TheCityUK

CLIFFORD CHANCE

A LEGAL ASSESSMENT OF THE UK'S RELATIONSHIP WITH THE EU

A FINANCIAL SERVICES PERSPECTIVE

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FOREWORD

TheCityUK, the leading cross-sectoral body for financial and related professional services in the UK, is gathering evidence of the importance of the UK's relationship with the EU including our industry's view of how that relationship should develop to enable the UK to be part of a globally competitive Europe.

A study of the views of business leaders in our industry, *The City Speaks*, showed unequivocal support for the UK's continued membership of the EU. Our survey of public attitudes to EU membership, *The City Listens*, made it clear how important the views of business leaders are in helping people decide about the EU. *Finance for Jobs and Growth in Europe* illustrated the role of financial services in delivering solutions to the policy challenges facing the EU. *Analysing the Case for EU Membership* sets out how the economic evidence stacks up.

This study by Clifford Chance LLP summarises the legal implications of different EU membership scenarios for the UK from a financial services perspective. Its message is clear: membership of the EU is essential for the UK's success and for the ability of our businesses to compete in world markets.

It has been suggested that the UK could fundamentally change its relationship with Europe, but still maintain all the benefits of membership. This is not the case.

Continued EU membership is essential to this country's economic wellbeing, but that does not mean that the status quo is good enough. Europe must reform and modernise if it is to better serve the needs of its 500 million people. TheCityUK is gathering evidence as a starting point in the reform debate; the next step is to use this evidence to show how Europe can be made increasingly competitive and successful.

Gerry Grimstone
Chairman of TheCityUK

EXECUTIVE SUMMARY

Since the financial and sovereign debt crisis that began in 2007 and started to abate only in 2013, the United Kingdom's position in the European Union has gone to the top of the political agenda. The UK now faces the possibility of a referendum on membership of the EU. The result of such a vote would have profound effects on the UK for decades to come. With that in mind, it is important to understand the legal nature of the UK's current position and the strength of the case for the alternatives. This paper examines those questions from a financial services perspective, and its main conclusions are below.

1. The common feature of the five scenarios which see the UK leave the EU is the risk of damage to UK financial services through uncertainty, reduced market access and loss of influence

- Access to the EU's Internal Market in financial services for non EU-member states under the EEA Agreement is fractured and increasingly fraught. Membership of EEA-EFTA would not guarantee access to the EU's Internal Market in financial services.
- If the UK were to leave the EU for the EEA/EFTA, the UK would maintain access to the EU's Internal Market, but would lose all formal legal influence over EU legislation while still having to implement the bulk of it. There would be a material risk that the UK would have to implement EU rules that ignored or even damaged UK interests where otherwise the UK would have had a vote or possibly veto.

2. EU regulation is complex but the reality is that the UK wields very significant influence

- Within the EU, complex developments such as banking union could have an impact on how the Internal Market operates. It is crucial that the new structures work well together and do not undermine the integrity of the Internal Market.
- More often than not, the UK is successful in getting what it wants in relation to financial services. The City as it exists today functions as a market place of firms from across the EU and outside. Key aspects of EU financial services law are modelled on those of the UK, such as large parts of the Markets in Financial Instruments Directive (MiFID) and the Market Abuse Directive.
- This is made possible by the framework of Internal Market legislation. As a member of the EU, the UK, backed by its expertise in financial services, is in a position to sustain its influence on the framework provided it is seen as committed to it. To abandon this for some untried, unknown and unpredictable alternative would carry very significant risks.
- It is of paramount importance that the UK gains and keeps the means to increase regulatory convergence, preserve market access and promote the UK's interests in global fora.

3. The UK needs to continue to make the case for reform of the EU. Harmonisation will not always be the best answer

- The Internal Market in financial services represents a tremendous achievement, especially in the context of passporting and the ability for firms to easily access a market of 28 member states and over 500 million consumers. There is more to be done for the Internal Market in financial services to ensure that it is effective for euro area and non-euro area countries alike.
- A blend of mutual recognition and harmonisation has been able to cater for difficult and sometimes contentious policy areas such as financial services, where products can be complex and the need for consumer and investor protection is high but the EU must bear in mind that harmonisation will not always the best answer.

- Attempts by member states to carve out large exemptions from the existing treaties would come with a high risk of failure and open up the possibility of other member states seeking exemptions for their own perceived national commercial champions, leading to fragmentation of the Internal Market.

4. Whatever happens, the UK needs to find an accommodation with the euro area. EU membership offers the best position from which to do that

- Banking union will pose a particular challenge to policy makers in the UK and EU as they seek to accommodate two global currencies and overlapping prudential, competition, resolution and central bank regimes. The UK has supported the creation of a banking union while insisting that the UK not be financially liable for the resolution of any euro area financial institutions.
- The tension between the supervisory aspect of EU level regulation and the standard setting and regulatory convergence aspect of creating a coherent Internal Market in financial services within the EU is of paramount concern and one where the UK should play an active role in ensuring the integrity of the Internal Market.
- The UK has secured protections such that any new measures among the 18 member states of the euro area should not undermine the integrity of the Internal Market of the 28, in particular by having secured a requirement for European Banking Authority decisions to be made by a double majority of both euro area member states and non-euro area member states.
- It is difficult to see how the UK would have been able to secure these safeguards from outside the EU. Importantly, as a member of the EU, the UK can also seek redress in the European Court of Justice if it considers undertakings in respect of banking union are not being met or that the Internal Market is being undermined.

