Balance of Competences Consultation Response

Free Movement of Financial Services and the Free Movement of Capital

January 2014

This is a joint response from the Law Society of England and Wales and the Law Society of Scotland (the Law Societies).

The Law Society of England and Wales is the independent professional body, established for solicitors in 1825, that works globally to support and represent its 166,000 members, promoting the highest professional standards and the rule of law.

The Law Society of Scotland is the professional body for Scottish solicitors, established in 1949. It is not only the representative and regulatory body for all practising Scottish solicitors but also has an important duty to work towards the public interest.

Introduction

I. UK membership of the EU has brought significant benefits to solicitors, law firms and their clients, most particularly through the ability to trade, provide services and establish across the EU and to seek effective redress to cross-border legal issues.

II. The legal services sector plays a key role in the UK economy, the UK's competitive advantage and in improving the efficiency of doing business. Legal services directly contributed £27.2bn[1] in turnover to the UK economy in 2011. This included almost £4bn of exports – a substantial volume of which was generated through trade with EU Member States.

III. The UK legal services sector is globally focussed with offices and lawyers based throughout Europe and the world. Law firms exist in order to service the needs of their clients; these are commonly British businesses trading throughout the Internal Market and increasingly non-British clients doing business in the Internal Market.

IV. The legal profession works day-to-day with clients throughout the EU dealing with a broad range of legal issues across a diverse range of fields, from commercial transactions, intellectual property and competition law to employment law, civil justice and dispute resolution.

V. It is for these reasons that the Law Societies and the legal profession have an interest in the stability of the UK's position within the EU and the future role of the UK at the heart of EU rule-making.

VI. The Law Societies nevertheless accept that there is a debate as to the appropriate level of EU competence in various policy areas and will input into the other reviews of the balance of competences of most relevance to the legal profession.

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[1] http://www.ons.gov.uk/ons/rel/abs/annual-business-survey/2011-revised-results/index.html

Question 1 - How have EU rules on financial services affected you or your organisation? Are they proportionate in their focus and application? Do they respect the principle of subsidiarity? Do they go too far or not far enough?

1. A large number of solicitors are involved in providing regulatory and other advice to firms within the financial services industry. As the consultation document itself points out, the financial services sector is able to source complementary professional services within the UK and the legal profession works closely with the financial services industry from banking and investment to insurance and pension funds. Many solicitors therefore have in-depth expertise in dealing with financial services legislation which emanates from the EU. The EU rules on financial services have had a substantive impact on the practices of solicitors, not only in places such as London and Edinburgh, but as international firms, or firms carrying out international work, have developed in financial sectors elsewhere, such as Paris, Frankfurt and New York, etc.

2. There is no "one size fits all" answer as to whether the EU rules on financial services are proportionate and comply with the subsidiarity principle. Similarly, there is no blanket answer as to whether they go too far, not far enough, or strike the right balance. The Societies note, however, that the UK has only very infrequently[2] been overridden in the Council on financial services legislation which would suggest that the vast bulk of EU legislation in this area is acceptable to the UK.

3. A proliferation of EU legislation governing banking institutions has been agreed in the wake of the banking collapse which triggered the last economic crisis. The Law Societies believe that this legislation should be given a chance to settle in and a comprehensive review of its effectiveness carried out before further steps are taken in this sphere.

4. The EU Commission and other institutions have been active in the field of card payment systems (direct debit and credit cards), and payments for small transactions to ease the flow of capital and to make payments by consumer easier. This is a good example of where action at the EU level is particularly useful and is an important step towards completing the Internal Market.

5. The Societies emphasise the importance of ensuring that all EU legislation does comply with the principles of proportionality and subsidiarity. The policy objective should be clearly defined in legislation and used to test each element of the proposal.

Question 2 - How might the UK benefit from more or less EU action? Should more legislation be made at the national or EU level? Should there be more non-legislative action, for example, competition enquiries?

6. Free Movement of Services and the Free Movement of Capital are both founding freedoms, essential to the very idea of an internal market.[3]

7. The Internal Market functions well in many areas but it is not yet complete. This is particularly evident in the services sector, including for financial services. The cross-border provision of retail financial services still needs to be developed, for example, in relation to the provision of personal banking services and insurance at the retail level. Further legislation will be needed at the EU level to achieve this but the action

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[2] The only incidence of which the Societies are aware was the recent proposal to limit bankers' bonuses.

[3] The free movement of capital in practice has developed more slowly; for example the UK removed exchange controls some years after the UK joined the EEC in 1973.

with the USA. This may also hold true when the EU Member States are negotiating international regulatory agreements where the combined power of the EU may well prove more effective in influencing the negotiations than a single Member State negotiating alone. The UK has the potential to use this to its advantage to ensure that the standards further the UK's own strategic objectives and offer the correct levels of regulation to balance the need for growth with other factors such as consumer and taxpayer protections.

