Brexit or Bremain: What does it mean for the financial services industry?

1. On 23 June 2016 UK voters will decide whether the UK remains within the European Union (“EU”). The decision is, of course, significant to each citizen of the UK but it is also of paramount importance to the financial services industry. This paper analyses what a decision to remain in the EU would mean to the financial services industry given the new UK settlement achieved by the Prime Minister and set out in the European Council Conclusions of 18 and 19 February 2016. It also analyses what a decision to leave the EU could mean for the sector. As is explained at paragraphs 29 - 36, a key issue is whether financial services firms would be able to access the markets of other EU countries in the same way as currently.

2. Although this paper focuses on matters specific to the financial services sector, it is important to note that membership of the EU involves much more than is discussed herein. UK voters as individuals are affected by the UK’s membership of the EU because it influences matters as diverse as social and employment policy, consumer policy, the ability to travel between Member States for work and pleasure, information rights and judicial cooperation both in civil and police and criminal matters. Equally, the EU affects financial services firms in ways additional to those set out in this paper because of the EU’s varying competences in respect of matters such as employment law, company law, competition policy, state aid and insolvency.

How does the EU affect the financial services industry?

3. The EU operates solely within the competences conferred on it by its constituent Member States under the Treaties1. If a competence is not conferred on the EU, it remains at national level. Financial services is not identified within a specific competence but it falls under the internal market which is an area of shared competence2. Shared competences3 are areas in which both the EU and individual Member States are able to legislate and adopt legally binding acts. Individual Member States may exercise their own competence where the EU does not exercise, or has decided not to exercise, its own competence.

4. The ‘four freedoms’ of goods4, persons5, establishment and right to provide services6 and capital7 lie at the heart of the internal market. The general rule is that Member States may not discriminate against those who exercise their rights to one of the four freedoms nor impose non-discriminatory obstacles to the exercise of any of the four freedoms unless those obstacles can be justified. The EU has competence to legislate to achieve the objectives of the internal market and has legal Treaty bases to pass legislation to promote the four freedoms. The Treaties also provide that the EU can introduce legislation in the area of the internal market simply to harmonise

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1 The Treaty on European Union (“TEU”) and the Treaty on the Functioning of the European Union (“TFEU”)
2 One of the two original core objectives of the European Economic Community, the forerunner of the EU, was the development of a common market, which became known as the single or internal market.
3 Article 4 TFEU
4 Article 28 TFEU
5 Article 45 TFEU
6 Articles 49 and 56 TFEU
7 Articles 63 – 66 TFEU
national provisions\(^8\). Thus the basis for legislation in the area of financial services is one or more of the four freedoms and / or harmonisation.

5. The freedom of establishment and right to provide services means that financial institutions established in a European Economic Area („EEA“)\(^9\) Member State benefit from a ‘passport’ which enables them to access the markets of other EEA Member States without having to set up a subsidiary and obtain a licence to operate as a financial services institution in those Member States. On this basis a financial institution which establishes itself in the UK may choose either to:

(a) establish a branch in another EEA Member State (the ‘host’ state), referred to as an ‘establishment’ passport; or

(b) carry out its permitted activities cross-border, without establishing a presence in the host Member State, referred to as a ‘services’ passport.

This passport is used extensively by UK financial services institutions to access other EEA markets and by other EEA financial services institutions to access the UK markets.

6. Traditionally, the EU has written the financial services rulebook but given Member States significant discretion as regards the implementation, supervision and enforcement of that rule book. The financial crisis changed this approach: there was a deliberate move away from the localised solutions of individual Member States towards a more pan-European response. The creation of the European System of Financial Supervision consisting of a European Systemic Risk Board and three European Supervisory Authorities (“ESAs”), a new legislative process which involves the greater use of directly applicable regulations to set out the rules on financial services and the conferral of some direct supervisory powers on the ESAs evidence this new approach. The creation of banking union\(^{10}\), arguably the greatest transfer of sovereignty from individual Member States to the EU that has yet occurred, is the most apposite example of the pan-European approach but it also points to the development of a multi-speed EU as a consequence of the EU’s response to the financial crisis. Banking union is only mandatory for the 18 Member States within the Eurozone and creates a single supervisor for banks in the Eurozone. The Member States outside the Eurozone (the “Euro-outs”) may voluntarily participate in banking union but the UK, Sweden and the Czech Republic have already indicated that they will not participate.