5. Both European and global interests of the UK's financial and professional services sectors are best served by remaining a member of the EU

- EU membership provides the UK with maximum influence in setting the rules of the European Internal Market, which is the UK's home market, and on crucial aspects of financial services policy.
- Current UK membership of the EU not only gives the UK access to the most powerful tools to promote its interests, including voting and veto rights, but it is also significantly tailored to meet UK-specific objectives with opt-outs from the euro, the Schengen free-movement area and various justice and home affairs measures.
- Since 1999 and after the global financial crisis, there has also been an increased drive to coordinate financial services regulation and strategic decisions at a global level.
- The increasing use of international fora such as the WTO and the Basel Committee on Banking Supervision for strategic decision-making provides challenges and opportunities for the UK. Currently, the UK enjoys double representation through EU membership in addition to being involved in its own right.
- Outside the EU, there is the long-term prospect of the relative waning of the influence of advanced economies, as developing economies become increasingly assertive in global fora. Without allies and the collective strength that comes from coordinated regional economic interests, the UK could find itself in a difficult and isolated position.

INTRODUCTION

British membership of the EU is controversial. An Observer/Opinium poll found that 26 per cent of UK voters regarded the EU as a "good thing" compared with 42 per cent who said it was a "bad thing".[1] However, in contrast, in a poll carried out by Ipsos MORI for TheCityUK, 84 per cent of city business leaders polled said that the UK should stay in the EU, and 5 per cent that the UK should leave.[2]

The EU was created to ensure peace and prosperity in Europe, after the devastating conflicts of the first half of the 20th century. The EU has grown over time from six in 1958 to 28 today, with others hoping to join. For many states, becoming a member was a crucial milestone on the path to democracy. It now consists of a market of over 500 million people and in 2011 accounted for approximately £11 trillion in GDP. This makes the EU the largest borderless market in the world, bigger than the USA and bigger than China. In an increasingly interconnected world, it should be borne in mind how important it is to be part of the world's largest trading bloc.

The UK has been a member of the EU since 1973, and has ever since played a key role in the development of the Internal Market. It was a British member of the European Commission[3], Lord Cockfield, who masterminded the achievement of the EU Internal Market in the late 1980s. The UK has been the strongest promoter of integration in the goods, services and capital markets. In particular, the UK financial services sector has played a central role in shaping EU-wide norms concerning financial services regulation. For example, large parts of the Markets in Financial Instruments Directive (MiFID) are modelled on the corresponding UK legislation.

All EU members, including the UK, face the question of whether the benefits that come with membership are worth giving up individual rights of action in particular areas. Put another way, does EU membership provide benefits such that they are worth the risk of sometimes being outvoted in areas where previously one would have had the right to act independently? Also, would the UK outside the EU find that it becomes much more lightly regulated? The opposite is worth considering: that the UK may have to comply not just with existing EU regulations for its exporters to the EU but a UK-only layer of regulations in addition to that.

With the possibility of a referendum on UK membership of the EU in the coming years, it is important to understand the nature of the UK's current status, and the alternatives. The EU is founded on treaties and therefore legally based – hence the importance of legal analysis.

There is an open and broader question of whether the EU, or indeed the euro area, in its current form is politically or economically sustainable, which this paper does not focus on. It is worth noting, however, that the EU and particularly the euro area have come under extreme systemic pressure since late 2009, and both have managed to survive. It is difficult to imagine a more challenging "stress test" for the euro and the EU. Given the political will behind the EU and the euro, it is reasonable to conclude that, barring extreme and unforeseen developments, both institutions will continue to adapt, albeit fitfully, to evolving market conditions.

Part one of this paper considers eight possible options for the UK regarding the EU based on existing scenarios, or developments flowing from them that are foreseeable in the medium term. It examines three scenarios in which the UK remains a member of the EU and five in which it does not. While there are merits in discussing the wide range of potential impacts these scenarios would present, this paper is primarily focused on the role of the financial services and the professional services industries in the UK. The reality of the UK's relationship with the EU over the coming decades may borrow parts from a number of these scenarios and it is possible any future scenario may take a different, as yet unknown, character.

Part two of this paper sketches out a brief history of the Internal Market and the UK's role in its development. It examines the progress to date in the development of the Internal Market in financial services and discusses existing legal and practical barriers within it. It goes on to examine the impact of the financial crisis and look at the benefits of the market for the EU and the UK before setting out areas for further reform.

Part three of this paper examines how the regulation and supervisory relationship in financial services functions between the UK and the EU. The system of financial services regulation in Europe is a myriad of overlapping and complementing regulatory structures and various external influences. This part also examines the challenges faced by non-EU European countries such as Norway, Switzerland and other third countries when seeking to gain access to the EU's Internal Market in financial services. It concludes with an examination of the importance of the G20 and Basel financial accords.

It would be impossible to make an informed decision on the UK's membership of the EU without consideration of these facts.

Malcolm Sweeting
Senior Partner
Clifford Chance LLP

[1] The Guardian, 'Shock four-country poll reveals widening gulf between Britain and EU', 1 December 2013, accessed on 10 April 2014 at: http://www.theguardian.com/world/2013/nov/30/shock-poll-reveals-gulf-britain-eu-france-germany-poland-hostile

[2] Ipsos MORI / The City UK polling, ' Access to Single European Market key to UK competitiveness ', 30 October 2013, accessed on 11 April 2014 at: http://www.ipsos-mori.com/researchpublications/researcharchive/3287/Access-to-Single-European-Market-key-to-UK-competitiveness-says-business-leaders.aspx

[3] The European Commission is an institution of the European Union. It represents and upholds the interests of the EU as a whole. It drafts proposals for new EU legislation and manages the day-to-day business of implementing EU policies.

PART 1

SCENARIOS AND CONSEQUENCES

OVERVIEW OF SCENARIOS

The eight scenarios examined in this section comprise three in which the UK remains a member of the EU and five in which it does not. The reality of the UK's relationship with the EU over the coming decades may borrow parts from a number of these scenarios and it is possible any future scenario may take a different, as yet unknown, character.

