

# LAW AND ECONOMICS YEARLY REVIEW

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

*Editors*

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*in association with*



# LAW AND ECONOMICS YEARLY REVIEW

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

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**AGAIN ABOUT BREXIT: FROM THE IMPACT  
ON FINANCIAL RELATIONSHIPS  
TO THE GEOPOLITICAL BALANCES OF THE UNION  
(i.e. the implications on the constitutional  
integration in Europe) \***

Francesco Capriglione\*\* - Renato Ibrido\*\*\*

**ABSTRACT:** *The “United Kingdom European Union membership referendum” triggered a procedural and legal path leading up to the exit of Great Britain from the EU, thus resulting in a halt to the integration process of this community started off back in 1973. From this point of view, Brexit is to be seen as a watershed, separating UK from the EU, inter alia, on a cultural level.*

*One year after the Brexit referendum, this article explores the economic, geopolitical and constitutional implications of the vote of 23 June 2016, taking into account certain issues that have not been fully dealt with so far in the scholarly debate: the financial impact of the Brexit; the perspective of a strengthening of the Franco-German axis; the relationship between austerity and Eurosceptic populism; the role of the referendum concerning European matters and the crisis of the representative democracy.*

*Furthermore, the Authors analyze the Brexit consequences with regard to the reorganization of the EU institutional framework as well as the issue of the democratization of the European economic governance.*

**SUMMARY:** 1. Introduction. - 2. First assessment on Brexit. - 3. (continued): ... Scenario of the implementation process of Brexit. - 4. The approval of the guidelines for Brexit negotiation - 5.

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\* Although jointly elaborated, this article has been drafted as follows: paragraphs 1, 2, 3, 4, 5, 6, 7, 8, 9 and 18, by Prof. Francesco Capriglione while the others by Renato Ibrido.

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The economic impact of Brexit. - 6. (continued): ... Banking relationships and reorganization of the EU financial system. - 7. The EU and the implications of the complex *post-crisis* EU regulation. - 8. The new geopolitical framework of the Union: perspective of a strengthening of the Franco-German axis.- 9. Towards a cultural metamorphosis of Europe. - 10. The transformation of the European liberal-democratic paradigm – 11. The perspectives of constitutional integration process in Europe. – 12. European constitutional unity between solidarity and stability. – 13. Interweaving of *austerity*, Eurosceptic populism and criticism of representative democracy: the Italian case – 14. The problem of the relationship between Internet and democracy: the ideology of the web – 15. The crisis of politics: the dimension of the national and European representative institutions. - 16. Referendum and European integration. - 17. (continued): ... Referendum on Brexit and the *Miller* case. - 18. The awareness of a genetic mutation of the Union and the absence of perspective of a new constituent phase.

1. The U.K. referendum vote that took place on 23 June 2016 triggered a legal trajectory leading up to the exit of the United Kingdom from the EU, thus resulting in a halt to the integration process started off back in 1973. Such a landmark event has brought up a great deal of discussion, from examining the reasons behind the very choice of changing the course of history to the concrete procedural difficulties in bringing about such transition which has witnessed the UK wait-and-see attitude *vis-a-vis* the EU need for a prompt response to the exit.<sup>1</sup>

In approaching the debate, the aim of this paper is to advance the scholarly and political discussion by taking into account issues that have not been fully dealt with so far. Such issues relate to changes in the social, political and economic reality of Europe. To be accurate, we specifically refer to the implications on the geopolitical picture of continental Europe stemming from such event, considering the scepticism spreading over and the spectre of an halt to the euro and the

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<sup>1</sup>See, among others, CARAVITA, *Brexit: keep calm and apply the European Constitution*, in *federalismi.it* of 29 June 2016, p. 4; PELLEGRINI, *Riflessioni sulla Brexit e prime valutazioni dei suoi esiti*, in *federalismi.it* of 7 September 2016, p. 5 ff.; *Brexit: an anti-historical divorce which can change the EU*, in *Law and economics yearly review*, 2016, I, p. 4 ff.; AMOROSINO and LEMMA, *Administrative and transaction costs arising from Brexit. A regulatory challenge*, *ibidem*, p. 29 ff.

whole European Union.<sup>2</sup> Indeed, to get the full understanding of Brexit the geopolitical implications should be accounted for, and so should its interaction with the benefits of a cultural exchange between the dominant liberal logic in Great Britain (the peculiarities of certain regulatory mechanisms and the principles of government that can be attributed to it) and the German *ordoliberal* regime (which purports forms of social development characterizing from economic reforms that would be taken out of political hegemony).<sup>3</sup> Obviously, for such purposes an analysis must take into account the affirmation of populist movements, too; and indeed, such populist trend enlightens the trajectory to break up the European construction, now pivoting on spread discontent resulting from years of crisis and austerity and invoking utopian forms of 'direct democracy', now advancing demolition criticisms against any initiative aimed at growth, to this end, inspired by salient 'sovereign' models, considered illusorily beneficial panacea of all the evils of the present.

Against this backdrop, Brexit is to be seen as a watershed, separating Great Britain from the EU on the cultural level; consequently, the lack of integration will be taken over by reciprocity or correlation of an economic nature. Hence the prospect of European constitutionalism, whose boundaries are relentlessly marked by the decadence of the liberal-democratic paradigm and, therefore, by social immobility and shortcomings of political action; The reasons for a worsening of the "crisis of politics" have to be identified, which for more than a decade have determined the situation in some of the Member States of the Union. Thus, the instability conditions of such Member States are likely to result in a "parliamenta-

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<sup>2</sup>The situation described in the text is admirably outlined in the pages of the editorial by Spinelli, titled *L'analisi. La latitanza dei partiti*, published in *la Repubblica.it* on 3 October 2012. Likewise, the considerations by Guzzetti (see *Relazione alla 88<sup>o</sup> Giornata mondiale del risparmio*, Rome 31 October 2012, p. 9), in which the Author highlights how «*the international crisis in Italy has amplified the longstanding weaknesses of the country, which had never been adequately tackled with the necessary commitment. Tax evasion, corruption, red tape are all evils that need to be discomfited, if we want the economy to recover and safeguard our savings*».

<sup>3</sup>Reference is made to the famous line of thought sparked off by the English historian Adam Ferguson, author of the famous essay on the history of civil society of 1767. Such scholarship has been expanded by Adam Smith and Karl Marx, as well as by the ideological political ideology underlying the so called Social market economy (commonly referred to as German ordoliberalism), elaborated by the Freiburg's school and inspired by liberal positions.

ism” no longer able to carry out its institutional function, which is notoriously expressed through the production of laws aimed at transposing the instances promoted by civil society.

Such crisis situation is eventually leading to a welfare downsize, no longer to be seen in a wide perspective, as ranging from the welfare state (providing and guaranteeing social rights and services) to the pursuit of purposes of general interest (aimed at reducing social inequalities).

On top of that, the EU post-crisis financial regulation is negatively affecting such scenario, eventually making things even worse. Indeed, the regulatory overhaul leading up to the SSM brought about uncertainties. On one hand, this mechanism introduced new supervisory practices (as split between the ECB and the national competent authorities, depending on the whether the supervised bank is significant or not, respectively)<sup>4</sup>. On the other hand, new provisions modifying prudential regulation of credit institutions in terms of remuneration and incentive policies and practices and dealing with crisis management have been enacted<sup>5</sup>. Hence, in striving to produce sweeping reforms the resulting regulatory framework at times ends up raising questions as to whether the EU legislator had adopted the appropriate methodological approach in designing the regulatory solution.

Consequently, the new sets of rules need to be carefully looked at (i.e. Directive 2013/36/EU, hereinafter CRD IV and Directive 2014/59/EU, commonly referred to as BRRD, along with Regulation 806/2014, SRMR), as to detect any short-

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<sup>4</sup>For an analysis of the new supervisory architecture, see, among others, CAPRIGLIONE, *European Banking Union. A challenge for a more united Europe*, in *Law and economics yearly review*, 2013, I, p. 5 ff; CHITI – SANTORO (eds.), *L'unione bancaria europea*, Pisa, 2016; IBRIDO, *L'unione bancaria europea. Profili costituzionali*, Rome, 2017; ANDENAS-SUPINO, *Politics and finance with reference to the European institutional frame*, in *Law and economics yearly review*, 2015, I, p. 144 ff.

<sup>5</sup>We are referring to the measures provided in Directive 2013/36/UE and Directive 2014/59/UE. For an examination of both, see, among others, HOPT, *Corporate Governance of Banks and Other Financial Institutions after the Financial Crisis*, in *J. Corp. Law Stud.*, v. 13 no. 2, p. 219 ff.; ARMOUR-GORDON, *Systemic Harms and Shareholder Value*, in *J. Legal Anal.*, 2014, n. 6, p. 35 ff; CAPRIGLIONE, *Regolazione europea post-crisi e prospettive di ricerca del diritto dell'economia: il difficile equilibrio tra politica e finanza*, in *Riv. trim dir. e proc. civ.*, 2016, p. 537 ff.; SUPINO, *Soggettività bancaria assetti patrimoniali regole prudenziali*, Milanofiori Assago, 2017, 71 ff.

comings to be overcome.

Indeed, regulatory interventions are called for as to overcome the impasse reached by some member States, such as Italy. Such impasse is worsened by social immobility and populism (as divided between those advocating direct democracy and those advocating sovereign nationalist positions, but either way opposing what is called the “Europe of Bankers”, and immigration).

Against this situation, it is quite evident the difficulties in reaching the stability of the system (both politically and economically) by fostering a new era of the European Union based upon flexibility and solidarity, both tied to taking responsibility. This is a journey of hope that is exposed to various kinds of obstacles... we cannot drop it, if we still believe in the 'European dream' as an antidote to isolationism and bearer of peace and prosperity, as the history of seventy years of a common strand of life for European peoples already taught us.

2. Obviously, these considerations are to be entrenched in a solid and wide intellectual soil that encompasses the examination of the implications arising out of Brexit, having passed one year from the referendum expressed by the British people.

The fears raised by the supporters of the “remains”, worried by the negative economic consequences, appear to be unfounded, as reality actually proves to the contrary. In fact, the specialized press reports outline a situation that is definitely different from what might be expected after the election. Current economic dynamics are characterized by a reduction in the trade balance deficit, with a trade deficit significantly lower than the one recorded in the months prior to Brexit.<sup>6</sup>

Besides, it is worth noticing that finance has embarked on ways of creating new business forms, “even more profitable” than those experienced in the past,

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<sup>6</sup>See, among others, *Brexit, dati economici positivi: ecco perché l'economia Uk non peggiora*, available at [www.affaritaliani.it/affari-europei/brexit-ecco-perche-economia-britannica-non-peggiorata](http://www.affaritaliani.it/affari-europei/brexit-ecco-perche-economia-britannica-non-peggiorata).

being the U.K. now capable of acting as a “hinge” not only between the US and Europe, but also between Russia and China.<sup>7</sup>

Hence the economic growth forecasts formulated by the consultancy firms, which refer to, among other things, an increase in consumer confidence, back to pre-referendum levels<sup>8</sup>, as well as the action undertaken by the Bank of England which reduced interest rates and announced a significant extension of its quantitative easing program<sup>9</sup>. Positive scenario, this, which is completed with respect to data released by the IMF that «revised figures and forecasts a few months ago, announcing that ... (by the end of the year) ... British GDP will grow by 1.8 per cent», thus Britain would establish itself «for 2016 as the most robust economy of the G7, the group of the seven richest industrialized countries in the world»;<sup>10</sup> therefore the call for re-examining the consequences of Brexit, which now appear way different from the catastrophic predictions formulated by the supporters of the “remain” vote.

However, this improvement could be explained by the increase in exports due to the pound’s depreciation, which took place after the referendum vote, followed by a significant reduction in imports; so the positive reaction of the U.K (to an event that could have been particularly traumatic) must be technically and temporally confined.<sup>11</sup> In that respect, OECD analysis shows that the British economy, despite not having suffered immediate damage from Brexit, may in the future face a slowdown in GDP, up to its settling at 1% (to a level, therefore, lower than in the last few years) for causes attributable, inter alia, to a contraction in in-

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<sup>7</sup>See *A proposito... A che punto è la Brexit?* available at [www.contropiano.org/news/internazionale-news/2016/12/06](http://www.contropiano.org/news/internazionale-news/2016/12/06).

<sup>8</sup>See DE FRAJA, *Economia al tempo della Brexit: da dove arrivano le nubi*, in [www.lavoce.info](http://www.lavoce.info) of 7 October 2016.

<sup>9</sup>See *Brexit: Londra taglia i tassi, potenzia il QE e taglia le stime di crescita UK*, available at [www.investireoggi.it/economia/brexit-londra-taglia-tassi-potenzia-qe-taglia-le-stime-crescita-uk](http://www.investireoggi.it/economia/brexit-londra-taglia-tassi-potenzia-qe-taglia-le-stime-crescita-uk).

<sup>10</sup> See FRANCESCHINI, *Brexit, il Pil inglese cresce e l'economia smentisce gli economisti*, available at [www.repubblica.it/economia/rubriche/affari-in-piazza/2016/10/04/news/brexit\\_il\\_pil\\_inglese\\_cresce\\_e\\_l\\_economia\\_smentisce\\_gli\\_economisti](http://www.repubblica.it/economia/rubriche/affari-in-piazza/2016/10/04/news/brexit_il_pil_inglese_cresce_e_l_economia_smentisce_gli_economisti).

<sup>11</sup>On the argument see the speech of Iain Begg, London School of Economics Professor, reported in the article of DEGLI INNOCENTI, *Sei mesi dopo, Brexit cerca ancora la sua strada*, available at [www.ilsole24ore.com/art/mondo/2016-12-22/sei-mesi-dopo-brexit-cerca-ancora-sua-strada](http://www.ilsole24ore.com/art/mondo/2016-12-22/sei-mesi-dopo-brexit-cerca-ancora-sua-strada); in particular, Professor Begg states that it would be hard to maintain that British economy went beyond Brexit without damages.

vestments by companies.<sup>12</sup>

Six months after the vote of 23 June 2016, a first report on the outcomes of Brexit is contained in a “Report” entitled “Six months on”, drawn up by a group of British academics under the direction of Anand Menon of King’s College of London.<sup>13</sup> Such Report emphasises the existence of a long-lasting “wait-and-see” situation, characterized by a climate of uncertainty about the future of the United Kingdom that are rooted in the lack of a clear political line by the new Premier Theresa May on such a matter. In fact, Anand Menon, in answering to the question «where are we now?» sharply argues «we are little closer to knowing what Brexit actually means»! Furthermore, in the same Report, as the argument goes, despite the «seismic waves» caused by the *referendum*, no material changes in the Government's policies are taking place as May avoids making decisions on the subject, holding a vague and elusive attitude,<sup>14</sup> which – as emphasized by the British press – is not disregarded even in the presence of Queen Elizabeth II.<sup>15</sup>

The results of this Report confirm the fears witnessed by the EU right after the referendum. Such fears relate to the inevitable delays linked to the lack of a genuine will of the British Government to activate the procedure provided for in art. 50 TEU, and to the consequences that such delays could have caused to the precarious balance of the Union, threatened by a rampant “populism” certainly urged by the United Kingdom's exit option. Hence the continuation of the uncertainty stemming from Brexit, which – if longed for too long – constitutes a critical factor which will end up hampering any attempt to set a productive relationship

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<sup>12</sup>In such respect, see *Brexit, contrordine: dopo il "sì" nessun "drammatico deterioramento" dell'economia*, available at [www.amato.blogautore.repubblica.it/2016/09/21/contrordine-dopo-la-brexit-nessun-drammatico-deterioramento-delleconomia](http://www.amato.blogautore.repubblica.it/2016/09/21/contrordine-dopo-la-brexit-nessun-drammatico-deterioramento-delleconomia), where the OECD's comments concerning the uncertainties of the future economic and political trajectory are also reported.

<sup>13</sup>The ‘Report’, coordinated by *The UK in a Changing Europe* and *Political Studies Association*, is available at <http://ukandeu.ac.uk/wp-content/uploads/2016/12/Brexit-Six-months-on.pdf>.

<sup>14</sup>For a general overview, see *Sei mesi dopo, Brexit cerca ancora la sua strada*, available at [www.ilsole24ore.com/art/mondo/2016-12-22/sei-mesi-dopo-brexit-cerca-ancora-sua-strada](http://www.ilsole24ore.com/art/mondo/2016-12-22/sei-mesi-dopo-brexit-cerca-ancora-sua-strada).

<sup>15</sup>In that respect, it is worth noticing how the press depicted such situation, see, among others, *Brexit: Queen frustrated with Theresa May over her 'secrecy' regarding deal negotiations*, available at [www.independent.co.uk/news/uk/politics/brexit-queen-eliza-beth-theresa-may-secrecy-deal-negotiations-article-50-balmoral-a7492586.html](http://www.independent.co.uk/news/uk/politics/brexit-queen-eliza-beth-theresa-may-secrecy-deal-negotiations-article-50-balmoral-a7492586.html), where it is stated «Prime Minister allegedly stuck to ‘Brexit means Brexit’ line and refused to give the Queen a ‘running commentary’».

between Great Britain and the Union.

3. On this premise, the analysis showing that the British growth will be slowly decreasing over time is particularly important. This is a consequence arising from the fact that Brexit will break the close connections between the UK and the EU in the production of goods, which the globalisation has so far supported. At the same time, it is rather difficult to quantify the relative costs, which is a specific aspect of the general issue that some scholars have studied.<sup>16</sup> Additionally, over time, administrative and transactional costs arising from the article 50 TEU withdrawing procedure can negatively impact the British economy. Accordingly, scholars have correctly argued that the negotiation between the UK and the EU will be costly (even though it is very difficult to quantify such costs). And these costs, due to the asymmetries between the interests of the two parties, make it difficult to reach an agreement.<sup>17</sup> Such a situation is made even more difficult by a possible divergence between the parties about the technicalities to manage the process with the consequent risk that one party can purposely delay to apply the withdrawing clauses.

From this point of view, the tendency of delaying the formal exit after the *referendum* is significant and appears to be based on the same “waiting” attitude shown after the elections of the former British Prime Minister David Cameron.<sup>18</sup>

In such a context, the considerations of the scholars with regard to the Parliament’s «necessary previous ratification of the popular vote» are relevant;<sup>19</sup> this political intervention, indeed, appears to be aimed at finding in the «British Par-

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<sup>16</sup>See DHINGRA - HUANG - OTTAVIANO - PESSOA - SAMPSON - REENEN, *The costs and benefits of leaving the EU: trade effects*, *Economic Policy*, available at [www.economic-policy.org](http://www.economic-policy.org).

<sup>17</sup>See AMOROSINO and LEMMA, *Administrative and transaction costs arising from Brexit. A regulatory challenge*, p. 29, who underline that as a consequence of Brexit, in the financial sector, the UK regulator could introduce new rules less costly for the industry than the ones adopted by the EU legislator.

<sup>18</sup>The British Supreme Court decided to return to the Parliament the decision to formally start the withdrawal from the Union; see *Servirà il voto del Parlamento per Brexit*, available at [www.ilpost.it/2017/01/24/voto-parlamento-brexit](http://www.ilpost.it/2017/01/24/voto-parlamento-brexit).

<sup>19</sup>See PELLEGRINI, *Riflessioni sulla Brexit e prime valutazioni dei suoi esiti*, p. 5, who stresses that such a situation would create a «substantial modification of the democratic logic», despite being legally compliant with the result of the *referendum*.

liament's policies [...] mechanisms which are apt to change the people's decision» adopted with the *referendum*.<sup>20</sup> It is obvious that such an intervention – the formal justification of which lies in some public documents where it is underlined that the British Government is not legally bound to respect the result of the *referendum* due to its “advisory” nature<sup>21</sup> - weakens the importance of the ‘universal suffrage’ and also creates a constitutional issue. This, in turn, unequivocally represents an «European constitutional issue» that impacts the principle of sincere cooperation between the Union and the Member States under article 4.3 of the TEU.<sup>22</sup>

More in general, the reference to the political context above described – the causes of which are lacking (or inadequate) relationships within the EU – highlights the shortcomings of the Union's democratic functioning; what is notoriously called democratic *deficit*. Such shortcomings arise, inter alia, from a sort of «disconnection» (so called “democratic disconnect”) among the purposes which are drafted by the supranational institutions and the control activity performed at national level (with the consequent impact on the dynamics of the political representation).<sup>23</sup> The effect arising from such a situation is the substantial overcoming of the traditional link between parliamentary sovereignty and popular sovereignty;<sup>24</sup> in fact, such a conduct (*i.e.* to give the British political leaders the possibility of postponing the exit or even “dissolving” its effects) shows all the critical issues deriving from the *referendum*. Indeed, it has opened up the ‘Pandora's box’ in which

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<sup>20</sup>See PELLEGRINI, *Riflessioni sulla Brexit e prime valutazioni dei suoi esiti*.

<sup>21</sup>See the *Library Note* titled *Leaving the EU: Parliament's Role in the Process*, published by the House of Lords, where it is discussed the role of the Parliament in the withdrawing procedure; see also the *Briefing Paper* published by the House of Commons titled *Brexit: What Happens Next?*, where many different issues concerning the withdrawal are analyzed, including the legal path to follow and the function of the parliamentary control on the negotiations; on this aspect see PRIMO DI NICOLA, *La Brexit non vincolante. Il documento choc che può bloccare il referendum*, available at [www.tiscali.it](http://www.tiscali.it), 28 June 2016.

<sup>22</sup>See CARAVITA, *Brexit: keep calm and apply the European Constitution*, p. 4.

<sup>23</sup>See LINDSETH P.L., *Power and Legitimacy: Reconciling Europe and the Nation-State*, Oxford University Press, Oxford, 2010, p. 234; LUPO, *Parlamenti e governi nella Costituzione “composita” dell'Unione europea*, in AA. VV., *Corso di diritto pubblico dell'economia*, Padova, 2016, p. 143.

<sup>24</sup>On these aspects see ROSA, *Referendum e sovranità parlamentare nel Regno Unito*, intervention at the conference ‘*Referendum e democrazia parlamentare*’, Luiss Cesp, Rome, 21 July 2016.

the fragile components of the European Union are hardly kept, with the consequence that, due to Brexit, now the Union's integration could further draw back.

In the first months of 2017, the conclusion of the parliamentary procedure of withdrawing from the Union – by confirming the existence of a sort of Parliament's veto power *in subiecta materia* – has also marked the beginning of the negotiations which will end with the U.K. exit from «the 28 club within two years time (except for extensions)».<sup>25</sup> And it seems that the final result of Brexit will depend on the negotiations between Great Britain and the EU; accordingly there are two possible scenarios: (a) Hard Brexit with the exit of the UK from the common market and a hypothetical agreement regulated by the World Trade Organisation (Wto), which should be similar to the agreements between the EU and both the US and Japan; (b) Soft Brexit allowing the UK to remain within the common market (in a way which should be similar to the agreement between the EU and Norway). Obviously, both options – regardless of the triumphalist tones of the politicians about how to withdraw<sup>26</sup> - will bring about significant costs that will change the «social well-being ... in terms of actual value of the amount of goods and services that the British citizens on average can buy... compared to the alternative scenario where the UK remained in the EU».<sup>27</sup>

Such a defensive attitude with regard to its own interests and the autonomous position held by the UK reflects the strategy steadily used by this country on financial matters, such as, for example, the refusal to adopt the EURO as a currency and, more recently, the refusal to participate in the Banking Union.<sup>28</sup> The reason for these choices is based on the willingness to handle without external in-

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<sup>25</sup>See *Brexit, Londra approva la legge. Scozia: «Via a iter per referendum su addio a Uk»*, available at [ilFattoQuotidiano.it](http://ilFattoQuotidiano.it), 13 March 2017.

<sup>26</sup>See *Brexit, Londra: «Non verseremo 100 miliardi. La Ue vuole influenzare il voto degli inglesi»*, available at [www.corriere.it/esteri/17\\_maggio\\_03/brexit-londra-non-verseremo-100-miliardi-uscire-ue](http://www.corriere.it/esteri/17_maggio_03/brexit-londra-non-verseremo-100-miliardi-uscire-ue).

<sup>27</sup>See ICHINO and MONACELLI, *Londra vota brexit. Morbida o estrema saremo comunque più poveri*, available at [CorrierEconomia](http://CorrierEconomia), 5 June 2017.

<sup>28</sup>About the participation in the Banking Union, the reactions to the proposal presented by the European Commission are significant; see ONNO RUDING, *The contents and timing of a european banking union: reflections on the differing views*, ceps essay, 30 November 2012, p. 2, available at [www.ceps.eu](http://www.ceps.eu), p. 4, where it is said that «the UK has already declared its intention to opt-out», even though «its first signal was that it would not block the proposal as such».

interferences both the monetary sovereignty and the financial supervision; and its purpose is to keep the leading position of London as one of the main international financial centres (which needs an 'environment' characterised by full freedom in operating),<sup>29</sup> despite its intention of delaying the realisation of the common programs; this, in turn, highlights an approach which is in contrast with the cooperative spirit which should characterise the Member States (also creating doubts about the real desire of the country to stay in the Union in the long term).

Evidently, the European Central Bank Chairman's words pronounced during the «political debate surrounding Britain's EU» were not listened; particularly, the precise statement «I cannot say which of the two sets of arguments is stronger, the economic or the political ones, neither am I going to enter into a domestic policy debate, but what I can say is that Europe needs a more European UK as much as the UK needs a more British Europe».<sup>30</sup> This was an auspice putting together all those who – despite skepticism on the integration within the 'old continent' – have, over time, continued to believe in the cooperation between Great Britain and the Eurozone; and accordingly, Mario Draghi also said «with such deep interconnections, the UK and the euro area share a common interest: the stability in the functioning of our economic system and particularly our financial markets».

4. The adoption by the EU leaders of the political guidelines in April 2017 (following the UK notification under article 50 of the TEU) along with the publication of a Recommendation containing the technical directives for the negotiation allow to identify the context in which such negotiations will take place.<sup>31</sup>

From the political perspective, the foreseeable situation is characterised by the difficult harmonisation between the two positions. With regard to the EU, be-

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<sup>29</sup>Accordingly, the adoption of the EU directives impacting the financial system which were in contrast with the British interests was blocked; see CAVALLITTO,  *Mercati finanziari, il muro della vigilanza britannica contro le riforme ue*, available at [http://www.ilfattoquotidiano.it/2013/08/31/mercati\\_finanziari](http://www.ilfattoquotidiano.it/2013/08/31/mercati_finanziari).

<sup>30</sup>See STEEN, *Mario Draghi in City of London call for 'more European Uk'*, in *Financial times*, 23 May 2013.

<sup>31</sup>See EUROPEAN COUNCIL, EUCO XT 20004/17, Brussels, 29 April 2017.

side some supporters (*in primis* Wolfgang Schaeuble) of a ‘harsh’ position (due to the unavailability to grant advantages to the UK after the exit),<sup>32</sup> there are positions (such as the one of the Italian Prime Minister Paolo Gentiloni) calling for reasonableness and the need to avoid a revengeful and punitive approach, on the assumption that is important to set a separation allowing the UK to overcome the technical and economic difficulties which inevitably will come up.<sup>33</sup>

On the contrary, the UK has the difficult task of setting, in the same ‘transactional’ context, the terms of the ‘separation’ (*rectius*: divorce) from the Union and the ways in which the future economic and legal relationships between the parties will be carried out. The results of the 8 June 2017 British political elections – with the Conservative Party which lost many seats in Parliament and the position of Theresa May significantly weakened<sup>34</sup> – will make even more complicated the negotiation, that, on the basis of the Treaties, must end in two years time.

In order to overcome the uncertainties arising from the execution of Brexit

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<sup>32</sup>See TAINO, *Schäuble: in caso di Brexit, Regno Unito fuori dal mercato unico*, available at [www.corriere.it/economia/16\\_giugno\\_10/schauble-caso-brexit-regno-unito-fuori-mercato-unicounione-europea-ue](http://www.corriere.it/economia/16_giugno_10/schauble-caso-brexit-regno-unito-fuori-mercato-unicounione-europea-ue); see also *Brexit, la Ue approva le linee guida per il negoziato*, available at [www.lastampa.it/2017/04/29/esteri/brexit-la-ue-approva-le-linee-guida-per-il-negoziato](http://www.lastampa.it/2017/04/29/esteri/brexit-la-ue-approva-le-linee-guida-per-il-negoziato).

<sup>33</sup>See *Atti parlamentari*, XVII LEGISLATURA, Report no. 785 of Thursday 27 April 2017, *Intervention of the President of the Council of Ministers concerning information on the extraordinary European Council Meeting on Brexit*.

The words pronounced by the Italian Prime Minister Paolo Gentiloni in that context are significant: «despite the complexity of the negotiations, an aspect [...] must be out of discussion, namely the fact that we and the UK are linked by a strong and old geopolitical friendship based on common interests, membership in the NATO as well as in other fora, which should be wrong to underestimate, forget and deny in front of such a new scenario. I do want to say that even more clearly: if someone – and there is such a view in some components of the EU27 – had in mind that the British position has to be somehow punished, as a sort of revenge to give an example to other countries thinking about leaving the EU, [...] in my view that would be a serious mistake».

<sup>34</sup>After the 8 June 2017 elections, the UK Parliament is in a situation that has been defined as ‘hung parliament’, where no parties have the majority which is necessary to form a stable government; see *What is a hung parliament? What happens when no party wins an election majority?* available at [www.telegraph.co.uk/news/0/hung-parliament1](http://www.telegraph.co.uk/news/0/hung-parliament1). Despite such a situation, Theresa May went to visit the Queen to ask for the formal appointment; see *Humbled Theresa May says losing Tory candidates 'didn't deserve it' but vows to be PM for five more years with support of the DUP... but do her rivals have other ideas?*, available at [www.dailymail.co.uk/news/article-4586042/Stunning-exit-poll-suggests-Theresa-LOST-seats.html#ixzz4jfehHedt](http://www.dailymail.co.uk/news/article-4586042/Stunning-exit-poll-suggests-Theresa-LOST-seats.html#ixzz4jfehHedt); see also *Elezioni Gran Bretagna 2017, May: “Nuovo governo per un Paese sicuro e la Brexit. Accordo con unionisti nord-irlandesi*, available at [www.ilfattoquotidiano.it/2017/06/09/elezioni-gran-bretagna-2017-risultati-tory-testa-ma-senza-maggioranza-may-perde-la-sfida-ipotesi-governo-conunionisti](http://www.ilfattoquotidiano.it/2017/06/09/elezioni-gran-bretagna-2017-risultati-tory-testa-ma-senza-maggioranza-may-perde-la-sfida-ipotesi-governo-conunionisti). It is also significant that the UKIP (Nigel Farage’s party) did not obtain any seat in the new Parliament, especially considering that this was the most active party in supporting Brexit.

– and therefore to safeguard the positions based on the rights connected to the previous UK membership to the EU – it is appropriate to analyse the Union’s guidelines that set out the criteria to follow to reach an agreement built on a balance between rights and duties which is able to provide equal conditions. On this premise, the safeguard of the common market integrity depends on the exclusion of sectorial participations, on the grounds that a non-EU country, that does not respect the same duties as a Member State, cannot enjoy its same rights and advantages. In such a context, the identification of the *iter procedendi* and its steps is particularly relevant. It is underlined that the negotiations will be conducted with unified positions of the EU countries and only through pre-set programs; it follows that it will not be possible to find solutions regarding single aspects of the relationship and/or to reach separate agreements between certain Member States and the UK on specific aspects.

It is clear that the negotiations will have to grant to citizens, enterprises and international partners the highest degree of clarity and legal certainty with regard to the immediate effects of the UK’s withdrawal from the Union. Therefore, it is necessary to allow an orderly exit with the consequent withdrawal from any right and duty arising from its status of EU Member State; whilst the future relationships between the parties will be dealt with during the second stage of the negotiations under article 50 of the TEU. As a consequence, it is crucially important to agree, at the time of the formal exit, on the reciprocal guarantees aimed at safeguarding the rights arising from the European Union law of both the EU and UK citizens; this is, for example, the case of effective, non-discriminatory and global measures, including the possibility for EU citizens of obtaining the permanent residence permit after a five years stay in the UK and vice versa.

In the described context, the negotiations will have to take adequate forms in order to protect the enterprises doing cross-border business between the EU and the UK; such protection will have to be extended to all the players that have signed contracts and commercial agreements or have participated to programs funded by the EU on the assumption that the UK would have remained inside the

Union. These are regulatory principles aimed at guaranteeing compliance with the duties of both the EU and the UK. This approach lies on the need to maintain rights and duties arising from the participation of the Union in international agreements; accordingly, the European Council expects that the UK fulfills any obligation arising from the agreements signed during the time of its EU membership. Even the further argument underlined by the EU guidelines of keeping the jurisdiction of the European Court of Justice with regard to any pending proceeding involving the UK or UK legal and natural persons at the time of the formal exit is understandable, notwithstanding the importance of setting ways allowing the rule of law and the equal treatment principle to properly work.

Although the European Union appears to be willing to conduct a negotiation which will be respectful of the rights in question and aimed at recognising the equal position of all the involved players, the British Prime Minister does not look willing to share the EU guidelines. The UK priorities are the access to the common market without custom duties, the end of the European Court of Justice jurisdiction and the end of the free movement of migrants.<sup>35</sup> This seems to be a potential reason to disagree and is caused by the rigid position taken by Theresa May; some remarks by the UK Foreign Affairs Minister Boris Johnson are of the same nature (the EU could have to pay the UK due to Brexit); if they are perceived as a threat, they could make the negotiation very difficult.<sup>36</sup> In fact, beside positions (such as the German one) which are not inclined to give up protecting the European interests, there are different positions (such as the ones of Junker and the Belgian Prime Minister Charles Michel) which stress the fact that London cannot deceive itself and that Brexit will not be free.<sup>37</sup>

Of course, the hard approach in the negotiations will not help solve in the appropriate way an issue impacting the essence itself of the European Union. The

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<sup>35</sup>See *Brexit, May respinge le linee guida dell'Unione europea*, available at [www.repubblica.it/esteri/2017/04/30/news/brexit\\_may\\_respinge\\_le\\_linee\\_guida\\_della\\_ue-164253903/](http://www.repubblica.it/esteri/2017/04/30/news/brexit_may_respinge_le_linee_guida_della_ue-164253903/)

<sup>36</sup>See *Brexit, Johnson: «È l'Ue che rischia di dover pagare il Regno Unito»*, available at [www.corriere.it/esteri/17\\_maggio\\_13/brexit-johnson-ue-rischia-dover-pagare-regno-unito](http://www.corriere.it/esteri/17_maggio_13/brexit-johnson-ue-rischia-dover-pagare-regno-unito).

<sup>37</sup>See *Brexit, Ue approva linee guida: "Londra non si illuda"* available at [tg24.sky.it/mondo/2017/04/29/brexit-bruxelles-linee-guida-ue.html](http://tg24.sky.it/mondo/2017/04/29/brexit-bruxelles-linee-guida-ue.html).

UK – regardless of its decision to leave – is and will keep being a fundamental component of the European socio-political and economic context that, over time, has seen the progressive increase of a bunch of countries close to each other and really connected for their history, culture and civilization. Therefore, the only desirable form of exit which is coherent with the international context is the one allowing the creation of a close partnership between the Union and the UK after its withdrawal; this can take the form of a number of relationships between the two that, although temporary limited, show close and working links which are able to satisfy both parties' interests. And of course, these links should go beyond the commercial relationships.

In light of such considerations, the start of the negotiations about a free trade agreement between the UK and EU will have to maintain any right and duty regulated by the Treaties with regard to all the involved citizens. And such rights and duties will have to be maintained even after the formal exit. This is the appropriate approach of a new relationship wanting to be based on the principle of sincere cooperation. Theresa May's statements during the 23 June 2017 European Council meeting look inspired by such a view. She said that no European citizen would have to leave the UK after Brexit;<sup>38</sup> this position has been confirmed in a paper, that however did not persuade the EU leaders who have asked for more guarantees and more certainties.<sup>39</sup>

5. These guidelines, which aim is to simplify the *exit* process – even showing firmness in relation to the protection (in terms of reciprocity) of the positions that will be facing each other, will undergo an important test during the negotiations that will be complex for the reasons that we will try to summarize below.

On this regard, we have to start from analysing the *Great Repeal Bill*, con-

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<sup>38</sup>See MARRONI, *Brexit: May promette piena tutela ai cittadini Ue*, available at [www.ilsole24ore.com/art/notizie/2017-06-23/brexit-may-promette-piena-tutela-cittadini-ue](http://www.ilsole24ore.com/art/notizie/2017-06-23/brexit-may-promette-piena-tutela-cittadini-ue); see also May, *vogliamo che i cittadini Ue restino in Gran Bretagna*, available at [www.ansa.it/europa/notizie/rubriche/altrenews/2017/06/26/may-vogliamo-che-i-cittadini-ue-restino-in-gb](http://www.ansa.it/europa/notizie/rubriche/altrenews/2017/06/26/may-vogliamo-che-i-cittadini-ue-restino-in-gb).

<sup>39</sup>See DEGLI INNOCENTI, *Diritti dei cittadini europei, May non convince la Ue*, available at [www.ilsole24ore.com/art/mondo/2017-06-27/diritti-cittadini-europei-may-non-convince-ue](http://www.ilsole24ore.com/art/mondo/2017-06-27/diritti-cittadini-europei-may-non-convince-ue).

tained in the *White Paper* named “*Legislating for the United Kingdom’s withdrawal from the European Union*” presented at the end of March 2017<sup>40</sup> by the Ministry for *Brexit* David Davies. In it, the goals pursued by the U.K. are highlighted, aimed at restoring a full sovereignty for the British institutions, as well as converting into national legislation the EU laws in force when *Brexit* will be executed; the rationale behind that is the intent of assuring a structural continuity of the system and the continuation of the activities, being for the latter necessary to avoid abrupt changes in the regulations.

Moreover, it is clarified that with *Brexit* the jurisdiction of the European Court of Justice will be withdrawn for all the cases law pertaining to the United Kingdom and that the European Court of Justice will be allowed to maintain only a residual authority on those cases in which it is necessary to interpret the meaning of a law deriving from European regulations.

We are facing a programmatic context definitely complicated for what it concerns the identification of the institutional autonomy position claimed by the Great Britain. Such context does neither offer any details on the possible contents of the negotiations that the U.K. will have to agree upon with the EU after its exit, nor any indication on the economic and financial scenario in which the United Kingdom might assume different and variegate positions (going from the adhesion to the European Single Market to the participation to a “custom union” or to a “free trade agreement” or the “failed fulfilment of any kind of agreement”, with the obvious consequence that the existing commercial relationships will be submitted to the rules of the *World Trade Organization*).

It must also be added the problematic definition of the obligations of the United Kingdom towards the European Union that will have to be remitted before the exit process (“*Brexit Bill*”)<sup>41</sup>; it follows a situation distinguished by disputable

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<sup>40</sup>The details can be found on <http://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP7793#fullreport>.

<sup>41</sup>See SIGNORINI, *Brexit: possibili riflessi su economia e finanza*, deposition at the Commissions III Foreign and European Affairs and XIV European Union Policies, Chamber of Deputies, 26 April 2017, p.7 of the press proof.

positions held by the interested parties and by difficulties in estimating the quotas due by the Great Britain to the European Union. It can be therefore imagined a negotiation path full of uncertainties and characterized by “long term economic costs” that might have a negative impact on the British economy, especially if the latter will be “associated with a lower growth of productivity”.<sup>42</sup> It is no coincidence that the European Commission submitted two *position paper* regarding the citizens’ rights and the United Kingdom’s financial obligations in light of the negotiation for *Brexit*, underlining in the second one some principles that will have to be followed not only to respect the financial obligations deriving from the entire adhesion period to the European Union, but also to deal with methodologic questions regarding the estimation of the United Kingdom’s financial obligations and the consequences of the exit of the latter from the European Investment Bank, the European Central Bank and the European Investment Fund.<sup>43</sup>

The uncertainties that characterizes the above described scenario do not allow any hypothesis on the choices that will be taken during the negotiations, hence, for the moment, the analysis can be only addressed using a “what if” approach. More in particular – in this prodromal phase of the U.K. from the European Union – it is necessary to focus, under a methodological point of view, the composite set of problems that underlie the execution of an event that will have an impact on the economic relationships of the whole European Union; this, with consequences at an organization level that might interest the definition of the European Union financial system’s summit.

With such preconditions, the adhesion to the single market seems probably the least likely to happen hypothesis, as a consequence of the latter is the acceptance of the four fundamental freedoms (free movement of people, services, goods and capital) on which the European construction has been founded, as it

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<sup>42</sup>See SIGNORINI, *supra*.

<sup>43</sup>See EUROPEAN COMMISSION, *Position papers transmitted to the EU27 on Article 50 negotiations*, available at [https://ec.europa.eu/commission/publications/draft-euposition-papers-article-50-negotiations\\_en](https://ec.europa.eu/commission/publications/draft-euposition-papers-article-50-negotiations_en). In relation to the specific problem of the negotiation regarding the consequences of the United Kingdom’s exit from the EIB, see MARCHEGANI, *Gli effetti della Brexit sulla Banca europea per gli investimenti*, in *federalismi.it*, 19 April 2017.

has been expressively established by the Agreement signed in Porto in May 1992, that has regulated the “European Economic Area”.<sup>44</sup> Likewise, it has to be admitted, as it has been highlighted in literature, in relation to the implicit acceptance of the principles related to “competition” and “State aid”, as well as to those principles related to topics associated with the abovementioned four fundamental freedoms, “as welfare policies (labour law, equality of sexes), consumers’ protection, environment, statistic and corporate law”, all addressed in the Treaties.<sup>45</sup> Specifically, the decisional procedures defined in the Agreement on the “European Economic Area” involve a substantial waive of “operative sovereignty” for the participant States, as it has been previously emphasized for the Member States of EFTA<sup>46</sup> and as it has been recently repeated stressing the “existing parallelism between the *preamble* of that Agreement and the Treaty on European Union’s one”.<sup>47</sup>

Similarly, it appears highly doubtful the participation to a “custom union” with the EU Member States as this would also have as a consequence the adoption of part of the European regulation and the waiver of imposing custom duties autonomously (art. 28 and ss of the TFEU). The “package” of the new Union Customs Code, applicable since 1<sup>st</sup> May 2016<sup>48</sup>, does not leave any doubts in this regard, as it appears from its clear rules on Customs Representation (art. 18-21), Application of the customs legislation (art. 22-37), Authorizations (art. 38-41) etc., a complex set of rules that establishes the regulatory restrictions that impact on the freedom of those States bounded by such Code of autonomously deciding on

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<sup>44</sup>See, in particular, article 1.2 of such Agreement where it is declared that “the association shall entail [...] (a) the free movement of goods; (b) the free movement of persons; (c) the free movement of services; (d) the free movement of capital; (e) the setting up of a system ensuring that competition is not distorted and that the rules thereon are equally respected; as well as (f) closer cooperation in other fields, such as research and development, the environment, education and social policy”.

<sup>45</sup>See PRAINO, *Processo di integrazione europea e sovranità. Indicazioni provenienti dalle altre forme di affiliazione con l’UE*, in *Osservatorio costituzionale*, booklet 2 of 2016.

<sup>46</sup>See GSTOHL, *EFTA and the European Economic Area or the Politics of Frustration*, in *Cooperation and Conflict*, v. 29, n. 4, 1994, p. 333 ff.

<sup>47</sup>See PRAINO, *supra*, p. 6.

<sup>48</sup>Reference is made to the Regulation (EU) n. 952/2013 of 9 October 1993 (GUUE – L. n. 269 of 10.10.2013) laying down the Union Customs Code and repealing, since its application date (30.10.2013), the Regulation (EC) n. 450/2008.

the execution of the commercial relationships with other States.

Thus, the only choices are either to stipulate a “free trade agreement” or to renounce the execution of any kind of agreement and this latter hypothesis, as it has been already disclosed, the application of the WTO rules will result in a mutual obligation to grant, under a commercial point of view, a non-discriminatory treatment (*i.e.* equal to the ones granted to those countries with whom there are no bilateral agreements in place). In both cases, the United Kingdom would have to be classified as a “third country”; in the first hypothesis, such classification is envisaged by art. 209, second paragraph, of the TFEU (in which it is established that “the Union may conclude with third countries and competent international organisations any agreement helping to achieve the objectives” in cooperation matters pursued by the Union itself), while in the second hypothesis such classification is *in re ipsa*, as it is intrinsic with the nature of the established relationships. To all that it has to be added that in the “free trade agreements” – as it can be assumed by the existing ones<sup>49</sup> - the parties gradually remove taxes and import duty rates applicable to the import and export of industrial and agricultural goods, thus starting a gradual liberalization of services and investments. This with the obvious consequence of reproducing (even if on a small scale) the conditions present in the “single market” that the Great Britain, presumably, does not want to accept; it is not a coincidence that on this subject it has been underlined that “even if there were a free trade agreement, the Great Britain will still have to bear administrative costs linked ... to the certification that the good exported towards the EU ... are not from countries in which the European Union imposes custom duties”.<sup>50</sup>

6. In relation to the specific banking and financial relationships, it has to be immediately observed that the British credit intermediaries, in relation to the position of the Great Britain as a *third country*, would lose the “European passport”,

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<sup>49</sup>See, for example, the one with Korea, available on <http://eur-lex.europa.eu/legal-content/IT/TXT/HTML>.

<sup>50</sup>See SIGNORINI, *supra*, p. 8.

with all the relevant consequences. They would then need a new licence, without which - in relation to those banks already established in the European Union – during negotiations the only consequence would be a specific amnesty. Such solution, though, does not seem viable in light of a recent opinion issued by ESMA<sup>51</sup>, where some general principles are presented in relation to the coherence of the authorizations granted by the national competent authorities for the relocation abroad of financial firms and, therefore, to the forms of supervision on the latter. More in particular, reference is made to the prohibition of automatic recognition of the existing authorizations (to which is matched the mandatory release of new licences by national competent authorities), as well as to the strict controls on the respect and effective application of the European law; in such regulatory context, a specific care is devoted to the scrutiny of the reasons behind the relocation of financial participants, in light of possible relocations of “shell companies”.<sup>52</sup>

The revoke of the “European passport”, implicating the equivalence between British and third countries’ intermediaries, obliges the first to follow the so-called *equivalence criteria* if they want to be admitted to service provision. Regulation (EU) No 600/2014 disciplines the assessment of “equivalence”, whose decision is referred to the European Commission (art. 1, paragraph 5). It is thus specified that these decisions “should be adopted only if the legal and supervisory framework of the third country provides for an effective equivalent system for the recognition of investment firms authorised under foreign legal regimes” (*whereas* n. 44); therefore, the European Commission’s decision certifies that “ensure that firms authorised in that third country comply with legally binding prudential and

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<sup>51</sup>See the editorial *Parere ESMA sulla riorganizzazione post-Brexit degli operatori residenti nel Regno Unito*, available at [www.dirittobancario.it/news/finanza/parere-esma-sulla-riorganizzazione-post-brexit-degli-operatori-residenti-nel-regno-unito](http://www.dirittobancario.it/news/finanza/parere-esma-sulla-riorganizzazione-post-brexit-degli-operatori-residenti-nel-regno-unito).

<sup>52</sup>See the editorial *L’ESMA ha pubblicato un parere per promuovere l’applicazione omogenea delle normative in materia di trasferimento delle istituzioni finanziarie* available on [www.dejalexonbrexit.eu](http://www.dejalexonbrexit.eu), where it is highlighted that ESMA means to prevent such cases where British financial participants, in order to keep the access to the European markets, try to externalize part of their activities in Member States’ territories; hence the specific care to be used in relation to the relocation of the so called “shell companies” in order to assure that the conditions for authorizing the relocation are respected, avoiding the risk of a speculative choice in relation to the supervisory regime (“*supervisory arbitrage*”).

business conduct requirements which have equivalent effect to the requirements set out” in the abovementioned Regulation (EU) No 600/2014, in the Directive 2013/36/EU and in the Directive 2014/65/EU (art. 47).<sup>53</sup>

In light of the abovementioned set of rules, the uncertainties raised at the technical level can be understood regarding the fact that the British financial institutions’ demand “*to establish a fully authorized branch or subsidiary*” in the States of the European Union – considering that they will be considered as a “third country” if the United Kingdom will not negotiate an agreement with the EU, will inevitably result in a request for a new authorization to operate subject to the recourse to the abovementioned “*equivalent regimes*”.<sup>54</sup> Also the reasons behind a feasible establishment of branches, executed by some British banks, in those countries of the European Union - like Ireland and the Republic of Malta – can be understood, as these countries are known for being available to allow fast (and without too much bureaucracy) authorization processes; this route might be, in fact, the one that will be followed in order to be able to operate, under “the freedom to provide services” in those Member States that, after the post-*Brexit* negotiations, might consider such financial institutions as belonging to “third countries” and, thus, might submit these institutions to the relevant disciplinary measures.

Hence, the expectation of changes that might result in the restructuring of banks and investment firms’ business and especially in the review/amendment of transactions with long-term results. This appears clearly when considering that *Brexit* might be interpreted as a “reason of force majeure” and might lead to the termination of those negotiations incurred with British *asset managers* that were European citizens when the contract was finalized (this is the case of pension funds that executed “asset management contracts”). It is understood that in these

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<sup>53</sup>It has to be noted that the Directive 2014/65/EU (so-called Mifid 2) envisages for financial instruments’ markets, the possibility that “where a Member State considers that the appropriate level of protection for its retail clients or retail clients who have requested to be treated as professional clients can be achieved by the establishment of a branch by the third-country firm it is appropriate to introduce a minimum common regulatory framework at Union level with respect to the requirements applicable to those branches” (*whereas* n. 109).

<sup>54</sup>See the survey *Making sense out of Brexit. What will it mean to leave the EU?* Published by Eversheds, London 2016, p. 15 and ff.

circumstances the only alternative for a British intermediary is to establish a branch in a State of the European Union. All of this without mentioning, for example, the impossibility for the British SME to access (in the future) the special financing programmes granted by the EU.<sup>55</sup>

Another significant consequence of the loss of the “European passport” by the British banks is the impact that such event will have on the role carried out until today by the *City of London* as global financial centre. The latter, in fact, is characterized by the presence of many non-European intermediaries that uses its infrastructures (famous for the high level expertise) to establish an operative channel towards the States of the European Union; hence its role regarding the *clearing* activity in relation to financial instruments denominated in Euro and, particularly, derivatives.

It is obvious that this situation will change after *Brexit*, as the latter – as already explained – will have the effect of nullifying the legal and factual prerequisites that allow the *City* to keep its role as the big European financial “platform”, capable of executing all the requests for intervention usually addressed to it. This might provoke a likely exodus of the existing institutional investor towards other “financial centres” in other EU States; hence, the prospect (for Italy) to revitalize the Milan stock exchange, as also suggested by the ministerial authority itself that promoted – together with Bank of Italy, Consob, Milan City Council and Lombardy Region – the establishment of the “*Milano European Financial Hub*” Committee, which has the aim of attracting banking institutions, funds and “human capital” in a post-*Brexit* perspective, especially in strategic fields, like, for example, *fintech*, *asset management* and *private equity*.<sup>56</sup>

On the other hand, it has to be noted that *Brexit* will not have a negative impact on the functioning of Borsa Italiana S.p.A. that since 2007 is controlled – as

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<sup>55</sup>See the survey *Making sense out of Brexit. What will it mean to leave the EU?*, *supra*, p. 13 and 16.

<sup>56</sup>See the Public Statement n. 88 of MEF in which it is underlined the activity carried out by the Government that, in the last years, introduced “effective measures to attract funds and finance economy with significant results [...] (highlighting) [...] in particular [...] the *human capital* package [...] (aimed at attracting) [...] in our Country *mangers* and promising talents”.

known – by the *London Stock Exchange Group*. This is because being controlled by a foreign entity, as is the case for the abovementioned financial markets management company, does not affect the “management responsibility of the latter” as its organisation – and, therefore, the obligations in relation to transparency, the regular performance of negotiation and investors’ protection that have to be respected in compliance with Directive 2004/39/CE – is supervised by Consob, as provided for by art. 64 *tuf*.<sup>57</sup> This indicates a set of rules that – in allocating important supervisory powers to the competent authority (increased by the law n. 262/2005 that also assigned to Consob the power to regulate accounting transparency criteria, the requirements for controlled companies’ listing etc.) – contains at a national level the characterization of “management companies’ areas of freedom”.<sup>58</sup>

In such regulatory context the competent authority – retrieving the rule set out in art. 39, par. 1, lett. *f*, of the Directive 2004/39/CE (now art. 47 of the Directive MIFID II) – established that management companies must have available “at the time of authorisation and on an ongoing basis, sufficient financial resources to facilitate its orderly functioning, having regard to the nature and extent of the transactions concluded on the market and the range and degree of the risks to which it is exposed”. Consequently, an accurate doctrine, in this regards, underlined that suspension and removal from trading ordered by the management company must refer to the “failure to comply” with the provisions that regulate the activity of the markets’ operators by operators itself.<sup>59</sup>

As a result of this, the definition of the ownership structure of Borsa Ital-

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<sup>57</sup>The joint stock company model – in the Legislative Decree no. 415 of 1996 that transposed the Directives no. 1993/22/CEE and no. 1993/6/CEE – was considered by the Italian legislator in line with a “modern concept of market as an enterprise, self-managed by the participants through specific management companies”; see DRAGHI *Commento sub art. 46 del decreto legislativo 23 luglio 1996, n. 415*, in *La disciplina degli intermediari e dei mercati finanziari*, by Capriglione, Padova, 1997, p. 385 ff. Such model seemed, in fact, relevant for the role of service provider of the “markets management company”, in light of the acknowledgment of the private entrepreneurial nature of the organization and management activity of the exchanges in a competitive environment.

<sup>58</sup>See ANNUNZIATA, *La disciplina del mercato mobiliare*, Torino, 2014, p. 271 ff.

<sup>59</sup>See SEPE, *I mercati*, in Vv.Aa., *Manuale di diritto finanziario*, Padova, 2015, p. 670.

iana s.p.a. should be deemed to be of no concern for carrying out operational processes of such management company. Moreover, pursuant to the TUF legislation, ‘anyone (provided that s/he is of good repute) will be allowed to be a shareholder (even a controlling one)’ of these companies;<sup>60</sup> such conclusion is reinforced by the consideration that supervision on markets and their structures ‘is exercised not at a consolidated level, but in the realm of the single company’.<sup>61</sup>

Under a different standpoint, we should also note that Brexit will give rise to the need of moving the headquarters of the EBA, currently located in London, to another EU country. This occurrence could even determine a reshaping of the distribution of powers between the bodies making up the ESFS, whose structure – which has been validated since January 2011 – is broken down into three supervisory authorities, in charge of the banking sector (EBA), markets and financial instruments (ESMA), insurance and occupational pensions (EIOPA), respectively.<sup>62</sup> Hence, the need for implementing some reforms, with the rationale of taking into account the implications on the EBA’s role brought by the exit of the United Kingdom from the European Banking Union (EBU), could arise inside the apical organisation of the European financial order, where – in addition to the abovementioned authorities – the European Systemic Risk Board (ESRB), chaired by the President of the ECB (who is in charge of detecting and monitoring the potential threats to the financial stability by issuing inputs and guidelines aimed at avoiding them)<sup>63</sup> is also included.

In the aftermath of the Commission’s proposal for establishing the EBU, I

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<sup>60</sup>See ANNUNZIATA, *supra*, p. 273.

<sup>61</sup>See SIGNORINI, *supra*, p. 11.

<sup>62</sup>*Inter alia*, see TROIANO, *L’architettura di vertice dell’ordinamento finanziario europeo*, in VV.AA., *Corso di diritto pubblico dell’economia*, Padova, 2016, p. 560 ff.; ID., *Interactions Between EU and National Authorities in the New Structure of EU Financial System Supervision*, in *Law and Economics Yearly Review*, no. 1/2012, p. 104 ff., readable on [www.lawandeconomicsyearlyreview.org.uk](http://www.lawandeconomicsyearlyreview.org.uk); where the functions of the new authorities in the European financial order are pointed out; GUARRACINO, *Supervisione bancaria europea. Sistema delle fonti e modelli teorici*, Padova, 2012, p. 139.

<sup>63</sup>See PELLEGRINI, *L’architettura di vertice dell’ordinamento finanziario europeo: funzioni e limiti della supervisione*, in *Riv. trim. dir. ec.*, 2012, I, p. 57, where, in laying down the functions of the European Systemic Risk Board (ESRB) is thoroughly underlined that it is ‘presided by the President of the ECB (for a five-year period)’ (p. 58), with the purpose of detecting is such connection the basis for a common shaping of the action to be implemented.

had already highlighted the need to proceed with the adoption of an adequate connection between the banking supervisory authorities working inside the ESFS, on the one hand, and the European Central Bank, on the other (given the new skills attributed to the latter).<sup>64</sup> This, not only in order to avoid possible overlaps of powers (stemming from the concentration into the same person of the presidency of both the ECB and the ESRB), but also with the purpose of ensuring a continuity of action by the EBA (which reflects the positions of the whole of EU Member States, whence the function – delegated to it – of granting adequate levels of operating equilibrium in the European realm).<sup>65</sup>

Having said this, as pointed out by the literature, in light of an exhaustive conduct of banking supervision, we may notice the towering, peculiar centrality of the relationship between the EBA and the ECB.<sup>66</sup> It is deeply true that, among the *criteria* inspiring the EU Regulation No. 1024/2013, is explicitly envisaged the EBA's role of 'developing draft technical standards and guidelines and recommendations ensuring supervisory convergence and consistency of supervisory outcomes within the Union' (Recital 32). Furthermore, it is equally true that this principle is matched by the direct provision of the ECB's corresponding powers 'to adopt regulations in accordance with Article 132 of the Treaty on the Functioning of the European Union (TFEU)', *i.e.* to the extent that it is deemed to be necessary in order to accomplish its institutional tasks.<sup>67</sup>

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<sup>64</sup>We are referring mainly to the circumstance that, in exercising its *regulatory* function, the EBA will be forced to extricate itself from often conflicting positions; this, with obvious, significant implications, such as the perspective of a scarcely proactive *agere*, related with the purpose of not excessively burden certain consolidated realities in the 'banking union' Member States. This conclusion is not separable from the further occurrence that the EBA will even withdraw itself from taking decisions whose content is estimated to be hardly appreciable (by one of the two "blocks" of States to which its interventions are addressed).

<sup>65</sup>See CAPRIGLIONE, *Mercato regole democrazia*, Padova, 2013, p. 87.

<sup>66</sup>See WYMEERSCH, *The European Banking Union. A first analysis, supra*, p. 20; GUARRACINO, *Dal meccanismo di vigilanza unico (SSM) ai sistemi centralizzati di risoluzione delle crisi e di garanzia dei depositi: la progressiva europeizzazione del settore bancario*, in *Riv. trim. dir. ec.*, 2012, I, p. 207, where is highlighted that "the recent reform project regarding banking supervision in the Eurozone, advanced by the Commission last September, envisages an intervention on the governance of the EBA, also aimed at ensuring its decision-making functionality".

<sup>67</sup>It follows that also the "stress tests" must be deemed to be attributable to the realm of the ECB's prudential assessments "in coordination with the EBA, where appropriate", whereas – since they

It follows that the elements explicating that relationship are entrusted with the particular function of *balancing* the different tendencies (sometimes conflicting) that may arise in the concrete realm; at the same time, the need for achieving the preservation of the prerogatives and powers of each of the abovementioned authorities keeps unchanged. A coordination of the efforts put in place by the components of the current order of the European financial system (as constructed in accordance with the guidance provided by the De Larosière Report) should, thus, be regarded as strictly correlated with the need to achieve adequate forms of *cooperation* in the fulfilment of supervisory tasks (on sectors which are not uniform), such that one could prevent the autonomy and independence of those authorities – as acknowledged by the European regulator – from being trespassed.

In light of what we have said, a peculiar relevance is taken by the ‘public consultation’ launched by the Commission ‘on the operations of the European Supervisory Authorities’ with the purpose of identifying the areas where it will be possible to improve the effectiveness and efficiency of the ESAs.<sup>68</sup> More in detail, as far as the EBA is concerned – regardless of the search for a new place where it could be reallocated, occurrence which anyway brings a relevant input in the reshaping of its institutional standing – it is no doubt that, in the near future, the solution to this issue could be found by shrinking its role; a goal achievable in ways that, at present day, we have not been able to identify yet, and that will nonetheless be useful in order to solve potential situations of conflict with other ESFS bodies. This ‘rebuilding’ hypothesis, as properly underlined in technical terms, might be broken down into a twofold path: *a)* a *tout court* reduction in the EBA’s scope of intervention; *b)* this authority’s powers being split between the other bodies making up the apical organisation of the European financial order (ESMA

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were first applied (July 2010 and July 2011) – it seemed that they should have been regarded as the latter’s (exclusive) prerogative. Whence, the possibility of alleged overlaps, or supposed frictions between the authorities in question, with the additional risk of undermining the systemic consistency pursued by the regulator.

<sup>68</sup>See the document published by the EU Commission Representation in Italy, readable at [https://ec.europa.eu/info/consultations/finance-2017-esas-operations\\_en](https://ec.europa.eu/info/consultations/finance-2017-esas-operations_en), where is pointed out that the consultation has been open until 16<sup>th</sup> May 2017.

and EIOPA), with the clear consequence of achieving the former's dismantlement and rendering a rebalancing of tasks, with regard to differentiated activities, necessary.<sup>69</sup>

7. If we targeted a complete analysis of the effects of Brexit onto the banking realm, we should take into account that its implementation crosses the tough moment experienced by the European financial system, for the latter has to face the complex and problematic subjection to the regulation adopted by the EU legislator in the wake of the well-known events of 2007 and the following years. Nevertheless, the complicated *corpus* involving the production of new forms of *supervision* and management of banking crises, both underlying the construction of the European Banking Union, raises some interpretational concerns over what is defined as 'a new integration by means of centralisation', as well as the already-occurred transfer outside the Member States of large portions of the regulatory and supervisory activities (whence the residual executive functions recognised to domestic authorities).<sup>70</sup>

In identifying the causes of such complexity, reading the 'Framework Regulation' ECB/2014/468 – where the *Single Supervisory Mechanism* is designed – we may notice a structure which, though clear and precise with regard to the monitoring aspect of the 'single mechanism', appears to be hardly intelligible as we deal with the ways in which the ECB's powers are connected to those of the domestic competent authorities. This, not only because of the felt sense of 'limitation on sovereignty' (which is echoed by some Eurosceptic tendencies) implicit in the initiation of the SSM, but also in order to detect the actual size of the down-sizing brought, in this way, to national administrations. Moreover, of a greater scope is the complexity regarding the analysis and methodological approach which characterise the technical forms of the 'crisis resolution' procedures. The upheav-

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<sup>69</sup>See SIGNORINI, *supra*, p. 11.

