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Contents

News and calendar 1

Clearing of euro-denominated securities............... 2

The UK's anti-money laundering regime 5

Since the first edition of Lex et Brexit was published two weeks ago, we now have a new UK Government in place, with a new Prime Minister and a new "Secretary of State for Exiting the European Union". The shape of the UK's future relationship with the EU, or even the key objectives of the new UK Government in the Brexit negotiations, remain unclear.

In this second edition, we have addressed one of the more controversial areas of Brexit aftermath: whether London's position as a key center for the clearing of euro-denominated securities and derivatives can be maintained. Although the attempt by the European Central Bank (the "**ECB**") to impose a eurozone "location policy" failed in the EU courts last year, we conclude that Brexit materially increases the possibility that substantial volumes of clearing activity will move out of London, which may be a contributing factor towards a gradual migration of broker-dealer and derivatives trading activity out of the UK.

We then examine the impact of Brexit on the development of anti-money laundering legislation in the EU. Although there will be concerns about divergence in the anti-money laundering regimes of the UK and the EU over the longer term, in the short term we expect the UK to maintain and develop a system which is substantially the same as that operating in the remaining EU member states.

News and Calendar

News

- Theresa May becomes the UK's new Prime Minister and grants three prominent Brexit campaigners cabinet appointments connected to the Brexit process:
  - Boris Johnson, as Foreign Secretary
  - David Davis, as Secretary of State for Exiting the European Union
  - Liam Fox, as Secretary of State for International Trade
- Valdis Dombrovskis, Latvia's former prime minister, becomes the European Commission's new financial services commissioner, following the resignation of UK commissioner Jonathan Hill
- UK agrees to give up its six-month EU presidency in 2017
- Banking crisis continues to unfold in Italy, as discussions between the Italian government and the EU on the rescue of Italian banks proceed with hopes for a mixed "TARP" and institutional bailout

Calendar

- Theresa May not expected to trigger Article 50 of the Lisbon Treaty before the end of this year
- First legal challenge on Brexit process to be heard in the UK courts in October

Clearing of Euro-Denominated Securities

In the wake of the Brexit referendum result, a number of commentators and politicians have focused on the position of London as a key center for the clearing of euro-denominated securities and derivatives. Many, including the President of the Republic of France, have suggested that when the UK leaves the EU, it will be open to the ECB to exclude clearing houses in the UK from being able to clear euro-denominated financial instruments. This assumption is predicated on an ECB policy statement that systemically important euro-denominated clearing should occur in a eurozone member state (rather than any other country). Following a challenge by the UK Government, this policy was overturned by a ruling of the EU's General Court (the "**General Court**") in 2015.

> **"The City, which thanks to the EU, was able to handle clearing operations for the eurozone, will not be able to do them…It can serve as an example for those who seek the end of Europe … It can serve as a lesson."[1]**

What is (euro) clearing?

A clearing house or, in the derivatives world, a central clearing counterparty ("**CCP**") acts as the "buyer to every seller and the seller to every buyer" in securities or derivatives transactions where the parties have agreed to clearing; in other words, the clearing entity interposes itself between the two parties so that one transaction becomes two matching contractual obligations.

Although clearing houses and CCPs provide a number of benefits to the financial system in terms of reducing bilateral counterparty risk, the scale of their operations can represent a source of systemic risk. Any serious disruption to the functioning of a major clearing entity would cause systemic problems and might therefore require a large amount of liquidity support from the supervising central bank. Consequently, clearing entities are subject to special regulatory regimes in many jurisdictions, including the UK.

London is one of the most important centers for the clearing of all types of derivatives. In particular, compared with other cities in the EU, it dominates the clearing of euro-denominated derivatives, having a daily turnover of transactions worth approximately 927 billion euros.[2]

In the derivatives sphere, the European Market Infrastructure Regulation ("**EMIR**") provides, *inter alia*, for the prudential regulation of CCPs, including requirements for authorization, capital, margins, organizational rules and the establishment of a default fund. The major CCPs for the EU derivatives market are concentrated in London. UK CCPs are authorized by the Bank of England.

The Bank of England also regulates UK-based clearing houses for clearing of securities.

The ECB view: euro-denominated clearing should happen in the eurozone

For a number of years, the ECB had raised concerns over the systemic risk to the functioning of the eurozone posed by clearing entities outside of its regulatory control, particularly those in the UK. On July 5, 2011, the ECB issued a "Eurosystem Oversight Policy Framework" document which would require clearing houses with daily exposures of more than 5 billion euros in one of the main euro-denominated categories of derivative to be located in the eurozone (the "**location policy**").