Three scenarios where the UK remains in the EU

I. Reform within the existing treaties. This scenario imagines a UK which does not seek to radically alter the balance of competencies between itself and the EU under the threat of departure.

II. EU-minus. A renegotiated version of the UK's current membership, where the UK secures opt-outs from certain areas while retaining its current rights and obligations in others and/or instigates institutional reforms to repatriate competences to all member states.

III. EU-plus. This scenario examines the possibility of the UK becoming more involved in the EU by giving up its current opt-outs.

Five scenarios where the UK leaves the EU

IV. EEA + EFTA membership. The UK would leave the EU and could emulate Norway in becoming a member of the European Economic Area and the European Free Trade Association.

V. Bilateral agreements + EFTA. The UK would leave the EU and could emulate Switzerland in agreeing sector-by-sector treaties with the EU, and Free Trade Agreements with the EFTA countries.

VI. Customs Union. The UK would leave the EU and could emulate Turkey and enter into a Customs Union with the EU.

VII. UK/EU FTA. The UK would be outside the EU but could seek to negotiate a comprehensive Free Trade Agreement with the EU.

VIII. The WTO option. The UK would leave the EU and rely on its membership of the World Trade Organisation as a basis for trade with the EU.

In each scenario we describe the factual basis, set out the rights and obligations associated with it and provide an analysis of the challenges which it presents.

Alternative EU scenarios

Yes | No | Partial

	Access to the EU Internal Market	Freedom to set own external trade policy	European Council Commission Parliament[1]	Court of Justice of the European Union[2]	Social And employment policy	Common Agricultural Policy	Contribute to the EU budget	Justice and Home affairs	Schengen area	Charter of Fundamental Rights	Free to regulate own Financial Sector	Membership of the euro
1 Reform within existing treaties	Yes	Partial	Yes	Yes	Yes	Yes	Yes	Partial [6]	No	Partial [8]	No	No
2 EU Minus	Yes	Partial	Yes	Yes	No	Yes	Yes	Partial [7]	No	Partial [9]	No	No
3 EU Plus	Yes	Partial	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes
4 EEA + EFTA	Partial [3]	Yes	No	No	No	No	Yes	No	No	No	Yes	No
5 Bilateral agreements + EFTA	Partial [4]	Yes	No	No	No	No	No	No	No	No	Yes	No
6 Customs Union	Partial [5]	Partial	No	No	No	No	No	No	No	No	Yes	No
7 UK/EU FTA	No	Yes	No	No	No	No	No	No	No	No	Yes	No
8 WTO	No	Yes	No	No	No	No	No	No	No	No	Yes	No

[1] Membership of and voting rights on the European Council, Council of the European Union, the Commission and Parliament.
[2] Nomination of a judge to both the Court of Justice of the European Union and the General Court of the European Union.
[3] The EEA agreement provides for access to the EU's Internal Market although at present it does not offer full access to the Internal Market in financial services.
[4] See Analysis of Bilateral Agreements and EFTA at page 22.
[5] Access to the EU Internal Market for goods without the need for Rules of Origin.
[6] The UK has the right to opt in / out of certain measures.
[7] The UK would have a right to opt in / out as it saw fit.
[8] The UK has a protocol that clarifies that the CFR does not create rights in UK courts.
[9] The UK would retain a protocol that clarifies that the CFR does not create rights in UK courts.

I. REFORM WITHIN THE EXISTING TREATIES

Summary

The UK is one of the 28 members of the EU, having joined on 1 January 1973. Since then, the EU has evolved with the UK as an important member. It is worth noting that the terms of the UK's current membership of the EU are significantly tailored to meet UK needs as expressed by various governments since joining (as described by the points below labeled 'opt out/right to join'.) This scenario considers a situation where the UK does not seek to radically alter the balance of competencies between itself and the EU under the threat of departure.

Rights

- Access to the EU Internal Market.
- Membership of the EU Customs Union.
- Representation in the Council of the EU.
- Elected members of the European Parliament.
- Nomination of a commissioner to the European Commission.
- Nomination of a judge to both the Court of Justice of the European Union and the General Court of the European Union.
- Receive funding from EU policies and funding programmes paid for by the Union's own resources.
- OPT OUT/RIGHT TO JOIN the Schengen free-movement area. This provides for passport-free travel between its members as well as participation in the Schengen Information System – a multinational database designed to share criminal and migration information on persons of interest. Iceland, Norway, Liechtenstein and Switzerland, all non-EU member states, are also members of the Schengen area.
- OPT OUT/RIGHT TO JOIN the Single Currency. New members are obliged to join when their economies are ready, but there is no such obligation on the UK, which has a perpetual opt-out from the European Single Currency. The UK retains the right to join the euro if it wishes to do so in the future.
- OPT OUT/RIGHT TO OPT IN to various Justice and Home Affairs measures.
- A special protocol clarifies that the EU Charter of Fundamental Rights does not create rights enforceable in UK courts.

Obligations

- To abide by the provisions of EU law, especially in the areas of the Internal Market and the EU Customs Union / Common Commercial Policy. In relation to the Internal Market, this means that it is illegal for member states to provide state-aid to business undertakings except as permitted under EU rules and impose tariff or non-tariff barriers on goods coming from outside their national border.
- Customs Union and the Common Commercial Policy are two of the EU's five exclusive competencies[4]. The Customs Union abolishes customs controls and the EU imposes a common external tariff on goods coming in from third countries. As such the EU negotiates trade deals as a single entity by virtue of the Common Commercial Policy. The Commission is responsible for negotiating trade agreements, however, it is important to note that the Council of the EU's Trade Committee gives the Commission its mandate to open negotiations and thereafter gives the Commission negotiating directives. The Council and Parliament approve trade agreements by qualified majority. In the area of services, the Council acts by unanimity, giving every member a veto.
- To abide by the rulings of the Court of Justice of the European Union and the General Court of the European Union based in Luxembourg. These courts are often confused with the European Court of Human Rights based in Strasbourg. That court is a body of the Council of Europe, a separate organization from the EU.
- To contribute to the EU budget. The UK is currently a net-contributor.