<sup>70</sup>*Inter alia*, see TORCHIA, *La nuova governance economica dell'Unione europea e l'Unione bancaria*, in VV.AA., *L'unione bancaria europea*, *supra*, p. 53 ff. and respectively PISANESCHI, *La regolazione bancaria multilivello e l'art. 47 della costituzione*, *ibidem*, p. 153 ff.

als that have been recorded *in subjecta materia* during recent years establish their connection with a disciplinary rationale that – by abandoning previous tutioristic purposes, aimed at safeguarding the subjective positions of savers without any particular restraints – impacts in an innovative manner onto the juridical-economic reality under observation. The legislative intent of overcoming previous forms of ‘socialisation of losses’<sup>71</sup> – thus, in antithesis of the ‘crisis management’ ways followed in the past – resulted in a mechanism that, unlike the crisis management tools applied in the past, attributes to the *market* a rebalancing function that cannot yet be supposed, given the substantial lack of those factual requisites which could be able to secure such a desirable condition.

We may find some statements that are destined to lower the legislator’s willingness to achieve the dissolution of the distressed banking firm; whence, the priority given to the adoption of *preventive* measures targeted at a twofold direction (as a precursor to the crisis and in its aftermath, respectively) corresponding to different authorities: the supervisory body and the newly-instituted one, in charge of the specific matter of resolution.<sup>72</sup> The peculiar internalisation of losses (achieved through the ‘resolution plan’ prepared by the authority and, in particular, the application of bail-in) sets a concrete limit to investor protection, other

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<sup>71</sup>Such mechanism has been defined in this way by the literature because, in the concrete realm, burdened taxpayers with the financial assistance aimed at rescuing the distressed banks; on this subject, see CAPRIGLIONE, *Regolazione europea post-crisi e prospettive di ricerca del diritto dell’economia: il difficile equilibrio tra politica e finanza*, in *Riv. trim. dir. e proc. civ.*, 2016, p. 537 ff.

<sup>72</sup>A disciplinary scheme has been constructed such that some provisions give substance to a pre-phasic context, represented by the drafting of plans (targeted at recovery, as well as resolution), other identify particular intervention *tools* aimed at avoiding the expulsion from the market of distressed entities. These last are made of four procedural ways that are expressed by the possibility to implement, alternatively or in a combined manner, the “sale of business”, the “asset separation” between a “good bank” and a “bad” one, the creation of a “bridge bank” and the application of “bail-in”. In literature see (*inter alia*) LOIACONO *et al.*, *L’Unione bancaria e il possibile impatto dei nuovi strumenti di risoluzione delle crisi: un’analisi empirica*, in *Federalismi.it*, 2015; HADJEMMANUIL, *Bank Resolution Financing in the Banking Union*, in *LSE Legal Studies Working Paper*, No. 6/2015, p. 25 ff.; LEMMA, *La nuova procedura di risoluzione: indicazioni per un’insolvenza obbligatoria?*, in *Riv. trim. dir. ec.*, 2016, II, p. 31; ROSSANO, *La nuova regolazione delle crisi bancarie*, Milan, 2017, p. 88; SUPINO, *Soggettività bancaria assetti patrimoniali regole prudenziali*, Milan, 2017, p. 91, where is recalled the famous work by HUERTAS-NIETO, *A game changer: The EU banking recovery and resolution directive*, available on [voxeu.org](http://voxeu.org).

than legitimising the hypothesis (formulated by the doctrine) of an occurred breach of the *par condicio creditorum* principle.<sup>73</sup>

It is clear that such regulation impacts on the governance of credit institutions, because, following the new resolution programme, the legislative provisions attributing only to shareholders the exercise of the imperative power underlying the management function seems to be at least outdated. Equally, it is reflected onto the ownership structure of the members of the credit industry, determining a disincentive to investments in the equity of banks following changes (retrievable *vis-à-vis* the past) in those measures which allow to investigate the relation between risk and return;<sup>74</sup> thus, by highlighting a clear contradiction between the discipline of banking crises and the prescriptions of Directive No. 20/36/EU (so-called ‘CRD IV’), whose goal is ‘that institutions have a good organisation and adequate own funds, having regard to the risks to which the institutions are or might be exposed’ (Recital 44).

Hence, we witness the rise of a scenario dominated by the investors’ mistrust in markets, which are conditioned by their reduced appeal in cultivating relationships with banks or undertaking investments in their capital; mistrust which is due not only to decreasing profitability to which credit institutions have been exposed because of the *financial turmoil* in recent years, but also to the threats connected with the new risks arising from the (distressed entities) undergoing resolution procedures.

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<sup>73</sup>After all, the Italian legislator seems to be aware of this, as we are allowed to deduct from the fact that in the Legislative Decree No. 181/2015 the application of Art. 91, par. 1 *bis*, letter *c* TUB is deferred “to the Greek calends” (1<sup>st</sup> January 2019).

In literature, *inter alia*, see LENER, *Profili problematici del bail-in*, relation at the conference ‘La gestione delle crisi bancarie e l’assicurazione dei depositi nel quadro dell’unione bancaria europea’, organized by the FITD, held in Rome on 22 January 2016.

<sup>74</sup>The measures designed to evaluate the financial investments allow to establish comparisons between the instruments on the market and, thus, to make choices that take into account the latter’s specificity, computed in accordance with the results provided by the traditional breakdown into the Value at Risk (VaR), Sharpe Ratio, Tracking Error Volatility (TEV) and Information Ratio (IR). Hence, it becomes possible to choose between alternative investment decisions with regard to the risk spread – labelled as ‘risk premium’ – for a certain asset *vis-à-vis* the others compared to it; see BREALEY – MYERS – SANDRI, *Principi di finanza aziendale*, Milan, 1999, *passim*; TUTINO, *Performance, valore e misurazione dei risultati nell’azienda*, Milan, 2012, *passim*, in particular p. 79 ff.

Such context is affected by Brexit, whose effects – by widening the uncertainties characterising the phase-in of the technical forms of resolution (let us only think to the ‘rescue’ of the four troubled Italian banks) – certainly appear to be destined to render the *transition* to the new, just-recalled European regulation even harder. Nevertheless, the likely fading in the financial centrality of the City, which has always been the engine of international economic relations, will deprive the Union of a safe reference with regard to the detection of factors which could contribute to achieving levels of stability that are needed in order for the new historical change, regarding the industry in question, to be appeased without troubles.

In forthcoming years, the doctrinal debate will be very likely oriented to provide *clarity* upon the issues that we have exposed here and, still, on the search for points of *reconciliation* with regard to defining the new relational forms that will be adopted in the encounter between the U.K. and the Union: the former will undoubtedly have to face the negative consequences of a more limited operational expansion toward EU countries and of a separation from the Old Continent, of which it anyway represents an integral part; the latter will suffer the *loss* of the balancing contribution from a country which is universally recognised as the cradle of democratic parliamentarianism and of a liberalism which has been able to translate into cultural openness and a profound civic sense.

8. In relation to the economic and financial effects of Brexit must be considered also its influence on the geopolitical situation of the Eurozone and, more generally, of the EU. In particular, shall be taken into consideration the relevant implications of Brexit on the previous relationships between Member States which had reached – not without difficulties – a balance among the different role of each of them (in consideration of their location, strategic positioning of their borders, size and capacity of their exports, etc.).

As already highlighted on previous occasions, the scenario of the EU after the 2007 financial crisis is characterized by the role of Germany as Europe’s «lo-

comotive» of the economic recovery.<sup>75</sup> Germany has been supported in this role by other Member States which limited and contained the adverse effects of the financial turmoil that involved a large part of Europe (Netherlands, Austria, Slovakia and Finland); therefore, it becomes possible to outline a specific area including countries which propose the austerity as the only way to ensure the «staying together», making it significantly onerous for other countries mostly from Southern Europe (Italy, Spain, Portugal, Greece), where the economic recession produced growing difficulties, therefore such countries badly tolerate the austerity regime imposed by the European institutions (often influenced by the *hegemonic* impulse of Germany). This has produced a disparity between positions of Member States which makes difficult to jointly proceed towards a political union.

In this context, France and United Kingdom have a peculiar position. The first considering itself as an essential part of EU since the famous declaration made on May 9<sup>th</sup> 1950 by Robert Schuman, the French Minister for Foreign Affairs, concerning the creation of a “European Coal and Steel Community”; therefore, France works towards ensuring the creation of adequate basics to support the economic development of Europe by activating the integration process, considered as an essential prerequisite for a convergence of interests of the different countries and, therefore, for the development of the integration process. This is the reason of the intense inclusive spirit of France – recently revived by the election of President Macron, whose proposals are fully oriented towards the revitalization of the European project and the recovery of its political significance<sup>76</sup> – which leads this Country to join Germany by activating the so-called «Franco-German Axis» which assumed prominence in defining the policies of the Union.

Therefore, can be explained the special attention of France in acting as the

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<sup>75</sup>See CAPRIGLIONE and SACCO GINEVRI, *Politics and finance in the European Union*, Padova, 2016, p. 196 ff.

<sup>76</sup>On this argument, see the editorial of the ‘Institute for International Political Studies’ *La Francia (e l’Europa) di Macron*, at [www.ispionline.it/it/articoli/articolo/europa/la-francia-e-leuropa-di-macron-16758](http://www.ispionline.it/it/articoli/articolo/europa/la-francia-e-leuropa-di-macron-16758), pointing out Macron's proposals: a common defense system, strengthening the Eurozone, strengthening common migration policies and reforming the post-Brexit Parliament.

primary custodian of autonomy and liberal prerogatives characterizing the evolution of the Union; an attitude which seems to aim at offsetting – by adopting a strong political stance – its weaker economic contribution to the process of European integration and development. This strategy has its origins in the sense of *grandeur* – «*une certaine idée de la France*», a certain idea of France, in the words of General De Gaulle and the Gaullists<sup>77</sup> – which leads such Country to adopt policies aimed at achieving a leading position in all fields: from politics to economics, culture and warfare.

On the other hand, U.K. – due to its cultural pattern – frequently took positions on political decisions of the Union which made clear a sort of *detachment* from the continental Europe. More specifically, the modalities of its relationships with the EU reveal the intention not to be fully engaged in the affairs of a Europe whose reality is maybe perceived as extraneous, overriding in all respects. The entry of U.K. in the European Economic Community, repeatedly requested and at length opposed by the French vetoes, took place with a low level of empathy for the rest of the Continent<sup>78</sup> and reveals the difficulties of U.K. politics in overcoming the obstacles of the transition from a traditionally global to a regional status.<sup>79</sup>

Hence the peculiar position of such State towards the six countries of the Europe, whose intention is not to be totally involved. Indeed, the support in the economic integration as a prelude to the political one has always been poor; while (in the logic of EU accession) seemed to prevail the purpose of taking advantage from the Community mechanisms based on intergovernmental methods. A traditional adherence to national *sovereignty* (covered in its various components)

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<sup>77</sup>For an analysis of *de Gaulle's diplomacy* see MORAVCSIK, *De Gaulle Between Grain and Grandeur: The Political Economy of French Ec Policy, 1958–1970*, in *Journal of Cold War Studies*, 2000, vol. 2, no. 3, p. 4 ff.

<sup>78</sup>See CAPRIGLIONE and SACCO GINEVRI, *Politics and finance in the European Union*, *supra*, p. 211, in which the authors remember the famous episode of the resignation of Sir Teddy Taylor from *Heath's government minister* when he became aware of the decision to sign the Treaties of Rome.

<sup>79</sup>See PARR, *Britain's Policy Towards the European Community. Harold Wilson and Britain's World Role, 1964-1967*, London, 2005; TOOMEY, *Harold Wilson's EEC application: inside the Foreign Office 1964-7*, University College Dublin Press, 2007.

is the basis of political choices transforming the abovementioned “empathic detachment” in a sort of ideological “separation”. As a result, the United Kingdom excluded itself from those forms of progressive integration which, according to Jean Monnet’ suggestions, could/should have led – following a functional process (in which some Countries share certain activities and economic resources) – towards the fulfillment of a political Union.<sup>80</sup>

*Insularity* has been read by the United Kingdom according to patterns that, against the essence of cooperation, led this Country to believe in its *alterity*, ending up on assuming behaviors considered due to an unjustified arrogance and, in some cases, due to the opposition to the European project.<sup>81</sup>

This explains the positions assumed by the United Kingdom, with respect to the most important issues concerning the measures for coordinating the EU’s economic and banking policies. Specific reference is made to the decision of the UK not to adopt the “single currency” and to its policy towards European affairs, oriented (since 1992, *i.e.* from the Maastricht Treaty) to protect its national interests. This entails the several requests for adjustments (*rectius*: changes) to internal laws and regulations and explains the inconsistent positions with the idea of an all-embracing membership where the common interest shall prevail. Specific regard shall also be paid to the *Report* prepared by the House of Lords on the status of the crisis in the Eurozone and, in particular, on the proposed “fiscal compact” (and the related measures)<sup>82</sup>, as well as to the declaration issued by the UK with respect to the review of the rules on capital requirements of banks (pursuant to

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<sup>80</sup>The method followed by this French statesman is inspired by the «functionalism» of MITRANY D., *A working peace system*, London, 1943 and by the «neo-functionalism» of HAAS, *The Uniting of Europe – Political, Social and Economic Forces, 1950-1957*, London, 1958; ID. *Beyond the Nation State*, London, 1964, and of LINDBERG, *The Political Dynamics of European Economic Integration*, London, 1963.

<sup>81</sup>In literature the analysis of such reality consists in evaluations which refer, on the one hand, to the ‘gatekeeper’ action carried out by the British central government *vis-à-vis* the EU (in order to keep safe the national sovereignty), on the other hand, to the explicit semi-detachment of the UK from the EU; see, among others, GEORGE, *Britain and the European Community: The Politics of Semi-Detachment*, Oxford, Clarendon Press, 1992; MORAVCSIK, *Preferences and power in the European Community: a liberal intergovernmentalist approach*, in *Journal of Common Market Studies*, 1993, no. 4, p. 473 ff.

<sup>82</sup>See HOUSE OF LORDS, *European union committee, 25th report of session 2010-2012, The euro area crisis*.

the regulatory package called “CRD IV”, composed by the EU Regulation 575/2013 and EU Directive 2013/36).<sup>83</sup>

A similar behavioral logic can be recognized also with respect to the English determination not to adhere to the EBU. Indeed, despite certain analyses – carried out with reference to criteria based on a cost/benefit *ratio* – demonstrated that UK and Sweden could have been among the principal beneficiaries of joining the EBU,<sup>84</sup> this membership has never been requested. The way the United Kingdom reacted to the Commission’s proposal necessarily compromised the relationships with the Union; such reaction made clear that the lack of interest of the United Kingdom in the European forms of “single supervision” would have lead – within the relevant decision making processes – to *votes* and *judgments* obstructing the success of the proposals or, at least, aimed at reducing their scope, thus fostering «*the undesirable development of a multi-speed Europe*».<sup>85</sup>

On this premise, the effects of Brexit on the European geopolitical structure, as stressed by the unanimous specialized press, materialize, in the first place, on the strengthening of the Franco-German axis.<sup>86</sup> It is no coincidence that Macron and Merkel, during a European summit held at the end of June 2017, jointly reiterated their will to “go back promoting European integration”, giving a new impulse to the relevant process;<sup>87</sup> hence, the possibility of a “joint roadmap” that, in the coming years, should lead to a reform of the Union and, therefore, to

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<sup>83</sup>Furthermore, the refusal to accept a regulation aimed at granting financial stability is supported by unspecified arguments, see Council of the European Union, 2 April 2013, 7748/13, Add2 (Addendum 2 to the note point “I”).

<sup>84</sup>See, among others, SCHOENMAKER and SIEGMANNB, *Efficiency Gains of a European Banking Union*, Duisenberg School of Finance –VU University Amsterdam, January 31, 2013, p. 17.

<sup>85</sup>See ONNO RUDING, *supra*, *ibid*.

<sup>86</sup>See, among others, BONZANO, *Asse franco-tedesco: la strategia europea di Emmanuel Macron* available at <http://formiche.net/blog/2017/05/25/asse-franco-tedesco-secondo-macron>; FABRINI, *Come non sbagliare la partita in Europa*, available at [www.ilsole24ore.com/art/commenti-e-idee/2017-06-25/come-non-sbagliare-partita-europa](http://www.ilsole24ore.com/art/commenti-e-idee/2017-06-25/come-non-sbagliare-partita-europa); DEBENEDETTI, *Se Parigi sceglie il riformismo tedesco*, available at [www.ilsole24ore.com/art/commenti-e-idee/2017-05-15/se-parigi-sceglie-riformismo-tedesco](http://www.ilsole24ore.com/art/commenti-e-idee/2017-05-15/se-parigi-sceglie-riformismo-tedesco).

<sup>87</sup>See the editorial *Conferenza congiunta Merkel-Macron al termine del vertice Ue*, available at [www.ansa.it/europa/notizie/rubriche/altrenews/2017/06/23/conferenza-congiunta-merkel-macron-al-termini-del-vertice-ue](http://www.ansa.it/europa/notizie/rubriche/altrenews/2017/06/23/conferenza-congiunta-merkel-macron-al-termini-del-vertice-ue).

potential modification of the Treaties.<sup>88</sup> It is clear that the absence of the United Kingdom from the EU facilitates the cohesion of countries which, due to their political stability and economic strength, are able to *refound* the Union overtaking the crisis of identity the Union is currently experiencing (due to the lack of a common socio-cultural background adequate to overcome the [not only economic] differences among Member States).

Of course, it shall be considered that – in a European context marked by various imbalances between the Member States – the assumption of a supporting actor role (in pursuing the creation of an 'exemplary model' of supranational cooperation, suitable for promoting forms of more intense cohesion) requires an equal position of France and Germany that does not exist. The economic gap between these countries (and therefore the substantial German primacy, based on the austerity and on the strict interpretation of the Treaties) could give rise to the establishment of a German-led system. Hence, it is possible to imagine the recurrence of the *contradictions* which have already undermined the German and French 'directory' in the past.<sup>89</sup>

Italy – due to the limitations deriving from its history<sup>90</sup> – could be cut off from this project, despite the encouraging statements of the Italian Economy Minister on this regard.<sup>91</sup> Indeed, (i) the delay which characterizes the re-start of the economic recovery after the crisis, (ii) the illness of a significant part of the banking system (burdened by an overwhelming weight of non-performing loans and hence from the prospect of being subjected to resolution procedures, avoided by prompt legislative decrees<sup>92</sup>), (iii) the existence of a political context unable to

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<sup>88</sup>See ROMANO, *Riparte l'asse franco tedesco. Macron: cambiare i trattati si può*, available at [www.ilsole24ore.com/art/mondo/2017-06-23/riparte-l-asse-francotedescomacroncambiaretrattati-si-puo](http://www.ilsole24ore.com/art/mondo/2017-06-23/riparte-l-asse-francotedescomacroncambiaretrattati-si-puo).

<sup>89</sup>See CAPRIGLIONE and SACCO GINEVRI, *Politics and finance in the European Union*, *supra*, p. 221.

<sup>90</sup>See CAPRIGLIONE, *Mercato regole democrazia*, *supra*, p. 196 ff.

<sup>91</sup>See the editorial *Padoan chiama l'asse franco-tedesco: "Insieme per politiche comuni sulla crescita"* available at [www.huffingtonpost.it/2017/06/18/padoan-chiama-lasse-franco-tedesco-insieme-per-politiche-comu\\_a](http://www.huffingtonpost.it/2017/06/18/padoan-chiama-lasse-franco-tedesco-insieme-per-politiche-comu_a).

<sup>92</sup>Reference is made, in particular, to Decree Law 25 June 2017, no. 99, which resolved on the execution of the compulsory administrative liquidation of Banca Popolare di Vicenza S.p.A. and of

support the comparison with modernity, or to prepare the regulatory *humus* in order to promptly adopt measures to promote a sustainable development, are all elements which hinder a more intense participation of Italy to the “dialogue” between the governments of Member States. The need for renewal could *perhaps* lead to an adjustment of such situation; need for renewal strongly felt by the population, wishful for a return to order, to transparency, to the proper exercise of public powers, to a political pattern that ceases to disappoint exposing the Country to the risk of a growing populism!<sup>93</sup>

After Brexit, the European Union seems invaded by the will of renewal and of proceeding on the path of a growing integration. The self-imposed isolation of the United Kingdom will make such Country to look for an alternative to the relationship within the EU, perhaps with the US. Such a tendency is also compliant with a political line for a long time pursued by UK, interested in consolidating its coalition with the United States, to whom it has been strictly connected.<sup>94</sup> Therefore, the possible upgrading of a British-American axis would hardly compensate the losses of the Brexit-induced operational reduction.

Hence, the difficulties that United Kingdom is supposed to meet, *in primis* the problematic composition of a “majority of government” by May.<sup>95</sup> Such difficulties could be compensated by a “return to the past”, *i.e.* revoking the notification that initiated the exit procedure from the Union; initiative that, even if legally feasible, has to be excluded because of its impacts on UK’s *reputation*, unacceptable for a Country that has always paid attention to its prestige of world power.

#### 9. An unintended consequence, less considered, of *Brexit* concerns its ef-

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Veneto Banca S.p.A., as well as on the terms and conditions of the measures adopted to support those banks according to the European regulation concerning State aids (see Article 1, paragraph 1 of the abovementioned Legislative).

<sup>93</sup>The situation illustrated in the paper is well described by B. SPINELLI, *L’analisi. La latitanza dei partiti*, published on *la Repubblica.it* of 3 October 2012.

<sup>94</sup>See on this argument KENNETH HEIN, *Preserving the Myth: British and French Relations with the United States Following World War II*, available at <http://ssrn.com/abstract>.

<sup>95</sup>See *supra* note n. 34.

fect on socio-cultural aspects that for the relevance of British thought have animated the political and economic development of European Union.

In particular, it refers to the positive role that the philosophical thinking of some British scholars has pursued, since long time ago, on sociological ground – that in the United Kingdom has characterized the cultural formation – from Adam Ferguson, who identified arguments connected to the principles of regulated freedom and free government,<sup>96</sup> to J. Stuart Mill, who following the theories of Jeremy Bentham, positively argued the «free market».<sup>97</sup>

This theoretical framework is related to the basis of a progress founded on common interests and, therefore, able to overcome the individualism of social actors. Then the relevant priority ascribed to the *civil society* – which in the arguments of Ferguson is subordinated the function of State – and to the theory of an entrepreneurial reality based on necessary division of tasks, which assignment to different individuals allows to achieve lower production costs and significant increases of profits.

In this regard, it is identified the thesis of *liberal* theory that is found in the model of «real democracy» represented in this analysis; model that – as known – aims to identify the limits of power lawfully exercised by society on the individual.<sup>98</sup> Therefore, the configuration recognized, in this context, to the utilitarian criterion of «maximum well-being» for the largest number of citizens: it assumes, in fact, the argument of a system that seeks a commonality of life inspired by the assertion of freedom (understood in its wider sense: from the possibility to express dissent against the dominant ideas, the adoption of feelings, customs and

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<sup>96</sup>On this discussion, see the well-known work *An Essay on the History of Civil Society* of 1767.

<sup>97</sup>See the important contribution *Principles of political economy*, 1848, in which the liberal theory supports the formulated socio-political thesis.

<sup>98</sup>It is referred to the relationship between liberalism and democracy (see *supra* para. 10) and, therefore, to the contraposition of the former to the forms of state absolutism, in which the democracy identifies forms of government that confer the power to the community.

It is considered the relationship between the fundamental principles of distribution of powers, subject to well-known studies (see CONSTANT, *Discorso sulla libertà degli antichi paragonata a quella dei moderni*, Paris, 1820) and, currently in the aftermath of the globalization, to the analysis of relation between «representation and political participation», as a foundation of a *governance* that include individuals not aligned with the institutions of government (see *inter alia* ALLUM, *Democrazia reale*, Turin, 2011).

rules of conduct which are not subject to taxation and constraints).

It is evident that there is an ethical-political orientation that, through conceptual and operational features, has been able to influence over time the evolutionary process of Western countries to the modern era, marked by the affirmation of democratic systems characterized by ideologies and practices tendentially against to absolutism and hegemony. The contemporary history - which looks at the politics as the center of social issues<sup>99</sup> - rationally justifies the imposition of 'power' (understood as man's domination on man) on the criteria of the «social contract», which places to the individuals responsible of a community, the obligation to structure the interventions linking their content to the collective needs.<sup>100</sup>

In this premise it is understandable how currently the debate regarding the optimal formula for the «exercise of power» is aimed at restricting the intervention of the state to favor the freedom of action of the individual. Significant, therefore, should be considered the contribution that comes from the thought of the mentioned British philosophers whose first in-depth investigations on the dialectical relationship that politics (sometimes leading to centric conceptions) is able to activate between its institutional and social power, which it expresses itself through forms of absolute freedom (which, in the economic field, find legitimacy in private initiative and, therefore, contrast, to leadership and planning).

It is evident, therefore, the reason why the system that qualifies the democratic regime – which points to the theories of modern constitutionalism, has been defined as a «procedural idea on which everyone can agree»<sup>101</sup> - is considered, by the most eminent doctrine, preferential as a proposing of a political formula that, better than anything else, allows an organizational scheme aimed to guarantee

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<sup>99</sup>See BOBBIO, *Teoria generale della politica*, Turin, Einaudi, 2007. On the “social contract”, cf. RAWLS, *Una teoria della giustizia* (1971), Milan, 1984. On contractualism as “alternative” in the historical constitutional background, see RIDOLA, *Diritti fondamentali. Un'introduzione*, Turin, 2006, p. 7.

<sup>100</sup>The idea of «social contractualism» has found its own definition in the seminal work *Social Contract* of ROUSSEAU (Amsterdam, 1762), aimed at identifying the form of a “social and political order” that allows to link legitimacy of action and following of objectives pursued by the interest «so that justice and utility are not separated».

<sup>101</sup>See MONTEDORO, *Il ruolo della giurisprudenza nei sistemi costituzionali multilivello*, in *Il giudice e l'economia*, Rome, 2015, p. 173.

«the wider and safer participation of the majority of citizens ... to the decisions affecting the whole society».<sup>102</sup>

There is a need to explore what can be the 'integrity' of the democratic European system in the face of the change induced by *Brexit*, which could be followed by the abandonment of the vision of a methodological rationalism (of a neoliberal spirit) under which the joint participation of all Member States to the definition of Union policies is necessary to expand the pluralistic dialectic on which the democratic coexistence is based. The question at stake is what can be the configuration of the socio-political reality of the EU when the intermediary action of the United Kingdom will be fallen, which (though motivated by the realization of the national interest and, then, intended to obtain concessions and benefits according to a behavioral attitude traditionally pursued by this country) has been aimed at mitigating certain policies and/or policy choices attributed to the hegemonic position of some Member States. Similarly, in the face of the expansion of an economy that proposes, as a self-referential key, a new paradigm of regulation of coexistence, there is ample perplexity with regard to the need to seek adequate check and balance systems that can provide the necessary dialectics to the functioning of market democracy, systems in many occasions practiced on the basis of appropriate indications of Great Britain.

There are some doubts that it is possible to reduce through verifications in which the comparison between the 'sovereign power' of the states and the 'market' may have as a result the configurability of a new *Leviathan*, which has now become a symbol of a power whose roots, disenchanted by the logical past of statutory legitimacy, appear incardinated in the sacredness of a meritocratic culture that assumes the 'economic rationality' as its epicenter. In this way, it emerges a socioeconomic context, in which a reinterpretation of the German *ordoliberal* thesis can be found, which - albeit moving from the ranks of the European liberal tradition, deriving from the theories of the Austrian school and, in

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<sup>102</sup>See BOBBIO, *Quale socialismo*, Turin, 1976, p. 42, where it is referred to Hobbes's thesis (*i.e.* the foundation of right is identified in the decision of king).

particular, the ideological orientations headed by Friedrich von Hayek and Ludwig von Mises<sup>103</sup> - has been considered relevant in the literature in the configuration of a European Economic Constitution, an institutional prerequisite for the implementation of the normative provisions of the Maastricht Treaty.<sup>104</sup>

Therefore, the reference to the definition of an incisive *framework* of the European Union to the founding principles of this doctrinal perspective, in which is attributed to the market regulation a ground not identifiable in the economic and constitutional British culture. As a result, there is a change of perspective in the strategies of management of issues raised by the process of integration, particularly there is room for opportunities in the consolidation of powerful authority of Germany.<sup>105</sup>

10. In the resolution of 28 June 2016 on the decision to leave the EU resulting from the UK referendum, the European Parliament pointed out that the outcomes of the UK referendum require a deep «reflection on the future of the EU», in particular with regard to the democratization of the Union. Also the European Council – with the statement of 29 June 2016 – started a political reflection to give an impulse to further reforms, also to provide security, jobs and growth.

In this framework, we will analyse, in the follow paragraphs, the implications of Brexit concerning the reorganization of the European institution as well as the problem of the democratization of the European economic governance.

The above considerations confirm how the European integration process

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<sup>103</sup>It is referred, in particular, to the work of HAYEK, *The Use of Knowledge in Society*, in *American Economic Review*, 1945, n. 4, p. 519 ss, in which the Author illustrates the mechanism of free prices and the principle of self-organization; see also the work of MISES, *Economic Policy. Thoughts for Today and Tomorrow*, 1979, who offers a deep analysis of the interaction between market forces and government intervention.

<sup>104</sup>See MESTMAECKER, *European Economic Constitution*, in Basedow/Hopt/Zimmermann (Hrsg.), *The Max Planck Encyclopedia of European Private Law*, Bd. I, Oxford University Press, Oxford 2012, p. 587.

<sup>105</sup>On the German ordoliberalism and its own different interpretations, in the literature see SAIITTO, *Economia e stato costituzionale, Contributo allo studio della “Costituzione economica” in Germania*, Milan, 2015, 64 ff.; MICCÙ, “*Economia e costituzione*”: una lettura della giuspubblicistica tedesca, in *Quad. Plur.*, 1996, 243 ff.; SOMMA, *La dittatura dello spread. Germania, Europa e crisi del debito*, Rome, 2014; BONINI, *Economia sociale di mercato*, Bologna, 2012, 74 ff.

has also been greatly affected by the traditional alternative which at state level has characterised the reflection on the constitutional order of the economy. Indeed, on the one hand, we find the idea that for the most part the social order constitutes the outcome of the free composition of the forces operating within society, and thus something natural and necessary<sup>106</sup>; on the other, the typically German conviction (later to merge into the Treaties), that instead that order represents ‘the result of a *construction*’, and therefore ‘something artificial, within which the active and conscious role of the State’ and ‘of the public powers is unavoidable’<sup>107</sup>.

Furthermore, with respect to the experience of the national states public intervention in the construction of the economic order, in the European Union seems to have excessively sacrificed the democratic dimension to the advantage of a bureaucratic and intergovernmental approach. It is no coincidence that the modalities of the EU’s economic governance have been juxtaposed to ‘a management by means of independent authorities’ rather than to ‘a political decision-making process on democratic bases’<sup>108</sup>. This course even led Jean-Paul Fitoussi to evoke the image of the ‘benevolent dictator’: according to this scholar, the economic government of the EU would border on being an enlightened despot ‘immune from popular pressures, but searching for the common good’ through the application of a doctrine ‘superior to all the others in terms of economic efficiency’<sup>109</sup>.

It is true that with respect to the first phases of the integration process,

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<sup>106</sup>For the thesis of the incompatibility of state intervention in the economy with the principles of the “*rule of law*”, in the British doctrine, see the classical opinion of DICEY, *Introduction to the Study of the Law of the Constitution*<sup>10</sup>, London, 1959, 187 ff. and – in the Austrian School – VON HAYEK, *Rules and Order*, London, 1973.

<sup>107</sup>See FIORAVANTI, *Cultura costituzionale e trasformazioni economico-sociali: l’esperienza del Novecento*, in BIFULCO – ROSELLI (eds.), *Crisi economica e trasformazioni della dimensione giuridica. La costituzionalizzazione del pareggio di bilancio tra internazionalizzazione economica, processo di integrazione europea e sovranità nazionale*, Torino, 2013, 13 ff.

<sup>108</sup>See RIDOLA, *La parlamentarizzazione degli assetti istituzionali dell’Unione europea fra democrazia rappresentativa e democrazia partecipativa*, in ID., *Diritto comparato e diritto costituzionale europeo*, Torino, 2010, 325 ff. and notably 337.

<sup>109</sup>See FITOUSSI, *Il dittatore benevolo. Saggio sul governo dell’Europa*, Bologna, 2002, notably 7 e 44.

many steps forward have been made in the empowerment of the role of the representative institutions (European Parliament, National Parliaments) within the framework of the decision-making processes of the Union<sup>110</sup>. Nevertheless, the tendency to the *parliamentarisation* of the European Union continues to coexist and compete with bureaucratic-top-down tendencies ‘that still stifle the idea of a *bürgernahe Demokratie*’, or that is, an authentic democracy of citizens<sup>111</sup>.

It suffices to think of the growing complexity of the decision-making procedures in the European Union – not easily decipherable by the uninitiated – which made the question of the detachment of public opinion from the democratic processes of the Union spring to the foreground. From this point of view, the effort made during the review of the Treaties to overcome some of the decision-making modules typical of international organisations does not appear to have brought about a simplification of the EU’s institutional framework, but on the contrary it has made it even more complex, with the added establishment of an intricate interweaving of agencies, working groups and specialised decision-making headquarters of a bureaucratic rather than democratic nature. The lack of rationalisation of the institutional procedures and structures has thus been an obstacle to the emergence of an authentic European ‘public space’.

Or one must look at the insufficient level of transparency of the works of the Council, which has been identified with the institution characterised by the greatest degree of secrecy of all the bodies exercising legislative functions among those to be found west of Beijing<sup>112</sup>. This consequently affects the transparency of

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<sup>110</sup>On the process of the progressive *empowerment* of the European Parliament, in the huge amount of literature, see at least FASONE – LUPO, *Il Parlamento europeo alla luce delle novità introdotte nel Trattato di Lisbona e nel suo regolamento interno*, in *Studi sull’integrazione europea*, 7, 2012, 329 ff.; RIDOLA, *La parlamentarizzazione degli assetti istituzionali dell’Unione europea fra democrazia rappresentativa e democrazia partecipativa*. On the National Parliaments in the European Union, see MANZELLA – LUPO (eds.), *Il sistema parlamentare euro-nazionale. Lezioni*, Torino, 2014.

<sup>111</sup>See RIDOLA, *Federalismo europeo e modelli federali. Spunti di riflessione sul Trattato di Lisbona. L’Unione europea verso una res publica federalista*, in ID., *Diritto comparato e diritto costituzionale europeo*. 417 ff. and notably 444.

<sup>112</sup>This sharp observation was made by HIX, *What’s Wrong with the Europe Union and How to Fix It*, Cambridge, 2008. On the problem of publicity and transparency of the decision-making processes, see CURTIN, *Judging EU Secrecy*, in *Amsterdam Law School Research Paper No.*

the decision-making processes in a negative way, accentuating their opacity.

In particular, reference is made to the use of the ‘comitological’ mechanism which (allowing the involvement of the national administrations in the exercise of EU functions) takes away from the competent European authorities the power to formulate their actions independently of national interests<sup>113</sup>. Consequently, as highlighted in the literature, ‘no significant increases are recorded in relations or the adoption of provisions in which adequate space is recognised for the ideals of commonality and solidarity’.<sup>114</sup>

Lastly, one must consider the tendency towards the dispersion and fragmentation of the decision-making centres of the EU;<sup>115</sup> while in the Madisonian concept of democracy<sup>116</sup> the dispersion of power appeared to be aimed at the limitation and sharing of the latter, in the European context the fragmentation of the decision-making centres seems instead to make such authorities evade ‘the traditional forms of parliamentary oversight and political responsibility’, and hence even more powerful<sup>117</sup>.

The economic-financial and sovereign debt crisis has further increased the above-mentioned tensions and critical issues. In particular, it highlighted a significant reshaping of *politics* with respect to *technique* as well as a consistent reduction of power of self-determination of the Member States (or at least some of them) in the choices of budget policies.

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2012-103; CURTIN – MENDES, *Transparency and Participation*, in *Revue Francaise d'Administration Publique*, 2011, 101 ff.; COSTA, *Peut-on délibérer à l'échelle supranationale? La délibération au Parlement européen entre pratique démocratique et méthode de décision*, *Journée d'études du groupe intercentres «Gouvernance et délibération»*, Sciences Po Bordeaux, 2010.

<sup>113</sup>See SAVINO, *La comitologia dopo Lisbona: alla ricerca dell'equilibrio perduto*, in *Giornale di diritto amministrativo*, 2011, 1041 ff.. On the evolution of the Comitology phenomenon see Bergstrom, *Comitology - Delegation of Powers in the European Union and the Committee System*, Oxford, 2005; POLLACK, *The Engines of European Integration. Delegation, Agency, and Agenda Setting in the EU*, Oxford, 2003, 114 ff.

<sup>114</sup>See CAPRIGLIONE – SACCO GINEVRI, *Politics and finance in the European Union*, 262.

<sup>115</sup>See CURTIN, *Challenging Executive Dominance in European Democracy*, in *Modern Law Review*, 1, 2014, 1 ff. and notably 7.

<sup>116</sup>On the Madisonian democratic paradigm, see LA SPINA – G. MAJONE, *Lo stato regolatore*, Bologna, 2010, 167 ff.; DAHL, *A Preface to Democratic Theory*, Chicago, 1956.

<sup>117</sup>See LUPO, *Il controllo parlamentare sui Governi degli stati membri dell'Unione europea, tra trasparenza e privacy*, in *Federalismi*, 3, 2015, notably 7.

In a previous piece of work – published following the coming into force of the *Fiscal Compact* – it was highlighted that only the ‘possibility to see the realisation of a *political union*’ would have allowed to recover the democratic logic<sup>118</sup>. Even if the present-day events do not seem to be going in this direction, this does not exempt the scholar from asking questions on the constitutional potentiality of the integration process in the EU. The following paragraphs will thus be dedicated to the subject of constitutional unity in the European Union, also in light of the crisis of the political dimension of the representative institutions.

11. In his work of 1928, Rudolf Smend – in examining among other things the subject of the relations between the *Reich* and the *Länder* in the context of German federalism – underlined the fact that political unity is an ongoing process of integration to be built day by day. According to Smend the spiritual and patriotic unity of a community subsists on procedures of material integration hinged on shared symbols and values. In this framework, also fundamental rights – as a factor able to define the belonging of a citizen to the national community – would represent a decisive element in this permanent integration process<sup>119</sup>.

For the purpose of contextualising the process of intensification of the constitutional interdependencies between the European Union and its Member States, part of the doctrine proposed the application of the concept of “constitutional integration” to the EU, which clearly owes a lot to the suggestions contained in the above mentioned Smendian integration theory (*Integrationslehre*). Furthermore, the accuracy of the term “constitutional integration” is the subject of debate and has even been openly contested by that doctrinal thesis that has emphasised the persistent lack of a real European political unity<sup>120</sup>.

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<sup>118</sup>See CAPRIGLIONE, *Mercato regole democrazia. L’UEM tra euroscetticismo e identità nazionali*, Torino, 2013, 36.

<sup>119</sup>See SMEND, *Verfassung und Verfassungsrecht*, München, Duncker-Humblot, 1928, trans. it.: *Costituzione e diritto costituzionale*, Milano, 1988.

<sup>120</sup>This is the interpretation proposed by M. LUCIANI, *Integrazione europea, sovranità statale e sovranità popolare*, in *XXI Secolo. Norme e idee*, Roma, 2009, 339 ff.. *Contra* RIDOLA, *Diritti fondamentali e “integrazione” costituzionale in Europa. Tra passato e futuro: questioni di metodo*

In light of such interpretative controversy, one must ask whether the path towards the strengthening of the system for the protection of rights at supranational level and the reorganisation of the institutional structures of the EU has truly achieved that minimum degree of political unity required by a real “constitutional integration” process.

An articulate answer must be given to this question.

On the one hand, the failure of the project for a European Constitution represented a serious setback in the course towards the consolidation of the politico-constitutional dimension of the Union and the consequent overcoming of the traditional bureaucratic-regulatory dimension of the EU. As is well known, the Convention on the future of Europe<sup>121</sup>, established with the Laeken Declaration, had concluded its work in July 2003, drafting the project ambitiously named ‘Treaty establishing a Constitution for Europe’<sup>122</sup>. This project foresaw the abrogation of the Treaties in force at that time and their substitution with a single text aimed in particular at reorganising the attributions, the institutional framework and the decision-making processes of the Union. The ratification process of the constitutional Treaty was nevertheless brusquely interrupted following the French referendum in May 2005 and the Dutch one in June of the same year, which threw out the proposal to adopt the European Constitution<sup>123</sup>.

The role played by the referendum in holding back the integration process will be dealt with hereinafter (see par. n. 16-17). For the moment it suffices to un-

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*comparativo nella costruzione di un diritto costituzionale europeo*, in ID., *Diritto comparato e diritto costituzionale europeo*, Torino, 2010, 199 ff., notably 201-202.

<sup>121</sup>See BIN – CARETTI – PITRUZZELLA, *Profili costituzionali dell’Unione europea*, Bologna, 2015, spec. 117 ff.; DE VERGOTTINI, *Costituzione europea*, in *Enc. dir. Ann*, Milano, 2007, 445 ff.; PINELLI, *Il momento della scrittura: contributo al dibattito sulla Costituzione europea*, Bologna, 2002.

<sup>122</sup>The Convention comprised a Chair, 2 Vice-Chairs, 15 representatives of the Member States’ heads of state or government, 30 members of the National Parliaments (2 per country), 16 members of the European Parliament and 2 members of the Commission. The draft of Constitutional Treaty was presented to the Italian Presidency on 18 July 2003. A subsequent Intergovernmental Conference adopted this draft on 18 June 2004, albeit with some relevant amendments. On the outcomes of the Convention on the future of Europe, see PINELLI, *Il momento della scrittura: contributo al dibattito sulla Costituzione europea*, 2002.

<sup>123</sup>The French referendum on the Constitutional Treaty was held on 29 May 2005. The result was a victory for the “No” campaign, with 55% of voters. The Dutch referendum was held instead on 1 June 2005. The 61% of citizens rejected the treaty.

derline that not even the successive Lisbon Treaty managed to heal the wound of the failed approval of the constitutional Treaty; and indeed, even though adopting great part of the provisions contained in the above mentioned constitutional project, the Treaty in question had to renounce one of the most significant elements of “material integration”, that is to say, the use of the term “European Constitution” as the *nomen iuris* of the Treaty.

On the other hand, despite the lack of a *single constitutional document* in the traditional meaning of the word, the Court of Justice and a number of important scholars have highlighted the constitutional nature of the integration process.

With reference to the European jurisprudence, Opinion No. 1/1991 of the Court of Justice stated that the Treaties, «albeit concluded in the form of an international agreement, none the less constitutes the *constitutional charter* of a Community based on the rule of law».

With regard to the doctrine, an eminent German scholar affirmed that the question “does Europe need a Constitution” is not relevant, because Europe has already a “multilevel constitution”: a constitution made up of the Constitutions of the Member States bound together by a complementary constitutional body consisting of the European Treaties<sup>124</sup>.

More recently – in the framework of the theories of “*constitutionalism pluralism*” – the existence of a “*Composite constitution*” – grounded at the same time on the European Treaties and on Constitutions of the Member States – was affirmed<sup>125</sup>. According this thesis, through the European clauses contained in the national Constitutions as well as the Treaties’ references to national constitutional law, the parts of the composite constitution mutually assume one another’s exis-

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<sup>124</sup>See PERNICE, *Multilevel Constitutionalism and the Treaty of Amsterdam: European Constitution – Making revisited?*, in *Common Market Law Review*, 36, 1999, 703 ff. and notably 706-707.

<sup>125</sup>See BESSELINK – REESTMAN, *The Fiscal Compact and the European Constitutions: “Europe Speaking German”*, in *European Constitutional Law Review*, 8, 2012, 1 ff. and notably 7 and, in the Italian literature, LUPO, *Parlamento europeo e Parlamenti nazionali nella Costituzione “composite” nell’UE: le diverse letture possibili*, in *Rivista AIC*, 3, 2014.

tence<sup>126</sup>.

The developments of the normative framework would also seem to point to an intensification of the constitutional integration process in Europe. It suffices to think in particular of the adoption of the Charter of Fundamental Rights of the EU in 2000, to which the successive Lisbon Treaty gave the same juridical value as the Treaties<sup>127</sup>. In such way a particularly significant junction was reached in the constitutional integration process in Europe, especially if one considers that – on the basis of art. 16 of the *Declaration of the Rights of Man and of the Citizen* of 1789 – only the societies able to ensure the guarantee of rights can declare that they have a ‘Constitution’<sup>128</sup>.

12. Despite the effort of the doctrine and jurisprudence to valorise the constitutional potential of the Treaties, there are various reservations with regard to the real degree of political-constitutional unity achieved by the Union. Such doubts would seem to be reinforced following the economic-financial crisis which – as expected – brought about a weakening of the role carried out by the community method at institutional level and a consequent empowerment of the inter-governmental method<sup>129</sup>.

In this framework, the persistence of a triple *deficit* has been highlighted in

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<sup>126</sup>See FASONE – LUPO, Introduction, in LUPO – FASONE (eds.), *Interparliamentary Cooperation in the Composite European Constitution (Parliamentary Democracy in Europe)*, Oxford, 2016, 1 ff. and notably 7.

<sup>127</sup>On the constitutional status of the Charter, see RIDOLA, *La Carta dei diritti fondamentali dell’Unione Europea e le “tradizioni costituzionali comuni” degli stati membri*, in ID., *Diritto comparato e diritto costituzionale europeo*.

<sup>128</sup>According to the art. 6, par. 3 TEU, the «fundamental rights, as guaranteed by the European Convention for the Protection of Human Rights and Fundamental Freedoms and as they result from the constitutional traditions common to the Member States, shall constitute general principles of the Union’s law». See RIDOLA, *La Carta dei diritti fondamentali dell’Unione Europea e le “tradizioni costituzionali comuni” degli stati membri*.

<sup>129</sup>See FABBRINI, *Which European Union? Europe After the Euro Crisis*, Cambridge, 2015, according to which the Lisbon Treaty formalised the existence of two “constitutions”: on the one hand an organisational structure within a quadrilateral, with two legislative institutions (European Parliament, Council) and two executives, (Commission, European Council); on the other hand, an intergovernmental “constitution” in the field of the policies historically close to the heart of national sovereignty. With the economic-financial crisis – according to the author – the second constitution would have gained ground over the first.

the doctrine that risks undermining the ‘constitutional unity’ of the EU<sup>130</sup>. Firstly, an efficiency *deficit* has been outlined by the doctrine in relation to the imbalance between the speed and force of coercion of the decisions on monetary policy and the slow and cumbersome nature of those regarding economic policy<sup>131</sup>; secondly, it pinpoints a connection *deficit* in inter-institutional relations, above all with reference to the fragmentary nature of the political direction and the dispersion of responsibility within the Union<sup>132</sup>; lastly, a democracy *deficit* is considered, which today is expressed also in a reduction of the margin of discretion lying with the national political decisionmakers<sup>133</sup>.

More generally, one must ask whether the realisation of an authentic process of constitutional integration presupposes a more advanced equilibrium at European level between solidarity and stability. Under this profile, the examination of the German constitutional jurisprudence appears rich in reconstructive starting points. In the judgement known as *Maastricht-Urteil*<sup>134</sup>, the German federal constitutional Court made the distinction between *Solidargemeinschaft* (“community of solidarity”) and *Stabilitätsgemeinschaft* (“community of stability”). In such premise, the Court maintained that the national federal State constitutes the paradigmatic case of a *Solidargemeinschaft* and, therefore, of a community based on the sharing of risks and opportunities, on equalisation and the prin-

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<sup>130</sup>See MANZELLA, *Verso un governo parlamentare euro-nazionale*, in MANZELLA – LUPO (eds.), *Il sistema parlamentare euro-nazionale. Lezioni*, Torino, 2014, 1 ff.

<sup>131</sup>See MANZELLA – PINELLI – GIANNITI, *Politica monetaria e politica economica nell’Unione europea*, in *Astrid*, 2016; CONTALDI, *Politica economica e monetaria (diritto dell’Unione europea)*, in *Enc. Dir. (annali)*, VII, Milano, 2014, 811; RAFFIOTTA, *Il volto ambiguo della Banca centrale europea*, in MORRONE (eds.), *La costituzione finanziaria. La decisione di bilancio dello Stato costituzionale europeo*, Torino, 2015, 215 ff.

<sup>132</sup>See GOZI, *Il Governo dell’Europa*, Bologna, 2000, 137 ff.; CURTIN, *Challenging Executive Dominance in European Democracy*, notably 7; MAGNETTE, *L’Union européenne: un regime semi-parlementaire*, in DELWIT – DE WAELE – MAGNETTE (eds.), *A quoi sert le Parlement européen?*, Bruxelles, 1999, 25 ff. and notably 28.

<sup>133</sup>See CRAIG, *Integration, democracy and legitimacy*, in CRAIG – DE BURCA (eds.), *The evolution of EU Law*<sup>2</sup>, Oxford, 2011, 13 ff. and notably 28 ff.; GRASSO, *Il costituzionalismo della crisi. Uno studio sui limiti del potere e sulla sua legittimazione al tempo della globalizzazione*, Napoli, 2012; BENVENUTI, *Libertà senza liberazione. Per una critica della ragione costituzionale dell’Unione europea*, Napoli, 2016; M. POIARES MADURO, *A New Governance for the European Union and the Euro: Democracy and Justice*, in *RSCAS Policy Papers*, 2012.

<sup>134</sup>This is a decision whereby the German federal constitutional Court confirmed the compatibility with the fundamental Law of Bonne of the Treaty of Maastricht.

ciple according to which no component of the Federation must be left behind.

According to the above jurisprudence, the European Union would not constitute a community of solidarity but only a *Stabilitätsgemeinschaft*, as in this logic the principle prevails according to which each State is exclusively responsible for itself (*staatliche Eigenverantwortung*). It follows that the ‘community of stability’ would be required to take upon itself all the potential interests of the European community, but only those interests functional in the realisation of an integrated market inspired by the principle of competition. Moreover, it is evident that in such order of ideas one ends up giving primary importance exclusively to the realisation of national objectives!

The interpretation given by the above German Court to the nature of the constitutional integration process in Europe has been the subject of criticism<sup>135</sup>. In fact – far from being considered as values between themselves in competition – solidarity and stability would appear to represent two sides of the same coin. As the crisis would seem to have demonstrated, the realisation of the principle of stability appears possible only in the presence of a sufficient level of solidarity and political cohesion. One is aware of the fact that the virtuous Member States may not share such assumption, which for them leads to increased costs in EU participation; furthermore the fact must not be neglected that such a likelihood is exhausted in the short term, where the benefits of a solidarity that might facilitate the recovery within the whole are of the Union is destined to be resolved to the benefit of all the countries that are part of it. In a different perspective from the one represented by the German federal constitutional Court, solidarity and stability find their point of composition in the principle of responsibility; that is, in the case of the EU, it implies the need for all the components of the latter to pull their weight to strengthen that relationship of reciprocal trust that moreover constitutes the political presupposition for the much needed review of the Treaties with

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<sup>135</sup>For an outline of this debate, see SAITTO, *Economia e stato costituzionale. Contributo allo studio della “Costituzione economica” in Germania*, Milano, 2015, 281 ff.

a greater sense of solidarity<sup>136</sup>.

That said, with reference to the possibility of a reform of the Treaties, the attribution of its own *fiscal capacity* to the Eurozone has been advanced on various sides, and linked to this the creation of a democratically legitimated centre able to govern economic policy at European level. Among the various hypotheses is for example the proposal to set up a budget of the Eurozone, which some authors would like to see organised in four sectors (structural reforms, cyclical stabilisation, fight against unemployment, debt repayment)<sup>137</sup>. These hypotheses deserve due consideration: without a budget of Eurozone that goes over the current ‘multiannual financial framework’ – which is fuelled by the 1.24% of the GDP of the Member States – it is not possible to give the Union the thrust necessary for its development. Furthermore, as already pointed out in the literature, the existence of a direct fiscal obligation with the common institutions – without any intermediations of the original state – represents a fundamental passage in the construction of a *status* of the European citizen based not only on rights but also on duties able to strengthen their belonging to Europe<sup>138</sup>.

Nevertheless, before the resistance of individualistic attitudes by the Member States, the path towards a new ‘constituent’ phase at European level still appears to be very far from being possible to undertake. From this point of view, the opportunity of a strengthening of the Union’s stability through solidarity and responsibility would seem to have been taken only to a limited extent. Despite the ‘generalised need for cohesion and solidarity’ the Member States therefore continue to show ‘a poor sense of political responsibility’, often erecting walls and refusing to face the humanitarian emergency characterising the present day<sup>139</sup>. This is probably the main problem area in the pathway towards an authentic

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<sup>136</sup>On the need for more fitting forms of conciliation between respect of fiscal adjustment constraints and solidarity logics in the Union, see CAPRIGLIONE – TROISI, *L’ordinamento finanziario dell’UE dopo la crisi*, Torino, 2014, notably 136-137.

<sup>137</sup>See MANZELLA, *Verso un governo parlamentare euro-nazionale*, 1 ff.

<sup>138</sup>See LIPPOLIS, *La cittadinanza europea*, Bologna, 1994, 184.

<sup>139</sup>See CAPRIGLIONE, *Il referendum UK e l’ipotesi di Brexit (La prospettiva del way out e la convenienza a “restare uniti”)*, in *Federalismi*, 7, 2016, 10.

European constitutional unity!

13. As is well known, the economic and financial crisis put the European Union before one of the most difficult tests in its history. Above all in the countries hit by a greater unemployment rate and the compression of basic rights – culture, healthcare, education, *etc.* – the activity of the EU institutions has been the subject of harsh contestations, highlighting a growing disenchantment of the public opinion towards the prospects of the European project. In some countries, the malcontent towards the austerity policies – often attributed to the impositions of a number of Member States (Germany in particular) – has transformed into a loud social protest, as in the case of the protests organised by the *Indignados* movements in Spain which began in May 2011.

More generally, the austerity policies applied following the big crisis of the last decade, have pinpointed the profound weakness of the solidarity mechanisms, social cohesion and the reduction of inequalities<sup>140</sup>. Exploiting the widespread perception of economic insecurity deriving from such policies, the populist movements in the whole of Europe have significantly increased their consensus, fuelling a crisis rhetoric that identified those responsible for the state of moral and material decline of society in three main categories: politicians, bankers and immigrants.

This period of contestation would appear to have taken the same polemical course in Italy too, with calls for the return to “monetary sovereignty” and the closing of borders. Nevertheless, upon more detailed analysis, the *Italian case* would seem to present specific features with regard to the other ones characterised by the affirmation of populist movements. Some of the issues typical of populisms – aversion to immigrants, refusal of the single currency and the polemic

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<sup>140</sup>For a comparison of the crisis triggered by the events surrounding the *subprime* mortgages and the Great Depression of the 30s, see CAPRIGLIONE, *Crisi a confronto (1929 e 2008). Il caso italiano*; CAPRIGLIONE – TROISI, *L'ordinamento finanziario dell'UE dopo la Crisi*, notably 121 ff.; CIOCCA, *1929 e 2009: due crisi commensurabili?*, in *Apertacotrada*, 2009; REINHART – ROGOFF, *This time is different: eight centuries of financial folly*, Princeton, 2009, tr. it.: *Questa volta è diverso. Otto secoli di follia finanziaria*, Milano, 2010.

against the world of finance – have indeed been used not only by the more traditional parties, but also by a political subject of a new type, the Five Star Movement, which does not seem easy to compare with other Eurosceptic parties<sup>141</sup>. Through the experimentation of participation practices founded on new technologies, the Five Star Movement set out to contribute to the definition of a ‘new model of democracy’. While in other nations the Eurosceptic parties called for a return to a full state sovereignty – to be exercised, however, according to traditional representative mechanisms (for example, the experience of the National Front in France) – in Italy the criticism towards the European technocracies aims to overcome the current democratic-representative structures, favouring the transition to an unprecedented form of *direct deliberative democracy*, operating bottom up.

At constitutional level, the distrust in the representative institutions was moreover translated into requests aimed re-establishing the imperative mandate and in the extension of the principle of transparency also to the informal preparatory meetings leading up to political decision-making<sup>142</sup>. The method of *mediating synthesis* and *compromise* – instead of representing the element of vitality of democratic parliamentarism according to the teaching of Kelsen<sup>143</sup> – was depicted as a sign of ‘double-dealing’ and ‘dishonesty’. Hence the introduction of statutory prohibitions to the formation of alliances with the traditional parties<sup>144</sup> and the imposing of contracts on candidates with penalties aimed at sanctioning violations

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<sup>141</sup>The inclusion of the Five Star Movement among the populist parties is not unanimously shared in the literature dealing with this subject. In an affirmative sense, see. TAGUIEFF, *Le nouveau national-populisme*, Paris, 2012. Contra BIORCIO – NATALE, *Politica a 5 Stelle. Idee, storia e strategie de Movimento di Grillo*, Milano, 2013.

<sup>142</sup>Emblematic – from this point of view – was the request by the Five Star Movement for streaming as a non-negotiable condition for taking part in the consultations of the Presidents of the Council charged appointed as of March 2013. According to URBINATI, *Democrazia in diretta. Le nuove sfide della rappresentanza*, Milano, 2013, 16, the practice of *streaming* is not aimed at ensuring a greater participation of the citizens in the reaching of political decisions, as rather at claiming ‘a judging action by the public’, with the ensuing risk of giving a platform to conformist and approving stances.

<sup>143</sup>KELSEN, *La democrazia*, Bologna, 1981.

<sup>144</sup>The prohibition of alliance with other parties is to be found in the Code of conduct of the elected of the 5 Star Movement in Parliament: [http://www.beppegrillo.it/movimento/codice\\_comportamento\\_parlamentare.php](http://www.beppegrillo.it/movimento/codice_comportamento_parlamentare.php)

of the decisions of movement's leaders<sup>145</sup>.

In light of these considerations, the specific nature of the Italian case must therefore be stressed, in which the contestation of the *austerity* policies planned at European level gave substance to a democratic project without parties and representative institutions. It was described as an "impolitic democracy", made up of experts from different sectors, raw information gathered both with statistical instruments and with information put together by citizens via the web, and the elected members being called upon to do what they promise to do with a final statement that looks more like the ones used in business than in political accountability<sup>146</sup>.

Emblematic of this was the Five Star Movement's choice to resort to the selection of candidates by means of the prior examination of their *curriculum vitae* by web. This method of selection was criticised for having sacrificed the factors of legitimation deriving from consensus in favour of the ideal of a neutral and impolitic competence (the confirmation of which would furthermore be referred to the web according to criteria that are difficult to verify)<sup>147</sup>.

14. The analysis of the implications of this new model of direct deliberative democracy leads one to question the delicate relationship between *Internet* and democracy.

According to the supporters of the so-called "digital democracy", *Internet* has made it possible for an increasingly widespread number of subjects to voice their opinions, fostering the circulation of information, the transparency of decision-making processes and the control of the activities of the elected members. For example, thanks to periodical online consultations, citizens would be in the condition to express their preferences and send them to the elected rapidly and economically. More generally speaking, for the supporters of digital democracy,

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<sup>145</sup>See GRASSO, *Mandato imperativo e mandato di partito: il caso del MoVimento 5 Stelle*, in *Osservatorio AIC*, 2, 2017.

<sup>146</sup>See URBINATI, *Democrazia in diretta. Le nuove sfide della rappresentanza*, 13.

<sup>147</sup>See URBINATI, *Democrazia in diretta. Le nuove sfide della rappresentanza*, 13.

the opportunities for participation offered by the web would be at the basis of a new model of interaction between civil society and the institutions based on a continuous exchange of opinions on projects and ideas, which would not require the intermediation of other subjects (primarily, the political parties).

Indeed, there appear to be many difficulties relative to the transfer of the deliberative processes typical of politics to the web, as will be shown in the following paragraphs.

Firstly, not all citizens have the possibility and the technology skills to take part in a political process online in an informed and active way by means of procedures that are actually inaccessible to a considerable part of the population. But even given that all citizens – of any age and social background – can effectively take part in debates and decisions on internet, the efficacy of these deliberative mechanisms seems rather dubious when the questions submitted to electronic voting entails the resolving of complex technical problems and is thus not attributable to issues of immediate perception. From this point of view, the “web democracy” could perhaps permit the elaboration of some episodic and fragmentary policies, focussed on single battles. Nevertheless, it does not seem to be equipped for the development of a wider scope strategies<sup>148</sup>.

In this context the use of digital instruments in the framework of the political mediation process could present great difficulties with respect to other areas of application, such as for example that of financial innovation driven by the new technologies<sup>149</sup>.

Secondly, Internet – even though representing an important knowledge engine – has posed the democratic problem of how to conciliate the larger availability of information with the control of its reliability, also avoiding economic concentrations in the communications market. From this point of view, it has been

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<sup>148</sup>See CUNIBERTI, *Nuove tecnologie e libertà della comunicazione*, Milano, 2008, 350-355.

<sup>149</sup>On the relationship between technology and financial innovation, see MINTO, *FinTech and the “Hunting Technique”: How to Hit a Moving Target*, in *Open Review of Management, Banking and Finance*, 2017. With particular reference to the transformations brought about by the big data phenomenon, see moreover DI PORTO, *La regolazione degli obblighi informativi. Le sfide delle scienze cognitive e dei big data*, Napoli, 2017.

highlighted how it is illusory to consider that the great quantity of data available online automatically leads to transparency and truth. On the contrary, there is the danger that these transformations end up relegating the single user to isolated worlds impermeable to creativity, innovation and the democratic exchange of ideas<sup>150</sup>. In particular, without a pluralistic and competitive environment in communications markets, the risks related to the web can transform Internet from a potential vehicle of freedom into a tool that broadens inequalities. And this leaving aside the fact that in this way the dominium of the new communication multinationals (*Google, Soros, etc.*) is fuelled and empowered.

Further questions arise in relation to the absence of a suitable framework of exact and easily verifiable rules able to govern the democratic practices of the web. The limitations deriving from the lack of procedural certainties in the execution of online consultations arose for example on the occasion of the decision of the owners of the Five Stars Movement's symbol to call an electronic consultation with a prior warning of only a few hours to ratify the proposal to adhere to the group of liberal democrats in the European Parliament (ALDE). The fact that in this consultation 78.5% of those who had joined one of the most Eurosceptic parties in the Italian political scene voted in favour of the proposal to enter the most Europeanist parties of the European Parliament would appear to be a further confirmation of the fact that the outcomes of online consultations must always be regarded with great prudence<sup>151</sup>.