The UK, supported by Sweden (another non-eurozone member state), challenged the location policy in the General Court, the court of first instance for the Court of Justice of the European Union (the "**CJEU**").

[1] Francois Hollande, President of the Republic of France, quoted in the Financial Times on June 29, 2016.

[2] http://bruegel.org/2016/06/brexit-and-the-uks-euro-denominated-market-the-role-of-clearing-houses/

The UK challenge in the EU court

The ECB argued that the UK did not have standing to bring proceedings to challenge acts of the ECB because the UK had not agreed to the protocols which established the eurozone regulatory framework (i.e., because the UK had not adopted the euro as its currency). The General Court rejected this submission and held that the UK had standing as a member of the EU under Article 263 of the Treaty on the Functioning of the European Union ("**TFEU**"), despite not being part of the eurozone arrangements.

The UK challenged the location policy on the following grounds:

- the ECB had no competence to create a location requirement as part of its regulation of payment systems;
- the TFEU provides for freedom of establishment, freedom to provide services and free movement of capital in the EU, and these freedoms would be infringed by the location policy;
- the location policy might result in an anti-competitive situation in breach of the TFEU;
- the location policy infringed the principle of non-discrimination between Member States in the TFEU; and
- no justification for the discriminatory nature of the location policy could be made on the basis of the principle of proportionality.

In response, the ECB pointed to its establishment statute (the "**ECB Statute**"), which provides the ECB with the ability to make regulations "to ensure efficient and sound clearing and payments systems in the Union and with other countries," while the TFEU gives the ECB the task to "promote the smooth operation of payment systems."

The judgment – March 2015

The General Court found in favor of the UK on the first ground: the ECB has no competency to impose a location requirement for clearing houses. In the view of the General Court, the relevant provisions of the ECB Statute gave the ECB powers to adopt regulations in relation to payment systems alone, not the clearing of securities or derivatives.

> **"…the ECB has competence to adopt regulations to ensure efficiency and safety of payment systems, including those with a clearing stage, rather than…an autonomous regulatory competence in respect of all clearing systems."**

The General Court did, however, acknowledge that there were "very close links" between payment systems and securities clearing systems and that disruptions to the latter could have serious repercussions for the former. That said, the existence of these links did not justify, in the General Court's view, an acceptance of an implicit power of the ECB to regulate all EU clearing systems. This point led the General Court to comment that it would be open to the ECB to request that the ECB Statute be amended through a simplified legislative process to give the ECB these powers. In practice, this means that the ECB could be granted the relevant extra regulatory powers without having to obtain the consent of each of the current 28 EU member states.

The General Court did not address the other aspects of the UK's argument and, thus, left open the question of whether a location policy would, for example, undermine the fundamental freedoms of the single market.

In the aftermath of the General Court's decision, the ECB did not appeal to the Court of Justice (the highest court in the EU and ultimate arbiter of EU law). To deal with the systemic risk concern that the ECB identified, the ECB and the Bank of England agreed enhanced arrangements for information exchange and cooperation regarding UK CCPs with significant euro-denominated business. At the same time, the ECB and the Bank of England extended the scope of their standing swap line to facilitate, if necessary, the provision of multi-currency liquidity support by both central banks to CCPs established in the UK and the eurozone respectively.

What next?

It is clear that the ECB, under its current powers in the TFEU and the ECB Statute, does not have the power to regulate the location of clearing houses and CCPs. Yet it is also clear that the ECB continues to believe that the euro-denominated clearing activities of such institutions pose a systemic risk to the functioning of the eurozone. Last year's court decision means that, under current law, the ECB would not, however, be in a position to reinstate the location policy immediately following the UK's withdrawal from the EU.

Many politicians and commentators, most notably the President of the Republic of France, have indicated that Brexit provides an opportunity to re-establish the location policy. This may be motivated partly by a desire to punish the UK for leaving the EU (such punishment being seen as a deterrent to other member states considering Brexit-style referenda) but also an attempt to benefit eurozone financial centers such as Paris or Frankfurt, by attracting key financial market infrastructure to those jurisdictions, together with some of the operations of the clearing member banks.

Changing the ECB Statute

As the General Court noted, it would be open to the ECB to request an amendment to the ECB Statute or for the European Commission, the political executive of the EU, to propose such an amendment.[3] Although the ECB Statute is a protocol to the TFEU and changing such a provision would usually require unanimity of member states, the TFEU provides that an amendment to the relevant parts of the ECB Statute could be passed by the so-called "ordinary legislative procedure," which means that only a qualified majority of member states[4] and the approval of the European Parliament would be required.

