Working draft: 24 June 2016

BREXIT: IMPLICATIONS FOR CAPITAL MARKET REGULATION

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 working paper 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: Invoking Article 50

2 The first formal step towards withdrawal from the EU is for the UK to invoke Article 50 of the EU Treaty. This is considered to be the only legal way to withdraw from the EU. Article 50 has not previously been tested, but it should provide a period of up to two years for the UK 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.

3 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, in the event of a further renegotiation with the EU in response to the UK vote to leave, or at the end of the withdrawal negotiations once the exit terms for the UK had become clear. 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.

4 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 (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).

---

[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.

Stage 2: Withdrawal negotiations

(i) Withdrawal options for the UK

5 During the negotiations on withdrawal, 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"[3] 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.

6 In its assessment in March 2016 of possible models for the UK outside the EU, HM Treasury considered three main withdrawal options[4]:

- *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). 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 be expected to accept EU financial regulation under the jurisdiction of the European Court of Justice; it would continue to accept the free movement of people from the EU; and it would continue making a contribution to the EU budget. During the UK referendum campaign, the campaign to leave the EU (the "Brexit campaign") has in general argued against adopting the Norwegian option on the grounds that the UK would not want effectively to be subject to the European Court of Justice after leaving the EU; and that, under the Norwegian option, it would not be possible to restrict immigration from the EU to the UK.

- *Leave the EU and negotiate a bilateral trade agreement:* Under this option, the UK would negotiate a bilateral agreement with the EU (like Canada).[5] The negotiation of the Canadian agreement with the EU (CETA) has so far taken seven years to negotiate, and 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. In the case of the UK, the President of the European Council has estimated that a new bilateral UK/EU agreement would take up to seven years to complete, while the leaders of the Brexit campaign have said that the UK would hope to complete negotiations by the end of 2019.[6]

- *Leave the EU and trade under 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

[3] 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.

[4] HM Treasury: *Alternatives to Membership: Possible Models for the UK outside the EU* (March 2016).

[5] 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.

[6] 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.

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.[7]

(ii) UK withdrawal negotiations with the EU

7 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 decision by the British people in the referendum to leave the EU.

8 However, it appears that the priority for 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. A vote to leave the EU may be interpreted by the UK Government as a vote to leave the EU Single Market, which comes under the jurisdiction of the European Court of Justice and requires the free movement of people within the EU. Remaining in the EU Single Market after UK withdrawal appears also to have been ruled out by the German Finance Minister, on the basis that "out" means "out".

9 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. Given that the President of the European Council has estimated that negotiating and ratifying such an agreement might take up to seven years, it might be necessary – if the UK were to leave the EU in the meantime[8] – for the UK to trade under WTO rules for a period. That might not be necessary if the negotiations were complete by the end of 2019, 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.

10 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, 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.

---

[7] 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.

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

- 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.

11 There will 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[9]. 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. This assumes that the UK would be willing to grant cross-border access to the EU on a reciprocal basis. Some EU legislation provides that the EU can deem third country regimes to be equivalent in exchange for reciprocity, though that does not apply in all cases.

12 But the EU would be expected to insist that, as a condition for future access to the EU Single Market on favourable terms, UK law should be kept up to date in future in conformity with EU law under the European Court of Justice. And the EU may also set, as a condition, that the free movement of people with the EU should continue. 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 UK vote 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.

(iii) UK negotiations with the rest of the world

13 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.[10] 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 would be subject to WTO rules.

---

[9] ie English and Scottish law.

[10] "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).

Stage 3: Post-withdrawal

(i) Implications for capital market regulation in the UK

14 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 continue to need to meet these global standards, even though it has voted to leave the EU.

- *EU level:* The UK will need to continue to comply 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 markets regulation, that will include the CRD, the Prospectus Regulation, the Market Abuse Regulation, MiFID II/MiFIR, 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

15 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. The decision of the UK to leave the EU may 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 European Central Bank may take a different approach to counterparties in the UK 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? Will central bank swap lines be reduced? 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: eg after withdrawal, the UK may no longer qualify to be a full member of the European Investment Bank; and the European Banking Authority, which is currently based in London, may decide to move its headquarters to a centre in the rest of the EU.

- There is also a question whether English 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

16 Aside from the impact on the UK economy, the UK decision to leave will also 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.

17 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 contemplating joining 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

18 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 subsequently to applying as an independent country to rejoin the EU.

19 In the case of Northern Ireland, the border between the North and South of Ireland will be 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

20 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 the uncertainty about what Brexit will involve. But financial institutions' planning is likely to include, *inter alia:*

- 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;

- 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;[11]

- 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

[11] "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.

- 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 would be 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.

Contact: Paul Richards
paul.richards@icmagroup.org