The transfer of tools for the control of the Members of Parliament to the web could moreover bring about the advent of a new elite, or that is to say, the set of citizens with the technical skills to manipulate the creation of consensus by the net. Instead of bringing citizens together, digital democracy would end up putting the web users in communication by more functional modalities to guarantee

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<sup>150</sup>See MENSI, *Internet, regole, democrazia*, in *Amm. in camm.* 2017, 10.

<sup>151</sup>The request made by the Five Star Movement was furthermore rejected by the ALDE group by reason of its position of uncompromising criticism towards the European Union by the Movement. See *M5s, Parlamento Ue: salta il passaggio a eurogruppo Alde. Verhofstadt: "Poche garanzie"*, in *La Repubblica*, 9 gennaio 2017, [http://www.repubblica.it/politica/2017/01/09/news/m5s\\_euro\\_parlamento\\_alde-155680742/](http://www.repubblica.it/politica/2017/01/09/news/m5s_euro_parlamento_alde-155680742/)

the legitimation of this unprecedented elite. In this perspective, it must not be excluded that the web – from a tool of participation – ends up by transforming itself into the instrument of legitimation of a decision (already) taken elsewhere, in often non-transparent contexts and ways.

In light of these considerations it must be asked whether the web is really the solution to the numerous problems of contemporary democracies or whether it constitutes a part of the problem (notwithstanding the extraordinary opportunities offered by Internet and the new technologies). Indeed, the danger is one of triggering an inverse process with respect to the one hoped for by the very supporters of the models of digital democracy. Instead of guaranteeing greater democratic participation from the bottom, an exaggerated use of the democratic practices of the web could speed up the crisis of the representative institutions, paving the way to authoritarian models based on the manipulation and control of public opinion. As has been said, left to itself, it will be hard for cyberspace to maintain the promises of freedom and greater participation of citizens in public life. It could even become a perfect tool of control<sup>152</sup>.

15. As has been highlighted, the transfer of the tools of political participation to the web has brought about a deep transformation of the democratic processes, contributing to the development of essentially atomistic forms of interaction guided by suggestions of public opinion analysis and the new technologies.

In light of the above reflections, it appears opportune to make a few comments on the reasons that have contributed to the crisis of politics and the representative institutions, which has undergone a sharp increase following the abovementioned merging of austerity, Eurosceptic populism and the advent of the ideology of the web.

The parliamentary institutions have always been considered as the fulcrum of the western democratic systems. The Constitutions of the legal systems of plu-

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<sup>152</sup>See LESSIG, *Introduction, in Free Software, Free Society. The Selected Essays of Richard M. Stallman*, Boston, 2002.

ralist democracy have always entrusted their parliaments with the task of realising the fundamental project of the promotion of the person, equality and equal social dignity by means of legislation. In this framework, the legislative Act – as a product of a visible, open and indeterminate parliamentary procedure in the outcome – is traditionally considered as the main setting in which to formulate and manage social conflicts in the framework of the ‘constitutional principle of solidarity’.

According to eminent doctrine, this model – which indeed has historically accompanied the construction and consolidation of the *welfare-state* with landmark statutes on social items (it suffices to think of the workers statute in Italy) – would today be the subject of a process of systematic erosion<sup>153</sup>. The experience of the recent years has indeed demonstrated that the Parliament has lost its position of centrality in normative production at both a quantitative and qualitative level, to progressively slide towards “lateral” collocations<sup>154</sup>. The idea of a legislating Parliament called upon to approve great landmark statutes on social items is increasingly substituted by that of a “meta-legislator” Parliament, limited to giving the organisational framework for the regulation of economic and social life, which moreover is decided in other “places” – evidently non parliamentary – and with tools that are different from the legislative Act. Between social immobility and a lack of political initiative, at the most the Parliament manages to focus its legislative action on a few emergencies, as well as the discipline of private relations (moreover often without any awareness of the preferences and needs of those represented)<sup>155</sup>.

The incapacity of the parliamentary institutions to carry out the institutional functions that they are supposed to has thus contributed to the re-dimensioning of the welfare state, both with reference to the protection of rights and social services and in relation to the pursuit of policies directed at the reduction of

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<sup>153</sup>See BURNS – ANDERSEN, *L’Unione e la politica postparlamentare*, in *Il Mulino*, 1998, 419 ff.

<sup>154</sup>See BURNS – ANDERSEN, *L’Unione e la politica postparlamentare*.

<sup>155</sup>See FILIPPETTA, *Governance plurale, controllo parlamentare e rappresentanza politica al tempo della globalizzazione*, in *DPCE*, 2, 2005, 791 ff.; ID., *Il controllo parlamentare e le trasformazioni della rappresentanza politica*, in *Osservatorio AIC*, 2014.

inequalities.

More in general, the traditional representative capacity of Parliaments would appear to be under pressure from the emergence of a new *multi-polar* system of representation and regulation, in which the individual is not considered in the role of citizen-voter, but as user, consumer, tax payer, worker, *etc.*, according to each single case<sup>156</sup>. This is particularly true with regard to the tendency to transfer powers of regulation to the so-called independent administrations which identify the holders of a regulatory power aimed at progressively substituting that of primary regulation<sup>157</sup>.

One is therefore in the presence of forms of pseudo-representation that result in fragmenting and hyper-sectorising the regulation of economic matters. Hence the tendency to the diffusion, both in political science and juridical literature, of an idea of *post-*: (i) “post-parliamentary” according to Andersen and Burns, who with this expression described the unstoppable process of empowerment of the executives, the technostructures and the galaxy of people having a technical-scientific, corporative legitimation or players with sectorial rather than general interests<sup>158</sup>; (ii) “post-democracy” for Crouch, who outlined the progressive drying up of the channels that had made representative democracy vigorous and strong<sup>159</sup>.

In this historical period of the crisis of politics, perhaps the very model of legitimation of public decisions risks changing: during the “legislator Parliament

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<sup>156</sup>See FILIPPETTA, *Governance plurale, controllo parlamentare e rappresentanza politica al tempo della globalizzazione*, 791 ff.

<sup>157</sup>On the independent administrative authorities, see at least MERUSI, *Democrazia e autorità indipendenti: un romanzo quasi giallo*, Bologna 2000; CAPRIGLIONE, *Il rapporto tra politica ed amministrazione. Le amministrazioni indipendenti*, in *Amm. in Camm.*, 2007; MONTEDORO, *Le amministrazioni indipendenti*, in PELLEGRINI (ed.), *Elementi di diritto pubblico dell'economia*, Padova, 2012, 271 ff.; AMATO, *Autorità semi-indipendenti e autorità di garanzia*, in *Rivista trimestrale di diritto pubblico*, 3, 1997, 645 ff.; PREDIERI, *L'erompere delle autorità amministrative indipendenti*, Firenze, 1997; CASSESE – FRANCHINI (eds.), *I garanti delle regole. Le Autorità indipendenti*, Bologna, 1996; MANETTI, *Poteri neutrali e Costituzione*, Milano, 1994; ID., *Autorità indipendenti (dir. cost.)*, in *Enc. giur.*, IV, Roma, 1997; CLARICH, *Autorità indipendenti. Bilancio e prospettive di un modello*, Bologna, 2005; BASSI – MERUSI (eds.), *Mercati e amministrazioni indipendenti*, Milano, 1993.

<sup>158</sup>See BURNS – ANDERSEN, *L'Unione e la politica postparlamentare*, 419 ff.

<sup>159</sup>See CROUCH, *Postdemocrazia*, Roma-Bari, 2003.

age”, the latter came from the consensus of the electorate. On the basis of such legitimation, the representatives gathered and organised the needs coming from society regarding a reconstruction project of economic and social conflicts through the exercise of the legislative function. Conversely, in the age of the “meta-legislator Parliament”, the traditional legitimation coming from the vote risks being lost, in view of the tendency to its substitution by unprecedented forms of self-legitimation founded on the conformity of the decision taken with parameters of timeliness, efficiency and rationality of public action. In other words, the link between representation and parliamentary institution could be lost, with the danger of a disconnection between politics and society as well as the orientation to a transformation of the former into mere technical administration<sup>160</sup>.

From this point of view, it is reasonable to consider that parliamentary arenas capable of supporting and leading political direction can *also* exercise those technical functions made indispensable by the complexity of our times. However, the opposite is probably not the case: Parliaments that lose their political and representative vocation could seem altogether unsuitable to carry out tasks for which other types of apparatus are somewhat more equipped.

Faced with this scenario of deep transformations, it is legitimate to wonder about the future and the perspectives of parliamentarianism. In our opinion, the latter will still prove to be fundamental – and must still be fundamental – on two conditions.

The first can be related to the need to reconnect Parliament and society, so as to channel towards the institutional “centre” the demands for participation coming from the structured “periphery” of interlocutors active in civil society. This moreover assumes: (i) the introduction of suitable communication mechanisms of transparency, publicity, pluralism and participation into the procedures of political deliberation; (ii) and organic regulation of the public role of the organisations of interests; (iii) the allocation of tools of oversight to the representative assemblies

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<sup>160</sup>See FILIPPETTA, *Governance plurale, controllo parlamentare e rappresentanza politica al tempo della globalizzazione*, 802.

in addition to the accountability of the specialised government and representation circuits. In this way, the parliamentary institutions will be able to guarantee a permanent link with civil society, answering those needs for participation that rise from the bottom and which otherwise appear destined to being intercepted by anti-politics and populisms<sup>161</sup>.

Given the above, this work of Parliament-society reconnection is possible as long as – and here we come to the second condition – there is a total acceptance of the challenges and innovations imposed by the processes of supranational integration, which must be *interpreted* and not *endured* by Parliaments<sup>162</sup>.

From this point of view, the future of representation cannot be linked to an unrealistic reappropriation by national Parliaments of functions now collocated elsewhere, but by the capacity of the representative assemblies, at all levels, (EU, State, regions, *etc.*) to work together, thus creating the inter-parliamentary representative framework to ensure the oversight and democratic accountability of the new *de facto* powers appearing on the scene of supranational *governance*<sup>163</sup>.

16. In a lively parliamentary debate in the French National Assembly in 1962, Paul Reynaud opposed the Prime Minister Georges Pompidou, who had invoked the ‘voice of the free France’ by calling a referendum. In his response, he expressed himself in the following terms: ‘France, Mr. Prime Minister, is here, in this House and there is no other expression of national will, except that of the deputies when they express themselves by vote’<sup>164</sup>.

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<sup>161</sup>On the connection between Parliament and civil society in the parliamentary rules of procedure, see GIANFRANCESCO, *Ciò che è vivo e ciò che è morto dei Regolamenti parlamentari del 1971*, in MANZELLA (ed.), *I Regolamenti parlamentari a quarant’anni dal 1971*, Bologna, 2012; PICCIONE, *Gli istituti di partecipazione nei regolamenti parlamentari all’avvio della XVII legislatura: cronaca di una riforma annunciata, ma ancora da meditare*, in *Osservatorio AIC*, 2013.

<sup>162</sup>On such need, see MANZELLA, *Il Parlamento federatore*, in *Quad. cost.*, 1, 2002, 35 ff.; LUPO –FASONE (eds.), *Interparliamentary Cooperation in the Composite European Constitution (Parliamentary Democracy in Europe)*, Oxford, 2016.

<sup>163</sup>In this sense, see MANZELLA, *Il Parlamento federatore*, 35 ff.

<sup>164</sup>The episode is dealt with by DUVERGER, *Referendum e sistemi politici*, in LUCIANI – VOLPI, *Referendum. Problemi teorici ed esperienze costituzionali*, Roma-Bari, 1992. In 1962, the President of the Republic De Gaulle exercised his power to call a referendum on the organisation

Reynaud's citation serves as introduction of one of the recurrent classical themes of constitutionalist literature, or that is to say, the problem of the compatibility of the referendum with the representative democracy<sup>165</sup>.

The reasons for this difficult encounter between parliamentarianism and referendums were grasped by Boris Mirkine-Guetzévitch at the beginning of the 1930s<sup>166</sup>. Replying to Carré de Malberg, who had hoped for the creation of a new 'model of sovereignty' based on the complete integration between referendum and representative democracy<sup>167</sup>, Mirkine-Guetzévitch had highlighted how such *mélange* was virtually impossible, as can be seen from his words: 'parliamentarism, and it can never be repeated often enough, is a natural, logical and almost automatic consequence of the *sincere* application of the representative system'. He thus concluded that 'in many cases, the "decisions of the people" have no value for the juridical conscience of democracy"<sup>168</sup>.

More recently, it has been highlighted that the theses that are uncritically in favour of the systematic use of referendums tend to give rise to a plebiscitary or dogmatic concept of democracy (...) that can no longer find a place in the democratic-pluralistic constitutional legal orders<sup>169</sup>. In recent years, in fact, the "appeal to the people" cannot claim to overstep the complex game of checks and balances

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of public powers (art. 11 French Const. 1958) with the aim of proposing the introduction of the direct election of the Head of State. As highlighted in literature, the recourse to such power has in fact entailed the violation of the constitutional review procedure set down in art. 89 Fr. Const. (CECCANTI, *La forma di governo parlamentare in trasformazione*, Bologna, 1997, 107 ff.).

<sup>165</sup>About the referendum in the Italian experience, see MORTATI, *Note introduttive ad uno studio sui partiti politici nell'ordinamento italiano*, in *Scritti giuridici in memoria di V.E. Orlando*, II, Padova, 1957, 382 ff., now in *Raccolta di scritti*, III, Milano, 1972, 384; LUCIANI, *Il referendum abrogativo. Commento dell'art. 75*, in BRANCA (ed.), *Commentario della Costituzione*, Bologna-Roma, 2005; VOLPI, *Referendum nel diritto costituzionale*, in *Dig. Pubbl.*, XII, Torino, 1997, 494 ff.; SALERNO, *Referendum*, in *Enc. dir.*, Milano, XXXIX, 1988; RIDOLA, *Brevi note sul rapporto fra referendum e parlamentarismo alla luce della giurisprudenza costituzionale italiana*, in *Il giudizio di ammissibilità del referendum abrogativo*, Milano, 1998, 221 ff.; BARCELLONA, *Votare contro. Il referendum come opposizione e norma*, Milano, FrancoAngeli, 2016.

<sup>166</sup>See MIRKINE GUETZEVITCH, *Le référendum e le parlementarisme dans les nouvelles Constitutions européennes*, in *Annuaire de l'Institut international de droit public*, 1931, 285 ff.

<sup>167</sup>See CARRE DE MALBERG, *Considérations théoriques sur la question de la combinaison du référendum avec le parlementarisme*, in *Annuaire de l'Institut international de droit public*, 1931, 256 ff.

<sup>168</sup>See MIRKINE GUETZEVITCH, *Le référendum e le parlementarisme dans les nouvelles Constitutions européennes*.

<sup>169</sup>See VOLPI, *Referendum nel diritto costituzionale*, spec. 497-498.

and the role of groups and institutions of pluralism characterising contemporary democracies<sup>170</sup>.

The doctrine has thus proposed a distinction between “bottom-up” referendum techniques, that is to say, based on a widespread initiative rooted in civil society; and “top-down” referendum techniques, in which the electorate is consulted on initiative of the same ‘subjects’ belonging to the sphere of the ‘constitutional organisation’, to which the formulation of the referendum question also belongs<sup>171</sup>. In relation to the second group of referendum techniques, the problem arises of a possible use of the instruments of direct democracy in a plebiscitary way, with the consequent difficulty to guarantee the rights of the minorities.

One of the main objections advanced to the idea of the integration between direct democracy and parliamentarianism regards the tendency of the referendum to discourage the formation of convergences around intermediate positions. In fact, by reducing the possibilities of choice at disposal of the electorate to only two options (“yes” or “no”), such institute seems structurally unsuitable to foster agreements among opposing sides. Hence the profiles of critical issues – usually to be found in all referendums – which have marked the greatest problem areas in the context of popular votes in matters of European affairs. In relation to the latter, the need is particularly felt to leave the entire range of solutions involved to the policymaker, as well as to preserve channels for dialogue within the framework of the complex talks characterising the European decision-making process.

It is no coincidence that in the last decades, the referendums on European policies ended up playing a curbing role with respect to the integration process. The reduced possibility of alternative decision-making choices, referred to above, has in fact entailed an extremisation and simplification of the public debate on

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<sup>170</sup>See VOLPI, *Referendum nel diritto costituzionale*, 498.

<sup>171</sup>See RIDOLA, *Brevi note sul rapporto fra referendum e parlamentarismo alla luce della giurisprudenza costituzionale italiana*, 222.

European affairs, offering, among other things, a formidable mouthpiece to the positions of Eurosceptic populist movements.

From this point of view, the referendum on Brexit is emblematic. The British electors were given a blunt question – “*Leave*” or “*Remain*” – which did not take into consideration that the potentially available possibilities were well over two. As the events of the ongoing negotiations between the United Kingdom and the European Union has demonstrated, there are many Brexit models, just as it is possible to find many (and varied) models for the redefinition of the relations between the EU and Great Britain within the Union. For example, among these is the position of those who, even though voting to *Leave* did not necessarily intend to endorse the exit of the United Kingdom from the common market. At the same time, not all the *Remain* voters were willing to accept the keeping of the *status quo*. In the presence of such a reality, it is evident how the recourse to a referendum ends up altering the correspondence between the real orientation of society and the consequences of the electoral result. This has the further effect of reducing the decision-making freedom of the electorate at the level of practicalities!

Furthermore, well before *Brexit*, other referendums had contributed to the slowing-down process of European integration. It suffices to think of the referendums of 2005 in France and the Netherlands, which brought about the interruption of the ratification process of the European constitutional Treaty (see above para. 11). As is well known, further to this event was an inversion in the tendency in the construction of an “*ever closer Union*”, of which the negative repercussions in the limited reciprocal trust among the Member States are to be seen even now<sup>172</sup>.

Analogously the referendum held in the Netherlands in April 2016 must be considered, with which the Dutch voters rejected the association agreement drawn up by the European Union with the Ukraine. Only in June 2017, after the

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<sup>172</sup>On the referendum concerning European matters, see CLOSA, *Why convene referendums? Explaining choices in EU constitutional politics*, in *Journal of European Public Policy*, 2017, 1311 ff.

elections of March 2017, in light of the new political equilibrium, the Dutch Parliament approved the ratification of the association agreement.

To this can be added the fact that the Eurosceptic movements were given further important success on the occasion of the Irish referendums of 2001 and 2008 on the ratification of the Treaties of Nice and Lisbon respectively. On that occasion, even though the initial negative vote was overcome by successive referendums in favour of the adoption of the above-mentioned Treaties, it must be pointed out that in Ireland recourse to such referendums represented a significant slowing-down factor of the integration process<sup>173</sup>.

Something similar took place in Denmark, a country in which two referendums were needed before reaching a vote in favour of the ratification of the Treaty of Maastricht<sup>174</sup> (even obtaining important concessions with respect to the *status* of the other Member States)<sup>175</sup>. These problems were reflected at a later date when, in 2000, the Danish electorate voted against the adoption of the single currency. This solution was shared by the Swedish citizens in the 2003 referendum when they rejected the admission to the Eurozone<sup>176</sup>.

Lastly, some referendums on European matters are of a particular nature, and which – more than damaging – were useless. The Greek referendum of July 2015 can be collocated in such context, in which 61% of the Greek citizens voted against the plan proposed by the European Commission, the ECB and IMF relative to the drawing up of a new financial support programme (which would have al-

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<sup>173</sup>The negative vote of the referendum of 7 June 2001 relative to the adoption of the Treaty of Nice was overcome in the following referendum of 19 October 2002. The dissenting vote decreed by the referendum of 12 June 2008 concerning the Treaty of Lisbon was instead defeated with the referendum of 2 October 2009.

<sup>174</sup>The reference is to the referendums of 2 June 1992 and 18 May 1993.

<sup>175</sup>On the differentiated integration, see EHLERMANN, *How Flexible is Community Law? An Unusual Approach to the Concept of "Two Speeds"*, in *Michigan Law Review*, 1984, 1274 ff.; ID., *Increased Differentiation or Stronger Uniformity*, in *EUI Working Paper*, 21, 1995, [http://cadmus.eui.eu/bitstream/handle/1814/1396/95\\_21.pdf?sequence=1](http://cadmus.eui.eu/bitstream/handle/1814/1396/95_21.pdf?sequence=1); WALKER, *Sovereignty and Differentiated Integration in the European Union*, in *European Law Journal*, 4, 1998, 355 ff.; STUBB, *A Categorization of Differentiated Integration*, in *Journal of Common Market Studies*, 1996, 283 ff.

<sup>176</sup>On the *de facto* opting out provided for in Sweden, see PAPARELLA, *Unione monetaria europea e indipendenza delle Banche centrali. Il caso della Sveriges Riksbank*, in ROSELLI (eds.), *Europa e banche centrali*, Napoli, 2004, 150 ff.

lowed Greece to remain in the Eurozone)<sup>177</sup>. It must be pointed out here that the agreement later made by Greece with the banks only marginally modified the terms of the agreement already rejected by the electorate. But this is not all. In some respects, the Tsipras Government drew up a reform plan with the banks that was even harsher than the one put to the vote in the referendum. This was the writing of ‘a page of European history that certainly does not shine for political clarity, democratic rules, or the repercussions on the definition of the future fate of the EU’<sup>178</sup>.

17. In accordance with the provisions laid down by the *European Union Referendum Act 2015* (EURA 2015)<sup>179</sup>, on 26 June 2016 the citizens of the United Kingdom were called upon to vote on the hypothesis of their country exiting the EU. Moreover, also owing to the formally advisory nature of the referendum (nevertheless perceived by the public opinion as political binding), various problems of a constitutional kind arose<sup>180</sup>, which led the British commentators to see in *Brexit* the ‘*constitutional case of the century*’<sup>181</sup>.

Following the success of the ‘leave’ vote, the new Government led by

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<sup>177</sup>The Greek referendum of 5 July 2015 had nevertheless advisory value. For more on this, see GRASSO, *Il referendum greco e la questione democratica nella (ri)costruzione del soggetto politico europeo*, in *Osservatorio AIC*, 2015.

<sup>178</sup>See CAPRIGLIONE, *Grecia: una tragedia del nuovo millennio*, in *Apertacontrada*, 2015, [www.apertacontrada.it/2015/07/23/grecia-una-tragedia-del-nuovo-millennio-i/print](http://www.apertacontrada.it/2015/07/23/grecia-una-tragedia-del-nuovo-millennio-i/print).

<sup>179</sup>In the United Kingdom there is no legislation of an organic nature relative to the discipline of referendums. The holding of each single referendum is thus ruled by ad hoc laws. On the criticality arising from the absence of organic referendum regulations, see POLITO, *La roulette russa della democrazia*, in *Il Corriere della Sera*, 5 luglio 2016. On the *European Union Referendum Act 2015*, see MARTINELLI, *Il referendum Brexit come “asso nella manica” di Cameron nel negoziato con l’Unione europea*, in *Quad. cost.*, 1, 2016, 111 ff.; CARVALE, “*With them*” o “*of them*”: il dilemma di David Cameron, in *Federalismi*, 23, 2015.

<sup>180</sup>On the constitutional implications of the Brexit referendum, see the *special issue* di *German Law Journal* and notably AVBELJ, *Brexit: An End to the End of History*, in *17 German Law Journal, Brexit Supplement*, 2016, 1 ff.; MÖLLERS, *They Do What They Want, But Do They Also Know What They Want?*, *ivi*, 71 ff.; CARBONI, *A proposito della Brexit: gli effetti del referendum sul Regno Unito e l’Unione europea*, in *DPCE online*, 2, 2016; CURTI GIALDINO, *Oltre la Brexit: brevi note sulle implicazioni giuridiche e politiche per il futuro prossimo dell’Unione europea*, in *Federalismi*, 13, 2016; ROSA, *Referendum e democrazia parlamentare in UK*, paper CESP, 21.7.2016; GOLDONI – MARTINICO, *Il ritiro della marea? Alcune considerazioni giuridico-costituzionali sul c.d. Brexit*, in *Federalismi*, 18, 2016.

<sup>181</sup>SEE EECKHOUT, *The UK decision to withdraw from the EU: parliament or government?*, 2016, *Constitution Unit*.

Theresa May announced its intention to trigger the *withdrawal clause*, foreseen by art. 50 TEU<sup>182</sup>. According to Theresa May, the possibility for the Government to give notice of its withdrawal from the European Union without the need for further parliamentary passages finds foundation in the convention that assigns an exclusive competence on foreign policy to the executive<sup>183</sup>.

Such interpretation was contested by a part of the British doctrine. According to this orientation, the Prime Minister cannot autonomously give notice of the withdrawal from the European Union but must obtain a prior approval of the Parliament, which in the opinion of a number of authors should be contained in a legislative Act<sup>184</sup>, while according to others it could also be adopted with a resolution of the House of Commons<sup>185</sup>. Half way between the interpretative line proposed by Theresa May and the one requiring a prior parliamentary passage is the thesis advancing the possibility of an autonomous intervention by the Government through an *Order in Council*, submitted nevertheless to the Parliament's successive power of oversight and *override*<sup>186</sup>.

In any case, some British citizens appealed to the *High Court of England and*

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<sup>182</sup>On the withdrawal clause, see WYROZUMSKA, *Withdrawal from the Union*, in BLANKE – MANGIAMELI (eds.), *The European Union after Lisbon: Constitutional Basis, Economic Order and External Action*, Berlin-Heidelberg, 2013, 343 ff.; RIEDER, *The withdrawal clause of the Lisbon Treaty in the light of EU Citizenship: Between Disintegration and Integration*, in *Fordham International Law Journal*, 37, 2013, 149 ff.; HOFMEISTER, *Should I stay or Should I go? – A Critical Analysis of the Right to withdraw from the EU*, in *European Law Journal*, 16, 2010, 594 ff.; NICOLAIDES, *Withdrawal from the European Union: A Typology of Effects*, in *Maastricht Journal of European and Comparative Law*, 20, 2013, 211 ff.; ATHANASSIOU, *Withdrawal and Expulsion from the EU and EMU: Some Reflections*, in *ECB Legal Working Papers Series*, 10, 2009; SAVASTANO, *Prime osservazioni sul diritto di recedere dall'Unione europea*, in *Federalismi*, 22, 2015; NASSO, *Il recesso degli stati dall'Unione: effettiva possibilità o previsione meramente... ansiolitica?*, in TERUEL LOZANO – PÉREZ MIRAS – RAFFIOTTA (eds.), *Desafíos del constitucionalismo ante la integración europea*, Murcia, 2015, 469 ff.

<sup>183</sup>This is the position of ELLIOTT, *On why, as a matter of law, triggering Article 50 does not require Parliament to legislate*, in <https://publiclawforeveryone.com/2016/06/30/brexit-on-why-as-a-matter-of-law-triggering-article-50-does-not-require-parliament-to-legislate/>.

<sup>184</sup>See BARBER, T. Hickman and J. King, *'Pulling the Article 50 'Trigger': Parliament's Indispensable Role'*, *U.K. Const. L. Blog* (27th Jun 2016), <https://ukconstitutionallaw.org/>.

<sup>185</sup>See HAZELL – SHALDON, *What role will parliament have in triggering Article 50 and shaping the terms of Brexit?*, in <https://constitution-unit.com/2016/07/19/what-role-will-parliament-have-in-triggering-article-50-and-shaping-the-terms-of-brexit/>.

<sup>186</sup>See TUCKER, *Triggering Brexit: A Decision for the Government, but under Parliamentary Scrutiny*, *U.K. Const. L. Blog* (29th Jun 2016), <https://ukconstitutionallaw.org/>. On these different interpretations, see ROSA, *Referendum e democrazia parlamentare in UK*.

*Wales*. Valorising the principle of parliamentary sovereignty, the decision of 3 November ruled that ‘*the Secretary of State does not have the power under the Crown’s prerogative to give notice pursuant to Article 50 of the TEU for the United Kingdom to withdraw from the European Union*’.

The legal arguments of this ruling were wholeheartedly confirmed and implemented by the Supreme Court in the following judgement on the Miller case of 24 January 2017, which established that the Government can legitimately trigger the withdrawal clause only after having obtained authorisation from the Parliament, which must be adopted by a Legislative Act. In support of this conclusion, the Court invoked two main arguments. Firstly, it ascertained that the irrevocability of the notice constitutes an assumption shared by the parties in the case; hence the need to enclose the act of withdrawal with suitable guarantees to protect the prerogatives of the above-mentioned parliamentary institution. Secondly, the *Miller* judgement confirmed that the constraints deriving from the *European Communities Act 1972* – that is to say the legislative act making it possible for EU law to enter the British legal system – can be overcome only by a legislative source, since the Government cannot back out of respecting EU law, at least up to the time of the streamlining of the withdrawal process.

With regard to the question of the necessary parliamentary authorisation, the Supreme Court ruled with a majority of 8 judges to 3. Hence the evident lack of a full convergence on the interpretative solutions concerning the withdrawal process, diversities in orientation which, furthermore, are to be found in the British doctrinal debate.

As far as the different profile of the role of sub-state Parliaments in the context of the withdrawal process from the Union is concerned, the Court ruled unanimously. With regard to this, it is necessary to start by saying that, in accordance with the *Sewel convention*, the Westminster Parliament can legislate on matters of interest of the ‘Devolved regions’ only with the consensus of the lat-

ter<sup>187</sup>; this constraint could have conditioned (according to some suggestions by the Scottish Government) the exit of the United Kingdom from the Union. In the case of *Brexit*, the agreement between the national Parliament and the sub-state Parliaments was all but taken for granted, considering that in the referendum some Nations sided in favour of 'remain'. Furthermore, the case of Scotland presented a rather peculiar complexity; insofar as only one year before the poll the Scottish voters – traditionally in favour of the European integration process – had voted to remain in Great Britain without considering the possible outcome of the following referendum on *Brexit*, which was contrary to what they wanted<sup>188</sup>.

In such premise, the judgement of the Supreme Court should have taken into due consideration the reasoning adopted by the above territorial institutions. Conversely, in order to exclude the recognition of any conceivable right of veto, the High Court maintained that the agreements in question are without any binding juridical efficacy, the reason for which their *justiciability* cannot be invoked before the judge. In light of this reconstruction of the role of the conventional rules, the Court thus confirmed that the Westminster Parliament can authorise the withdrawal from the European Union even without the agreement of the Regions having special autonomy following the devolution process. It is evident how the above solution appears coherent at the level of juridical formalism. Nevertheless, this does not seem as convincing in a constitutional and systematic perspective, given that the institutional agreements must be considered fully binding, as manifestations of the will of the constitutional operators<sup>189</sup>.

Going on to look at the events that led up to the triggering of the notice,

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<sup>187</sup>On the devolution in UK, see *ex multis*, TORRE (ed.), *Processi di devolution e transizioni costituzionali negli stati europei*, Torino, 2007; TRENCH (ed.), *Devolution and power in the United Kingdom*, Manchester, 2007; LEYLAND, *Devolution in the United Kingdom: a case of perpetual metamorphosis*, in *Le istituzioni del federalismo*, 1/2, 2010, 175 ff.

<sup>188</sup>On the Scottish referendum, see CARAVALE, *Il referendum sull'indipendenza scozzese: quali scenari futuri per la devolution britannica?*, in *Federalismi*, 1, 2015; MAINARDI, *Il referendum in Scozia: tra devolution e indipendenza*, in *Federalismi*, 17, 2014.

<sup>189</sup>On the convention in the British constitutional experience, see RIDOLA, *Democrazia rappresentativa e parlamentarismo*, Torino, 2011, 164 ff.; RESCIGNO, *Le convenzioni costituzionali*, Padova, 1972; LEYLAND, *The Constitution of the United Kingdom: A Contextual Analysis*, Oxford, 2016; ID., *Constitutional conventions and the preservation of the spirit of the British constitution*, in *Rivista AIC*, 4, 2014.

one must bear in mind that at a later date the Government presented the *European Union (Notification of Withdrawal) Bill* to the Houses, a measure aimed at authorising the Prime Minister to trigger the withdrawal clause in accordance with art. 50 TEU. The bill in question was then approved definitively by the *House of Commons*, which rejected the amendments approved by the *House of Lords*; hence the conferral of the *royal assent* on 16 March 2017, an unavoidable premise for the notice made by the Prime Minister to the European Council (on 29 March 2017) of the intention of the United Kingdom to withdraw from the EU.

This procedural process arouses uncertainties in which not only the different (and sometimes opposite) interpretative options are mirrored regarding the question being examined, but also the contradictions existing in the country faced with decisions destined to have profound effects on its future.

18. After the Brexit vote, in an initial assessment of the referendum results, we saw a chance for the other EU countries to set a new course for the project of European integration. We assumed that an intelligent handling of the phase subsequent to the Britain's decision to leave the European Union – jointly managed by all the Member States – could have strengthened cooperation, promoting a growth agenda. At that time, we were motivated by a desire to keep the «European dream» alive, dream that the majority of people (including Britain's young generations) have believed in.

In support of this claim, there was the idea that acting responsibly and complying with the Treaties could have avoided a setback in the process of Europeanization initiated a few decades ago. The measures put in place across Europe in the aftermath of the 2007 financial crisis – followed by a call for countries in difficulties to smooth out their debts – have been perceived as imposed constraints, increasing criticism of European austerity policies. The financial discipline of most virtuous Member States (Germany, in particular) have informed the programmes of economic recovery, with the consequence of accentuating the criticalities of several EU nations already entered in recession.

The Brexit scenario presents uncertainty and fuels criticism to the creation of a common currency. As a consequence, people start questioning the Euro and – more in general – the irreversibility of membership of the European Union.<sup>190</sup> Euroscepticism spreads across the continent clouding memories of over half a century of peace and prosperity. The benefits of EU membership are often forgotten, as well as the positive effects of homogenising the rules which govern the financial markets, in spite of the fact that the regulatory harmonization has contributed to modernise different disciplinary systems, improving the overall conditions of competition.

Searching the reasons for this widespread economic and social unease, the declining trust in the EU seems to be caused by a parallel decline in politics. The general discontent of the population fuels nationalist (anachronistic) sentiments<sup>191</sup> and induces some people to nurture the option of leaving the Union. All this weakens the European spirit and generates event such as the *Brexit*, which has been however influenced by very country-specific factors.

Our desire of union seems difficult to implement in practice. The process of overcoming the financial crisis – varying significantly from one Member State to another - had thus far not been accompanied by greater converging intentions, higher levels of cohesion or increased solidarity. The European project remains incomplete and dissatisfaction with inadequate policy making is largely shown.<sup>192</sup> As a consequence, it seems difficult – if not unrealistic – to think of *another* Europe, as the one we hoped to create after the *Brexit*.

What happened last year highlighted to us the weakness of the compro-

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<sup>190</sup>See, among others, DI TARANTO, *Le basi problematiche della moneta europea*, in *Aspenia, I futuri del capitalismo*, 2012, no. 56, p. 176-183; ID., *Il salvataggio temporaneo di Atene? Vantaggioso solo per Berlino*, in *Milano Finanza*, 16th March 2012; ID., *L'Europa tradita*, Rome, 2014, *passim*; ID., *Così l'Italia può cambiare l'euro (e guadagnarci)*, available at [ilsussidiario.net](http://ilsussidiario.net), section *Economia e Finanza*, 19 January 2014; SAVONA, *Serve un piano B per uscire dall'Euro. Da Renzi mi aspetto molto*, an interview gave on 9 March 2014, available at [www.forexinfo.it](http://www.forexinfo.it); RINALDI, *Europa kaput (S)venduti all'euro*, with the introduction of SAVONA, Rome, 2013.

<sup>191</sup>See BOLAFFI - TERRANO, *Marine Le Pen&Co. Populismi e neopopulismi in Europa*, e-book published by *goWare&FIRSTonline*, 2014, in which the authors, moving beyond current events, describe populist movements across countries.

<sup>192</sup>See FABBRINI, *Implicazioni istituzionali della crisi dell'euro*, in *il Mulino*, 2012, no. 1, p. 96 ff.

mises at the bottom of the European construction. At disciplinary level, we should also consider the transition to a new, complex regulation (partially contained in the Directives n. 2013/36/EU and n. 2014/59/EU) related to the creation of the European Banking Union. This is a wide-ranging piece of legislation, apparently self-contradictory.<sup>193</sup> The novel rules reflect often inconsistent positions of the European leaders, as recently shown in crisis circumstances that would have been required the activation of the Single resolution mechanism (cf. Regulation n. 806/2014/EU).<sup>194</sup> The public finance regulation (so called *Fiscal Compact*) led further difficulties, laying down restrictions and penalties in case of non-compliance.<sup>195</sup>

In another aspect, Member States still fail to coordinate their efforts in dealing with migratory flows of people who move from poor and war-torn nations. Several European countries refuse to adopt strong decisions to solve the issue, «without however rising adequate awareness or sufficiently shared sensitivities in our Continent, which are the necessary prerequisites for common incisive action»

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<sup>193</sup>See CAPRIGLIONE, *La nuova gestione delle crisi bancarie tra complessità normativa e logiche di mercato*, in *Riv. trim. dir. ec.*, 2017, p. 150, where the Author argues that the Bank Recovery and Resolution Directive has created a «disincentive for participation in banks' ownership structures» jointly with «the indications of the Directive n. 2013/36/UE, on the capital adequacy of credit institutions» (p.152).

<sup>194</sup>Conflicting positions were taken after an emergency decree has been issued by the Italian government to put under national insolvency procedure (*i.e.* liquidation) Banca Popolare di Vicenza S.p.A. and Veneto Banca S.p.A (see Decree Law of 25 June 2017). This choice followed a decision of the ECB which, as the authority responsible for supervision, declared that the two Italian banks «were failing or likely to fail». Then, the *Single Resolution Board* decided that it was not in the *public interest* to proceed with the resolution of the troubled banks, while European Commission approved aid for market exit of the failing entities under Italian insolvency law. Some German politicians (Ferber, Schaeuble) condemned the fact that a “regulatory loophole” now exists in the European Banking Union after Italy was allowed to wind up two ailing banks with public money. See Draghi difende l'Italia: “Berlino ha speso l'11% del Pil per salvare i suoi istituti”, in *La Stampa*, 27 June 2017, available at [www.ilfattoquotidiano.it/2017/06/26/popolari-venete-ok-dellue-al-salvataggio-berlino-muore-lunione-bancaria-el-pais-cosi-pagano-i-contribuenti](http://www.lastampa.it/2017/06/27/italia/cronache/draghi-difende-litalia-berlino-ha-speso-l-del-pil-per-salvareisuoiistituti;Popolari-venete-ok-dell'Ue-al-salvataggio. Berlino: “Muore l'unione bancaria” e El Pais: “Così pagano i contribuenti”</a>, available at <a href=).

<sup>195</sup>The “Treaty on Stability, Coordination and Governance in the Economic and Monetary Union”, otherwise known as the Fiscal Compact Treaty, introduced numerical benchmarks for the governance of public finance in Member States, (*eg.* the government debt-to-GDP ratio); See DE IOANNA, *Fiscal compact tra istituzioni ed economia*, in *Riv. Giurid. Mezzog.*, 2013, n. 1-2, p. 22 ff.; TROISI and CAPRIGLIONE, *L'ordinamento finanziario dell'UE dopo la crisi*, Milano Assago, 2014, p. 134 ff.

as recently pointed out by the President of the Italian Republic Sergio Mattarella. But European countries – continued President Mattarella – should be the expression of «open and inclusive social models in which solidarity, acceptance and assistance are terms that translate into tangible actions to assist the most vulnerable; models in which ‘diversity’ is considered an element of cultural and social enrichment and not a cause of divisiveness and isolation».<sup>196</sup> Accordingly, it is not reasonable to address the humanitarian emergency above described by *constructing walls* or rejecting people who have the right to be treated with respect for their dignity.<sup>197</sup>

Faced with this situation, the question arises as to whether the Europe of Citizens has been replaced by a Europe of technocrats and financiers. It is entirely possible that the widely criticized UK’s choice «to leave» – beyond the motivations here stated – has insured to Britain (as a country with a liberal and democratic tradition) a way to escape from the climate of uncertainty Europe has entered into. In this scenario, the creation of a *different* Europe, wanted by many European politicians – is nothing more than a *wishful thinking* hard to be converted in evidence. Conversely, the general elections in Austria, Netherlands and France ended up with the victory of pro-European forces: the sculpture by Jan Fabre «The man measuring the clouds» - recently exhibited in Naples - seems an invitation to dream!

Some years ago, when we saw the end of the crisis approaching, we argued that the relaunched project of the EU founding fathers could have led to a Europe united in its diversity.<sup>198</sup> This a very challenging task that can be achieved through a renewed European spirit, overcoming obstacles created by individualism, hege-

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<sup>196</sup>See the “Toast by the President of the Italian Republic Sergio Mattarella at the State Dinner offered by the Governor General of Canada David Johnston”, available at <http://www.quirinale.it/>.

<sup>197</sup>The Italian government has been struggling to obtain from EU some budget flexibility to face the immigration crisis: on one hand, the EC permitted a *temporary* deviation from the medium-term objective (MTO) to cover unexpected expenditures related to increased immigration flows; on the other, Italy asked Brussels for more flexibility over its budget to help manage the immigrants crisis; see LUPO and IBRIDO, *Le deroghe al divieto di indebitamento tra Fiscal Compact e articolo 81 della Costituzione*, in *Riv. trim. dir. econ.*, 2017, I, p. 206 ff., and in particular 236 ff.).

<sup>198</sup>See TROISI - CAPRIGLIONE, *L’ordinamento finanziario dell’UE dopo la crisi*, *supra*, p. 171.

monic intentions or superficiality. This path of hope is still viable if we intend to avoid the costs of another potential *discessus* and if we do not want to resign ourselves to the idea that Europe is no longer 'united in diversity', but instead 'united for necessity'.

## WHAT IS NEXT FOR EUROPE?

Stefano Micossi\*

**ABSTRACT:** *This essay provides an overview of the most important changes recently happened in the European social, political, and economic reality. In a context strongly characterized by a continuous threat to the fundamental values underlying the EU, it is desirable to move towards the relaunch of a shared European project and the recovery of its political dimension in order to strengthen common policies in the fields, among others, of security and defence, migration, economic and banking integration. In such a scenario, Italy needs to grow up and to accelerate the recovery after the crisis years in order to play a central role in the re-launch of the European construction.*

**SUMMARY:** 1. The evolution of the EU political framework. - 2. Recent financial implication and the peculiarities of the Italian case.

1. Europe is facing an unprecedented challenge to the values of openness, internationalization, liberal democracy, market social economy since the post-world war. Those values have been at the root of 70 years of peace, growth and prosperity but they are now going through a very difficult phase, besieged by historic internal and external challenges. This requires a strong political response, both at European and national level.

The elections in Austria, Netherlands and, on the top, France have shown that – once confronted with the fundamental choice between pro-or-against Europe, pro-or-against the euro – the electorate chose stability, the common currency and the Union. But there is still a lot to do to overcome the challenge. European institutions should bring back consensus over shared projects, supported by

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public opinion. The institutions and member states should reflect over their mistakes and re-launch the European construction on new foundations of effectiveness and democratic legitimacy – in order to meet the extraordinary challenges of security and immigration, environment, the economic and monetary union in a contest of divergent economic systems.

Two premises must be made:

- i. Going back to nationalisms and closing borders would be a disaster that, in the end, would pose a threat even to the ultimate goal of peace.
- ii. The way forward in the European construction must be founded on what has already been achieved; there is no other European project that we can invoke to take the place of the one we have. Of course, the institutions and the legal framework can be revised, as well as the allocation of competences between the Union and the member states – but it is not possible to backtrack on the rights of freedom and integration of the internal market, which are fundamental building blocks of the European construction.

At the European level, the Franco-German axis is gaining traction again following the French elections. The European Commission has published new reflection documents to stimulate the debate on the future of European institutions and policies and set out the ways forward. Treaty changes are no longer a taboo, not even in Berlin. And one should keep in mind that president Macron always quotes Italy as a key player in this new phase – a clear sign of the need to re-balance the weights in the negotiating process, otherwise too biased in favour of Germany.

The current relationship between Italy and the European Union is far from ideal, but Italy strongly benefitted from membership in the European Union and the euro. Italy should grow up, stop blaming others for its low growth and high unemployment, and accept that its problems require domestic reform. Italy must first and foremost reduce her enormous public debt – that undermines its ability to grow and exposes the country to the risk of renewed financial instability. If Italy succeeds in placing its public debt back onto a sustainable and credible path of re-

duction, restored investors' confidence will more than compensate any depressive effect of budgetary discipline.

As for security and defence, NATO stands as the cornerstone of our defence policy. Nevertheless, it is obvious, as Merkel warned, that "Europeans truly have to take our fate into our own hands" given the changes in the US policy and Russian assertiveness at European borders. The European Commission has recently published a document that outlines the main trends and challenges based on two building blocks: the strengthening of the industrial and technological base of the defence sector and the definition of a European capabilities and armaments policy. However joint guidelines – still missing – will be needed, as well as the need to keep the UK engaged with the EU in this crucial sector.

Concerning immigration, Italy has long been isolated and left alone to cope with massive migratory flow, too intense to be absorbed in our societies without serious pressure on national political, economic and social systems. The situation is evolving thanks to the decisive action of the Italian Minister of Interior, Marco Minniti who has strengthened Italian credibility making the Italian asylum and return system much more effective than it used to be, identifying quickly those in need of protection, while taking actions to facilitate the swift return of economic migrants who represent the vast majority of migrants arriving to Italy. In May, a joint letter to the European Commission by ministers Marco Minniti and Thomas de Maizière contributed to outline a coherent and comprehensive approach to migration, with regards to effective control of external borders and the full implementation of targeted cooperation with key countries in terms of origin of migrants and transit routes, while the establishment of the European Border and Coast Guard is taking form. In recent weeks, Italy has been successful at convincing its European partners to step up common actions to stem migrant flows at source, strengthen common action for the control of the Central Mediterranean route and revitalize the re-allocation system within Europe which has not worked satisfactorily so-far. A new Code of Conduct is being drafted for NGOs operating rescue boats off the Libyan coast - whose proliferation has represented a "pull fac-

tor” that is attracting migrants and enticing smugglers.

2. Lastly, the Economic and Monetary Union. On 30 May 2017, the European Commission presented a reflection document setting out with clarity possible ways forward for deepening and completing the Economic and Monetary Union, building on the Five Presidents’ Report of 2015. The options presented by the Commission would involve steps in two key areas: first, the banking and financial Union, still incomplete but advancing, and second, the Fiscal Union, still not in the making.

The banking and financial union can advance only if progresses are made in parallel on both ‘risk reduction’ in the national financial systems – a request especially addressed to Italy – and ‘risk sharing’, mainly through the European deposit insurance scheme and an adequate common fiscal back-stop for the Single Resolution Fund of banking crises. Concrete proposals are on the table, Italy could contribute to accelerate the process with concrete actions on its public debt and banks’ balance sheets risk reduction.

On fiscal union, the design is not defined yet. President Macron tends to interpret it as broader room to support national fiscal policies, mainly for investment in new technologies and infrastructure. In Berlin, on the other hand, the framework for a progress in strengthening the economic and budgetary policies, without elements of a political union, still meets strong opposition. A discussion has opened on the possible role of the European Stability Mechanism (ESM) in overseeing the economic policies of euro area countries —whether as a complement or a substitute to the Commission. In this regard, some member states do feel that a ‘politicized’ Commission may be a less effective enforcer of economic and budgetary disciplines, and therefore are eyeing the possibility of transferring this task to a body more directly under the control of the member states (or rather, creditor countries).

On the tasks of common fiscal capacity for the eurozone, the dialogue has started with various possible means of intervention: a European unemployment

insurance system toppling national schemes, for anti-cyclical purposes (on this Italy has put on the table a useful proposal); and a European Investment Protection Scheme to protect investment in the event of a downturn, by supporting well-identified priorities and already planned projects or activities at national level.

Be that as it may, it is important that all parties in current discussions recognize that the establishment of a common budget to ensure broader objectives of political economy requires strong budgetary discipline at national level, with full restoration of the no-bail-out clause in Article 125 of the TFEU.

Once the “no bail out” rule is fully re-established, this would render the sovereign debt of member states “risky”, as they would potentially be subject to restructuring. As such, for the area’s financial markets to work, a “safe” public debt instrument— i.e. one collectively guaranteed by all member states in the euro area, issued at the federal level— that banks and other financial intermediaries could use to manage their liquidity should be established. This debt instrument would allow for the sharing amongst member states of some sovereign risks, but in an environment of financial stability and budgetary discipline, which would prevent both lax budgetary policy and the institutionalization of permanent transfers between member states.

The existence of a safe joint debt instrument and fiscal capacity naturally presupposes a euro area minister of finance in charge of their management, and indeed more broadly of an effective framework for deciding common policies and overseeing their implementation. Italy and France have a paramount role to play in facilitating such progress, by restoring full confidence in their budgetary and economic policies and by bringing back their economies on a path of structural economic convergence towards Germany, cutting at their roots sovereign risks.

The wind has changed and Europe is moving again, it is up to us all to create the conditions for renewed progress in advancing the European construction.

# THE IMPACT OF BREXIT ON THE UK ALTERNATIVE INVESTMENT FUND INDUSTRY \*

Rodrigo Olivares-Caminal\*\* - Marco Bodellini\*\*\*

**ABSTRACT:** *Following the 23 June 2016 referendum through which the British people have decided to leave the European Union and the 29 March 2017 notification to the European Council of the UK intention to withdraw from the Union, on 31 May 2017, ESMA published an opinion providing nine principles regarding the supervisory approach to be held by EU Countries' Authorities in the event of relocations of entities, activities and/or functions from the UK to the other 27 Member States as a consequence of Brexit.*

*The opinion, entitled "General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union", looks like the first act of a "regulatory war" that the UK and the EU will "fight" in order, on the one hand, to keep in London, and, on the other, to attract to the other EU Countries, both financial players and their operations.*

*Obviously such an opinion has an impact even on the alternative investment fund industry that in the EU, so far, has been mainly based in London.*

*Moving from the analysis of the EU and UK regulation on alternative investment funds and the main contents of such an opinion, the article aims at discussing whether or not Brexit will pose a threat to London as the main European and global financial centre for alternative investment fund activities.*

**SUMMARY:** 1. Introduction. – 2. The EU legal framework for alternative investment funds and fund managers. – 3. The political and legislative reasons for the adoption of the AIFMD. – 4. The aim of the Directive and its legislative approach. – 5. The rules of the Directive. – 6. The transposition of the AIFMD in the UK. – 7. The UK alternative investment fund industry after the adoption

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\*Although jointly elaborated, this article has been drafted as follows: paragraphs 5 and 6 by Rodrigo Olivares-Caminal; paragraphs 1, 2, 3, 4, 7, 8, 9 and 10 by Marco Bodellini.

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and transposition of the AIFMD. – 8. Brexit potential impact on the British alternative investment fund sector. – 9. The position of ESMA. – 10. Concluding remarks.

1. After the formalisation of Brexit,<sup>1</sup> both the parties – the UK and the EU – have started getting ready for the negotiation phase which will be taking place in the next two years.

Obviously, one of the most important components of such a negotiation will relate to the common market's access for UK financial entities and products. Among them, alternative investment funds and alternative investment fund managers will attract a high degree of attention from both parties. Indeed, this sector of the financial system is particularly important for the UK since London has always been the main international financial centre for their activities. And, at the same time, one of the reasons for London being the world capital of alternative investment fund activities has been the free access on the wealthy EU market. This is why Brexit is likely to have a significant impact on the UK investment fund industry and for the same reason the UK negotiators should not underestimate the importance of the free access on the common market and of the delegation of functions to UK managers for the success of London as an international centre for investment fund activities.

This article analyses the new EU regulation on the alternative investment fund managers and the way in which the UK legislator successfully transposed it into the domestic system and then focuses on the main possible scenarios which will materialise after Brexit, trying to contribute to the academic discussion about its impact on the British financial system.

The article is divided in ten sections, after the introduction, section two is about the new EU legal framework for alternative investment fund managers; section three focuses on the main political and legislative reasons for the adoption of the Alternative Investment Fund Managers Directive; section four analyses both

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<sup>1</sup>This has been done by mean of a notification submitted to the European Council on 29 March 2017 whereby the UK notified its intention to leave the European Union.

aims and legal approach of such Directive; section five deals with its new rules, whilst section six discusses the way in which the UK legislator transposed it into the domestic system; section seven is an assessment of the UK alternative investment fund industry “health conditions” after the transposition of the Directive; section eight seeks to foresee the impact of Brexit on the British alternative investment fund industry, whilst section nine analyses the position recently taken by ESMA with regard to potential relocations of financial entities from the UK to the other 27 Member States as a consequence of Brexit; finally, section ten provides some concluding remarks.

2. In 2011, the EU legislator decided to radically change its regulatory approach with regard to the alternative investment fund industry. Until that moment, there was no Union legislation governing the activities of alternative investment funds and alternative investment fund managers, and therefore the EU Member States were free to regulate or not this relevant sector of the financial system.<sup>2</sup> Accordingly, often these activities and the firms performing them were unregulated or very “lightly” regulated and in any case the rules applied only at national level.<sup>3</sup>

Taking benefit of this regulatory “void”, some EU Countries had become important international financial centres for both managing and marketing alternative investment funds. Among these, the UK was (and still is) the most important.<sup>4</sup>

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<sup>2</sup>See BODELLINI, ‘The European Union regulation on marketing of alternative investment funds: another step towards integration of the European Union financial market’, (2016) *Business Law Review*, 37, p. 208.

<sup>3</sup>See ZETZSCHE, ‘Introduction: Overview, Regulatory History and Technique, Transition’ in ZETZSCHE (Ed.), *The Alternative Investment Fund Managers Directive*, (1st edition, Wolters Kluwer 2012) p. 1, arguing that, before 2011, both the alternative investment funds and their managers were not subject to European regulation. However many asset managers of such funds were licensed for portfolio management and/or investment advice under MiFID and, at the same time, the sale of fund units, qualified as securities, was subject to the Prospectus Directive.

<sup>4</sup>See QUAGLIA, ‘The “old” and “new” Political Economy of Hedge Fund Regulation in the European Union’ (2011) *West European Politics*, 34, p. 668, highlighting that the UK hosts four-fifths of the EU managers of alternative investment funds; see also SENNHOLZ WEINHARDT, ‘Regulatory Competition as a social fact: Constructing and contesting the threat of hedge fund

Mainly due to the crisis and as a legislative response to it, in June 2011, the European Parliament and the Council adopted the so-called Alternative Investment Fund Managers Directive (hereinafter AIFMD)<sup>5</sup> with the aim to harmonise the regulation of both the management and marketing of alternative investment funds in the Union.<sup>6</sup>

3. The global financial crisis of 2007-2008 had increased the conviction that it was necessary to rethink the regulatory framework governing the financial markets. This conviction was based on the perception of the need to regulate and oversee the so-called “shadow banking system”, which would include, among others, alternative investment funds such as structured investment vehicles, private equity funds<sup>7</sup> and hedge funds.<sup>8</sup>

Those in favour of this new regulatory approach argued that the financial crisis had shown that risks can move easily and quickly from one financial sector to another, and then spread around the global system. This has been made easier as result of the activity of alternative investment fund managers.<sup>9</sup>

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managers relocation from Britain’ (2014) *Review of International Political Economy*, 21, p. 1248, who states that the majority of the hedge funds assets in Europe are managed from the UK.

<sup>5</sup>Directive 2011/61/EU of the European Parliament and the Council of 8 June 2011.

<sup>6</sup>See BODELLINI, ‘The European Union regulation on marketing of alternative investment funds: another step towards integration of the European Union financial market’, (2016) *Business Law Review*, 37, p. 210-211.

<sup>7</sup>See PAYNE, ‘Private Equity and its Regulation in Europe’ (2011) *European Business Organization Law Review*, 12, pp. 559-585; see FERRAN, ‘After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU’ (2011) *European Business Organization Law Review*, 12, pp. 379-414.

<sup>8</sup>See BODELLINI, ‘The U.S. (un)regulation of hedge funds’ (2017) *Rivista Trimestrale di Diritto dell’Economia*, 2, p. 251; BODELLINI, ‘From systemic risk to financial scandals: the shortcomings of U.S. hedge fund regulation’ (2017) *Brooklyn Journal of Corporate, Financial & Commercial Law*, 11, p. 417; AWREY, ‘The limits of EU hedge fund regulation’ (2011) *Law and Financial Markets Review*, 5, p. 119; see also ZETZSCHE, ‘Introduction: Overview, Regulatory History and Technique, Transition’ in ZETZSCHE (Ed.), *The Alternative Investment Fund Managers Directive*, (1st edition, Wolters Kluwer 2012) p. 3, who highlights that the G20 decisions committed all G20 States to subject all participants in the financial markets to regulation.

<sup>9</sup>This was also the position of the President of the European Commission, who in 2010 said that “the adoption of the directive means that hedge funds and private equity will no longer operate in a regulatory void outside the scope of supervisors. The new regime brings transparency and security to the way these funds are managed and operate, which adds to the overall stability of our financial system. After important decisions on a new European supervisory architecture earlier this autumn, today’s directive – which coincides with the G20 Summit meeting in Seoul – is another example of

Therefore, even though the global financial crisis was not deemed to have been caused by the managers of alternative investment funds,<sup>10</sup> policy makers remained concerned about their capability to spread the risks across the system,<sup>11</sup> and this concern was amplified by the extremely large size of the sector.<sup>12</sup>

This political view was supported by the several countries of continental Europe, including Germany, France and Italy, whilst the UK, according to its more liberal and business-friendly legislative approach, did not support the argument of the need to make these financial players subject to more regulation and supervision. This is because their activities usually do not involve retail investors.<sup>13</sup> The UK Government, in particular, feared that the new regulation could lead many managers away from the EU to other less regulated jurisdictions.<sup>14</sup>

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how the EU is leading the way in implementing our G20 commitments”; see EUROPEAN COMMISSION, ‘Statement at the Occasion of the European Parliament Vote on the Directive on Hedge Funds and Private Equity’, 11 November 2010, (Reference: MEMO/10/573).

<sup>10</sup>See BULLER – LINDSTROM, ‘Hedging its Bets: The U.K. and the Politics of European Financial Services Regulation’ (2013) *New Political Economy*, 18, p. 392, arguing that “it is widely accepted that banking sector, not the alternative investment industry, was primarily responsible for the global financial crisis”.

<sup>11</sup>See Recital (3) of the AIFMD, under which, “recent difficulties in financial markets have underlined that many AIFM strategies are vulnerable to some or several important risks in relation to investors, other market participants and markets”.

<sup>12</sup>See Recital (1) of the AIFMD, that specifies that “managers of alternative investment funds (AIFMs) are responsible for the management of a significant amount of invested assets in the Union, account for significant amounts of trading in markets for financial instruments, and can exercise an important influence on markets and companies in which they invest”.

<sup>13</sup>See QUAGLIA, ‘The politics of “Third Country Equivalence” in Post-Crisis Financial Services Regulation in the European Union’ (2015) *West European Politics*, 38, p. 168, who describes perfectly what business-friendly anglosaxon approach means; about the political fight for the adoption of the Directive, see QUAGLIA, ‘The “old” and “new” Political Economy of Hedge Fund Regulation in the European Union’ (2011) *West European Politics*, 34, p. 670. The U.K. position was motivated by the fact that usually only professional clients, sophisticated investors and high net worth individuals can invest in alternative investment funds. So given that retail investors are not involved, it was considered not necessary to increase the level of regulation and supervision; about this see COPLAND, ‘The EU proposals for the regulation of alternative investments’ (2012) *Economic Affairs*, 32, p. 32; BULLER – LINDSTROM, ‘Hedging its Bets: The U.K. and the Politics of European Financial Services Regulation’ (2013) *New Political Economy*, 18, p. 392.

<sup>14</sup>See QUAGLIA, ‘The “old” and “new” Political Economy of Hedge Fund Regulation in the European Union’ (2011) *West European Politics*, 34, p. 666, highlighting that, in the British policy-makers’ opinion, the Directive could place “Europe at a competitive disadvantage vis-à-vis less regulated jurisdictions”, such as Switzerland; BOURNE – EDWARDS, ‘Producing trust, knowledge and expertise in financial markets: The global hedge fund industry “represent” itself’, (2012) *Culture and Organization*, 18, p. 117; see also BULLER – LINDSTROM, ‘Hedging its Bets: The U.K. and the Politics of European Financial Services Regulation’ (2013) *New Political*

Despite the opposition of the British Government, however, the Directive was adopted by the European Parliament and the Council on 8 June 2011.<sup>15</sup>

4. The aim of the AIFMD is to increase and harmonise at EU level the regulation on the management<sup>16</sup> and marketing<sup>17</sup> to professional investors<sup>18</sup> of

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Economy, 18, p. 401, who point out that also the London industry of alternative investment funds opposed the adoption of the AIFMD since the very beginning.

<sup>15</sup>The idea to regulate the managers of alternative investment funds comes from the De Larosière report and from the IOSCO Final Report on hedge funds oversight; see DE LAROSIÈRE AND OTHERS, 'Report by the High Level Group on Financial Supervision in the EU', Brussels, 25 February 2009, available at [www.ec.europa.eu](http://www.ec.europa.eu); see also IOSCO, 'Hedge Funds Oversight', Final Report, June 2009; accordingly see ANDENAS – CHIU, 'Regulatory Governance of Alternative Investment Fund Managers' (2014) *Law and Economics Yearly Review*, 3, p. 209; more in general, about the new aims of the financial regulation after the crisis see BLACKMORE – JEAPES, 'The global financial crisis: one global financial regulator or multiple regulators?' (2009) *Capital Markets Law Journal*, 4, p. 112; MOLONEY, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market – A Tale of Two Competences: Part (1) Rule-Making' (2011) *European Business Organization Law Review*, 12, pp. 41-86; MOLONEY, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market – A Tale of Two Competences: Part (2) Rules in Action' (2011) *European Business Organization Law Review*, 12, pp. 177-225; MOLONEY, 'Resetting the Location of Regulatory and Supervisory Control over EU Financial Markets: Lesson from Five Years on' (2013) *International and Comparative Law Quarterly*, 62, pp. 955-965; MOLONEY, 'Reform or Revolution? The Financial Crisis, EU Financial Markets Law, and the European Securities and Markets Authority' (2011) *International and Comparative Law Quarterly*, 60, pp. 521-533; MCMAHON – MOLONEY, 'Financial Market Regulation in the Post-Financial Services Action Plan Era' (2006) *International and Comparative Law Quarterly*, 55, pp. 982-992.

