and that are already subject to data protection obligations under the Gramm-Leach-Bliley Act (GLBA),[698] are exempt from key provisions of the CCPA, except that there may still be a private right of action for data security breaches established under the CCPA.[699] GLBA applies to financial institutions when offering financial products or services to a consumer for personal, family or household purposes. It is a relatively targeted, limited law with respect to privacy, in comparison to GDPR. Like the CCPA, GLBA is directed toward consumer protections. Under GLBA, financial institutions must implement safeguards to protect the security and confidentiality of customer records,[700] provide a privacy policy when establishing a customer relationship,[701] and provide notice to consumers of any disclosures of non-public personal information to unaffiliated third parties, along with an option to opt-out of those disclosures.[702] Where financial institutions handle personal information for products and services other than in the personal, family or household context, the CCPA continues to apply.[703]

Further, in response to criticism and feedback from numerous stakeholders the CCPA was amended several times between its initial passage in 2018 and the time at which it came into effect, on 1 January 2020. Two amendments adopted in 2019 reflect a sensitivity to commercial interests that is more often a part of common law systems.[704] The amendments narrowed the scope of the CCPA in response to business concerns that the CCPA requirements were unduly burdensome and affected business operations beyond the needs of consumer protection.[705] The amendments excluded from key CCPA requirements the personal information that a business holds about its own employees and similar personnel,[706] as well as the personal information that a business gathers about employees and similar personnel of other businesses, in the context of providing or receiving business-to-business products or services, or conducting due diligence.[707]

The UK has had to apply GDPR whilst within the EU. It continued to be obliged to do so until the end of last year.[708] From the beginning of this year, until a new system is introduced, the UK will apply the copy of GDPR that was adopted in UK law to ensure legal continuity as part of leaving the EU.[709] It is likely that at some point GDPR will be replaced in the UK. The UK may introduce a replacement data privacy framework, with an approach that seeks to balance concerns of GDPR compatibility with

698 15 U.S.C. § 6801 *et seq*.
699 Cal. Civ. Code §§ 1798.145(e) and 1798.150.
700 15 U.S.C. § 6801.
701 15 U.S.C. § 6803.
702 15 U.S.C. § 6802.
703 Cal. Civ. Code §§ 1798.145(e). Financial institutions that provide services to institutional clients may still rely on the business-to-business exemption at Cal. Civ. Code. § 1798.145(n), discussed above.
704 Cal. Assembly Bills Nos. 25 and 1355 (2019). These amendments to the CCPA, referred to as AB-25 and AB-1355, established exemptions from CCPA obligations for personal data that are used solely in an employment context or in the context of business-to-business (B2B) transactions.
705 Cal. AB-1355, Senate Floor Analysis, Third Reading (Sep. 12, 2019), noting that the amendment is intended to address businesses' concerns, in operationalising the CCPA, that applying consumer rights to business transactions and communications will result in unintended consequences, by broadly exempting personal information used in that context from CCPA provisions. See also AB 1355, Assembly Floor Analysis, Concurrence in Senate Amendments (Sep. 12, 2019), noting that the B2B exemption will "prevent an employee from one business interfering with the due diligence efforts of another business."
706 Cal. Civ. Code § 1798.145(h).
707 Cal. Civ. Code § 1798.145(n). Under current law, the so-called "employee exemption" and "B2B exemption" will each expire on 1 January 2021. *Id.* at § 1798.145(h)(4) & (n)(3).
708 GDPR currently applies in the UK due to the UK having been a member state of the EU in 2016 when GDPR was passed. The UK's Data Protection Act 2018 provides, among other things, for the exemptions, derogations and restrictions available to member states under the GDPR. A UK version of GDPR came into force at the end of 2020, when the Brexit transition period came to an end. The UK's version of GDPR is essentially identical to GDPR. However, the UK is now free to adopt its own data privacy regime, subject to any restrictions on doing so which it may agree to with the EU or other jurisdictions.
709 The Data Protection, Privacy and Electronic Communications (Amendments etc) (EU Exit) Regulations 2019 (SI 2019/419) onshore the GDPR into UK law and also amend the Data Protection Act and other UK privacy-related legislation.

features that are more sympathetic to its own political values and reflective of the common law approach.[710]

2. Employment laws

There are other ancillary restrictions which cramp financial business, including employment laws designed more for an old fashioned industrial economy and less for high-end services provision. For instance, EU-inherited employment law has often, in practice, proved itself to be difficult to interpret in a clear and coherent manner in a modern commercial economy. One particular example is in relation to the EU Acquired Rights Directive.[711] This Directive plays a critical role in many mergers and acquisitions transactions (where those transactions are structured as the sale or purchase of assets) as well as in many situations in which services are outsourced to unaffiliated, third-party contractors. Despite its central importance, there has, for decades, been considerable uncertainty as to whether or not the Directive regime applies in some situations, particularly in the case of the outsourcing of labour-intensive services. Furthermore, although the Directive seeks to protect worker rights in the event of asset deals or outsourcings, in practice it does not reflect the commercial realities of many situations. So, on an asset sale, a purchaser will very often wish to adjust the employment terms of incoming staff, who are transferring to the new firm by operation of the Directive, onto its own staff terms. This is with a view to its entire workforce being employed on one standard set of terms, rather than having different groups of employees on different terms, with different employee benefits and so on. Such a commercial objective is entirely reasonable and yet under the Directive it is, technically, fraught with risk and uncertainty. It is unclear whether changing the incoming staff's employment terms, even with the consent of those employees, is valid or even possible.

[710] The UK may re-examine the OECD Guidelines 1980 and the Council of Europe "Treaty No. 108", fn 680 above, which it had implemented in its Data Protection Act 1984 prior to the application of the harmonised EU regime.
[711] Directive 2001/23/EC.

ANNEX 3: EU REGULATION MASKING AND PROLIFERATING EUROZONE RISK

This Annex sets out in more detail the examples referred to in section 2.3 of Chapter 2 of how EU financial regulation has been distorted to protect the fragmented legal structure of the Eurozone in a manner which creates financial risk for market operators and also investors and savers.

Controlling adverse ratings of EU member state debt

The EU has empowered the pan-EU supervisor, ESMA, to oversee credit rating agencies, allowing it to control adverse credit ratings of member debt across the EU as a whole. The Credit Rating Agencies Regulation[712] came into force after a series of downgrades by rating agencies of Eurozone member state government debt, and was intended by many of those framing the Regulation to permit ESMA to control the judgements of those rating agencies in a manner acceptable to the Eurozone.[713] This creates a conflict of interest for ESMA between a desire to act as a proper supervisor of rating agencies in the financial markets, and a need to preserve the Eurozone, placing severe limits on independent objective analysis of Eurozone debt.[714]

Controlling the downwards pressure created by short sellers on EU member state debt

The EU has introduced a power for its regulators to ban short selling of EU government bonds, which has been used to reduce the downwards pressure on the value of Eurozone bonds in particular.

The Short Selling Regulation[715] allows member state regulators to ban the short selling of government bonds (among other financial instruments), which in turn means there is a dampening effect on those wishing to sell short, hedge or take a negative view of the value of those bonds.[716] This reduces the ability of the market to adjust swiftly to events, and introduces undesirable market inefficiencies as well as increased risk.[717]

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712 Regulation (EC) No 1060/2009.

713 See *Managing Euro Risk*, fn 5 above, Chapter 5, Factor 5.

714 In the aftermath of the Eurozone crisis of 2009-2012, S&P, Moody's and Fitch were prosecuted criminally in Italy for destabilising Italy by downgrading Italian government debt; they were acquitted, but only after a trial: *Italy seeks trials over credit downgrades*, 12 November 2012, FT.com, www.ft.com/content/46ac9fae-2cbd-11e2-9211-00144feabdc0, *Milan judge drops rating reports case against Fitch*, 6 May 2016, Reuters, https://uk.reuters.com/article/italy-fitch-probe/milan-judge-drops-rating-reports-case-against-fitch-idUSL5N1832EU, *Rating agencies cleared in Italian manipulation trial*, 31 March 2017, Business Recorder, https://fp.brecorder.com/2017/03/20170331160845/. In the US, credit rating agencies and, in particular, the "issuer-pays" business model, came under scrutiny following the financial crisis: it was considered that companies paying ratings agencies for their own ratings created an inherent conflict of interest. The primary US legislation in this area is the Dodd-Frank Act 2010. Similar to the EU legislation in this area Dodd-Frank imposes independence, methodology and disclosure requirements on the agencies it regulates. However, a key difference between the two is that Dodd-Frank, unlike the Credit Rating Agencies Regulation, does not seek to remedy the problems of an "issuer-pays" model with an even more conflicted model where the issuers of rated debt—Eurozone governments—stand behind the regulator which regulates the rating agencies.

715 Regulation (EU) No 236/2012.

716 The very fact of these restrictions appears to reduce liquidity, as shown by the Association for Financial Markets in Europe's *European Primary Dealers Handbook* (published annually since 2008). Comparison of numbers per market over time shows a reduction of liquidity, although this does not include how much capacity each dealer has. These restrictions were instituted through various measures during the Eurozone crisis, which led to the downfall of MF Global and others. The effective cause of MF Global's collapse was in the event a fall in the market price of the risky Eurozone government bonds it was using as collateral in its repo-to-maturity strategy. The repo-to-maturity counterparties exercised margin calls to restore the loan-to-collateral ratio and the resultant liquidity issues, both directly as a result of meeting the margin calls and from the downgrade to junk when the ratings agencies caught wind of the trades, finished MF Global off.

717 Such bans were imposed in March 2020 in France, Italy, Spain, Greece, Belgium and Austria (all civil law countries) under the Short Selling Regulation, and attracted criticism, *e.g.* Jamie Powell, *Against the Short-selling ban*, 18 March 2020, FT.com, https://ftalphaville.ft.com/2020/03/18/1584523654000/Against-the-short-selling-ban/, citing academic

Encouraging central counterparties to accept Eurozone risk

The EU has created a regulatory incentive for CCPs[718] to accept additional risk from Eurozone member state bonds, which is then effectively borne by the global markets. EU law regulates EU CCPs, and also non-EU CCPs recognised by the EU as legitimate venues for EU customers to use for their clearing (which now includes UK CCPs, from the end of last year). CCPs are only permitted to accept cash or certain government bonds—including EU member state bonds, and UK and US government bonds—as collateral.[719] CCPs may themselves determine which issuers to accept. Some CCPs will not accept all EU member state issuers' bonds as collateral. EU law also requires the investment of cash held by CCPs into such assets and other high-quality "sovereign" debt instruments, but again CCPs may choose between these instruments when making their decisions.

Revisions to EMIR, known as EMIR 2.2,[720] enhance the ECB's role in the regulation of CCPs and include regulatory restrictions and processes for CCPs to change the kinds of sovereign debt (a term which includes EU member state debt) they will accept, allowing an EU-based CCP's college of regulators, which will generally include the ECB in its capacity as banking supervisor of large Eurozone banks,[721] to prevent a CCP from changing accepted collateral classes on risk grounds.[722] The aim is for the Eurozone to determine for itself the level of risk arising from its member states' debt. Because the members and users of EU CCPs and non-EU CCPs recognised by the EU are the main global financial institutions, a decision to force CCPs to treat such collateral as having an artificially high value would mutualise the risk of that mispriced collateral and offload the risk, through the CCP's members (for whom the CCP operates its collateral system), into the global markets—a highly dangerous move.[723] Christian Noyer, the former Governor of the Banque de France, made clear that CCPs' margining policies will be set to protect the euro area,[724] which clearly means the EU is likely to restrict the level

studies which indicate short selling bans do not work and in fact increase the probability of default and volatility in the targeted companies. Also, Carson Block, *Bans on short selling are handouts to the 'corporate socialists'*, 26 March 2020, FT.com, www.ft.com/content/ccf6b816-4e1c-4b01-8921-4d2cc5a4cf5a, which comments on the reduction in market liquidity and increased costs that short selling bans create. An example of detrimental effects of such a ban was seen when Germany announced a ban on naked shorts of bonds in the early days of the Eurozone crisis (2010), which resulted in sharp falls in share prices and severe volatility of the euro. Responding to the announcement, an analyst said at the time: "we are in for one hell of a ride. I am not saying we are going down the trashcan, but we have had a dose of the poorest European leadership imaginable" (K. Allen, *German short-selling ban sparks new euro crisis*, 19 May 2010, The Guardian, https://www.theguardian.com/business/2010/may/19/german-short-selling-ban.

718 For a description of the role of CCPs, see the text that surrounds fn 316 above.

719 European Market Infrastructure Regulation (EMIR), article 46, read with the related Regulatory Technical Standards (Commission Delegated Regulation (EU) No 153/2013).