7. Banking union is one example of the UK treading (or wanting to tread) a different path to the majority of the EU in the context of financial services: there are others. The UK abstained from, and later unsuccessfully challenged\(^{11}\), the short selling regulation (Regulation (EU) 236/2012) because of the wide-ranging powers conferred on the European Securities and Markets Authority. The UK voted against the CRD IV package (consisting of the Capital Requirements Regulation (Regulation (EU) 575/2013) and the Capital Requirements Directive IV (Directive 2013/36 EU)) because of the controversial cap on bankers’ bonuses. The UK has also unsuccessfully challenged the proposed financial transactions tax\(^{12}\) because of its anticipated effect on entities established in countries (inside and outside the EU) which will not adopt the tax. Finally, the UK successfully challenged the ECB’s Eurosystem Oversight Policy Framework, which would have required clearing houses to undertake Euro-denominated business from within the Eurozone only\(^{13}\).

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\(^8\) Article 114 TFEU
\(^9\) The EEA consists of the EU Member States plus Iceland, Lichtenstein and Norway.

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\(^{10}\) The conferral of prudential supervision of banks in the Eurozone on the European Central Bank (“ECB”) as opposed to national supervisors.

\(^{11}\) Case C-270/12 United Kingdom v European Parliament & Council of the EU

\(^{12}\) Case C-209/13 United Kingdom v Council of the EU

\(^{13}\) Case T-496/11 United Kingdom v European Central Bank
8. In addition to these obvious differences of opinion and as noted above, the UK has had concerns about the effect of banking union which is binding the Eurozone in an “ever closer union.” The UK has been concerned that the increasingly common interests of the Eurozone could lead to the possibility that decisions of the Council of the EU, binding all Member States, would be dominated by the Eurozone. This concern has been exacerbated by the new post-Lisbon voting rules which give the Eurozone an in-built double majority, thus opening up the possibility of caucusing. It was this concern that led, during the negotiations on the Single Supervisory Mechanism, to an amendment of the regulation establishing the European Banking Authority providing for a double majority voting lock so that specified measures can only be adopted with a majority of the Eurozone and a separate majority of the Euro-outs. These amendments were possible because the European Supervisory Authorities are established under secondary legislation: similar changes to Council voting rules would require Treaty change which is notoriously difficult to negotiate and attain.

The UK settlement

9. Such concerns led the UK government to include economic governance in the four categories of reform it wanted to negotiate with the EU before it would proceed with the referendum. Its focus in this category was the relationship between the Eurozone and the Euro-outs. In its negotiations, the UK requested clear and binding principles in seven areas to protect the Euro-outs. These areas were:

(a) recognition that the EU has more than one currency;
(b) agreement that there will be no discrimination on the basis of the currency used;
(c) protection of the integrity of the internal market;
(d) agreement that participation in new mechanisms such as the Single Supervisory Mechanism must be voluntary for the Euro-outs;
(e) agreement that the Euro-outs should not be financially liable for operations that support the euro;
(f) recognition that financial stability and supervision may be key competences for the ECB but they are also key competences of national central banks, such as the Bank of England;
(g) acceptance that all issues that affect all Member States should be discussed and decided by all Member States.

10. All seven principles are addressed in some form in the Council Conclusions of 18 - 19 February 2016, although they have been watered down from the formulation originally sought by the UK Government. They will be embodied in two Decisions that will become effective on the date that the UK informs the Council that it has

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14 The phrase “ever closer union” is found in the preamble to, and Article 1 of, the TEU. It has been the subject of much discussion and UK concern but, arguably, is relatively innocuous. The preamble provides that the Member States are “RESOLVED to continue the process of creating an ever closer union among the people of Europe, in which decisions are taken as closely as possible to the citizen in accordance with the principle of subsidiarity.”