<sup>16</sup>"Managing AIFs", under art. 4 lett. (w) of the AIFMD and its Annex I, means "performing at least portfolio management or risk management for one or more AIFs"; see ZETZSCHE, 'Appointment, Authorization and Organization of the AIFM', in ZETZSCHE (Ed.), *The Alternative Investment Fund Managers Directive*, (1st edition, Wolters Kluwer 2012) p. 160, underlining that management of AIFs means performing at least investment management functions under the Annex I for one or more AIFs, and, on the other side, that investment management functions which an AIFM shall at least perform when managing an AIF are portfolio management and risk management together.

<sup>17</sup>"Marketing units or shares of AIFs", under art. 4 lett. (x) of the AIFMD, means "a direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages to or with investors domiciled or with a registered office in the Union".

<sup>18</sup>A professional investor is, under Article 4, paragraph 1.ag) of the AIFMD, "an investor which is considered to be a professional client or may, on request, be treated as a professional client within the meaning of Annex II to Directive 2004/39/EC"; see ZETZSCHE – ECKNER, 'Investor Information, Disclosure and Transparency' in ZETZSCHE (Ed.), *The Alternative Investment Fund Managers Directive*, (1st edition, Wolters Kluwer 2012) p. 360, who observe that the category of professional investors under AIFMD includes all professional clients defined by MiFID and those who could on demand qualify as professional clients under MiFID.

Annex II of MiFID provides that "professional client is a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs ... The following should all be regarded as professionals in all investment services and activities and financial instruments for the purposes of the Directive.

alternative investment funds (AIFs)<sup>19</sup> and the national and cross-border supervision of their managers (AIFMs).<sup>20</sup>

To do so, the AIFMD has firstly introduced common requirements governing the authorisation of the AIFMs,<sup>21</sup> whilst the increase of the cross-border supervision is due to the new transnational operation perspectives given by the Directive itself through the introduction of a Passport regime<sup>22</sup> allowing the

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(1) Entities which are required to be authorised or regulated to operate in the financial markets. The list below should be understood as including all authorised entities carrying out the characteristic activities of the entities mentioned: entities authorised by a Member State under a Directive, entities authorised or regulated by a Member State without reference to a Directive, and entities authorised or regulated by a non- Member State: (a) Credit institutions, (b) Investment firms, (c) Other authorised or regulated financial institutions, (d) Insurance companies, (e) Collective investment schemes and management companies of such schemes, (f) Pension funds and management companies of such funds, (g) Commodity and commodity derivatives dealers, (h) Locals, (i) Other institutional investors.

(2) Large undertakings meeting two of the following size requirements on a company basis: balance sheet total: EUR 20.000.000, net turn over: EUR 40.000.000, own funds: EUR 2.000.000.

(3) National and regional governments, public bodies that manage public debt, Central Banks, international and supranational institutions such as the World Bank, the IMF, the ECB, the EIB and other similar international organisations.

(4) Other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financing transactions”.

But in addition, “clients other than those mentioned in section I, including public sector bodies and private individual investors, may also be allowed to waive some of the protections afforded by the conduct of business rules”.

<sup>19</sup>AIFs are described by art. 4 lett. (a) of the AIFMD as “collective investment undertakings, including investment compartments thereof, which: (i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and (ii) do not require authorization pursuant to Article 5 of Directive 2009/65/EC”; see ZETZSCHE, ‘Scope of the AIFMD’ in ZETZSCHE (Ed.), *The Alternative Investment Fund Managers Directive*, (1st edition, Wolters Kluwer 2012) p. 40, who observes that the Directive defines the concept of “AIF” introducing a number of explanatory elements and providing a catalogue of activities excluded from its application.

<sup>20</sup>AIFMs are defined, according to art. 4 lett. (b) of the AIFMD, as “legal persons whose regular business is managing one or more AIFs”.

<sup>21</sup>See Recital (2) of the AIFMD, according to which “the impact of AIFMs on the markets in which they operate is largely beneficial, but recent financial difficulties have underlined how the activities of AIFMs may also serve to spread or amplify risks through the financial system. Uncoordinated national responses make the efficient management of those risks difficult”.

<sup>22</sup>See ARMOUR, ‘Brexit and Financial Services – Bargaining in the shadow of Equivalence’ (2017) Brexit Negotiations Series – University of Oxford, available at [www.law.ox.ac.uk/business-law-blog](http://www.law.ox.ac.uk/business-law-blog), stressing that “a very different legal regime operates within the EU. The member states have agreed to a common corpus of financial regulation, which since the financial crisis is written through EU-level sectoral agencies. In return, financial services firms that obtain authorization within this single rule-book from the national competent authority (‘NCA’) in their country are then free to offer services throughout the EU member states without any need for further local authorizations. This is known as the ‘financial services passport’. Technically, there are many separate passports available under different pieces of financial services legislation, but they operate in an additive way, and EU law encompasses so much of

managers of such funds to carry out freely their activities also in other Member States.<sup>23</sup>

The result has been not only to have in place a harmonised and stringent regulatory and supervisory framework for these activities within the Union,<sup>24</sup> but also a continental integrated market for alternative investment funds.<sup>25</sup>

It is also worth noting that the AIFMD does not directly regulate the AIFs, which, therefore, continue to be subject to the internal rules of each Member State and to be supervised by the national Authorities. Indeed, the legal definition of AIFs is used just in order to identify their managers, who, in turn, are subject to the new regulation.<sup>26</sup> The reason why the EU legislator used this approach is due to the fact that it was considered disproportionate to regulate the structure and/or composition of the portfolios of such funds at Union level due to their large variety.<sup>27</sup>

Even though the reasons for this legislative choice are quite simple to

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financial services, that from most firms' perspective, the consequence is simply that whatever they are locally authorized to do, they are authorized to do throughout the EU".

<sup>23</sup>See BODELLINI, 'The European Union regulation on marketing of alternative investment funds: another step towards integration of the European Union financial market', (2016) *Business Law Review*, 37, p. 210.

<sup>24</sup>See Recital (4) of the AIFMD, which also adds that to achieve the goal to create an harmonised internal market, the Directive aims to regulate both the AIFMs with registered office in a Member State (EU AIFMs) and those which have their registered office in a third country (non-EU AIFMs). For this reason the AIFMD has extraterritorial effects. According to that, Recital (9) of the Directive specifies that "when transposing this Directive into national law, the Member States should take into account the regulatory purpose of that requirement and should ensure that investment firms established in a third country that, pursuant to the relevant national law, can provide investment services in respect of AIFs also fall within the scope of that requirement. The provision of investment services by those entities in respect of AIFs should never amount to a de facto circumvention of this Directive by means of turning the AIFM into a letter-box entity, irrespective of whether the AIFM is established in the Union or in a third country".

<sup>25</sup>See BODELLINI, 'The European Union regulation on marketing of alternative investment funds: another step towards integration of the European Union financial market', (2016) *Business Law Review*, 37, *passim*.

<sup>26</sup>See BODELLINI, 'Does it still make sense, from the EU perspective, to distinguish between UCITS and non-UCITS schemes?', (2016) *Capital Markets Law Journal*, 11, p. 531.

<sup>27</sup>See Recital 10 of the AIFMD under which "This Directive therefore does not prevent Member States from adopting or from continuing to apply national requirements in respect of AIFs established in their territory. The fact that a Member State may impose requirements additional to those applicable in other Member States on AIFs established in its territory should not prevent the exercise of rights of AIFMs authorised in accordance with this Directive in other Member States to market to professional investors in the Union certain AIFs established outside the Member State imposing additional requirements and which are therefore not subject to and do not need to comply with those additional requirements".

understand,<sup>28</sup> at the same time, it is obvious that such approach can encourage regulatory arbitrage, addressing managers in the choice of their jurisdiction. It is likely that they will choose EU Countries where the regulation of the funds are more lenient and business-friendly in order to establish both themselves and their investment funds, given that the burdens and the benefits introduced by the Directive are the same in all the EU Countries.<sup>29</sup>

The scope of the AIFMD is broad as it applies: (1) to all EU AIFMs<sup>30</sup> managing EU AIFs<sup>31</sup> or non-EU AIFs,<sup>32</sup> irrespective of whether or not they are marketed in the Union; (2) to non-EU AIFMs managing EU AIFs, irrespective of whether or not they are marketed in the Union; and, (3) to non-EU AIFMs marketing EU AIFs or non-EU AIFs in the Union.<sup>33</sup>

This also means that the Directive impacts third-country entities, since it applies even to non-EU AIFMs<sup>34</sup> that operate in the Union and indirectly to non-EU AIFs managed by EU AIFMs or marketed in the Union by EU AIFMs or non-EU

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<sup>28</sup>Probably, the EU legislator decided not to regulate directly the funds also because usually the AIFs are established outside the EU for tax purposes; about the hedge funds sector see COPLAND, 'The EU proposals for the regulation of alternative investments' *Economic Affairs*, 2012, 32, p. 33, who observes that only 5% of the global hedge fund sector is domiciled in the EU.

<sup>29</sup>See ZETZSCHE, 'Scope of the AIFMD' in ZETZSCHE (Ed.), *The Alternative Investment Fund Managers Directive*, (1st edition, Wolters Kluwer 2012) p. 40, who underlines that from a technical perspective, under the AIFMD, the AIFs are not subject to authorization even though the law of the Member States can provide for an additional authorization of the funds. Obviously, this approach can encourage regulatory arbitrage among the different Member States. In other words, the asset managers probably will avoid the EU jurisdictions whose laws require the authorization of the AIFs, given that such jurisdictions cannot prohibit the access of foreign EU AIFs into their domestic market.

<sup>30</sup>Under Article 4, paragraph 1.l) of the AIFMD "'EU AIFM' means an AIFM which has its registered office in a Member State".

<sup>31</sup>Under Article 4, paragraph 1.k) of the AIFMD "'EU AIF' means: (i) an AIF which is authorised or registered in a Member State under the applicable national law; or (ii) an AIF which is not authorised or registered in a Member State, but has its registered office and/or head office in a Member State".

<sup>32</sup>It is the typical working model of the hedge funds, given that, very often, their managers are domiciled in the UK and the funds are established under the Cayman or BVI law; see GREIG, 'United Kingdom' in ZETZSCHE (Ed.), *The Alternative Investment Fund Managers Directive*, (1st edition, Wolters Kluwer 2012) p. 699, who explains that this structure is motivated by tax reasons.

<sup>33</sup>See Recital (13) of the AIFMD.

<sup>34</sup>Recital (14) of the AIFMD, about non-EU AIFMs, specifies that although "this Directive lays down requirements regarding the manner in which AIFMs should manage AIFs under their responsibility", for non-EU AIFMs, this is limited to the management of EU AIFs and other AIFs the units or shares of which are also marketed to professional investors in the Union.

AIFMs. In fact, even non-EU AIFMs interested in managing EU AIFs or in marketing AIFs (both EU and non-EU) in the Union with a passport must be authorised by the Authorities of the Member States. But the benefit that they can obtain by being subjected to the EU regulation is relevant and is represented by the possibility to access directly the entire EU market.<sup>35</sup>

From the marketing perspective, the Directive gives the non-EU AIFMs two different possibilities to access the EU market: (1) with the EU passport; or, (2) through the national private placement regimes.<sup>36</sup> In the first case – which is not yet available but could be implemented in the future – the non-EU AIFM needs to be authorized by the EU Authorities, whilst in the second one the authorization is not requested having the managers to comply with the domestic regulation of the country where they want to operate.<sup>37</sup>

5. The rules introduced by the AIFMD relate to the authorization of the AIFMs,<sup>38</sup> their obligations of compliance, conduct of business,<sup>39</sup> capital requirements, conflicts of interest, custody of the funds' assets entrusted to an independent depositary,<sup>40</sup> the valuation procedures of these assets<sup>41</sup> and, above all,

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<sup>35</sup>About more in general the possibility to use the passport for non-EU AIFMs and non-EU AIFs, see BULLER – LINDSTROM, 'Hedging its Bets: The U.K. and the Politics of European Financial Services Regulation' *New Political Economy*, 2013, Vol. 18, No. 3, p. 397, who underline that this innovation was considered by the British Government as "a very good outcome".

<sup>36</sup>It is important to underline that the Directive could allow in the future, for the first time, the use of the mechanism of the EU passport also to non-EU AIFMs; see KLEBECK, 'Interplay between the AIFMD and the UCITSD' in ZETZSCHE (Ed.), *The Alternative Investment Fund Managers Directive*, (1st edition, Wolters Kluwer 2012) p. 87.

<sup>37</sup>See DUNCAN – CURTAIN – CROSIGNANI, 'Alternative regulation: the directive on alternative investment fund managers' (2011) *Capital Markets Law Journal*, 6, p. 351, who point out that the expression "private placement regime" means marketing without a passport and therefore pursuant to the national laws of the Member States.

<sup>38</sup>Article 6 of the AIFMD states that "Member States shall ensure that no AIFMs manage AIFs unless they are authorised in accordance with this Directive"; Recital (18) of the AIFMD makes it clear that "no EU AIFM should be able to manage and/or market EU AIFs to professional investors in the Union unless it has been authorised in accordance with this Directive. An AIFM authorised in accordance with this Directive should meet the conditions for authorisation established in this Directive at all times".

<sup>39</sup>According to Article 5 of the AIFMD, each AIF managed within the scope of this Directive has to have a single AIFM, which is responsible for ensuring compliance with this Directive.

<sup>40</sup>This rule, included in Article 21 of the AIFMD, represents a very relevant innovation in the sector of the alternative investment funds (above all hedge funds) given that, before the adoption

the passport regime, that can be considered as a “reward” to balance these expensive regulatory burden.<sup>42</sup> This passport, indeed, gives the managers (in the future maybe also non-EU managers)<sup>43</sup> the opportunity to carry out freely the activities of management and marketing to professional investors of AIFs (in the future maybe also non-EU AIFs)<sup>44</sup> across the EU territory.<sup>45</sup>

The introduction of these new rules can be seen as a direct regulation of the managers and an indirect regulation of the funds.<sup>46</sup>

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of the Directive, only a few legislation (for example the Italian one) had similar provisions. About the rationale behind this rule, see, in particular, Recital 32 of the AIFMD, under which, “recent developments underline the crucial need to separate asset safe-keeping and management functions, and to segregate investor assets from those of the manager. Although AIFMs manage AIFs with different business models and arrangements for, inter alia, asset safe-keeping, it is essential that a depositary separate from the AIFM is appointed to exercise depositary functions with respect to AIFs”.

<sup>41</sup>See DUNCAN – CURTAIN – CROSIGNANI, ‘Alternative regulation: the directive on alternative investment fund managers’ (2011) *Capital Markets Law Journal*, 6, pp. 326 – 362.

<sup>42</sup>It is obvious, in fact, that all the new regulatory burdens, introduced by the AIFMD, represent significant costs for the AIFMs; see BULLER – LINDSTROM, ‘Hedging its Bets: The U.K. and the Politics of European Financial Services Regulation’ (2013) *New Political Economy*, 18, p. 396, who highlight that “an impact assessment commissioned by the FSA in 2009 estimated that the directive would impose one-off compliance costs of 3.2 billion euros”.

<sup>43</sup>See ESMA, ‘Advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs’, 30 July 2015, *passim*, available at [www.esma.europa.eu](http://www.esma.europa.eu), where the Authority analyses the impact of the potential extension of the EU AIFMD passport to 6 non-EU Countries: U.S., Guernsey, Jersey, Hong Kong, Switzerland, Singapore; see also ESMA, ‘Opening Statement – Steven Maijor to ECON Scrutiny Hearing on AIFMD Passport’, p. 5, available at [www.esma.europa.eu](http://www.esma.europa.eu) where the Chair of the Authority highlights that “the advice was positive with respect to the extension of the passport to Guernsey and Jersey, while we considered that Switzerland would remove any remaining obstacles with the enactment of pending legislation. We did not reach a definitive view on the other three jurisdictions due to concerns related to competition, regulatory issues and a lack of sufficient evidence to carry out a proper assessment of the relevant criteria”.

<sup>44</sup>See DUNCAN – CURTAIN – CROSIGNANI, ‘Alternative regulation: the directive on alternative investment fund managers’ (2011) *Capital Markets Law Journal*, 6, pp. 326 – 362.

<sup>45</sup>See ZETZSCHE – ECKNER, ‘Investor Information, Disclosure and Transparency’ in ZETZSCHE (Ed.) *The Alternative Investment Fund Managers Directive*, (1st edition, Wolters Kluwer 2012) p. 360, who observe that the AIFMD passport is modelled on the UCITSD and the only difference is that, while with the UCITSD passport it is possible to market funds units or shares both to retail and professional investors, with the AIFMD one, the target market is only that one of the professional investors.

<sup>46</sup>See WAGNER – SCHLOMER – ZETZSCHE, ‘AIFMD vs. MiFID: Similarities and Differences’ in ZETZSCHE (Ed.) *The Alternative Investment Fund Managers Directive*, (1st edition, Wolters Kluwer 2012) p. 105, who underline that many rules of the Directive that are apparently manager regulations are rather product regulations through the back door, like, for instance, the ones on assets’ valuation and depositary; see also KLEBECK, ‘Interplay between the AIFMD and the UCITSD’ in ZETZSCHE (Ed.) *The Alternative Investment Fund Managers Directive*, (1st edition, Wolters Kluwer 2012) p. 77, who underlines that, while prior to the AIFMD it was possible quite

From a different perspective, it is possible to argue that in order to create a clear and understandable EU-wide regulatory framework and an efficient supervisory system, the AIFMD has established that the AIFMs, *in primis*, must be authorized<sup>47</sup> to operate by the supervisory authority of their Member State, and, *in secundis*, have to provide potential investors with different types of information about: (1) the investment strategies and their objectives; (2) the valuation policies of the assets; (3) the procedures for the redemption of the units or shares; (4) the custody of the assets; (5) the procedures for the risk management; and, (6) the remuneration policies of the management.<sup>48</sup>

From the regulatory point of view, the AIFMD shows some similarities<sup>49</sup>

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clearly to distinguish between the regulated (harmonized) UCITS and the unregulated (non-harmonized) alternative investment funds different to UCITS, now this is no longer possible.

<sup>47</sup>See Recital (15) of the AIFMD that states that “the authorisation of EU AIFMs in accordance with this Directive covers the management of EU AIFs established in the home Member State of the AIFM. Subject to further notification requirements, this also includes the marketing to professional investors within the Union of EU AIFs managed by the EU AIFM and the management of EU AIFs established in Member States other than the home Member State of the AIFM. This Directive also provides for the conditions subject to which authorised EU AIFMs are entitled to market non-EU AIFs to professional investors in the Union and the conditions subject to which a non-EU AIFM can obtain an authorisation to manage EU AIFs and/or to market AIFs to professional investors in the Union with a passport. During a period that is intended to be transitional, Member States should also be able to allow EU AIFMs to market non-EU AIFs in their territory only and/or to allow non-EU AIFMs to manage EU AIFs, and/or market AIFs to professional investors, in their territory only, subject to national law, in so far as certain minimum conditions pursuant to this Directive are met”; see also ZETZSCHE, ‘Scope of the AIFMD’ in ZETZSCHE (Ed.) *The Alternative Investment Fund Managers Directive*, (1st edition, Wolters Kluwer 2012) p. 40, who underlines that the authorization concerns both the management and the marketing to professional investors of alternative investment funds; see also HORAN, ‘White Collar Crime, Money Laundering and Taxation: The AIFMD and Hedge Funds – An International and Irish Perspective’ in ZETZSCHE (Ed.) *The Alternative Investment Fund Managers Directive*, (1st edition, Wolters Kluwer 2012) p. 111, who highlights that the choice of requiring the managers authorization is motivated by the awareness that in the past huge losses have been caused by non-registered AIFMs.

<sup>48</sup>See AWREY, ‘The limits of EU Hedge Fund Regulation’ (2011) *Law and Financial Markets Review*, 5, p. 119.

<sup>49</sup>But for a different view, see WAGNER – SCHLOMER – ZETZSCHE, ‘AIFMD vs. MiFID: Similarities and Differences’, in ZETZSCHE (Ed.) *The Alternative Investment Fund Managers Directive*, (1st edition, Wolters Kluwer 2012) p. 105, who underline that the AIFMD, as well as the MiFID, regulates the manager, while the focus of the UCITSD is on the products; see also MOLONEY, *EU Securities and Financial Markets Regulation*, (3rd Edition, Oxford University Press 2014) p. 283, who lists similarities and differences between the UCITSD and the AIFMD, underlining that the the UCITS regime is aimed at protecting retail investors, whilst the AIFMD, being a creature of the financial crisis, is mainly concerned with financial stability and highlighting that with respect to organizational, conduct and risk-management regulation the two regimes are similar; see ECMI – CEPS, ‘Rethinking Asset Management from Financial Stability to Investor Protection and Economic Growth’, Report of a CEPS-ECMI Task Force, Brussels, 2012, p. 21,

with the UCITS Directive,<sup>50</sup> particularly, with regard to the working structure of the AIFs, given that it is built on the basis of the so called “investment triangle model”, characterising also the Undertakings for the Collective Investment in Transferable Securities, where the three corners are represented by: 1) the investors, 2) the asset manager, 3) the depositary-custodian,<sup>51</sup> with the fund itself that is in the centre.<sup>52</sup> This means that the asset manager decides the investment strategies and the depositary holds the assets on behalf of the fund and in order to grant more protection to the investors.<sup>53</sup>

6. Despite the opposition towards the adoption of the Directive, the UK legislator transposed it into the internal system by issuing the Alternative Investment Fund Managers Regulations 2013, (so-called Regulations 2013).<sup>54</sup> The Regulations 2013, in particular, has introduced in the domestic law the new categories of AIFs and AIFMs created by the Directive and amended a number of other legislation, including the Financial Services and Markets Act 2000 (FSMA 2000) and the Regulated Activities Order 2001 (RAO 2001).<sup>55</sup>

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where it is observed that the AIFMD borrows a significant part of its contents from the principles in the UCITSD, such as the rules concerning minimum operating conditions, conduct of business and segregation of the assets.

<sup>50</sup>The UCITS Directives are: Council Directive (EEC) 85/611, adopted on 20 December 1985; Council Directive (EC) 2001/107 and Council Directive (EC) 2001/108, both adopted on 21 January 2002, (*i.e.* UCITS III package); Council Directive (EC) 2009/65, adopted on 13 July 2009, (*i.e.* UCITSD IV); Council Directive (EU) 2014/91, adopted on 28 August 2014, (*i.e.* UCITSD V).

<sup>51</sup>About the important function carried out by the depositary of UCITS schemes see NAVEAUX – GRAAS, ‘Direct Action by Investors against a UCITS depositary-a short-lived landmark ruling?’, (2012) *Capital Markets Law Journal*, 7, p. 466, who underline that UCITS must entrust their assets to a depositary for safekeeping. The function of the depositary is very important because it is involved in the process in order to protect the position of the investors.

<sup>52</sup>See ZETZSCHE, ‘Introduction: Overview, Regulatory History and Technique, Transition’ in ZETZSCHE (Ed.) *The Alternative Investment Fund Managers Directive*, (1st edition, Wolters Kluwer 2012) p. 13.

<sup>53</sup>About such a way of working of the investment funds see BODELLINI, ‘Does it still make sense, from the EU perspective, to distinguish between UCITS and non-UCITS schemes?’, (2016) *Capital Markets Law Journal*, 11, p. 532-533.

<sup>54</sup>The Statutory Instrument 2013 No. 1773.

<sup>55</sup>On the UK domestic regulation of alternative investment funds see BODELLINI, ‘The marketing of hedge funds in the United Kingdom: did the system maintain its attractiveness after the transposition of the Alternative Investment Fund Managers Directive?’, (2016) *Business Law Review*, 37, p. 163.

Regulation 3 of the Regulations 2013 adopts the same definition of AIF<sup>56</sup> provided by the AIFMD, specifying that “an AIF may be open-ended or closed-ended, and constituted in any legal form, including under a contract, by means of a trust or under statute”.<sup>57</sup>

Regulation 4, instead, provides the definition of AIFM, as “a legal person, the regular business of which is managing one or more AIFs”. The AIFM of an AIF, according to the same article, “may be either: (a) another person appointed by or on behalf of the AIF and which through that appointment is responsible for managing the AIF (“external AIFM”); or (b) where the legal form of the AIF permits internal management and where the AIF’s governing body chooses not to appoint an external AIFM, the AIF itself (“internal AIFM”)”.<sup>58</sup>

The same regulation, additionally, describes the activity of managing AIFs as performing at least risk management or portfolio management for the AIF; whilst, about the marketing of units or shares of AIFs, regulation 45 states that “an AIFM markets an AIF when the AIFM makes a direct or indirect offering or placement of units or shares of an AIF managed by it to or with an investor domiciled or

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<sup>56</sup>“AIF means a collective investment undertaking, including investment compartments of such an undertaking, which:

- (a) raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of these investors; and
- (b) does not require authorisation pursuant to Article 5 of the UCITS directive”.

<sup>57</sup>According to regulation 3, instead, “ none of the following entities is an AIF— (a) an institution for occupational retirement provision which falls within the scope of Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision (a); (b) a holding company; (c) an employee participation scheme or employee savings scheme; (d) a securitisation special purpose entity”.

<sup>58</sup>At any rate, regulation 4 specifies that “none of the following entities is an AIFM: (a) an institution for occupational retirement provision which falls within the scope of Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision (b), including, where applicable, the authorised entities responsible for managing such institutions and acting on their behalf referred to in Article 2.1 of that directive, or the investment managers appointed pursuant to Article 19.1 of that directive, in so far as they do not manage AIFs; (b) the European Central Bank, the European Investment Bank, the European Investment Fund, a bilateral development bank, the World Bank, the International Monetary Fund, any other supranational institution or similar international organisation, or a European Development Finance Institution, in the event that such institution or organisation manages AIFs and in so far as those AIFs act in the public interest; (c) a national central bank; (d) a national, regional or local government or body or other institution which manages funds supporting social security and pension systems; (e) a holding company; (f) an employee participation scheme or employee savings scheme; (g) a securitisation special purpose entity”.

with a registered office in an EEA State, or when another person makes such an offering or placement at the initiative of, or on behalf of, the AIFM”.<sup>59</sup>

The impact of the new UK legislation on the AIFMs is relevant, given that, before the transposition of the AIFMD, according to the FSMA 2000 and the RAO 2001, the managers of investment funds other than UCITSs had to be authorised by the FSA,<sup>60</sup> now FCA,<sup>61</sup> simply for carrying on some of the following specified activities, depending on the business model: dealing as principal, arranging deals in investments, management functions or investment advice.<sup>62</sup>

Now, due to the transposition of the AIFMD, instead, the activity of “managing an AIF” is treated as a regulated activity under the FSMA 2000 and the RAO 2001 in the same way as the activity of “managing a UCITS”.<sup>63</sup>

This is due to the fact that section 19 of FSMA 2000 provides a general prohibition precluding anyone other than an authorised person or an exempt person from carrying on regulated activities and to the fact that the RAO 2001, as amended by the Regulations 2013, now qualifies “managing an AIF”<sup>64</sup> as a reserved activity. As a consequence the entities wanting to carry on such activity need to be authorised by the FCA for “managing an AIF”.<sup>65</sup>

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<sup>59</sup>Regulation 45 also adds that “an investment firm markets an AIF when it makes a direct or indirect offering or placement of units or shares of the AIF to or with an investor domiciled or with a registered office in an EEA State at the initiative of, or on behalf of, the AIFM of that AIF”.

<sup>60</sup>Financial Services Authority.

<sup>61</sup>Financial Conduct Authority.

<sup>62</sup>See GABBERT, *Hedge Funds* (1st Edition, LexisNexis 2008) p. 2; see also CORNISH – MASON, *International Guide to Hedge Fund Regulation* (1st Edition, Bloomsbury Publishing 2009) p. 484, and DUNCAN – CURTAIN – CROSIGNANI, ‘Alternative regulation: the directive on alternative investment fund managers’ (2011) *Capital Markets Law Journal*, 6, p. 330.

<sup>63</sup>Before the implementation of the AIFMD, the activity of managing collective investment schemes different to UCITS fell into the category of “managing investment” (RAO, art. 37) and/or “advising” (RAO, art. 53); in this way see LOMNICKA, ‘Collective Investments Schemes’ in WALKER – PURVES – BLAIR (Eds.), *Financial Services Law*, (3rd Edition, Oxford University Press 2014), p. 886.

<sup>64</sup>According to Section 51ZC of RAO 2001, “a person manages an AIF when the person performs at least risk management or portfolio management for the AIF”.

<sup>65</sup>Article 5 of Regulations 2013 along with part 4.A. of FSMA 2000 and section 51ZC of RAO 2001 govern the release of the authorisation also listing the requisites that the applicant has to meet in order to be authorised by the FCA. Article 5 (3) of the Regulations 2013 states that the regulator must not give the permission under FSMA 2000 to carry on the activity of managing an AIF unless “(a) the applicant would be an AIFM and would be the only AIFM of each AIF it managed; (b) the regulator is satisfied that the applicant will comply with the implementing provisions applicable to

The new UK regulatory framework represents a significant change, given that many managers, who before the transposition of the AIFMD were authorised for managing investment, had to apply in order to be re-authorised for “managing an AIF”.<sup>66</sup>

Even the new rules concerning the depositary and the external valuer represent very innovative provisions since, before transposing the AIFMD, the UK system had nothing similar regarding investment funds other than UCITSs.<sup>67</sup> In fact, in the past, the managers were authorised mostly for management functions or investment advice, so it was not necessary to appoint an independent depositary for the custody of the fund’s assets and an external valuer for calculating the net asset value of the fund.<sup>68</sup>

7. Despite the strong opposition of the British Government against the adoption of the AIFMD, even after its transposition into the domestic system, the UK has maintained its international leading position as a financial centre for the management and marketing of alternative investment funds.<sup>69</sup> Indeed, due to the introduction of the AIFMD passport, the British industry has increased its size benefiting from the new opportunities to freely access the market of the other

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a full-scope UK AIFM; (c) the applicant has sufficient initial capital and own funds in accordance with implementing provisions relating to Article 9 of the directive; and (d) the shareholders or members of the AIFM that have qualifying holdings are suitable taking into account the need to ensure the sound and prudent management of the AIFM”.

<sup>66</sup>According to the FCA position published on [www.fca.org.uk](http://www.fca.org.uk), “a number of fund managers in the UK, before the implementation of AIFMD, held a permission to manage investments. It is likely that some of these firms, dependent on business models, will need to be re-authorised under the AIFMD to operate as AIF managers. These may include: a) MiFID firms carrying out portfolio management and/or risk management for EEA funds that are not UCITS funds or funds located offshore in third-country jurisdictions, such as the US and Cayman Islands; and b) operators of collective investment schemes that are not UCITS funds carrying out portfolio management and/or risk management in-house”.

<sup>67</sup>See GABBERT, *Hedge Funds*, (1st Edition, LexisNexis 2008) *passim*.

<sup>68</sup>See KATZ, ‘Wholesale Investment Firms’ in WALKER – PURVES – BLAIR (Eds.), *Financial Services Law*, (3rd Edition, Oxford University Press 2014) p. 737.

<sup>69</sup>See QUAGLIA, ‘The “old” and “new” Political Economy of Hedge Fund Regulation in the European Union’ (2011) *West European Politics*, 34, p. 668; see also SENNHOLZ WEINHARDT, ‘Regulatory Competition as a social fact: Constructing and contesting the threat of hedge fund managers relocation from Britain’ (2014) *Review of International Political Economy*, 21, p. 1248.

Member States.<sup>70</sup>

Following the adoption of the AIFMD, it is possible to distinguish two different ways for UK-based AIFMs to access the market of the other EU Member States.<sup>71</sup>

The first one is through the passport under articles 32<sup>72</sup> and 33<sup>73</sup> of the AIFMD. This is the case in which UK AIFMs manage UK or EU AIFs and sell their units domestically as well as in the other EU Countries. The data published by ESMA has confirmed that many UK AIFMs have been using massively the EU AIFMD passport since its introduction by managing AIFs established in other EU Countries and by selling units of AIFs, both established in the UK and in other EU Countries, either domestically or in the other 27 Member States.<sup>74</sup>

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<sup>70</sup>See ESMA, ‘Notification frameworks and home-host responsibilities under UCITS and AIFMD’, 7 April 2017, 33, available at [www.esma.europa.eu](http://www.esma.europa.eu), where the Authority points out that the UK is the EU country with the highest number of managers, both UCITS and AIFMs, that is 842; the UK is also the first EU Country for cross-border services provided by AIFMs, amounting to 209 services; UK AIFMs are the most active managers of AIFs established in other EU countries with 153 cases; Also the number of funds established in the UK is significant, with 2862 UCITS funds. While the number of UK AIFs marketed in the UK by UK AIFMs is the highest at EU level with 4689 funds. The UK is also the first EU market for AIFs established in other EU Countries and managed by UK managers with 1342 funds. The number of UK AIFs marketed by UK AIFMs in other EU Member States amounts to 338 funds, whilst the number of EU AIFs established in Member States other than the UK, managed by UK AIFMs and marketed in other EU Countries is 316; see also ESMA, ‘Opinion to the European Parliament, Council and Commission and responses to the call for evidence on the functioning of the AIFMD EU passport and on the National Private Placement Regimes’, 30 July 2015, *passim*, available at [www.esma.europa.eu](http://www.esma.europa.eu), where the Authority points out that from July 2013 to March 2015, 7868 EU AIFs were notified for marketing in other EU Member States in accordance with article 32 AIFMD, with the highest number of outbound notifications coming from the U.K., *i.e.* 5027. Additionally, the Authority highlights that 1777 non-EU AIFMs, in the same period, marketed AIFs in the Member States in accordance with article 42(1) of AIFMD, including 1013 in the U.K. and that 4356 AIFs were marketed in the Member States by non-EU AIFMs in accordance with article 42(1) of AIFMD, of which 2657 in the U.K.

<sup>71</sup>See BODELLINI, ‘The European Union regulation on marketing of alternative investment funds: another step towards integration of the European Union financial market’, (2016) *Business Law Review*, 37, *passim*.

<sup>72</sup>That is about the marketing of units or shares of EU AIFs in Member States other than in the home Member State of the AIFM.

<sup>73</sup>That is about the conditions for managing EU AIFs established in other Member States.

<sup>74</sup>See ESMA, ‘Opinion to the European Parliament, Council and Commission and responses to the call for evidence on the functioning of the AIFMD EU passport and on the National Private Placement Regimes’, 30 July 2015, *passim*, available at <https://www.esma.europa.eu>, where the Authority points out that from July 2013 to March 2015, 7868 EU AIFs were notified for marketing in other EU Member States in accordance with article 32 AIFMD, with the highest number of outbound notifications coming from the U.K., *i.e.* 5027.

The second one is under article 36 of the AIFMD<sup>75</sup> and is the case in which UK AIFMs manage and sell in the EU Countries units of AIFs established in jurisdictions outside the EU, mainly the Cayman Islands and the British Virgin Islands,<sup>76</sup> on the basis of the so-called private placement regime of the EU Countries in question.<sup>77</sup>

The data concerning the activities of non-EU AIFMs and non-EU AIFs in the Union, published by ESMA, confirms that the UK is the favoured gateway for non-EU entities to access the EU market.<sup>78</sup>

8. After the official exit of the UK from the European Union,<sup>79</sup> there could be three alternative scenarios with regard to the access of UK financial entities on

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<sup>75</sup>That is about the conditions for the marketing in Member States without a passport of non-EU AIFs managed by an EU AIFM.

<sup>76</sup>See GREIG, 'United Kingdom' in ZETZSCHE (Ed.), *The Alternative Investment Fund Managers Directive*, (1st edition, Wolters Kluwer 2012) p. 699.

<sup>77</sup>This is due to the fact even if there are provisions under article 35 of the AIFMD regulating the marketing in the Union with a passport of non-EU AIFs managed by EU AIFMs, this mechanism is not yet in place.

<sup>78</sup>See ESMA, 'Advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs', 30 July 2015, p. 166, available at <https://www.esma.europa.eu>, where the Authority points out that in the period October 2014 – December 2014, the non-EEA AIFs managed by EEA AIFMs and marketed in the U.K. pursuant to article 36 of AIFMD were from Bahamas (1), Bermuda (9), Cayman Islands (275), Guernsey (25), Jersey (8), US (19) and British Virgin Islands (25), whilst the non-EEA AIFMs marketing AIFs in the U.K. under article 42 of AIFMD were from Australia (12), Bermuda (16), Brazil (2), Canada (3), Cayman Islands (33), Guernsey (57), Hong Kong (15), Isle of Man (2), Japan (16), Jersey (27), Mauritius (6), Republic of Korea (1), Mexico (4), Singapore (11), South Africa (1), Switzerland (9), Thailand (2), United States (269), British Virgin Islands (3) and US Virgin Islands (1). Finally, the non-EEA AIFs managed by non-EEA AIFMs and marketed in the U.K. in the same period under article 42 of AIFMD were from Australia (13), Bahamas (1), Bermuda (28), Canada (3), Cayman Islands (587), Guernsey (121), Hong Kong (2), Japan (18), Jersey (47), Mauritius (9), Mexico (4), Singapore (7), Switzerland (1), Thailand (2), United States (236) and British Virgin Islands (42); see also ESMA, 'Opinion to the European Parliament, Council and Commission and responses to the call for evidence on the functioning of the AIFMD EU passport and on the National Private Placement Regimes', 30 July 2015, *passim*, available at <https://www.esma.europa.eu>, where it is said that from July 2013 to March 2015, 1777 non-EU AIFMs marketed AIFs in the Member States in accordance with article 42(1) of AIFMD, including 1013 in the U.K. and that 4356 AIFs were marketed in the Member States by non-EU AIFMs in accordance with article 42(1) of AIFMD, of which 2657 in the U.K.

<sup>79</sup>For some interesting critical reflections on Brexit both from a political and legal point of view, see CAPRIGLIONE, IBRIDO, 'Again about Brexit: from impact on financial and economic relationships to European geopolitical structures', (2017) *Law and Economics Yearly Review*, 1, *passim*; CAPRIGLIONE, 'Brexit: an anti-historical divorce which can change the EU', (2016) *Law and Economics Yearly Review*, 1, p. 4.

the common market.<sup>80</sup>

In the first scenario, the UK could decide to maintain its status of European Economic Area (EEA) Country.<sup>81</sup> In such a case, British AIFMs and AIFs can continue to benefit from the EU AIFMD passport since it is granted to both EU and EEA entities.<sup>82</sup>

In the second scenario, if the UK does not maintain its European Economic Area (EEA) Country status, it will be considered as a third country. As a consequence, its AIFMs and AIFs will have to wait for the decision of the Commission regarding the extension of the AIFMD passport to non-EU AIFMs and AIFs. From this perspective, if the domestic regulation will not be changed, the UK could obtain a positive assessment from ESMA since its regulation is set on the basis of the AIFMD so it should be considered as equivalent. This, in turn, could speed up and ease the legislative process managed by the Commission to grant to the UK the third country passport under the AIFMD.

The third scenario could be that the UK will negotiate a specific agreement with the Union allowing British financial entities to access the EU market.<sup>83</sup>

However, assuming that after Brexit the parties do not reach a specific agreement

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<sup>80</sup>See MOLONEY, 'Financial Services, the EU, and Brexit: an uncertain future for the City?', (2016) *German Law Journal*, 17, p. 75, arguing that "the nature of the UK's relationship with the EU following its exit from the EU has yet to be determined. But the consequences of the extraction of the UK from the EU financial governance are likely to be disruptive in nature and long term in duration".

<sup>81</sup>Even though all the EU Member States are also member of the European Economic Area (EEA), formally the EEA agreement is different and separated from the EU Treaties; this means that if the UK wants to leave also the EEA it will have to formally withdraw even from this second agreement; see Schroeter – Nemeček, 'The (uncertain) Impact of Brexit on the United Kingdom's Membership in the European Economic Area' (2016) *European Business Law Review*, 27, p. 921.

<sup>82</sup>This scenario however appears to be political impossible according to ARMOUR, 'Brexit and Financial Services – Bargaining in the shadow of Equivalence' (2017) *Brexit Negotiations Series – University of Oxford*, available at [www.law.ox.ac.uk/business-law-blog](http://www.law.ox.ac.uk/business-law-blog), who explains that this is due to the fact that "EEA membership entails acceptance of the 'four freedoms' including continued free movement of persons which has been ruled out by the UK Government. Nevertheless, given the level of UK–EU activity described above, there are clear benefits to both sides in coming to some sort of bilateral agreement regarding financial services".

<sup>83</sup>See RINGE, 'The irrelevance of Brexit for the European Financial Market', (2017) *University of Oxford Legal Research Paper Series*, Paper no. 10/2017, p. 16, arguing that this can be a possible outcome of the political negotiations as both parties can obtain benefits in keeping allowing UK financial entities to freely access the common market. For this reason a special deal between EU and UK is the most likely future scenario.

allowing UK financial players to freely access the common market as has been so far and at the same time that the UK will not maintain its status of EEA Country,<sup>84</sup> then the free access of the EU market with the AIFMD passport will cease to be available.<sup>85</sup> The reason is that so far the EU passport has been given just to EU and EEA entities.<sup>86</sup> UK-based AIFMs and AIFs after Brexit will lose their current status as EU entities, simultaneously losing also the benefit of the passport under the current rules.<sup>87</sup>

On the opposite, the access of the EU Countries' market under the so-called private placement regime can still occur even if on the basis of the provisions of article 42 of the AIFMD<sup>88</sup> instead of article 36.<sup>89</sup> This means that from this perspective there will not be significant adverse regulatory changes.<sup>90</sup>

In such a context, the day after Brexit, the UK alternative investment fund industry, relying on the total conformity of its legislation to the EU rules, can hope to be considered over time as an equivalent system. The benefit of being considered as an equivalent third country would be the availability for its financial entities of a centralised authorisation process. In other words, firms based in equivalent third countries are exempted from national authorisations with the

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<sup>84</sup>This is also the assumption on which the ESMA's opinion lies; see ESMA, 'General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union', Opinion published on 31 May 2017, available at [www.esma.europa.eu](http://www.esma.europa.eu), p. 2, where it is underlined that "the opinion assumes that the UK will become a third country after its withdrawal from the EU. This is without prejudice to any specific arrangements that may be reached between the UK and the EU".

<sup>85</sup> See MOLONEY, 'Financial Services, the EU, and Brexit: an uncertain future for the City?', (2016) *German Law Journal*, 17, p. 77, arguing that this is one of the few certainties about the post-Brexit scenario.

<sup>86</sup>See BODELLINI, 'The European Union regulation on marketing of alternative investment funds: another step towards integration of the European Union financial market', (2016) *Business Law Review*, 37, p. 215.

<sup>87</sup>See ARMOUR, 'Brexit and Financial Services – Bargaining in the shadow of Equivalence' (2017) *Brexit Negotiations Series – University of Oxford*, available at [www.law.ox.ac.uk/business-law-blog](http://www.law.ox.ac.uk/business-law-blog), underlining that "the loss of this ability to 'passport' services throughout the EU is at the centre of the financial sector's concerns over Brexit".

<sup>88</sup>That is about the conditions for the marketing in Member States without a passport of AIFs managed by a non-EU AIFM.

<sup>89</sup>See footnote no. 75.

<sup>90</sup>See BODELLINI, 'The European Union regulation on marketing of alternative investment funds: another step towards integration of the European Union financial market', (2016) *Business Law Review*, 37, p. 215-216.

legal effect that they would not need to open a subsidiary in the EU to operate in the common market.<sup>91</sup>

However, the main problem is represented by the fact that the third country equivalence regime is available just in a limited number of EU legislation with the consequence that this benefit cannot be enjoyed in any sector of the financial system.<sup>92</sup>

But even more importantly the decision of giving the equivalence “label” to a third country is mainly a political choice made by the Commission on the basis of the technical assessment performed by the relevant European Supervisory Authority.<sup>93</sup> And from this point of view the current harshness of the negotiations between the EU and the UK obviously could influence the Commission’s position,<sup>94</sup> making it very difficult for the latter to get such a recognition.<sup>95</sup>

9. The difficulty in obtaining the required recognition by the Commission discussed in the previous section seems to be confirmed by the position recently taken by ESMA.

The point is that Brexit could be an incentive for UK-based alternative investment fund managers and alternative investment funds to relocate in one or more of the other 27 EU Countries in order to keep benefiting from the passport under the

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<sup>91</sup>See ARMOUR, ‘Brexit and Financial Services – Bargaining in the shadow of Equivalence’ (2017) Brexit Negotiations Series – University of Oxford, available at [www.law.ox.ac.uk/business-law-blog](http://www.law.ox.ac.uk/business-law-blog).

<sup>92</sup>See ARMOUR, ‘Brexit and Financial Services – Bargaining in the shadow of Equivalence’ (2017) Brexit Negotiations Series – University of Oxford, available at [www.law.ox.ac.uk/business-law-blog](http://www.law.ox.ac.uk/business-law-blog), highlighting that “the European Commission maintains a list of current 3CE determinations, which details 39 different equivalence regimes under 14 different pieces of EU financial services legislation”.

<sup>93</sup>It is interesting to note that some months after the Brexit referendum, the EU Commission published a working document about the equivalence decisions in financial services policy, which, even if without mentioning Brexit, looks like the new regulatory guideline to deal with the UK financial industry after its withdrawal from the Union, see European Commission, ‘Commission Staff Working Document – EU equivalence decisions in financial services policy: an assessment’, Brussels 27 February 2017, available at [www.ec.europa.eu](http://www.ec.europa.eu).

<sup>94</sup>Accordingly see MOLONEY, ‘Financial Services, the EU, and Brexit: an uncertain future for the City?’, (2016) German Law Journal, 17, p. 78.

<sup>95</sup>Accordingly see RINGE, ‘The irrelevance of Brexit for the European Financial Market’, (2017) University of Oxford Legal Research Paper Series, Paper no. 10/2017, p. 9.

AIFMD.

ESMA is afraid that such a situation can end up persuading the regulators of the other 27 Member States to lower the level of regulation (what can be defined as a “race to the bottom”) in order to attract the UK financial entities wishing to move away from London.<sup>96</sup>

The second ESMA’s concern – that is actually very connected to the first one – relates to the cases of delegation and outsourcing. Many UK-based managers might want to set up a management company in the EU and simultaneously delegate and/or outsource back to the UK-based entity most of the activities. Such a structure would allow to keep the core part of the financial activities in the UK and at the same time benefit from the passport through the EU-based vehicle. It is obvious that ESMA is concerned about such a risk which would materialise an evident circumvention of the main EU principles, namely the so-called four freedoms.<sup>97</sup>

As a response to these concerns, ESMA published an opinion, setting out nine principles, that actually looks like a regulatory “attack” to the UK financial system.<sup>98</sup> These nine principles are: 1) no automatic recognition of existing authorisations; 2) authorisations granted by EU27 NCAs should be rigorous and efficient; 3) NCAs should be able to verify the objective reasons for relocation; 4)

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<sup>96</sup>This concern was clearly explained by Mr. Steven Maijoor, Chair of ESMA in a seminar organised by the European Parliament where he said “as UK-headquartered market participants are considering their options across the EU27, it is essential that national regulators do not compete on regulatory or supervisory treatment. Some practical examples where this may be a risk include such issues as the possibilities to delegate and outsource to a UK entity, while being registered and supervised by one of the EU27 financial markets regulators”; see ESMA, ‘Review of the European Supervisory Authorities: Opportunities to ensure a safe and sound financial system’, ALDE Seminar on the Review of the European Supervisory Authorities, European Parliament, Brussels 8 February 2017, available at [www.esma.europa.eu](http://www.esma.europa.eu), p. 4.

<sup>97</sup>*I.e.*: 1) free movement of goods, 2) free movement of capital, 3) free movement of people and 4) freedom to establish and provide services, which are the legal foundations of the common market and cannot be separately enjoyed by the EU Member States.

<sup>98</sup>Even if the declared reasons for this opinion are that “as the UK plays a prominent role in the EU Single Market, the relocation of entities, activities and functions following the UK’s decision to withdraw creates a unique situation which requires a common effort at EU level to ensure a consistent supervisory approach to safeguard investor protection, the orderly functioning of financial markets and financial stability”; see ESMA, ‘General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union’, Opinion published on 31 May 2017, available at [www.esma.europa.eu](http://www.esma.europa.eu), p. 1.

special attention should be granted to avoid letter-box entities in the EU27; 5) outsourcing and delegation to third countries is only possible under strict conditions; 6) NCSa should ensure that substance requirements are met; 7) NCAs should ensure sound governance of EU entities; 8) NCAs must be in a position to effectively supervise and enforce Union law; 9) coordination to ensure effective monitoring by ESMA.<sup>99</sup>

This hostile attitude clearly emerges from the tone and the language used as well as from its very purpose which is to provide a set of guidelines for the Member States' Authorities to specifically manage the relationships between supervisors and supervised entities of both the EU Countries and the UK in the post-Brexit scenario.<sup>100</sup>

Accordingly there are a number of unnecessary remarks highlighting the ESMA's "punitive" approach. This is what can be derived from obvious and redundant statements uselessly pointing out that the new "authorisations must be granted in full compliance with Union law and in a coherent manner across the EU27"<sup>101</sup> and that "any outsourcing or delegation arrangement from entities authorised in the EU27 to third country entities should be strictly framed and consistently supervised. Outsourcing or delegation arrangements, under which entities confer either a substantial degree of activities or critical functions to other entities, should not result in those entities becoming letter-box entities".<sup>102</sup> Of the same nature are the principles remarking that there will be no automatic recognition of the existing authorisations of UK financial entities in the other EU Member

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<sup>99</sup>See ESMA, 'General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union', Opinion published on 31 May 2017, available at [www.esma.europa.eu](http://www.esma.europa.eu), *passim*.

<sup>100</sup>In other words, it is "a practical tool to achieve supervisory convergence. It addresses regulatory and supervisory arbitrage risks that arise as a result of increased requests from financial market participants seeking to relocate in the EU27 within a relatively short period of time. This opinion is addressed to the national competent authorities (NCAs), in particular of those 27 EU Member States that will remain in the EU ('EU27')"; see ESMA, 'General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union', Opinion published on 31 May 2017, available at [www.esma.europa.eu](http://www.esma.europa.eu), p. 1.

<sup>101</sup> See ESMA, 'General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union', Opinion published on 31 May 2017, available at [www.esma.europa.eu](http://www.esma.europa.eu), p. 2.

<sup>102</sup> *Id.*

States and that the authorisation process conducted by the Member States' authorities should be rigorous; whilst the argument that the process of authorisation takes time and therefore entities seeking to relocate should approach the EU authorities as early as possible looks even more threatening.<sup>103</sup>

Indeed, there is no need to specify that the authorisation process must be run according to the Union law and that outsourcing and delegation arrangements cannot end up making the entities that delegate and outsource activities “empty boxes” without real functions and operations. These are notorious regulatory principles of the EU financial law which have always applied regardless of Brexit. The ESMA's need of highlighting these well-known principles appears to be a “call to arms” addressed to the EU national competent authorities aimed at making increasingly more difficult and burdensome for UK-based financial entities access the common market after Brexit. And this is likely to arise from the political aim of not allowing the UK to be better off after Brexit, since this can become an incentive for other EU Countries to follow in its footsteps.

Even if this is somehow understandable from a political point of view as the future of the European Union is currently at stake, at the same time it is rather obvious that when the UK will be a third country it will be very difficult and even politically embarrassing to justify a discriminating treatment compared to other non-EU Countries.

10. The UK has been so far the EU country which has benefited the most from the introduction of the AIFMD passport. This is confirmed by the data published by ESMA.<sup>104</sup>

Of course, it could be argued that the main business model is the one with

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<sup>103</sup> *Id.*

<sup>104</sup> See ESMA, ‘Opinion to the European Parliament, Council and Commission and responses to the call for evidence on the functioning of the AIFMD EU passport and on the National Private Placement Regimes’, 30 July 2015, *passim*, available at <https://www.esma.europa.eu>, where the Authority points out that from July 2013 to March 2015, 7868 EU AIFs were notified for marketing in other EU Member States in accordance with article 32 AIFMD, with the highest number of outbound notifications coming from the U.K., *i.e.* 5027.

UK AIFMs managing non-EU AIFs. And such a model currently does not allow the use of the passport.<sup>105</sup> This would mean that the exit from the EU and the consequent loss of the AIFMD passport benefits would not be such a big deal for the UK alternative investment fund industry.

However, the impossibility to freely access the EU market along with a likely increase of regulation and supervision with regard to the delegation and/or outsource of management functions to UK AIFMs could represent a significant threat for the sector.

This concern lies on the consideration that many UK financial entities authorised either under MiFID<sup>106</sup> or under AIFMD perform a huge amount of activities as managers delegated by other EU UCITS companies or EU AIFMs.<sup>107</sup> Any limitation on the ability of EU managers (both UCITS and AIFMs) to delegate and/or outsource portfolio management and/or risk management functions to UK entities could severely impact the British AIF industry.

These considerations should be carefully kept in mind by the UK negotiators in the negotiations with the Union in order to find a way enabling British AIFMs and AIFs to maintain some kind of simplified access to the EU market as well as the possibility to be delegated without restrictions by EU entities for portfolio management and risk management functions even after Brexit.

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<sup>105</sup>See BODELLINI, 'The European Union regulation on marketing of alternative investment funds: another step towards integration of the European Union financial market', (2016) *Business Law Review*, 37, p. 215.

<sup>106</sup>Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.

<sup>107</sup>On the distinction between UCITS schemes and AIFs see BODELLINI, 'Does it still make sense, from the EU perspective, to distinguish between UCITS and non-UCITS schemes?', (2016) *Capital Markets Law Journal*, 11, p. 528.

## THE GOOD, THE BAD AND THE UGLY: DIFFERENTIATING FINTECH FROM A FINANCIAL STABILITY PERSPECTIVE \*

Andrea Minto\*\* - Moritz Voelkerling\*\*\* - Melanie Wulff\*\*\*\*

**ABSTRACT:** *Providers who combine digital technologies with financial services in an innovative manner (FinTech companies) have been increasingly entering financial markets and taking over established financial intermediaries' economic functions or parts of their value chain. This is relentlessly projected to affect competition in some parts of the financial system and to impact its structure and dynamics, calling upon policy- and law-makers to take a close look at the financial stability implications. The aim of this paper is to develop a theoretical framework to aid supervisors, policy- and law-makers in managing risks and harnessing opportunities arising from the transition to the "FinTech era". Until now, "FinTech" has been vaguely associated with concepts like "disruption", "decentralisation" and "disintermediation". Very little efforts have been spent on explaining the relevance of each of them. Departing from the prevailing current, this paper deploys such concepts as filters in risk-profiling FinTech. According to our model, we identify four filters (economic function, disruptive potential, disintermediation, and decentralisation) against which to categorise "FinTech". The output of the filtering process is intended to facilitate the examination of questions relating to policy and regulatory responses.*

**SUMMARY:** 1.1. Overview. – 1.2. Defining FinTech for the purposes of this study. – 1.3. The

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filtering approach: an introduction to the model. – 2. Stage 1: FinTechs and their economic function. – 3. Stage 2: Considering a financial innovation’s disruptive potential. – 4. Stages 3 and 4: Identifying the processes of disintermediation and decentralisation. – 4.1. Financial (dis)intermediation. – 4.2. Financial (de)centralisation. – 5. Legal response. – 5.1. When to regulate? – 5.2. How to regulate? – 5.3. Where to regulate? – 6. Conclusion

1.1. Over the past few years, the financial sector has been undergoing structural change. New providers who combine digital technologies with financial services in an innovative manner (known as FinTech companies) have been nibbling away at incumbents’ market share and profitability and are thus transforming the financial industry’s competitive patterns.<sup>108</sup> Not only has competitive pressure become more intense, but the structure of financial institutions is being transformed and the dividing line between institutions and financial markets blurred.<sup>109</sup>

From Google Wallet to Bitcoin, all these technology-enabled financial innovations have been a “wake-up call” to address the regulatory aspects of a new “era” of financial services and market players. The FinTech sector comprises a very heterogeneous group of providers of technology-driven financial innovations. Some of them open up new markets in the financial industry; others offer new solutions to replace or augment products or services already offered by banks, asset managers or insurance companies.

Although considerable scholarly ink has been spilled on financial innovation, scarce attention, if any, has been paid to how technological innovation creates significant repercussions at the industry level and causes structural changes

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<sup>108</sup>According to a survey by Price Waterhouse Coopers (PWC) (PWC, ‘Global FinTech Survey 2016’ <<https://www.pwc.com/gx/en/advisory-services/FinTech/pwc-fintech-global-report.pdf>> accessed 22 June 2017), the current situation seems to combine FinTechs that challenge incumbent financial institutions with FinTechs that are bought up by incumbents who feel their business models’ viability under threat. The data collected in various segments of the markets, such as payments, banking, insurance, asset management, show that 32% of the respondents engage in joint partnerships with FinTech companies, 9% acquire them and 22% buy and sell services to FinTech companies.

<sup>109</sup>See FRAME and WHITE, ‘Technological change, financial innovation, and diffusion in banking’ in Berger, Molyneux, and Wilson (eds.), *The Oxford Handbook of Banking* (2nd edn, Oxford University Press, 2015) 271-311.

to the industry itself, opening up new markets and value networks while shaking up established market players.<sup>110</sup>

Such structural changes in the financial sector have relevant policy and regulatory implications, especially in the quest to prevent the build-up of vulnerabilities and to mitigate associated financial stability risks. In fact, it is uncertain which scenario this transformation is going to lead to. On the one hand, financial innovation can increase the diversity of the financial sector. The heterogeneity of market participants' risk profiles might make the system safer and more robust in the face of negative shocks: the more different the various activities and business models are, the weaker is the correlation between the risks financial providers are exposed to.

On the other hand, a more numerous and more interconnected set of economic actors might cause financial markets to be more susceptible to financial contagion and systemic risk. Schwarcz points out that technological innovation can increase procyclicality in the financial sector, compound concentration risks and have a broad negative impact on public confidence.<sup>111</sup> Decentralisation can bring about efficiencies and new risks at the same time. Along with the benefits stemming from intensified competition, it might also create market fragmentation, interconnectedness and opacity, making it difficult for market participants to effectively process information,<sup>112</sup> and for supervisors to locate, assess and address potential risks.<sup>113</sup> This could enable risk to accumulate unnoticed and unchecked.<sup>114</sup>

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<sup>110</sup>See, however, the pioneering study carried out by CHIU, 'The disruptive implications of FinTech-policy themes for financial regulators' (2017) 21(1) *Journal of Technology Law & Policy* <<https://ssrn.com/abstract=2812667>> accessed 22 June 2017; WALKER, 'Financial technology law – A new beginning and a new future' (2017) 50(1) *The International Lawyer*, 137ff. Besides, see Bank of England, 'Fair and effective market review' (Final Report, June 2015).

<sup>111</sup>See SCHWARCZ, 'Regulating shadow banking' (2012) 31(1) *Review of Banking and Financial Law* <<https://ssrn.com/abstract=1993185>> accessed on 22 June 2017.

<sup>112</sup>See AWREY, 'Complexity, innovation and the regulation of modern financial markets' (2011) *Oxford Legal Studies Research Paper No. 49/2011*; (2012) 2 (2) *Harvard Business Law Review*, 235-294 <<https://ssrn.com/abstract=1916649>> accessed 22 June 2017.

<sup>113</sup>See BRUMMER writes in 'Disruptive technology and securities regulation' (2015) 84 *Fordham Law Review*, 977-980 <<http://ir.lawnet.fordham.edu/flr/vol84/iss3/6>> accessed on 22 June 2017, that "innovation runs circles around the ability of regulators to respond and adapt. The

The uncertainties relating to FinTech companies' market position and the interaction between them and traditional financial intermediaries render it difficult, if not nigh on possible, for regulators and supervisors to compare and weigh the advantages and disadvantages of these developments and possibly gauge the net result. Rapid technological changes make expanding the regulatory perimeter a more arduous task.

A complex network of participants, who perform a variety of functions, is developing in a legal environment that is still highly fragmented and based on an institutional framework where entities are regulated, supervised, and overseen by a diverse group of competent authorities<sup>115</sup>.

Not only should the regulatory scope and goals be adapted so as to capture technological and financial innovation, but technological advances should also be used to inform regulatory strategies. At the juncture of these two phenomena (regulatory techniques and technological developments) lies regulatory technology or "RegTech" – the use of technology, particularly information technology, in the context of regulatory monitoring, reporting and compliance.<sup>116</sup> In fact, regulatory authorities, too, can innovate with regard to the substance of rules on the one hand, and in terms of their strategy to account for the change in the architecture on the other.

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proliferation of new market infrastructures as a result challenges academics and policymakers alike at both conceptual and operational levels of regulatory design".

<sup>114</sup>Financial innovation has been assimilated to shadow banking as far as the potential to trigger systemic risk is concerned: G. B. Gorton and A. Metrick, 'Regulating the Shadow Banking System' (2010) <<https://ssrn.com/abstract=1676947>> or <<http://dx.doi.org/10.2139/ssrn.1676947>> accessed on 22 June 2017.

<sup>115</sup>For further information, see UK Government Office for Science, 'Distributed Ledger Technology: beyond block chain' (2016) <[www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/492972/g-s-16-1-distributed-ledger-technology.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/492972/g-s-16-1-distributed-ledger-technology.pdf)> accessed 22 June 2017.

<sup>116</sup>For policymakers and regulators, the challenge of regulating rapidly transforming financial systems means increasing the use of and reliance on RegTech. Whilst the principal regulatory objectives (e.g. financial stability, prudential safety and soundness, consumer protection and market integrity, and market competition and development) remain, their means of application are becoming increasingly inadequate. RegTech developments are leading towards a paradigm shift necessitating the reconceptualisation of financial regulation: see inter alia ARNER, BARBERIS and BUCKLEY, 'FinTech, RegTech and the Reconceptualization of Financial Regulation' (2016) University of Hong Kong Faculty of Law Research Paper No. 2016/035 <<https://ssrn.com/abstract=2847806>> accessed 22 June 2017; MAUPIN, 'Mapping the Global Legal Landscape of Blockchain Technologies' (2017) <<https://ssrn.com/abstract=2930077>> accessed 22 June 2017.

This composite mosaic calls upon supervisors, regulators and legislators to collect all the pieces and produce a comprehensive picture in the quest to keep up with modern financial intermediation and the complexity that comes with the process of innovation.

1.2. Before moving to any meaningful examination of regulatory and policy questions relating to FinTech, we want to clarify semantics. A short discussion of concepts commonly associated with the notion of FinTech and of what they actually mean serves to bring these phenomena into sharper focus.