Analysis

Both the rights and obligations of EU membership are considerable. The UK has full access to the Internal

[4] These are: (i) the customs union; (ii) competition law for the Internal Market; (iii) monetary policy for the euro; (iv) the common fisheries policy; and (v) the common commercial policy. This includes the conclusions of international agreements to enable the Union to implement these exclusive competences.

Market, and has an equal part in making the rules, which, like all the other members of the EU, it then has to follow. It is also worth noting that obligations can also be rights and vice versa. The obligation to abide by EU law for example comes with the right to rely on it.

The corollary of this is that EU members give up the right of independent action and policy making in those areas which are exclusive EU competences, and those areas in which there is shared competence[5] subject to the applicable legislative procedure.

The EU is based on two treaties (the treaties) between its members. The Treaty on the Functioning of the European Union (TFEU) is the founding instrument of the EU, and is often referred to as the Treaty of Rome after the city where it was signed in 1957. The second treaty, the Treaty on European Union (TEU), was signed in Maastricht in 1992. They have been amended numerous times since 1957, most recently in Lisbon in 2007. Any change to the treaties which envisages an extension of the EU's competencies must be agreed by all the EU's members.

Article 5 TEU provides that:

> *"(1)The limits of Union competence are governed by the principle of conferral. The use of Union competences is governed by the principles of subsidiarity and proportionality.*
>
> *(2)Under the principle of conferral, the Union shall act within the limits of the powers conferred upon it by the member states in the Treaties to attain the objectives therein."*

Under this principle of conferral, the EU can only do what comes within its competence and in order to attain the objectives of the treaties. While so acting, the EU must act within the limits of its powers and respect the principles of subsidiarity and proportionality. Subsidiarity means that the EU should only undertake actions which cannot be better tackled at national level, but subsidiarity questions are highly political and a challenge on this basis has never succeeded. Proportionality means that the content and form of EU action must not exceed what is necessary to achieve the objectives of the Treaties. Legal challenges on this basis have, on occasion, succeeded.

The UK has negotiated opt-outs from various policy areas such as the euro, which it currently does not wish to join. This does affect the UK's position in the EU as the euro area member states integrate further. For example, measures undertaken in respect of banking union will include all banks in the euro area; countries outside the euro area can opt to subject their national banking regulators to decisions of the European Central Bank under "close cooperation" arrangements. The UK has declared that it will not participate in the Single Supervisory Mechanism[6] nor any Single Resolution Mechanism[7]. These initiatives demonstrate how groupings are developing in the EU without the UK taking any action itself. It also demonstrates how the EU institutions and legal bases for action are being used by a subset of the EU which the UK is not a part of although this precedent was largely set with the creation of the ECB in 1998[8]. These groupings could become more effective given that the Lisbon Treaty introduces a new voting system for calculating Qualified Majority Voting (QMV), known as Double Majority Voting (DMV) from 2014. DMV is designed to make agreement to EU legislation more representative of member state populations. The UK's share of votes in the Council of the EU will increase under DMV and indeed will be one of the largest in the EU; however, the euro area will have sufficient votes to have a qualified majority if acting in unison. The new system becomes operational from 1 November 2014. This solution may not be in place long however as the DMV mechanism will be reviewed once the number of non-euro area member states falls to four and it is also politically subject to change as the mechanism is subject to QMV in the ordinary legislative procedure.

[5] These are: (i) the Internal Market; (ii) social policy; (iii) economic, social and territorial cohesion (also known as the "Regional Policy" or "Structural Funds"; (iv) agricultural and fisheries (excluding the conservation of marine biological resources); (v) the environment; (vi) consumer protection; (vii) transport; (viii) trans-European networks; (ix) energy; (x) freedom, security and justice; and (xi) common safety concerns in public health matters related to areas of EU competence in the Treaties. The Treaties also provide for complementing action on research, technical development, space, development cooperation and humanitarian aid where the EU can exercise competence but not to the exclusion of member state activity in the area.

[6] Using powers set out in TFEU, article 127(6), the Single Supervisory Mechanism creates a new system of financial supervision whereby the ECB will directly supervise significant credit institutions.

[7] The Single Resolution Mechanism is intended to break the link between banks and sovereigns and provide for a single mechanism to resolve failing banks without falling back on member states.

[8] The legal basis for the single monetary policy is the Treaty establishing the European Community and the Statute of the European System of Central Banks of the European Central Bank. The Statute established both the ECB and the European System of Central Banks ("ESCB") on 1 June 1998.

The UK would, on past performance, continue to pursue its objectives of market-oriented reform of the Internal Market, greater external trade, protection of the integrity of the Internal Market as the euro develops institutions within the EU and more effective regulation. The tension between the UK and the euro area within the institutional structures of the EU would be the most significant area of challenge. Regardless of what the UK does it will have to find an accommodation with euro area member states.

The UK has secured protections in legislation such that any new measures among the 18 member states of the euro area should not undermine the integrity of the Internal Market of the 28. In the context of banking union, the ECB must take into account the principles of equality and non-discrimination, that the ECB should not, directly or indirectly, discriminate against any member state or group of member states and that there ought to be equal treatment between the member states of the euro area and those outside the area. In addition, the UK has secured a requirement for European Banking Authority (EBA) decisions to be made by a double majority of both euro area member states and non-euro area member states.[9] This was agreed, and can be changed, by QMV. As discussed, the euro area will have a built-in qualified majority from November 2014 which gives rise to the risk of caucusing, but the diversity of its members' interests and economic backgrounds may provide mitigation in that regard, given the inherent difficulty in finding unanimous agreement amongst such a group.