15 The Council of the EU, generally together with the European Parliament, is the EU legislature: it adopts the laws proposed by the European Council.

16 The legislative package that conferred on the ECB prudential supervision of banks in the Eurozone States.

17 Treaty change is not a panacea. Even if it is agreed politically, in many Member States it triggers constitutional requirements, such as national referenda or the requirement of approval by national assemblies, which must be satisfied before it can be implemented. It is also not a cast iron guarantee. For example, although Article 18 TFEU prohibits discrimination on the grounds of nationality, the ECB still introduced the discriminatory policy discussed at paragraph 6 above and which the UK had to challenge before the European court.

18 A Decision concerning a new settlement for the United Kingdom within the European Union and a Decision on specific provisions relating to the effective management of the banking union and of the consequences of further integration of the euro area.
decided to remain a member of the EU, if that is the outcome of the referendum. The Decisions are legally binding on the Council but it is necessary to bear in mind that they represent decisions of the Council only. As noted above at footnote 15, the Council is only one part of the EU’s legislature: the European Parliament is its co-legislator, and all EU legislation is proposed by the Commission. Thus, even if the Decisions and Declarations contain guarantees (as to which see below), they could not be determinative of the future direction of travel in the EU. The Commission controls the legislation that is proposed, and the Parliament has equal rights to the Council in its amendment and adoption.

11. The draft Decision on a new settlement for the UK:

(a) recognises that not all Member States are legally bound to join the euro but reiterates that, with the exception of those States, Member States are committed to join the euro when they meet the conditions for doing so;

(b) makes the point that, as a result of derogations such as the ones set out in the sub-paragraph above, it is possible to have “different paths of integration for different Member States, allowing those that want to deepen integration to move ahead, whilst respecting the rights of those which do not want to take such a course”;

(c) states that measures to deepen economic and monetary union are voluntary for the Euro-outs but remain open to their participation;

(d) states that “Discrimination between natural or legal persons based on the official currency of the Member State, or, as the case may be, the currency that has legal tender in the Member State, where they are established is prohibited. Any difference of treatment must be based on objective reasons”;

(e) suggests that legislation to be applied by the ECB in its prudential supervision of banks in the Eurozone “may need to be conceived in a more uniform manner than corresponding rules to be applied by national authorities of Member States that do not take part in the banking union.” Accordingly, “specific provisions within the single rulebook and other relevant instruments may be necessary, while preserving the level-playing field and contributing to financial stability.” This text is less explicit than earlier versions which stated that different provisions may be necessary for the Eurozone and Euro-outs but does still appear to recognise the possibility for a difference in the future rules that will apply within, and outside, the Eurozone;

(f) states that measures to safeguard the financial stability of the Eurozone will not impose costs on the Euro-outs;

(g) provides that the financial stability of the Euro-outs is a matter for their own authorities unless they have joined the Single Supervisory Mechanism; and

(h) reiterates that all members of the Council participate in its deliberations, even where not all members have the right to vote, and meetings of the Eurozone must respect the competence of the Council.

12. The draft Decision on the consequences of further integration of the euro area provides that if any Euro-out Member State objects to the Council adopting a legislative act by qualified majority in the area of economic governance on the basis that it does not respect the principles set out in the Decision on a new settlement for the UK, it may request further discussion of the issue in Council. This enables a Euro-out Member State (such as the UK) to ensure that a proposal is immediately placed on hold pending specific discussion of that State’s concerns. The Council shall “do all in its power to reach ... a satisfactory solution to address concerns” raised by the Euro-out Member State. The provision, however, only guarantees a discussion: the process is “without prejudice to the normal operation of the legislative procedure of the Union and cannot result in a situation which would amount to allowing a Member State a veto”.