Despite the fact that FinTech is gathering momentum, a great deal of confusion seems to surround the phenomenon and the terms commonly used to describe it. The term “FinTech” is not a clear-cut notion but means different things to different people. FinTech has been used by industry and media in a variety of ways and thus does not have a single definition. Indeed, FinTech is most commonly associated with start-ups or technology companies that provide financial services in an innovative manner.<sup>117</sup> At the same time, however, FinTech is also used to describe a variety of innovative business models and emerging technologies that have the potential to transform the financial services industry.<sup>118</sup> Along with that, other concepts connected with FinTech are vaguely tossed around, such as disruption, disintermediation, and decentralisation. Despite the fact that in today’s parlance the concepts at hand – technology, innovation – are used to a large extent simultaneously and interchangeably, they tend to express different stages or phenomena which should not be confused or overlapped. To give an example, DLT or

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<sup>117</sup>See, inter alia, PWC, ‘What is FinTech?’ (April 2016) <[www.pwc.com/us/en/financial-services/publications/viewpoints/assets/pwc-fsi-what-is-fintech.pdf](http://www.pwc.com/us/en/financial-services/publications/viewpoints/assets/pwc-fsi-what-is-fintech.pdf)>.

<sup>118</sup>International Organization of Securities Commissions, ‘IOSCO Research Report on Financial Technologies (Fintech)’ (February 2017) <[www.iosco.org/library/pubdocs/pdf/IOSCOPD554.pdf](http://www.iosco.org/library/pubdocs/pdf/IOSCOPD554.pdf)>; Deloitte, ‘RegTech is the new FinTech: How agile regulatory technology is helping firms better understand and manage their risks’, (2015, available at <<https://www2.deloitte.com/content/dam/Deloitte/ie/Documents/FinancialServices/ie-regtech-pdf.pdf>> accessed 22 June 2017; WALKER, ‘Financial Technology Law – A New Beginning a New Future’ (2017) 50(1) *The International Lawyer*, 137.

blockchain<sup>119</sup> are often used to mean financial innovation. Yet DLT and blockchain are but the technological advances that can be used to produce innovative financial solutions. They can certainly result in financial innovations, such as the adoption of virtual currencies based on the blockchain. However, they can also be exploited in sectors/functions other than the financial realm, like the pharmaceutical, energy, and healthcare industries and many others.<sup>120</sup> While common wisdom suggests that whatever technological advancement is applied to financial services or practices results in financial innovation, it quite often wrongly confines the applicability of some technologies to the realm of financial services. DLT as such does not make life different, but the ways in which it is implemented and applied can modify consumption patterns, attitudes and behaviours in ways that upend market practices and demand specific regulatory responses.

It is therefore the innovation itself – which is the result of the subsequent application of new technologies – that should be closely looked at. If the actual innovation is applied to the financial sector, then the innovation can be regarded as a financial innovation.

For the purposes of this paper, then, the term FinTech describes the application of a specific technology in the financial sector in form of the resulting inno-

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<sup>119</sup>Strictly speaking, DLT and blockchain are two different concepts. A report by the UK Government Office for Science (2016) explains the difference: “Distributed ledgers are a type of database that is spread across multiple sites, countries or institutions, and is typically public. Records are stored one after the other in a continuous ledger, rather than sorted into blocks, but they can only be added when the participants reach a quorum... A block chain is a type of database that takes a number of records and puts them in a block (rather like collating them on to a single sheet of paper). Each block is then ‘chained’ to the next block, using a cryptographic signature. This allows block chains to be used like a ledger, which can be shared and corroborated by anyone with the appropriate permissions.” (UK Government Office for Science, ‘Distributed ledger technology: beyond block chain’, A report by the UK Government Chief Scientific Adviser, December 2015, available at <[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/492972/gs-16-1-distributed-ledger-technology.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/492972/gs-16-1-distributed-ledger-technology.pdf)>). Most FinTech applications combine both features, i.e. they consist of a blockchain that is stored in a decentralised manner, i.e. as a distributed ledger. For the purpose of this paper, we will use both terms interchangeably.

<sup>120</sup>DLT has shown its considerable adaptability as a variety of market sectors have sought to find ways of incorporating its abilities into their operations. While so far most of the focus has been on the financial services industry, this is beginning to change and to expand to other industries since DLT could streamline an array of different services, both in government and the wider economy. In that respect, see the comprehensive piece of work published by UK Government Office for Science, Distributed ledger technology: beyond blockchain, A report by the UK Government Chief Scientific Adviser, December 2015.

vation. It is used as shorthand for “*technology-enabled financial innovations*”, which suitably describes the interaction between technology and innovation in the financial sector. Accordingly, FinTech companies are the providers (firms) who offer technology-based innovative financial solutions.

1.3. The objective of this study is to advance the academic and public policy debate surrounding regulatory approaches towards FinTech. In order to gain a more robust understanding of the regulatory challenges, this study strives to disentangle technology-enabled financial innovations by means of a “filtering process”. We identified four parameters (filters) against which to categorise technology-enabled financial innovation: 1. economic function; 2. disruptive potential; 3. presence of disintermediation; 4. presence of decentralisation.

Each stage of the filtering process aims at increasing awareness of the characteristics of the financial innovation under examination, its potential risks to financial stability, and how these may affect the design and style of policy and regulatory responses.

In the first stage, the study categorises FinTech into one of four economic functions: 1. payment services; 2. lending and capital raising; 3. investment and trade; 4. clearing and settlement. This breakdown is warranted by the common sets of risks prevailing in each of the categories: although there might be common risks across categories, each of them is characterised by the predominance of (a) specific one(s). Since different risks require different regulatory strategies and tools, categorising FinTechs according to their economic function – and thus according to the main risks they may pose – adds significantly to the appropriateness of financial stability policy.<sup>121</sup>

The second filter is premised on the hypothesis that technological innovations should be considered carefully and split into “sustaining” and “disruptive”

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<sup>121</sup>We acknowledge that some FinTechs might fall into more than just one of the categories mentioned here. However, in such cases we are in favour of choosing the category with the most adequate risk profile for the FinTech in question.

innovations. According to Christensen's innovation model theory,<sup>122</sup> not all FinTech solutions qualify as disruptive. This study draws a dividing line between: 1) creation of new markets and value networks that eventually disrupt and displace established market leaders and alliances ("disruptive innovation"); and 2) situations where innovations are adopted primarily by FinTech companies who use them to effectively compete with established financial institutions across the value chain ("sustaining innovation"). In our view, this distinction is of great significance for the nature of the regulatory strategy that is ultimately drawn up. Consequently, while the study takes a relatively lax stance towards sustaining innovations (based on the assumption that they are less likely to raise financial stability concerns), it approaches innovative disrupters by applying the subsequent filters. However, this does not imply a preference for sustaining innovation.

The third and fourth filters are closely related and are based on the concepts of disintermediation and decentralisation, respectively. The third filter examines whether a technology-enabled financial innovation is capable of breaking up traditional financial ties and networks (thus potentially resulting in disintermediation) or whether it merely modifies market practices by adding another layer of intermediation (layering). The fourth and final stage of the filtering process is connected to the third one and puts forward the question of whether the FinTech is displacing and eroding the role of established structures that are characterised by a single financial intermediary (or a small number of them) at the centre of all business (decentralisation). Despite being closely linked, we consider disintermediation and decentralisation to be two different phenomena or filters which need to be looked at separately.

The output of this filtering process is a "profiled" FinTech which is better described in terms of the risks and threats it may pose to financial stability than it

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<sup>122</sup>See CHRISTENSEN, 'The Innovator's Dilemma - When New Technologies Cause Great Firms to Fail' (1997) Harvard Business Review Press, and, more recently, CHRISTENSEN, RAYNOR, and McDonald, 'What is disruptive innovation?' (2015) Harvard Business Review <<https://hbr.org/2015/12/what-is-disruptive-innovation>>.

was to start with (risk profile). Such a process is therefore expected to help policymakers and legislators devise and implement appropriate regulatory responses, which are considered in part 5 of our paper.

2. When approaching FinTech from a regulatory point of view, it is vital for the quality of any assessment that a more thorough distinction is made. Different activities in different sectors of the financial market have different risk profiles, and the particular intensity of common risks may also vary. In other words, the risks one has to monitor with regard to financial stability differ depending on whether, for instance, the payment services sector is concerned or the lending sector. Even if a risk is present in more than one sector – e.g. counterparty risk in the two aforementioned sectors – it may vary in intensity between these sectors. Since different risks require different strategies or tools to address them, and higher risk intensities demand greater attention, it can be instructive to categorise FinTechs according to their economic functions.

Therefore, as a first stage in our four-stage model, we suggest employing a functional approach that separates FinTechs according to the economic function they perform.<sup>123</sup> Unlike the institutional perspective, which Merton and Bodie consider “static”,<sup>124</sup> it not only offers a glance beyond FinTechs’ legal names and forms, but is also flexible in that it is able to capture future, additional types of entities and activities that perform these economic functions and may potentially pose risks to the financial system.<sup>125</sup>

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<sup>123</sup>For a detailed discussion of the functional perspective, see MERTON, ‘*A functional perspective of financial intermediation*’ (1995) 24(2) *Financial Management*, Vol. 24, No. 2, Silver Anniversary Commemoration, 1995, pp. 23-41, <<http://www.jstor.org/stable/3665532>> accessed 22 June 2017.

<sup>124</sup>See MERTON and BODIE, ‘A conceptual framework for analyzing the financial environment’, in Crane, Froot, Mason, Perold, Merton, Bodie, Sirri and Tufano (eds.) *The global financial system, a functional perspective*, 1995, Boston: Harvard Business School Press, 1995, 3–31.

<sup>125</sup>See also MERTON, ‘A functional perspective of financial intermediation’ (1995) *Financial Management*, Vol. 24, No. 2, Silver Anniversary Commemoration, 23-41, available at <<http://www.jstor.org/stable/3665532>> and FSB, ‘Strengthening oversight and regulation of shadow banking: policy framework for strengthening oversight and regulation of shadow banking entities’ (2013) <[http://www.fsb.org/wp-content/uploads/r\\_130829c.pdf?page\\_moved=1](http://www.fsb.org/wp-content/uploads/r_130829c.pdf?page_moved=1)>. See also R. C. Merton, n 27, and Financial Stability Board, ‘Strengthening Oversight and Regulation of Shadow

Several ways of classifying economic functions have been proposed in the literature.<sup>126</sup> Drawing on Merton and Bodie, we propose four main categories of FinTech: payment services, lending and capital raising, investment and trade, and clearing and settlement. These four categories should encompass the majority of FinTech activities; however, new and additional categories can always be defined. Each of these categories comes with its own set of risks and risk intensities. For brevity's sake, we will limit our paper to giving a few examples for each category.

#### *Category 1: payment services*

FinTech entities and activities that provide any kind of payment service, such as mobile and web-based financial services, including what are dubbed “fast” or “instant” payment services, belong to this category.<sup>127</sup> Moreover, applications based on DLT that provide, for instance, (cross-border) interbank payments or digital currencies can be part of this category.

Potential risks that the provision of this economic function may entail very much depend on the precise business model that is utilised. If a payment is available to the payee before the payment services provider has received it from the payer, this may give rise to counterparty risk.<sup>128</sup> In this case, the payment has the characteristics of a loan extended by the payee's payment service provider to the payer's payment service provider until settlement has been processed. It thus in-

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Banking: Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities' (2013) <[http://www.fsb.org/wp-content/uploads/r\\_130829c.pdf?page\\_moved=1](http://www.fsb.org/wp-content/uploads/r_130829c.pdf?page_moved=1)> accessed 22 June 2017.

<sup>126</sup>See, for instance, WILSON and CAMPBELL 'Financial functional analysis: a conceptual framework for understanding the changing financial system' (2016) 23(4) *Journal of Economic Methodology*, 413-431; R. C. Merton and Z. Bodie, n28. The authors identify six functions: (1) clearing and settling payments, (2) pooling resources and subdividing shares, (3) transferring resources across time and space, (4) managing risk, (5) providing information and (6) dealing with incentive problems.

<sup>127</sup>Sometimes, crowdfunding platforms can also be considered payment services if they purely provide the service of matching lenders and borrowers and forwarding the money. However, in general, most crowdfunding activities fall into the “lending and capital raising” category.

<sup>128</sup>Counterparty risk is the risk that one party to a contract will not be able to fulfil its contractual obligations. For a discussion, see F. Fabozzi, F. Modigliani and F. Jones, 'Foundations of financial markets and institutions' (2014) 4th ed, Pearson, 30; G. Ferrarini, 'Understanding the role of corporate governance in financial institutions: a research agenda' (2017) *Ondernemingsrecht*, 2017/13.

creases the latter's leverage. On the other hand, if settlement between the two payment service providers takes place in real time, there is a continuous need for sufficient liquidity to settle every transaction separately and at any time, even outside normal business hours. If a provider faces a (temporary) liquidity shortage, payment requests may be rejected, which could damage the reputation of the payment service provider concerned, or spill across the sector and possibly to banks if the service provider processes payments between bank accounts. Instant payment services,<sup>129</sup> especially, may accelerate bank runs if customers choose to withdraw money from their deposits via instant payment services rather than queuing at a bank branch or ATM.<sup>130</sup>

In general, there is a risk that reputational problems may spread from a payment service provider to a bank since the services of both sectors are highly interconnected. While most FinTech companies that provide payment services do not take deposits, there are some that do. This makes them liable to banking regulation in many jurisdictions, but not in all of them. If these deposits are not covered by deposit insurance, the FinTech company in question may be especially prone to runs.<sup>131</sup> Additionally, the provision of payment services may generate network effects.<sup>132</sup> This could cause the sector to eventually be dominated by one or just a few large players. Over time, one or more of them may become too big to

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<sup>129</sup>The Euro Retail Payments Board has defined instant payments as “electronic retail payment solutions available 24/7/365 and resulting in the immediate or close- to- immediate interbank clearing of the transaction and crediting of the payee’s account with confirmation to the payer (within seconds of payment initiation),. This is irrespective of the underlying payment instrument used (credit transfer, direct debit or payment card) and of the underlying clearing and settlement arrangements for clearing (whether bilateral interbank clearing or clearing via infrastructures) and settlement (e.g. with guarantees or in real time) that make this possible”. (ECB ERPB, ‘Pan-European instant payments in euro: definition, vision and way forward’, 2014, <[http://www.ecb.europa.eu/paym/retpaym/shared/pdf/2nd\\_eprb\\_meeting\\_item6.pdf?27ef4897696839d1e7d0918f6b2dae48](http://www.ecb.europa.eu/paym/retpaym/shared/pdf/2nd_eprb_meeting_item6.pdf?27ef4897696839d1e7d0918f6b2dae48)> accessed 22 June 2017).

<sup>130</sup>For a detailed discussion of risks and benefits of fast payment services, see BIS CPMI, ‘Fast payments – enhancing the speed and availability of retail payments’, (2016) <<http://www.bis.org/cpmi/publ/d154.pdf>> accessed 22 June 2017.

<sup>131</sup>A bank run happens when depositors rush to withdraw their deposits because they expect the bank to fail.: See D. W. Diamond and P. H. Dybvig, ‘Bank runs, deposit insurance, and liquidity’ (1983) 91(3) *Journal of Political Economy*, Vol. 91, No. 3, 401-419.

<sup>132</sup>See ECONOMIDES, ‘Nonbanks in the payments system: vertical integration issues’ (2006) NET Institute Working Paper #07-06, <[http://www.stern.nyu.edu/networks/Economides\\_Nonbanks\\_Payments\\_System.pdf](http://www.stern.nyu.edu/networks/Economides_Nonbanks_Payments_System.pdf)> accessed 22 June 2017.

fail<sup>133</sup> or too connected to fail.<sup>134</sup> Finally, cyber threats have to be considered. With increasing dependence on technology and the introduction of more and more interface links, cyber-attacks or flaws in IT software and algorithms may lead to stability concerns. A resulting system-wide loss of confidence seems especially conceivable when deposits, for instance with mobile payment service providers, are not covered by deposit insurance.

### *Category 2: lending and capital raising*

This category mainly encompasses all types of crowdfunding/investing<sup>135</sup>. There is a great deal of heterogeneity in the various business models run by crowdfunding platforms. Some serve purely as a matching service for lenders and borrowers; others issue securities. In general, the platforms' business models are still evolving and thus risks may also be changing depending on the specific business model.

Generally, these platform-based funding activities are subject to a number of information asymmetry problems, such as principal-agent problems<sup>136</sup> between

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<sup>133</sup>See BERNANKE (2010) described a too-big-to-fail firm as one "... whose size, complexity, interconnectedness, and critical functions are such that, should the firm go unexpectedly into liquidation, the rest of the financial system and the economy would face severe adverse consequences." (B. Bernanke, 'Causes of the recent financial and economic crisis' (Testimony before the Financial Crisis Inquiry Commission, 2010, Washington, D.C., <<https://www.federalreserve.gov/newsevents/testimony/bernanke20100902a.htm>> accessed 22 June 2017).

<sup>134</sup>See LEÓN et al. (2011) define an institution as too-connected-to-fail (TCTF) "... when, due to its degree of connectedness – either direct or indirect –, its inability to meet its obligations could result in the inability of other system participants or of financial institutions in other parts of the financial system (i.e. the whole financial infrastructure) to meet their obligations as they become due." (LEÓN, MACHADO, CEPEDA and SARMIENTO, 'Too-connected-to-fail institutions and payments system's stability: assessing challenges for financial authorities', (2011) Borradores de Economía, No. 644, <<https://ssrn.com/abstract=2101221>> accessed 22 June 2017).

<sup>135</sup>The FCA in the UK, for example, groups crowdfunding into four types: (i) equity crowdfunding; (ii) crowdfunded lending; (iii) Reward crowdfunding; and (iv) donation crowdfunding. The FCA only governs (i)-(ii) though.

<sup>136</sup>See JENSEN and MECKLING describe the issue of principal-agent problems as a situation where "one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal." (M. Jensen and W. H. Meckling, 'Theory of the firm: managerial behavior, agency costs and ownership structure' (1976), Journal of Financial Economics, V. 3, No. 4, 305-360, <[https://papers.ssrn.com/sol3/papers2.cfm?abstract\\_id=94043](https://papers.ssrn.com/sol3/papers2.cfm?abstract_id=94043)> accessed 22 June 2017).

platform providers, issuers and investors, and mispricing of risks.<sup>137</sup> Misaligned incentives can exacerbate these problems. Crowdfunding platforms can be considered two-sided markets that are subject to indirect network effects, i.e. each side benefits from a larger number of participants on the other side.<sup>138</sup> Consequently, the platform may have an incentive to underestimate the risk underlying the projects it offers to investors.

In addition, institutional investors, such as banks and investment funds, are increasingly investing in loans originated via crowd-lending platforms. Losses might thus spread to banks and other large financial intermediaries.<sup>139</sup> Another possible channel of contagion is that some platforms have started to bundle and consolidate loans and sell them on to third parties in the form of asset-backed securities.<sup>140</sup> Thus, crowd-lending platforms increase interconnectedness in the financial system. Moreover, they may open the door to regulatory arbitrage. Kirby and Worner note that “investing in un-collateralised loans, via peer-to-peer lending platforms, may be a way for banks and other large institutional investors to circumvent capital requirements or other regulatory requirements.”<sup>141</sup> Titan Bank already uses a crowd-lending platform to originate loans that would be too costly for the bank itself to fund directly.<sup>142</sup>

When crowdfunding platforms extend their activities from the domestic to the cross-border provision of finance, a plethora of legal questions arise. For instance, it is not clear which jurisdiction’s legal system would apply to these con-

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<sup>137</sup>For a discussion of asymmetric information and pricing strategies for crowdfunding platforms, see BELLEFLAMME, OMRANI and PEITZ, ‘The economics of crowdfunding platforms’ (2015) *Information Economics and Policy* 33, 11-28.

<sup>138</sup>See, for example, ROCHET and TIROLE, ‘Platform competition in two-sided markets’ (2003) *European Economic Association*, 990-1029.

<sup>139</sup>See Aquilina and W. Kraus, ‘Market-based finance: its contributions and emerging issues’ (2016) FCA Occasional Paper No. 18, <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2848161](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2848161)> accessed 22 June 2017.

<sup>140</sup>See KIRBY and WORNER, ‘Crowd-funding: an infant industry growing fast’ (2014) IOSCO Staff Working Paper, <<http://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf>> accessed 22 June 2017.

<sup>141</sup>*Ibid.*

<sup>142</sup>See ALLOWAY, ‘Big banks muscle in on peer-to-peer lending’, (*Financial Times*, 28 October 2013), <<https://www.ft.com/content/b0696414-3f3f-11e3-9657-00144feabdc0?mhq5j=e1>> accessed 22 June 2017.

tracts. And would the jurisdiction that regulates the platform also cover all of its activities or only those in that jurisdiction?<sup>143</sup> There is an opportunity for international regulatory arbitrage when a platform is domiciled in a jurisdiction where it and its transactions are only lightly regulated, but it can conduct business in other jurisdictions without having to submit to these jurisdictions' (stricter) regulation.

Demand for credit rises and falls with the financial/credit cycle, and loans granted on crowd-lending platforms are generally associated with relatively higher credit risk. Therefore, it seems conceivable that platform-based lending might dry out during a bust in the credit cycle and thus fuel procyclicality.<sup>144</sup> In addition, crowd-lending exposes investors to liquidity risk since there is not yet a well-functioning secondary market for loans originated via lending platforms. Finally, the growth of crowdfunding may contribute to shifts in the allocation of risks and change channels of potential contagion within the financial system.

### *Category 3: investment and trade*

Frequently discussed examples of this category are robo-advisory systems and social trading communities. The term robo-advisor encompasses automated internet-based services in the context of investment advice, investment or contract broking and portfolio management<sup>145</sup>. Through online platforms they offer automated advisory services and provide their customers with the opportunity to receive a diversified portfolio proposal based on personal information. The composition of that portfolio and any changes made to it are usually based on algorithms derived from portfolio theory models.<sup>146</sup> Social trading communities are vir-

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<sup>143</sup>See KIRBY and WORNER, n44.

<sup>144</sup>See LANDAU (2009) defines procyclicality as "...the tendency of financial variables to fluctuate around a trend during the economic cycle. Increased procyclicality thus simply means fluctuations with broader amplitude." (Remarks by J.-P. Landau, 'Procyclicality – what it means and what could be done' (Remarks by Deputy Governor of the Bank of France, at the Bank of Spain's conference on Procyclicality and the Role of Financial Regulation; Madrid, 4 May 2009 <<http://www.bis.org/review/r090805d.pdf>> accessed 22 June 2017).

<sup>145</sup>It seems appropriate to clarify that many robo advisory systems are merely offering guidance and principles, not proper advice, as they would then fall under the respective financial services rules and advisor liability in the different jurisdiction.

<sup>146</sup>See Deutsche Bundesbank 'Financial Stability Review 2016' (2016, Frankfurt am Main).

tual spaces in which trading and social media are combined. Trade information is provided in a highly transparent manner that allows participants to copy each other's investment strategies. Usually, the participants are either trade leaders who establish the original trade or sample portfolio, respectively, or they belong to the group of trade followers who have trust in the leader's expertise and copy its trades and strategies.

Both robo-advisory platforms and social trading give rise to some stability concerns. If robo-advisors widely make use of very similar algorithms, or a significant number of trade followers follow the same leaders, this may lead to some sort of herding behaviour, which may drive asset prices away from fundamentals and set off price spirals if portfolio shifts take place simultaneously.<sup>147</sup> These effects can be exacerbated when the use of robo-advice increasingly spreads to institutional investors.<sup>148</sup> Moreover, one can imagine how such herding behaviour might support procyclical developments that further threaten financial stability.

Additionally, these services are subject to operational risks like cyber-attacks, social bots or flaws in the algorithms.<sup>149</sup> Systems that depend on computer algorithms and/or social media are always vulnerable to manipulation or coding mistakes made by developers. These may cause huge financial losses and lead to a loss of confidence that can spread to other connected parts of the financial sector.

#### *Category 4: clearing and settlement*

The fourth and final category comprises all post-trade activities, i.e. clearing and settlement systems. When two business partners agree on a financial transac-

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<sup>147</sup>For a discussion of herding behaviour and asset price bubbles, see BRUNNERMEIER, 'Asset pricing under asymmetric information: bubbles, crashes, technical analysis, and herding' (2001) Oxford University Press, Oxford, UK.

<sup>148</sup>Some robo-advice service providers are already branching out into the institutional investment sector. For instance, Betterment has launched a B2B offering called Betterment for Advisors: (BETTERMENT, 'Betterment Launches Platform for Advisors' (15 October 2014) <<https://www.betterment.com/resources/inside-betterment/product-news/betterment-launches-institutional-platform/>> accessed 22 June 2017).

<sup>149</sup>The CFA Institute's FinTech Survey Report 2016 surveyed 3,800 capital markets members. According to the report, 46% of respondents considered flaws in the algorithm as the biggest risk introduced by automated financial advice tools. (CFA Institute, 'The FinTech survey report', April 2016, <[https://www.cfainstitute.org/Survey/FinTech\\_survey.pdf](https://www.cfainstitute.org/Survey/FinTech_survey.pdf)>).

tion, this is usually followed by a number of downstream intermediary processes conducted by different entities, such as corresponding banks, central counterparties, automated clearing houses, etc. FinTech service providers operating in this environment are mostly trying to offer a short cut through this jungle of intermediation. They target different stages of the procedure, while Bitcoin or other DLT-based services aim to cut out middle men altogether to facilitate peer-to-peer interactions.

Two important risks to financial stability that may emanate from these ongoing developments are an increase in financial market participants' interconnectedness (which may exacerbate contagion in the event of a crisis) and the risk that certain companies that provide services which are widely used throughout the financial system become too big to fail.

Increased automation may also contribute to herding behaviour among actors involved in the clearing and settlement process – as described above in the case of robo-advisors and social trading – and potentially increase procyclicality and market volatility.<sup>150</sup> Additionally, operational risks and cyber-attacks or flawed algorithms play a significant role here, too. In her paper on the operational risks of Bitcoin, Walch points out that attacks on the Bitcoin software or network are a systemic operational risk to the Bitcoin blockchain as a financial market infrastructure.<sup>151</sup> This is an issue that concerns any new technological solution that is supposed to make post-trade processes easier, especially the increasing number of new DLT-based applications.

FinTech activities in this category may also foster the development of market segments that are currently hampered by cumbersome post-trading processes. Although this may be welcome in terms of economic efficiency, it also bears

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<sup>150</sup>ESMA, 'The distributed ledger technology applied to securities markets' (2016) ESMA Discussion Paper <[https://www.esma.europa.eu/sites/default/files/library/2016-773\\_dp\\_dlt.pdf](https://www.esma.europa.eu/sites/default/files/library/2016-773_dp_dlt.pdf)> accessed 22 June 2017.

<sup>151</sup>See WALCH, 'The Bitcoin blockchain as financial market infrastructure: a consideration of operational risk' (2015), 18 NYU Journal of Legislation and Public Policy, 837, <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2579482](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2579482)> accessed 22 June 2017.

the potential to create new pockets of risks in financial markets.<sup>152</sup> Finally, when cross-border transactions take place via clearing and settlement systems that are conducted, for example, on the basis of DLT, it is unclear which jurisdiction's legal framework applies and how it will be enforced.<sup>153</sup>

The above are just a few of the more salient examples of financial stability risks that may be relevant for each economic function. But they serve to illustrate that risks can be broad and complex, and that policy-makers should analyse them carefully for each category before moving to the next stage in the process.

3. The categorisation of a FinTech activity according to its economic function gives policymakers a better understanding of the risks associated with this activity. But when technology-driven financial innovation is approached from a regulatory point of view, it is also necessary to consider the disruptive potential of different innovations. This does not imply that there is anything negative or "bad" about disruptive innovations, or that they should be contained. They simply may have different risk properties in terms of financial stability risk than so-called "sustaining" innovations.

While the term "disruptive" is widely used in relation to FinTech, it is mostly used in a broad and fuzzy sense. Almost all FinTech activities are attributed a certain degree of disruptiveness, but rarely is this general statement followed by an analysis of what makes the FinTech in question disruptive. Hence, it is useful to start by thinking about how to define "disruptiveness". Christensen et al. describe disruption as "... a process whereby a smaller company with fewer resources is able to successfully challenge established incumbent businesses."<sup>154</sup> But when does this happen, and how do we identify innovation that has the potential to be disruptive?

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<sup>152</sup>See ESMA, n54.

<sup>153</sup>Moreover, in most jurisdictions legal certainty regarding DLT and blockchain does not exist yet either.

<sup>154</sup>See CHRISTENSEN, RAYNOR, and McDonald 'What is disruptive innovation?' (2015) Harvard Business Review, <<https://hbr.org/2015/12/what-is-disruptive-innovation>> accessed 22 June 2017.

In his seminal book, Christensen notes that disruptive innovations generally start at the low end of a market by serving customers that are not served by incumbents, either because they have no need for the incumbents' product or service at all, or because it does not serve their needs well. The entrant generally offers a cheaper product that is of poorer quality in terms of the performance metrics that the incumbents' customers value most, but instead offers attributes that are deemed superior by customers outside the incumbents' mainstream market. Disruptors tap into this unserved customer segment and, by continuously improving key attributes of their product, eventually manage to move upmarket and into the mainstream, thus competing directly with incumbents and eventually replacing them.<sup>155</sup> By contrast, most innovations – either by incumbents or by new entrants – which lead to marginal improvements to existing products, and that compete in the mainstream market, are considered “sustaining” innovations by Christensen.<sup>156</sup>

Not all FinTech activities are inherently disruptive. But differentiating between “disruptive” and “sustaining” innovations is useful because, in our view, the implications for financial stability policy are different.

A sustaining financial innovation improves upon a pre-existing product or service. According to Christensen, it competes directly with the incumbent product in the mainstream market and may eventually replace it. However, there are no changes to the market as such. No disruption takes place. Since the entrant merely improves an existing product or service, any possible risks to financial stability, such as incentive problems, externalities, etc., are mostly already covered by existing regulation or can be covered through minor changes to existing regulation.

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<sup>155</sup>See CHRISTENSEN, ‘The innovator’s dilemma – when new technologies cause great firms to fail’ (1997), Harvard Business Review Press, Boston, MA.

<sup>156</sup>See, for instance, CHRISTENSEN, RAYNOR, and MCDONALD, ‘What is disruptive innovation?’, Harvard Business Review, 2015, <https://hbr.org/2015/12/what-is-disruptive-innovation> and CHRISTENSEN, ‘The Innovator’s Dilemma - When New Technologies Cause Great Firms to Fail’, Harvard Business Review Press, 1997, Boston, MA.

A disruptive financial innovation, on the other hand, introduces a new product or service that initially caters for a previously unserved segment of the market. Since it is new and serves a niche, chances are that any potential risks it may pose to financial stability may not be addressed anywhere in the legislation and adjusting existing legislation may not be suitable for this kind of product or service. Legislators may initially ignore it because it serves a small market, and thus possible contagion to other parts of the financial system remains very limited. However, if the innovation disrupts existing markets and the entrants' business grows to replace incumbents, the risks to financial stability may be severe but hard to contain when supervisory authorities lack reliable data and the entrant has taken over the market.

While in practice it is not always possible to draw such a clear line between disruptive and sustaining innovations, Christensen's theoretical framework is still helpful for assessing the true disruptive potential of an innovation and thus its possible impact on financial stability.

Therefore, it seems appropriate to categorise FinTech into sustaining and disruptive activities and to analyse the respective potential degree of risk to the stability of the financial system. In this way, appropriate legal responses can be considered accordingly.

4. At the next stage it should be examined whether the FinTech in question has the potential to disintermediate or decentralise the financial process. Current regulatory frameworks are built around the idea of intermediation. This does not mean that disintermediation is not desirable, but it would potentially require regulatory adjustments – however, so would a network with more intermediation that leads to a decentralised system with more but smaller players. The reasons why it matters for financial stability if a FinTech has the potential to contribute to disintermediation or decentralisation are presented in the following.

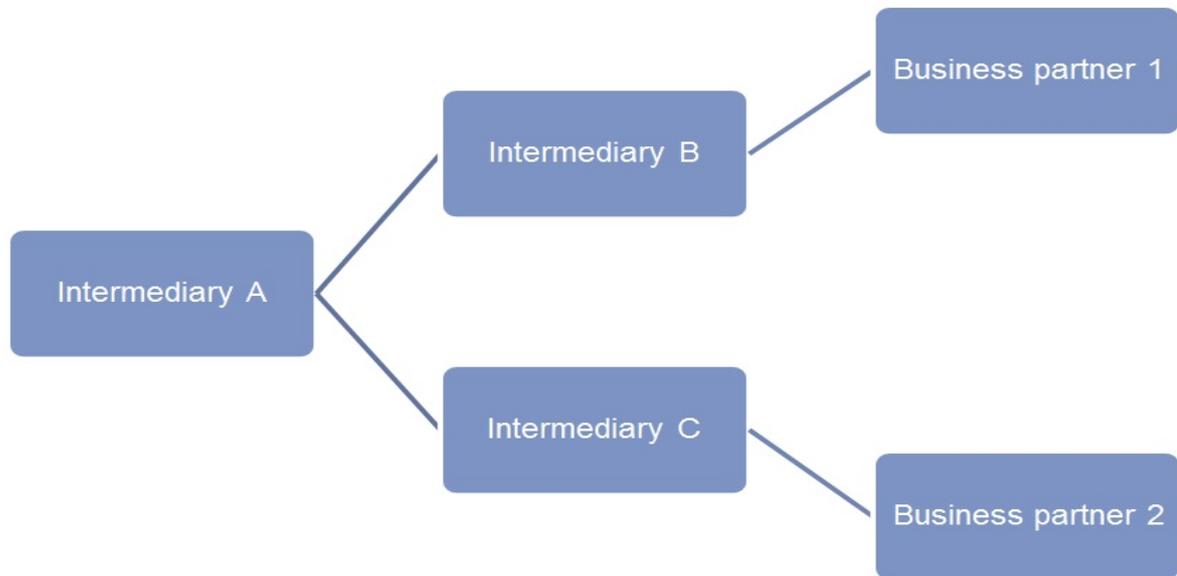
4.1. Banks, brokers, stock exchanges and clearing houses are just some of the institutions which show that intermediation is a fundamental fact of today's financial world. All kinds of financial intermediation are designed to make business easier and more efficient for all the parties involved. It aims to bring trading partners together, overcome information asymmetries and set legal and practical standards for trade and transactions. Moreover, most financial services involve lower transaction costs if they are provided or mediated by a specialised third party as opposed to being done on one's own. Lin names core financial functions like asset aggregation, market making, risk management, and information clearing and states that financial intermediation generally makes them more efficient and less risky.<sup>157</sup> However, a lot of financial intermediation might, from a customer's perspective, be inconvenient or even superfluous. Furthermore, Lin provides evidence that "certain financial intermediaries, because of a focus on fee generation, actually make many transactions less efficient and riskier."

Innovators and entrepreneurs in the financial sector use unmet customers' needs and prevailing inefficiencies to promote new solutions that are aimed at enhancing or even replacing traditional financial intermediary services. Like many other industries, finance has seen a lot of transformation in recent years. New technology and the resulting innovations have made certain services or institutions superfluous or consigned them to the margins. Traditional commercial bank branches are increasingly being replaced by a rising number of online services; internet platforms offer crowdlending or robo-advice; and services like PayPal or Venmo have changed intermediation in payments. This fast and widespread transformation has only just begun and is a popular topic of discussion. When considering what are known as FinTech developments, it is often said that FinTechs generally try to *disrupt and disintermediate* the existing financial networks. Those terms have become buzzwords and are sometimes used in a misleading fashion. True disintermediation is rather rare. It would mean that a FinTech would

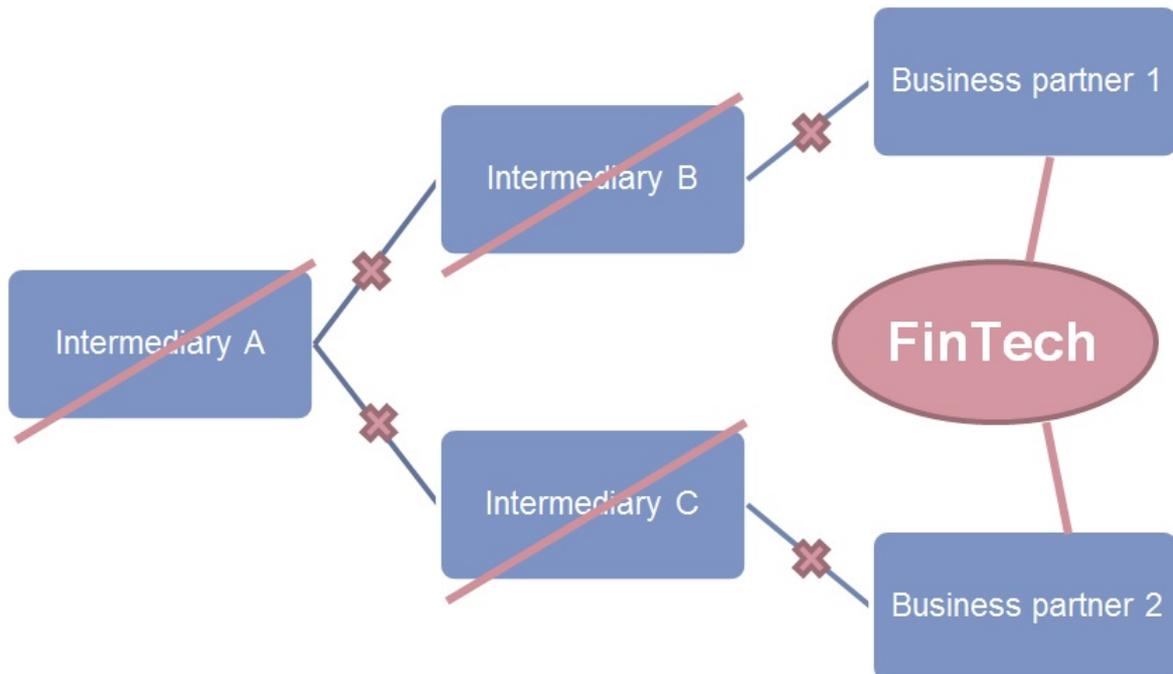
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<sup>157</sup>See LIN, 'Infinite financial intermediation' (2015), Wake Forest Law Review, Vol. 50, 643<[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2711379](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2711379)> accessed 22 June 2017.

not only replace an existing intermediary (or several of them) but would rather make its service and therefore its existence superfluous (see figure 1).



a) *Intermediaries involved in a transaction between two business partners*



b) *Disintermediation via the introduction of a FinTech*

**Figure 1: True disintermediation caused by a FinTech**

A technology that was designed to challenge intermediation in such a way is DLT or blockchain technology. When Nakamoto published his influential article on Bitcoin, he introduced it as a “purely peer-to-peer version of electronic cash”, one that does not need an intermediary or central authority but is instead validated by the network itself – the blockchain.<sup>158</sup> The cryptocurrency Bitcoin has been the topic of critical debate, and its potential to replace regular currencies has been questioned by numerous experts. The same experts do, however, admit that the underlying blockchain technology has a great deal of potential.<sup>159</sup> The fact that, by design, a public blockchain does not need an intermediary because participants derive validation and trust from the technology itself, challenges the existence of banks and other traditional intermediaries in today’s financial system. However, the downsides of public blockchains, such as a lack of privacy<sup>160</sup> or irreversibility, are stopping some market participants from getting overexcited. Private blockchains and distributed ledger solutions try to overcome these disadvantages in order to reap the benefits of a technology that seems to offer significant efficiency gains in the long run. The challenge, however, is to make blockchain-based systems compliant with existing regulation, compatible with traditional systems, and still beneficial in terms of efficiency gains.

In the event of such real disintermediation, regulators have to check whether the applicable rules for the process in question still fit the new reality and, moreover, regulation has to contain procedures that capture every new risk that may emerge. Possible questions which might arise in that context are whether the FinTech is able to provide the same quality of service, is capable of conducting an appropriate risk management and maintaining a secure infrastructure, or what the role of the intermediary was beforehand, especially with regard

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<sup>158</sup>See NAKAMOTO, ‘Bitcoin: A Peer-to-Peer Electronic Cash System’ (2008) <<https://bitcoin.org/bitcoin.pdf>> accessed 22 June 2017.

<sup>159</sup>See, for example, BUITENHEK, ‘Understanding and Applying Blockchain Technology in Banking: Evolution or Revolution?’ (2016) 1(2) *Journal of Digital Banking*, Vol 1(2), p. 111ff.

<sup>160</sup>Although Bitcoin, for example, is frequently used by criminals because its use of the blockchain technology guarantees anonymity, when it is applied to a narrow market, it is possible to set up the system such that distributed ledgers can be seen by everyone, which allows certain transactions to be retraced and therefore creates a lack of privacy.

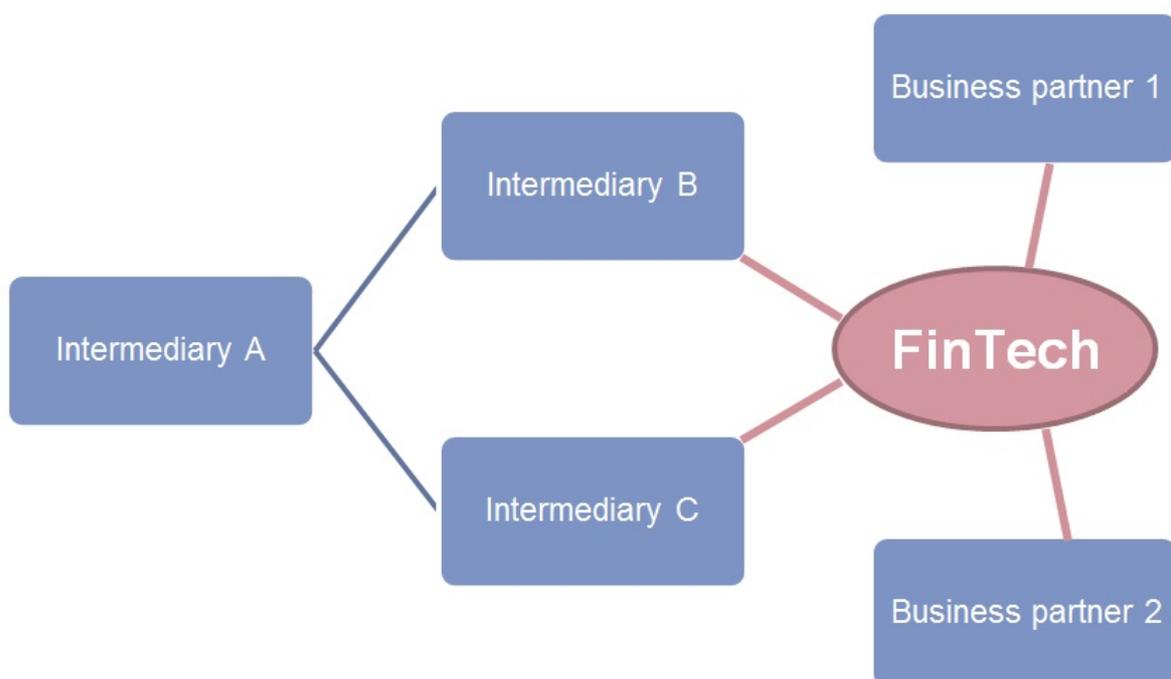
to its relevance for financial stability. In the case of DLT or other highly sophisticated technologies, it is important for regulatory authorities to keep track of developments in these fields. Blockchain technology, for example, could become a game changer for financial intermediation, and it is therefore crucial to supervise it from a financial stability perspective. The nature of questions that have to be asked and the analytical strategies that are applied are vital for any assessment of the regulation's appropriateness and might significantly differ from the questions and strategies that are considered when no disintermediation takes place. A classification of FinTechs according to this characteristic is therefore valuable and adds clarity to the discussion about regulating technology-enabled financial innovation.

4.2. The term disintermediation implies the breakup of traditional ties in finance by circumventing intermediation. The first part is evident in most cases: traditional networks and ties are indeed shaken up. However, the second part is not so clear. Despite all the revolution and potential disruption FinTechs might entail, intermediation is likely to remain a vital part of finance. What can be observed is a tendency to shift from a single-source financial service provider to a broad range of specialised companies that aim to offer their services in a faster and cheaper manner in a digital environment. That means that traditional banks' business models of providing all kinds of financial services to its customers are challenged by innovations such as having one's account with an online bank, using specialised services to conduct cross-border payments, obtaining an investment proposal from a robo-adviser and taking out a loan via crowdlending. Although the latter sounds more cumbersome, it is generally more convenient for the generation of "digital natives", especially since these specialised FinTech solutions often work in a kind of symbiosis where they support each other or are accessible through the same channels and devices. Thus, the word disintermediation is used when what we see is in fact some sort of decentralisation – banks' position in the centre of finance is beginning to erode. This might sound somewhat dramatic, and

one might argue that banks are still (and will be years and decades to come) the most important players in the world of finance. However, the tendency towards a more heterogeneous system is observable and decentralisation does not necessarily mean the end of intermediation. That is because true disintermediation, as described above, where ties in the financial network are eliminated, is barely happening. In fact, the rise of FinTechs has, if anything, strengthened intermediation through substitution and what is called “layering”. Lin describes Apple Pay as a prominent example of layering:

*“While the outward-facing technology of Apple Pay appears incredibly simple and convenient, it has not simplified the credit card transaction process. Instead of eliminating a link in that highly intermediated process, Apple Pay has added another layer of intermediation – Apple – into that process.”*

It shows that many innovative solutions in finance actually create additional intermediation. Even if they tried to eliminate certain nodes within the network, the inherent interconnected nature of finance and the given market and legal structures might force them to obey the rules and thus cooperate with established intermediaries.<sup>161</sup>



<sup>161</sup>See JUDGE ‘Fee effects’ (2013) 98(5) Iowa Law Review, Vol. 98(5), p. 1517.

## **Figure 2: Layering leads to decentralisation in the financial system**

Figure 2 shows how a FinTech adds another layer to the scenario of the intermediated transaction between two business partners. For the end-customer, it appears as if the FinTech is facilitating direct interaction with the respective business partner (peer-to-peer), while in fact the same intermediated processes are still happening in the background.

The era of FinTech will most likely not cause broad disintermediation in the true sense of the word. Most of today's financial innovations serve the core purposes of financial intermediation, yet in new ways that are easier and more convenient for businesses and consumers alike. The fact that finance and financial services are moving closer to the customer often creates a sense that financial transactions are becoming more direct. Using one's phone for transactions which one used to need to see a bank clerk for leads one to believe that the middle man has been eliminated. That perception, however, disregards the processes that are still happening in the background – the complex layers of financial intermediation which FinTechs are a part of.

In the future we might see a financial system that is indeed disintermediated from traditional banks, but which has, in exchange, gained additional players who replace their services. It creates a heterogeneous network which Lin thinks could develop into “the ultimate intermediary”. Considering financial stability, this could have important implications: a more decentralised system implies a lower risk of certain players becoming “too big to fail” – however, in such a network every link would become more important and therefore risks of being “too linked to fail” may arise.<sup>162</sup> It is very important to look in greater detail at any FinTech that contributes to such a scenario because it involves a different set of regulatory questions that need to be dealt with. Therefore, at the third stage of our filtering process we recommend examining whether the FinTech in question has 1) any po-

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<sup>162</sup>See Lin, T. C. W. (2013): “The New Investor”, *UCLA Law Review*, Vol. 678, p. 699.

tential to disintermediate and/or 2) contributes to decentralisation or layering within the financial system.

5. A number of technological innovations with potentially transformative implications for the financial system, its intermediaries and users are now receiving close attention from international standard setters and regulators. The Financial Stability Board is evaluating the potential financial stability implications of emerging financial technology innovation for the financial system as a whole<sup>163</sup>. The Bank for International Settlements is also working to better understand the potential impact of operational disruption to core financial institutions or infrastructure on financial stability<sup>164</sup>.

Work has also been undertaken by regulators operating in FinTech hubs such as Singapore and London. Regulators in the United Kingdom have recently proposed new approaches to facilitate connectivity in financial services, while attempting to mitigate the associated risks. Examples are the FCA's Regulatory Sandbox<sup>165</sup> and UK Competition & Markets Authority policies<sup>166</sup>. The European Union is developing its own regulatory response and package of measures to pursue the creation of a Capital Markets Union<sup>167</sup>. On 23 March 2017 the European

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<sup>163</sup>See, i.e., letter from CARNEY, Chairman of FSB, to G20 Finance Ministers (22 February 2016) <<http://www.fsb.org/wp-content/uploads/FSB-Chair-letter-to-G20-Ministers-and-Governors-February-2016.pdf>> accessed 22 June 2017; FSB, 'FinTech Credit: Market Structure, Business Models and Financial Stability Implications' (2017) <[http://www.bis.org/publ/cgfs\\_fsb1.htm](http://www.bis.org/publ/cgfs_fsb1.htm)> accessed 22 June 2017.

<sup>164</sup>See, i.e., Bank for International Settlements, Committee on Payments and Markets Infrastructures, 'Distributed Ledger Technology in payment, clearing and settlement. An analytical framework' (2017) <<http://www.bis.org/cpmi/publ/d157.htm>> accessed 22 June 2017.

<sup>165</sup>Financial Conduct Authority, 'Regulatory sandbox' (2017) <[www.fca.org.uk/firms/regulatory-sandbox](http://www.fca.org.uk/firms/regulatory-sandbox)> accessed 22 June 2017.

<sup>166</sup>See UK Competition & Markets Authority, 'Retail Banking Market Investigation: Final Report' (2016).

<sup>167</sup>European Commission, 'Capital Markets Union: an Action Plan to boost business funding and investment financing' (Press Release, 30 September 2015); European Commission, 'Communication from the Commission on the Mid-Term review of the Capital Markets Union Action Plan' COM (2017) 292 final.

Commission published a Consultation Document on Fintech<sup>168</sup>, which solicited opinions on consumer awareness and protection and supervisory convergence<sup>169</sup>.

Against this backdrop, the filtering process aims at identifying and assessing the risks to the regulator's objectives that are posed by technology-enabled financial innovation, and to address those using the various regulatory strategies and tools, if need be, that they possess.

Having applied the filter, we now have a risk profile for a FinTech that shows us the main financial stability risks which may emanate from it, in terms of both its activities and whether it disrupts, disintermediates, decentralises or adds a layer. This risk profile provides a base for determining how to proceed in terms of policy. Policymakers have three options:

*1) Take no action*

If the FinTech's risk profile does not show any risks at all that are not currently covered by the existing regulatory perimeter, no action is necessary on the part of policymakers. It may also be the case that the risk profile identifies only a few risks which the policymaker deems to be of minor significance. In this case, the policymaker may also decide not to take any action.

*2) Monitor*

A more likely response in case any risks are identified which are not yet adequately addressed by existing regulation may be to monitor the activity or sector in question. Even when risks are considered to be of minor importance by the policymaker, they may evolve as the sector or activity develops and grows in volume and importance. Therefore, establishing a monitoring system to keep track of

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<sup>168</sup>European Commission, 'Fintech - A more competitive and innovative European Sector' (Consultation document, 23 March 2017) <[https://ec.europa.eu/info/sites/info/files/2017-fintech-consultation-document\\_en\\_0.pdf](https://ec.europa.eu/info/sites/info/files/2017-fintech-consultation-document_en_0.pdf)> accessed 22 June 2017.

<sup>169</sup>See the reaction by the European Banking Authority, 'EBA response to the EC Consultation Document on Fintech: a more competitive and innovative European Financial Sector' (15 June 2017) <<http://www.eba.europa.eu/documents/10180/187341/EBA+response+to+the+European+Commission+Consultation+Document+on+FinTech+-+June+2017.pdf>> accessed 22 June 2017.

all risks, even when they are minor, will help policy-makers to develop a better understanding of the sector in question and its evolution as well as its attendant risks. This will help them in the future to determine whether regulatory action may be appropriate or even necessary.

But even if the FinTech's risk profile shows more significant risks, or if its business model or activities are so new and innovative that they fall partially, mostly or completely outside the regulatory perimeter, policymakers and legislators may choose to refrain from initiating regulatory action and instead establish a monitoring system first in order to better understand the sector and its risks. Based on the results of regular monitoring, they may then decide to take action at a later stage. Monitoring is especially important when the FinTech is deemed to be potentially disruptive or it decentralises and/or disintermediates.

### *3) Regulate*

If risks identified during the filtering process are deemed to be significant, especially if the FinTech has the potential to be disruptive or to disintermediate or decentralise, the policymaker may decide that regulatory action is warranted without establishing a monitoring system first. This could also be the case if the FinTech company in question has a business model or product or provides a service that is so new and innovative that it is mostly or completely unregulated<sup>170</sup>. But even if the risks identified are only minor, there may be reasons for policy-makers to take regulatory action immediately without establishing a monitoring system first. Such reasons are discussed in further detail in section 5.1.

However, a monitoring system does not necessarily have to be established before regulatory action is taken; regulation and monitoring can also be estab-

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<sup>170</sup>This varies greatly from jurisdiction to jurisdiction; e.g. cryptocurrencies are regulated in the US under inter alia the Security Act 1933 and Commodity Exchange Act 1936, whereas in Denmark, cryptocurrencies are not found to be encompassed by the existing financial regulation, see Danish Financial Supervisory Authority, 'Warning against Solomon-Layb' (17 December 2013) <[www.finanstilsynet.dk/da/Nyheder-og-Presse/Pressemeddelelser/Arkiv/Presse-2013/Advarsel-mod-virtuelle-valutaer-bitcom-mfl-2013](http://www.finanstilsynet.dk/da/Nyheder-og-Presse/Pressemeddelelser/Arkiv/Presse-2013/Advarsel-mod-virtuelle-valutaer-bitcom-mfl-2013)> accessed 22 June 2017.

lished in tandem. This allows policymakers to keep track of market developments while addressing potential risks as early as possible.

If policymakers decide that option 2) (monitoring) or 3) (regulatory response) are appropriate, it is necessary to consider the attendant trade-offs that this decision involves. In general, policymakers face three important questions that precede any type of regulatory response. These questions are: when to regulate, how to regulate, and at what level to regulate. We will now discuss each of these questions and their inherent trade-offs in greater detail.

5.1. The first question that policymakers have to consider when they deliberate regulatory action is the question of the temporal dimension. At what stage of a specific FinTech sector's development should policymakers take action? Taking action as long as the sector in question is still in its infancy and thus only a niche market has its merits. Early regulatory action will eliminate potential regulatory uncertainty from the FinTechs' point of view, since they will know early on what regulatory requirements they have to fulfil and do not have to worry about suddenly facing regulatory requirements later on in their products' or business models' lifecycle when their way of doing business has become entrenched. Once the sector in question has grown, policymakers may face significant resistance in bringing the sector within the regulatory perimeter and imposing new requirements. On the other hand, policymakers have to bear in mind that introducing regulatory requirements for a nascent industry may act as a barrier to entry and hinder the development of that particular market.

#### *Precautionary vs reactive policy action*

As described above, policymakers have to weigh different considerations and trade-offs when deciding on taking action. One is the level of uncertainty surrounding the regulatory response, since policymakers do not know *ex ante* how a technology-driven financial innovation will evolve and which risks it may pose in the future. Many FinTechs' products and business models may increase efficiency

and consumer welfare, but it is unclear whether they will grow beyond serving a niche market and how they may fare in a downturn. Additionally, in an environment of uncertainty, concepts such as “risk-based regulation” might be difficult to implement.<sup>171</sup>

In this setting, policymakers have to weigh the benefits and drawbacks of taking precautionary action vs acting reactively, i.e. in response to a problem or situation. Both concepts have their respective merits. As discussed above, precautionary regulation may act as a hindrance to industry development, while acting reactively may breed legal uncertainty for the FinTech companies, since rules could well be adapted to new situations in a changeable and unsettled environment, and may therefore run into resistance on the companies’ part. Thus, there is substantial discretion for policymakers. Early and comprehensive monitoring can provide a base for the regulatory decision, but it remains difficult to identify the optimal timing to take regulatory action.

The introduction of materiality thresholds appears to offer a solution; however, this may result in regulatory arbitrage since it creates an incentive to circumvent the regulatory perimeter. Additionally, it provides a disincentive for firms to grow beyond the thresholds in order to avoid becoming subject to the regulation in question.<sup>172</sup>

In general, precautionary legislation may particularly have its merits when an innovation is deemed potentially disruptive. In such a setting, and particularly when policymakers assess the innovation as being disintermediating and/or decentralising in addition to its disruptive potential, early regulatory action may be advisable.

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<sup>171</sup>See BLACK, ‘Paradoxes and failures: ‘new governance’ techniques and the financial crisis’ (2012) 75(6) *The Modern Law Review* 75(6), 2012, 1053.

<sup>172</sup>For instance GOURIO and ROYS, ‘Size-dependent regulations, firm size distribution, and reallocation’ (2014) 5 *Quantitative Economics*, 377–416, <<http://onlinelibrary.wiley.com/doi/10.3982/QE338/pdf>> accessed 22 June 2017; N. Guner, G. Ventura, and Y. Xu, ‘Macroeconomic Implications of Size-Dependent Policies’ (2008) and 11(4) *Review of Economic Dynamics*, 721–744; GARCÍA-SANTANA and PIJOAN-MAS, ‘Small scale reservation laws and the misallocation of talent’ (2011) CEPR Discussion Paper No. 8242 (suggested that size-dependent policies have a large negative impact on total factor productivity since productive firms have less incentive to grow).

### *Reliability vs responsiveness*

Another trade-off policymakers face when deciding when to take regulatory action is the question of regulatory stability vs responsiveness. Regulators have to define how frequently they adapt the regulatory framework as a result of the emergence of new financial innovations. Regulatory regimes are usually based on the financial system architecture in place at the time the legal framework enters into force.<sup>173</sup> The regulation in place for incumbent market participants, however, may pose entry barriers<sup>174</sup> for potential new competitors, may not cover new business models and activities, or may simply be unsuitable for some new entrants.

Thus, a dynamic financial sector that brings forth a multitude of financial innovations – be they technology-driven ones or traditional ones – may require an equally dynamic, responsive regulatory policy. On the other hand, businesses need legal certainty and a stable regulatory environment in order to thrive. Frequent modifications of the regulatory approach and scope will decrease predictability and increase transition costs, possibly impairing long-term planning and investment in the regulated industry.<sup>175</sup>

A first consideration for policymakers on this question may be whether they are mainly facing technology-driven financial innovations that can be characterised as sustaining. If this is the case, regulatory stability may be the strategy of choice. Since it is likely that only minor adjustments to the regulatory framework will be required, they may be made whenever the time seems convenient. On the other hand, for potentially disruptive innovations, it may be useful to take regulatory action early on while the business is still serving a niche market. In this manner, the FinTech has legal certainty about what requirements it will have to com-

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<sup>173</sup>See S. L. Schwarcz, 'The Functional Regulation of Finance, Finance' (2014) 2-3, <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2437544](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2437544)> accessed 22 June 2017,

<sup>174</sup>However, for the purposes of financial stability, entry barriers that were deliberately established to contain systemic risk should not be seen as problematic as long as they are technology-neutral (see below).

<sup>175</sup>See BALDWIN, 'Regulatory stability and the challenges of re-regulating.: A CERRE study' (Centre on Regulation in Europe, 2013, 7) <[http://cerre.eu/sites/cerre/files/130204\\_CERRE\\_Study\\_Stability\\_Final.pdf](http://cerre.eu/sites/cerre/files/130204_CERRE_Study_Stability_Final.pdf)> accessed 22 June 2017.

ply with, and policymakers may avoid facing substantial resistance when they try to introduce legislation once the FinTech has already reached a significant size and market power.

Policymakers thus have to weigh different considerations when deciding on when to take regulatory action. But the timing is only one aspect in a sequence of considerations that need to be taken into account when policymakers contemplate the introduction of new rules or adjusting the existing regulation.

5.2. In addition to policymakers having to decide when to adjust the regulatory framework, it is important to consider what form this intervention should take. Much like the matter of timing, the question of the kind of regulatory intervention that is to be introduced involves trade-offs that the policymaker has to carefully weigh against each other.

In the following, we outline three major regulatory trade-offs that have to be considered: 1) principles vs rules; 2) function vs entity; and 3) one size fits all vs tailor-made.

#### *Principles-based vs rules-based regulation*

The first trade-off concerns the dialectic between principles-based and rules-based approaches. In its simplest form, a principles-based approach sets out general objectives to be achieved while leaving the choice of form and methods for achieving these objectives to firms. A rules-based regulatory regime, by contrast, prescribes detailed individual rules, laying down the precise conduct firms are required to adopt.

The principles vs rules trade-off represents one of the most enduring dialectics in all of legal thought in terms of determining the optimal legal strategy for achieving regulatory goals.<sup>176</sup> In that respect, legal and economic scholars alike have attempted to differentiate between rules and principles on the basis of *inter*

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<sup>176</sup>See inter alia AWREY, 'Regulating financial innovation: a more principles-based alternative?' (2010) 5(2) Brooklyn Journal of Corporate, Financial and Commercial Law, 273-315.

*alia* their general or specific style,<sup>177</sup> their temporal orientation,<sup>178</sup> the degree of discretion which they confer upon regulated actors,<sup>179</sup> and the position they occupy within the hierarchy of norms.<sup>180</sup>

The largely binary nature of this debate is likely to misrepresent the fact that, in reality, rules and principles are “endpoints of a spectrum”.<sup>181</sup> However, they are still quite useful – despite the simplification – for describing the advantages and disadvantages of the two extreme approaches and then to set a hybrid regulatory response accordingly.

A rules-based approach aims to increase certainty and predictability, for regulators and regulated entities alike. For the former, it ensures that a clear objective has been set to be achieved; for the latter, it is easier to estimate the compliance costs.

On the other hand, principles-based regulation moves from a relationship in which regulators instruct and the regulated entities comply to one in which regulators communicate their goals and expectations, and regulated entities are expected to adopt processes and practices that ensure that these goals are substantively met.

For regulated entities, principles-based regulation can provide flexibility, facilitate innovation and thus enhance competitiveness. Principles-based regulation can be beneficial for regulators, too: it can provide them with flexibility, facilitate regulatory innovation in the methods of supervision adopted; enable the regula-

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<sup>177</sup>See CUNNINGHAM, ‘A prescription to retire the rhetoric of “principles-based systems” in corporate law, securities regulation, and accounting’ (2007) 60 *Vanderbilt Law Review*, 1411-1419.

