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Brexit: A Financial Free Zone Within the City

The UK Government recently indicated that it intends to negotiate a unique EU-UK relationship post-Brexit. It is hoped that the arrangements will be appropriate for the UK and London's position as a leading international financial centre. A number of existing models have been discussed and will no doubt be analysed, with variations, by the Government. This client note sets out a framework for new opportunities which could be developed in the UK post-Brexit, by establishing a "financial free zone" in London. This would enable the UK to take a bifurcated approach to financial services post-Brexit. The UK as a whole could take an equivalence-based approach or other route to financial services regulation enabling single market access such that financial institutions could continue to provide services cross-border into the EU in a similar way to the present. Separately, the financial free zone could adopt a far more free-market approach to regulation within the zone, subject to tight controls on systemic risk. This would provide optionality to market participants as to whether they wish to do business cross-border at all. We discuss the characteristics and purpose of financial free zones and a proposed framework for the establishment of a London zone.

A Financial Free Zone

Free zones have a number of characteristics in common, namely they are limited to a geographic region, have a single administration, offer benefits to participants, such as tax or investment incentives, and have separate streamlined procedures. Free zones have traditionally had a policy and infrastructure role in developing countries, as they can be used as a tool for economic growth and to attract foreign direct investment. Free zones have been in place in Gibraltar and Singapore from 1704 and 1819, respectively, with the first modern industrial free zone being established in Shannon, Ireland in 1959.

Whilst free zones have traditionally been set up to encourage trade exports and foreign direct investment, a more contemporary approach is the creation of a multi-sectoral zone. For example, the Chinese government is creating a special economic zone at Qianhai bay, Shenzhen, which specializes in financial services, logistics, technology and startups. Within the zone, firms will be given help to raise Yuan offshore, and banks established in Hong Kong will be able to enter the zone more easily than under the current set-up. These measures are designed to reduce the severity of China's capital controls[1] and encourage financial cooperation with Hong Kong. Financial free zones are a similar concept. The zone is located in an area demarcated for financial activity to be conducted and is set up with its own legal and regulatory system. The United Arab Emirates ("**UAE**") has several free zones, used for sectors as diverse as duty-free, shipping and financial services. Most recently, it established the Abu Dhabi Global Market ("**ADGM**"), a broad-based international financial centre for local, regional and international institutions, with the aim of it being a catalyst for the growth of a dynamic

[1] China Offshore, "Qianhai Bay Special Economic Zone to act as bridge between Hong Kong and the mainland," available here.

financial services sector in the UAE.[2] The Dubai International Finance Centre ("**DIFC**") was established in 2004 to encourage businesses and financial institutions to tap into the emerging markets of the Middle East, Africa and South Asia and has also proven to be highly successful.

A London International Financial Centre

A London International Financial Centre ("**LIFC**") could see the creation of a new, small territorial area within London demarcated for London-based financial institutions wishing to operate on an even more free-market based model than the rest of the market. The LIFC would have its own laws and regulations, based on the common law and UK statutes, but tailored for a high-growth, highly dynamic market subject to the main constraint that the laws must nevertheless (as with all modern financial services laws) minimize systemic risk and ensure clean markets. The LIFC could also create streamlined work visa processes, to ensure continuing ready access to a worldwide talent pool.

This LIFC would not seek equivalence, as a matter of course, with the EU except on topics it wished to or even, potentially, substituted compliance recognition with the US. It would have a stand-alone regime where institutions could operate in a highly deregulated environment but in the EU time zone.

Own Territory

The LIFC would need its own territory. Historically, the City of London housed the main financial businesses in the UK but the financial sector has spread as it has grown and a lot of the business is also located in Canary Wharf. A clearly demarcated area would be needed to bring certainty as to where certain activities could be undertaken within the free zone framework. We do not propose that London, the City or Canary Wharf be designated. Rather, such a proposal would work best in a significant area of new-build or regeneration-build real estate, such that those using the free zone freely choose to participate in it.

