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The UK vote to leave the EU: implications for capital market regulation

Quarterly Assessment by Paul Richards

Introduction

1 As a result of the UK vote in the EU referendum on 23 June to leave the EU, there is considerable uncertainty in capital markets about the implications. The purpose of this Quarterly Assessment is to focus on the implications of the UK vote to leave (ie Brexit) for capital market regulation.[1] It does not cover the wider political and economic implications of the UK vote to leave. HM Treasury and the Bank of England, the IMF and the OECD, among others, have already set out their assessments of the potential impact of the UK vote to leave on UK economic growth and inflation, the sterling exchange rate, UK interest rates, the UK's credit rating, the stability of the UK financial system, foreign direct investment and employment in the UK, both in the near term and the longer term; and they have also set out their assessments of the potential economic impact on the rest of the EU, as the UK's main export market.

Stage 1: Notification of withdrawal

2 The first formal step towards withdrawal from the EU is for the UK Government to notify the European Council of the UK's intention to withdraw by invoking Article 50 of the EU Treaty. Invoking Article 50 is considered to be the only legal way to leave the EU. It is for the UK Government to decide when to invoke Article 50, subject to majority support in Parliament. The Heads of Government of the remaining 27 EU Member States stated at their meeting on 29 June that the UK should notify the European Council as quickly as possible, and that "there can be no negotiations of any kind before this notification has taken place".

3 Article 50 has not previously been tested, but it should provide a period of up to two years for the UK Government to negotiate withdrawal from the EU with the European Council, acting by enhanced qualified majority voting (QMV) with the consent of the European Parliament.[2] If no agreement is reached, the UK will leave the EU two years after Article 50 is invoked, unless there is unanimity among the other 27 EU Member States on extending the negotiations beyond two years.

4 A second referendum has been ruled out by the UK Government. It is not clear whether this would necessarily bind a future Government. A second referendum might in theory be called, for example, at the end of the withdrawal negotiations once the settlement terms for the UK have become clear; and the settlement terms would in any case need to be approved in the UK by Parliament. There are precedents for second referenda in the cases of Denmark and Ireland. But these referenda concerned EU Treaty changes. They did not involve withdrawal from the EU under Article 50. Once Article 50 has been invoked, it is not clear whether it would be possible for the UK to stop the Article 50 process before withdrawal if the UK subsequently decided to remain in the EU.

5 EU legislation – including new EU laws – will continue in effect in the UK until withdrawal. But following the vote in the UK to leave the EU, it is not clear what would happen if the primacy of EU legislation in the UK were to be challenged in some way before UK withdrawal.[3]

6 The safeguards negotiated by the UK Government with the European Council on 19 February, if the UK voted to remain in the EU, will not apply now that the UK has voted to leave.[4]

> **"Invoking Article 50 is considered to be the only legal way to leave the EU.**

1. This paper updates the previous Quarterly Assessment on: Brexit: Practical Implications for Capital Markets (April 2016).

2. Qualified majority voting: at least 55% of EU Member States representing at least 65% of the total EU population. Enhanced qualified majority voting: at least 72% of EU Member States representing 65% of the EU population.

3. eg by limiting in the UK the powers of the European Court of Justice or restricting free movement of people into the UK from the rest of the EU.

4. Decision of Heads of State or Government, meeting within the European Council, concerning a New Settlement for the United Kingdom within the European Union, 19 February 2016.

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It is not yet clear which approach the UK Government will adopt, nor what the EU response will be.

Stage 2: Withdrawal negotiations

(i) Withdrawal options for the UK

7 During the negotiations on withdrawal[5], the UK Government is expected to seek a new agreement on UK/EU relations in future. In the negotiations on a new agreement, the main question affecting capital markets will be the terms of future UK access to the EU Single Market, given that the UK currently has unrestricted free access through the “single passport”[6] as a member of the EU, and that unrestricted free access to the EU Single Market will cease on the UK’s withdrawal unless there are new arrangements to replace it.