As a member of the EU, the UK can seek redress in the Court of Justice of the EU if it considers undertakings in respect of banking union are not being met or that Internal Market rules are being prejudiced by other areas of EU action. Subsidiarity, proportionality and the integrity of the Internal Market are treaty principles which the CJEU and the European Commission are bound to uphold, but on which they will form their own views in the specific circumstances. On this basis, the UK has embarked on a series of legal challenges in the financial services sector. On 22 January 2014 the CJEU dismissed the UK's challenge[10] to the powers conferred on the European Securities and Markets Authority (ESMA) in the short selling regulation.[11] The UK has other cases outstanding in relation to the extraterritorial impact of the proposed Financial Transaction Tax, the remuneration provisions contained in the Capital Requirements Directive IV (CRD4), and the ECB's location policy for clearing houses dealing with large euro-based transactions. In some cases the UK argued that the legislation adopted would have a particular adverse effect on financial services in the UK or are explicitly discriminatory.

Prior to the strategy of seeking to enforce its treaty rights in the Courts, the UK attempted to achieve many of its objectives by wielding its veto in December 2011, when it blocked the proposed EU "fiscal compact" being adopted under the EU legislative framework. However, the euro area member states and others came to an intergovernmental agreement outside the EU treaties which achieved the UK's aim of staying outside any "fiscal compact" but did not secure any of the other objectives it sought. On the other hand, working with other member states in the Council of the EU has led to commitments aimed at protecting the Internal Market and the rights of non-euro area member states whereas vetoing euro area integration in the European Council led to the UK being ignored. The former strategy has so far been more effective in achieving UK objectives in relation to the financial services and professional services industry.

Rationalising the European Commission

Currently there are 28 commissioners. This is not dictated by a consideration of how the functions of the Commission should best be delineated but rather by however many members of the EU there are. This has resulted in thematically related policy areas being spread across the portfolios of different commissioners. A more efficient system would be to appoint a number of commissioners as vice presidents of the commission to coordinate the work of other commissioners more

[9] European Commission Press Release, 'An important step towards a real banking union in Europe: Statement by Commissioner Michel Barnier following the trilogue agreement on the creation of the Single Supervisory Mechanism for the eurozone', MEMO/13/251, 19 March 2013.

[10] Case C-270-12, United Kingdom v European Parliament & Council of the EU [2014]; not yet reported.

[11] Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps.

coherently. A Vice President for the Single Market may for example coordinate the work of the existing Internal Market and Services commissioner, the Research, Innovation and Science commissioner and the Digital Agenda commissioner. This would not require treaty change and would streamline the work of the Commission.

Increasing influence of UK policymakers and civil servants

In addition to any safeguards in the treaties, the role of the European Commission as guardian of the Internal Market is an important one. Maintaining a powerful commission as a guardian of the interests of the EU of 28 members helps to ensure that the euro area is not able to override Internal Market objectives. If the Commission is to continue to be an effective guardian of the integrity of the Internal Market, it is necessary to staff it with high calibre civil servants and technical experts. This has been an area where the UK has failed in recent years with a decrease in the number of UK nationals on the staff of the European Commission by 24 per cent in the seven years to 2012, and by 16 per cent in the two years to 2012.[12] Currently, UK nationals represent 4.6 per cent of Commission staff compared to an overall population of 12.5 per cent of the EU.[13]

The situation is set to deteriorate further as the largest cohort of UK nationals in the European Commission is in relatively senior positions and UK nationals represent only 2.2 per cent of entry level administrators.[14] The re-introduction of the UK Civil Service European Faststream programme for graduates in 2010 might be helpful in this regard; however, since its re-introduction, no graduates in the programme have been successful in gaining a position at the European Commission.[15]

In addition to permanent Commission staff, the flow of seconded national experts from various civil service departments in the UK to the European institutions remains limited and, according to David Lidington, the Minister for Europe, the UK currently lacks a strategic approach to the use of secondments of UK civil servants to the EU institutions.[16]

In order to increase the ability for the European Commission to further strengthen the Internal Market and respect the positions of both euro-ins and euro-outs it is essential that the UK increase its influence within the EU institutions; as former UK diplomat Sir Colin Budd explains, "all EU member states rely significantly on the nationals they have in the EU institutions as part of their collective networking strength".[17]

At the moment, the UK is lacking in this collective networking strength and the situation is likely to get worse before it gets better, but is a clear area where the UK government could work harder and take a more comprehensive approach to ensure that the legal and procedural safeguards for non-euro area member states and the independence of the European Commission are respected.

> “THE UK HAS SECURED PROTECTIONS IN LEGISLATION SUCH THAT ANY NEW MEASURES AMONG THE 18 MEMBER STATES OF THE EURO SHOULD NOT UNDERMINE THE INTEGRITY OF THE INTERNAL MARKET OF THE 28.

[12] House of Commons Foreign Affairs Select Committee, 'The UK staff presence in the EU institutions', 25 June 2013.
[13] Ibid.
[14] Ibid.
[15] Ibid.
[16] Ibid.
[17] House of Commons Foreign Affairs Committee, First Report of Session 2013-14, 'The future of the European Union: UK Government policy', 11 June 2013, HC 87-II, Ev 62.

II. EU-MINUS: LESS INTEGRATION THROUGH TREATY CHANGE

Summary

The UK could retain its membership of the EU while seeking to negotiate further opt-outs from the EU in areas in which it did not wish to participate and/or instigate institutional reforms to repatriate competences to all member states.