720 Regulation (EU) 2019/2099 amending EMIR.

721 See article 18(2)(c) of EMIR, which includes, within the college, the competent authorities responsible for the supervision of the clearing members of the CCP which are established in the three member states with the largest contributions to the default fund of the CCP on an aggregate basis over a one-year period. The ECB's supervisory arm, which regulates significant Eurozone banks, will typically be covered by this provision. Under article 18(2)(h) the college will also frequently include the ECB as the "central [bank] of issue of the most relevant [EU currency] of the financial instruments cleared" – *i.e.* the euro.

722 See *Managing Euro Risk*, fn 5 above, Chapter 5, Factor 3.

723 Barnabas Reynolds, *EU-managed control of euro clearing is not viable*, 15 May 2017, FT.com, www.ft.com/content/64f5d320-3403-11e7-99bd-13beb0903fa3, rebutting the argument of various Eurozone politicians and central bankers that the Eurozone should be able to control euro clearing. This argument was effectively a response to CCPs having ceased to accept some Eurozone member state issuers' instruments, or haircutting them considerably, during the Eurozone crisis. Concerns were expressed that these haircuts resulted in market price reductions in certain Eurozone member state debt and a decrease in demand for that debt—A. Armakola, R. Douady, J-P. Laurent and F. Molteni, *Repurchase Agreements and Systemic Risk in the European Sovereign Debt Crises: The Role of European Clearing Houses* (2017) Université Paris1 Panthéon-Sorbonne (https://hal.archives-ouvertes.fr/hal-01479252v1), cited by ESMA in *Report on securities financing transactions and leverage in the EU*, 4 October 2016, ESMA/2016/1415. See also Stephen Morris and Patrick Jenkins, *Policymakers urge action on EU sovereign debt 'doom loop'*, 23 December 2018, Financial Times, and Isabel Schnabel, *Europe's banking union lacks the key element of deposit insurance*, 28 August 2018, Financial Times.

724 Quoted in Hawkes, A., *'London must lose euro trading': On eve of crucial Brexit talks, continental bankers close ranks threatening 83,000 jobs in City*, 17 June 2017, Financial Mail on Sunday. See also Barnier, quoted in the Daily Telegraph, 10 June 2020 as saying that London should not be a European hub after Brexit as this is not in the EU's interest.

of haircutting (*i.e.* discounting in value), or even the rejection, of Eurozone member state debt collateral by CCPs.

Offloading retail risk into the global markets

The EU has used procedures available under its bank regulation to offload the risk from member state retail (and other) depositors and investors onto the global markets. It has done so through the Bank Recovery and Resolution Directive[725] regime and its equivalent for ECB-regulated banks, the SRM.[726] These regimes give the EU authorities the power, in the context of the resolution of EU banks which are seen to be "failing or likely to fail", to "bail-in" creditors, *i.e.* incrementally to write off the bank's equity holdings and write down its subordinated debt, and then its senior debt, up to a point where this allows the bank to continue in business, whilst ensuring the protection of retail depositors up to a limit of €100,000 in their accounts.[727] In practice, the authorities have sought to manipulate the application of this regime for the purpose of targeting international wholesale investors by bailing-in their debt and avoiding the strict application of some of its rules so as to minimise the bail-in for local individual Eurozone member state taxpayers, as well as local retail investors in bank equity or debt and local depositors.[728] The action itself is driven by a desire to protect local investors.[729]

Discouraging cross-border intra-Eurozone bailouts

There is a lack of cross-border intra-Eurozone bank mergers and acquisition activity. This is because cross-border mergers could expose the acquirer, and other contributors to the deposit guarantee scheme of the acquirer's country, to the balance sheet, non-performing loans and any partiality in the application of law and regulation of the target bank and its domestic framework.[730] Also, were such cross-border takeovers to be allowed, for instance in the case of takeovers of firms in southern Eurozone countries, this would reduce significantly the ability of the target's country to raise capital by issuing bonds to its local financial institutions, since those institutions would become foreign-owned and controlled. This would deprive the state of ready buyers for its debt and reduce the state's ability to leave the Eurozone, were that ever to be politically desired.[731] There are separate factors also at play, for instance with the reluctance of the German or French regulators to countenance a merger of German and French banks, which is more of a power play as to who runs the combined bank, Frankfurt or Paris, and a wish to preserve national champion institutions for potential future Eurozone success.[732]

Permitting transactions which obscure the risk arising from Eurozone banks

The EU has permitted the use of securitisations by Eurozone banks of their non-performing loans in a manner that obscures the risk arising from those portfolios and muddies it with the relevant Eurozone member state's credit risk. The EU has enabled banks to securitise non-performing loans and repackage

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725 Directive 2014/59/EU.

726 Regulation (EU) No 806/2014.

727 See fn 320 above.

728 So, for instance, there has been a failure to apply a rule requiring the write-down of 8% of bank liabilities upon receipt of public monies (State aid) in numerous cases of EU bank resolution or recapitalisation, spanning Greece, Italy, Cyprus, Germany and elsewhere: see *Managing Euro Risk*, fn 5 above, Chapter 5, Factor 1.

729 Such a motivation is not unknown elsewhere. Iceland notoriously privileged local depositors in direct response to bank runs during the 2007-2008 crisis (P. Baudino, J.T. Sturlson, J-P. Svoronos, *The banking crisis in Iceland,* March 2020, Financial Stability Institute, https://www.bis.org/fsi/fsicms1.pdf). For discussion of local depositor preference in the US, see fn 74 above. However, the position for the Eurozone is different. The effects of prioritising local investors and depositors within the Eurozone add to the systemic risk the zone creates for others by displacing more risk elsewhere.

730 See fn 322 above.

731 See *Managing Euro Risk*, fn 5 above, Chapter 5, Factor 2. Another factor, as noted in *Why the euro zone hasn't seen more cross-border bank mergers*, 12 June 2018, The Economist, is that three-fifths of Eurozone banks' holdings of corporate and governmental bonds are from their home countries. This concentrated exposure to banks' home governments' bonds provides a bottleneck to cross-border bank mergers and acquisitions, with the Eurozone lacking a common safe asset to break this doom loop.

732 This tendency has so far proved to be enduring in certain member states. For instance, it was observed in *A Big, and rare, European bank merger*, 15 June 2005, The Economist.

them, with guarantees by the relevant Eurozone member state where the borrowers are located. The originating banks are allowed to treat themselves as no longer exposed to those non-performing loans. EU law then permits EU banks to hold the securitised loans at a level reflecting a risk-free, sovereign treatment of the Eurozone member state guarantee, not taking into account the true credit risk arising from that guarantee. The approach was pioneered by Italy[733] and was subsequently used by Greece in the "Hercules" programme.[734] Yet in these cases the relevant member state providing the guarantee was itself only ranked as investment grade (Republic of Italy) or speculative grade (Republic of Greece) in its creditworthiness.[735]

So for instance, the Greek "Hercules" programme, approved by the European Commission,[736] to securitise the €75 billion nominal of non-performing loans in the Greek banking system, allowed those loans to be sold by the bank that generated them to a special-purpose securitisation entity, which then issued tranches of bonds to finance the purchase. Under the programme large volumes of the senior tranches of the bonds are guaranteed by the Republic of Greece toward their holder. This allows for the release of the entirety of the €10.5–14.0 billion of common equity tier 1 capital (which is a measure that shows how well a bank can withstand financial stress and remain solvent) that was tied up behind the non-performing loans.[737]

Proposed mutualisation of Eurozone risk for the global financial sector

A further mutualisation of Eurozone risk across the global financial sector is proposed through a European Deposit Guarantee Scheme (EDIS),[738] which would mutualise the effects of a failure of a Eurozone bank by sharing losses for local deposit-takers across the banking community operating within the Eurozone as a whole. The Scheme would be pre-funded by the EU subsidiaries of global firms, alongside local firms. In the context of Brexit, the EU has been trying to ensure that international financial firms operate to provide services and products to EU customers from places of business within the EU itself. Particular pressure is being applied in favour of Germany and France, both of which are within the Eurozone. However, the Scheme would increase the exposures to Eurozone financial risk of international banks operating through subsidiaries in the EU.[739] Moreover, although it is the case that, in general, EDIS is essential for a single banking market, as things stand the EDIS would create an additional degree of moral hazard, given the shortcomings of the construction of that market.[740] This is because local regulators would be further incentivised to protect their institutions as the ones purchasing many of their member state's bond issues, given that third-party monies contributed to the Scheme would be used to bail out their local bank depositors.

733 The Republic of Italy agreed to provide €12 billion of guarantees to assist with securitisation of non-performing loans. See *Italy: Liquidation of Veneto Banca and Banca Popolare di Vicenza*, 12 July 2017, Economic Research Department, BNPParibas, https://economic-research.bnpparibas.com/html/en-US/Liquidation-Veneto-Banca-Banca-Popolare-Vicenza7/12/2017,30109.
See also https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr170623.en.html.

734 See https://europa.eu/rapid/press-release_IP-19-6058_en.htm.

735 https://tradingeconomics.com/greece/rating.

736 See https://europa.eu/rapid/press-release_IP-19-6058_en.htm.

737 See *Managing Euro Risk*, fn 5 above, Chapter 5, Factor 4.

738 See Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme, COM(2015) 586 final, 24/11/2015.

739 See *Managing Euro Risk*, fn 5 above, Chapter 5, Factor 6.

740 See fn 475 above and accompanying text.

ANNEX 4: ENSURING INTERNATIONAL ARRANGEMENTS RESPECT UK SOVEREIGNTY WHILST ENHANCING THE RECOGNITION OF UK COURT JUDGMENTS

The UK must make certain that any new arrangements entered into at an international level preserve its sovereignty whilst also expanding commercial opportunities and buttressing the court system central to the system of law which supports its competitive advantage in financial services. The UK should also seek to enhance the application of its common law system. This involves:

- *not fettering its rulemaking ability by arrangements in any international treaty*, which restrict the UK's ability to legislate, make rules and regulations and to supervise financial firms in its absolute discretion—except in so far as the UK is part of an international body that agrees key international standards;

- *encouraging the international recognition of the judgments* of UK courts for financial services matters, assisting further in the evolution of case law precedent.

1. Ensuring that international arrangements do not fetter UK sovereignty, and responding to the EU's political (not risk-driven) approach

As the 2020 UK-EU Trade and Cooperation Agreement has shown, it is unnecessary for the UK to bind itself to civil law or EU legal methodology and thinking in its relationship with its future trading partners.[741] It would also be undesirable as a matter of principle for the UK to do so.[742] Transnational law, at least as practised in the EU, can be seen to be at odds with the necessity for self-government that is fundamental to the UK's democratic tradition and its protection of liberty.[743] The task in any future negotiations is to explore and agree a basis for financial services trade consistent with that necessity.

The potential for financial services trade or regulatory arrangements to constrain the UK's sovereignty and approach to the law

Central to the analysis is the principle that no regulatory alignment with foreign (including EU) standards or methods of thinking should be agreed by the UK or arrangements entered into which are interpreted by a foreign court (including the CJEU). Such agreement would reduce or remove the UK's ability to reclaim its common law (and Scots law) method. Future financial services trade deals under international (WTO) law, whether as chapters of a free trade agreement (FTA) or by way of a mutual recognition agreement (MRA), must ensure the UK's legal and regulatory system is not constrained. The UK should therefore seek the recognition of its laws, regulations and supervisory processes without restrictions on the operation of common law principles. This will allow foreign countries to rely on the probity of the UK's arrangements. If properly established, UK-based financial services institutions would provide their services and products, cross-border from the UK, without duplicative regulation in the foreign country or without UK-based financial institutions being obliged to provide those services from foreign-based subsidiary operations, adding cost and expense to their sales.

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[741] See Rachel Russell, *ERG star chamber verdict in FULL: Read exactly why Brexiteers back Boris's Brexit deal*, 29 December 2020, Daily Express. The author was a member of the so-called Star Chamber and co-authored this opinion for Members of Parliament on how the UK-EU Trade and Cooperation Agreement 2020 complies with UK sovereignty.

[742] "But if we are to be told by a foreign Power... what we shall do, and what we shall not do, we have Independence yet to seek, & have contended hitherto for very little": George Washington's letter to Alexander Hamilton, 8th May 1796, https://founders.archives.gov/documents/Washington/99-01-02-00497.

[743] For a purist explanation, see, for instance, J Rabkin's *Why Sovereignty Matters* (1998) AEI Press, *Law Without Nations? Why Constitutional Government Requires Sovereign States* (2005) Princeton University Press, and *The Case for Sovereignty: Why the World Should Welcome American Independence* (2003) AEI Press. Indeed similar (but lesser) concerns arise over the UK being a signatory to the European Convention on Human Rights 1950.

There are various EU financial services regulations which contain so-called "equivalence" provisions. These provide that financial services firms can avoid duplicative or prohibitive EU law, regulation and supervision for cross-border business where the laws of their home state achieve equivalent outcomes to those of the corresponding EU law and regulation. After Brexit, the UK and the EU are considering unilateral declarations of equivalence under their respective regimes and are negotiating a Memorandum of Understanding for a framework for future financial services cooperation.[744] As it is, the EU already has equivalence-based arrangements with numerous countries, and unilateral declarations for the UK are likely to be forthcoming.