8 In its assessment in March 2016 of possible models for the UK outside the EU, HM Treasury considered three main withdrawal options[7]:

- *Leave the EU and join the European Economic Area (EEA):* Under this option, the UK would apply to join EFTA as a means of joining the EEA (like Norway).[8] As a result, the UK would continue to have unrestricted free access to the EU Single Market through the single passport. But the UK would not have a vote on new EU legislation in future and would need to continue complying with EU financial regulation under the jurisdiction of the European Court of Justice, accepting the free movement of people from the EU and making a contribution to the EU budget.
- *Leave the EU and negotiate a bilateral trade agreement:* Under this option, the UK would negotiate a bilateral agreement with the EU (like Canada).[9] The negotiation of the Canadian agreement with the EU (CETA) has so far taken seven years, and it still needs to be ratified by all 28 EU Member States and the European Parliament. Once ratified, CETA will allow substantial access to the EU Single Market for most goods, but will not provide a single passport for financial services.
- *Leave the EU and trade under World Trade Organisation (WTO) rules*, including trade in services through the General Agreement on Trade in Services (GATS): This option would not require prior agreement by the UK with the rest of the EU, nor involve the implementation of EU regulations, nor acceptance of the free movement of people from the EU, nor making a budgetary contribution to the EU. But it would not give preferential access to the EU Single Market. Instead, it would mean that UK exports both to the EU and other WTO members would be subject to the same WTO tariffs; and, in the case of services, the EU would only be obliged to give a much more basic framework under GATS than the EU Single Market, and much less favourable access.[10]

(ii) UK withdrawal negotiations with the EU

9 It is not yet clear which approach the UK Government will adopt, nor what the EU response will be. If the UK wanted to obtain the most favourable terms of access to the EU Single Market, this would mean complying with EU legislation, both at the outset and on a continuing basis in future; continuing to permit free movement of people between the UK and the rest of the EU; and continuing also to make a contribution to the EU budget. It has been reported that there might be a majority in the House of Commons in favour of retaining unrestricted free access to the EU Single Market through the single passport as the best way of implementing the vote by the British people in the referendum to leave the EU.

10 However, it appears that the priority for the UK campaign to leave the EU (the “Brexit campaign”) is to ensure that, after the UK withdraws, the UK will not be subject to the European Court of Justice and that the UK can control EU immigration. It is not clear whether the UK vote to leave the EU will be interpreted by the UK Government as a vote to give priority to these objectives, even if this means leaving the EU Single Market, which

5. eg the terms of withdrawal from the UK’s budgetary commitments to the EU.

6. The “single passport” allows financial services operators legally established in one EU Member State to establish or provide their services in the other Member States without further authorisation requirements.

7. HM Treasury: Alternatives to Membership: Possible Models for the UK outside the EU (March 2016).

8. It is possible that the idea of an “association agreement” between the UK and the EU would be a variation on the Norwegian option, though that is not yet clear.

9. Switzerland has 120 bilateral agreements with the EU. But the EU is not thought to favour this model, particularly since 2014 when Switzerland voted to restrict EU immigration.

10. The previous Secretary General of the WTO warned in May that “the WTO would be a terrible replacement for access to the EU Single Market”, and that “there has not been a major WTO deal in 23 years”: Pascal Lamy: Britain Won’t Get Better Trade Deals if it Leaves Europe: The Times, 3 May 2016.

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The EU would be expected to argue that, as a condition for future access to the EU Single Market on favourable terms, UK law should continue to conform in future with EU law.

comes under the jurisdiction of the European Court of Justice and requires the free movement of people within the EU. But the Heads of Government of the remaining 27 EU Member States said at their meeting on 29 June that “access to the Single Market requires acceptance of all four freedoms” (ie including the freedom of movement of people within the EU).

11 Under those circumstances, negotiating a Canadian-style trade agreement with the EU would be one option for the UK. But, in addition to the complexity of the issues at stake, any UK trade deal with the EU would have to be ratified by all the other 27 EU Member States and the European Parliament. The President of the European Council has estimated that negotiating and ratifying such an agreement might take up to seven years[11]. If so, it might be necessary – should the UK leave the EU in the meantime[12] – for the UK to trade under WTO rules for a period. But that might not be necessary if the negotiations could be completed by 2020 (ie the currently scheduled date for the next General Election in the UK), as the Brexit campaign hopes. If the UK adopted this approach, it is not yet clear what would happen in the case of UK financial services.

12 To leave the EU, UK legislation will need to be changed, in particular by repealing the UK European Communities Act 1972. In the case of the capital markets, the regulations affecting the UK at present are largely set at EU level. EU regulations take the form of Directives, which have to be transposed into UK law[13], and Regulations, which apply directly in UK law without transposition:

- Although EU Directives have been transposed into UK law, the UK Government will need to take decisions about whether to keep, modify or discard them. For example, how will MiFID II, which is due to be implemented on 3 January 2018, be handled?
- As EU Regulations apply directly in the UK, they will cease to apply once the UK European Communities Act 1972 has been repealed. The question will then arise whether to replace them, and if so on what basis. This would be the case, for example, with MiFIR.
- These issues relate not only to EU legislation at Level 1, but to Regulatory and Implementing Technical Standards at Level 2 under the auspices of the European Supervisory Authorities (ESAs). In addition, Credit Rating Agencies in the UK are directly supervised by ESMA. It is not clear what future arrangements there will be between the ESAs and the UK.