The following points are examples of ideas that are being discussed in relation to any attempt to renegotiate the UK's membership of the EU:

- An "emergency brake" for any member state regarding future EU legislation that affects financial services.
- Upgrade the "yellow card" procedure to a "red card".
- Remove the EU's competency in the area of social and employment law, or allow individual member states to opt out from EU law in relation to social and employment law.
- A treaty safeguard for the Internal Market to ensure that there is no discrimination against non-euro area member states' interests.
- Remove the EU's competency in the area of policing and criminal justice measures, or allow individual member states to opt out from EU law in relation to them, superseding the UK's block opt-out in the Lisbon Treaty.
- Abolish the Strasbourg seat of the European Parliament, the Economic and Social Committee, and the Committee of the Regions.
- Establish new controls on the free movement of people either by extending transition periods for new members that join the EU, or by further tightening immigration rules and rules on access to benefits.
- Remove the principle of "ever closer union" from the EU treaties.

An outcome along the lines of the first seven points would change the EU institutional framework and alter the decision-making process. The removal of a reference to achieving "ever closer union" from the treaties would be of more political than legal significance.

Rights

- Access to the EU Internal Market.
- Membership of the EU Customs Union.
- Representation in the Council of the EU.
- Elected members of the European Parliament.
- Nomination of a commissioner to the European Commission.
- Receive funding from EU policies and funding programmes paid for by the Union's own resources.
- Nomination of a judge to both the Court of Justice of the European Union and the General Court of the European Union.
- OPT OUT/RIGHT TO JOIN the Schengen free-movement area. This provides for passport-free travel between its members as well as participation in the Schengen Information System – a multinational database designed to share criminal and migration information on persons of interest. Iceland, Norway, Liechtenstein and Switzerland, all non-EU member states, are also members of the Schengen area.
- OPT OUT/RIGHT TO JOIN the Single Currency. New members are obliged to join when their economies are ready, but there is no such obligation on the UK, which has a perpetual opt-out from the European Single Currency. The UK retains the right to join the euro if it wishes to do so in the future.
- OPT OUT/RIGHT TO OPT IN to various Justice and Home Affairs measures.
- A special protocol clarifies that the EU Charter of Fundamental Rights does not create rights enforceable in UK courts.

Obligations

- To abide by the provisions of EU law, especially in the areas of the Internal Market and the EU Customs Union. In relation to the former, this means that member states cannot provide state-aid to business except as permitted under EU rules, impose tariff or non-tariff barriers on goods coming from outside their national border and, in relation to the Customs Union, accept that under the Common Commercial Policy the European Commission acts as negotiator of all trade and investment agreements on behalf of the EU as a whole.

- To abide by the rulings of the Court of Justice of the European Union and the general Court of the European Union.
- To contribute to the EU budget. The UK is currently a net-contributor.

Analysis

Emergency brake for financial services

The freedom for any member state to use an emergency brake on legislation on financial services (or any other topic) would effectively amount to a veto by any member state in any particular field to the development of the Internal Market.

Such a provision could be used by the UK to protect the UK financial services industry against poorly conceived financial regulation emanating from the EU. It could also, however, be used by other member states in the area of financial services. If new barriers were to arise in the area of financial services this could result in the UK being unable to address them. The alternative would be to seek the UK's position by exerting its influence within the existing legislative framework. The UK has a strong record over the past 40 years in doing this.

Upgrade the "yellow card" procedure to a "red card"

The current "yellow card" procedure was created by the Lisbon Treaty in the Protocol on the Application of the Principles of Subsidiarity and Proportionality. Yellow and orange card procedures are set out in Article 7(2) and (3). If a third or more of national parliaments consider that a Commission proposal breaches subsidiarity, they may produce a "reasoned opinion" and ask that it be withdrawn. This must be done within eight weeks. The Commission then has to withdraw the proposal or say why it will proceed despite the objections. The Commission to be appointed in 2014 could agree – via an inter-institutional agreement – to consider any use of the yellow card to be a red card and withdraw the proposal. A treaty change – to the protocol – could also change the threshold to a half of national parliaments or more. This is the sort of change that is aligned with current trends in, for example, the German and Dutch governments to increase the powers of national parliaments.

Repatriation of social and employment law

The discussion of whether social and employment law could revert to being an exclusive competence of member states can sit uncomfortably with the desire to protect the integrity of the Internal Market. Since the Single European Act, social and employment concerns, including those related to the health and safety of workers, have been included as aspects of Internal Market legislative competence.

The Working Time Directive is a key example of this, although there are other, less contentious aspects of what could be considered social and employment law which are also relevant in order to facilitate free movement within the Internal Market. Rules to ensure, for example, that a citizen of one member-state who lives and works in another does not have to pay social security contributions in both countries and that he/she gets access to social benefits and pensions in the country where he/she works and pays taxes (rules currently said to benefit about a million British citizens working in other EU member states).[18]

Employment and social law remain largely an area of member state competence and most employment-related legislation that affects the UK financial services industry originates from the UK Parliament. Those areas which are governed by Titles IX and X of the TFEU are:

- Title IX – Employment, which provides the EU with a competence to assist the coordination of policies for member states in the Union to raise the level of employment. Under the Treaties, this is purely a coordinating and supportive role to member state action and prohibits EU measures to harmonise the laws of member states in this field. In terms of EU competence, there does not appear to be any aspect

[18] Katinka Barysch, 'The working time directive: What's the fuss about?', Centre for European Reform, April 2013, p 2.

of Title IX of the TFEU which acts to inhibit or preclude member states from taking action in the field of employment policy nor anything which harmonises employment practices.