17. Ancillary to this, creating a regulatory system on a larger scale can provide a blueprint for integration and standardisation. The Law Society of England and Wales raised this point in relation to the Free Movement of Goods consultation paper and it holds true in relation to the sale of financial products.

Question 3 - How have EU rules helped or made it harder to achieve objectives such as financial stability, growth, competitiveness and consumer protection?

18. The Law Societies do not offer any view on the economic consequences of individual EU initiatives in relation to their effect on controlling or promoting financial stability, growth and competitiveness.[6]

19. However, the existence of a Single Market for financial services as a whole is of benefit to UK businesses and the UK economy. The Internal Market rules facilitate competition, including in relation to financial services. This allows the UK to build on its competitive advantage as a leading player in this field.

20. Competition between lawyers and in particular between law firms in major financial centres in the EU, has had a major impact on the way in which legal advice is given to providers of financial services. Not only have UK (and particularly London) based firms been able to benefit from providing legal advice in relation to financial services in other European centres, but equally law firms in those places have become more organised and efficient in the way in which they provide legal services; so competition between law firms has been an EU benefit.

Question 4 - Is the volume and detail of EU rule-making in financial services pitched at the right level? Has the use of Regulations or Directives and maximum or minimum harmonisation presented obstacles to national objectives in any cases?

21. A large quantity of new financial services legislation has been introduced in recent years which goes to the very core of the single market. A certain amount of time must elapse for implementation and to allow the new measures to effect changes in the financial services system before it is possible to properly assess their effectiveness.

22. The ability of financial services firms to create branches is an efficient way of ensuring that entities are regulated while making it easier for them to expand across borders. It reduces the need to comply with multiple sets of rules. This must be supplemented by harmonisation of basic minimum standards to avoid regulatory or supervisory arbitrage and to protect consumers.

23. The FSCS (Financial Services Compensation Scheme) emanates from the EU and is an important mechanism for protecting the private funds of ordinary citizens.

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[6] For the Law Societies' view on the impact of EU law in relation to consumer protection, please see the Joint Response of the Law Societies to the Competition and Consumer Policy consultation paper also submitted as part of the third tranche of the Balance of Competences Review.

should be targeted to specific areas where it is required, should comply with the principles of subsidiarity and proportionality and must be fit for purpose.

8. Improvements are being made in relation to retail financial services but the level of integration remains unsatisfactory. Part of this is due to the lack of, or at least a perception that there is a lack of, consumer protection in this area.

9. A further aspect is due to the absence of tax harmonisation measures in the EU in the sector concerned. This can be seen in the series of UCITS Directives dealing with the regulated funds industry where the potential to exploit the advantages of the Internal Market is hampered by a lack of harmonised tax treatment concerning UCITS funds.[4]

10. Another area which has proven problematic for UK nationals wishing to move throughout the EU is pensions; it is often difficult, if not impossible, to transport pensions between Member States or to continue contributing to pension schemes in home jurisdictions if the pension-owner is located elsewhere. Anecdotal evidence from UK lawyers who have worked in other Member States suggests that further work should be done on the transfer of occupational pensions. Although agreement has recently been reached on new legislation regarding the portability of pensions, the measures do not extend to transferability of pensions.

11. Some practitioners point to the fact that the ability to take action at an EU level was helpful in reducing the worst effects of the recent financial crisis. Without legislation put forward by the Commission to deal with the crisis on a pan-European basis, the economic damage could have been far greater.

12. However, certain legislation on the table following the crisis risks rolling back advances which have already been made, for example in relation to different regulatory requirements to be imposed on the structure of banks.

13. In that context it is also important for the United Kingdom to avoid bringing forward legislation, for example in the Financial Services (Banking Reform) Act 2013 in relation to the imposition of ring-fencing which might require repeal or substantial amendment if and when EU regulations in the same area come into effect. Such action may impose additional, and no doubt very substantial, compliance costs on the banking industry, which in turn are likely to be passed on to its customers.

14. It is important to note that certain legislative initiatives are instigated by international organisations such as the Financial Stability Board (FSB) and G20. A recent example of this is the implementation of the Basel III requirements in CRD IV.[5] In cases such as this, the UK would be required to implement changes in any case as part of its international obligations. As these agreements are intended to standardise systems at a global level, it seems logical to implement them at EU level to further the aim of consistency.