13 There is likely to be a better chance of gaining favourable terms of access to the EU Single Market, after the UK leaves, if existing EU legislation is “grandfathered”: ie Directives already transposed into UK law are left unchanged; and Regulations which will no longer apply directly in the UK once the UK European Communities Act 1972 is repealed are replicated under UK law. This would make it easier for the UK to argue that, when it withdraws from the EU, UK legislation is equivalent to the EU at the outset, so that the UK can obtain favourable access to the EU Single Market as a result. It assumes that the UK would be willing to grant cross-border access to the EU on a reciprocal basis. Some EU legislation (eg MiFID II) provides that the EU can deem third country regimes to be equivalent in exchange for reciprocity, though that does not apply in all cases, and in the case of MiFID II it depends on a judgment by ESMA.

14 The EU would be expected to argue that, as a condition for future access to the EU Single Market on favourable terms, UK law should continue to conform in future with EU law under the European Court of Justice. And the EU may also set, as a condition, that the free movement of people between the UK and the EU should continue.[14] It is not clear whether this would be politically acceptable in the UK. On the one side, the Brexit campaign in the UK has argued against meeting these conditions. On the other side, there might be a majority in the House of Commons for staying in the EU Single Market as the best way of implementing the vote by the British people to leave the EU. Whatever the eventual outcome, there will be uncertainty about the outcome until the withdrawal negotiations with the rest of the EU are complete: ie for two years or longer.

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11. The House of Lords European Committee has estimated that an agreement between the UK and the EU would take between four and nine years to complete. The Former Secretary General of the WTO has estimated that it would take between five and fifteen years.

12. eg if there is not unanimity under Article 50 on extending the negotiating period beyond two years.

13. ie English and Scottish law.

14. However, in the case of the 2014 agreement between the EU and the Ukraine, there are restrictions on free movement of people.

> It is by no means clear that leaving the EU will lead to less capital markets regulation in the UK than would otherwise be the case.

(iii) UK negotiations with the rest of the world

15 As trade agreements between the EU and the rest of the world are an EU rather than national competence, new agreements will need to be negotiated between the UK and 53 other markets in the rest of the world, unless the UK is going to trade solely under WTO rules. It needs to be established to what extent negotiations can begin immediately or whether the UK's largest trading partners (eg the US and China) will insist on waiting for an EU agreement first. There is also a question about how long these agreements will take to negotiate.[15] During his visit to London in April, President Obama said that, if the UK voted to leave the EU, a UK/US trade deal would be at the back of the queue, and could take five to ten years. As the UK has not been directly involved in trade negotiations for over 40 years, the UK will also need to train officials or hire experts to conduct them. In the meantime, after withdrawal from the EU, UK trade with the rest of the world would be subject to WTO rules.

Stage 3: Post-withdrawal

(i) Implications for capital market regulation in the UK

16 It is by no means clear that leaving the EU will lead to less capital markets regulation in the UK than would otherwise be the case, for three main reasons:

- *Global level:* While the detailed regulations affecting capital markets in the UK are set at EU level, the overall framework for capital markets regulation is set at global level by the G20, working through the FSB, BCBS and IOSCO. The UK participates in the G20, and will need to continue meeting these global standards, even though it has voted to leave the EU.
- *EU level:* The UK will need to continue complying with the terms of EU regulations, if it wants to obtain favourable terms of access to the EU Single Market after leaving the EU. In the case of capital market regulation, that would be expected to include the CRD, the Prospectus Regulation, the Market Abuse Regulation, MiFID II/MiFIR, Solvency II, UCITS, AIFMD and EMIR, among others.
- *National level:* Since the international financial crisis, the national regulators in the UK – the PRA and FCA – have been among the most prominent national regulators in promoting strict regulation, as the FSA was before them.