However, for the UK a tighter, more predictable and reliable arrangement than unilateral equivalence declarations would be preferable. Once the Brexit politics have died down, the EU should in due course be willing to give "access" to its market for UK-based financial businesses under a more ambitious model known as Enhanced Equivalence, as proposed by the author and by the UK Government in the Brexit negotiations with the EU.[745] Such an approach is not only possible but can relatively easily be put in place and a draft outline for such a treaty and regulatory text has been submitted to ministers in the context of the Brexit negotiations.[746] Only then could the UK continue to mitigate Eurozone risk on behalf of itself and the global financial market in the cheapest way, since UK financial firms would not be operating through EU subsidiaries and so the costs of those subsidiaries, and the exposures of the UK firms to their subsidiaries, would not need to be accounted for or charged back to EU customers (see Chapter 2, section 2.4). Under such an arrangement:

- The parties would enter into a binding agreement which would provide for equivalence in both directions, on a sub-sector by sub-sector basis, so long as each party's laws achieve similar high-level outcomes.[747] This could be achieved by making minor adjustments to the existing concept of equivalence as understood in EU law, which would be to the EU's benefit in that overall cost savings would arise for the EU in its access to the UK's global market.[748]

- Such an arrangement would enable UK financial businesses to sell their services and products cross-border to EU customers, but only under UK law.

- For wholesale business, the UK's financial laws, regulations and rules would be recognised by the EU so long as these are compliant with international standards. The arrangement would require the UK's regime to achieve high-level outcomes equivalent to those of EU law, assessed principally by reference to the international Basel Rules[749] – which contain standards with which the UK system already complies.[750] The UK would offer the same arrangement to the EU. No line-by-line comparison or more detailed accreditation of the UK's system would be needed. Interestingly, the EU has agreed to apply the Basel Rules

744 UK and EU Declarations, 30 December 2020, which include: "[t]he Parties will discuss, inter alia, how to move forward on both sides with equivalence determinations between the Union and United Kingdom, without prejudice to the unilateral and autonomous decision-making process of each side."

745 Barnabas Reynolds, *A Template for Enhanced Equivalence: Creating a Lasting Relationship in Financial Services between the EU and the UK* (2017) Politeia, a proposal subsequently adopted by the UK Government in its post-Chequers White Paper (HM Government, *The future relationship between the United Kingdom and the European Union*, 12 July 2018, CM 9593, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/786626/The_Future_Relationship_between_the_United_Kingdom_and_the_European_Union_120319.pdf). See also Barnabas Reynolds, *Free Trade in U.K.-EU Financial Services – How Best to Structure a Brexit Free Trade Deal* (2018) Politeia; *EU-U.K. Financial Services After Brexit: Enhanced Equivalence – A Win Proposition* (2018) New Direction / Politeia and *How to Leave the EU: What's Best for Britain, Best for the EU?* (2017, 2018) New Direction-Politeia.

746 See fn 745 above.

747 *A Template for Enhanced Equivalence*, fn 745 above.

748 See fn 745 above.

749 See fn 75 above.

750 The UK led the way in creating the Basel Rules: see fn 75 above. Notably, the EU has applied the Basel Rules more restrictively than required, in that the Rules themselves were only designed for internationally-active banks, and yet the EU applies them to all banks, though not in respect of the crucial Eurozone issues (see Chapter 2, section 2.3).

and other international standards in the UK-EU Trade and Cooperation Agreement 2020, although how the EU intends to fulfil this obligation (given its relaxation of the Basel Rules for the Eurozone) remains unclear.[751]

- For consumer business, the recognition for specific businesses would be conditional on compliance with host state regulations governing consumer sales – *i.e.* the rules applicable in the state in which the consumer is located.

- There would be arrangements for collaboration between the UK and EU authorities, including on new initiatives, and a presumption of equivalence on any new measures—given the fact that Eurozone risk seeps across all financial services and the UK needs to have predictable levers across each area if it is to give the EU the cheapest form of access to its global market.[752] There would also be binding, independent arbitration on equivalence decisions.[753] Any withdrawal of an equivalence determination would be only for the relevant sub-sector in which equivalence is no longer achieved.

- In addition, if the EU wishes to continue the previous special arrangements that the UK offered within the EU legal order, whereby the UK has mitigated Eurozone risk on behalf of itself and the global financial market, it would be possible to do so whilst respecting the UK's sovereign independence. The UK could potentially make an accommodation to the EU, involving a continued recognition of its practice of disapplying the Basel standards for member state debt (see Chapter 2, section 2.3 above), so long as the future arrangements are sufficiently predictable and transparent (at least to UK authorities) to enable the UK to mitigate the overall risk.

Proposals have been made that a relationship be established with the US along the same lines, with adjustments for the US system.[754]

The latest EU framework for 3rd country equivalence arrangements for derivatives central counterparties

The EU's thinking on equivalence has recently evolved but is compatible with such a model. The new EU delegated regulations on the comparability and tiering criteria for third-country CCPs[755] under EMIR, EMIR 2.2, provide a new and interesting prototype for an enhanced EU equivalence framework

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751 The UK-EU Trade and Cooperation Agreement 2020 contains a "best endeavours" commitment for the parties to implement certain international standards, including those of the Financial Stability Board; the Basel Committee on Banking Supervision (in particular its "Core Principle for Effective Banking Supervision"); the International Association of Insurance Supervisors (in particular its "Insurance Core Principles") and the International Organisation of Securities Commissions (in particular its "Objectives and Principles of Securities Regulation"): Article SERVIN.5.41. As explained in Chapter 2, section 2.3, the EU does not in fact apply the Basel standards, at least on a purposive interpretation, to its treatment of risk arising from the Eurozone, so the commitment to apply those standards in this Agreement is intriguing.

752 *A Template for Enhanced Equivalence*, fn 745 above.

753 *Ibid.*

754 The author has proposed that a relationship be established with the US similar to his Enhanced Equivalence proposal for the EU relationship, with adjustments for the US system: Barnabas Reynolds, *Evaluating the Opportunity for US-UK Financial Services Trade Liberalization*, 16 December 2020, Mercatus Center. The author has also drafted the Treaty text which would implement this proposal: see the financial services Annex in D. Ikenson, S. Lester, and D. Hannan, ed., *The Ideal US-UK Free Trade Agreement: A Free Trader's Perspective* (2018), Washington, DC: Cato Institute.

755 Commission Delegated Regulation (EU) 2020/1303 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to the criteria that ESMA should take into account to determine whether a central counterparty established in a third-country is systemically important or likely to become systemically important for the financial stability of the Union or of one or more of its Member States and Commission Delegated Regulation (EU) 2020/1304 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to the minimum elements to be assessed by ESMA when assessing third-country CCPs' requests for comparable compliance and the modalities and conditions of that assessment.

in areas sensitive to systemic risk, and illustrate the way in which, despite tendencies to the contrary, the EU ultimately seeks a pragmatic approach to the recognition of third-country laws.

- *The background.* EMIR 2.2 introduced a two-tier system for the regulation of third-country CCPs, whereby ESMA, the European Supervisory Authority responsible for the securities markets,[756] will categorise each CCP as either a non-systemically important CCP (a Tier 1 CCP) or a systemically important CCP (a Tier 2 CCP). In addition, any CCP that is considered to be "of…substantial systemic importance", will not be granted recognition at all and would be required to establish itself in the EU in order to provide clearing services in the EU, although this point is a political one, since there is no clear mechanism for procuring (or indeed any ability to procure) such an outcome.

  Tier 1 CCPs will continue to operate under EMIR's existing equivalence framework. CCPs in Tier 2 must comply with a stricter set of standards involving an extensive assessment of the prudential[757] and conduct of business regulation, governance and margin requirements that are applicable to EU CCPs and will be subject to direct supervision by ESMA to some degree. EMIR 2.2 sets out the criteria that ESMA must take into account when deciding into which tier a third-country CCP falls (so-called "tiering"). The Commission's delegated regulation, which provides more detail of how the tiering system will work, establishes a new *de minimis* test based upon quantitative thresholds, which aims at taking many third-country CCPs out of ESMA's tiering assessments entirely (whereas ESMA would have subjected all third-country CCPs, globally, to onerous information production processes).

- *Comparability.* Under a new test known as "comparability", which goes further than the traditional "equivalence" concept (in a call for closer alignment), a Tier 2 CCP may be assessed as complying with the requirements applicable to EU CCPs (as set out in EMIR) if it complies with comparable requirements in its own country.[758] The Commission's delegated regulation, which provides more detail under this regime, is relatively proportional, transparent and predictable in result. In particular:

  - it requires ESMA to rely in the first instance on published information and existing assessments by CCPs of their compliance with the standards of the International Organization of Securities Commissions (IOSCO);

  - instead of involving a line-by-line literal assessment by ESMA of whether EMIR (and its technical standards) have been enacted into third-country laws (as proposed by ESMA), they have been drafted as a set of high-level principles, summarising key principles of EMIR, which third-country CCPs must satisfy.

- *Rejection of a restrictive approach.* Significantly, the Commission took on board very little of ESMA's technical advice for a hugely extensive application of both the tiering and comparability regimes, and effectively rebuked ESMA for attempting to legislate so widely to expand its powers and remit by requiring extensive information from third-country CCPs.

Less helpfully, the forthcoming changes to the EU's equivalence regime for third-country investment firms providing wholesale investment services into the EU should be noted. These involve onerous reporting to ESMA at the point of registration and annually.[759]

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756 See fn 195 above and the surrounding text.
757 See fn 172 above.
758 Article 25(2c), EMIR.
759 The changes to the equivalence regime third-country investment firms under MiFIR (fn 179 above) will apply across the EU from 26 June 2021.

The necessity for political will – and an understanding of the options

However, to achieve a satisfactory outcome for mutual recognition of standards, using some form of Enhanced Equivalence arrangement, strong political will may be required. Whatever the manner in which future arrangements are ultimately couched, the UK should not subject itself to mechanisms which control the content of UK financial services law or regulation, or which seek to control the exercise of UK supervisory powers. In the Brexit negotiations the EU not only resisted the recognition of UK laws and regulations as a negotiating ploy but it also sought to control future UK rulemaking in financial services after the end of 2020, when the transition period came to an end.[760] This is despite the UK leaving the EU's legal framework at that point. In fact, some of the EU proposals, including in their proposed post-Brexit relationship deal, went even further, requiring the UK to apply EU law as an unmovable floor in return for access, and essentially prohibiting any "better regulation" agenda being pursued in the UK.[761] In the context of wider trade, the EU and its spokespersons have been trying to fetter the UK's future discretion by discussing the concept of a "level playing field", whereby (on the EU's version of this concept) EU law would apply in the UK—or, in the financial services context, law almost identical to EU law would apply. This is ironic since it is the EU law arrangements for the Eurozone which create an unlevel playing field.[762] The EU's real concern is a financial market which it does not control and, especially, its inability in particular to control sentiment towards the euro currency, in its fragile and half-built state. However, this impropriety cannot be accommodated. The result would also be that businesses would operate without any benefits arising to the UK from its own system.[763] As can be seen in the present work that would involve overriding the essential—and superior—nature of UK law. The UK cannot agree to this and has not done so. The EU's contention that EU law needs to be applied in the UK should always be rejected, since this would exacerbate the risks arising from the Eurozone's legal arrangements for savers and investors worldwide. There may be particular rules the UK could maintain which happen also to suit the EU or its other trading partners, but the UK needs at all times to retain the discretion to remove or replace those rules; and it must not enter into arrangements which would make doing so a point of major market upheaval, with the result that there would be a disincentive from its ever taking such a step.

A similar response should be given to EU attempts to exert control over UK financial regulation through its use of unilateral equivalence declarations, which the EU is considering making now that the UK is out of the EU scheme. The EU has been endeavouring to use its equivalence provisions in a confrontational manner, to ends similar to those of the level playing field concept.[764] Indeed, the EU has indicated that unless the UK adopts financial laws and regulations satisfactory to the EU, the UK will not benefit from any market access to the EU's markets for financial institutions seeking to sell their services and products to EU customers through these equivalence mechanisms, after they ceased to be entitled to do so (by virtue of the EU financial services passport) at the end of last year.[765] The

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760 See fn 340 above.

761 The idea that the UK must meet a minimum regulatory floor set by the EU, which has been somewhat disingenuously named "dynamic alignment", was approved as the EU's mandate for negotiation with the UK in a European Parliament Resolution on 7 February 2020 (2020/2557(RSP), https://www.europarl.europa.eu/doceo/document/B-9-2020-0098_EN.html). The Resolution explicitly sets its sights on any attempt by the UK to gain a competitive advantage by improving upon the EU's regulatory environment: "[the EU] need[s] to ensure that the UK does not gain unfair competitive advantage through the undercutting of levels of protection and [needs to] prevent regulatory arbitrage by market operators", *ibid.,* Recital 13.