15. This collective approach to implementation may also mean that other international counterparts are less likely to question the UK's implementation methods; any EU-agreed approach draws together expertise from multiple jurisdictions, regulators and industry experts in a particular field and is therefore likely to be persuasive.

16. In other consultations the Law Society of England and Wales has spoken about the combined negotiating power, for example in negotiating trade deals, notably the Transatlantic Trade and Investment Partnership (TTIP) currently being negotiated

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

[5] The fourth Capital Requirements Directive

Question 7 - What has been the impact of the shift towards regulation and supervision at the EU level, for instance with the creation of the European Supervisory Authorities? Should the balance of supervisory powers and responsibilities be different?

30. The European Supervisory Authorities (ESAs) are nascent and so it is understandably taking some time for them to become fully functional and effective in their regulatory spheres of influence.

31. One of the problems arising from cross-border banks and other financial institutions is that it is difficult to genuinely assess the weakness or strength of that institution. A common supervisory system can help to mitigate this problem. However, regulation will often be best enforced at Member State level, albeit that the broad lines of policy are coordinated and decided by the EU.

Question 8 - Does the UK have an appropriate level of influence on EU legislation in financial services? How different would rules be if the UK was solely responsible for them?

32. As noted above, the UK has very rarely been overruled on financial services legislation in Council.

33. The Law Societies are unable to predict how different the rules would be if the UK was solely responsible. However, the fact that the UK's view has so consistently been complied with might suggest that the rules would not be very different.

34. Indeed in a number of pieces of legislation the EU legislation bears a close correlation to the system which was operating in the UK before it was introduced in the EU, for example many aspects of the proposed Rescue and Recovery Directive follow elements of the Banking Act 2009.

35. A distinction needs to be drawn here between influence at Level 1 (EU legislation), and the other (Lamfalussy) Levels down to coordination and monitoring of Member State implementation. The key challenge for the UK Government remains bolstering the number of senior UK officials in DG Internal Market (DG Markt) and DG Competition. EU legislation (particularly in the financial services domain) tends to emanate at policy level in DG Markt (and to a lesser extent DG Competition) during which period consultations, hearings and other discussion fora are organized and populated. Greater influence at Commissioner/Cabinet/Head of Unit level would increase UK influence in these key areas. Likewise, the UK Government should consider the UK quotient in ESMA, EBA and EIOPA.

    At the lower levels the UK Government, the FCA[10] and other key UK authorities have had some significant influence. For example, at technical level FCA industry experts and market specialists have made invaluable contributions in the context, for example of EMIR and other financial services legislation (sometimes under difficult circumstances in light of omissions or contentious inclusions at Level 1).

[10] Financial Conduct Authority - the functions of which were formerly carried out by the Financial Services Authortiy (FSA).

24. Broadly speaking the four stage Lamfalussy legislative process which aims to strengthen the EU regulatory and financial sector supervision framework has worked satisfactorily to date. It can be seen, for example, in the context of the European Market Infrastructures Regulation (EMIR- Level 1) where the Commission ESMA's binding technical standards (Level 2) have cascaded down into UK rules and guidelines (led by national regulators). The practical improvements made as a result of the 2008 Lamfalussy review were a step forward, although since then and in the wake of the financial crisis further refinements may be advisable.

25. One area where the Commission and certain Member States have struggled is in ensuring timely transposition of EU legislation into national law (Level 4). Late or incorrect transposition potentially affects all areas of law - not just financial services legislation - and the Commission (along with ESMA and the other EU financial regulators) should maintain pressure on some of the less proactive Member States to combat this.

Question 5 - How has the EU's approach to Third Country access affected the ability of UK firms and markets to trade internationally?

26. Third country access is of particular concern to the UK as its financial services markets are traditionally more open than those of many other Member States. Examples of legislation where this issue has been raised include the AIFMD,[7] EMIR and MiFID II.[8]

Question 6 - Do you think that more or less EU-level regulation in the area of retail financial services would bring benefits to consumers?

27. It is not the quantity, but rather the efficacy which is most important in judging the benefits of EU-level regulation to consumers in this area.

28. Initiatives such as the introduction of KIDs for UCITS funds (as set out under the UCITS IV Directive) aim to facilitate comparison between funds. A similar idea has now been proposed for packaged retail investment products (PRIPs). Such initiatives will only succeed, however, if the documents produced achieve this end in practice.[9] This requires clear guidelines as to the information which is deemed important or necessary for the consumer to make an informed decision.

29. Of course regulation alone is not enough and effective enforcement mechanisms are also required for regulation to succeed, as with any other set of rules or laws.