19 The UK and Denmark
What could Brexit look like?

13. The new settlement detailed above would take effect if the UK voted to remain in the EU but what would happen if the UK voted to leave the EU is far from clear. If the referendum produces an “out” result, the Prime Minister has indicated that withdrawal from the EU would be carried out under Article 50 TEU. Article 50, however, only provides for the negotiation of a withdrawal arrangement and not a deal on the UK’s future relationship with the EU. It would make sense (from the UK’s perspective at least) for the two sets of negotiations to be handled together or for the UK not to activate Article 50 until there is some clarity as to the UK’s future relationship with the EU. The lack of a precedent, however, means that it is far from clear whether either option is possible.

14. For the financial services industry, maintaining full access to the internal market would be crucial. From a legal point of view there are three main possible relationships that the UK could have with the EU post-withdrawal. These are all modelled on existing relationships between the EU and other states and give differing rights of access to the internal market. They are as follows:

(A) European Economic Area eg Iceland, Lichtenstein and Norway

15. Iceland, Lichtenstein and Norway have access to the internal market as EEA. The EEA Agreement (the “Agreement”) includes EU legislation covering the four freedoms throughout all EEA States and cooperation in various other areas, including research and development, education and social policy. The Agreement guarantees equal rights and obligations within the internal market for citizens and economic operators in the EEA.

16. Iceland, Lichtenstein and Norway are obliged to implement all internal market rules in exchange for access to the internal market but they do not take part in the negotiation of those rules. They also contribute towards the EU budget: in Norway’s case, around 90% of Britain’s net payment per head. Further, they are obliged to accept persons migrating from EU Member States in exercise of EU free movement rights.

17. In order to join the EEA, the UK would need to negotiate access to the European Free Trade Area (“EFTA”) and then EEA membership with EEA and EFTA members. Given the obligations of EEA membership, there seems little advantage to the UK in pursuing this option. As Nikolai Astrup, a Norwegian Conservative MP stated in 2013, “If you want to run Europe, you must be in Europe. If you want to be run by Europe, feel free to join Norway in the European Economic Area.”

18. This option is, however, the only option that would give the financial services sector similar access to the internal market as it enjoys under EU membership: the passport discussed at paragraph 5 above. The UK is, however, likely to regard the price of such access as too high.

(B) Bilateral agreements (under EFTA membership) eg Switzerland

19. Switzerland is an EFTA State but is not part of the EEA Agreement. Instead it currently has around 100 bilateral agreements with the EU that give access to the internal market for goods but not most services. Switzerland also contributes to the EU budget. In 1999 the EU and Switzerland signed an agreement on freedom of movement which gives the other’s citizens the right to enter, live and work in its territory. Switzerland is an associate member of Europe’s border-free Schengen area and a full participant in the Dublin system for dealing with asylum claims.

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20 Greenland (a Danish dependency) withdrew from the European Economic Community (a precursor to the EU) in 1985 and Algeria left upon its independence from France in 1962. Greenland’s exit was the product of three years of negotiations. It predated Article 50 TEU.

21 EFTA consists of the EEA Member States plus Switzerland. The EFTA Convention Agreement establishes the intergovernmental institutions of EFTA and the EEA.

22 The Dublin Regulation (604/2014) determines the EU Member State responsible for examining an application for asylum seekers seeking international protection under the Geneva Convention and the EU Qualification Directive.
20. The EU has closer ties with Switzerland than any other non-EEA State but bilateral relations have been severely strained since the February 2014 Swiss anti-immigration initiative, the outcome of which called into question the principles of free movement of persons and the internal market that underpin those relations.

21. The network of agreements is complex and sometimes incoherent: they are currently managed through a structure of more than 15 joint committees. There are, however, neither proper mechanisms to adapt the agreements to evolving EU legislation nor surveillance nor efficient dispute settlement mechanisms. The EU has determined not to give Switzerland further access to the internal market until a framework agreement is established but negotiations have stagnated.