762 See fn 327 above.

763 *E.g.* speech by European Commission President von der Leyen, *Old friends, new beginnings: building another future for the EU-UK partnership*, delivered at the London School of Economics on 8 January 2020, available at https://ec.europa.eu/commission/presscorner/detail/en/speech_20_3.

764 See fn 340 above. This is highly questionable as a matter of international standards. IOSCO said, in guidance published on 26 June 2020, that the EU's current equivalence regime fails to conform in two key areas: it does not allow appeals against its decisions, and can be withdrawn at 30 days' notice. Deference arrangements should also be sufficiently flexible to allow an assessed jurisdiction to make changes to its regulation without risking having a decision revoked.

765 Michel Barnier, the EU's negotiator, declared in February in Strasbourg that "there will be no open-ended provision for financial services 'equivalence' as a result of the upcoming talks over the two sides' future relationships", reported in Financial Times (Mehreen Khan and Sam Fleming, *Brexit: Barnier rebuffs UK pitch for 'permanent equivalence' in financial services*, 11 February 2020, FT.com, www.ft.com/content/34ab4fb8-4cbc-11ea-95a0-43d18ec715f5. The European Commission has made such statements as: only equivalence decisions "necessary to safeguard the financial

EU has therefore been trying to impose its rules on the UK by making its equivalence declarations for the UK conditional on being bound by EU rules, and otherwise forcing the UK's global financial businesses to provide some of their services to the EU's customer base by means of EU subsidiaries. The UK rightly rejected any use of EU law in this context too.

If no Enhanced Equivalence arrangement is agreed, the UK's financial businesses will need to sell, cross-border, to EU customers under any equivalence arrangements unilaterally declared by the EU. Or, if these are not forthcoming, UK firms will need to sell some services and products through EU places of business under EU law. The consequent costs would need to be charged back to EU customers.[766] It is unnecessary—and undesirable as a matter of principle—for the UK to bind itself to EU legal methodology and thinking now that it has decided to release itself from this. No such steps are required for the approach set out in Chapters 4 and 5 above to be successful, nor for the UK system to be capable of operating efficiently with the future EU legal and regulatory regime. The value to the UK of market access to the EU—and certainly on such terms—does not justify foregoing the innate advantages of the common law. Even more importantly, any such approach would introduce considerable risk into the UK's financial regulatory framework since the UK would no longer be able to legislate and regulate dynamically for this evolving industry sector.[767]

What is more, despite its posturing, the EU is eventually likely to recognise the UK regime, at least unilaterally, as equivalent, whatever the shape taken by UK law and regulation.[768] The EU needs easy access to the global financial market hosted in the UK if it wishes to access global capital flows in the cheapest manner and to avoid unnecessary costs of EU-based intermediary entities, with all the capital and regulatory expense that they would impose. The financial impact of COVID-19 only makes this more acute. The EU law architecture for the Eurozone is highly risky, exposing Eurozone member states to the risk of default and the EU's financial system to reliance upon risky member debt as one of the main available "liquid" financial assets for EU financial institutions to hold. The EU has managed to keep this show on the road by applying legal fictions and accounting techniques that do not pass muster in the international community. The EU is likely over the next few decades to need the UK's help and easy access to its global market arising from a lack of EU restrictions and costs imposed on UK-based financial firms. This would allow it to continue its journey to Eurozone integration with the support of the UK in ensuring it has the cheapest possible access to the global financial market. The UK would continue to mitigate Eurozone risk, since the UK is where the EU meets the global market. The EU would be given breathing space to decide, over the next decades, whether and how to integrate further so that the euro currency arrangements, and the legal and regulatory arrangements underpinning those, become normalised. At that point the risk arising from the present structures would disappear

stability in the EU27" would be issued in favour of the UK (European Commission Communication, *Preparing for the withdrawal of the United Kingdom from the European Union on 30 March 2019: Implementing the Commission's Contingency Action Plan,* 19 December 2018, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX%3A52018DC0890. See also Barnabas Reynolds, Thomas Donegan, Sandra Collins, *The EU-UK Future Relationship: EU Announces its Timetable for Cross-Border Equivalence in Financial Services*, 15 January 2020, Shearman & Sterling, https://www.shearman.com/perspectives/2020/01/eu-uk-future--eu-announces-timetable-for-cross-border-equivalence-in-financial-services--brexit).

766 See *The Art of the No Deal*, fn 1 above, for how the UK can continue to operate its financial market successfully anyway. See also, *A Blueprint for Brexit*, fn 1 above. Also, the rapid development of FinTech means that customers are likely increasingly to operate autonomously to access financial services cross-border from their smart devices, regardless of any attempts by their national legislators to require particular methods of access, allowing the UK to operate as a global hub for retail financial services as much as for the wholesale markets.

767 Sir Jon Cunliffe, Deputy Governor of the Bank of England for Financial Stability, has stated "self-evidently, the UK cannot outsource regulation and supervision of the world's leading complex financial system to another jurisdiction": Sir Jon Cunliffe, *Governance of Financial Globalisation*, speech to the German Economic Council Annual Finance Conference, 11 February 2020 (*https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/governance-of-financial-globalisation-speech-by-jon-cunliffe.pdf*).

768 See *A Blueprint for Brexit* and *The Art of the No Deal*, fn 1 above.

and the risks of dealings with and within the zone would be just like those for the UK or US. But given the costs, that is likely to be a long way ahead.[769]

2. Enhancing the UK's case law system through arrangements for the international recognition of UK court judgments

At present there is no common set of rules in place for the recognition of court judgments in the broad international context, although a number of bilateral arrangements between specific countries, and regional multilateral arrangements, exist. However, these are generally limited in scope and insufficient for international business needs.

Arbitration

Furthermore, one reason for the reduction in case law precedent over and above those already mentioned[770] is the increasing use of international arbitration. By any measure, arbitration has enjoyed incredible success in the past half century as a means of resolving international disputes. One of the principal reasons for this success is the existence of a workable multilateral regime for the recognition and enforcement of arbitral awards internationally, the New York Convention 1958. This applies to any international arbitral award from a contracting state and not just those in the financial sector. Today, there are 165 parties to the New York Convention,[771] including (as from 1975) the UK,[772] each of which has agreed to recognise and enforce foreign arbitral awards in its domestic courts, subject only to certain very limited exceptions.[773] The New York Convention has a built-in pro-enforcement bias, imposing on national courts a presumptive obligation to give effect to foreign awards.

A major benefit of arbitration is also that the proceedings are confidential, which means that commercial parties need not air their dirty linen in public. However, this attractiveness is counterbalanced by the fact that by its nature, this results in no case law being developed. There may be no right of appeal[774] and the sophisticated powers, formalities and checks and balances that exist within a court-based system are lacking.

Judgments

There is a strong regime for the mutual recognition and enforcement of judgments between EU member states under EU law.[775] However, there is no one equivalent international recognition instrument in widespread use for commercial (including financial services) court judgments. The 2005 Hague Convention on Choice of Court Agreements,[776] which entered into force in 2015, goes some way to addressing the matter. It provides a framework of rules around jurisdiction for business-related civil or commercial disputes which are subject to a valid choice of court agreement, unless the dispute is purely

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769 The stresses on the EU's position are likely to be exacerbated by the considerable expense to member states of coping with COVID-19, and the political reluctance in the northern Eurozone to provide more than a limited bailout of the southern Eurozone.

770 See Chapter 3, section 3.3 above.

771 Convention on the Recognition and Enforcement of Foreign Arbitral Awards, New York, 10 June 1958.

772 The EU is not the signatory for the New York Convention. It is the individual member states who are the signatories. The UK's membership of the New York Convention is therefore current and unaffected by its departure from the EU.

773 Article V.

774 In most leading arbitral jurisdictions, there is no appeal to an award for error of law. This is true, for example, in France (Art. 1518 and 1520 of the French Code of Civil Procedure), Switzerland (Art. 190(2) of the Swiss Law on Private International Law) and Sweden (Section 34 of the Swedish Arbitration Act). It is also true in jurisdictions whose arbitration laws are based on the UNCITRAL Model Law (a model arbitration law produced by the United Nations Commission on International Trade Law). The UK is one of the few jurisdictions that in certain circumstances allows an appeal on a point of English law (Section 69 of the Arbitration Act 1996), unless the parties have waived that right in their arbitration agreement or through their choice of institutional rules (e.g. ICC Rules and LCIA Rules).

775 For example, Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters.

776 The Convention of 30 June 2005 on Choice of Court Agreements, produced under the auspices of the Hague Conference on Private International Law, www.hcch.net.

domestic (*i.e.*, it is between parties in one single country where all aspects relevant to the dispute are connected only with that country). Parties under the Convention recognise a choice of court agreement between parties where this is an "exclusive" choice of a particular court. Courts not chosen in the agreement will stay all proceedings, unless the chosen court refuses to uphold the choice of jurisdiction. Other contracting states will recognise and enforce the judgments of the chosen court. This Convention has, to date, only been signed by the EU, Mexico, Singapore, Denmark and Montenegro,[777] and now the UK following Brexit.[778]

There is also a new 2019 Hague Convention on the Recognition and Enforcement of Foreign Judgments[779] which would, when ratified, regulate more fully the recognition and enforcement of civil and commercial court judgments as between contracting states.[780] This represents a natural evolution of the 2005 Convention, providing for much broader recognition and enforcement of judgments. It covers judgments across wide areas of civil and commercial law, regardless of how the dispute arose. Given the EU's stated preference to accede to the Convention in the future, this may offer the UK an alternative means of providing for the recognition and enforcement of judgments as between the EU and the UK. Although the 2019 Convention, unlike the 2005 Convention, does not address issues of jurisdiction, the Hague Conference on Private International Law (HCCH)'s Council on General Affairs and Policy has indicated that work has already begun on a new instrument to address further issues of jurisdiction in cross border disputes.[781]

As a result, whether or not a judgment issued by a court in the UK will be capable of being enforced against the judgment debtor's assets abroad will depend on whether the judgment arises from a dispute where the UK courts were the chosen forum and the country in which enforcement is sought is a signatory to the 2005 Hague Convention, or whether the UK has in place any bilateral or multilateral arrangement with the country in which the assets are located against which enforcement is sought or, failing that, whether local law will facilitate enforcement for other reasons.

Where an arrangement exists, it may be that *exequatur*[782] (a writ of execution or enforcement) can be given on the judgment quickly and easily. Where none exists, the award creditor may need to bring a new substantive action before the enforcement courts. This is not to say that parties must start from scratch, however, as these proceedings are typically brought as a claim on a debt evidenced by the foreign judgment and, in most jurisdictions, the local court will simply have regard to the local criteria for the recognition and enforcement of the foreign judgment, rather than the merits underpinning it.[783]

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777 https://www.hcch.net/en/instruments/conventions/full-text/?cid=98

778 On 28 September 2020, the UK deposited an instrument of accession for the 2005 Convention, which took effect at 11pm on 31 December 2020: https://www.hcch.net/en/instruments/conventions/status-table/notifications/?csid=1318&disp=resdn.

779 The Convention of 2 July 2019 on the Recognition and Enforcement of Foreign Judgments in Civil or Commercial Matters, produced under the auspices of the Hague Conference on Private International Law, www.hcch.net.

780 The Convention currently only has two signatories, Ukraine and Uruguay. No announcement has yet been made by the EU in this respect. However, the EU Commission has published an impact assessment which concludes that the EU should accede to the convention and is consulting on whether to do so (https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12166-Accession-to-the-Judgments-Convention).

781 Conclusions and Recommendation of the HCCH Council on General Affairs and Policy (5–8 March 2019). According to the HCCH: "With the successful conclusion of the 2019 Judgments Convention, the focus of the normative work of the HCCH in the area of civil and commercial law has now turned again to the question of jurisdiction: on which grounds should the parties to a civil or commercial dispute be able to seise [*i.e.* activate] the courts of a certain State; on which grounds can a State exercise jurisdiction in civil and commercial matters; how can harmonised rules in this area reduce the risk of parallel litigation in multiple States? The search for an answer to these questions was put on hold during the negotiations of both the 2005 Choice of Court Convention and 2019 Judgments Conventions; the work of the HCCH on this last piece of the puzzle has now begun": https://www.hcch.net/en/projects/legislative-projects/jurisdiction-project.

782 This is a term, used particularly in Latin countries such as France, Spain, Italy and Portugal, that describes a procedure and writ of execution, for the enforcement of a foreign judgment in a state.

783 https://www.judiciary.uk/wp-content/uploads/2019/06/Multilateral-Memorandum-on-Enforcement.pdf. However, some countries like China recognise UK arbitral awards but generally do not recognise judgments of the English courts.