Could the UK oppose such a change?

Even while the UK maintains its EU membership during the Brexit negotiations, it would have to mobilize support among both eurozone and non-eurozone members to oppose any change to the ECB's powers. In the context of an imminent Brexit, the ability of the UK to achieve its legislative aims is already much diminished; if the ECB or the European Commission were minded to seek this change, it would seem unlikely that the UK could do much to oppose it at the political level.

While a member of the EU, the UK would have standing to challenge such a change in the CJEU, likely on the basis of one the arguments that were not addressed in the 2015 General Court decision. If such a challenge were made after Article 50 of the TFEU, the "exit provision," had been invoked, the CJEU would be put in the difficult position of not knowing what the final relationship between the UK and the EU might look like. There is no guarantee that the UK would prevail in such an action; even if it did, it might lose the benefit of such a decision when it leaves the EU.

Of course, once the UK leaves the EU, it would not have standing to directly challenge an EU rule or piece of legislation in the CJEU, even if it were to negotiate continued membership of the European Economic Area (the "**EEA**"). It is possible that a remaining EU member state outside the eurozone could challenge the location policy or the ECB Statute amendment, but it is far from clear that this would happen.

EEA arrangements do allow for the settlement of disputes between EU member states and non-EU EEA member states as to the interpretation of the EEA Agreement, but it is uncertain at this point whether the UK, if it became a non-EU EEA member state, would have the ability to challenge a location policy or other piece of EU legislation designed to address euro-denominated clearing issues.

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[3] Article 129(3) TFEU.

[4] A "qualified majority" is reached if two conditions are met: (i) 55% of member states vote in favor; and (ii) the proposal is supported by member states representing at least 65% of the total EU population.

Other impacts of Brexit on clearing operations in London

Brexit may also limit the ability of clearing member banks in London to execute derivatives transactions with EU clients if the EU passport for the provision of financial services is not maintained (please see the first issue of Lex et Brexit for more detail). Furthermore, if the UK leaves the EU and does not negotiate continued EEA membership, CCPs in the UK would become "third country" CCPs under EMIR, meaning that there would be a need for equivalence assessments for the UK and for UK CCPs to register with the European Securities and Markets Authority ("**ESMA**") in order to continue to provide clearing services to EU counterparties. We will consider the impact of Brexit on EMIR in detail in a future edition of Lex et Brexit.

In summary, Brexit materially increases the possibility that substantial volumes of clearing activity will move out of London. If this were to occur, it may act as a contributing factor towards a gradual migration of broker-dealer and derivatives trading activity out of the UK. Decisions about whether to reinstate a location policy for euro-denominated instruments will essentially be political in nature, and may well form a significant part of the negotiations around continued market access for UK financial services firms.

The UK's Anti-Money Laundering Regime

In the past several years, compliance with anti-money laundering legislation has been an area of key concern for financial institutions. These institutions must comply with the anti-money laundering regimes of each jurisdiction in which they operate, including, where relevant, that of the UK. Here, we consider Brexit's impact on the UK's anti-money laundering regime.

The current regime

The Third Money Laundering Directive ("**MLD3**") has governed the EU's anti-money laundering regime since December 2007. As a directive, MLD3 had to be implemented into the national laws of each member state. In the UK, MLD3 was implemented mainly via the Money Laundering Regulations 2007 (the "**MLRs**").

The MLRs apply to a wide range of firms, including UK financial institutions. Under the MLRs, firms are required, *inter alia*, to perform due diligence on their customers, keep adequate records, establish and maintain appropriate anti-money laundering policies and procedures, and provide training to staff.

Brexit's implications for revisions to anti-money laundering legislation

In June 2015, the EU member states agreed on a joint initiative to strengthen the EU's anti-money laundering regime – the Fourth Money Laundering Directive ("**MLD4**"). MLD4 will repeal and replace MLD3. Although MLD4 initially had to be transposed into national laws by June 26, 2017, the European Commission has recently put forward a legislative proposal that would, *inter alia*, bring forward the deadline for transposition to January 1, 2017. Since it is likely that the UK will not have left the EU by either date, the UK is expected to continue with its implementation of the legislation. In fact, on July 12, 2016, the Financial Conduct Authority published its anti-money laundering annual report 2015/16, in which it stated that it "will continue to work with the Treasury on key policy areas like the transposition of [MLD4]."