<sup>178</sup>See KAPLOW, ‘Rules versus standards: an economic analysis’ (1992) 42 *Duke Law Journal* pp. 565–67; SCHAUER, ‘The tyranny of choice and the rulification of standards’ (2005) 14 *Journal of Contemporary Legal Issues*, 803–04.

<sup>179</sup>See NELSON, ‘Behavioral evidence on the effects of principles- and rules-based standards’ (2003), 17 *Acct. Rev.* 91.

<sup>180</sup>See Sunstein, ‘Problems with rules’ (1995), 83:(4) *Cal. L. Rev.*, 953-966.

<sup>181</sup>See Korobkin, ‘Behavioral analysis and legal form: rules vs. standards revisited’ (2000) 79 *Oregon Law Review*, 23-26.

tory regime to have some durability in a rapidly changing market environment; and enhance regulatory competitiveness.<sup>182</sup>

A key benefit of principles-based regulation is that it can potentially be applied to a sector that is undergoing rapid change without regularly adapting the regulatory framework itself. That makes it very suitable especially for FinTechs that are potentially disruptive or that disintermediate or decentralise. However, principles-based regulation is very demanding in that it requires both regular interaction between the regulator and the regulated institutions and a great deal of trust between them.<sup>183</sup> Furthermore, the principles chosen have to be specific enough to be operationalised by regulated entities.

Lately, the dialectic “rules versus principles” has been pushed forward and recast in terms of the transaction and social costs stemming from 1) the generation of legal norms, 2) their subsequent application by decision-makers, and 3) the resulting incentive effects on those subject to their application.<sup>184</sup>

If we take this perspective, the generation of detailed rules will typically result in greater ex ante transaction costs attributable to the time and effort expended by drafters in order to articulate the empirical substance of triggers and to match this trigger with the appropriate legal response<sup>185</sup>.

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<sup>182</sup>See BLACK, ‘Forms and paradoxes of principles based regulation’ (2008) LSE Law, Society and Economy Working Papers 13/2008. The FSA itself puts forward cogent reasons for adopting PBR which accord with the advantages of principles often noted in academic commentaries. It offers four main reasons for adopting a more principles-based approach. First, effectiveness: detailed rules, it argues, have been incapable of preventing misconduct in a range of areas, such as the misselling of retail financial products. Second, durability: regulation that has a focus on outcomes is better able to adapt to a rapidly changing market environment than one which is based on prescriptive rules. Third, accessibility: principles are far more accessible to senior management and smaller firms in particular others than a bewildering mass of detailed requirements. Fourth: fostering substantive compliance: a large volume of detailed provisions can divert attention towards adhering to the letter rather than the spirit of the rules, making it less likely that the FSA will achieve its regulatory objectives.

<sup>183</sup>See BLACK (2012), Paradoxes and Failures: ‘New Governance’ Techniques and the Financial Crisis, *The Modern Law Review* 75(6), p 1045.

<sup>184</sup>See Awrey, *Regulating Financial Innovation: A More Principles-Based Alternative?* 5:2 *Brooklyn Journal of Corporate, Financial and Commercial Law* 273-315 (2010).

<sup>185</sup>See KOROBKIN, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited*, 79 *OR. L. REV.* 23, 26 (2000).

### *Regulation by function vs regulation by entity*

Historically, banking regulation has generally been based on the principle of “regulation by entity”, which means that the regulatory framework's applicability is tied to the institution that is to be regulated – especially banks that have been granted an official authorisation to perform banking business. The “regulation by function” approach, on the other hand, is centred on the economic function fulfilled by an institution or market. This approach can be more efficient for governing dynamic markets as it focuses on economic functions, which tend to exhibit less variation over time.<sup>186</sup> Entity-based regulatory approaches are useful to better identify the object of regulation, whereas a function-based approach is more promising for the purpose of adapting regulation to unknown challenges to financial stability.

The vast variety of financial instruments, institutions, and activities involved in FinTech may challenge the classic categorisation by entities. Furthermore, searching for an all-encompassing regulation by entities might prove to be a futile endeavour. As discussed in section 2, FinTechs are very heterogeneous and evolving fast. Thus, a FinTech company should tend to be defined in terms of the purpose for which it runs its business – that is, by looking at the economic function it performs – especially if FinTechs’ potential contribution to systemic risk is the standpoint of analysis.

If the purpose of regulating FinTech is to cope with systemic risk, the regulatory strategy should be linked as far as possible to the structural changes the financial market is undergoing.<sup>187</sup> In that respect, a “regulation by function” approach could pay off in terms of adaptability in a dynamic environment. This is particularly relevant in the light of current, FinTech-driven trends. However, as previous studies have already pointed out, the material implementation of a

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<sup>186</sup>See SCHWARCZ (16 June 2014), *The Functional Regulation of Finance*, p 4, URL: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2437544](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2437544) .

<sup>187</sup>See HANSEN, ‘Challenges in identifying and measuring systemic risk’ in M. Brunnermeier and A. Krishnamurthy (eds.) *Risk topography: systemic risk and macro modeling* (NBER Macroeconomics Annual 2011, Vol. 26, University of Chicago Press, 2014).

“regulation by function” approach might prove technically challenging and it usually requires cooperation among several regulatory authorities.<sup>188</sup> In addition, a “regulation by function” approach crucially depends on the possibility of identifying the relevant economic functions.<sup>189</sup> In that regard, such a distinction is consistent with the categorisation provided in step 1 of the filter model (see section 2).

### *One size fits all vs tailor-made regulation*

When confronted with the emergence of innovation, existing regulation can either be uniformly applied to the sector, products or entities in question, or a special regulatory regime can be established. A tailor-made regulatory regime for FinTechs would notably create the risk of sectoral regulatory arbitrage via an artificial fragmentation between established financial institutions and FinTech companies.<sup>190</sup> For a technology-neutral regulator, special regulation for technological innovations should only be considered if the innovations concerned have different risk properties that justify special treatment.<sup>191</sup> The spread of new processes, disintegrated value chains and altered consumer behaviour on the back of technological innovation may engender completely new risks that were not foreseen by the existing regulatory framework. For instance, technological innovation might cause local shocks to spread more rapidly through the system.<sup>192</sup> Therefore, identifying the specific risks pertaining to specific FinTech entities or activities via

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<sup>188</sup>See PHILIPPON ‘The FinTech opportunity’ (2016) NBER Working Paper No. 22476, 14 <<http://www.nber.org/papers/w22476>> accessed 22 June 2017

<sup>189</sup>See, for instance, WILSON and CAMPBELL, Financial functional analysis: a conceptual framework for understanding the changing financial system, (2016) 23(4) Journal of Economic Methodology, 413-431, MERTON and BODIE, ‘A conceptual framework for analyzing the financial environment’, in Crane, Froot, Mason, Perold, Merton, Bodie, SIRRI and TUFANO (eds.), ‘The global financial system, a functional perspective’, 1995, Boston: Harvard Business School Press: 3–31.

<sup>190</sup>See DAROLLES ‘The rise of FinTechs and their regulation’ (2016) 20 Banque de France Financial Stability Review, 90.

<sup>191</sup>See DOMBRET ‘Herausforderung Digitalisierung in Banken und Sparkassen – Investition in die Zukunft’ (Keynote speech at the fifth DVFA FinTech Forum, <[http://www.bundesbank.de/Redaktion/DE/Reden/2016/2016\\_10\\_10\\_dombret.html?startpageId=StartseiteDE&startpageAreaId=Teaserbereich&startpageLinkName=2016\\_10\\_10\\_dombret+380406](http://www.bundesbank.de/Redaktion/DE/Reden/2016/2016_10_10_dombret.html?startpageId=StartseiteDE&startpageAreaId=Teaserbereich&startpageLinkName=2016_10_10_dombret+380406)> accessed 22 June 2017.

<sup>192</sup>See SCHWARCZ (16 June 2014), The Functional Regulation of Finance, URL: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2437544](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2437544), p 31.

their economic function is a vital first step towards determining whether there are any risks that require tailor-made legislation.

5.3. At the third stage, there is the question of “where to regulate”. Much like in the preceding stages, decisions have to be made and their appropriateness depends on the features of the FinTech in question and its respective risk profile. At this stage, these decisions are concerned with whether the legal response has to be developed as an exclusively national approach or whether it requires international efforts or at least cross-border agreements.

Given the globally interconnected financial markets and the growing relevance of FinTechs, there might be a need for international coordination to contain any potential for cross-border regulatory arbitrage and negative spill-overs. In cases where technological innovation further facilitates the cross-border provision of services, an exclusively national regulatory approach is likely to be ineffective as long as it remains uncoordinated with potentially different frameworks in other affected jurisdictions.

Different regulatory stances towards FinTechs within the EU contribute to the fact that special FinTech regulation, where it already exists, rarely takes the cross-border provision of services into account.<sup>193</sup> Competition between regulators can – in theory – lead to welfare gains by efficiently adapting regulatory stringency to the preferences of each jurisdiction but, in the presence of cross-border service provision, it can also result in negative spill-overs, regulatory arbitrage and a regulatory race to the bottom.<sup>194</sup> Standard-setting at the

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<sup>193</sup>The Monopolies Commission ‘XXI Biennial Report, Chapter V’ (2016), 66<[http://www.monopolkommission.de/images/HG21/HGXXI\\_Chapter\\_V.pdf](http://www.monopolkommission.de/images/HG21/HGXXI_Chapter_V.pdf)> accessed 22 June 2017.

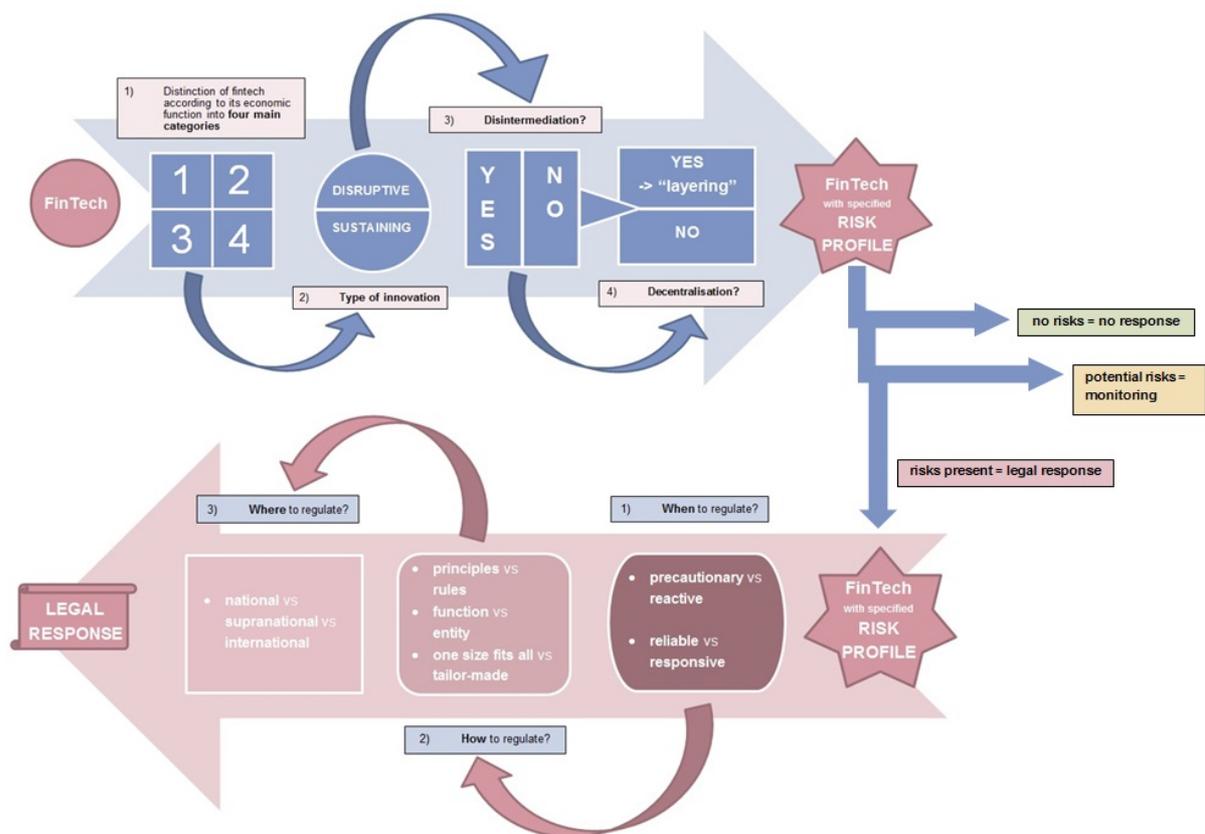
<sup>194</sup>See, for example, ACHARYA ‘Is the international convergence of capital adequacy regulation desirable?’ (2003) 58(6) *The Journal of Finance*, 2745-2781 (for cross-border competition of banking supervisors in a regime of harmonised capital regulation); CHOI and GUZMAN ‘National laws, international money: regulation in a global capital market’ (1997) 65(5) *Fordham Law Review* 65(5), pp, 1855-1908 (for competition of securities regulators); OATES and SCHWAB ‘Economic competition among jurisdictions enhancing or distortion inducing?’ (1988) 35 *Journal of Public Economics*, 333-354 (for competition in public finance and environmental regulation).

international level might therefore contribute to creating a level playing field and reduce systemic risk in cases of cross-border services.

However, international or supranational coordination requires the political will of all the affected jurisdictions and more time and negotiations than drafting a national legal response. The resources and transaction costs are only worth investing if the risk profile of the FinTech in question requires it, i.e. risks stemming from cross-border activities were identified in step one. In fact, some FinTechs might operate solely within a single jurisdiction and are unlikely to expand their business across borders. A national regulatory strategy would then be more effective and cheaper since it would come with fewer compromises and lower transaction costs.

To handle the trade-off in question between harmonising different national regulatory approaches and minimising transaction costs, the competent authorities are required to have a good understanding of the risk profile and cross-border reach of the FinTech in question. A clearer distinction between different FinTechs and a precise identification of their financial stability risks is therefore once more required.

Once these trade-offs have been considered and appropriate decisions have been made, the legislator will be in a position to implement a legal response that can tackle the financial stability risks deriving from the FinTech in question without hampering its – or the entire industry's – development and positive impact on general economic welfare. Thus, we see how our filtering approach is able to lead policymakers and regulatory bodies from a simple awareness of the appearance of a potentially impactful FinTech that is not yet properly described to finding a legal response in case one is needed.



**Figure 3: Identifying FinTech risks and establishing the appropriate legal response**

Figure 3 shows what has been discussed so far in this paper. In a first step, it is important to distinguish the many different FinTechs from each other, examine their features and clearly define their risk profile. We proposed to do so by way of the described four-stage approach. Once a FinTech has been sufficiently analysed and described, the resulting risk profile permits an assessment of whether, and if so, what type of action is needed. This action can then be either the establishment or continuation of monitoring or a concrete legal response in the sense of adjusting existing regulation or introducing new rules. For the latter case, we described which general trade-offs underpin the process of designing regulation which need to be dealt with in order to implement an appropriate and sound legal response.

6. The evolution of financial innovation looks set to have a severe impact on the basic infrastructure for financial services. The industry itself – as a nexus of

parties – is undergoing structural changes due to the advent of a new era of technology-enabled financial innovation and market players. This transition generates financial stability concerns and a host of pressing regulatory challenges.

This paper develops a theoretical framework for advancing the intellectual and policy debate surrounding such concerns and challenges. In doing so, it aims to capture and clarify some essential characteristics of FinTech and to use them as filters in a four-stage process that helps to inform the regulatory response. The filtering process helps to disentangle and better identify the potential financial stability implications that the FinTech under examination may pose. By assigning a risk profile, the framework thus eventually facilitates regulatory engagement with financial innovation, making it easier for policymakers and legislators to evaluate different strategies and determine the appropriate response.

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

Martin Berkeley \*\* - Andrea Miglionico \*\*\*

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

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

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

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

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

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

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

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<sup>1</sup>See SCHILLER, *The Subprime Solution* (Princeton University Press 2008) 87-88.

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

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

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

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

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

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

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<sup>5</sup>See THAL LARSEN and HUGHES, 'Sants signals more muscular regulatory era', *Financial Times*, 13 March 2009, 19.

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

<sup>7</sup>See PAULSON, 'Reform the architecture of regulation', *Financial Times*, 18 March 2009, 13.

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

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

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

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

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<sup>9</sup>Communication from the Commission to the European Parliament and the Council. A Roadmap Towards a Banking Union COM(2012) 510 final.

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

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

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

<sup>13</sup>The Economist, 'Bolting the stable door', 21<sup>st</sup> March 2009, 35.

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

<sup>15</sup>FSA, 'Treating Customers Fairly: Towards Fair Outcomes for Consumers', July 2006.

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

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

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<sup>16</sup>E.F. Gerding, ‘Code, Crash, and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis’ (2009) 84(2) *Washington Law Review*, 132-133.

<sup>17</sup>FSA, ‘Principles Based Regulation: Focusing on the Outcomes that Matter’, April 2007.

<sup>18</sup>The single banking license was introduced by the Second Banking Directive (89/646/EEC) to provide access to EU financial institutions to do business with each other. In this way, credit institutions which are authorized to operate in any Member State are allowed to establish branches and to provide cross-border services throughout the community on the basis of the principle of home country supervision.

<sup>19</sup>Mutual recognition means harmonization of a managed regulatory system. It implies mutual trust and adoption of common rules.

third-country regulatory regimes.

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

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

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

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

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

<sup>23</sup>See MUGARURA, ‘The “EU Brexit” implication on a single banking license and other aspects of financial markets regulation in the UK’ (2016) 58(4) *International Journal of Law and Management*, 477.

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

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

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

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

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

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

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

<sup>29</sup>See LANNOO, 'EU Financial Market Access After Brexit' (2016) (51)5 *Intereconomics*, 255.

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

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

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

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

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

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

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

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

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

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

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

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<sup>35</sup>See MOLONEY (*supra* note 28) 43-44.

<sup>36</sup>See SHOENMAKER and VERON, ‘Brexit should drive integration of EU capital markets’, Bruegel Blog Post, 24 February 2017, available at: <http://bruegel.org/2017/02/brexit-should-drive-integration-of-eu-capital-markets/>.

<sup>37</sup>See BLACK, ‘The development of risk-based regulation in financial services: just ‘modelling through’?’ in Black, Lodge, Thatcher (eds), *Regulatory Innovation - A Comparative Analysis* (Edward Elgar, Cheltenham 2005) 174.

<sup>38</sup>See KRAAKMAN, HERTIG and ROCK, ‘Issuers and investor protection’, in H. Kraakman, P.

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

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

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

<sup>39</sup>See BLACK, 'Rules and Regulators' (Clarendon Press, Oxford 1997) 215-216.

<sup>40</sup>See EASTERBROOK and FISCHER, 'Mandatory Disclosure and the Protection of Investors' (1984) 70(4) *Virginia Law Review*, 669-670.

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

<sup>42</sup>See GILSON and KRAAKMAN, 'The Mechanisms of Market Efficiency' (1984) 70(4) *Virginia Law Review*, 549.

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

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

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

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<sup>43</sup>See COFFEE JR., 'Market Failure and the Economic Case for a Mandatory Disclosure System' (1984) 70(4) *Virginia Law Review*, 734.

<sup>44</sup>See MCBARNET and WHELAN, 'The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control' (1991) 54(6) *The Modern Law Review*, 848.

<sup>45</sup>See FOX, 'Civil Liability and Mandatory Disclosure' (2009) 109 *Columbia Law Review*, 237.

<sup>46</sup>See BRIAULT, 'Revisiting the rationale for a single financial services regulator', FSA Occasional Paper Series No 16, London, 2002, 21-24.

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

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

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

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

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<sup>47</sup>See KOKKINIS, 'The Impact of Brexit on the Legal Framework for Cross-Border Corporate Activity' (2016) 27(7) *European Business Law Review*, 973.

<sup>48</sup>See BLACK, 'Paradoxes and Failures: "New Governance" Techniques and the Financial Crisis' (2012) 75(6) *Modern Law Review*, 1042-1045.

<sup>49</sup>FSA, 'The Turner Review. A regulatory response to the global banking crisis', March 2009.

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

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

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<sup>50</sup>See BLACK, "Which Arrow?": rule type and regulatory policy' (1995) 1 *Public Law*, 94-95.

<sup>51</sup>See SCHWARCZ, 'The "Principles" Paradox' (2008) Duke Law School Legal Studies Paper No 205.

<sup>52</sup>The "Treating Customers Fairly Initiative" represents the clearest example of the FSA's principles-based regime. It consists of a set of best practices by which firms are to ensure market confidence and consumer protection.

<sup>53</sup>See PARKER, 'The Ethics of Advising on Regulatory Compliance: Autonomy or Interdependence?' (2000) 28(4) *Journal of Business Ethics*, 346.

<sup>54</sup>See NELSON, 'Behavioural Evidence on the Effects of Principles-and Rules-Based Standards' (2003) 17(1) *Accounting Horizons*, 100-101.

<sup>55</sup>See BLACK, 'Using Rules Effectively' in C. McCrudden (ed), *Regulation and Deregulation* (Oxford University Press 1998) 101.

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

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

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

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<sup>56</sup>See POWER, 'Organized Uncertainty. Designing a World of Risk Management' (Oxford University Press, 2007) 48-49.

<sup>57</sup>See BLACK and ROUCH, 'The development of the global markets as rule-makers: engagement and legitimacy' (2008) 2(3) *Law and Financial Markets Review*, 223-225.

<sup>58</sup>See BLACK, 'Critical Reflections on Regulation', *Australian Journal of Legal Philosophy* (2002) 27(1) 21-22.

<sup>59</sup>See MOLONEY 'Confidence and Competence: The Conundrum of EC Capital Markets Law' (2004) 4(1) *Journal of Corporate Law Studies*, 11-12.

<sup>60</sup>See FISHER, BEWSEY, WATERS and OVEY, *The Law of Investor Protection* (London, Sweet & Maxwell 2003) 18.

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

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

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<sup>61</sup>See BENJAMIN, *Financial Law* (OUP: Oxford University Press 2007) 590.

<sup>62</sup>MiFID Directive Level 2 (2006/73/EC) recital 28.

<sup>63</sup>See HARVEY and PARRY, ‘The Law of Consumer Protection and Fair Trading’ (Butterworths, London 2000) 50-51.

<sup>64</sup>See *Office of Fair Trading v Abbey National and others* [2009] EWCA Civ 116.

<sup>65</sup>See BLITZ, ‘The Brexit vote and UK Markets one year on’, *Financial Times*, 22 June 2017.

<sup>66</sup>See FAULCONBRIDGE, ‘Disputed memo says Britain has no Brexit plan’, *Reuters*, 15 November 2016.

EU position to appearing to be a hard line ‘Brexit’. Further confusion was sown with her now infamous statement of ‘Brexit means Brexit’.<sup>67</sup>

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

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

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

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<sup>67</sup>Then Home Secretary Theresa May launching her leadership bid for the Conservative Party, 30 June 2016, Birmingham.

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

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

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

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

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<sup>68</sup>The Economist, ‘If Britain became “Singapore-on-Thames”. The British economy if the country crashes out of the European Union’, 13 July 2017.

<sup>69</sup>See BINHAM and PARKER, ‘Banks step up fightback against wave of UK regulation’, *Financial Times*, 5 June 2015.

<sup>70</sup>The City UK, *Key facts about UK -based financial and related professional services*, April 2017, p. 4.

<sup>71</sup>It is not uncommon to find team members of different nationalities using their language and cultural skills to the benefit of their banks.

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

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

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

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

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

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

<sup>74</sup>See WYMAN, *The Impact of the UK’s Exit from the EU on the UK-Based Financial Services Sector*, 2016.

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

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

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

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

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<sup>75</sup>*Ibid.*

<sup>76</sup>Woodford Investment Management, *The Economic Impact of Brexit*, February 2016, Capital Economics, Para 4.3, pp. 21-22.

<sup>77</sup>These are wide and include diverse areas such as health, education and economic development, see Government of Wales Act 2006 and the Northern Ireland Act 1998.

<sup>78</sup>For example, there exists an on-going debate for a separate legal system in Wales, recently expressed by the Welsh Counsel General Theodore Huckle QC, *Why Wales needs its own legal jurisdiction*, 7 April 2016, The Institute of Welsh Affairs.

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

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

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<sup>79</sup>Joint statement from the First Ministers of Wales and Scotland in reaction to the EU (Withdrawal) Bill, 13 July 2017.

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

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

<sup>82</sup>Gibraltar voted to remain in the EU by 96%: source Electoral Commission.

<sup>83</sup>See HENLEY, *Rocked by Brexit vote, Gibraltar lays plans for new kind of EU relationship*, 22 October 2016.

<sup>84</sup>See House of Lords, *Leaving the European Union: Status of Gibraltar*, 2 May 2017.

<sup>85</sup>*Ibid*: Henley 2016.

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

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

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

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<sup>86</sup>See OUDÉA, 'New Basel banking rules' impact on European economy', *Financial Times*, 28 November 2016.

self-enforcement however, it would introduce a concept of responsible management characterised by capability and the ability to combine “the versatility and flexibility of voluntary self-regulation, avoiding many of the inherent weaknesses of voluntarism”.<sup>87</sup>

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

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

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<sup>87</sup>See AYRES and BRAITHWAITE, *Responsive Regulation. Transcending the Deregulation Debate* (New York, Oxford University Press 1992) 106.

<sup>88</sup>See GRABOSKY, ‘Using Non-Governmental Resources to Foster Regulatory Compliance’ (1995) 8(4) *Governance: An International Journal of Policy, Administration and Institutions*, 543.

<sup>89</sup>Financial Reporting Council, ‘The Combined Code on Corporate Governance, June 2008, 16; Financial Reporting Council, ‘Internal Control. Revised Guidance for Directors on the Combined Code’, October 2005, 3-4.

<sup>90</sup>FSA, ‘Better Regulation Action Plan’, CP 05/10, December 2005; FSA, ‘Better Regulation Action Plan. Progress Report’, June 2006.

<sup>91</sup>See ALFIERI, ‘The Fall of Legal Ethics and the Rise of Risk Management’ (2006) 94(6) *Georgetown Law Journal*, 1933-1934.

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

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

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

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

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

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

## FISCAL COMPACT AND BALANCED BUDGET AMENDMENTS

Gabriella Mazzei \*

**ABSTRACT:** *In recent years the process of deep integration between the legal systems of EU Member States has led to a swift progress in designing budgetary rules. This has been one of the achievements of the monetary union between the euro area countries and has come from the awareness that national economic systems are intimately intertwined. Therefore, national legal systems had to be adjusted and these adjustments were extended to national constitutions.*

*As a result, national constitutions were modified and the traditional criteria which single states had used in their budget policies were reviewed. This process was initiated at a higher level than single states. It is a peculiar process as it is not either a reaction or an indirect process, but EU member states gradually adapted their well-established economic policies as well as their monitoring and control practices to a set of rules, which were directly issued by the EU legal system.*

*The introduction of a complex set of new national rules aiming at fostering budgetary discipline is a very significant result of this process. This process started with a gradual evolution of the Treaties. Then, more precise rules were issued and the Fiscal Compact was finalized. As a result of this whole process, a balanced budget amendment was introduced in national constitutions.*

*In this work, an insight of the fundamental legal framework coming from the Fiscal Compact is provided. This analysis is performed by a continuous comparison with EU rules and leads to the recognition that profound changes, even at a constitutional level, were generated by these developments. These amendments are a mirror of the actual shift in budget policy decision-making process.*

**SUMMARY:** 1. Preamble. – 2. Planning capacity and State expenditure: from the original struc-

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ture of the Constitution to the 2012 reform. – 3. UE fiscal and budgetary governance and national rules. – 4. The principle of ensuring balanced budgets enshrined in the Constitution. – 5. The budgetary cycle. – 6. Conclusions.

1. Fundamental choices of economic policy require careful planning of public expenditure and revenues in every EU member state. economic planning is inextricably linked to continuous monitoring and control of public budgets.

This widespread acknowledgment is the result of improved economic policies in EU countries, and translates itself into a set of rules guiding budgetary choices. The process described above takes slightly different forms in the provisions which are actually introduced, but it is generally characterized by the need to design clear and objective rules. Such fundamental rules must inspire consistent budgetary choices, which efficiently support economic policies aiming at maintaining the necessary balance between keeping sound public finances and meeting both general and specific public needs.

Budgetary choices are paramount for the implementation of national economic policies. The set rules laying down the objectives and methods for the implementation of budgetary choices in every single EU member state are a significant indication of the balance that they actually strike between objectives set and efforts they really make to achieve expected results. This is the reason why the above mentioned set of rules, which are analyzed in a structured and coordinated manner, is particularly relevant and its importance transcends their technical content. They are very useful for clearly understanding the real meaning of strategic choices for EU citizens.

This approach is particularly interesting as this set of rules is assessed with reference to the EU legal system and regulatory choices that are heavily influenced by the process of integration. Another peculiar aspect of this analysis of the development of this integration process between different levels of regulation is that these rules are set both at national and EU level and a shift in perspective can

help understand the substantial changes in the policies inspiring single rules.

Objective studies have achieved a widespread consensus, whereby in recent years a marked trend towards member states' compliance with EU budget rules has been recorded. This trend has been increasingly and more directly influenced by the European Union, to the point that the EU imposed constraints and instruments of unbeatable strength on member states. Such constraints and instruments gained formal recognition in constitutional norms.

Therefore, not only does this process end up with aligning national legislations, but it also "dismantled" traditional rules. Direct and strict compliance with fundamental policies set at an international level became a priority.

Legal developments in Italy in the last few years are a glaring example of this trend, as they showed the tendency to a rapid and strict compliance with EU rules. This tendency involved the definition of basic budget rules and objectives. Objectives, constraints and adaptation processes in the budgetary field were enshrined in the constitution.

2. In the Italian legal system, the Constitution of 1947 contained basic planning and control rules of public expenditure. Article 81 of the Constitution (in its version in force until the amendments of 2012) set out some binding principles<sup>1</sup>.

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<sup>1</sup>See the following publications related to Art. 81 of the Constitution before the 2012 amendments: *Le sentenze della Corte costituzionale e l'art. 81, u.c., della Costituzione*, Milano, 1993; AMATUCCI, *Funzioni e disciplina del bilancio dello Stato*, Napoli, 1970; ID., *L'ordinamento giuridico della finanza pubblica*, Napoli, 2007; ANELLI C., *Natura giuridica dei bilanci pubblici*, Empoli, 1967, BARETTONI ARLERI (diretto da), *Dizionario di contabilità pubblica*, Milano, 1989; BASSANINI, MERLINI, *Crisi fiscale e indirizzo politico*, Bologna, 1995; BERGONZINI, *Teoria e pratica delle procedure di bilancio dopo la legge n. 196 del 2009*, in *Quaderni cost.*, 2011, 39 ss.; BRANCASI, *Legge finanziaria e legge di bilancio*, Milano, 1985; ID., *L'ordinamento contabile*, Torino, 2005; CAIANIELLO, *Bilancio, legge finanziaria, «coperture» e mitologie costituzionali (per una sola legge di bilancio, a Costituzione invariata)*, in *Foro amm.*, 2000, 3641 ss.; CAPUTO, *La sessione di bilancio 2009: spunti e prospettive alla luce della riforma della legge di contabilità*, in *Rass. parl.*, 2010, 77 ss.; CARBONI, *Il «potere di bilancio» fra processi decisionali interni e comunitari*, in *Quaderni cost.*, 2006, 25 s.; COLARULLO, *L'indirizzo della spesa fra governo e parlamento*, Milano, 1986; ID., *La legislazione di spesa fuori della sessione di bilancio*, Milano, 1991; DA EMPOLI, DE IOANNA, VEGAS, *Il bilancio dello Stato. La finanza pubblica tra Governo e Parlamento*, 4<sup>a</sup> ed., Milano, 2005; DE IOANNA, *Parlamento e spesa pubblica. Profili istituzionali del bilancio pubblico in Italia*, Bologna, 1993; ID., *Sulla copertura finanziaria delle leggi di spesa e di minore*

In addition to the principle any new law must be provided with the financial means to cover its costs before it is passed, article 81 stated that the budget law was a mere provision of law, in the sense that new taxes or expenditure could not be introduced by means of the law approving the budget. The public finance provisions leading to the approval of the annual budget were based on two draft laws: a budget draft law (formal law), which was based on the legislation in force; and a stability draft law (substantive law), which set the financial reference framework for every year covered by the budget. This substantive draft law also specified the annual adjustments needed and set forth by the legislation in force

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*entrata: un'analisi introduttiva*, in corso di pubblicazione in *Quaderni della Rassegna parlamentare*, Milano, 2006; DE IOANNA, FOTIA, *Il bilancio dello Stato. Norme, istituzioni, prassi*, Roma, 1996; DEGNI M., *La decisione di bilancio nel sistema maggioritario. Attori, istituti e procedure nell'esperienza italiana*, Roma, 2004; DELLA CANANEA, *Indirizzo e controllo della finanza pubblica*, Bologna, 1996; DI PLINIO, *Diritto pubblico dell'economia*, Milano, 1998; DICKMANN, *La legge finanziaria nella prospettiva di una riforma*, in *Rass. parl.*, 2008, 341 ss.; ID., *La riforma della legislazione di finanza pubblica e del sistema del bilancio dello Stato e degli enti pubblici*, in *Federalismi.it*, 2010, 1; DI GASPARE, LUPO (a cura di), *Le procedure finanziarie in un sistema istituzionale multilivello*, Milano, 2005; FORTE, *La riforma del bilancio in Parlamento: strumenti e procedure*, Napoli, 1992; LUPO, *Le procedure di bilancio dopo l'ingresso nell'Unione economica e monetaria*, in *Quaderni cost.*, 1999, 523 ss.; LUPO N., *Art. 81*, in *Commentario alla Costituzione*, a cura di BIFULCO – CELOTTO – OLIVETTI, vol. II, Artt. 55-100, Utet, Torino, 2006; LUPO, *Costituzione e bilancio: l'articolo 81 della Costituzione tra interpretazione, attuazione e aggiramento*, Roma, 2007; MACCANICO, *L'articolo 81 della Costituzione nel sistema delle garanzie costituzionali della spesa pubblica*, in *Studi sulla Costituzione*, II, Milano, 1958, 515 s.; MORTATI, *Istituzioni di diritto pubblico*, Cedam, Padova, 1991; MUSUMECI, *La legge finanziaria*, Torino, 2002; OLIVETTI, *Le sessioni di bilancio*, in *Il parlamento repubblicano*, a cura di LABRIOLA, Milano, 1999, 575 ss.; ONIDA, *Le leggi di spesa nella Costituzione*, Milano, 1969; PALANZA, *Una nuova legge e un ordine del giorno per la riorganizzazione del processo di bilancio come metodo della politica generale (legge 25 giugno 1999, n. 208)*, in *Rass. parl.*, 1999, 635 ss.; PEREZ, *La nuova legge di contabilità*, in *Giornale Dir. Amm.*, 2010, 669 ss.; ID. (a cura di), *Le limitazioni amministrative della spesa*, Milano, 2003; PARADISO, *Luigi Einaudi e il mito del pareggio di bilancio*, in *Pensiero Economico Italiano*, vol. 12, 2004; RIVOSECCHI, *L'indirizzo politico finanziario tra Costituzione italiana e vincoli europei*, Padova, 2007; RIVOSECCHI, *L'equilibrio di bilancio: dalla riforma costituzionale alla giustiziabilità*, in *www.rivistaaic.it*, 2016; ROGARI, *Il bilancio dello Stato. Evoluzione giuridica ed economica con esame comparativo dei bilanci degli altri Paesi*, Padova 1977; RUINI, *Il bilancio dello Stato e l'art. 81 della Costituzione*, in *Riv. pol. econ.*, 1955, 1021 s.; SALERNO, *La programmazione di bilancio in Italia. Origine ed analisi di una riforma*, Padova, 1983; SALMONI, *Equilibrio finanziario, vincoli comunitari e giurisprudenza costituzionale*, in *Interpretazione conforme e tecniche argomentative*, a cura di D'AMICO e RANDAZZO, Giappichelli, Torino, 2009; SALVEMINI, *I guardiani del bilancio. Una norma importante ma di difficile applicazione: l'articolo 81 della Costituzione*, Venezia, 2003; TALICE, *La legge di bilancio*, Milano 1969; ZANGANI, *I recenti sviluppi delle procedure parlamentari di bilancio: la terza fase dell'evoluzione in atto*, in *Il parlamento nella transizione*, a cura di TRAVERSA, CASU, Milano, 1998, 137 ss

for the same length of time, so that the financial impact of the budget was compliant with the targets of public finances.

This is the reason why, it is legitimate to argue that the original article 81 of the Constitution contained guidelines for the decision-making process, rather than substantial constraints<sup>2</sup>.

Constitutional law no. 1 of the 20<sup>th</sup> of April 2012 profoundly changed this landscape by introducing the so-called balanced budget in the Constitution<sup>3</sup>. In

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<sup>2</sup>See LUCIANI, *Costituzione, bilancio, diritti e doveri dei cittadini*, relazione conclusiva presentata al 58° Convegno di Studi amministrativi “Dalla crisi economica al pareggio di bilancio: prospettive, percorsi e responsabilità”, Varenna, 20-22.9.2012; DELLA CANANEA, *Indirizzo e controllo della finanza pubblica*, Il Mulino, 1996; RIVOSECCHI, *Parlamento e sistema delle autonomie all’ombra del Governo nelle trasformazioni della decisione di bilancio*, in “Rivista AIC”, n. 1/2012; DEGNI, *La decisione di bilancio nel sistema maggioritario. Attori, istituti e procedure nell’esperienza italiana*, Ediesse, 2004

<sup>3</sup>Among many publications see BERGO, *Pareggio di bilancio “all’italiana”. Qualche riflessione a margine della legge 24 dicembre 2012, n. 243 attuativa della riforma costituzionale più silenziosa degli ultimi tempi*, in *Federalismi.it*, n. 6/2013; BIFULCO, *Le riforme costituzionali in materia di bilancio in Germania, Spagna e Italia alla luce del processo federale europeo*, in *Crisi economica e trasformazioni della dimensione giuridica. La costituzionalizzazione del pareggio di bilancio tra internazionalizzazione economica, processo di integrazione europea e sovranità nazionale*, a cura di BIFULCO e ROSELLI, Giappichelli, Torino, 2013; BILANCIA, *Note critiche sul c.d. “pareggio di bilancio”*, in *Rivista AIC*, n. 2/2012; BOGNETTI, *Il pareggio di bilancio nella Carta costituzionale*, in *Rivista AIC*, n. 4, 2011; BRANCASI, *Il principio del pareggio di bilancio in Costituzione*, in *Osservatorio sulle fonti*, 2012, 2; ID., *La disciplina costituzionale del bilancio: genesi, attuazione, evoluzione e elusione*, in *Costituzione e pareggio di bilancio*, Jovene, Napoli, 2012; BRANCASI, *L’introduzione del principio del c.d. pareggio di bilancio: un esempio di revisione affrettata della Costituzione*, in *Quaderni Costituzionali*, 108 ss., 2012; BUZZACCHI, *Copertura finanziaria e pareggio di bilancio: un binomio a rime obbligate?*, in *Rivista AIC*, n. 4, 2012; CARLASSARE, *Diritti di prestazione e vincoli di bilancio*, in *www.costituzionalismo.it*, 2015; CARNEVALE, *La revisione costituzionale nella prassi del “terzo millennio”. Una rassegna problematica*, in *Rivista AIC* n. 1/2013, 12 e 13; COSENTINO, *Il principio del pareggio di bilancio nella Carta Costituzionale. Dalle fonti alle recenti sentenze della Corte*, La Sapienza, 2015; FORTE, *La recente giurisprudenza costituzionale in tema di art. 81 Cost.*, in *Rassegna parlamentare*, 2013, 177 ss; GIUPPONI, *Il principio costituzionale dell’equilibrio di bilancio e la sua attuazione*, in *Quad. Cost.*, 2014, 51 ss.; GOLINO, *Il principio del pareggio di bilancio. Evoluzione e prospettive*, Cedam, 2013; GORETTI e RIZZUTO, *La costituzionalizzazione del pareggio di bilancio. Prime riflessioni*, Università Economica Bocconi, Short notes, 2/2011; LO CONTE, *Equilibrio di bilancio, vincoli sovranazionali e riforma costituzionale*, Giappichelli, 2015; LUCIANI, *Costituzione, bilancio, diritti e doveri dei cittadini*, in *Astrid rassegna*, *www.astrid-online.it/rassegna*, 3/2013; ID., *L’equilibrio di bilancio e i principi fondamentali: la prospettiva del controllo di costituzionalità*, in *Corte costituzionale, Il principio dell’equilibrio di bilancio secondo la riforma costituzionale del 2012*, Atti del Seminario svoltosi in Roma, Palazzo della Consulta, 22 novembre 2013, Giuffrè, Milano, 2014; LUPO, *Il nuovo articolo 81 della Costituzione e la legge rinforzata, Relazione al Convegno “Dalla crisi economica al pareggio di bilancio: prospettive, percorsi e responsabilità”*, Varenna 20-22 settembre 2012; ID., *La revisione costituzionale della disciplina di bilancio e il sistema delle fonti*, in *Il Filangieri*, 2011; MORGANTE, *La costituzionalizzazione del pareggio di bilancio*, in

particular, Article 1 of this law fully replaces Article 81 of the Constitution and marks a shift from the simple function of stating the resources needed to finance new or increased taxes or expenditure to the obligation for the State to “*balance revenue and expenditure in its budget, taking account of the adverse and favourable phases of the economic cycle*”. The constraint of a balanced budget becomes then tighter (it is more than the aim of achieving a balanced budget at a certain moment in time). This adds a quality-related and dynamic aspect to this provision as the budget is now constantly under scrutiny, on the basis of changing generaleconomic conditions<sup>4</sup>.

Therefore, this is not a merely formal or static approach, but a much more complex (and at the same time accountable) requirement of substantial rigour.

In this context, “*no recourse shall be made to borrowing except for the purpose of taking account of the effects of the economic cycle or, subject to authorization by the two Houses approved by an absolute majority vote of their Members, in exceptional circumstances*” (second paragraph of Article 81 of the Constitution).

Following this reform process, the budget law has lost its formal nature (since the old text of the third paragraph of Article 81 was abandoned). The content of the budget law is now decided on the basis of a law of the State, which must be approved by an absolute majority of the members of each Chamber (Article 81, sixth paragraph of the Constitution).

But above all, the Constitution states that this law, which must be approved by a qualified majority in each Chamber, is intended to transpose not only basic inflow and outflow entries but also “*the fundamental rules and the criteria to en-*

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“federalismi.it”, n. 14/2012; MORRONE, *Pareggio di bilancio e Stato costituzionale*, in *Lavoro e Diritto*, Il Mulino, 2013; PACE, *Pareggio di bilancio: qualcosa si può fare*, in *Rivista telematica dell’Associazione italiana dei costituzionalisti*, n.3/2011; RIVOSECCHI, *Legge di bilancio e leggi di spesa tra vecchio e nuovo articolo 81 della Costituzione*, in *Rivista della Corte dei conti*, n. 1-2, 2013; SANTORO, *Manuale di Contabilità e di finanza pubblica*, VI Ed., Maggioli, San Marino, 2013; TABACCHI, *L’equilibrio dei bilanci: una regola costituzionale “europea” per le finanze pubbliche*, in *Rassegna parlamentare*, 2013.

<sup>4</sup>See SILEONI, *Pareggio di bilancio. Prospettive per una maggiore credibilità della finanza pubblica*, in “Istituto Bruno Leoni Focus”, n. 193 – 22.11.2011; BOGNETTI, *Il pareggio del bilancio nella Carta costituzionale*, in “Rivista AIC”, n. 4/2011.

*sure a balance between revenue and expenditure and the sustainability of general government debt (...) in compliance with the principles established with a constitutional law”*

This reform process was finalized by broadly extending the very same principle to the whole of the Italian general government (this shows the complexity of the various level of the Italian general government, which comes as a result of the difficulties in adopting the original Constitution). Art. 97, first paragraph, states that *“General government entities, in accordance with European Union law, shall ensure balanced budgets and the sustainability of public debt”*.

The main aspects of the approved reform are now coming to the surface. New criteria to assess the financial viability of public interventions are set. They are now related to the mandatory balance between revenue and expenditure, as mentioned above. They are also related to the limits to the recourse to borrowing. This is understandable as the Italian state is burdened by a stock of public debt which is higher (much higher!) than 100% of the wealth generated by the country every year<sup>5</sup>. The concept of "debt sustainability" is introduced. This concept is new in this context and paves the way to the introduction of new methods to progressively reduce this stock of public debt. Even though this reduction is only gradual for the moment, this step is unavoidable otherwise the Italian debt would become unsustainable. This whole vision is extended all entities of the Italian general government, and is not limited to the State only.

As regards the specific relationship between national government and local authorities in terms of basic financial discipline, the new constitutional architecture still recognizes the financial autonomy of revenue and expenditure for the different levels of territorial government (municipalities, provinces, metropolitan

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<sup>5</sup>According to Bank of Italy estimates of may 2017, Italian public debt amounted to 2.278.855 Million Euro (see public debt ratio of GDP was estimated at 132,5% for 2017 in programming documents of public finances. 2017 Document on the Economy and Finance of the Italian government ([http://www.mef.gov.it/focus/article\\_0031.html](http://www.mef.gov.it/focus/article_0031.html))).

cities and regions)<sup>6</sup>, but it is harnessed by the need "to ensure balanced budgets"<sup>7</sup>.

Moreover, with the aim of completing the renewal of the institutional framework to ensure internal and external consistency, local authorities "shall contribute to ensuring compliance with the economic and financial constraints imposed under European Union law". Local authorities are still financially autonomous but are now subject to the very same EU membership obligations to which the central government is subject. While local authorities were not necessarily forced to take corrective financial action in the past, a direct and immediate relationship EU rules is now created. As a consequence, local authorities are now subject to the same rules as the central government, as they are now an integral part of one single system of public finance.

A so-called *golden rule* complete this reform process. Local authorities are entitled to resort to borrowing not only "to finance investment expenditure" (provision already introduced with the constitutional reform of 2001) but "borrowing operations may now be carried out subject to the adoption of repayment plans and on the basis of special agreements reached at a regional level in order to ensure that the final cash-based accounts of all the local authorities, including the region itself, are balanced". More rigour is self-evident and higher efficiency in this process is introduced.

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<sup>6</sup>See D'ATENA, *Diritto regionale*, Giappichelli, 2010; DE FIORES, *Note critiche sul federalismo fiscale*, in *Costituzionalismo.it*, fascicolo n. 2, 18 Giugno 2009; JORIO, GAMBINO, D'IGNAZIO, *Il federalismo fiscale, commento articolo per articolo alla legge 5 Maggio 2009, n. 42*; GROPPI, OLIVETTI (a cura di), *La Repubblica delle autonomie, Regioni* VANDELLI L., *Il sistema delle autonomie locali*, Bologna, il Mulino editore, IV edizione, 2011 ed *enti locali nel nuovo titolo V*, II edizione, Torino, Giappichelli editore, 2003, pag. 244.

<sup>7</sup>See RIVOSECCHI, *Il difetto di copertura di una legge regionale di bilancio: la Corte accelera sul c.d. pareggio*, in *Giurisprudenza costituzionale*, 2012; SALERNO, *Equilibrio di bilancio, coordinamento finanziario e autonomie territoriali*, in *Il Filangieri – Quaderno 2011, Costituzione e pareggio di bilancio*, a cura di LIPPOLIS, LUPO, SALERNO, SCACCIA, Napoli, Jovene, 2011, 150 s. e 159; SCACCIA, *L'ente regionale fra mitologia federale e realtà costituzionale*, *Rivista AIC*, n. 1/2014; TUCCIARELLI, *Pareggio di bilancio e federalismo fiscale*, in *Quaderni costituzionali*, 2012; URICCHIO (a cura di), *I percorsi del federalismo fiscale*, Bari, Cacucci editore, 2012; VALICENTI, *Equilibrio di bilancio e coordinamento della finanza pubblica delle autonomie territoriali*, in *Rivista AIC* n. 1/2012.

The completion of the process of constitutional reform described above requires the constant monitoring of public finance trends, of the causes of deviation from the forecasts, the introduction of a maximum limit on the accumulated negative deviation, beyond which corrective measures need to be taken. These are all areas dealt with by a new budget law. This new budget law must be approved with a qualified majority and it deals with many aspects pertaining with the completion of the reform process described in this document (pursuant to Article 5 of Constitutional Law No.1 of the 20th of April 2012)<sup>8</sup>.

The same legal instrument is also used to determine when severe economic recessions, financial crises and severe natural catastrophes can be considered as extraordinary events which (pursuant to art. 81 second paragraph) may allow for the recourse to borrowing due to the effects of the economic cycle, namely beyond the maximum limit of negative deviation forecasts. The recourse to borrowing is also subject to a repayment plan (Article 5 Paragraph 1, letter d) of the aforementioned constitutional law no. 1 of the 20th of April 2012).

In the same context new rules on expenditure were introduced. They are the pillar of this reform as they serve as a safeguard for a balanced budget (in other words, a budgetary spending limit, as we can infer from the mechanisms that are automatically triggered as soon as thresholds are exceeded), and for a reduction of the ratio between public debt and gross domestic product over the long term, in compliance with public finance targets (Article 5, paragraph 1, letter e) Constitutional law no. 1 of 2012). Moreover, in line with the general orientations of this reform, the reduction of public debt is no longer considered as a task which the central (state) has to perform. Public debt is transformed into a (negative) endowment, for which the responsibility must be shared between all levels of government as *“Regions, municipalities, provinces, metropolitan cities and the auton-*

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<sup>8</sup>See CANAPARO, *La legge costituzionale n. 1 del 2012: la riforma dell’art. 81, il pareggio di bilancio e il nuovo impianto costituzionale in materia di finanza pubblica*, in “federalismi.it”, n. 13/2012.

*omous provinces of Trento and Bolzano shall contribute to the sustainability of general government debt* "(Article 5, paragraph 2, letter c Constitutional law no. 1 of 2012)<sup>9</sup>. In any case, financial resources drawn from the state budget can be used to finance the basic level of performance of public services pertaining to other levels of government. These public services are those who are associated with fundamental civil and social rights. This intervention is justified within the pre-determined limits set by the same law to be approved by a qualified majority (Article 5, paragraph 1, letter g) L. Cost. 1/2012).

The implementation of this whole range of complex and very significant Constitutional reforms regarding laws on the economy was finalized with law number 243 of the 24th of December 2012, which was adopted pursuant to art. 81, sixth paragraph, of the Constitution (and therefore approved by an absolute majority of the members of each Chamber and in compliance with the principles set forth by the aforementioned constitutional law No. 1 of the 20th of April 2012). The result was a system based on the obligation of the Italian general government to ensure a balanced budget (Article 3 of Law No 243 of 2012). This is basically a precise commitment to achieve a structural balance in the medium term between revenue and expenditure. This balance is identified on the basis of criteria established by the European Union<sup>10</sup>.

Therefore, this approach is not either associated with *time-related* requirements nor is it triggered by an emergency situation. This approach sets out precise convergence trajectories for the accounting aggregates of revenue and expenditure, which are corrected according to the economic cycle and net of *one-off* or temporary measures.

The stability of this whole set of rules is achieved by rigorously determining

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<sup>9</sup>See RIVOSECCHI, *Il coordinamento dinamico della finanza pubblica tra patto di stabilità, patto di convergenza e determinazione dei fabbisogni standard degli enti territoriali*, in "Rivista AIC", n. 1/2012.

<sup>10</sup>See the seminal work by CHESSA, *Pareggio strutturale di bilancio, keynesismo e unione monetaria*, in *Quad. cost.*, 2016; CIOLLI, *Le ragioni dei diritti e il pareggio di bilancio*, Aracne, 2012.

objectives as well as methods and conditions to accomplish them.

This whole range of measures set the course to achieve the ultimate outcome (imposed by the constitution) of balanced budgets. They are designed to be applicable to both central government and local authorities in the same way, as set forth by law no. 243 of 2012. This law states that the net balance to be funded (the differential between tax revenues, revenues from sales, depreciation of assets, recovery of debt as well as current and capital expenditure) and must be consistent with the objectives set out in the financial and budgetary planning documents. These documents also deal with net borrowing targets, which are divided into sub-sectors, in order to ensure that at least medium-term objectives are achieved.

As stated below, these medium term targets include a "*structural balance*", which is the balance of the consolidated accounts adjusted to allow for the effects of the economic cycle, net of any one-off or temporary measures. In any case, this parameter is set in accordance with the EU<sup>11</sup>.

The option of achieving the coveted balanced budget by "*ensuring the attainment of at least the medium-term objective*" in case of exceptional events and deviation from the target objectives set out in the financial and budgetary planning documents is the most interesting aspect that emerges from this law as it mitigates excessive rigidity (art.3 paragraph 3 and 5, Law no 243 of 2012). Another fundamental aspect allowing for greater flexibility in this set of measures is the emphasis on the financial impact of structural reforms, as they have a significant impact on the sustainability of public finances. This way, purely qualitative elements are actually reflected in the assessment of a process based on rigorous quantitative criteria. The result (the outcome) is very peculiar and very predictable (in its development), taking into account that the interests of a whole state are involved.

A second and very significant aspect of this reform process is the introduc-

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<sup>11</sup>See BOITANI, LANDI, *Il labirinto delle regole europee: L'Obiettivo di medio termine*, in *LaVoce.info*, 4.7.2014.

tion of a completely new concept, which is a key legal constraint: the sustainability of public debt. This concept is even elevated to the rank of constitutional criterion and is described in detail in subsequent regulatory provisions of implementation.

In particular, budgetary planning documents will now have to indicate targets (applicable to all government entities) for the ratio of public debt to gross domestic product "*as envisaged in EU Law*". When this ratio exceeds the EU-defined reference value, a reduction that is consistent with the criteria and the EU common framework of relevant factors (Article 4 L. 243/2012) shall be ensured.

Thus, a process of transposition into precise rules and legal constraints by means of an adequate legislative process is set up for the general rules stating the macro-objectives allocated to each EU member state in the context of the Stability and Growth Pact <sup>12</sup>.

In other words, the constraints and precautions in the relationship between States and between States and EU institutions are transformed into elements of national law. This is a hierarchical legal process coming from the highest and most rigid source (the Constitution), which then spreads to all key elements of the national legal system, in order to bring it in line with EU standards. The pieces of this legally complex jigsaw are firmly held together. It is certainly a new process, but it is paramount to protect the conditions which are at the basis of a fully structured community, as outlined above<sup>13</sup>.

Another key part of this reform is the introduction of precise monitoring mechanisms for expenditure (Article 5 law no. 243/2012). These mechanisms are paramount to the effectiveness of this process. They are used to check "in real time" expenditure trends, thus preventing possible deviation from the targets set

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<sup>12</sup>See BALLARDIN, *Il coordinamento della politica economica europea dopo il Fiscal Compact*, in *Diritto.it*, 24 aprile 2013; TOSATO, *La riforma costituzionale del 2012 alla luce della normativa dell'Unione: l'interazione tra i livelli europeo e interno, relazione al seminario "Il principio dell'equilibrio di bilancio secondo la riforma costituzionale del 2012"*, Corte Costituzionale, 2013; DICKMANN, *Le regole della governance economica europea e il pareggio di bilancio in Costituzione*, in "federalismi.it", 2012, 4.

<sup>13</sup>See CAPUANO e GRIGLIO, *La nuova governance economica europea. I risvolti sulle procedure parlamentari italiane*, in MANZELLA e LUPO (a cura di), *Il sistema parlamentare euro-nazionale*, Giappichelli, 2014, pp. 227-265.

in budgetary planning documents, which are consistent with the EU parameters. Such monitoring mechanisms are useful to take necessary and predefined corrective measures with a predefined goal: bringing deviations within the boundaries set by the budgetary planning documents (and the figures fully-shared with the EU).

In this context, deviations from the targets set in budgetary planning documents are only allowed for periods of severe economic recession, or for extraordinary events beyond the control of the State, such as serious financial crises and natural catastrophes that have a major impact on the general financial position of the country.

In this case and after consultation with the European Commission, the Government shall submit a report to the Houses of Parliament containing an updated set of public finance targets, as well as a specific authorization request specifying the expected magnitude and duration of the deviation from the original targets, indicating the purposes for which the resources available will be allocated as well as a plan for realigning the public accounts with the budget targets.

As you can see, the reform process is very rigorously planned and is always guided by criteria and rules that constantly refer to the system of constraints and prior consent coming from the EU, even during the unfolding stages of the very same reform process.

As a result, the self-determination capacity of the state is harnessed. This goes beyond constant consistency with EU requirements. As you may well anticipate, this is the most distinguishing feature of the new set of national rules that is envisaged. Not only are these new rules inspired by a greater rigour compared with those of the Constitution of 1947, but constant reference to a set of rules outside those of the State (and of a different level) is made. This is new major change in the power of self-determination of the state in the financial sphere.

Apart from the aforementioned new range of national rules set by the

Costitution<sup>14</sup>, the key principles emerging from the process of implementation of the 2012 constitutional reform in public finance can be summarized as follows<sup>15</sup>:

a) Non-negative commitment and cash-based balance of final revenues and final expenditure (art. 9, paragraph 1, law 243/2012);

b) Corrective measures to ensure budgetary realignment, including repayment plans in the short term (art. 9, paragraph 2, law 243/2012);

c) Introduction of a system of financial sanctions and rewards inspired by the principles of proportionality and a specific focus on possible conflicts of interest, by means of a mechanism aimed at transforming sanctions into financial rewards for virtuous local authorities.

Article 10 of the law 243/2012 reiterates that local authorities may borrow only in order to finance investment expenditure. This new set of rules introduces a number of mandatory procedural tools and mechanisms which clearly look like a further guarantee against the risk of circumvention of the constraints imposed on local authorities. Thus, precise amortization plans are envisaged. Their duration cannot exceed the useful life of the investment. Such amortization plans shall show both the impact of the obligations taken on future financial years and the procedures for recovering charges and costs<sup>16</sup>.

Local authorities may also resort to earnings retained from previous financial years to finance investment, but they are entitled to do so only on the basis of specific agreements signed at a regional level. The aim of this provision is

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<sup>14</sup>See MARCAZZAN, *La riforma del Titolo V della Costituzione: il nuovo ruolo delle Regioni nei rapporti con lo Stato e con l'Unione europea*, in *Amministrazione in cammino*, 2003; MAZZOCCHI, *Entrate e spese regionali. L'esperienza dei primi anni di vita delle Regioni*, in A. Barbera, P. D. Giarda e G. Mazzocchi, *Dove vanno le Regioni*, 129, 1976.

<sup>15</sup>See RIVOSECCHI, *Il coordinamento della finanza pubblica: dall'attuazione del Titolo V alla deroga al riparto costituzionale delle competenze?*, in *Il regionalismo italiano tra giurisprudenza costituzionale e involuzioni legislative dopo la revisione del Titolo V*, a cura di MANGIAMELI, Giuffrè, Milano, 2014.

<sup>16</sup>See BARBERA, *Da un federalismo "insincero" a un regionalismo "preso sul serio"? Una riflessione sull'esperienza regionale*, in *Forum di Quaderni Costituzionali*, 2012; BILANCIA F., *Spending review e pareggio di bilancio. Cosa rimane dell'autonomia locale?*, in *Revista d'Estudis Autònoms i Federals*, n. 20/2014; CIMBOLINI L., *Pareggio di bilancio ed enti locali. Il contenuto delle norme attuative e le prime riflessioni sul tema*, in *Azienditalia* 7/2013, [www.astrid-online.it](http://www.astrid-online.it).

obvious: to ensure in a non-formal way that all local authorities within Italian regions comply with the requirement of a balanced budget. The rule allowing national solidarity pacts is consistent with such a purpose. These pacts can be a means to finance investment beyond funds that available for spending after complying with debt thresholds and by using funds coming from previous financial years as they are not covered by the above mentioned agreements.

As secondary element in the background, the State is granted the power to fill in for regions in case of inaction by regions or delays in adopting intervention plans. This is a guarantee for the effectiveness of the whole set of measures<sup>17</sup>.

The range of key principles for the rules that all local authorities are required to apply, is completed by sustainability forecasts and provisions to curtail public debt (Article 12 law 243/2012) and standard costs (Articles 11 and 9, paragraph 5, Law 243/2012).

On this point in particular, the focused should be placed on the forecast issued by the State with the view of ensuring the financing of basic levels of public services and supporting basic services related to civil and social rights, on the basis of the economic cycle the or upon the occurrence of exceptional events. A homogeneous evaluation of the price for a specific service is needed. Thanks to this homogeneous evaluation, price deviations at local level which are unjustified by actual emergency situations are identified (and then eliminated over time). These are the so-called standard costs. They are valued as cross-criteria for the alignment of local authorities' financial system to more virtuous practices through the overall alignment of the benchmark. It is obvious that the concrete translation of this principle into punctual rules of conduct requires a difficult objective as well as non-discriminatory selection of relevant factors. This selection must be based on real and comparable data, going beyond regional differences which are due to

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<sup>17</sup>See PANEBIANCO, *Il Parlamento fra pareggio di bilancio e federalismo fiscale*, Aracne, 2014; RIVOSECCHI, *Il c.d. pareggio di bilancio tra Corte e legislatore, anche nei suoi riflessi sulle Regioni: quando la paura prevale sulla ragione*, in *Rivista AIC* n. 3/2012;

other reason (historical reasons as well as social, environmental, infrastructural reasons or the effective participation to the employment market, and so on).

In the framework of the same reform process, the review of the procedures and the content of national rules for programming and defining expenditure is certainly neither a coincidence nor irrelevant. Basically, the review of budget content seems to be inspired by the willingness to centralize the budget decision-making process and make it easier to control, and therefore, to constantly connect it to the rigorous financial planning targets, which are set in accordance with the European Union. This reinforces the idea of a system that is more rigorous and fully consistent with EU rules.

3. As we saw, the set of national rules governing programming and public finances, are not separate from EU rules. On the contrary, a certain influence had already begun to develop in the past, but the magnitude and the incidence of it have grown dramatically over the last few years, and it has now turned into a complex set of legally relevant and binding rules and constraints, which are now even constitutional in their nature<sup>18</sup>. This influence is so strong now so as to modify the Italian legal system on the basis of new parameters (which are different from the fundamental principles originally set forth by Republican Constitution and from the institutional setup resulting from the same Constitution). Therefore, the system of rules set out by the European Union play a decisive role. These rules are more than simply a sign of new common perceptions and trends, but, as stated above, they are now the actual financial foundations of the State, both procedurally and from the point of view of content.