In the European context, the UK had sought to accede to the 2007 Lugano Convention[784] from the end of 2020 (the Brexit transition period). The Convention regulates and provides a streamlined procedure for the enforcement of judgments between EU and Non-EU States. European Free Trade Association (EFTA) states have a right of accession under Article 71 of the Convention. Other non-EU states, such as the UK, may also accede provided they receive the unanimous agreement of the other contracting parties (Article 72). Until the end of last year, the regime under the EU's Brussels Recast Regulation[785] applied in the UK by virtue of Article 127 of the Brexit Withdrawal Agreement and provided for a similarly simplified regime for the recognition and enforcement in EU states of judgments issued by the UK, and *vice versa*. However, the Brussels Recast Regulation ceased to govern new proceedings following the expiration of the transition period[786] and, unless and until the UK accedes to the Lugano Convention, there will be no comparable arrangement in place between the UK and the EU courts for the recognition and enforcement of judgments other than the 2005 Hague Convention for choice of court provisions.[787] The UK's application to accede to the Lugano Convention was lodged with the Swiss Federal Council on 8 April 2020.[788] The EU is currently blocking such a step,[789] and it remains subject to negotiation.

Although the Lugano Convention would be similar to the regime applicable to the UK until the end of last year under the Brussels Recast Regulation,[790] it is in fact based on the previous version of the Brussels Regulation, and therefore does not reflect the recent changes made to the EU regime. Accession would therefore still roll back a number of developments since then, including the rules relating to jurisdiction agreements (Article 25)[791], exclusive jurisdiction over matters closely connected with a particular member state (Article 24) and claims involving consumers and employees where the other party is not domiciled in the EU (Articles 18 and 21 respectively).[792] Both the Lugano Convention

784 Convention on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters 2007, O J 2009 L 147, p. 5. See the Notification to the Parties of the Convention on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters, concluded at Lugano on 30 October 2007, 612-04-04-01 – LUG 2/20.

785 Regulation (E.U.) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, OJ 2012, L 351, p. 1.

786 Pursuant to Article 67 of the Withdrawal Agreement, the Brussels Recast Regulation will apply to legal proceedings, as well as to the recognition and enforcement of judgments given in such legal proceedings, instituted before the end of the transition period *(i.e.*, before the end of 2020).

787 However, the UK and Norway have agreed to reaffirm a pre-existing bilateral treaty pre-dating the Lugano Convention, dealing with comparable issues of jurisdiction and judicial co-operation between them until and unless the UK formally accedes to the Lugano convention: https://www.gov.uk/government/publications/uknorway-agreement-on-the-continued-application-and-amendment-of-the-convention-providing-for-the-reciprocal-recognition-and-enforcement-of-judgment.

788 https://www.eda.admin.ch/dam/eda/fr/documents/aussenpolitik/voelkerrecht/autres-conventions/Lugano2/200414-LUG_en.pdf

789 UK accession requires the unanimous consent of all of the contracting parties. The UK has received the support of Switzerland, Norway and Iceland (announced on 28 January 2020), but, at the time of writing, has not received support from Denmark or the EU. The matter was not addressed in the UK-EU Trade and Cooperation Agreement 2020 regarding the future relationship of the parties following the end of the transition period.

790 The Lugano Convention, as with the Brussels Recast regime, has a number of defences and carve outs. For example, neither regime extends to revenue, customs or administrative matters, personal status, matrimonial matters, wills and succession, insolvency or arbitration, since these are matters generally for national law or (for instance in the case of arbitration) governed by other arrangements. In addition, recognition may be resisted on the grounds of public policy, judgment in default, or irreconcilability with another judgment in the enforcing state or an earlier judgment in another member state.

791 For example, under the previous Brussels Regulation regime, at least one party to a jurisdiction agreement needed to be domiciled in a member state to provide a ground for jurisdiction.

792 In particular, the Lugano Convention continues to suffer from one of the most serious shortcomings arising out of the previous Brussels Regulation, The EU regime generally provides that the court first seised of (*i.e.* in receipt of) a claim has priority, and any other court subsequently seised (*i.e.* in receipt) of parallel proceedings must stay them. The first Brussels Regulation failed to carve out adequately from this general principle the effect of exclusive jurisdiction clauses, leading parties to launch proceedings in their favoured forum pre-emptively so as to undermine such agreements (commonly referred to as the "Italian Torpedo"). The validity of such tactics was upheld by the CJEU, (see Case C-116/02 *Gasser v Misat*) and this feature remained a point of criticism until it was eventually addressed by Article 31 of the Brussels Recast Regulation. However, these changes did not extend to the Lugano Convention, a point recently brought into sharp relief in *Mastermelt Ltd v Sigfried Evionnaz SA* [2020] EWHC 927 (QB), in which the English High

and the Recast Brussels Regulation are evolutions of the regime introduced under the 1968 Brussels Convention, which has its origins in the civil law approach, comprising relatively inflexible, outcome-neutral criteria for the assumption and declining of jurisdiction. However, adjustments were made to the 1968 Convention after the UK's accession to the E(E)C in 1972 to ensure it was broadly satisfactory to UK commercial interests.[793] Aspects which continue to prove controversial include the lack of *forum non conveniens* discretion, unnecessarily broad *lis alibi pendens* rules and the fact that CJEU case law gets incorporated. However, it is sensible to see whether such arrangements can be made to operate satisfactorily between the UK and EU after Brexit.[794]

Depending on the outcome of these negotiations, it may be for the UK to seek out an alternative international instrument regulating the recognition and enforcement of commercial court judgments, with a pro-enforcement bias at its core. In this regard, the 2019 Hague Convention regime, if it becomes established, and any new instrument on jurisdiction (which is currently in contemplation), may not only offer an alternative to the Lugano Convention, but may also represent an opportunity to replicate the success of the New York Convention for commercial court judgments and better serve the international business community.

Court expressly rejected the argument that the Convention had to be read in light of Article 31 of the Brussels Recast Regulation.

793 Gardella & Radicati di Brozolo, *op cit,* fn 275 above. Amendments were made in various areas, for instance in relation to insurance contracts and trusts. However, the civil law foundations remain intact despite the accession of common law countries.

794 The Foreign Judgments (Reciprocal Enforcement) Act applies to judgments from some EU countries (Austria, Belgium, France, Germany, Italy, the Netherlands and Norway) where the EU regime does not otherwise apply.

ANNEX 5: THE US APPROACH TO REGULATORY PREDICTABILITY, AND THE ACCOUNTABILITY OF US FINANCIAL REGULATORS

The US securities markets and industry have had statutory regulators since 1934, when the Securities and Exchange Commission (SEC) was established. The SEC has primary responsibility for the regulation of not only the country's stock and options exchanges, but also other organisations and activities which in any way touch on the securities industry, such as public companies, broker-dealers, investment advisors and non-exempt investment funds. The SEC accomplishes its mission by promulgating rules, issuing informal guidance, and enforcing securities laws and regulations. The SEC may also delegate authority to self-regulatory organisations (SROs), which are non-governmental membership organisations that can exercise significant authority over their members, including by adopting and enforcing rules, imposing fines and other sanctions. SROs include the national exchanges and the Financial Industry Regulatory Authority, Inc. (FINRA), the principal regulator of US broker-dealers, and they are themselves supervised by the SEC and must comply with applicable provisions of the Securities Exchange Act of 1934 (a law governing the secondary trading of securities) and rules made under that Act which govern their conduct. The CFTC, established in 1975, regulates the US commodities, as well as certain derivatives, markets, which includes futures, swaps, and certain kinds of options, and sometimes works hand-in-hand with the SEC to ensure a coordinated approach to securities regulation and enforcement.

Whilst this framework grants significant power and autonomy to US regulators, it is not without limits. The framework provides several key means for the oversight of regulators, primarily by Congress, as well as a system of independent judicial review to ensure that the regulators stay within their statutory authority.

Because US regulators exist only by Congressional statute, Congress, and in particular Congressional committees, play a significant oversight role. This oversight comes in various forms. First, the heads of US regulators must generally be appointed by the President and confirmed by the Senate. New administrations generally appoint new heads of agencies, but in the case of multi-member bodies such as the SEC and CFTC, Commissioners typically remain in their position beyond a Presidential transition. Tradition has ensured a politically balanced approach to appointments in the case of multi-member bodies, and Presidents have normally sought to avoid controversial selections. Nevertheless, the power granted to the Senate to weigh in on any appointments is a significant check on any authority Commissioners may seek to wield.[795]

Second, once the regulators have been confirmed and granted power, Congressional committees can and frequently do summon those regulators to appear before them to answer questions as to how they are fulfilling their mandates.[796] This provides an opportunity to bring heads of agencies or other senior staff in to Congress, to testify as to particular actions taken or not taken or otherwise explain agency policies. Congressional representatives also have the ability formally and informally to request information from the regulators and to express views as to potential regulatory action. And because Congress approves the agencies' budgets, this power is not merely toothless – if Congress does not receive answers it deems satisfactory, it can severely curtail agencies' powers simply through its control of the purse, even without enacting any new laws.

Third, Congress always has the power to enact laws that either expand, or constrict, the regulators' powers. In general, there is significant give and take between Congress and the regulators in the

795 The Fed is *sui generis* but even then new Governors (*i.e.* the 8 members of the board) are appointed by the President and confirmed by the Senate.

796 Although regulators will typically testify voluntarily at the request of the relevant oversight committee, witnesses can also be subpoenaed. There can be liability (civil or criminal) for non-appearance and for untruthful answers.

legislative process. The regulators may want legislative changes to be made by Congress, or may have views on legislation proposed by others. Statutes can be passed to require the regulators to take certain actions, or to preclude the regulators from taking certain actions. But the regulators and Congress do not always see eye-to-eye. Special procedures for Congressional review of regulations, under the Congressional Review Act (CRA),[797] empower Congress to review, by way of an expedited legislative process, new federal regulations issued by government agencies and, by passage of a joint resolution, to overrule a regulation. Once a rule is repealed, the CRA also prohibits the reissuing of the rule in substantially the same form or the issuing of a new rule that is substantially the same "unless the reissued or new rule is specifically authorised by a law enacted after the date of the joint resolution disapproving the original rule".[798] Congress has a window of time lasting 60 legislative days (i.e., days that Congress is actually in session, rather than simple calendar days) to disapprove of any given rule by simple majority vote, failing which the rule will go into effect at the end of that period.[799]

As a practical matter, these powers collectively mean that the regulators can always be second-guessed by Congress, which has the inherent power to overrule decisions that the regulators may make.

The limits to regulatory power are not enforced solely by Congress, however. The public, through the courts, also has the power to place limits on the regulators, and these limits are often the ones that have the greatest impact.

Regulatory actions are subject to judicial review where they are alleged to be in conflict with statutory authority or constitutional principles, under the provisions of the particular statute governing the agency as well as general administrative law requirements such as those of the Administrative Procedure Act (APA).[800] Judicial review typically arises in the context of a challenge to a regulation or a challenge to a specific enforcement action.

A regulation may, for example, be challenged on the basis that the regulators exceeded their authority in making it, or that the regulation is inconsistent with the relevant statute or violates the Constitution. Challenge may also occur for failure by the regulator to follow required statutory processes for rulemakings.[801] The scope of rulemaking authority for a particular regulator varies depending on the governing statute as well as judicial precedent and historical practice. For some areas (including some aspects of securities or derivatives regulation or consumer protection), those powers are more explicitly defined (although potentially still broad); for other areas (such as for the Federal Reserve in its oversight of banks) the powers are more wide-ranging. The level of deference by courts to agency interpretations of relevant statutes flows from the degree of specificity provided by statute, but it is also a topic of ongoing debate. Under the so-called *Chevron* doctrine,[802] in the absence of a clear statutory mandate, courts generally defer to reasonable agency interpretations of their governing statutes. The doctrine has come under increasing criticism, under the view that it is the function of courts to interpret statutes, without any special deference to agency interpretations; but at least in cases where there is a clear congressional directive for an agency to fill a gap, there is every reason to expect that agencies will continue to have significant power to promulgate regulations, so long as they engage in reasoned decision-making and explain their analysis consistent with the APA.

Rules must generally be adopted by way of a formal public notice-and-comment process under the APA. This includes publishing a proposed rule in the *Federal Register* to notify the public and to give them an opportunity to submit comments. And, most importantly, agencies then must adequately address those comments, and explain their reasoning, in promulgating a final rule. Rules may thus be challenged on the grounds of a number of potential failures in that process, including a failure to conduct

797 5 U.S. Code Chapter 8 – Congressional Review of Agency Rulemaking (enacted as Subtitle E of the Contract with America Advancement Act of 1996 (Pub. L. 104–121)).
798 5 U.S. Code § 801(b)(2).
799 See, generally, 5 U.S.C. 801 *et seq*.
800 5 U.S.C. 551 *et seq*.
801 See, *e.g.*, 15 U.S.C. 78y.
802 *Chevron USA, Inc.*, fn 407 above.

an adequate cost-benefit analysis, to take into account the results of that analysis or to take into account comments made by members of the public on a proposed rule.