Under MLD4, the Joint Committee of the European Supervisory Authorities (consisting of ESMA, the European Banking Authority and the European Insurance and Occupational Pensions Authority, together the "**Joint Committee**") is required to develop guidelines on certain topics, including the factors that a firm must consider when assessing the risks associated with establishing a business relationship or performing a transaction with or for a particular customer (the "**risk factor guidelines**"). The risk factor guidelines are also intended to provide direction on how a firm can adapt its customer due diligence measures to reflect the risks that it has identified. Guidelines produced by the European Supervisory Authorities operate on a "comply or explain" basis, which means that a firm must make every effort to comply with the guidelines or otherwise explain why it is unable to do so.

In the UK, the Joint Money Laundering Steering Group ("**JMLSG**") produces guidance on the implementation of UK anti-money laundering legislation specifically for financial services firms. This guidance has been approved by HM Treasury, which means that UK courts and regulators must consider a firm's compliance with the guidance when determining whether or not it has breached its obligations under the legislation.

The JMLSG's guidance covers many of the points considered in the risk factor guidelines. For instance, it also identifies factors that a firm should consider when assessing a customer's risk profile. In its response to the Joint Committee's consultation on the risk factor guidelines, the JMLSG noted that "overlaps in the scope and coverage of the proposed guidelines and domestic guidance will raise practical compliance issues." There is a question, therefore, whether UK firms should use the Joint Committee's guidelines or the JMLSG's guidance as their primary reference material once MLD4 is implemented into UK law. Following the UK's withdrawal from the EU, and assuming it does not retain its membership of the EEA, it is clear that only the JMLSG's guidance will be of any legal significance, as it has been endorsed by HM Treasury. As a result, in the lead-up to Brexit, it is possible that UK firms may prefer to rely on the JMLSG's guidance rather than guidance provided by the Joint Committee.

What does Brexit mean for future anti-money laundering legislation?

Another layer of legislation?

Firms that operate on an international scale often have global anti-money laundering policies in place, which are then tailored to comply with national regimes. Adhering to the different national regimes is a costly and time-consuming exercise. When the UK withdraws from the EU, it will no longer have to comply with the EU's anti-money laundering legislation. Therefore, it is possible that Brexit will lead to an accelerated and intentional divergence between the anti-money laundering regimes of the UK and the EU, which would only add to the expense and time required to comply with the various systems.

On the other hand, both MLD3 and MLD4 are minimum harmonization directives, which means that each directive sets a threshold for anti-money laundering legislation that a member state must meet. A member state may, however, impose stricter requirements via its implementing legislation. The UK has often done so, i.e., it has frequently "gold plated" EU anti-money laundering legislation. For example, the UK has adopted an "all crimes approach" in its anti-money laundering legislation, which means that every money laundering offence must be reported – there is no *de minimis* threshold.

In addition, the UK, most EU member states and the European Commission are members of the Financial Action Task Force (the "**FATF**"), an intra-governmental body responsible for the development of the international anti-money laundering framework. All of these entities will remain members of the FATF once the UK withdraws from the EU and, thus, will continue to look to the standards the FATF produces. As a result, it is unlikely that anti-money laundering legislation in the UK and the EU will start to deviate significantly.

Loss of ability to shape future EU anti-money laundering legislation

Following a Brexit where EEA membership is not maintained, if a UK financial institution wants to transact with an EU financial institution, the UK financial institution will continue to be subject to the EU's anti-money laundering legislation, i.e., the EU financial institution will need to perform due diligence on the UK financial institution as prescribed by the EU's anti-money laundering legislation. Once the UK withdraws from the EU – and regardless of the exit package that it negotiates – the UK will lose its ability to shape future EU anti-money laundering legislation and guidance, which may be of significance to financial institutions. For example, when MLD3 was negotiated, following representations from various interested parties, HM Treasury successfully advocated that trustees of debt issues should be exempted from the requirement to identify and verify the identity of beneficial owners. Following Brexit, the UK will not have such influence over any future EU anti-money laundering legislation. In fact, the UK's influence over the outstanding pieces of MLD4, such as the various guidelines, has likely diminished already in the wake of the Brexit referendum result.

The UK's loss of influence is mitigated, however, by the existence of the FATF. The UK will remain a member of the FATF following Brexit, which means that it will continue to have some influence on the

standards it produces. Since these standards provide a framework for the EU's anti-money laundering legislation, the UK will, by extension, retain some limited influence over future EU anti-money laundering legislation.

Ultimately, although the UK's influence on future EU anti-money laundering legislation has diminished since the Brexit vote, and there may be some divergence in the UK and EU anti-money laundering regimes over the longer term, we expect that, at least in the short term, the UK will maintain and develop a regime that is substantially the same as that operating in the EU.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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