(ii) Implications for UK relations with EU and euro-area institutions

17 The withdrawal of the UK from the EU will affect the capital market relationship between the UK and the European authorities in a number of other ways. For example:

- The EU's project for Capital Markets Union, promoted by the European Commission, is likely to be affected. There is a risk that the UK vote to leave the EU will fragment capital markets in the EU between London as an international financial centre and the rest of the EU, particularly if the UK is no longer a member of the EU Single Market after withdrawal. The UK's vote to leave has also led to the resignation of Lord Hill, the European Commissioner for Financial Stability, Financial Services and Capital Markets Union.
- The European Central Bank may take a different approach to counterparties in London with the objective of drawing euro markets from London into the euro area. For example, will access to the euro payments system be affected by the UK vote to leave the EU? And will central counterparty clearing move inside the euro area in order to obtain better access to liquidity from the ECB, as the ECB will no longer need to treat London-based activities as part of the EU?
- UK membership of other EU institutions involved in the capital markets will be affected. For example, after withdrawal, the UK may no longer qualify to be a full member of the European Investment Bank; the European Banking Authority, which is currently based in London, may decide to move its headquarters to a centre within the euro area; and it is not clear whether the proposed London Stock Exchange/Deutsche Börse merger will be permitted to have headquarters in London, if the merger goes ahead.

15. "It is probable that it would take an extended period to negotiate first our exit from the EU, secondly our future arrangements with the EU, and thirdly our trade deals with countries outside the EU, on any terms that would be acceptable to the UK. In short, a vote to leave the EU would be the start, not the end, of a process. It could lead to up to a decade or more of uncertainty.": HM Treasury: The Process for Withdrawing from the European Union (February 2016).

- There is also a question whether UK law will be used in EU financial contracts as much in future, and whether the EU and euro-area institutions will encourage the use of alternatives, and if so which these will be.

(iii) Implications for the EU

18 Aside from the impact on the UK economy, the UK decision to leave will have an impact on the economy of the EU; and there may be a political risk of contagion which results in referenda in some other EU Member States. So remaining EU Member States are not expected to respond during the withdrawal negotiations by granting favourable terms to the UK. It is also possible that the rest of the EU may react to the UK's withdrawal by proposing closer economic integration of the euro area and more cooperation on security and defence.

19 As the New Settlement for the UK agreed with the European Council on 19 February 2016 would only have applied if the UK had voted to remain in the EU, the New Settlement will not apply, since the UK has voted to leave. The New Settlement would have provided safeguards against discrimination between the euro area and the rest of the EU. So the absence of these safeguards may have implications, not only for the UK, but also for other non-euro area Member States, particularly those such as Sweden and Denmark not considering whether to join the euro area. Without the UK, the EU and the euro area could gradually become more synonymous.

(iv) Implications for the future of the United Kingdom

20 As the UK as a whole has voted to leave the EU, but Scotland has voted to remain, there will be uncertainty in capital markets about whether Scotland will in due course hold a second referendum (after the referendum in September 2014) on leaving the UK, with a view either to remaining in the EU when the UK leaves or, if that is not possible, applying as an independent country to rejoin the EU. In the case of Northern Ireland, the border between the North and South of Ireland is currently the UK's only land border with the rest of the EU. So the question will be whether the border should be controlled, and if so, how.

Business planning for Brexit

21 Planning for Brexit by financial institutions involved in the capital markets – both in the UK and outside the UK in relation to their UK counterparties – is still difficult because of uncertainty about the outcome of the negotiations between the UK and the EU and uncertainty about the length of time before the outcome becomes clear. But financial institutions' planning is likely to include, *inter alia:*

> **Planning for Brexit is still difficult because of uncertainty about the outcome of the negotiations between the UK and the EU and uncertainty about the length of time before the outcome becomes clear.**

- *taking steps to ensure their continued financial stability*: eg by checking the impact of Brexit on their capital adequacy, their liquidity and their access to funding against market volatility and the risk of capital flight;
- *setting out the risks of Brexit to their businesses*: eg in their annual reports; and considering whether a risk factor relating to Brexit needs to be included, in the event that they issue a prospectus;
- *checking whether their financial contracts will be affected*: eg to take account of changes in UK legislation after Brexit;
- *reviewing their future investment plans*: the UK will not be as attractive a location for access to the EU Single Market as it has been in the past as part of the EU Single Market, given the UK vote to leave the EU;[16]
- *reviewing their future staff location plans*: if EU citizens required permission to work in the UK in future, UK citizens would be expected to require permission in future to work in the EU; and
- *considering the time needed to make any changes*: in the case of any financial institution that decides to relocate some of its capital market activities and staff as a result of setting up subsidiaries in the rest of the EU to obtain passport-free access to the EU Single Market, planning such a transfer is likely to take time, and plans may need to be put into effect before the outcome of the UK's new trading relationship with the EU is known.

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16. "Over 5,000 firms, including banks, investment firms and insurance companies, hold passports which enable them to provide their financial services and establish branches in other EU Member States.": FCA evidence to the Treasury Select Committee: 3 February 2016.