Challenges to regulations may be brought by individuals or companies subject to the regulations, but also by industry groups and trade associations. For instance, the Securities Industry and Financial Markets Association (SIFMA) is one of the leading trade associations for broker-dealers operating in the US and global capital markets, and it engages in advocacy on legislative, regulatory and business policy matters affecting its members.

Enforcement actions may also be challenged, and have often provided a significant avenue for reining in agency overreach. Depending on the particular statute, regulators may have authority to proceed with their proposed enforcement action through civil litigation[803] or through an administrative proceeding,[804] and in some cases may be able to choose between the two. (Many of the underlying statutes can also be enforced in respect of criminal law aspects by the US Department of Justice.) In general, more serious forms of enforcement action, particularly in the financial regulatory area, tend to be brought through civil (or criminal) cases in court, though in recent years the SEC in particular has tended to favour administrative proceedings even for significant cases. In court cases, the parties will have the usual rights of appeal applicable in litigation. By contrast, enforcement actions through administrative proceedings are often heard initially by an administrative law judge or similar officer. A party will typically have a right of appeal within the agency (such as to the full commission, where appropriate), and then a further right of appeal to an appellate court, though the right of judicial appellate review is not for a *de novo* review but rather a limited one.

Notwithstanding these avenues for challenging agency action, in relation to more day-to-day regulatory issues, judicial review of regulations is sought infrequently, particularly in the area of financial regulation. Recognising the need to maintain cooperative relationships with the regulators, and to get certainty to debated issues, parties often choose instead to discuss issues with an agency informally, or raise issues through the public comment process for a formal rulemaking. And when facing threatened enforcement actions, regulated entities frequently opt to settle, rather than litigate. Not only is litigation a costly and time consuming way to proceed, challenging an agency which is promulgating rules and at the same time supervising the firm is difficult, and firms are concerned about their regulatory relationships in those cases. As a result, the more frequent challenges to agency actions are brought either by unregulated entities that happen to be caught up in a matter within the regulators' jurisdiction, or by individuals. Indeed, it is commonplace to see a regulated entity settle charges with a regulator, whilst an individual employee of that entity goes on to litigate claims that are substantively the same (and often wins).

Taken together, these multi-pronged mechanisms for reining in US regulators provide an effective framework, but only if enforced by those empowered to do so – Congress, the regulated industry, and entities and individuals ensnared in enforcement actions. Ever since 1934, there has been a natural ebb and flow, with certain decades reflecting more empowered regulators, followed inevitably by a sense that regulators have gone too far, which is then followed once again by a sense that regulators have not gone far enough, which often follows the political winds of the country as well as the latest scandal. For example, following the SEC's failure to identify the multi-billion Ponzi scheme (by a regulated entity[805]) that came to light as the 2008 financial crisis was reaching its peak, Congress enacted the Dodd-Frank Act, granting the SEC substantially more powers and placing a premium on enhanced enforcement. But with those enhanced powers, the SEC arguably overreached, as it – together with the Department of Justice – soon launched a series of insider trading investigations that resulted in over 80 criminal convictions, a number of which were later overturned on appeal as having been the result of

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[803] *E.g.* 15 U.S.C. 78u(d) *et seq* (SEC authority).
[804] *E.g.* 15 U.S.C. 78u-3 (SEC).
[805] See fn 440 above and the case of Madoff.

an overly aggressive interpretation of the law.[806] Striking the right equilibrium is not easy, but the tools are there to do so, as long as both the regulators and others use them.

In practical terms, one concern that might be raised is that the US authorities have proved quite capable of using novel interpretations of the law to bludgeon firms into submission in the same way as UK regulators have used their Principles, particularly in response to industry-wide events where there is a public outcry for accountability. In some of the US mortgage cases, for example, the Department of Justice came up with a novel theory of liability that many felt would probably lose in court upon ultimate appellate review,[807] but few of the banks fought it.[808] The point is that banks do not want to litigate against the regulators. It is too expensive and time-consuming to do so and, even if it might appear there is a good case on the law, the risk of adverse publicity is generally a sufficient disincentive to any action. Furthermore, no bank is prepared to allow itself to be indicted in a non-settled context for fear of a "run on the bank" whereby counterparties will not deal with them, customers will withdraw their funds, and regulatory exemptions for bad actors will be denied, with the result that any victory in court would prove Pyrrhic, at best.

806 See *e.g., U.S. v. Newman*, 773 F.3d 438 (2d Cir. 2014), which led to a series of convictions being vacated.

807 Oonagh McDonald, *Holding banks to account for the financial crisis?* (2016) 23 Journal of Financial Crime 45.

808 *Ibid.* See also W.W. Bratton and A. J. Levitin *A Tale of Two Markets: Regulation and Innovation in Post-Crisis Mortgage and Structured Finance Markets* (2019) Faculty Scholarship at Penn Law 2096, https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=3098&context=faculty_scholarship (p. 42): "These observations should not be taken to say that the Task Force was averse to theoretical innovation, even as it hewed to traditional bases of liability. It had a taste for finding new bottles for the old wine. It avoided federal securities law, even as it packaged what amounted to old-fashioned securities law complaints. It drew instead on the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the False Claims Act, a post-Civil War qui tam statute, framing allegations out of whole doctrinal cloth. It had its reasons for so doing—FIRREA has a long limitations period and a low threshold for proof of claim, and the False Claims Act has a treble damages kicker. Even so, none of the banks forced the Task Force to test its novel statutory applications in court and so none of the theories was ever adjudicated. The entire yield of fines and damages was raised at the settlement table."

ANNEX 6: WAIVERS, "NO ACTION" PROCEDURES, STATUTORY IMMUNITY AND JUDICIAL REVIEW

1. Waivers and "no action" procedures

The UK relies more than many other regimes on post-event enforcement action by the regulators and by individuals or private market participants, which may include enforcing clear, tightly drafted rules before public tribunals and courts. This is inherently an attractive approach. Sometimes however one-off situations arise which mean that the application of the rules would lead to absurd results. These situations are ones which cannot be resolved through interpretative guidance which would clarify the rules and then bind the regulator in subsequent judicial review proceedings.[809] The question then is whether to change the rules or to retain the power to make minor, unique, adjustments so as to provide certainty for market participants.

In the US, the regulators can grant "no action" relief, which is not relief that comes from the regulators such as the SEC or CFTC themselves. Rather, the staff of the SEC (for example) issue a letter explaining that they will "not recommend enforcement action" on a specific set of facts.[810] These general derogations, which effectively constitute an informal but binding amendment to or interpretation of the rules, must be distinguished from specific waivers.[811] The UK regulators have an approach that achieves a similar result but under a different name.[812] Regulators can grant waivers from compliance with their rules or grant modifications, which allow a rule to be swiftly amended or relaxed for a particular firm, to cater for that firm's specific situation.[813]

Now, general waivers to rules – or the US "no action" letters[814] – are inherently undesirable. This is because the widespread use of waivers would imply a lack of accuracy in the drafting of regulations. It is normally better for the regulators to update their regulations than to grant specific exemptions for particular firms. However, there are instances where a general derogation may be justifiable. First, there are circumstances when the rulemaking process would prove too slow or there is a reluctance on the part of the regulators to use up resource in a particularly niche area. Secondly, there are some cases where a situation arises which is so unusual that changing the rules themselves would be a wasted effort.

809 In the UK, interpretations are dealt with under section 138A of FSMA and are addressed in the PRA and FCA Handbooks, *e.g.* see SUP 8.3 of the FCA Handbook.

810 Here is an example of SEC members (in that capacity) discussing the difference between rulemaking and "no action" letter relief: https://www.sec.gov/news/public-statement/lee-crenshaw-customer-protection-2020-10-23. It might be said that the no action idea is less flexible to firms than the waiver procedure, because no action letters leave open the possibility of third-party claims referencing breaches of regulation. However, many practitioners are quite positive about US no action practice, as comprising a useful way of obtaining assurance concerning difficult interpretative questions. The process is transparent: the letters are published.

811 Thus, interpretations and one-off situations are often addressed through no-action letters or similar informal guidance, but this process can (if the point turns out to be of more general difficulty) lead to a more general policy expressed in an exemption, or a new rule being made.

812 The SEC and CFTC in fact have the power to issue exemptions (which are similar to waivers), but these usually require formal action by the agency itself, and are less common..

813 FSMA, section 138A. See also FSMA, section 250 (for unit trusts, *i.e.* funds), section 294 (for recognised investment exchanges and recognised clearing houses), and regulation 7 of the Open-Ended Investment Company Regulations 2001/1228.

814 The UK's waiver process might be seen to be better in principle than "no action" relief, since the latter implies that the law continues to be breached, but no action will be taken. There is a constitutional argument here, derived from the provision in the Bill of Rights 1688 to the effect that any purported exercise of a dispensing power is unlawful: "*Late dispensing Power.* That the pretended Power of Dispensing with Laws or the Execution of Laws by Regall Authoritie as it hath beene assumed and exercised of late is illegall." There is something unattractive from a rule of law perspective for a public authority to be saying in advance "I know this is the law, but don't worry, go ahead and break it". Indeed, in *Regina (on the application of Pretty) v Director of Public Prosecutions* [2001] UKHL 61, the House of Lords confirmed that a prosecutor does not have the power to give an undertaking not to prosecute in respect of a crime to be committed in the future. However, it is possible to secure prosecutorial commitments after the fact. One of the most striking examples is a corporate body's ability to secure a deferred prosecution agreement (introduced by the Crime and Courts Act 2013).

Thirdly, general derogations can be useful in creating bespoke regulatory regimes, such as the FCA's FinTech "sandbox".[815] These derogations apply only within the context of the "system within a system", and are subject to strict limits and compliance with the rules of the "sandbox". Specific or individual waivers can be desirable in providing firms with immediate assurance, allowing firms to take (or not take) action with certainty.

There is a role for the current waivers regime to continue and for binding regulatory decisions to be made in advance in limited circumstances, so as to facilitate predictability. These decisions should of course be made public (as they are required to be[816]) and available to others who find themselves in similar circumstances, which is what the courts would require as a matter of their judicial review jurisdiction. As a general matter, the waivers regime allows a market player to say to the regulator "If I do x, will you take enforcement action against me?" The regulator should not be required to refuse to answer the question as a judge would and say, "I cannot tell you until you have done it." But the system needs both to counterbalance any caution of the regulator in saying "no", and also to deter the giving of too ready a "yes" answer. Nor should the regulator be free from legal accountability if it says "Yes" just because that is seen as the safest option. This means that the regulator's conduct needs to be subject to oversight, as explained in Chapter 4 above. The regulator needs to operate within a framework of law in which saying "No" to such a question is not challenged, so long as the waiver processes have been properly followed. The regime should also provide a person who asks for such an answer with protection from the extreme consequences of things going wrong.

The existing UK waiver regime permits such an outcome. The use of waivers should not be to the exclusion of achieving predictability in the financial regulations themselves, but it can enable the rapid disapplication of rules which demonstrably make no sense in a particular instance. The FCA currently has over 1,150 waivers and modifications in issue as of 1 December 2020, which is in part a function of the highly prescriptive EU single rulebook and the EU-driven approach which the FCA currently applies.[817] This number should come down after the rulebook is scaled back in the manner set out in Chapter 3.

The UK should in fact consider widening the scope for the use of such mechanisms. At present, waivers and modifications cannot be granted for conduct rules, the "threshold conditions"[818] or certain trust scheme rules. The waivers are granted on application by a firm to the relevant regulator. In exceptional circumstances, the UK regulators can grant a modification by consent, which the regulator will initiate, but the firm concerned must notify the regulators if it wishes to make use of it.[819] However, the regulators cannot give a waiver that would be incompatible with the EU's extensive financial services regime. This is a limiting factor. There are, on occasion, waivers which are available to the regulators through EU legislation. For example, the Capital Requirements Regulation allows a firm to apply to its regulator for permission to change the firm's capital requirements.[820] However, the use of waivers as a regulatory tool has generally been hampered by EU law, which has until only recently permitted "no action" relief, in limited situations.[821]

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815 See fn 69 above.

816 Section 138B FSMA.

817 https://www.fca.org.uk/firms/waivers-modifications.

818 These are the minimum conditions for authorisation, imposed by the regulators.

819 FSMA, section 138A.

820 See, for example, Article 9 CRR (individual consolidation method) and Article 26(2) CRR (classification of interim or year-end profits as common equity tier 1 capital).