- Title X – Social Policy, which provides the EU with a competence to support and complement measures taken by member states in the following areas:
  - Social security and social protection.
  - Protection of workers where their employment is terminated.
  - Representation and defence of the interests of workers and employers.
  - Conditions of employment of third-country nationals legally residing in the EU.

  Such measures require unanimity for adoption in the Council of the EU, i.e. the UK already has a veto over the introduction of any EU measures taken on that basis. Unanimity is important as employment law and employment protection practices vary significantly between the member states. For example, trade union membership and its role in cross-sectoral collective bargaining agreements vary significantly with Finland and Sweden having high levels of union membership (74 per cent and 70 per cent respectively)[19] and unions taking part in boards of many companies; on the other hand, countries like France have very low rates of trade union membership (8 per cent)[20]. While there could be scope for the UK to repatriate this shared competence from the EU in this area, it is not clear what purpose this would serve, as the very little legislation actually emanating from the EU already has the UK government's positive assent and would therefore, presumably, be replicated independently at the UK level if those competences were made exclusive to member states. It is also worth bearing in mind that these measures are the result of political compromises between states with different approaches to health and safety legislation.

Agreeing minimum standards at the EU level prevents the market from becoming distorted by states seeking to gain a competitive advantage by implementing minimal welfare standards. The advantages of opting out of these measures or repatriating competence should be weighed against the risk of other EU members seeking to compete with the UK on the basis of less onerous standards.

In addition to the social policies listed above, the following legislation falls under Title X as well, but is adopted by QMV and not unanimity:

- Health and safety at work.
- Working conditions.
- Information and consultation of workers.
- Integration of workers excluded from the labour market.
- Equality of men and women in the labour market and work place.

It tends to be the case that most EU legislation to secure these objectives is adopted in the Internal Market framework, not as a matter of EU social policy independently.

In terms of any renegotiation, it is unlikely that other EU member states would agree to the wholesale repatriation of social and employment law. The EU is a complicated web of trade-offs whereby almost every member state has had to make concessions in some areas to achieve its objectives in others. France, for example, during the negotiation of the Internal Market programme in the 1980s and early 1990s, only agreed to open its borders to free circulation within the EU of sensitive imports restricted under "trade policy instruments" in exchange for social protections to prevent social dumping. From the UK point of view such linkages may be questionable, but such trade-offs are an element of European policy-making for all member states. The UK considered the prize of truly open borders worth the cost of minimum EU social protections.

The risk is that any attempt to unpick the current treaties would lead to every member state reintroducing settled matters. For example, some member states may seek to relax state-aid rules, others may seek to roll

[19] European Trade Union Institute webpage 'Trade Unions', accessed on 10 April 2014 at: http://www.worker-participation.eu/National-Industrial-Relations/Across-Europe/Trade-Unions2.
[20] Ibid.

back measures of mutual recognition of professional qualifications or, most worryingly, some may seek to impose prudential overrides on issues such as capital adequacy or try to pick apart the financial services passport. In order to prevent the risk of unwinding decades of compromise, other EU member states would probably be unwilling to go down that route.

This is not to say that any attempts to reform the EU are unlikely to succeed, but attempts by member states to carve out large exemptions from the existing treaties would come with a high risk of failure and open up the possibility of other member states seeking exemptions for their own perceived national commercial champions, leading to fragmentation of the Internal Market.

Treaty safeguards for the Internal Market for non-euro area member states

This is a key issue in the area of financial services. The UK government has been successful in promoting the interests of non-euro area member states with, for example, the requirement for EBA decisions to be made by a double majority of both euro area member states and non-euro area member states. This type of principle being enshrined in a Protocol to the Treaties would be beneficial to non-euro area member states and such an arrangement should be achievable by the UK government, in particular as its EU partners already seem to have accepted that such a principle is valid and necessary.

Remove the principle of "ever closer union" from the EU Treaties

This is a totemic provision from the original Treaty of Rome currently enshrined in Article 1 TEU.[21] A previous attempt to remove it during the negotiations on the Lisbon Treaty failed. In any event this provision has greater political than legal significance, given its general nature. This change would come with a very high price and would therefore risk making it more difficult to achieve UK negotiating objectives in other, more specific areas.

> " THE EU IS A COMPLICATED WEB OF TRADE-OFFS WHEREBY ALMOST EVERY MEMBER STATE HAS HAD TO MAKE CONCESSIONS IN SOME AREAS TO ACHIEVE ITS OBJECTIVES IN OTHERS.

[21] The provision reads: "This Treaty marks a new state in the process of creating an ever closer union among the peoples of Europe, in which decisions are taken as openly as possible and as closely to the citizen".

III. EU-PLUS: FURTHER INTEGRATION

Summary

The UK could, if it wished, join the various policy areas from which it has opted out.

Rights

- Access to the EU Internal Market.
- Membership of the EU Customs Union.
- Representation in the Council of the EU.
- Representation in the European Parliament.
- Representation in the European Commission.
- Representation on the Court of Justice of the European Union.
- Participation in the Single Currency. New members are obliged to join when their economies are ready. The UK retains the right to join if it wishes to do so in the future.
- Participation in the Schengen free-movement area. This provides for passport-free travel between its members and participation in the Schengen Information System. Iceland, Norway, Liechtenstein and Switzerland, all non-EU members, are part of the Schengen area.
- Participation in all Justice and Home Affairs measures.
- Provision for full application of the Charter of Fundamental Rights.

Obligations

- To abide by the provisions of EU law, especially in the areas of the Internal Market and the EU Customs Union. In relation to the former, this means that member states cannot provide state-aid to business except as permitted under EU rules, impose tariff or non-tariff barriers on goods coming from outside their national border and in relation to the Customs Union, accept that under the Common Commercial Policy the European Commission acts as negotiator of all trade and investment agreements on behalf of the EU as a whole.
- To abide by the rulings of the Court of Justice of the European Union.
- To contribute to the EU budget. The UK is currently a net-contributor.
- To abide by the provisions of EU law pertaining to membership of the Single Currency.