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[7] Alternative Investment Fund Managers Directive

[8] Markets in Financial Instruments Directive II

[9] Further in the context of key information documents it should be borne in mind that these are a good idea but they need to be long enough to be meaningful. They should only be used in relation to products which it is appropriate to sell to retail investors. Some practitioners suggest that if something is too complex to explain in a relatively short document, this may indicate that it is not suitable for sale to retail investors.

Question 9 - How effective and accountable is the EU policy-making process on financial services legislation, for example how effective are EU consultations and impact assessments? Are you satisfied that democratic due process is properly respected?

36. As a general rule the EU policy-making process on financial services legislation is satisfactory.

37. However, in some cases specific problems identified by the Law Societies will not necessarily be dealt with. This issue is not, however, confined to the EU process.

38. One notable case of the policy-making process not functioning properly in recent years can be seen in the proposed Financial Transaction Tax, which is now being progressed on the basis of the Enhanced Cooperation Procedure. The Law Society of England and Wales[11] has identified a number of concerns in relation to this proposal, in particular in relation to the extra-territorial effect, both in non-participating Member States and in a wider international context.

39. The Law Society of England and Wales is not convinced that the proposals on the Financial Transaction Tax are in accordance with the Treaties, or that they will enhance the single market in financial services. The extra-territorial effect proposed by the tax will have an adverse effect on Member States not imposing the FTT (which include the UK) and indeed outside the EU. However, the existence of the Mutual Assistance Directive probably results in the effects for non-participating Member States being worse than for non-Member States. The Council should therefore move away from the current proposal. It is reassuring to review the Council Legal Opinion but further work needs to be done to ensure that other Member States appreciate the problems with the current proposal. [12]

40. Another example of unsatisfactory policy-making and procedure was the policy and early legislative developments in relation to AIFMD. The first consultation was open over a Christmas holiday and truncated. It would have been preferable if the initial consultation would have been longer and better researched. This would have also saved the Commission, Member State Governments, regulators and stakeholders time and money.

Question 10 - What has been the effect of restrictions placed on Member States' ability to influence capital flows into and out of their economy, for example to achieve national public policy or tax objectives?

41. The Law Societies do not offer any comment on this question.

Question 11 - What may be the impact of future challenges and opportunities for the UK, for example related to non-membership of the euro area or development of the banking union?

42. There has been much talk recently of the potential adverse effects on non-eurozone countries from the increased political and economic integration of eurozone countries. This particularly entered the spotlight during negotiations over the establishment of a Single Supervisory Mechanism (SSM). While the Societies recognise that it is important to be aware of the unique situation of the eurozone countries, the experience of the SSM indicates that it is possible to ensure

[11] The Law Society of Scotland currently has no position on the Financial Transaction Tax.
[12] The Law Society of Scotland currently has no position on the Financial Transaction Tax.

appropriate safeguards are put in place, thus avoiding a negative impact on non-eurozone countries.

43. If further example of when the UK managed to prevent an unfavourable legislative provision was a proposed prohibition on, inter alia, regulated clearing houses for euro-denominated financial products being located outside the Eurozone put forward in 2011 by the European Central Bank (ECB) with initial Commission support). This proposal was not included in final (EMIR) legislation due in part to the UK Government's opposition, including challenging the legality of the proposal in the Court of Justice of the EU.

Question 12 - Do you have any further comments about issues in addition to those mentioned above?

44. As set out in the consultation document "the free movement of capital and payments is critical for the UK financial services industry, as well as other parts of the economy. It underpins the Single Market and allows the import and export of goods, and services". In this last respect, the provisions on the free movement of capital have been, and continue to be, essential to those wishing to provide cross border legal services and to UK law firms wishing to establish in other Member States, as both of these require capital to flow across borders.

45. It should also be noted that the free movement of capital both in and out of the UK has enormous benefits for UK citizens, companies and the UK economy as a whole.

46. Free movement of capital allows investment vehicles such as pensions funds, insurance companies and investment trusts to diversify risks and exploit investment opportunities across a wider market. It also allows UK companies to act as service providers for customers in other Member States.

47. Furthermore, the free movement of capital is an integral aspect of foreign direct investment (FDI). The UK is one of the main beneficiaries of FDI within the single market.

48. One other aspect not touched upon in the questions above is the unique role which the doctrine of direct effect plays in relation to the fundamental freedoms, including the free movement of capital and the freedom to provide services. This has proven to be effective in preventing attempts by one Member State at discrimination or protectionism against providers of services in, or from, other Members States. The UK legal system has embraced the concept of judicial cooperation built on the referral system and principle of direct effect since the latter was affirmed by the case of *van Gend en Loos*.[13]

[13] Case 26/62 *van Gend en Loos* [1963] ECR 1 – Court of Justice