821 The European Supervisory Authorities (ESAs) have traditionally published forbearance statements to waive temporarily specific regulatory obligations under powers granted to them by their founding regulations. A new power to issue "no action letters" was granted to each of the ESAs with effect from 1 January 2020 (Article 1(7), 2(8) and 3(8) of Regulation (EU) 2019/2175 of the European Parliament and of the Council of 18 December 2019 amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority), Regulation (EU) No 1094/2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority), Regulation (EU) No 600/2014 on markets in financial instruments, Regulation (EU) 2015/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds,

As a linked point, it is unavoidable that some market participants will seek reassurance from regulators as to their reading of the rules. The rules should be as clear as possible and any regulatory decisions should enhance that clarity by providing clear precedents. The point here is that market participants sometimes wish to be free to have discussions with officials in advance of action, not to determine permissibility but to avoid the cost of paying for legal advice. This is a little different from formal guidance. It is also different from the deference given under the EU and civil law systems to officials in determining the underlying purposes behind the law, where those purposes are said to be determinative of the meaning of the law. The latter model gives the officials special, quasi-law-making powers. In the UK context, seeking reassurance from officials on the application of rules made on a plain reading is acceptable. It is important that the ultimate method of interpretation is based on a plain reading of the words, so that no advantage is bestowed on those who discuss matters with officials. If it becomes apparent that there is a shortcoming in the wording of the rules which needs to be fixed, this should be achieved through the normal rulemaking processes, involving public consultation when required, or through the making of formal waivers.[822]

2. Statutory immunity of regulators

The regulators are granted statutory immunity from liability in actions by market participants and consumers for damages, so long as they act in good faith and respect human rights in the performance of their functions.[823] This immunity allows them to regulate and supervise firms robustly and reduces the risk of firms attempting to delay or avoid complying with regulatory direction by bringing potentially vexatious claims against the regulators for damages. Any consumer, regulated firm or individual directly affected by the way in which a regulator has carried out its function may make a complaint to the regulator. This is a process designed for convenience, speed and cost, rather than objective justice, since it makes the regulator the judge in its own cause. If the complainant is dissatisfied with the outcome of the regulator's investigation of the complaint, the matter can be taken to the Complaints Commissioner, an independent individual.[824] The Commissioner can make recommendations for the steps the regulator should take to remedy the situation, including recommending payment of *ex gratia* compensation. The regulator is not obliged to implement the recommendations, although the Commissioner may require it to publish its reasons for taking such a position.

Lately, the FCA has been criticised for serious delays in processing complaints[825] and, linked to this, has been accused of prevaricating over paying out compensation in two high-profile cases involving large numbers of investors. One involved a firm misdescribed by the FCA register as being authorised,[826] the other involved the fraudulent misselling of investments by a regulated firm but purportedly outside the perimeter of regulation.[827] The FCA, PRA and Bank of England have recently

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and Regulation (EU) 2015/847 on information accompanying transfers of funds), entitling them, amongst other things, to notify Member State regulators that they should deprioritise specific regulatory actions in exceptional circumstances. The ESAs have, to date, only rarely issued no action letters under these new powers.

822 FSMA, sections 137A and 138I.

823 FSMA, Schedule 1ZA, paragraph 25 and Schedule 1ZB, paragraph 33.

824 Further details on the Complaints Scheme are available in *Complaints against regulators*, March 2016. Complaints can be made about actions or inactions of the FCA, the PRA, the PSR and the Bank of England (in its oversight of CCPs and payment systems only).

825 Annual Report 2019/2020 of the Complaints Commissioner, *Reviewing how the financial services regulators consider complaints*.

826 In the *Collateral* case (involving Collateral (UK) Ltd (Collateral UK), Collateral Sales Ltd and Collateral Security Trustee Ltd), the FCA's register was wrong in listing on the financial services register a peer-to-peer lending platform as being authorised. Customers invested in it, and it subsequently turned out to be a fraud and entered into administration. Investors in this case have been caught up in the publicised delays to the FCA complaints process.

827 In the case of *London Capital & Finance Plc* (LC&F), a firm which raised cash in the form of tax-free Individual Savings Account (ISA) bonds and other bonds, receiving over £237m, mostly from retail investors, and has subsequently fallen into administration. The firm is under investigation by the Serious Fraud Office for a series of allegedly suspicious transactions and its key individuals have all been arrested. The firm's administrators have uncovered multi-million pound transactions with connected persons and to date have paid investors only 2.5% of the funds they invested. The FCA has been criticised for allowing a regulated institution to obtain £237m in what are essentially cash deposits from retail investors, based upon a limited set of permissions for "advising" and "arranging", with essentially no regulatory capital

proposed that they should be protected by a new financial cap of £10,000 on pay-outs for financial loss, except in exceptional circumstances, and one of £1,000 where a claimant has suffered distress or inconvenience.[828] These proposals have been criticised as limiting liability for past scandals where complaints handling has been delayed, and as failing to take into account the likely extent of investor losses as against the compensation limits.[829] There is clearly an asymmetry between the regulators' fining powers, which are unlimited and include not only redress and disgorgement but also punitive elements, and the regulators' own liabilities for misconduct, for which a cap is now proposed that would fail to cover actual losses suffered by investors. In principle there should not be circumstances where someone suffering a wrong goes without redress.[830]

3. The role of judicial review

The UK's system of administrative law, *i.e.* the law that governs the exercise of power by the regulators, Bank of England and other governmental authorities, provides a mechanism for curtailing the powers of the UK's financial services regulators.[831] It allows for a process of judicial review, under which challenges can be made to the decision-making of those authorities. The statutory powers and objectives of the regulators (particularly if revised in the manner proposed here[832]) provide an essential backdrop for any review. The courts are the ultimate tribunal for such matters. The law (which is itself currently under review[833]) therefore operates as an important safety net in the background.

One legal test which may be applied when challenging the decisions of regulators is that of unreasonableness or irrationality. This involves asking whether a decision is so unreasonable that no reasonable regulator could have come to it; or whether the regulator took into account irrelevant matters

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and little regulatory supervision. HM Treasury commissioned a review, leading to the Gloster Report. This made various findings, including that the FCA: (i) ignored various tip-offs concerning LC&F; and (ii) ignored LC&F's issuance activities on the basis that the FCA thought these were unregulated. Whilst some compensation for some investors will arise through the FSCS and potentially other avenues, such as *ex gratia* FCA compensation payments, it is not clear this will be sufficient to compensate affected investors. The government has therefore announced a compensation scheme, as occurred previously for Equitable Life. The FSCS's decision not to compensate in the LC&F case is now itself the subject of a judicial review. See also fn 845 below.

828 FCA consultation paper, *Complaints against the Regulators (The Financial Conduct Authority, the Prudential Regulation Authority and the Bank of England),* CP20/11, 20 July 2020. The consultation was so controversial that the responses period was extended by months following the intervention of MPs. Among the principal concerns was that the FCA was seeking to limit its own liability ahead of the publication of the Gloster Report into its regulatory failures concerning LC&F, not least since the consultation paper changes purported to apply retroactively to new complaints received by it concerning past behaviour. FCA board minutes from November 2020 state that "The board was cognisant of the concerns raised by some respondents regarding the timing of the amendments to the Complaints Scheme described in consultation paper CP20/11. In light of this, it was proposed that the policy statement on the consultation should not be published until towards the end of Q2 2021", *i.e.* after the publication of the Gloster Report and presumably after any *ex gratia* FCA payments related to LC&F have been considered, https://www.ftadviser.com/regulation/2020/12/24/fca-stays-controversial-changes-to-regulatory-compensation/.

829 Criticism of the brevity of the consultation has been widely reported and has included criticism from Mel Stride MP, Chairman of the Treasury Select Committee, in his letters of 11 September 2020 to the Interim Chief Executive Officer of the FCA and the Governor of the Bank of England, available at https://committees.parliament.uk/committee/158/treasury-committee/news/117491/financial-regulators-should-urgently-consider-extending-complaints-scheme-consultation/. Further, as reported in The Times on 24 August 2020, criticism of the move was received from the FCA's own complaints commissioner, Antony Townsend (available at: https://www.thetimes.co.uk/article/financial-conduct-authority-rushes-to-minimise-compensation-for-its-failings-jzwpmjvr6). It remains to be seen what now happens in the context of the LC&F case, in light of the Gloster Report and the Government's decision to set up a Treasury scheme to compensate certain investors who would otherwise lose out: see fn 626 above and the surrounding text.

830 *Crawford Adjusters (Cayman) Ltd v Sagicor General Insurance (Cayman) Ltd* [2013] UKPC 17, [2014] AC 366.

831 The focus here is on the system as it applies in England & Wales. Scotland and Northern Ireland have separate legal systems, though in the respects discussed here they are very similar.

832 See fn 576 above and surrounding text.

833 On 31 July 2020 the UK Government launched a review, chaired by Lord Faulks, of the judicial review process. As stated in the press release, the review will "consider whether the right balance is being struck between the rights of citizens to challenge executive decisions and the need for effective and efficient government": https://www.gov.uk/government/news/government-launches-independent-panel-to-look-at-judicial-review.

or failed to consider relevant matters in reaching its decision.[834] There are other grounds of challenge, which are error of law,[835] error of fact (at least in some cases), failure of legitimate expectation or procedural impropriety.[836] If there is an error of law or fact, then the decision can be sent back to the regulator to be reconsidered, or the judge's decision will effectively be substituted for that of the regulator. However, where the only grounds for challenge are "unreasonableness", as is often the case, there is a high threshold for the applicability of judicial review which means that court cases are rarely brought and decisions rarely given.[837]

Decisions can also be reviewed in some cases on grounds of discrimination.[838] Extreme caution is needed in applying the notion of non-discrimination. In other public law contexts, this notion has been taken to establish requirements not only that the same cases must receive the same treatment, but also that different cases be treated differently, and that the treatment should be different to the extent required by the scale of the difference.[839] The last mentioned has been a pernicious gloss on the notion since it can be extremely hard to measure such differences. There is not so much of a problem if the approach is applied to penalties raised during enforcement proceedings as opposed to the rules that are being enforced, but it is a development that should be handled carefully.

The judicial review regime is not intrusive for financial services, and judges are rarely called upon to determine regulatory matters. The regime is also somewhat distorted in that regulatory rules require firms and their senior managers first to engage with their regulator on an open and cooperative basis.[840] Furthermore, judicial review generally does not involve hearing expert evidence, and oral evidence is unusual, so expert evidence is not generally tested through cross-examination. If the issue is one on which experts appear reasonably to disagree, an argument that the decision was grossly irrational will fail. The judge is unlikely to be in a position to determine that one side of the evidence is misconceived.

In recent times, the number of challenges to the statutory compensation scheme, the FSCS, has been greater than that of challenges to the FCA,[841] despite the former's narrower role. This means that the FCA is operating subject only to limited challenge possibilities. The difference is at least in part because there will often be more money in challenging the FSCS, and no one is deterred by having a regulatory relationship with the FSCS which they want to avoid putting at risk, unlike the position as regards the FCA, which firms are reluctant to challenge, in an effort to preserve their relationship.[842] But judicial review only assesses extreme instances in which regulators have exceeded their powers at a single point in time. The power is particularly limited in the context of the financial services regulators in the context of their own rules, since to a large degree they make and interpret the law and set their own processes.

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834 *Associated Provincial Picture Houses Ltd v Wednesbury Corporation* [1947] EWCA Civ 1, [1948] 1 KB 223; *Tesco Stores Ltd v Secretary of State for the Environment* [1995] UKHL 22; [1995] 1 WLR 759.

835 The US's approach does not apply—*i.e.*, the approach set out in *Chevron USA, Inc.*, fn 407 above, which allows the US Congress to delegate to agencies the power to fill any gaps left by the statute pretty much how they like, unless manifestly unreasonable. So a UK court will decide on what a rule means, and not whether the regulator's interpretation is reasonable.

836 In cases of procedural impropriety, the court must be satisfied that the decision-maker has not followed relevant procedural requirements or has otherwise failed to observe principles of natural justice in reaching their decision (e.g. by not giving an affected person the opportunity to state their case, or by displaying bias or the appearance of bias). Further, if the decision-maker has given a clear and unambiguous representation that they will adopt a particular form of procedure, or a claimant otherwise has a legitimate expectation that they will be able to make representations or rely on the substantive rights of the decision-maker, this may also provide grounds for review.

837 See K. Costello, *"Wrenched from its context". The interpretation of Associated Provincial Picture Houses v Wednesbury Corporation* (2020) 136 LQR 609.

838 See Article 14 of the European Convention on Human Rights and section 6 of the Human Rights Act 1998. Essentially, where a public body makes a decision that is considered to "engage" one of the substantive rights guaranteed by the Convention (e.g. to the enjoyment of property), it must do so in a non-discriminatory way. Section 29 of the Equality Act 2010 also prohibits discrimination on certain grounds in the exercise of public functions or the provision of a public service. Article 21 of the Charter of Fundamental Rights of the European Union may also potentially be relevant.

839 *Matadeen v Pointu* [1998] UKPC 9; [1999] 1 AC 98, 109.