This is the reason why an insight inside the economic and fiscal governance in the EU must build on the Stability and Growth Pact (SGP), which was adopted by the European Council held in Amsterdam the 16th and 17th of June 1997. A num-

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<sup>18</sup>See CASO, *Il nuovo art. 81 della Costituzione e la legge rinforzata*, Relazione al 58° Convegno di studi amministrativi (*Dalla crisi economica al pareggio di bilancio: prospettive, percorsi e responsabilità*).

ber of precise quantitative limits, which were set as a benchmark of the soundness of public finances in each State, were the main objectives of the above summit. For example, a debt threshold not higher than 3% and a debt/GDP ratio not exceeding 60% were set (as stated in the excessive Protocol on the excessive debt, which was attached to the Treaty of Maastricht).

The resolution of the European Council of the 17th of June 1997 (97/ C 236/01), Regulations 1466 (regulation on the strengthening of the surveillance of budgetary positions) and 1467 (regulation on speeding up and clarifying the implementation of the excessive deficit procedure) of 1997 as well the newly adopted Code of Conduct were further steps which consolidated these basic assumptions.

In this context, the previous art. 104 of the Treaty establishing the European Community (which was then substantially taken over by the current article 126 of the Treaty on the Functioning of the European Union) transposes the mechanism consisting in quantitative thresholds (the actual figures are included in the the Protocol on the excessive deficit procedure, which is attached to the Treaties<sup>19</sup>). At the same time this article introduces a precious element of dynamism, which is represented by the statement whereby the ratio should decline “*substantially and continuously*”. In accordance with this statement, exceedances of threshold values should be only exceptional and temporary, and the debt should diminish “*sufficiently*” and approach the reference value at a “*satisfactory pace*”. Obviously, provisions envisaging adequate forms of reaction in case parameters are not met are a fundamental factor ensuring efficiency to this mechanism. This mechanism is based on a number of steps. First comes an (open ) confrontation with the

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<sup>19</sup>This move spread doubts over the consistency of the whole construction. These doubts were not content-based but they were legal in their nature and related to the legal policy of the EU. See doubts expressed by Professor Guarino in GUARINO, *Saggio di verità sull'Europa e sull'euro*, in “formiche.net”; *Cittadini europei e crisi dell'euro*, 2014, Editoriale scientifica; RINALDI, *Il prof. Guarino ha dimostrato l'illegittimità del fiscal compact, perché non l'ascolta nessuno?*, in “scenarieconomici.it”; LIPPI, *Fiscal compact, storia di una trappola. La verità di Guarino*, in “intelligonews.it”; *Il colpo di Stato avvenuto nel 1997 con l'introduzione del Patto di stabilità*, in “eticapa.it”.

Commission. In the event the excessive deficit persists despite a prior communication and a discussion with the State concerned, the EU Commissions delivers a detailed opinion to the Member state and informs the Council. The latter, acting on a Commission proposal, is to take a decision on the excessive deficit procedure. In case the Council identifies an excessive deficit, it adopts relevant recommendations in order to bring that situation to an end. In case of failure to act by the State, the Council may decide to give notice to Member State to take measures (within a specified time limit) to reduce the deficit and to submit reports in accordance with a specific timetable. In order to support this framework of measures exercising adequate pressure on the State to correct its excessive deficit, the Council may use one or more of the instruments which have been designated for this purpose. It may namely ask the European Investment Bank (EIB) to review its lending policy to the State concerned. The Council may also require the Member State concerned to make a non-interest-bearing deposit of an appropriate size, until the excessive deficit has been corrected or impose fines of an appropriate size.

The direct accountability imposed on Member states and their general government for their budgetary choices is a further guarantee for the effectiveness for this mechanism (so that all stakeholders take their own responsibilities), alongside the EU rule stating that member states' budgetary procedures should allow compliance with the obligations arising out EU Treaties, as well as Member States' obligation to promptly and regularly inform the Commission on their trends in public finances.

The subsequent evolution of the instruments for the implementation of fiscal and budgetary governance in Europe has been characterized by more country-specific provisions. This is not a static process based on acquired data; instead it is a very dynamic process including a growing number of new tools aiming at insuring the effectiveness of this process, such as monitoring tools,

correction mechanisms and more guarantees of effectiveness<sup>20</sup>.

Then came Regulation no. 1055 and Regulation no. 1056 of 2005, which mark the introduction of differentiated targets for member states, to take into account the diversity of budgetary positions, economic development trends and the situation of their public finance in terms of their sustainability.

The parameters set by the Treaty now find concrete implementation in the identification of a medium-term objective, as EU-agreed value based on the growth potential of the economy and the debt/GDP ratio. This value corresponds to the level of net structural debt, adjusted for the cycle and net of temporary and one-off measures. This value may also deviate from a nearly balanced or budget surplus but shall be as such to ensure an adequate margin of security compared to the 3% debt tolerance threshold and sustainability of public finances at the same time.

The subsequent interventions of 2011 paved the way to the so-called Six Pack. The so-called Six Pack is a systematically consistent set of measures aimed at strengthening the EU's capacity to prevent and react to imbalances of member States public finances, as such imbalances were becoming more threatening and urgent with the mounting of the sovereign debt crisis After 2010, which arose in 2011<sup>21</sup>. Thus, Regulations no. 1174 and 1176 of 2011, introduced precise macroeconomic surveillance mechanisms as well as prevention and correction of imbalances, while Regulations no. 1173, 1175 and 1177 of 2011 provided for a more rigorous application of the Stability and Growth Pact. Finally, Dir. 2011/85 referred directly to the content and budgetary procedures for the Member States.

The process of progressive alignment to the set of European rules designed to the oversee stability of the public finances of individual Member States is

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<sup>20</sup>See MORGANTE, *Note in tema di "Fiscal Compact"*, in "federalismi.it", n. 7/2012; FABBRINI, *Il pareggio di bilancio nelle Costituzioni degli Stati membri dell'UE*, in *Quaderni costituzionali*, n. 4, 2011.

<sup>21</sup>For more information about Italy, please see CAPRIGLIONE, *Crisi a confronto (1929 e 2009). Il caso italiano*, Cedam, 2009. ID, *Crisi finanziaria e dei debiti sovrani. L'UE tra rischi e opportunità*, Utet, 2012.

completed with the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union of the 2nd of March of 2012, commonly referred to as Fiscal Compact<sup>22</sup>.

First of all, precise constraints are introduced by an international treaty signed between all the countries of the Union, with the exception of the United Kingdom and the Czech Republic (this is the reason why no other regulatory instruments by the EU could be used<sup>23</sup>). Such constraints are aimed at the harmonization of existing rules and procedures, which are now merged together with the introduction of a precise rule, which is the budgetary balance rule. This rule shall be translated into a commitment by the Contracting Parties to transpose the budgetary balance rule into national rules, which shall preferably be constitutional in their nature<sup>24</sup>.

We can say that the first basic assumption of the new European governance framework, which we described above, is that individual states shall maintain sound public finances (this assumption is drawn from Article 126 of the Treaty on the functioning of the EU, as mentioned above). The two pillars of this dogma are

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<sup>22</sup>See CAPUANO, *Il trattato sul Fiscal Compact*, elaborato dal Senato della Repubblica (Servizio affari internazionali-Ufficio per i rapporti con le istituzioni dell'Unione europea), Dossier n. 94/DN, 16 aprile 2012; CASELLA, *Il Consiglio costituzionale francese e il trattato sul Fiscal Compact*, in *Forum di Quaderni Costituzionali*, 26 ottobre 2012; DEHOUSSE, *The "Fiscal Compact": legal uncertainty and political ambiguity*, in "Notre Europe Policy Brief", 33, 2012; DICKMANN, *Governance economica europea e misure nazionali per l'equilibrio dei bilanci pubblici*, 2012, Jovene; FABBRINI, *Il Fiscal Compact: un primo commento*, in *Quaderni Costituzionali*, n. 2, 2012; NUGNES, *Il Fiscal Compact. Prime riflessioni su un accordo ricognitivo*, in "Forum di Quaderni Costituzionali", marzo 2012, [www.forumcostituzionale.it](http://www.forumcostituzionale.it); PISAURO, *Come funziona il Fiscal Compact*, in [www.lavoce.info](http://www.lavoce.info), 31 gennaio 2012; RIVOSECCHI, *Il meccanismo europeo di stabilità e il fiscal compact tra Karlsruhe e Lussemburgo*, in *Quaderni costituzionali*, 2014; ROSSI, *Fiscal compact e conseguenze dell'integrazione differenziata nell'UE*, in BUONVICINI, BRUGNOLI (a cura di), *Il Fiscal compact*, Quaderni IAI, Edizioni Nuova Cultura; RUOTOLO, *La costituzione economica dell'Unione europea al tempo della crisi globale*, 2012, in *Studi sull'integrazione europea*, 2-3; TOSATO, *Il fiscal compact*, in AMATO - GUALTIERI (a cura di), *Prove di Europa unita. Le istituzioni europee di fronte alla crisi*, Firenze, 2013.

<sup>23</sup>Moreover, the intergovernmental agreement provided for its integration into the European treaties within five years of its entry in force (1.1.2013). For more information please see BORDIGNON, *Veto o non veto? L'Italia di fronte al Fiscal compact*, in "lavoce.info", 2017.

<sup>24</sup>See CIOLLI, *Il pareggio di bilancio in Costituzione, tra le ragioni del diritto costituzionale e i vincoli comunitari*, in "Diritto dell'economia", 2012, pp. 143 e ss.

represented by a balanced budget and by debt sustainability.

The instruments serving this construction are both related to the so-called "Preventive arm", namely all the instruments aimed at monitoring the policies of the Member States, and the so-called "Corrective arm", which is excessive deficit correction system.

In order to ensure the achievement a budget balance, budget targets are placed in a range from a structural deficit of 0.5% of the GDP to a balanced budget (namely 1% for countries with a debt/GDP ratio significantly below 60% and with very low sustainability risk). As to debt sustainability, new rules aiming at constantly reducing government debt exceeding 60 % of the GDP reference value are introduced. Then, the Stability and Growth Pact became obsolete as States were imposed the fiscal constraint of a balanced budget (Article paragraph 1). Following the introduction of this rule, a balanced balance or a budget surplus are achieved if the annual structural balance of the general government (namely the cyclically adjusted balance net of one-off and temporary measures) is equal to the country-specific medium term target, as set forth Stability and Growth Pact, including a newly-introduced limit of a structural deficit lower than 0,5 % of the GDP.

Country-specific net balance targets over the medium term are set. However, they are subject to a general deficit limit of 0.5% of GDP, or 1% of GDP for countries holding a public debt significantly consistent with the ceiling at 60% of GDP. According to common market knowledge, in case of a low risk for long-term sustainability of public finances, a wider margin of deviation can be allowed, since the overall context it is less alarming, which means that the real and tangible country-risk is lower.

The pre-conditions before for the implementation of these new rules are very significant. As clearly outlined in the recitals of the Treaty, the fully-fledged obligation for contracting States as EU Member States to consider their economic policies as a matter of common interest is the first basic pre-condition.

The need to ensure sufficient compliance with a few reduction parameters or mitigation mechanisms (deficit/GDP ratio within 3% and debt/GDP ratio not exceeding 60%) is no less important pre-condition.

Given the experience of the previous years and the urgency of the Treaty, some countries were urging the recourse to this instrument of public finance regulation and were not satisfied with existing measures. As a result, an additional precautionary measure was taken. Contracting Countries (all EU countries except for the United Kingdom and the Czech Republic) undertook the obligation to transpose the provisions of the Treaty by means of binding, permanent and (preferably) Constitutional laws. The EU Court of Justice would then settle potential disputes<sup>25</sup>.

The provision stating that financial assistance in the framework of European Stability Mechanism must be subject to the ratification of the Agreement is a further tool enhancing the effectiveness of this process. This holds just as true for the above mentioned requirements on the arrangements for transposing and implementing the provisions of the Treaty in national legal systems<sup>26</sup>. The real and substantial interests of member states would come to the surface and would affect the negotiation process and its outcome.

Therefore, the introduction of strong and urgent measures of public finance prior control was not considered as sufficient. Instead, this reform process clearly intended to ensure that rules would actually be binding for both national governments (which are responsible for the preparation and the management of the budget) and legislators, which are responsible for the approval of the budget (as well as of other laws governing revenue and expenditure). The binding nature of

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<sup>25</sup>See PEREZ, *Il Trattato di Bruxelles e il Fiscal Compact*, in “Giornale di Diritto Amministrativo”, 2012, n. 5.

<sup>26</sup>See LUNGI, *Governance europea 2011-2012*, in [www.contabilita-pubblica.it](http://www.contabilita-pubblica.it); ALLA L., *Verso una nuova governance economica della UE, novembre 2011*, in [www.amministrazioneincammino.luiss.it](http://www.amministrazioneincammino.luiss.it); Banca Centrale Europea, *La riforma della governance economica dell'area euro: elementi essenziali*, in Boll. BCE, marzo 2011; NAPOLITANO, *Il Meccanismo europeo di stabilità e la nuova frontiera costituzionale dell'Unione*, in “Giorn. dir. amm.”, 2012, p. 461 ss.; ROSSI, “*Fiscal Compact*” e trattato sul Meccanismo di Stabilità: aspetti istituzionali e conseguenze dell'integrazione differenziata dell'UE, in *Diritto dell'Unione Europea*, n. 2, 2/2012.

these provisions is inviolable and permanent and goes beyond majorities in power. These measures are equally binding for different levels of government (including local authorities)<sup>27</sup>.

As a result, rules implementing these principles were introduced. Such rules provide for debt reduction over twenty years on average and correction mechanisms to be triggered automatically in case of an excessive deficit. In order to do so, the excessive deficit procedure was reviewed. Member States would now submit a draft program including a detailed description of the structural reforms to be designed and implemented.

In addition to that, public debt issuance plans are now included in prior communications to the Council of the European Union and the Commission. This is the only way to find out in time whether Member States are actually taking measures to contain or reduce public debt within adequate time limits, so that suitable prior correction mechanism are triggered if needed.

In this context, possible scenarios after the discussion with Member States involved in this procedure should be highlighted. Indeed, disputes may arise. ECJ contracting parties are entitled to lodge an appeal and final decision is taken with adequate legal certainty.

This is the reason why instruments for the payment of a lump sum or adequate penalties were introduced, in case of failure to comply with such judgment. However, these penalties shall not exceed 0,1% of the GDP of each State in question.

4. Therefore the direct consequence of the above described Treaty for Italy's legal system was the constitutional reform of 2012, completed with Constitutional Law No. 1/2012 and Implementing Law No. 243/2012 (adopted by qualified majority), defining the overall set-up designed to meet the specific engagements

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<sup>27</sup>See BILANCIA, *Note critiche sul cd "Pareggio di bilancio"*, in "Rivistaaic.it", n. 2/2012, 3; MACCABIANI, *Democrazia rappresentativa e solidarietà nella governance economica europea: una lettura alla luce delle previsioni del Two Pack*, in "federalismi.it", 19.

taken up with the Fiscal Compact as outlined above.

At this juncture it is relevant to establish what is meant by ensuring balanced budgets, which is one of the fundamental pillars on which the new European tax and fiscal architecture relies in order to ensure stability.<sup>28</sup>

There exist two major emerging lines of thought.

On the one hand, we can consider ensuring a real accounting balance between revenue and expenditure - hence referring to the overall budget balance. When there is a significant debt stock (and hence a corresponding interest expenditure), the consequence of this approach is that the need to ensure balanced budgets results in the need to cancel the debt since the interest expenditure must be fully offset.

In the absence of deficit, the debt stock (at nominal values) would not basically change over time, while the GDP growth would lead to the progressive reduction of the debt / GDP ratio.

On the other hand, on the basis of the other possible approach, all the new constitutional architecture is characterized by clearly dynamic and not necessarily unchangeable concepts such as GDP growth rate, existing debt stock, sustainability, reduction pace and strategy, debt constraints, recourse to new debt. The interpretation of such references - in line with the regulatory provisions enshrined in the EU Treaty (considering that the Fiscal Compact itself refers their interpretation and implementation to the Treaties, in accordance with Article 2), which have not yet been repealed or amended - must not make us forget - as stated above - that Article 126 of the Treaty on the Functioning of the European Union sanctions excessive deficits resulting from the fact of exceeding reference values unless the ratio of the government deficit to gross domestic product has declined “*substan-*

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<sup>28</sup>See BUZZACCHI, *Bilancio e stabilità. Oltre l'equilibrio finanziario*, Giuffrè, Milano, 2015; CORONIDI, *La costituzionalizzazione dei vincoli di bilancio prima e dopo il Patto Europlus*, in “federalismi.it”, n. 5/2012; DICKMANN, *Le regole della governance economica europea il pareggio di bilancio in Costituzione*, in “federalismi.it”, n. 4/2012; ID., *Legislazione di spesa ed equilibrio di bilancio tra legittimità costituzionale e legittimità europea*, in “federalismi.it”, n. 10/2012; MORGANTE, *La costituzionalizzazione del pareggio di bilancio*, cit.; PEREZ, *Dal bilancio in pareggio all'equilibrio tra entrate e spese*, in *Giornale di diritto amministrativo*, 2012.

tially and continuously” and reached a level that “comes close” to the reference value; or, alternatively, the excess over the reference value is only “exceptional and temporary” and the ratio “remains close to the reference value”; while the ratio of government debt to gross domestic product is not “sufficiently diminishing and approaching the reference value at a satisfactory pace”.

Therefore, from this viewpoint, the issue does not only lie in a mere accounting balance between revenue and expenditure, but in the need for achieving balance targets, intended to be evaluated over a time period consistent with the medium-term goals set above all in line with the economic cycle trends. Therefore appropriate relevance is attached to concepts having more evident dynamism and flexibility, in which the pathway and its trend end up being even more important than the starting and arrival points, individually considered, precisely because – regardless of the need to strengthen the toolkit designed to ensure fiscal discipline – the public finance trends of a specific country cannot avoid considering the fundamental sustainability of the pathway followed.

In this regard, it should be pointed out that others have proposed a different and more systematic approach to the issue.<sup>29</sup> According to other interpretations of the reference provisions, the alternative between “fixed rule of budget balance” and “flexible principle of budget balance” must be regarded as misplaced, since a sort of continuity between the mainstream legal theory and the constitutional case law of Article 81 in its previous wording would seem to corroborate the options in favour of the second approach, with a view to safeguarding the powers of the constitutional bodies in the economic policy choices<sup>30</sup>.

Indeed - in a cross-cutting approach compared to the mere rigid opposition between the advocates of an interpretation of the new constitutional rules that

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<sup>29</sup>See CHESSA, *La Costituzione della moneta – Concorrenza, indipendenza della banca centrale, pareggio di bilancio*, Jovene 2016, pp. 395 e ss.

<sup>30</sup>See BRANCASI, *Governo della spesa pubblica e divieto di disavanzi eccessivi*, in DELLA CANANEA - NAPOLITANO (a cura di) *Per una nuova costituzione economica*, Il Mulino, 1998; RIVOCCHI *L'indirizzo politico finanziario tra Costituzione italiane e vincoli europei*, Cedam, 2007; DE IOANNA, *Parlamento e spesa pubblica. Profili istituzionali del bilancio pubblico in Italia*, Il Mulino, 1993.

may easily legitimize "flexible" budget policies enabling counter-cyclical choices and the advocates of a more "rigorous" interpretation, considering that a fixed target shall be achieved anyway - it is maintained that there is still an undeniable need not to depart from a numerical budget rule (namely the structural balance). Hence the need not to depart from a numerical constraint which, however - being linked to the structural and not to the nominal balance - allows to overcome an almost automatic interpretation of the ratio between actual revenue and expenditure, up to certainly allow to take the economic cycle fluctuations into account, so as to consider the difference between the actual and the potential product, i.e. without the influence of factors affecting the specific cycle. Nevertheless, also in this second approach, the fact remains that we cannot legitimize budgetary policies fully disregarding this objective constraint, expressed by the need to achieve a specific numerical target.<sup>31</sup>

Hence, from this viewpoint - apart from a strict comparison between extreme interpretations - the 2012 reform introduced in the Italian system a decisive factor for the convergence of budgetary policies towards quantitative, measurable and pre-defined targets which - although adequately enhancing the variables triggered off by the economic cycle trends – certainly removed from the constitutional system any presumed legitimacy of merely qualitative choices, which are self-sufficient only as expression of the political decision-making power.

In this regard, as already pointed out, assessing the economic situation becomes an essential aspect to define an ongoing process, albeit characterized by

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<sup>31</sup>This permits to refer the new provisions of Article 81 of the Constitution to a Balanced Budget Rule, i.e. one of the rules which - albeit to different extents and in not always homogeneous ways - anyway place numerical constraints on public budget management, sometimes also matched by flexibility clauses mitigating its effects with reference to exceptional events, although not denying its functionality, CHESSA, *La Costituzione della moneta – Concorrenza, indipendenza della banca centrale, pareggio di bilancio*, Jovene 2016, cit., pp. 397 e ss.; SCHAECHTER, KINDA, BUDINA, WEBER, *Fiscal Rules in Response to the Crisis – Toward the "Next-Generation" Rules. A New Dataset in IMF Working Papers*, 2012; MARE' - SARCINELLI, *La regola del bilancio in pareggio: come assicurarla e quale livello di governo?*, Relazione al convegno *Il principio dell'equilibrio di bilancio secondo la riforma costituzionale del 2012*, Corte costituzionale, Roma, 22 novembre 2013; BOVA, KINDA, MUTHOORA, TOSCANI, *Fiscle Rules at a glance: Country Details from a New Dataset*, in *IMF Working Papers*, 2012.

different levels of intensity and incisiveness depending on the expansionary or recessionary phases of the economic cycle. Hence deficits and imbalances between revenue and expenditure will be permitted (although within the limits set by the Fiscal Compact) owing to the physiological deterioration of public finances as an immediate result of the recessionary phase of the economic cycle: in fact, it is evident that lower growth or economic recession will result in lower tax revenue. On the contrary, in the economic growth phases, budget surpluses will emerge to offset the downturn-related deficits, which shall be used to reduce debt at the expected pace.<sup>32</sup>

This interpretation, resulting from a counter-cyclical approach, is also consistent with the provisions of Regulation 1055/2005/EC<sup>33</sup> and, similarly, of Regulation 1175/2011/EU.<sup>34</sup>

This complex regulatory revision outlines a flexible implementation of the Stability Pact and of the subsequent rules governing the need for sound public finances in national budgets, not to reduce its efficacy, but rather to ensure its concrete and not merely theoretical effectiveness. Declaration No. 30 on Article 126 of the Treaty on the Functioning of the European Union already showed the shift from a numerical approach, albeit similar for all States, to a careful approach focused on the impact on financial balances influenced by the economic situation

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<sup>32</sup>See SALVEMINI, *Poteri di bilancio e sistema istituzionale italiano. L'Organismo indipendente per la analisi e la verifica degli andamenti dei conti pubblici*, Relazione al 58° Convegno di studi amministrativi (*Dalla crisi economica al pareggio di bilancio: prospettive, percorsi e responsabilità*).

<sup>33</sup>It reads as follows: “A more symmetrical approach to fiscal policy over the cycle through enhanced budgetary discipline in economic good times should be achieved, with the objective of avoiding pro-cyclical policies and to gradually reach the medium-term objective. Adherence to the medium-term budgetary objective should allow Member States to deal with normal cyclical fluctuations while keeping the government deficit below the 3% of GDP reference value and ensure rapid progress towards fiscal sustainability. Taking this into account, it should allow room for budgetary manoeuvre, in particular for public investment.”

<sup>34</sup>It reads as follows; “Adherence to the medium-term objective for budgetary positions should allow Member States to have a safety margin with respect to the 3% GDP reference value in order to ensure sustainable public finances, or rapid progress towards sustainability, while leaving room for budgetary manoeuvre, in particular taking into account the need for public investment. The medium-term budgetary objective should be updated regularly on the basis of a commonly agreed method reflecting appropriately the risks of explicit and implicit liabilities for public finances, as embodied in the aims of the Stability and Growth Pact.”

and the corrective effects that fiscal policy can have in the individual countries.

As outlined above, the subsequent evolution is characterized by growing differentiation in the sense of adapting to the specificities of the economic and financial situations prevailing in the individual countries. Against this background, the medium-term fiscal balance target is consistent with the multi-year duration of the programming cycles, but appropriate room for manoeuvre is left to the Member States for implementing counter-cyclical economic and budgetary policies - hence austerity policies in expansionary phases and greater flexibility to implement expansionary policies in downturn phases.

The diversification of the balance targets for the various countries, permitted under Whereas No. 5 of Regulation 1055/2005/EC, is designed to "take into account the diversity of economic and budgetary positions and developments, as well as of fiscal risk to the sustainability of public finances, also in the face of prospective demographic changes".

Hence there is the concrete possibility of deviation from the general rule (budgetary positions close to balance or in surplus), but not according to merely political assessments or to assessments not affected by quantitative constraints, but within a pre-defined range: up to -1% of GDP and balance or surplus, because a safety margin with respect to the 3% reference value must be allowed for anyway, without undermining long-term sustainability. Therefore the logical corollary is to recognize that the objectives are to be considered not in merely financial terms, but in structural ones, i.e. in cyclically-adjusted terms and net of one-off and temporary measures.

With the Fiscal Compact, the flexibility margins are made more stringent and better defined, as the deficit range is fully indicated in the differential ranging between 1% and 0.5% of GDP<sup>35</sup>.

The balance relevant for the balanced budgetary position is the difference

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<sup>35</sup>It should be recalled that the 1% threshold is envisaged only for highly debt-compliant countries, since it is substantially lower than 60% and hence has low risks in terms of long-term sustainability of public finances.

between revenue and expenditure, net of one-off measures and net of the cyclical factors, measured according to the output gap. The latter should be understood as the difference between actual and potential GDP, derived from historical statistical data processed according to statistical assumptions and procedures.<sup>36</sup>

Also the assessment of the convergence path towards achieving the objectives set is affected by an inevitable differentiation for the specific conditions of the individual States. In this regard, the European Commission will take the positive tax and fiscal impact of structural reforms into account, to a different extent depending on the Member States' conditions.

For the countries which are in the preventive arm of the Stability Pact (i.e. not subject to excessive deficit procedures), the Commission<sup>37</sup> could accept a temporary deviation from the medium-term balance target within the limit of 0.5% of GDP (approximately 8.5 billion euro in the case of Italy), while ensuring an adequate safety margin in order to respect the 3% reference value.

For the countries which are in the corrective arm (i.e. subject to an excessive deficit procedure), the European Commission could recommend the Council to grant more time for deficit correction.

Significant deviation from the objective is recorded in case of a structural balance change equal to at least 0.5% of GDP in one single year or to at least 0.25% of GDP on average for two consecutive years. It is also necessary to assess the overall impact of the expenditure trends on the public balance, net of discretionary

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<sup>36</sup>Economic theories clarify that “*unlike the actual product which is objectively measurable, the potential product cannot obviously be measured with the same level of certainty, but it is the result of a highly uncertain estimate also based on a method relating to which there is no unanimous agreement among economic experts and academics*”, see CHESSA O., *La costituzione della moneta. Concorrenza, indipendenza della banca centrale, pareggio di bilancio*, Jovene, 2016, pp. 410 e ss.

<sup>37</sup>In this respect, it should be underlined that the European Commission and the Council exercise real control and intervention powers in case of Member States not meeting the criteria set by the European Union, SCACCIA, *L'equilibrio di bilancio fra Costituzione e vincoli europei*, in *Osservatoriosullefonti.it*, fasc. 2, 2013; BIFULCO, *Le riforme costituzionali in materia di bilancio in Germania, Spagna e Italia alla luce del processo federale europeo*, in BIFULCO, ROSELLI (a cura di) *Crisi economica e trasformazioni della dimensione giuridica*, Giappichelli, Quaderni CESIFIN, 2013; CHESSA, *La costituzione della moneta. Concorrenza, indipendenza della banca centrale, pareggio di bilancio*, Jovene, 2016, pp. 414 e ss.

measures on the revenue side – once again at values equal to at least 0.5% of GDP in one single year or cumulatively in two consecutive years.

In particular, however, the view prevails whereby we must also consider the cumulative impact on the government debt trends, precisely because different starting conditions cannot lead to similar assessments of the subsequent adjustment pathways. A more careful analysis shows that it is a prospective-evolutionary approach to the deviation significance, not a mere evaluation of the current differential.

For the Member States which have exceeded the medium-term budgetary objective, the deviation is not considered significant when the States have the possibility of substantial extraordinary revenue and the budgetary plans submitted in the stability programme do not jeopardize the objective in the programme reference period. Furthermore, the deviation is not considered relevant when it is caused by an unforeseeable event beyond the Member States' control (i.e. exceptional events).

Hence we are faced with a comprehensive assessment of compliance with the objectives set, as reaffirmed by the reference made to the structural balance and to the need for analysing expenditure net of discretionary measures on the revenue side. Therefore all the factors appropriately reflecting developments in the medium-term economic position (potential growth, prevailing economic conditions, implementation of development and innovation policies, etc.) are considered.

Ultimately, it is an evaluation not merely "based on accounting standards and principles" – hence uncritically relying on the mere interpretation of accounting data not necessarily related to the subjective and objective reference context. Hence what comes to the fore is rather the ongoing attention paid to the evolution of the medium-term budgetary position: therefore other principles and concepts are considered, such as the commitment for counter-cyclical fiscal consolidation, debt sustainability, the appropriate evaluation of public investment - ultimately

the overall quality of public finances up to considering the pension system reforming processes in terms of capitalization.

As mentioned above, however, deviations are acceptable only when the deficit remains close to the reference value and said value is exceeded only temporarily. For non-compliant Member States, the Council and the Commission examine whether the State pursues an adequate annual improvement of its cyclically-adjusted budget balance, net of one-off measures, required to achieve the medium-term budgetary objective, having 0,5% of GDP as benchmark. In this context of appropriate differentiation, greater efforts are required for the countries with a debt over 60%, or with considerable risks to the overall debt sustainability, which are asked to achieve an annual balance improvement over 0.5% of GDP.

In conclusion, the complex mix of these factors enables us to recognize that the budget balance is to be more properly understood as a balance and not as a mere accounting breakeven, characterized by a dynamic factor, that is the balance sustainability over time. Hence there is the possibility of non-coincidence with the breakeven if other factors can affect sustainability in the medium term. This is primarily due to the impact of growth of the debt stock.

Certainly, in principle any deficit expansionary budgetary policies (although in compliance with the fiscal balance under the previous wording of Article 81 of the Constitution) are not currently permitted. Only a deviation from the mere strict budget balance can be accepted, insofar as it is possible to measure the output gap - hence again an objective numerical value which can include the proper consideration of the economic cycle.

5. The necessary completion of the powers for governing public budgets is the definition of a budgetary cycle, that is the definition of the process which allows to outline the final budgetary choices through specific time schedules and modalities. Considering the vital importance of governing public spending and budgetary choices for the public administrations to achieve their institutional goals

- namely really serving the public interest - this process must necessarily make the various public powers involved coexist, in a balanced framework consistent with the characteristics of the institutional set-up typifying the legal system.

In the systems where Parliament plays a prominent role, such as in Italy, this harmonization - at the level of government choices – is focused on the definition of a Parliamentary budget adoption process pursuing the need for reconciling the roles played by the various institutional actors as a guarantee of democratic balance.

Precisely for these reasons, the definition of this process goes well beyond a merely technical dimension and takes up a purely political connotation. This means that the rules with which the process described above must comply shall allow to reach - in a timely and objective manner - results consistent with the characteristics imposed by an institutional architecture having even a constitutional rank. At the same time, however, said rules reflect a balance between the powers involved (mainly the legislative and the executive ones) and the initiatives that each of them can take (as in the usual dialectic between Parliamentary majority and opposition forces), providing the eminently political connotation mentioned above.

The further evolution that has been reaffirmed as unavoidable in recent years means that there is the need for an additional level of debate, represented by a note common to all the national systems called to express the specific tax and budgetary choices made in relation to what is provided for by the EU system.<sup>38</sup>

We have already noted how the EU system heavily affects the identification of the objectives of the national budget choices, up to the need for explicit compliance, according to a paradigm enshrined in the Constitution with the amendment of 2012<sup>39</sup>. Now this framework is consistently revived in the definition of the budgetary cycle, that is the process leading to the definition of public budgets at

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<sup>38</sup>See RIVOSECCHI, *Il governo europeo dei conti pubblici tra crisi economico-finanziaria e riflessi sul sistema delle fonti*, in “Osservatoriosullefonti.it”, n. 1/2011.

<sup>39</sup>See LUPO, *La revisione costituzionale della disciplina di bilancio e il sistema delle fonti*, in “Astrid-Rassegna”, n. 164 (15/2012).

State level. The budgetary cycle defined shall not only comply with a shared agenda of programming objectives, but must even be strictly included in a common set of deadlines, procedures and verification phases of the programming and implementing choices made by the individual Member States.

The timing and content of the national budget programming cycle are greatly influenced by the new economic governance rules adopted at European level. The stated objective is the clear will to foster stronger *ex-ante* coordination of the EU Member States' economic and budgetary policies and closer fiscal and macro-economic surveillance.<sup>40</sup>

For these reasons, the constraints imposed by EU law require the individual Member States to submit to the Community institutions (hence mainly to the European Commission) the public finance programming documents, even before they are finalized at national level.

The new multilateral surveillance procedure is functional to the enhanced mechanisms for the monitoring and surveillance of the Member States' macroeconomic and financial imbalances, defined with the package of measures commonly known as "Six Pack" (which came into force in December 2011).

Directive 2001/85/EU has specifically set minimum common rules for national budget frameworks, designed to make them more transparent, comparable and as complete and truthful as possible, with the same multi-annual programming time horizon (hence with a minimum three-year term).

Against this background, the "European Semester" has been defined, that is the process designed to envisage various key levels of strategic choices for the overall definition of national budgets.<sup>41</sup>

At first, this process develops and supervises the implementation of the Broad Economic Policy Guidelines of the Member States and the European Union,

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<sup>40</sup>See TOSATO, *I vincoli europei sulle politiche di bilancio*, in "ApertaContrada", 22.7.2012; BRANCASI, *Il coordinamento della finanza pubblica nel federalismo fiscale*, in "Dir. pubbl.", 2011.

<sup>41</sup>See RIZZONI, *Il "semestre europeo" fra sovranità di bilancio e autovincoli costituzionali: Germania, Francia e Italia a confronto*, in "Rivista AIC", 2011, 4.

pursuant to Article 121, paragraph 2, of the TFEU and of the Employment Guidelines pursuant to Article 148, paragraph 2, of the TFEU.

Another key factor is the submission (by April 30) and evaluation of the Member States' stability programs or convergence programs.

Then the process leads to the submission and evaluation of the Member States' national reform programs for growth and employment, defined in line with the broad economic guidelines, the Employment Guidelines and the general guidelines provided to the Member States by the European Commission (i.e. the Annual Growth Survey) and the European Council at the beginning of the annual surveillance cycle.

The necessary completion of the process is ensured by the surveillance activities designed to prevent and correct macroeconomic imbalances in accordance with EU Regulation No. 1176/2011.

In line with this scenario, the National Accounting Law (No. 196/2009), as amended by Law No. 163/2016, is aligned with the new timetable set by the European Union. April 10 is the deadline for submitting to Parliament the main national economic and financial programming document, namely the Economic and Financial Document (DEF), containing the Stability Program and the National Reform Programme (PNR) (first and third sections).

The submission of DEF in the first half of April enables Parliament to express its opinion on the programme objectives in due time for submitting - to the European Council and to the Commission, by April 30 - the Stability Programme and the PNR, thus taking into account the indications provided in the Annual Growth Survey drafted by the European Commission at the beginning of each year.

Also on the basis of the recommendations made by the European authorities in June-July, and in view of considering any change in the macroeconomic and public finance trends as against the DEF forecasts, an updated Note on DEF shall be submitted by September 27.

Following the "Six Pack", the national programming process was supple-

mented on the basis of a package of measures known as "Two Pack" (Regulation No. 472/2013 and Regulation No. 473/2013), which entered into force on May 30, 2013 and were self-executing in the national accounting systems.

Regulation No. 473/2013 provides to the Commission new powers enabling it to evaluate national budgetary plans and, where necessary, to request their revision to ensure the correction of excessive deficits.

The Regulation sets a "*Common Budgetary Timeline*", with a view to better fine tuning and synchronizing the main phases for drawing up national budgets. In addition to the deadlines already set with the European Semester, said timeline envisages the submission to the Commission and the Eurogroup - by October 15, namely shortly before the submission to Parliament of the budget bill on October 20 - of a Draft budget programming document for the subsequent year, summarizing the content of the package of measures defined with the above stated bills.

The document, which shall be submitted to Parliament again by October 15, must be consistent with the recommendations made by the European Institutions in the framework of the Growth and Stability Pact and with the recommendations made in the framework of the annual surveillance cycle, also in relation to the macroeconomic imbalance procedure.

Considering that achieving the financial objectives set out in the Stability and Growth Pact requires the contribution of all public administration sub-sectors, the budgetary programming document must provide information on the contribution provided by each of these sub-sectors.

The Commission's opinion on the draft budget programming document should be adopted as quickly as possible and, in any case, by November 30, taking into account the time schedules and the national Parliamentary procedures.

Member States are urged to take the Commission's opinion into account.

The extent to which such an opinion is considered in a Member State's budgetary law is assessed by the Commission when ascertaining the existence of an excessive deficit in the Member State concerned.

Failure to comply with the guidelines preliminary provided by the Commission should be considered an aggravating circumstance.

6. The changes made to the system, reaching up to the constitutional level, have contributed to innovate the budgetary policy rules profoundly. Undeniably the new set-up emerging from the process started both at EU and national levels - by making the former affect the latter and involving also the constitutional level - entails the need for reconsidering the budgetary choices of the democratic bodies having a political value.<sup>42</sup>

More specific rules on the identification of goals and unbreakable constraints constantly match the government's budgetary choices, even within the budgetary cycle. This different dimension of the regulatory choices made by the national lawmaker shows the irresistible tendency to operate in a framework not simply consistent with European guidelines, but rather directly governed by rules, objectives, specificities and constraints shared and imposed by the EU legal system. The choice to entrust the definition of the EU regulatory framework to self-executing measures leaves extremely limited margins for the subsequent national measures, which are very often only called upon to coordinate the lower levels of regulation, but within unchangeable fundamental assumptions defined at a level which goes well beyond the State's mere regulatory or statutory power.

Clearly this is the specific completion of an approach that is largely affected by the new approach emerged as a result of the sovereign debt crisis which broke out between 2010 and 2011.<sup>43</sup> The mix of already existing rules and measures has

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<sup>42</sup>See CAPRIGLIONE, *Mercato regole democrazia. L'UEM tra euroscetticismo ed identità nazionali*, Utet, 2013; ID., *Politica e finanza nell'Unione europea. Le ragioni di un difficile incontro*, Cedam, 2015.

<sup>43</sup>With specific reference to the situation prevailing in Europe as a result of the sovereign debt crisis, see ALLA, *Verso una nuova governance economica della UE, novembre 2011*, in [www.amministrazioneincammino.luiss.it](http://www.amministrazioneincammino.luiss.it); BANCA CENTRALE EUROPEA, *La riforma della governance economica dell'area euro: elementi essenziali*, in *Boll. BCE*, marzo 2011; CAPRIGLIONE, *Crisi finanziaria e dei debiti sovrani. L'UE tra rischi e opportunità*, Utet, 2012; *L'ordinamento finanziario dell'UE dopo la crisi*, Utet, 2014; LUNGHI, *Governance europea 2011-2012*, in [www.contabilita-pubblica.it](http://www.contabilita-pubblica.it); NAPOLITANO, *L'assistenza finanziaria europea e lo Stato*

been considered insufficient to ensure the financial stability of the individual national budgets, which is the prerequisite for greater financial stability in an area characterized by an unprecedented monetary integration.<sup>44</sup>

For these reasons, the strategy worked out by the European institutions has attached priority to an accurate fiscal discipline, pursued through instruments capable of having a decisive and pervasive impact on the national systems.<sup>45</sup> Hence, besides the sharing of fundamental choices for actually achieving the stability objectives, further constraints have emerged, thus placing the related regulatory framework within the institutional set-up of each national system through the specific guarantee of non-amendability resulting from the constitutional character of the regulatory changes introduced.<sup>46</sup>

Ultimately a set-up has emerged, inevitably reoriented towards a balance of political-institutional forces and tensions increasingly expressing the direct pervasiveness of the EU system on the choices made by the national lawmaker, according to a process that is certainly not new or exclusive, but capable of defining the

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“co-assicuratore”, in “Giornale di diritto amministrativo”, 2010, pp. 1085 e ss.; ID. *The Two Ways of Global Governance after the Financial Crisis: Multilateralism versus Cooperation among Governments*, in “International Journal of Constitutional Law”, vol. 9, n. 2, 2011, pp. 310 e ss.

<sup>44</sup> This seems to echo some of the most significant ideas and concepts of the German neoliberal theories (as brilliantly analyzed by CHESSA, in *La Costituzione della moneta – Concorrenza, indipendenza della banca centrale, pareggio di bilancio*, Jovene 2016, pp. 49 e ss.), whereby “in the long run no country can manage a deficit economy successfully” because “if the budget remains unbalanced permanently, the deferred requirements relating to tax obligations shall be met at a later stage and to a greater extent; furthermore the currency is ruined and there is the need for heavier and more damaging measures”, see DIETZE, EUCKEN, LAMPE, *Ordine economico e sociale*, in FORTE, FELICE (a cura di), *Il liberalismo delle regole. Genesi ed eredità dell’economia sociale di mercato*, Rubettino, 2010.

<sup>45</sup> In this connection see the interpretation proposed by BUCHANAN, *Stato, mercato e libertà*, Il Mulino, 2006, that analysed precisely the case of balanced budget as an emblematic expression of the overcoming of the fiscal prudence principles as a result of the cultural evolution imposed by the Keynesian approach. In this perspective, once reduced the strength of unwritten “moral principles” for ensuring sound public finances, politicians’ systematic recourse to deficit spending, as a way to ensure only voters’ satisfaction, can be overcome only by envisaging budgetary constraints explicitly chosen, imposed and implemented, since they are enshrined in written constitutional rules (see the brilliant analysis of CHESSA, in *La Costituzione della moneta – Concorrenza, indipendenza della banca centrale, pareggio di bilancio*, Jovene 2016, pp. 76 e ss.).

<sup>46</sup> See NAPOLITANO, *La crisi del debito sovrano e il rafforzamento della governance economica europea*, in *Uscire dalla crisi. Politiche pubbliche e trasformazioni istituzionali*, a cura di NAPOLITANO, il Mulino, 2012, p. 383 ss.; ID. *L’incerto futuro della nuova governance economica europea*, in “Quaderni costituzionali”, 2012, p. 141 ss.

key strategic choices within the ability of each national system to plan, monitor and supervise its budgetary choices as an essential expression of economic policy choices. Hence the stepping up of a process gradually reducing the areas traditionally covered by the democratic bodies' self-determination in governing the public budget, faced with this complex set of constraints – including the procedural ones – which ultimately place this activity at a higher and supranational level. Undoubtedly this process is a decisive factor of innovation introduced in the system, which now requires a rethinking of the traditional principles and rules according to the new configuration.<sup>47</sup>

Any traditional assessment of national budgetary rules must be rethought and placed in this process required by the need for supranational integration, especially in a context dominated by monetary integration, being aware that it has taken on a new fundamental value for the purposes of orienting financial policies. Said value is represented by the stability of the national financial framework within the European one, along the lines described above, which is now recognizable also in its constitutional dimension. Hence, from this viewpoint, the 2012 reform (not only at constitutional level) symbolically marks a definitive break with the past.<sup>48</sup>

The clarifications provided by the analysis of the real meaning of the principle of breakeven or balanced government budgets enshrined in the Constitution,

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<sup>47</sup>See PATRONI GRIFFI, *L'Europa e la sovranità condivisa: appunti di un discorso sulle ragioni del Diritto costituzionale europeo*, in “Diritto Pubblico Europeo-Rassegna on line”, gennaio 2015; NAPOLEONI, *Più Europa vuol dire meno sovranità nazionale*, in “nuovi-lavori.it”; BIN R., CARETTI, PITRUZZELLA, *Profili costituzionali dell'Unione europea*, 2015, Il Mulino; CARAVITA, *Quanta Europa c'è in Europa*, Giappichelli. With specific reference to the problems triggered off by the Fiscal Compact and the related process designed to re-orient (also at constitutional level) the national systems involved, see RUOTOLO, *La costituzione economica dell'Unione europea al tempo della crisi globale*, 2012, in *Studi sull'integrazione europea*, 2-3. ROSSI, *Fiscal compact e conseguenze dell'integrazione differenziata nell'UE*, in BUONVICINI - BRUGNOLI (a cura di), *Il Fiscal compact*, Quaderni IAI, Edizioni Nuova Cultura; DEHOUSSE, *The “Fiscal Compact”: legal uncertainty and political ambiguity*, in “Notre Europe Policy Brief”, 33, 2012; DICKMANN, *Governance economica europea e misure nazionali per l'equilibrio dei bilanci pubblici*, 2012, Jovene; NUGNES, *Il Fiscal Compact. Prime riflessioni su un accordo ricognitivo*, in “Forum di Quaderni Costituzionali”, marzo 2012, [www.forumcostituzionale.it](http://www.forumcostituzionale.it); MORGANTE, *La costituzionalizzazione del pareggio di bilancio*, in “federalismi.it”, n. 14/2012.

<sup>48</sup>It is by no mere coincidence that some experts and academics have underlined the “subversion of the logics of contemporary constitutionalism”, GUAZZAROTTI, *Crisi dell'euro e conflitto sociale. L'illusione della giustizia sociale attraverso il mercato*, Franco Angeli, 2016.

together with the assessment of the interferences between the national constitutional level and the EU regulations – albeit better defining the complex mix of constraints, objectives and programming choices - do not allow to play down the real institutional significance of the novelties introduced, in line with the shifting of the substantial centre of gravity of financial policy choices from the purely State dimension to the supranational one.

Hence this really seems to shape a process of reconstruction of structural institutions and rules that limit and direct the budgetary policy choices towards the general interest, in line with the assumption whereby the discretionary management of economic policy - which has proved to be unable to withstand the pressure dictated only by the search for voters' consensus - requires clear constraints, including constitutional ones, to limit the indiscriminate recourse to deficit government spending: only in this way, in fact, can we ensure public goods management not dominated by particular interests or powerful lobbies.<sup>49</sup>

Academics and experts do not unanimously agree on the outcome of the process and some even doubt that the new set-up is consistent with the overall system, because the basic principles of the constitutional architecture are undermined irremediably.<sup>50</sup>

It is certain, however, that the constitutional changes analysed - in the relationship of direct dependence and ongoing adherence to the Fiscal Compact and to the other EU and supranational choices – show a profound change in the whole institutional set-up resulting from a new balance of forces and decision-making centres undoubtedly epitomized in the government budget discipline.

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<sup>49</sup>See ALESINA, TABELLINI, *A positive theory of fiscal deficits and government debt in a democracy*, in *NBER Working Paper Series* n. 2308, 1987; ALESINA, DRAZER, *Why are stabilizations delayed?* In *NBER Working Paper Series* n. 3053, 1989; ALESINA, PEROTTI, *The political economy of budget deficits*, in *IMF Staff Papers*, vol. 42, n. 1, 1995.

<sup>50</sup>See DE IOANNA, *Costituzione fiscale e democrazia rappresentativa. Un cambio di paradigma*, in *Cultura giuridica e diritto vivente*, Special Issue, 2015.

## THE ENVIRONMENT AS A LEGAL INTEREST: THE CONTRIBUTION OF THE ECONOMIC ANALYSIS TO THE DEBATE IN BRAZILIAN LAW

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**ABSTRACT:** *The tension existing between economic development and environmental preservation inflicts debates in the contemporary scenario, highlighted by a context of continuing expansion of the global market. The conflict demands a deep reflection, oriented for the search of mechanisms promoting a minimum conciliation between two vectors. The European Union defines the environmental issue as one of the vertexes of its economic policy and intends to reconcile the protection to the environment with its competitive standing in the global market. In this line of thought, the seventh EU's environmental action programme provides as one of its priority purposes the correct approach of environmental externalities. Some models for environmental protection adopted by national States and their legal grounds will be described. Despite international concerns have taken the contemporary speech, it is important to see to what extent localities incorporate such global guidelines and what are the obstacles encountered in the effectiveness of environmental protection. The importance of economic instruments in the protection of the environment is growing, especially those that discourage pollution and reward conservation. The economic instruments of environmental protection existing in Brazil will also be described, with special emphasis on the mechanisms of compensation of negative externalities in en-*

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*terprises causing environmental impacts. The study of the Brazilian experience may effectively contribute to the appropriate consideration of the environmental external factors and optimize the mechanisms of negative externalities existing in the EU.*

**SUMMARY:** 1.Introduction. – 2.Overview of legal protection of environmental protection. – 3. Ramifications of the environmental legal interest: suggested solutions. – 4. Environmental compensation instruments in Brazilian legal system. – 5. Conclusion.

1. The movement of internationalization of the economies also attracted Law, which is becoming essentially global, especially with respect to economic blocs. The interest for the environment, especially in International Conventions, has been increasing gradually, until it is configured as a global concern.

Prior to the development of the environmental rules, environmental protection problems were encompassed by the protection of property or accepted as appendixes to the Administrative Law. Subsequently, the protection moves from property to the qualified environment as a legal interest, and Environmental Law arises as a new basis of protection and unifying element of a global policy, based on some basic principles of ecology. From this change of reference, the right to a healthy environment is built, understood as a diffuse right.

The concept of environment is essentially complex, however it has constant elements, which can be more or less specified by national laws. Given that environmental protection does not have a single definition, the observation of the several international models has the potential to contribute to the determination of the content of the right to the environment and its extension. It is intended to examine the legal progression of the issue in order to demonstrate how the legal systems in general have responded to this new interest to be legally protected and to what extent it has been done.

In spite of the insertion of environmental protection in several so-called "civilized" countries, each legal system internalizes this protection in a form or measure,

that is, to each one a conception of the environment can be assigned – whether as a fundamental right, protected value or interest raised to constitutional protection – on the condition that the minimum protection that is the responsibility of the National States is respected. The intensity of the protection of the environment is not absolute, but limited to the capacity of each State.

The exposure of the multiplicity of legal disciplines related to the status granted to the environment has repercussions on the proposed solutions, varying according to the context in which the problems are inserted. The issue receives more importance with the possibility of valuing the environmental interest and the development of mechanisms to compensate for negative environmental externalities, based on the consideration that natural resources can be considered as scarce interests, thus, the income and economic proceeds associated with its ownership or exclusive use shall be taken into account.

The exposure of the environmental protection in the several countries has the purpose to provide the necessary inspiration for the development of a model of joint protection that associates the advantages of private protection mechanisms with the limits imposed by legal texts as determined by the Seventh Environmental Action Programme of the European Union for 2020, which requires adequate investment from public and private sources on the environmental issue.

Private Law is based on an essentially proprietary protection; Environmental Law brings some publicist command and control techniques. The economic analysis can contribute to the improvement of both types of protection through the valuation of environmental interests. Within this perspective, the instruments of environmental compensation in Brazilian Law will be exposed, with the intention of contributing to the debate on the mechanisms of internalization of the environmental externalities.

2. The current framework of environmental protection is under the high principles of International Environmental Law, which aims to create a common space, marked by the harmonization of Member States' legislation with global guidelines.

Environmental protection in countries starts with sectoral legislation, protecting environmental elements individually considered such as water, soil, etc., which are specific legal interests (or environmental micro-interests), which occurs through Public Law instruments, in particular, by the Administrative Law of the environment, which progressively gains a greater proportion, and thus detaches from it, becoming endowed with autonomy.

Prior to the development of environmental regulations, environmental problems were considered as property issues and settled through the neighborhood law<sup>1</sup>. Some environmental protection instruments find correspondence in Roman Law, especially in matters relating to building, the neighborhood law and the protection of property. Therefore, in order to better understand the relations between property and the environment, it is important to not only examine the birth and development of Environmental Law as an autonomous branch of protection, but also as a transversal discipline that touches both Public and Private Laws.

The mentioned evolution shows that there is a sensitive variation of the environmental protection instruments, which may be of Public or Private Law. Public Law instruments have an essentially precautionary character, while Private Law instruments, as the protection of property, civil liability and contract, have a dimension turned to repression and establishment of the *status quo*<sup>2</sup>. Due to such reason, if, on one side, the latter can be considered less incisive, on the other side, they are endowed with more flexibility and have capacity of coordination with the instruments already existing.

Barbara Pozzo<sup>3</sup> distinguishes three key trends in international legislations and

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<sup>1</sup>See FERNANDEZ, *Direito ao ambiente e propriedade privada*. Coimbra: Coimbra Editora, 2001. p. 23.

<sup>2</sup>See CASERTANO, *Proprietà e ambiente: la soluzione italiana a confronto con le nuove esigenze di tutela*. Milano: Giuffrè, 2008. p. VIII.

<sup>3</sup>See POZZO, *Ambiente e Diritto Privato*. In: GRASSI, Stefano; CECCHETTI, ANDRONIO (a cura di). *Ambiente e Diritto. II*. Fondazione Carlo Marchi – Quaderni 3: Leo S. Olschki, 1999. p.447. On the variability of the Models, see also: POZZO, *La tutela dell'ambiente nelle Costituzioni: profili di diritto comparato alla luce dei nuovi principi introdotti dalla Carta de Nizza*. In: POZZO, RENNA, *L'ambiente nel nuovo titolo V della Costituzione*. Milano: Giuffrè, 2014. p. 3-26.

groups the legal systems in three diverse groups, according to the trend adopted, namely: i) countries where the environment is not assigned with the status of legal interest, maintaining the typology of the interests already existing; case in which the violations to the mentioned interests generated an environmental damage, said damage will be compensable<sup>4</sup>; ii) cases in which the legislator provides for the environmental legal interest as an autonomous interest and defines the infringing practices of said interest<sup>5</sup>; 3) cases in which there is a recognition of the environmental interest as an autonomous legal interest, without however providing a typified list of infringing practices<sup>6</sup>.

With the purpose of broadening the comparison, a fourth group is herein included, represented by the legal systems that, differently from the prior ones, brings the express provision of a right assigned to the nature itself<sup>7</sup>. Therefore, the varied types of protection will be examined, starting by German Law, which does not treat the environment as a legal value; then by the Italian Law, where the doctrine and case law constructed a notion of environmental interest; and then by Portuguese and Brazilian Laws, legal systems in which the environmental law has constitutional seat; and finalizing with the review of the Ecuador legislation, which enshrines a law of the natural environment.

In German Law, the environment is not foreseen as a legal interest, nor as a

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<sup>4</sup>Cf. the German Law of 1991 L'Umwelthaftungsgesetz (UmweltHG). In POZZO, *Il criterio di imputazione della responsabilità per danno all' ambiente nelle recenti leggi ecologiche*. In: TRIMARCHI (a cura di), *Per una riforma della responsabilità civile per danno all'ambiente*. Milano: Giuffrè, 1994, apud ALPA, FUSARO (a cura di), *Le metamorfosi del diritto di proprietà*. Matera: Antezza, 2014. p. 534.

<sup>5</sup>As examples, the Italian Law of 1986 and the project of environmental German code. In POZZO, *Il criterio di imputazione della responsabilità per danno all' ambiente nelle recenti leggi ecologiche*. In: TRIMARCHI, (a cura di), *Per una riforma della responsabilità civile per danno all'ambiente*. Milano: Giuffrè, 1994, apud ALPA, FUSARO (a cura di). *Le metamorfosi del diritto di proprietà*. Matera: Antezza, 2014. p. 534. With respect to a compared analysis of Environmental Law, see: AMIRANTE, *Diritto Ambientale Italiano e Comparato*. Napoli: Jovene Editore, 2003.

<sup>6</sup>Law No. 11/1987, of April 7, 1987. Available at: <<http://www.iapmei.pt/acessivel/iapmei-leg-03.php?lei=162>>. Accessed on: 02SEP2016.

<sup>7</sup>Constitución del Ecuador. Available at: <[http://www.asambleanacional.gov.ec/documentos/constitucion\\_de\\_bolsillo.pdf](http://www.asambleanacional.gov.ec/documentos/constitucion_de_bolsillo.pdf)> *Direito ambiental comparado: os "direitos da natureza" na Constituição do Equador e a Bolívia*. Available at: <[http://pretextointernacional.blogspot.com.br/2011/05/direito-ambiental-comparado-os-direitos\\_19.html](http://pretextointernacional.blogspot.com.br/2011/05/direito-ambiental-comparado-os-direitos_19.html)>. Accessed on: 10JUN2016.

fundamental right. When the issue of environmental protection emerged, the idea of granting constitutional status to a right to the environment was refuted, opting for its prediction among the objectives of the State. The legal system adopted the position of Michael Kloepfer who, while expatiating on environmental protection in Germany, in the year of 1978, suggested its insertion in the Fundamental Law as a normative determination directed to the State, resulting in the insertion of article 20a of the Fundamental Law, which provides:

Taking into account also its liability before the future generations, the State protects the vital natural resources and animals, within the scope of the constitutional order, through legislation and according to the law and the rights, through the Executive and Judiciary branches<sup>8</sup>.

The discussion is shifted from the sphere of the fundamental rights to the objectives to be pursued by the State, which guarantees the environmental protection, without the need to assign a right to the citizens<sup>9</sup>. The rule is oriented essentially to the State and does not allow the citizens to stand to sue in the defense of the environment, also not assigning a legal duty of protection to the individuals or to the society as a whole. Based on such discipline is the orientation that law should define the environmental protection, due to its highly abstract character. The constitutional text used for such purpose. Its duty is to guarantee the fundamental rights of the individuals before the State and not the protection of a collective interest, excessively abstract. For such reasons, the Federal Constitutional Law of 1949 does not consider the environment as a fundamental value, only deals with legislative competences, without establishing more specific orientations on the issue.

In the system for the division of powers of federative entities, the German central entity has a dual competence: (i) total legislative competence regarding the

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<sup>8</sup>See KLOEPFER, *Sobre o futuro Código Ambiental na Alemanha*. Available at: <[http://www.dfj.inf.br/Arquivos/PDF\\_Livre/10\\_Dout\\_Estrangeira\\_3.pdf](http://www.dfj.inf.br/Arquivos/PDF_Livre/10_Dout_Estrangeira_3.pdf)>. Access: 18JUN2016.

<sup>9</sup>See MATIAS, MATTEI, *Aspectos comparativos da proteção ambiental no Brasil e na Alemanha*. Available at: <[http://www.repositorio.ufc.br/bitstream/riufc/12049/1/2014\\_art\\_jlnmatias.pdf](http://www.repositorio.ufc.br/bitstream/riufc/12049/1/2014_art_jlnmatias.pdf)>. Accessed on: 20JUN2016.

control of air pollution, noise pollution and waste disposal, regulating all the discipline of these matters; 2) general competence regarding the protection of nature, water control and rural development, and it is only entitled to the establishment of guidelines and basic principles that should guide the development of these matters by the federated entities<sup>10</sup>.

Due to the above structure, the protection of the environment has occurred, in particular, through the law and administrative regulations<sup>11</sup>, and by decisions of the German Federal Constitutional Court. The latter denies to the environment the character of a fundamental right. Constitutional Court's case law considers it is possible to assign to the State an obligation of preserving the environment not based on the grounds of the right to the environment, but having as grounds the Social Rule of Law, of which environmental protection would be a clause.

The environment is protected as a means for the full development of the human personality. Environmental protection could be defined from the combination of the right to life and physical integrity with the constitutional guarantee of private property. Thus, citizens do not have active standing to sue to claim a violation of the fundamental right to the environment, which can be done only if the individual claims violation of other fundamental rights, such as the right to health or physical integrity<sup>12</sup>.

In 1988, the German Ministry of the Environment assigned a group of teachers the task of drafting an Environmental Code, which was finalized in 1990, when debates on its content begin. The project brought some innovations, among them, the introduction of the notion of environmental legal interest, which intends to remove

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<sup>10</sup>See REHBINDER, O direito ao ambiente na Alemanha. Conferências do INA, 1994, p. 250-268. Apud. FERNANDEZ, *Direito ao ambiente e propriedade privada*. (aproximação ao estudo da estrutura e das consequências das 'leis-reserva' portadoras de vínculos ambientais. Coimbra: Coimbra Editora, 2001. p. 19-20, nota 4.

<sup>11</sup>Environmental protection in the country is eminently administrative. Cf. MATIAS, MATTEI, Aspectos comparativos da proteção ambiental no Brasil e na Alemanha. In: *Revista do Programa de Pós-Graduação em Direito da UFC*, v. 34.2, p. 227-244, Jul./Dec. 2014. Available at: <[http://www.repositorio.ufc.br/bitstream/riufc/12049/1/2014\\_art\\_jlnmatias.pdf](http://www.repositorio.ufc.br/bitstream/riufc/12049/1/2014_art_jlnmatias.pdf)>. Access: 18JUN2016.

<sup>12</sup>See FERNANDEZ, op. cit. nota 4. p. 20.

the typicity of the protected legal interests<sup>13</sup>, characteristic of German legislation, to consecrate the natural heritage in general as object of protection. In addition, it also provided for the standing to sue of associations or environmental protection organizations for the introduction of class actions related to this subject.<sup>14</sup>

In November, 2007, a group of the Ministry of the Environment submitted an Official Project of Environmental Code, expected to be approved by the parliament until the end of 2008. The project was widely discussed among federal ministries and its final version resulted into a partial codification in 397 paragraphs, divided into six books: i) First Book: General dispositions and environmental law related to projects of establishments; ii) Second Book: Economy of Waters; iii) Third Book: Protection of nature and natural landscape; iv) Fourth Book: Non-ionizing Radiation; v) Fifth Book: (Law of) Emissions Trading; v) Sixth Book: (Law of) Renewable Energies<sup>15</sup>.

The trend was towards approval of the aforementioned project, which had the support of the jurists who were dedicated to the study of Environmental Law. Among the favorable arguments, the experts pointed out that the environment would enjoy a wider protection, while at the same time there would be a dismissal of administrative structures, burdened by the entanglement caused by profusion of laws. As practically all environmental protection took place through the administrative sphere, the adoption of an Environmental Code would facilitate the procedures by concentrating matters in a single piece of legislation, thus reducing the bureaucracy of the Administration through simplified and cohesive legislation.