22. It, therefore, seems unlikely the EU would establish a similar relationship with another non-EEA State but, if this were possible in principle, it is likely it would operate on a similar basis. The UK would have to negotiate a large range of bilateral agreements with the EU. The UK would not automatically have to implement new EU legislation and agreements would be negotiated on a case-by-case basis. A difficult decision as to what areas to prioritise would be required and see paragraph 25 below for the challenges of such negotiations.

23. Swiss financial institutions cannot benefit from the passport but the close relationship between Swiss and EU legislation on financial services, developed as a result of the bilateral agreements, has, in a number of instances, given Swiss financial institutions an advantage over institutions from other non-EEA countries as Swiss legislation is often regarded as “equivalent” to that of the EU. See paragraphs 31 - 33 below for a discussion of equivalence.

(C) Free Trade Area eg South Korea

24. This option contemplates a single bilateral free trade arrangement. The EU is a party to trade agreements and other agreements with a trade component both in the World Trade Organisation context and bilaterally with certain countries and regions. Countries, including South Korea and Canada, have free-trade deals with the EU that do not require observance of all its rules, paying into the budget or accepting persons exercising free movement rights. The EU has 53 such deals. The EU also has, or is negotiating, free-trade deals with the US (the controversial Trans-Atlantic Trade and Investment Partnership (“TTIP”)), China and India, which would not include a post-Brexit UK. Such deals do not, however, cover all services.

25. Post-withdrawal the UK would have to try to agree a free-trade deal with the EU to gain access to the internal market. The process would be lengthy and its precise outcome uncertain. In addition, the UK would wish to agree free-trade deals with other non-EU countries to replicate the free-trade deals from which it benefits as a member of the EU. This would be challenging because the UK no longer has an extensive body of its own trade negotiators and the UK alone may not be able to command terms as favourable as those secured by the EU acting as a bloc. As Sir Nicholas Macpherson, previous Permanent Secretary to HM Treasury commented, “...you’re going to be negotiating with a whole lot of battle-hardened trade negotiators and Britain does not have a department of trade full of equivalent experts.”

26. Although not necessarily attractive, this outcome currently seems most likely following a vote to withdraw from the EU. This would not, however, give financial services firms the same access to the internal market they currently enjoy: they could not use the passport.

What could Brexit mean to the financial services industry?

27. The result of the EU influence on UK financial services legislation detailed above is that the UK legislative framework for regulating financial services is entwined with EU regulation both because it has implemented directives and because it relies on regulations. Further, a large proportion of EU legislation implements international obligations or guidelines (ie those agreed at global level with countries other than just the EU), albeit the EU may “gold-plate” those obligations or guidelines for the purpose of its internal market. Accordingly, it would be a huge challenge for the UK to revoke or repeal its existing legislation and, if it were to do so, it might be faced with a need to replicate the EU legislation in order to meet global standards. It is likely that the UK might revoke or repeal certain discrete EU-specific obligations with which it does not agree, such as the cap on
bankers’ bonuses, but the vast majority of the corpus of financial services regulation would be likely to remain post-withdrawal, at least for the near future.

28. Indeed if the UK wished to maintain a relationship with the EU, which seems necessary in the financial services sector, it is likely to be best served by mirroring EU legislation as closely as possible. The UK is the leading global financial centre and the financial centre of the EU. Its status is at least helped by, if not dependent on, its position in the EU, as many non-EU financial services players see the UK as the gateway to Europe.

29. The loss of the passport described at paragraph 5 above, which would be inevitable (at the very least going forward) should any of the post-withdrawal options discussed above other than the EEA option be adopted, would be highly problematic for financial services institutions established in the UK and elsewhere in the EU. It would mean that financial institutions established in the UK (UK headquartered groups, branches of other EEA-headquartered groups and subsidiaries of non-UK headquartered groups) could not provide services to customers in the EU from the UK. Equally, financial institutions established in the EU could not provide services to UK customers from the EU.