840 Principle 11 of the Principles for Business, FCA Handbook; and Fundamental Rule 7 of the PRA Rulebook.

841 See for example *R (Christopher Willford) v Financial Services Authority* [2013] EWCA Civ 677. The outcome in this case indicates that the availability of judicial review in respect of the FCA's disciplinary powers is likely to be limited – the appropriate forum for such challenges would ordinarily be the Upper Tribunal (see fn 615 above).

842 See Chapter 4, section 4.2 above.

It is also part of their role to determine what is relevant.[843] Issues such as a true and fair market, or consumer protection, must be balanced against promoting competition and allowing new market entrants. Financial stability is a core issue but there are numerous ways to achieve it. Moreover, judicial review does not assess the general conduct or approach of the regulators. It does not oversee the removal of rules that are no longer necessary or which poorly address current regulatory needs. Nor does it address the style of rulemaking. It merely allows for two competing viewpoints to be considered as to the proper use of regulatory powers. As a result, the role of the Treasury Select Committee remains fundamental to the oversight of the regulators.

Nevertheless, the role of judicial review is also vital and enhancements should be considered. The underpinnings provided by an effective judicial review regime are important in setting an overall legal tone for the regulatory system, providing for reliability, predictability and a sense of fairness. Possible refinements to the process include further training of the judges, bringing in more expertise to advise the judges, and broadening the financial and economic context required to be taken into account.[844] Consideration should also be given to ensuring the sorts of topics that are subject to judicial review in the US, such as rulemakings by financial regulators, and enforcement actions, are similarly subject to review in practice in the UK: see Annex 5.

However, any changes should be limited in scope. For the most part, judicial review should continue more or less in its current form. It should only be available after a claimant has exhausted all other legal remedies. Sometimes, it will be necessary for the courts to reconsider a regulator's determination, especially where it involves legal judgement rather than being fact-based.[845] But whilst the jurisdiction is welcome, this should not be a signal for the undue extension of the techniques of control available. Any changes to the legal framework for regulation need to be sensitively handled. The UK has so far managed to ensure that judicial review of regulatory decision-making does not reinforce a culture of justification - the idea that it is the role of the courts to ensure that every act of the state that affects a person is substantively justifiable.[846] This concept, itself arguably a product of civil law influences, should not be allowed to take root in such a way that regulators are treated as judicial actors and their decisions constantly appealable to the courts. The potential damage must be avoided of any new regulatory approach being affected by an increase of deployment of reasoning based on

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843 Where a rule does not itself state, expressly or impliedly, what factors are to be taken into account in applying it to a particular set of circumstances, the decision-maker's selection of the factors to take into account (or not) is itself vulnerable to challenge only if unreasonable in the sense that it was so unreasonable that no reasonable decision-maker could have made that selection: *R (Khatun) v Newham LBC* [2005] QB 37.

844 The semi-judicial roles of the CMA and the Competition Appeals Tribunal could be considered for ideas in this context. Under section 76(7) of the Financial Services (Banking Reform) Act 2013, certain decisions of the Payments Systems Regulator can be appealed to the CMA in accordance with section 79 of that Act.

845 A case in point is the judicial review case launched by certain investors in LC&F. The claimants are contesting the FSCS's refusal to compensate a large number of LC&F investors on the grounds that LC&F was not conducting the regulated activity of dealing in investments as principal. The FSCS based its decision on a particular reading of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 and the revised Markets in Financial Instruments Directive. The claimants' case is based on technical legal arguments involving the interpretation of these and other key pieces of UK and EU financial services and consumer rights legislation, which, since they revolve around legal issues, are properly heard by a court in judicial review proceedings.

846 See *e.g.* David Dyzenhaus, *The Politics of Deference: Judicial Review and Democracy* in Michael Taggart ed., *The Province of Administrative Law* (1997) Hart, 279; Michael Taggart, *Deference, Proportionality, Wednesbury* [2008] NZLR 423; Mark Elliott, *Has the Common Law Duty to Give Reasons Come of Age Yet?* [2011] Public Law 56. A related right to justification claims that every person possesses a moral and, ideally, constitutional right to the justification that the culture of justification recommends.

discrimination,[847] proportionality[848] and reasonable expectations,[849] on the use of retrospective invalidating remedies,[850] and the abandonment of the presumption of regularity and "second actor" issues.[851] These techniques need careful consideration in the context of financial services. For instance, there would be concerns over any application of reasoning based on the concept of "reasonable expectations" if this were to allow individual parties to obtain a special position under the rules.[852] Furthermore, any approach should be avoided in so far as it would enable challengers to go as far back into the process as they want, to find a domino that can be knocked down and precipitate the invalidity of everything that followed the decision that has ultimately been quashed or reversed. In financial services, the pace of the market is rapid and this sort of approach would create unacceptable uncertainty. A path between the extremes is navigable, but needs thought and care.[853]

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847 Discrimination is not a stand-alone ground for judicial review and the Supreme Court recently confirmed that "equal treatment" is not a distinct principle of administrative law (*R (Gallaher Group Ltd and others) v Competition and Markets Authority* [2018] UKSC 25, [2019] AC 96). However, the principles of equality and non-discrimination have become tenets of UK law and have been invoked in some judicial review cases, for example in *R (Johnson) v Barnet LBC* [1989] 88 LGR 73.

848 There is ongoing debate as to whether proportionality should form a free-standing basis for judicial review. Although the judges in *R (Brind) v Secretary of State for the Home Department* [1991] 1 AC 696 refused to permit a judicial review claim based upon proportionality, their judgment appeared to leave room for proportionality to emerge as an independent basis for review in the future. Academic debate and subsequent cases have continued to contemplate the emergence of proportionality as a ground for review.

849 Judicial review on the grounds of legitimate expectation was first proposed by Lord Denning in *Schmidt v Secretary of State for Home Affairs* [1969] 2 Ch 149, and has since then been widely adopted, permitting applicants to bring a claim on the grounds that they have been deprived of a benefit or advantage which a public body caused them legitimately to expect they would be afforded.

850 One such remedy is the quashing order, which entitles the High Court to determine that a public body's decision be quashed and have no ongoing legal effect.

851 The theory of the "second actor" was described by C. Forsyth in his essay *"The Metaphysic of Nullity" – Invalidity, Conceptual Reasoning and the Rule of Law* (published in *The Golden Metwand and the Crooked Cord - Essays on Public Law in Honour of Sir William Wade* eds Forsyth and Hare (1998) OUP 159), in the following terms: "unlawful administrative acts are void in law. But they clearly exist in fact and they often appear to be valid; and those unaware of their invalidity may take decisions and act on the assumption that these acts are valid. When this happens the validity of these later acts depends upon the legal powers of the second actor." The second actor is the person who acts believing that the first act is valid.

852 This is a more general concern that was discussed in the context of waivers, in section 6.1 above.

853 The EU applies a wider, "margin of appreciation" test to discretionary agency decisions—an arrangement which is cruder than that under UK law and should not be followed. The "margin of appreciation" test originated in the European Court of Human Rights system but has been applied to discretionary agency decisions, especially the ECB's in *Gauweiler and Others v Deutscher Bundestag C-62/14* and *Weiss and Others*, C-493/17. The test is based on general concepts of proportionality, applied in civil law systems. It differs materially from one of reasonableness, as was confirmed in *R (Isiko) v Secretary of State for the Home Department* [2000] EWCA Civ 346. Proportionality is a more intrusive test than reasonableness/rationality because (i) the court has to review the balance struck by the decision-maker, not merely whether the decision was within a range of reasonable responses, (ii) the court has to consider the relative weight given to the various interests and considerations, and (iii) the reasoning is more structured, requiring engagement with the questions of whether there was a pressing social need for a particular measure or decision, and whether the measure/decision was a proportional means of meeting that need.

GLOSSARY OF TERMS USED

Term	Meaning
	Legislation
2BCD	Second Banking Coordination Directive
BRRD	Bank Recovery and Resolution Directive
BRRD II	Second Bank Recovery and Resolution Directive
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
EMIR	European Market Infrastructure Regulation
EMIR 2.1	First amendments to EMIR
EMIR 2.2	Second amendments to EMIR
FSMA	Financial Services and Markets Act 2000
MiFID II	Second Markets in Financial Instruments Directive
	Other Definitions
ADR	alternative dispute resolution
AML	anti-money laundering
APA	Administrative Procedure Act
BaFin	German Federal Financial Supervisory Authority
Basel I, II and III	Basel Rules of 1988, 2004 and 2010 respectively
Basel Rules	Rules on credit risk management issued by the Basel Committee
BBRS	Business Banking Resolution Service
BEIS	Department of Business, Energy and Industrial Strategy
BGB	*Bürgerliches Gesetzbuch*, the German civil code
BvG	*Bundesverfassungsgericht*, the German constitutional court
CCP	central counterparty
CCPA	California Consumer Privacy Act of 2018
CFTC	Commodity Futures Trading Commission

Term	Meaning
CJEU	Court of Justice of the European Union
CMA	Competition and Markets Authority
CRA	Congressional Review Act
EBA	European Banking Authority
ECB	European Central Bank
ECHR	European Convention on Human Rights
EDIS	European deposit insurance scheme
EDMC	Enforcement Decision Making Committee
EFTA	European Free Trade Association
EIOPA	European Insurance and Occupational Pensions Authority
ESA	European Supervisory Authority
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
EURIBOR	Euro Interbank Offered Rate
FCA	Financial Conduct Authority
FICC	Fixed Income, Currency and Commodities
FINRA	Financial Industry Regulatory Authority
FinTech	financial technology
FRAND	fair, reasonable and non-discriminatory
FSA	Financial Services Authority
FSAP	Financial Services Action Plan
FSB	Financial Stability Board
FSCS	Financial Services Compensation Scheme
FTA	Free trade agreement
GDPR	General Data Protection Regulation
GLBA	Gramm-Leach-Bliley Act

Term	Meaning
IOSCO	International Organization of Securities Commissions
ISAs	Individual Savings Accounts
ISD	Investment Services Directive
ISDA	International Swaps and Derivatives Association
ITS	implementing technical standards
LIBOR	London Inter-Bank Offered Rate
LTCM	Long-Term Capital Management
MEP	Member of the European Parliament
MiFIR	Markets in Financial Instruments Regulation
MP	Member of Parliament
MRA	Mutual recognition agreement
MTN	medium-term note
NCBs	National central banks
OECD	Organisation for Economic Co-Operation and Development
OTC	over-the-counter
PPI	payment protection insurance
PRA	Prudential Regulation Authority
PRIMA	place of the relevant intermediary approach
Principles	high-level principles made by the PRA and FCA governing firms' behaviour
PSPP	Public Sector Purchase Programme
PSR	Payment Systems Regulator
RDC	Regulatory Decisions Committee
REFIT	Regulatory Fitness and Performance Programme
repo	sale and repurchase
RTS	regulatory technical standards
SEC	Securities and Exchange Commission
SIB	Securities and Investments Board

Term	Meaning
SIFMA	Securities Industry and Financial Markets Association
SMEs	small and medium-sized enterprises
SRM	Single Resolution Mechanism
SROs	Self-Regulatory Organisations
TARGET2	real-time gross settlement (RTGS) system for national and cross-border payments in central bank money within the Eurozone
TCF	Treating Customers Fairly
UK	United Kingdom
US	United States of America
WTO	World Trade Organisation

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The UK's financial sector owes much of its strength to the tradition of the common law approach: now that the country has left the EU's legal system, it must restore UK law. *Restoring UK Law: Freeing the UK's Global Financial Market*, explains the differences of approach between the UK system and the code-based civil law systems on which much of EU law is based. For centuries the common law approach has facilitated commercial innovation. It has also been a significant factor for the strength and drive of the US technology sector. Its presumption, that people and businesses should be left alone, free to innovate, has proved its superiority time and again. Today the common law is used in the main, global financial centres, such as the UK. Here, market participants convene from all over the world for the purposes of trade, taking advantage of the benefits of liberty and legal certainty that the legal system brings.

The author, Barnabas Reynolds, who leads his firm's global financial advisory and regulatory practice, explains the contrast with the civil law regimes in France, Germany and other countries which follow a code-based system, including China and Japan. Such code-based systems developed particularly in the nineteenth century to apply rationalist or scientific principles for law-making, and tend to be intrinsically more controlling than the common law. The EU's legal system is based largely on the code-based civil law model.

Reynolds shows how the effects of EU law are particularly problematic for financial services, for which a very extensive set of laws has been introduced, along with an alien system of regulation; one measure alone (MiFID II) amounts to 1.7 million provisions. He concludes that now, having left the EU's legal system, the UK should reclaim its historic advantage – the freedom, predictability and safety that arises from its approach to law under the common law and also Scots law. UK law, built on precedent and case law, should once again be pre-eminent. EU laws should be removed, and regulation reformed, under enhanced Parliamentary supervision of the regulators and judicial accountability. In this way, the UK economy and the people of this country will reap the full benefits of Brexit, the common law and, with it, the fruits of true competitiveness.

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