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<sup>13</sup>German law of 1991 provides that: “qualora da una immissione nell’ambiente, proveniente da uno degli impianti indicati nell’appendice 1 (della presente legge), derivi la morte, la lesione del corpo o della salute, oppure della proprietà di un soggetto, il proprietario dell’impianto è tenuto a risarcire il danno che ne è derivato” (Cf. POZZO, *Il criterio di imputazione della responsabilità per danno all’ambiente nelle recenti leggi ecologiche*. In: TRIMARCHI (a cura di), *Per una riforma della responsabilità civile per danno all’ambiente*. Milano: Giuffrè, 1994, apud ALPA, FUSARO (a cura di). *Le metamorfosi del diritto di proprietà*. Matera: Antezza, 2014. p. 534).

<sup>14</sup>See RAMOS, *Direito Ambiental Comparado (Brasil-Alemanha-EUA): uma análise exemplificada dos instrumentos brasileiros à luz do direito comparado*. Maringá: Midiograf II, 2009. p. 52.

<sup>15</sup>See Kloepler, the remaining issues are: the right of establishments that do not depend on licensing, protection against harmful emissions, management of waste and recycling, soil protection and historically contaminated sites, protection against contamination by hazardous substances, among others (KLOEPFER, *Sobre o futuro Código Ambiental na Alemanha*. *Revista Direitos Fundamentais e Justiça* n.10, p. 53, Jan/Mar. 2010.).

Despite the efforts made in the beginning of the 2009 legislature, works on unifying laws in an Environmental Code was abandoned and the project was shelved due to the lack of consensus among the several political bases of the country, while maintaining the experience already consolidated of protecting the environment through sparse administrative-level laws<sup>16</sup>.

In Italy, the Constitution does not provide for the right to the environment as a fundamental right and there is no express consideration of the notion of environmental interest or common interests. Article 9 only refers to the protection of the landscape and historical heritage as fundamental principles of the Italian Republic, bringing a concept of limited environment, restricted to the idea of landscape as a mechanism to protect the territory<sup>17</sup>. However, on this point, unlike the German scenario, Italian doctrine and case law sought to progressively construct the concepts of environment and environmental legal interest.

Nevertheless, the absence of a legal concept ends up allowing a polysemy of meanings to the environment, being a concept that is not uniform, and several trends have arisen regarding its configuration. One of the first topics to be discussed was the concept of landscape. As the constitutional text does not provide for the protection of the environment by itself, and since the landscape is the closest notion brought by it, debates are held around this concept.

Initially linked to the aesthetic element, the concept was being re-dimensioned to include a more comprehensive environmental protection, appearing differentiated approaches, but always broadening: one aspect associates landscape with urbanism; another opinion argues that it is not restricted to aesthetic elements and must necessarily include a comprehensive natural dimension of the whole territory and not only some elements thereof<sup>18</sup>. Another part sought to build a broader concept of environ-

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<sup>16</sup>*Ibidem*, p. 57.

<sup>17</sup>Art. 9: “La Repubblica promuove lo sviluppo della cultura e la ricerca scientifica e tecnica. Tutela il paesaggio e il patrimonio storico e artistico della Nazione”. Available at: <<https://www.senato.it/documenti/repository/istituzione/costituzione.pdf>>. Accessed on: 21JUN2016.

<sup>18</sup>See MANTINI, *Lezioni di Diritto Pubblico dell'Ambiente*. Padova: Cedam, 1991. p. 33-37.

ment, which included not only the landscape protection, but also the institutes related to urban planning and territory, as well as protection against pollution. It is the position of Giannini<sup>19</sup>, for whom the concept of the environment has three different and autonomous meanings: 1) environmental interests, both natural and cultural; 2) environmental health; 3) urban planning of the territory<sup>20</sup>.

In addition to the connection of the environment to the protection of the landscape, another trend can be seen, in which a part of the doctrine tried to construct the concept of environment from the elements related to territory organization and health<sup>21</sup>. Such trend starts from Article 32 of the Italian Constitution, which guarantees the right to health for all citizens, and includes the right to a healthy environment as a logical consequence or manifestation of this individual right, adopting an anthropocentric perspective. It was also sought to achieve a unitary meaning, configuring the environment as a fundamental public interest of the community and as a subjective right to environmental health at the individual level.

The connection of the right to the environment with the right to health focuses on an essentially individual aspect of protection, which addresses the relationship between man and nature in an anthropocentric perspective. The Constitutional Court has sought to construct a notion of landscape, defined as the protection of varied interests, "which find in the territory their point of reference of incidence considered from an aesthetic and cultural point of view, forming part of a wider concept, the environment, but not confusing with it"<sup>22</sup>.

Finally, we moved towards a construction of the environmental legal interest as a unitary notion. Law No. 349/1986 – which establishes the Ministry of the Environment and also provides for environmental civil liability – sets a unifying notion

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<sup>19</sup>See GIANINI, *Ambiente: saggio sui suoi diversi aspetti giuridici*. *Rivista. Trimestrale di diritto pubblico* (1973), 1. Milano: Giuffrè. p. 1-39.

<sup>20</sup>See ALPA, *Pubblico e privato nel danno ambientale*. In: *Contratto Impresa*, 1987, p. 685.

<sup>21</sup>Art. 32: "La Repubblica tutela la salute come fondamentale diritto dell'individuo e interesse della collettività e garantisce cure gratuite agli indigenti". Available at: <<https://www.senato.it/documenti/repository/istituzione/costituzione.pdf>>. Accessed on: 21JUN2016.

<sup>22</sup>See MANTINI, *Lezioni di Diritto Pubblico dell'Ambiente*. Padova: Cedam, 1991. p. 34.

that serves as inspiration for the elaboration of the concept of environment as a unitary and immaterial interest<sup>23</sup>. Article 1 of the aforementioned law explicitly mentions, as attributions of the Ministry, the promotion, conservation and recovery of environmental conditions, "in accordance with the fundamental interests of the community as regards to quality of life, in addition to the conservation and enhancement of national natural heritage and defense of natural resources against pollution", setting a broad concept that includes not only the environmental elements and places the environment as an essential element in the quality of life of the community<sup>24</sup>. Equal notion can be understood from the reading of article 18 of the same law, which deals with environmental damage, defining as those that compromises the environment and causes damage to it by altering, degrading or destroying it in whole or in part<sup>25</sup>.

The case law of the Italian Constitutional Court has been favorable to the acceptance of the environment as a unitary and immaterial legal interest, a guideline that has been adopted since sentence No. 210/1987, in which the judges understood that the environment, although comprised by several elements that can be object of specific protections, should be considered a unitary intangible interest<sup>26</sup>. The combination of all these elements forms a systematic whole that leads the environmental legal interest to unity. The right to the environment would be a right of the person and an interest of the whole community, which focuses on a unitary interest

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<sup>23</sup>See POZZO, *Modelli proprietari e tutela dell'ambiente*. *Rivista Critica di Diritto Privato*. Anno XV. n.1, p.137-138, marzo 1997. Napoli: Jovene Editore.

<sup>24</sup>Art. 1°. 1. È istituito il Ministero dell'ambiente.

2. È compito del Ministero assicurare, in un quadro organico, la promozione, la conservazione ed il recupero delle condizioni ambientali conformi agli interessi fondamentali della collettività ed alla qualità della vita, nonché la conservazione e la valorizzazione del patrimonio naturale nazionale e la difesa delle risorse naturali dall'inquinamento. Available at: <[http://www.minambiente.it/sites/default/files/legge\\_08\\_07\\_1986\\_349.pdf](http://www.minambiente.it/sites/default/files/legge_08_07_1986_349.pdf)>. Accessed on: 21 jun. 2016.

<sup>25</sup>Art. 18. (...) 1. Qualunque fatto doloso o colposo in violazione di disposizioni di legge o di provvedimenti adottati in base a legge che comprometta l'ambiente, ad esso arrecando danno, alterandolo, deteriorandolo o distruggendolo in tutto o in parte, obbliga l'autore del fatto al risarcimento nei confronti dello Stato. Available at: <[http://www.minambiente.it/sites/default/files/legge\\_08\\_07\\_1986\\_349.pdf](http://www.minambiente.it/sites/default/files/legge_08_07_1986_349.pdf)>. Accessed on: 21JUN2016.

<sup>26</sup>Available at: <<http://www.giurcost.org/decisioni/1987/0210s-87.html>>. Accessed on: 21JUN2016.

comprehensive of all natural resources<sup>27</sup>.

Subsequently, the Italian Court of Cassation defined that the environment is an immaterial reality, which expresses an autonomous collective value that should not be confused with the material elements that compose it<sup>28</sup>. It is a reality devoid of materiality, but that is configured as an immaterial value worthy of autonomous legal protection, and thus, although formed by a set of material elements, is ontologically distinguished from them<sup>29</sup>. Hence, the conclusion that nature as an intangible public interest does not prevent dual environmental protection, that is, the environment as a unitary good and that of its elements individually considered<sup>30</sup>.

This construction gives grounds to the peculiarity of environmental damage within the structure of civil liability, which must be understood as the injury to a unitary set that, although it includes interests of different entitlement – public or private – are fundamentally distinguished from them as they comprise another reality, immaterial, which is configured as an autonomous legal interest, object of specific protec-

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<sup>27</sup>“Va riconosciuto lo sforzo in atto di dare un riconoscimento specifico alla salvaguardia dell'ambiente come diritto fondamentale della persona ed interesse fondamentale della collettività e di creare istituti giuridici per la sua protezione. Si tende, cioè, ad una concezione unitaria del bene ambientale comprensiva di tutte le risorse naturali e culturali. Esso comprende la conservazione, la razionale gestione ed il miglioramento delle condizioni naturali (aria, acque, suolo e territorio in tutte le sue componenti), la esistenza e la preservazione dei patrimoni genetici terrestri e marini, di tutte le specie animali e vegetali che in esso vivono allo stato naturale ed in definitiva la persona umana in tutte le sue estrinsecazioni. Ne deriva la repressione del danno ambientale cioè del pregiudizio arrecato, da qualsiasi attività volontaria o colposa, alla persona, agli animali, alle piante e alle risorse naturali (acqua, aria, suolo, mare), che costituisce offesa al diritto che vanta ogni cittadino individualmente e collettivamente. Trattasi di valori che in sostanza la Costituzione prevede e garantisce (artt. 9 e 32 Cost.), alla stregua dei quali, le norme di previsione abbisognano di una sempre più moderna interpretazione. E la direttiva comunitaria impegna lo Stato in maniera rilevante ad una considerazione coordinata dell'ambiente, alla esecuzione tempestiva e corretta degli impegni assunti e all'apprestamento delle misure opportune, necessarie ed indispensabili”. *Sentenza n. 210*. Anno 1987. Available at: <<http://www.giurcost.org/decisioni/1987/0210s-87.html>>. Accessed on: 21JUN2016.

<sup>28</sup>Court of Cassation, sentence of April 9, 1992, n. 4362. Cf. PARDOLESI, GRANIERI, *Oltre la funzione riparatoria delle responsabilità civile nella tutela ambientale*. In: *Ambiente e Diritto*. II. Firenze: Leo S. Olschki. p. 532.

<sup>29</sup>The issue of the definition of the environmental interest in Italy is within the problematics of the environmental civil liability, arising issues related to the ownership of the legal interest and on the legitimacy for the filing of the action. The controversy refers also to the legal qualification of the environmental damage and its possible inclusion in the category of damage to the Treasury.

<sup>30</sup>Cass. 19. Giugno. 1996, n. 5650. See PARDOLESI, GRANIERI, *Oltre la funzione riparatoria delle responsabilità civile nella tutela ambientale*. In: *Ambiente e Diritto*. II. Firenze: Leo S. Olschki. p. 532.

tion of the legal system<sup>31</sup>.

In Portugal, Article 66 of the Constitution of the Republic includes the right to the environment in the list of social rights, providing that "everyone is entitled to a human, healthy and ecologically balanced environment of life and the duty to defend it"<sup>32</sup>. After such declaration, the second part of the text follows, listing a series of postures and duties incumbent on the State to ensure the effectiveness of environmental protection, "through appropriate bodies and with the involvement and participation of citizens", as follows:

(a) prevent and control pollution and its effects and harmful forms of erosion; b) order and promote land use planning, with a view to the correct location of activities, a balanced social-economic development and the appreciation of the landscape; c) create and develop natural and recreational reserves and parks, and to classify and protect landscapes and sites, so as to guarantee the conservation of nature and the preservation of cultural values of historical or artistic interest; d) promote the rational use of natural resources, safeguarding their capacity for renewal and ecological stability, with respect for the principle of solidarity between generations; e) promote, in cooperation with local authorities, the environmental quality of towns and urban life, in particular in terms of architecture and the protection of historic areas; f) promoting the integration of environmental objectives into the various sectoral policies; g) promote environmental education and respect for environmental values<sup>33</sup>.

The provision offers a grade of detail barely observed in other Constitutions and therefore the Portuguese Constitutional Letter has been called the "*Environment*

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<sup>31</sup>Cass. Pen, 06 marzo, n. 16575. Apud LECCESE, *Danno all'ambiente e danno alla persona*. Available at: <<https://books.google.com>>. Accessed on: 22 jun. 2016.

<sup>32</sup>Article 66. Environment and quality of life

1. Everyone is entitled to a human, healthy and ecologically balanced life environment, and the duty to defend it. Available at: <<https://www.parlamento.pt/Legislacao/Paginas/ConstituicaoRepublicaPortuguesa.aspx>>. Accessed on: 05SEP2016.

<sup>33</sup>See Article 66, 2 of the Constitution of the Portuguese Republic. Available at: <<https://www.parlamento.pt/Legislacao/Paginas/ConstituicaoRepublicaPortuguesa.aspx>>. Accessed on: 05SEP2016.

*Constitution*”<sup>34</sup>, an expression created to highlight the care of the Legislator with the discipline of the environment, which emphasizes not only the environmental protection as an end rule, but also assigns behaviors to the State, and provides in detail the system of legislative and administrative competences.

There are authors who recognize that the Portuguese Republic would be a Social-Environmental State, which sets forth a new legal-constitutional program, characterized by an Environmental Constitutional Law<sup>35</sup>, a constitutional model whereby the legal protection of the environmental interests receives an importance as a form of protecting the human dignity itself. The environment would have been lifted to the class of autonomous legal interest and would have been submitted to a “constitutionalized environmental public order”<sup>36</sup>.

In Portuguese Law, the right to the environment is not reappointed to a class of the right to health or mere expression of human personality, being recognized as an autonomous right. However, the constitutional text provided for a social right and not in the chapter regarding rights, freedom and fundamental guarantees. Although it has not received such formal qualification, it is considered by a great part of the doctrine a right analogous to the fundamental rights and attracts to itself the legal system assigned to them, according to article 17 of the Portuguese Constitution<sup>37</sup>.

Therefore, as a right equivalent to a fundamental right, it must be analyzed in its two aspects. It can be said that it concentrates a negative claim of demanding from the State or other people the abstention of behaviors that generate environmental damages and a positive intention of demanding from the State the implemen-

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<sup>34</sup>See FERNANDEZ, *Direito ao ambiente e propriedade privada*. Coimbra: Coimbra Editora, 2001. p. 23. nota 10.

<sup>35</sup>See CANOTILHO, *Direito constitucional ambiental português e da União Europeia*. In: CANOTILHO, MORATO LEITE, (Orgs.) *Direito constitucional ambiental brasileiro*. São Paulo: Saraiva, 2010. p. 5.

<sup>36</sup>See CANOTILHO, MORATO LEITE, (Orgs.) *Direito constitucional ambiental brasileiro*. São Paulo: Saraiva, 2010. p.144.

<sup>37</sup>Article 17. System of Rights, freedoms and guarantees

The system of rights, freedoms and guarantees is applied to the assertions of title II and the fundamental rights of analogous nature. Available at: <<https://www.parlamento.pt/Legislacao/Paginas/ConstituicaoRepublicaPortuguesa.aspx>>. Accessed on: 05SEP2016.

tation of measures to ensure its protection<sup>38</sup>. However, as a social right, it does not have a *prima facie* content given by the Constitution and its typicality must be built by the law that will discipline its content.

With respect to fundamental rights defined by the members of the Constitutional Convention, the law has a limiting function, and is only able to restrict such rights in the cases expressly provided for in the Constitution, “and such restrictions shall be limited as necessary to safekeep other rights or interests constitutionally protected” (art. 18 of the Portuguese Constitution). Adversely, in case of rights with legal characterization, the law is entitled to an expansionist function, whose purpose is the implementation of a constitutional provision. This is the case of the right to the environment, which, as it is a right of legal construction, unlike the other fundamental rights defined by the Constitution, lacks preceptivity, since its concrete content must be given by the legislator, who is responsible for defining, consecrating and establishing its measure<sup>39</sup>.

Constitutional provision was established by the Environmental Basic Law, Law No. 11/87, of April 7, which offers a broad concept of environmental legal interest<sup>40</sup>, in addition to the provision of environmental civil liability<sup>41</sup>, without, however, typify-

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<sup>38</sup>See FERNANDEZ, *Direito ao ambiente e propriedade privada*. (aproximação ao estudo da estrutura e das consequências das ‘leis-reserva’ portadoras de vínculos ambientais. Coimbra: Coimbra Editora, 2001. p. 22.

<sup>39</sup>See FERNANDEZ, *Direito ao ambiente e propriedade privada*. (aproximação ao estudo da estrutura e das consequências das ‘leis-reserva’ portadoras de vínculos ambientais. Coimbra: Coimbra Editora, 2001. notas 16 e 17. p. 26-27.

<sup>40</sup>Article 5. Concepts and definitions

2-For the purposes of this law, it is considered that the expressions «environment», «territory system», «landscape», «continuum naturale», «quality of the environment» and «conservation of Nature» shall be understood in the conditions below:

Environment is the set of the physical, chemical, biological systems and their relations and the economic, social and cultural factors with direct or indirect, mediate or immediate effect on living beings and the men’s quality of life.

Available at: <<http://w3.ualg.pt/~jmartins/LegislaçãoAmbientalPortuguesa.pdf>>. Accessed on: 23 JUN 2016.

<sup>41</sup>Article 41. Objective liability

1-There is an obligation to indemnify, regardless of fault, whenever the agent has caused significant damages in the environment, by virtue of a particularly dangerous action, although with respect to the applicable regulations.

2-The amount of compensation to be fixed for damages caused to the environment shall be established

ing the conducts that can generate the damage and being a broad provision that brings an objective criteria of accusation, resulting from the practice of a hazardous activity. Decree-Law No. 69/2000, of May 3, which regulates the mentioned law, provides for the performance of environmental impacts compensatory measures, in the cases determined by the evaluation of environmental impact, providing that, in case of non-compliance, the violator is obliged to indemnify the State<sup>42</sup>, in a criteria which seems to assign the ownership of the environmental interest to the State and not exactly to the community.

The three legal systems discussed herein so far, although the several regulations of the environment, are inserted in the European Union and shall harmonize with its issued directives. Article 191 of the Treaty on the functioning of the EU<sup>43</sup> brings the basic directives of the environmental policy to be adopted by the States, jointly with article 11, which provides for the integration of the environmental component in the definition and performance of policies and actions developed by the

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in complementary legislation. Available at: <<http://w3.ualg.pt/~jmartins/LegislaçãoAmbientaPortuguesa.pdf>>. Accessed on: 23JUN2016.

<sup>42</sup>Article 41. Liability for damages to the environment

1 - If the compensatory measures referred to in the previous article are not enforced or, if implemented, do not completely eliminate the damage caused to the environment, the offender shall be obliged to indemnify the State. Available at: <<http://w3.ualg.pt/~jmartins/LegislaçãoAmbientaPortuguesa.pdf>>. Accessed on: 23JUN2016.

<sup>43</sup>Article 191. (ex-article 174 TCE)

1.The Federal Government's policy on the environment shall contribute to the pursuit of the following objectives:

- preservation, protection and improvement of the quality of the environment,
- the protection of human health,
- prudent and rational use of natural resources,
- promotion at international level of measures to tackle regional or global environmental problems, in particular combating climate change.

2.The Federal Government's policy on the environment shall aim to achieve a high level of protection, taking into account the diversity of situations in the different regions of the Federal Government. It shall be based on the principles of precaution and preventive action, primarily at source, of damage to the environment and the polluter-payer.

In this context, harmonization measures to meet environmental protection requirements will, where appropriate, include a safeguard clause allowing Member States to take, on non-economic environmental grounds, provisional measures subject to a process of control of the Federal Government. Available at: <<http://www.fd.uc.pt/CI/CEE/pm/Tratados/Lisboa/tratados-TUE-TFUE-V-Lisboa.html>>. Accessed on: 25JUN2016.

EU, with the purpose of promoting a sustainable development<sup>44</sup>. The requirements with respect to protection of the environment added to other normative and more specific acts, in addition to the normative acts determining the legal duty to sanction criminally the serious infractions against the environment, configure the so-called European Environmental Law<sup>45</sup>.

Note that the Treaty of Nice does not provide for the right to the environment as a fundamental right<sup>46</sup>, only determines that the members of the EU should take the necessary measures to integrate their policies of protection and improvement of the environment in order to guarantee the sustainable development<sup>47</sup>. As the EU Charter of Fundamental Rights imposes the rule, but does not offers compulsory mechanisms in case of non-compliance – a provision endowed of a pragmatic value – it is up to the Member States to determine the adequacy of their internal laws.

Considering the question in the European context, despite the brief summary, we will proceed to the analysis of the Brazilian legal system, as well as the experience of Ecuador, whose Constitution considers the environment as a subject of rights. In Brazil, Article 225 of the Federal Constitution provides:

Everyone is entitled to an ecologically balanced environment, a common interest of the people and essential to a healthy quality of life, imposing on the Government and the community the duty to defend and preserve it for present and fu-

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<sup>44</sup>Article 11. (ex-article 6 TCE)

Environmental protection requirements should be integrated into the definition and implementation of the Federal Government's policies and activities, in particular with a view to promoting sustainable development. Article 11 (ex-article 6, TCE). Available at: <<http://www.fd.uc.pt/CI/CEE/pm/Tratados/Lisboa/tratados-TUE-TFUE-V-Lisboa.html>>. Accessed on: 25JUN2016.

<sup>45</sup>See ARAGÃO, Alexandra. A proteção do ambiente em rede: uma estratégia nacional, uma responsabilidade Européia. *Periódico do CIEDA e do CIEJD*, n.1, jun./dez. 2009. Available at: <<http://www.europe-direct-aveiro.aeva.eu/debatereuropa/>>. Accessed on: 25JUN2016.

<sup>46</sup>See RAGO, Pasquale. *L'ambiente come nuovo diritto fondamentale della persona nella futura Costituzione Europea*. Available at: <[http://www.ambientediritto.it/dottrina/Dottrina%202004/ambiente\\_nuovo\\_diritto\\_rago.htm](http://www.ambientediritto.it/dottrina/Dottrina%202004/ambiente_nuovo_diritto_rago.htm)>. Accessed on: 21JUN2016.

<sup>47</sup>Art. 37. Protection of the environment

All the Federal Government's policies must incorporate a high level of environmental protection and the improvement of their quality, and ensure that they are in accordance with the principle of sustainable development. Available at: <[http://www.europarl.europa.eu/charter/pdf/text\\_pt.pdf](http://www.europarl.europa.eu/charter/pdf/text_pt.pdf)>. Accessed on: 25JUN2016.

ture generations<sup>48</sup>.

Brazilian constitutional definition of environment was strongly influenced by the Anglo-Saxon Law, in particular, the North-American Law<sup>49</sup>. It is adopted an extensive interpretation of the environmental interests which are protected in all their forms, including not only the economic and social interests, but also the set of influences and relations regulating life, in compliance with the National Environmental Policy, established by Law No. 6.938/1981<sup>50</sup>.

As in Portugal, this right is not provided for in the list of fundamental rights and guarantees of art. 5, but in Title VIII of the Constitution (The Social Order - article 193 to 232). Despite this, the wording of Article 225 leads the majority doctrine to consider that there is a fundamental right to the environment, classified as a fundamental right of third generation that configures a relationship between environmental protection and social protection<sup>51</sup>.

A balanced environment reveals as a collective interest, an interest of common use of the people<sup>52</sup>. It would be considered a collective legal interest, constitutionally protected, symbolizing a guarantee of the basic conditions necessary for the mainte-

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<sup>48</sup>Constitution of the Federative Republic of Brazil. Available at: [http://www.planalto.gov.br/ccivil\\_03/Constituicao/Constituicao.htm](http://www.planalto.gov.br/ccivil_03/Constituicao/Constituicao.htm). Accessed on: 05SEP2016.

<sup>49</sup>See RAMOS, *Direito ambiental comparado* (Brasil - Alemanha - EUA): uma análise exemplificada dos instrumentos legais brasileiros à luz do direito comparado. Maringá: Midiograf II, 2009. p. 58.

<sup>50</sup>Article 3 – For the purposes of this law, it should be understood as:

I – environment, the set of conditions, laws, influences and interactions of physical, chemical and biological order which allows, encompasses and rules the life in all its forms. Available at: [http://www.planalto.gov.br/ccivil\\_03/leis/L6938.htm](http://www.planalto.gov.br/ccivil_03/leis/L6938.htm). Access: 25JUN2016.

<sup>51</sup>See DERANI, *Direito Ambiental Econômico*. São Paulo: Max Limonad, 1997.p. 256; BELLO FILHO, *A previsão normativa do direito fundamental ao ambiente ecologicamente equilibrado na Constituição de 1988*. Available at: [http://www.lex.com.br/doutrina\\_27179662\\_A\\_PREVISAO\\_NORMATIVA\\_DO\\_DIREITO\\_FUNDAMENTAL\\_AO\\_AMBIENTE\\_ECOLOGICAMENTE\\_EQUIBRADO\\_NA\\_CONSTITUICAO\\_DE\\_1988.aspx](http://www.lex.com.br/doutrina_27179662_A_PREVISAO_NORMATIVA_DO_DIREITO_FUNDAMENTAL_AO_AMBIENTE_ECOLOGICAMENTE_EQUIBRADO_NA_CONSTITUICAO_DE_1988.aspx). Accessed on: 15 JUL 2016.

<sup>52</sup>“The right to environmental integrity – a typical third-generation right – is a legal prerogative of collective ownership, reflecting, within the process of affirmation of human rights, the significant expression of a power attributed not to the individual identified in its uniqueness, in a truly broader sense, to the social collectivity itself. (...), third-generation rights, which materialize collective powers attributed generically to all social formations, enshrine the principle of solidarity and constitute an important moment in the process of development, expansion and recognition of human rights, characterized as fundamental values unavailable by the note of an essential inexhaustibility” (BRASIL, STF, MS 22.164, rel. Min. Celso de Mello, julgamento em 30-10-1995, Plenário, DJ de 17-11-1995.) Available at: <http://www.stf.jus.br/portal/constituicao/artigobd.asp?item=%202004>. Access: 15JUL2016.

nance and development of human life.

Article 225 provides for a right and duty to the environment; because, at the same time that the community is the holder of a right to the environment, it also has the legal duty to preserve and protect it, characterizing the non-exclusivity of the environmental function by the public power<sup>53</sup>. On the other hand, as art. 170, inserted in Title VII – The Economic Order – provides for the defense of the environment as a principle of the economic order<sup>54</sup>, there are those who defend that the principle of the environment is a command of optimization, not a subjective right of diffuse ownership<sup>55</sup>. In addition, as an optimization warrant, it is a norm that orders something to be performed to the greatest extent possible, according to the possibilities, so it is not an absolute norm endowed with *prima facie* supremacy.

In Ecuador, unlike all legal systems hitherto mentioned, the constitutional text, approved in 2008<sup>56</sup>, reinforced traditional rights, including in relation to a healthy environment and quality of life. The country's Constitution calls the nature of *Pacha Mama*, and defines it as the place where life is reproduced, in accordance with the Andean worldview<sup>57</sup>. In addition, it provides nature as a subject of rights by adding

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<sup>53</sup>See BORGES, Direito Ambiental e teoria jurídica no final do século XX. p. 29. In: VARELA, BORGES, (Orgs.). *O novo em Direito Ambiental*. Belo Horizonte: Del Rey, 1990. p. 11-33,

<sup>54</sup>Art. 170 - The economic order, based on the valorization of human labor and free initiative, aims at guaranteeing everyone a dignified existence, according to the dictates of social justice, observing the following principles: VI - the defense of the environment, including through differentiated treatment according to the environmental impact of the products and services and their processes and elaboration and provision. Available at: <[http://www.planalto.gov.br/ccivil\\_03/constituicao/constituicao.htm](http://www.planalto.gov.br/ccivil_03/constituicao/constituicao.htm)>. Accessed on: 25 JUN 2016.

<sup>55</sup>See ROCHA, *O STF e o Meio Ambiente: A Tutela do Meio Ambiente em sede de Controle Concentrado de Constitucionalidade*. 2013. 159 f. Dissertação (Mestrado em Direito) - Faculdade de Direito, Universidade de São Paulo, São Paulo, 2013. f. 56-59. Available at: <<http://www.teses.usp.br/teses/disponiveis/2/2134/tde-05122013-154012/pt-br.php>>. Accessed on: 25JUN2016.

<sup>56</sup>Compared environmental law: the “law of the natural environment” in the Constitution of Ecuador and Bolivia. Available at: <[http://pretextointernacional.blogspot.com.br/2011/05/direito-ambiental-comparado-os-direitos\\_19.html](http://pretextointernacional.blogspot.com.br/2011/05/direito-ambiental-comparado-os-direitos_19.html)>. Accessed on: 25JUN2016.

<sup>57</sup>Capítulo séptimo Derechos de la naturaleza

Art. 71- La naturaleza o Pacha Mama, donde se reproduce y realiza la vida, tiene derecho a que se respete integralmente su existencia y el mantenimiento y regeneración de sus ciclos vitales, estructura, funciones y procesos evolutivos.

Toda persona, comunidad, pueblo o nacionalidad podrá exigir a la autoridad pública el cumplimiento de los derechos de la naturaleza. Para aplicar e interpretar estos derechos se observaran los principios establecidos en la Constitución, en lo que proceda.

that it "has the right to be fully restored if its natural systems are violated"<sup>58</sup>, which determination involves actions for the recovery of natural areas to its *status quo*. Such right to restoration is autonomous and does not depend on the obligation to indemnify the individuals and collective entities that depend on the natural systems affected.

It is possible to verify that, with the progressive autonomy of the Environmental Law, legislators are recognizing to the environment an intrinsic and autonomous value, lifting it to constitutional levels. The current trend is of insertion of the environmental protection in the national Constitutions by means of the protection of the environmental interest autonomously.

The analysis of the various legal systems mentioned allows us to verify that, in a more or less broad way, all the mentioned Constitutions recognize the environment as a value worthy of protection. In some cases protection occurs through the constitutional provision of a fundamental right to a healthy environment, in other cases, protection of the environment, although referenced in constitutional norms, does not assume the status of a fundamental right. There is also the possibility of assigning an autonomous subjective right to nature, resulting from its recognition as an entity endowed with autonomy.

The qualification of the environment as a legal interest, although it seems to provide a greater guarantee of protection to this value, brings numerous controversial issues that refer to both ownership as to the possibility of economic valuation of the environmental interest. These issues should be examined more closely and will be

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El Estado incentivará a las personas naturales y jurídicas, y a los colectivos, para que protejan la naturaleza, y promoverá el respeto a todos los elementos que forman un ecosistema. Available at: <[http://www.asambleanacional.gov.ec/documentos/constitucion\\_de\\_bolsillo.pdf](http://www.asambleanacional.gov.ec/documentos/constitucion_de_bolsillo.pdf)>. Accessed on: 25 JUN 2016.

<sup>58</sup>Art. 72-La naturaleza tiene derecho a la restauración. Esta restauración será independiente de la obligación que tienen el Estado y las personas naturales o jurídicas de indemnizar a los individuos y colectivos que dependan de los sistemas naturales afectados.

En los casos de impacto ambiental grave o permanente, incluidos los ocasionados por la explotación de los recursos naturales no renovables, el Estado establecerá los mecanismos más eficaces para alcanzar la restauración, y adoptará las medidas adecuadas para eliminar o mitigar las consecuencias ambientales nocivas. Available at: <[http://www.asambleanacional.gov.ec/documentos/constitucion\\_de\\_bolsillo.pdf](http://www.asambleanacional.gov.ec/documentos/constitucion_de_bolsillo.pdf)>. Accessed on: 25JUN2016.

explained in the next item, which will also point out some proposals for solutions.

3. The construction of the subjective right to the healthy environment has some important implications, among them, the possibility of qualifying it as a legal interest. Guido Alpa asks whether the right to the healthy environment really exists or if it is just a technical expedient that does not correspond to reality<sup>59</sup>.

Traditionally, legal interests are the objects of property rights and encompass things, whether movable or immovable, yet there is discussion about the possibility of exercising property rights over intangible interests. The question is whether the concept of property can be extended to intangible interests; since, in the Roman perspective, conformed by the Institutes of Gaius, only the tangible interests can be object of the property right<sup>60</sup>.

The qualification of the environment as an interest implies the analysis of important issues related to Private Law. The first one refers to the legal definition of interest, thematic that highlights an initial difficulty arising from the variability of definitions attributed by scholars, which shows that there is no uniformity in the theory of Civil Law on the subject. From each of the proposed definitions, another polemic lies in the difference between interest and thing and in the difficulty in establishing which of the concepts is the gender and which is the species<sup>61</sup>. Washington de Barros

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<sup>59</sup>See ALPA, Il diritto soggettivo all'ambiente salubre: 'nuovo diritto' o espediente tecnico? In: ALMERIGHI, ALPA, (commentati da). *Diritto e Ambiente: materiali di dottrina e giurisprudenza*. Parte I – Diritto Civile. Padova: Cedam, 1984. p. 431-446.

<sup>60</sup>“Gaius, the most eminent of the jurists of Rome, vehemently expressed the essence of Roman property in its classification of things by which the world offers itself to man. Applying the Stoic distinction between matter and spirit, he saw two broad categories: on the one hand, tangible things, “those we can touch”, such as money and land. These things offer themselves to the power of man in his material thickness directly and without intermediary [...] On the other side are the “intangible things”. These are mechanisms designed by man so that he could exercise over domains other than physical apprehension. Intangible things only exist by the work of the mind, they are rights (swears) in the sense of legal relations”. ALLAND, RIALS, Propriedade. In: *Dicionário da Cultura Jurídica*. São Paulo: Martins Fontes, 2012. p. 1444-1445.

<sup>61</sup>See GAMBARO, La proprietà. I beni, vol I. In: *Trattato di diritto civile*, diretto da Iudica e Zatti, Milano: Giuffrè, 1995. p. 45 et seq. Sobre o tema, consultar: PUGLIATTI, *Beni e cose in senso giuridico*. Milano: Giuffrè, 1962; SCOZZAFAVA, *I beni*. In: *Trattato di diritto civile del Consiglio Nazionale del Notariato diretto da Pietro Perlingieri*, III, 1. Napoli: Edizioni Scientifiche Italiane,

sums up the discussion in the following terms: "Sometimes, things are the gender and interests, the species, others, these are the gender and those, the species; others, finally, are the two terms used as synonyms, there being between them coincidence of signification"<sup>62</sup>.

Thus, it is that part of the doctrine understands that interest is all that can be subject of law, therefore, interest would be gender and the thing would be the species; for others, the thing would be gender and interest would be the species. Sharing the first opinion, Orlando Gomes<sup>63</sup> points out that interest and thing are not confused: the first is gender and the second is species. The notion of interest comprises what can be object of law without economic value, while that of thing is restricted to equity utilities, that is, those that have economic value. The second opinion is based on the notion that thing is everything that is external to man and includes what may be owned and what cannot be owned<sup>64</sup>. In this perspective, a thing is everything that exists objectively, to the exclusion of man; interests are things which, because of their utility and rarity, are appropriable and endowed with economic value. Thus, when a thing becomes a subject of law, it becomes technically defined as interest.

Hence, it is inferred that another important point for the protection of the environment is its definition as *res nullius* or *res communes omnium*, as well as the limits of appropriation. As *communes omnium*, a series of interests (water, air, light, atmospheric heat) are excluded, which cannot be considered interests in an economic sense because they are not capable of being appropriated and valued. However, from its association with a protected interest, it is proposed to overcome the dogma that identifies as *res nullius* the possibility of occupation, as well as the coincidence be-

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2013. p. 1-34; GROSSI, *I beni: itinerari fra 'moderno' e 'pos moderno'*. *Rivista Trimestrale di Diritto e Procedura Civile*, Milano: Giuffrè. dicembre. 2012. Anno LXVI. n. 4. p. 1059-1085.

<sup>62</sup>See MONTEIRO, *Curso de direito civil*. Parte Geral. 16. ed, revista e atualizada. São Paulo: Saraiva, 1977. p. 135.

<sup>63</sup>See GOMES, *Introdução ao direito civil*. 13. ed. Atualização e notas de Humberto Theodoro Júnior. Rio de Janeiro: Forense, 1999. p. 200.

<sup>64</sup>The commonly accepted notion for the word "thing" is that it is all bodily objects or natural entities susceptible of appropriation or use. (Cf. ALPA, FUSARO, *Le metamorfosi del diritto di proprietà*. Matera: Antezza, 2014. p. VIII).

tween *res alicuius* and non-occupation.

That is why there are also those who defend the autonomy of the right to the environment in relation to property rights, which means that ownership of the environment would do without the ownership of property rights. This is because the environmental interest would be of diffuse ownership and would coexist, so to speak, with property, be it private or public, regardless of the ownership or the owner of the interests singularly considered, which would have promoted the overcoming of the individualist type relationship between the owner and the interest protected<sup>65</sup>. Therefore, it would be possible to break with the concept of the environmental interest as *res nullius* or *communis* by associating it with a legal interest that is protective and worthy of legal protection.

In an essay on the value of things, starting from the classification made by Roman Law, which places sacred, religious, and public things out of trade and provisionally excludes the property from the *res nullius*, Yan Thomas<sup>66</sup> describes the process of capturing things by Law in establishing the regime of property and trade. The author argues that each branch of law defines its sphere of validity, declaring temporarily something outside the law, so that such exclusion defines what should be considered as law. This dynamic of exclusion/inclusion establishes the Right of Things and establishes its legal statute, especially in Roman Law, which establishes a reserve of unavailability and only subsequently establishes a wide sphere of availability, consisting of things that are in commerce, available, therefore, for free circulation and provided with value.

In the logic of the Roman Law, natural resources are considered *res communes omnium*, interests common to all humanity, enjoyable by the first that makes use or the first owner. Considered as unlimited resources, intended for common use and unsusceptible to individual appropriation, and therefore could not circulate or obtain

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<sup>65</sup>See MOTA, da. O conceito de natureza e a reparação das externalidades ambientais negativas. In: *Fundamentos teóricos do Direito Ambiental*. Rio de Janeiro: Elsevier, 2008. p. 1-28.

<sup>66</sup>See TOMAS, *Il valore delle cose*. Macerata: Quodlibet, 2015.

value. The consecration of ownership of the environment and its recognition as interest brings another discussion about the mechanisms of environmental protection, with several possibilities of response, ranging from publicist or privatist models, with intermediate proposals.

The determination of a diffuse right to the environment and its protection goes through several application mechanisms and techniques, which may result from state action or a market solution<sup>67</sup>. In the first perspective, the State acts in a way to neutralize the negative effects of the use of natural resources, imposing, for example, ecological taxes or mechanisms of environmental compensation. Taxation would be a form of collection for the use of environmental interest or the degree of pollution caused<sup>68</sup>.

In the second view, the market itself auto-regulates and establishes values for collective interests through a market ecology<sup>69</sup>. An example is the property rights, certificates that set the desired levels of use of an interest and that are distributed, freely tradable, with control of the environmental authority. Such solution is much criticized by environmentalist doctrine, since the idea of costs implies an economic analysis of the Law and the consequent pricing of the environmental interest by the economic agents themselves, which would reduce “both the social and the ecological to the restricted ends of the mercantile exchange”<sup>70</sup>.

Therefore, if the environmental protection occurs through Public Law instru-

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<sup>67</sup>On the use of market instruments to protect the environment, see the following works, with different perspectives: CAFAGNO, *Capitolo IV: Strumenti di mercato e tutela dell’ambiente*. In: *Diritto dell’Ambiente* (a cura di Giampaolo Rossi). Torino: Giappichelli, 2011. p. 171-184. Quanto aos instrumentos de Direito Público, pode-se citar: CORSO, *Capitolo III: La valutazione del rischio ambientale*. In: *Diritto dell’Ambiente* (a cura di Giampaolo Rossi). Torino: Giappichelli, 2011. p. 159-170.

<sup>68</sup>See SILVA FILHO e. O princípio do poluidor-pagador: da eficiência econômica à realização da justiça. In: MOTA, Mauricio (Coord.). *Fundamentos teóricos do Direito Ambiental*. Rio de Janeiro: Elsevier, 2008. p. 87.

<sup>69</sup>See FIGUEIREDO, *A propriedade no Direito Ambiental*. 4. ed. revista, atualizada e ampliada. São Paulo: RT, 2010. p. 128.

<sup>70</sup>See OST, *A natureza à margem da lei. A ecologia à prova do direito*. Lisboa: Fundação Piaget, 1995. p. 161.

ments, turned to the logics of the command and control<sup>71</sup>, there is also room for a protection of Private Law, which takes as grounds the mechanisms of civil liability<sup>72</sup>, being possible to speak about an integrated vision among the several instruments, as indicated by the EU Sixth Environment Action Programme (6<sup>th</sup> EAP), which provides for the integration of the environmental component in other policies, in collaboration with a market economy<sup>73</sup>.

Equally, the EU Seventh Environment Action Programme for 2020 (7<sup>th</sup> EAP), adopted by Decision No. 1386/2013 of the European Parliament, provides as priority object the promotion to the investments for the policy related to the environment, upon the adoption of a set of instruments supporting the effective management of the environmental impacts of the activities developed. Such mechanisms include economic benefits and market instruments *“to complement the legislative charts of the countries and involve the interested parties in several levels”*<sup>74</sup>.

This task is carried out through a dialogue between Economic Law and Environmental Law, with a view to creating mechanisms that act in the productive chain in order to allow the costs arising from the use of natural resources to be internalized. These mechanisms may be preventive, compensatory or indemnifying. The proposal that results from the economic analysis of the environment is the attribution of property rights to interests that would initially be considered non-valuables, due to their inclusion in a non-ownership regime.

Natural resources were used for a long time without great control, because in

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<sup>71</sup>See CASERTANO, *Proprietà e ambiente: la soluzione italiana a confronto con le nuove esigenze di tutela*. Milano: Giuffrè, 2008. p.13-14.

<sup>72</sup>This form of protection finds shelter in particular in the English, French and German legal systems. See CASERTANO, op. cit.p. 23.

<sup>73</sup>Available at: <<http://eur-lex.europa.eu/legal-content/PT/TXT/?uri=URISERV%3A128027>>. Accessed on: 29JUN2016.

<sup>74</sup>Explanatory Notes to the EU Seventh Environment Action Programme for 2020. Item 33: An appropriate set of policy instruments could help businesses and consumers better understand the environmental impact of their activities and manage such impact. These instruments include economic incentives, market instruments, information obligations and instruments and measures on a voluntary basis to complement legislative frameworks and involve the interested parties at various levels. Available at: <[http://www.icnf.pt/portal/pn/biodiversidade/ei/resource/doc/estrategia-uniao-europeia/3-7-PAA\\_Decisao-1386\\_2013.pdf](http://www.icnf.pt/portal/pn/biodiversidade/ei/resource/doc/estrategia-uniao-europeia/3-7-PAA_Decisao-1386_2013.pdf)>. Accessed on: 24JUL2017.

the collective imagination the prevailing idea was that they were inexhaustible and, as such, were outside the circulation and the market economy, which, under the legal nomenclature was expressed in the classification as *res communes omnium* and made possible the free appropriation by consumers-users. The definition excludes a series of interests, among them, water, air, light and atmospheric heat), which cannot be considered interests in the economic sense because they are not susceptible of appropriation.

However, the need for a better use of these resources gave rise to a change of perspective in approaching the theme: from the initial consideration of natural resources to unlimited, we began to consider the need to fit them into the list of scarce interests and value them economically<sup>75</sup>. The qualification of environmental resources as scarce interests allows their inclusion in the context of an economic problem: the basis for the existence of property rights would be the scarcity of resources and the most efficient form of allocation<sup>76</sup>.

Given the limitation of resources that were once thought to be unlimited, the discussion is turned to the solution of problems such as the scarcity and the conflict between the various intentions of appropriation. If a resource is scarce, the solution is to attribute it to someone and, later, establish the necessary mechanisms to distribute its utilities to the others; if the resource is unlimited, one can choose a system of universal or non-ownership communion<sup>77</sup>. In face of limited resources, the need arises to establish legal forms of attribution of ownership that are economically feasible and appropriate to each situation.

Once the property is assigned to someone, the owner must bear the costs of

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<sup>75</sup>See CENDON, *Proprietà, riserva e occupazione*. Napoli: Jovene Editore, 1997.

<sup>76</sup>On the same issue, see ALPA, Un'esperienza in progress: il modello nord-americano. In: *Diritto e ambiente: materiali di dottrina e giurisprudenza*. Commentati da Mario Almerighi e Guido Alpa. Parte I – *Diritto Civile*. Cedam: Padova, 1984. p. 249-258.

<sup>77</sup>See GAMBARO, *La proprietà: beni, proprietà, comunione*. In: *Trattato di Diritto Privato a cura di Giovanni Iudica e Paolo Zatti*. Milano. Giuffrè, 1990. p. 7 et seq. The author argues that human groups seem happier when it is possible to establish a situation of non-ownership, possibly because of a natural human aversion to rules and law or simply because the application of the laws, until actually considered necessary, turns out to be uneconomical, because the generated utilities are inferior to the annoyances.

his property, as well as the polluter with the costs of his activity, which can be done by means of a cost-benefit analysis between the risks and the profits obtained. In order for the property institution to function properly, the owner must bear all the costs of his actions, which should not be alleviated by the public sector, and, in such costs, must necessarily be taken into account those arising from activities that may affect the ecological balance and cause the need for risk compensation.<sup>78</sup>

The weighting of the economic elements involved through the cost-benefit analysis to solve the environmental issues allows the verification of the most appropriate measures, which cannot be overlooked of private autonomy and freedom of initiative. However, such measures should be adopted in cooperation with legislative environmental measures, based on the publicist techniques of command and control<sup>79</sup>. On the subject, Guido Alpa, criticizing the exclusively privatist US model, warns that the value in question imposes a publicist protection in Italian Law, due to the solidarist ideological option made by the Italian constitutional text<sup>80</sup>.

For Letizia Casertano, the right of property is called to occupy a new important role in the protection of the environment; however, that it is important to specify the hypothesis of the application of Private Law instruments, which should only be used when the damage to the environmental legal interest or its elements also violates individual rights protected by the law, such as the right to health and the right to property<sup>81</sup>. She also considers that, in order to ensure adequate protection of the environment, it must first be assigned an equity value and, in addition, a protection of the ownership type must be established. Due to the extension of the category of inter-

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<sup>78</sup>“It can be deduced from this position that the only way for the institution of private property to function in its fullness is when all the costs of the acts of its owners are borne by it, and not be relieved by the public power, which may have created even the initial incentive for that activity through subsidies, tax exemptions or monopoly concessions”. (MISES, Ludwig von. *Ação Humana*. Rio de Janeiro: Instituto Liberal, 1990. p. 914-916).

<sup>79</sup>On the private instruments of environment protection, see: DI GIOVANNI, *Strumenti privastici e tutela dell’ambiente*. Padova: Cedam, 1982.

<sup>80</sup>See ALPA, BESSONE, Un’esperienza in progress: il modello nord-americano. In: ALMERIGHI, ALPA, *Diritto e Ambiente: materiali di dottrina e giurisprudenza*. Parte I. *Diritto Civile*. Padova: Cedam, 1984. p. 258.

<sup>81</sup>See CASERTANO, *Proprietà e ambiente: la soluzione italiana a confronto con le nuove esigenze di tutela*. Milano: Giuffrè, 2008. p. 24.

ests object of property to encompass new immaterial realities, the protection mechanisms must adapt to the new requirements, adopting criteria of pragmatism and also equity in the solution of conflicts, in an attempt to simplification. Such would be the objective of Private Law in environmental protection<sup>82</sup>.

Environmental issues are real and should not be ignored. The challenge is to foster a harmonious coexistence between private autonomy and state intervention in the area of environmental limitations on private property. The possibility of application of typically proprietary protection instruments to the protection of the environment, together with economic mechanisms and publicist techniques, presents a still little explored potential for the effective protection of both values.

4. The equation established between the *environmental* value and the *property* value influences the Brazilian public policies and determines the ways of using the production and consumption assets, since the human needs are limitless and the resources limited. Thus, if the right to the environment is indivisible and can be attributed to the community as a whole, the one who uses the environmental interest to a greater extent deprives others of their use and must pay for the increased use.

The right to the environment, as a diffuse third-generation right, must be equitable and broadly guaranteed, requiring everyone to be able to abstractly use this interest made available to society. However, in reality, the user of the resource made available must bear all of its costs, both those that make it possible to use and those that result from it. This is what the principle of the user-payer enshrines, consecrated in national and international regulations.

It urges to clarify that the principle of the user-payer contains in its scope another principle, that of the polluter-payer – the one who can cause or causes pollution must pay for it. Thus, it can be argued that the polluter's liability for the damage caused and the internalization of the environmental costs (as a rule, outsourced) of

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<sup>82</sup>*Ibidem.* p. 28.

the production process are the two fundamental aspects of this principle.

It is from this perspective that Law 6.938/1981 established, on the one hand, legal support for the recognition of the polluter-payer principle, by establishing that the National Environmental Policy will aim at "imposing on the polluter and the predator the obligation to recover and/or indemnify the damages caused and, on the user, the contribution for the use of environmental resources for economic purposes"<sup>83</sup>. In addition, on the other hand, it established the civil liability of the polluter, regardless of fault, for damages caused to the environment and third parties<sup>84</sup>.

The polluter-payer principle, in its user-payer dimension, seeks to prevent the right to the environment from being enjoyed by all but paid for or supported only by some<sup>85</sup>, that is, to prevent the privatization of the profits of the productive process and the socialization of losses. In the course of the production process, in addition to internal production costs, externalities are generated, effects produced for third parties not participating in the productive process and which can be positive or negative. The first generates benefit to those who did not participate in the production process and the negatives causes damage to outsiders to that activity.

In addition to the desired end product, the production process also brings with it the so-called "negative environmental externalities", which, although derived from private production costs, are passed on to the community, the owner of the diffuse right to the balanced environment. The application of the polluter-payer seeks to correct such deviation and neutralize the social cost caused by pollution or environmen-

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<sup>83</sup>Article 4, VII.

<sup>84</sup>Article 14 - Without prejudice to the penalties defined by federal, state and municipal legislation, failure to comply with the measures necessary to preserve or correct the inconveniences and damages caused by degradation of environmental quality shall subject the offenders:

(...) Paragraph 1 - Without prejudice to the application of the penalties provided for in this article, the polluter is obliged, regardless of the existence of fault, to indemnify or repair the damages caused to the environment and to third parties, affected by its activity. The Federal and States Public Prosecutor's Office shall have the right to file civil and criminal liability actions for damages caused to the environment.

<sup>85</sup>See FERNANDEZ, *Direito ao Ambiente e propriedade privada*. Coimbra: Coimbra Editora, 2001, p.13.

tal degradation through the internalization of external costs arising from production.

Among the mechanisms established for the internalization of environmental externalities, environmental compensation is highlighted, applied in numerous different situations and institutes, but it brings together the scope of "making a degrading or polluting activity that adversely affects the environmental balance to offer a contribution to affect it positively"<sup>86</sup>.

The Environmental Law presents compensatory mechanisms that aim at the substitution of an environmental good for another of equivalent value, and in such dimension, it is possible to speak in environmental compensation *lato sensu*. The Brazilian legal system establishes the following species of environmental compensation<sup>87</sup>: (i) compensation for irreversible environmental damage (ecological compensation); (ii) compensation for suppression of Permanent Preservation Area; (iii) compensation of Legal Reserve; (iv) compensation for the suppression of Atlantic Rainforest; and (v) compensation for the implementation of enterprises that cause significant environmental impact.

Ecological compensation consists of "natural restoration of environmental damage in an area other than degraded area, with the aim of ensuring the conservation of equivalent ecological functions"<sup>88</sup>. An environmental benefit is offered to the community as a way to neutralize a loss generated by environmental damage.

Compensation for suppression of vegetation in Permanent Protection Area<sup>89</sup> determines that prior to the authorization of the environmental agency for said suppression, the entrepreneur must adopt compensatory measures to the environment,

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<sup>86</sup>See BECHARA, *Licenciamento e Compensação Ambiental na Lei do Sistema Nacional das Unidades de Conservação*. São Paulo: Atlas, 2009, p. 137.

<sup>87</sup>*Idem*. p. 137.

<sup>88</sup>See ALMEIDA, Marília Passos Torres de. *Compensação Ambiental na Lei do Sistema Nacional das Unidades de Conservação – Lei 9.985/00*. In: BENJAMIN, Antonio Herman de V e. (Org.). *Paisagem, natureza e direito*. São Paulo: Instituto O Direito por um Planeta Verde, 2005, p. 309.

<sup>89</sup>Article 1, Paragraph 2, of the Forestry Code: For the purposes of this Code, the following definitions shall apply: "II - permanent preservation area: protected area in accordance with arts. 2 and 3 of this Law, covered or not by native vegetation, with the environmental function of preserving water resources, landscape, geological stability, biodiversity, gene flow of fauna and flora, soil protection and welfare of human populations".

since the removal of the vegetation presumes the occurrence of environmental damage<sup>90</sup>.

The compensation of Legal Reserve<sup>91</sup> is provided for in article 44 of the Forestry Code<sup>92</sup> and imposes the performance of compensatory measures in case of cutting of vegetation of said area. Compensation of the Legal Reserve is foreseen for other areas with native vegetation, in cases where the restoration of the area in the property itself is not feasible or very difficult.

The compensation for the suppression of Atlantic Rainforest is required by Law 11.428/06, which conditions the cutting or suppression of native vegetation of the Atlantic Rainforest biome to the preservation or recovery in equivalent extension areas and with the same ecological characteristics<sup>93</sup>.

Lastly, compensation for the implementation of undertakings that cause significant environmental impact is provided for in article 36 of Law 9985/00<sup>94</sup> and is

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<sup>90</sup>Article 4 of the Forestry Code: “The suppression of vegetation in a permanent preservation area can only be authorized in case of public utility or social interest, duly characterized and motivated in a proper administrative procedure, when there is no technical and locational alternative to the proposed enterprise.

[...] Paragraph 4. The competent environmental agency shall indicate, prior to the issuance of authorization for the suppression of vegetation in a permanent preservation area, the mitigating and compensatory measures to be adopted by the entrepreneur.”

<sup>91</sup>For the purposes of this Code: “III - Legal Reserve: an area located inside a rural property or possession, except for permanent preservation, necessary for the sustainable use of natural resources, conservation and rehabilitation of ecological processes, the conservation of biodiversity and the protection and protection of native flora and fauna.”

<sup>92</sup>Article 44: “The owner or holder of a rural property with an area of native, natural, primitive or regenerated forest or other form of native vegetation in an extent inferior to that established in items I, II, III and IV of art. 16, subject to the provisions of its paragraphs 5 and 6, shall adopt the following alternatives, either individually or jointly: III - compensate the legal reserve for another equivalent area of ecological importance and extension, provided that it belongs to the same ecosystem and is located therein according to the criteria established in regulation.”

<sup>93</sup>Article 17. The cutting or suppression of primary or secondary vegetation in the middle or advanced stages of regeneration of the Atlantic Rainforest Biome, authorized by this Law, is conditioned to environmental compensation, in the form of an area equivalent to the extent of the deforested area, with the same ecological characteristics, in the same river basin, whenever possible in the same hydrographic basin, and, in the cases foreseen in arts. 30 and 31, both of this Law, in areas located in the same municipality or metropolitan region.

<sup>94</sup>Art. 36. In cases of environmental licensing of undertakings with significant environmental impact, as considered by the competent environmental agency, based on an environmental impact study and assessment report (EIA/RIMA), the entrepreneur is obliged to support the implementation and maintenance of the unit of the Integral Protection Group, in accordance with the provisions of this article and the regulation of this Law.

applicable in case of environmental licensing of potentially polluting activities that generate non-mitigable environmental impacts. The environmental agency, when analyzing the impacts of a particular enterprise, concludes that they are significant and will have an impact on the environment 's fruition by the community, which generates for the entrepreneur the duty of compensation by means of support to the implementation and maintenance of conservation units of the Integral Protection Group.

In the above hypotheses, as a rule, compensation appears as a mechanism for recomposition of the damaged interest. However, there are situations in which environmental compensation occurs even before environmental damage materializes. This is the case of the environmental compensation set by the law that establishes the National System of Conservation Units (Law 9985/00), an innovative institute and on which there is a controversy among scholars of the subject, who have not reached an agreement on its legal nature. The scholars usually define it as a tribute, as a public price or as an early compensation mechanism for future damages<sup>95</sup>.

The same divergence found in the doctrine appeared among the ministers of the Federal Supreme Court who, in the context of the judgment of the direct action for the declaration of unconstitutionality No. 3378/DF<sup>96</sup> – filed by the National Confederation of Industry with the purpose of having Article 36 and its paragraphs of Law 9,985/00 declared unconstitutional – have manifested themselves incidentally

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Paragraph 1. The amount of resources to be destined by the entrepreneur for this purpose cannot be less than half of the total costs predicted for the implementation of the enterprise, being the percentage fixed by the environmental licensing authority, according to the degree of environmental impact caused by the enterprise.

Paragraph 2 - The environmental licensing authority is responsible for defining the conservation units to be benefited, considering the proposals presented in the EIA / RIMA and listening to the entrepreneur, and may even be contemplated the creation of new conservation units.

Paragraph 3. When the enterprise affects a specific conservation unit or its buffer zone, the permit referred to in the main section of this article may only be granted upon authorization of the agency responsible for its administration, and the affected unit, even if not belonging to the Group of Integral Protection, should be one of the beneficiaries of the compensation defined in this article.

<sup>95</sup>See MILARÉ, ARTIGAS, *Compensação Ambiental: questões controvertidas. Revista de Direito Ambiental*, São Paulo, n. 43, jul/set., 2006, p. 101.

<sup>96</sup>See BRAZIL, Supreme Court, Direct Action for Declaration of Unconstitutionality – ADI 3378/DF, j. 9.4.2008. Available at: <www.stf.gov.br>. Accessed on: 31MAY2011.

on the subject. The Court divided on the legal nature of the institute and established two divergent currents: a first group of ministers decided on the indemnity nature of the compensation and the other group defended the existence of an effectively compensatory character.

Among the votes, it is highlighted, for its innovative nature, the one issued by Minister Carlos Ayres Brito, rapporteur, who determines that environmental compensation is a densification of the user-payer principle and defines it as a sharing of expenses with official measures of prevention of enterprises of significant environmental impact, bypassing the indemnity character of the institute<sup>97</sup>. The aforementioned compensation would be "a mechanism of social responsibility shared by the environmental costs of economic activity"<sup>98</sup>.

Another important aspect concerns the percentage of this environmental compensation imposed on the practitioner of the economic activity. The Supreme Court understood that the value of compensation-sharing should be set by the licensing authority in a manner proportional to the environmental impact, after carrying out an environmental impact study. With this, it declared unconstitutional Paragraph One of Article 36 of the aforementioned law, which expressly determined that the percentage of environmental compensation could not be less than 0.5% of the total costs for the implementation of the enterprise. The rapporteur emphasized that setting a previous percentage on the costs of the enterprise minimizes the effectiveness of the compensation, which should be full and complete.

The absence of previous objective parameters that support the aforementioned calculation is an obstacle to the exercise of economic activity and discourages investments. The Brazilian model, centered essentially on the command and control logic, must also take into account the need to adopt incentive measures, which, together with private property and environmental protection instruments, can effec-

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<sup>97</sup>See BRAZIL, Supreme Court, Direct Action for Declaration of Unconstitutionality – ADI 3378-6 – Environmental Compensation – Available at: <<http://www.oeco.com.br/paulo-bessa/16948-adi--3378-6-df--compensacao-ambiental>>. Accessed on: 31MAY2011.

<sup>98</sup>Pursuant to the vote of the Ministry Rapporteur of ADI 3378-6.

tively and adequately protect the peculiarities of the country.

5. The environmental rules allow a great influence of the national States in the system of property that, in the beginning, it is being publicized until it becomes a common worldwide issue, in which the interest of somebody can suffer restrictions by account of the environment considered as a legal interest worthy of protection. With this, often, the state looms large and imposes protective rules in an arbitrary way, occupying the role of individuals; unduly invading the private sphere and the arrangements between individuals.

It is argued that the right to the environment is not a *prima facie* right and does not constitute a pre-ordered right in relation to other established rights, such as property and economic initiative. Therefore, state intervention in property should not ignore private autonomy and freedom of economic initiative, which must be guaranteed to the individual. It should be noted that property is closely linked to the freedom and progress of a people; therefore, the State should foster free enterprise and promote an economic environment where individuals are encouraged to develop their potential and perform productive work.

Here is the heart of the problem: to establish an environmental protection that does not disregard private property, freedom of economic initiative and the reasons for its recognition by the legal system. Environmental issues are real and should not be ignored. The challenge is to establish a harmonious coexistence between private autonomy and state intervention.

In order to better understand the relationship between economic initiative and the environment, it is necessary to adopt joint mechanisms of protection, in association with public and private mechanisms: the former are essentially preventive in nature; those of Private Law, as property and civil liability are endowed with a dimension more focused on repression and the establishment of the *status quo*<sup>99</sup>. If, on the one hand, the latter can be considered less incisive, on the other hand, they are

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<sup>99</sup>See CASERTANO, *Proprietà e ambiente: la soluzione italiana a confronto con le nuove esigenze di tutela*. Milano: Giuffrè, 2008. p. VIII.

given greater flexibility and have the capacity of coordination with the instruments that already exist.

The rationale for decisions regarding policies and investments requires the development of protection mechanisms that enable the valuation of ecosystems, in association with the development of incentives for environmental preservation. Economic analysis offers the necessary substrate for the insertion of the environmental dimension into a dynamic that associates public and private elements, with a view to protecting the community and promoting investments.

Based on the fact that every right has a cost, including the diffuse right to the environment, the environmental interest is valued so that it can be computed in the negative externalities and later neutralized by means of its internalization. This is what happens in environmental compensation provided for in Law 9985/00, whose underlying idea is that the beneficiary of a particular activity or an increased use of a common good must bear its costs. On the other hand, incentive mechanisms and prizes for conservation must be improved so that owners do not individually bear the cost of environmental preservation, a cost that must also be shared with the community.