30. If existing passports were revoked and new/extended passports were not available, financial institutions would be required to seek a new or additional EU or UK base for operations if they wished to provide cross-border services. Thus a financial institution established in the UK would require an establishment in an EU country if it wished to service EU clients in a number of EU Member States, as that establishment would enable it to obtain another passport. Equally, EU financial institutions which wished to service UK clients would need a UK establishment. A financial services institution which establishes itself in a jurisdiction has to apply for a licence to operate as a provider of financial services and subject itself to the regulation of and supervision by the competent authority in the State in which it establishes itself. Accordingly, establishment in a jurisdiction is a costly and time-consuming exercise with far-ranging consequences: hence the value of a passport. Whilst the need to seek establishment in a new EU Member State would be a highly resource-intensive exercise for financial services institutions, it would not be without problems for those Member States which would be considered as new headquarters. It is also questionable whether, even given the attempts to break the link between banks and their sovereigns, any one Member State, or even the Eurozone, could afford to do so.

31. There is a mechanism for recognition of non-EEA Member States which gives financial services institutions established in their jurisdictions certain rights within the EEA, although such rights are in no way equivalent to the passport and the type of right is developed on a case-by-case basis in individual pieces of legislation. This process is known as equivalence. There is not a prescribed process but it typically involves an assessment of whether the third party legislative regime is equivalent to that in the EEA.

32. Given the close relationship between Switzerland and the EU, Switzerland is often one of the first non-EU jurisdictions to be granted equivalence. Other jurisdictions, including jurisdictions such as the US, which might be assumed to have similar legislation to the EU as they have implemented the same international obligations, can struggle to obtain equivalence, perhaps because the process is often politically influenced.

33. A need to benefit from equivalence decisions post any withdrawal may encourage the UK to maintain and develop legislation in line with that of the EU. Indeed, as noted above, much of the UK’s domestic financial services legislation has an EU source but that EU source in turn often implements international obligations. This provides another reason why UK financial services legislation post any Brexit is unlikely to diverge significantly from EU legislation, save perhaps where the EU has gold-plated international obligations as it has, for example, with capital requirements for banks and large investment firms. A further reason why UK financial services legislation is likely to mirror EU legislation, at least immediately post any Brexit, is that UK existing financial services legislation has been a principal source of EU legislation in recognition of the pre-eminence of the UK as a global financial centre. As a result of this pre-eminence, the UK’s domestic legislation has historically been amongst the most sophisticated in the world.
34. Thus it appears unlikely that the legislation that would govern UK financial services institutions, at least immediately post any Brexit, would differ significantly from that of the EU. This means that the main concern for those financial services entities would be access to the internal market. The loss of the passport discussed at paragraphs 29 - 30 above would be a great concern but there are arguments that existing passports could be preserved or that the loss should not be immediate on the UK’s withdrawal from the EU.

35. Greenland’s negotiations for withdrawal involved the agreement of transitional provisions during which Greenlanders, non-national residents and businesses with rights acquired under EU law retained such rights. A large part of the negotiations for the future relationship between the UK and the EU would concern such acquired or vested rights. The Greenland experience thus provides a precedent. There is also an argument that international law protects rights acquired or obligations exercised under treaties prior to withdrawal from them. Article 70(1)(b) of the Vienna Convention on the Law of Treaties provides that, unless the treaty provides, or parties to the treaty agree, otherwise, the termination of a treaty “does not affect any right, obligation or legal situation of the parties created through the execution of the treaty prior to its termination”.

36. As with much of what might happen post a decision to leave the EU, whether and how much such acquired rights would be protected cannot be predicted: the Greenland example does not bind the EU and it is by no means certain that the principles of international law can be applied to EU rights and obligations. Further, such arguments could not be used going forward. They would not permit the extension of existing passports to new jurisdictions or new services nor the acquisition of new passports to permit the outward provision of financial service from the UK nor the inward provision of financial services to the UK.

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23 Articles 65 – 72 specify the procedures to be followed and the consequences of termination or suspension of treaties.