Separate Regulatory Framework

It is likely that separate regulators will be needed for the LIFC from the rest of the UK. For example, the Financial Services Regulatory Authority ("**FSRA**") is the independent regulator for financial services in ADGM and the Dubai Financial Services Authority ("**DFSA**") is the independent regulator for financial services in the DIFC, with the Central Bank of the UAE, the Securities & Commodities Authority and the Insurance Authority regulating financial services in the rest of the UAE. In establishing the LIFC, the current regulatory architecture could be maintained so that the Bank of England, the Financial Conduct Authority ("**FCA**") and the Prudential Regulation Authority ("**PRA**") would continue to regulate financial services in the UK more generally. The Bank of England would continue to be responsible for macro-prudential regulation of the UK economy as a whole. Due to the EU compliant infrastructure and rules that are already administered by the Bank, the FCA and PRA, as well as the existence of good working relationships with the EU authorities such as the European Central Bank and the European Supervisory Authorities ("**ESAs**"),[3] these relationships should be continued separately from the LIFC.

2 You may like to see our client note, "Abu Dhabi Global Market: Financial Services Regulations and Rules," available here.

3 The ESAs comprise the European Securities and Markets Authority, the European Banking Authority and the European Insurance and Occupational Pensions Authority.

Independent Judicial System

Characteristically, financial free zones have independent judicial systems. Both ADGM and the DIFC, for example, have an independent judicial system and the special economic zone in Qianhai will also have its own separate legal system with a Shenzhen Court of International Arbitration and a Qianhai Tribunal.[4] The LIFC could establish either a separate judicial system or a designated court within the current judicial framework, to deal specifically with financial services issues arising within the LIFC regime.

Free Movement of People

An additional possible benefit of establishing an LIFC could be the introduction of preferential immigration laws, enabling foreign nationals to work in professional services within the LIFC and reside there. For example, the special economic zone being established in Qianhai has implemented a regime under which foreign nationals working within designated professional services can apply for permanent residence to live and work in the zone. A separate immigration regime for an LIFC could enable the UK to continue to benefit most easily from the international talent pool whilst implementing more stringent immigration controls for the rest of the UK.[5]

The Likely UK-EU Relationship: EU Equivalence Regimes

The introduction of the LIFC could allow the UK to develop within the LIFC financial services laws that differ more radically from those of the EU, giving London-based financial institutions a choice as to which regime best suits their business, whilst retaining the advantages of being based in London.

As set out in our previous client note,[6] the likely outcome for the UK as a whole is an equivalence-based relationship with the EU for financial services where financial market participants established in the UK can do business that is cross-border in law with counterparties and customers in the EU under UK laws that are equivalent to those in the relevant sector in the EU – and vice versa. A summary of the equivalence regimes is set out in our previous note. There are some holes in those regimes, many of which (if not all of them) we believe are likely to be plugged.

Conclusion

Whilst the future relationship between the UK and the EU remains to be negotiated, an LIFC is an exciting prospect for the UK's future financial sector. It could serve to boost further the UK's unparalleled position as a major financial centre and offer new opportunities to the UK, the EU economies and other markets around the world.

Our Role Establishing ADGM

Shearman & Sterling advised ADGM on its establishment as an international financial centre. Working closely with the leadership team at ADGM, Shearman & Sterling helped develop ADGM's world-class legal and regulatory regime to be in line with international standards to provide the sophistication and certainty found in the world's top financial centres. Shearman & Sterling has played a key role in ADGM's adoption of English common law by applying it in its jurisdiction for civil and commercial law. The application of English common

4 Qianhai Website, "Legal Environment," available here.

5 You may like to see our client note, "Brexit: Free Movement of Persons," available here.

6 "Brexit and Equivalence: Review of the Financial Services Framework Across All Sectors," available here.

law will govern matters such as contracts, tort, trusts, equitable remedies, unjust enrichment, damages, conflicts of laws, security and personal property. Additionally, Shearman & Sterling drafted all legislation governing matters such as companies, insolvency, interpretation, commercial licensing, arbitration, courts, employment, limited liability partnerships, real property, financial regulation and strata title.

Shearman & Sterling advises its clients on ADGM laws out of its Abu Dhabi, Dubai, London and US offices, and has unique insights as a result of its role in developing the legislation.

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