Analysis

It should be said at the very outset that this is a highly unlikely scenario.

In particular, participation in the Single Currency would bring with it loss of control over monetary policy, full participation in banking union, including the Single Supervisory Mechanism, and considerable pooling of risk. There is no political appetite for this in the UK at the moment, and that is unlikely to change in the foreseeable future. Furthermore, it can be strongly argued that the UK has benefited from its currency independence over the course of the past ten years, and it is extremely difficult to assess the counterfactual of how the UK and the euro area would have fared had it been a member from 1999 with any degree of robustness.

Membership of the Schengen Agreement would involve the lowering of border controls with other Schengen signatories. Given the current strong lack of political appetite for joining the Schengen area in the UK, it is not a realistic possibility. The same is true of full participation in Justice and Home Affairs matters and provision for full application of the Charter of Fundamental Rights.

IV. EEA + EFTA MEMBERSHIP

Summary

The UK could leave the EU and pursue a similar relationship to that enjoyed by Norway (as well as Iceland and Liechtenstein) as a member of the European Economic Area and the European Free Trade Association subject to the EEA Agreement. A number of separate steps would probably be required.

First, the UK would have to invoke Article 50 of the TEU, whereby it would cease to be a member of the EU two years following formal notification:

Article 50

1. Any member state may decide to withdraw from the Union in accordance with its own constitutional requirements.

2. A member state which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. That agreement shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.

3. The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the member state concerned, unanimously decides to extend this period.

Second, the EU would have to amend its own treaties to reflect UK departure.

Third, the UK would have to negotiate with EEA and EFTA members in order to join those organisations. These negotiations would pose a number of complex questions. For example, the UK would no longer be subject to the jurisdiction of the CJEU, but it would still have to apply Internal Market rules, which in turn would need to be enforced. EFTA members that are also members of the EEA (i.e. all but Switzerland) have recourse to the EFTA court, which has a separate body of jurisprudence which the UK may have to incorporate.

The UK would have to negotiate first with EFTA because it is not possible to be a member of the EEA without being a member of either the EU or EFTA. All of the four current members of EFTA would have to agree to the UK becoming a member. This could be straightforward if the existing EFTA membership were amenable to maintaining existing opt-outs from particular pieces of EU law which the EFTA members have adopted, such as Schengen, but could be more complicated if the existing member states did not agree with the UK's current position.

Furthermore, the existing EEA members (which include all of the EU member states) would need to agree that the UK could become a party to the EEA Agreement as an EFTA member. This may be difficult since the EEA Agreement was conceived as a vehicle for existing non-EU countries to integrate more closely with the EU with a view towards potential membership and not for an existing member to divorce itself of aspects of the EU. As such, the arrangements for such a move from EU member to EEA/EFTA membership could be either relatively straightforward or potentially very complex. Ultimately such a decision would be at the discretion of the existing EFTA members and remaining EEA members, not the UK.

Fourth, the UK would need to re-establish its independent tariff and trade regime, setting its own external tariff (which could involve negotiations to compensate other WTO members for tariff changes that adversely affected them) and confirming the terms on which it would adhere to certain WTO Agreements. The corollary of setting an autonomous UK tariff would be that, failing any other arrangement, the UK and EU would impose Most Favoured Nation (MFN) tariffs on each other's goods. A House of Commons Library study has estimated that about 90 per cent of UK goods would be covered by such tariffs. It is in any member's discretion as to what their MFN tariffs are. If tariffs were increased above EU levels, there would be complex consequences (for instance, the current average MFN EU tariff for motor vehicles is around 10 per cent, which would directly impact UK automotive exports to the EU; if UK producers secured UK tariff increases against their global competitors (in the EU and outside) that would trigger calls for compensation under the WTO agreements, increase prices for UK consumers and – ultimately – reduce the volume of trade both ways, with likely wealth-diminishing effects). The likelihood of this happening may depend on, amongst other things, the level of pressure from domestic business interests.

What would a 'no' vote mean?

An overarching point that applies to all five scenarios that envisage the UK outside the EU relates to the process following a 'no' vote in any referendum. The UK Electoral Commission has recommended that any such question should adopt the following wording:

"Should the United Kingdom remain a member of the European Union?"[22]

A 'no' vote to such a question would be clear in relation to the UK's membership of the EU, but it would say nothing about what arrangement should replace it. It would be for the government of the day to attempt to negotiate whatever agreement it saw fit with the EU and then ratify it. It is not possible to say how long this would take, and what the outcome of such a negotiation would be. Article 50 envisages two years to come to an agreement, however it may take longer. There is an obvious disadvantage to giving notice under Article 50 before the outcome is known, and any country would want to agree terms as far in advance as that were possible. However Article 50 envisages a process of notification of an intent to depart and then negotiation, so that may not be possible. The risk of uncertainty in relation to how long the process would take and what the outcome would be in those circumstances is considerable.

Rights

- The EEA Agreement[23] provides for access to the EU's Internal Market – although at present it does not offer full access to the Internal Market in financial services.
- Freedom to set own external trade policy. The UK would not be a party to the EU's Customs Union and Common Commercial Policy and so would not have to apply the EU Common External Tariff – although the UK would be subject to the EU's Common External Tariff rules, in particular in relation to rules of origin (ROO) requirements.
- The EEA agreement gives EFTA experts the ability to participate in consultations on the preparatory work of the Commission.[24] This extends to being able to participate in committees on Delegated Acts (Article 100 EEA), Programme Committees (Article 81 EEA) and other committees in specific areas (Article 101 EEA), but not in the work of the European Supervisory Authorities (ESAs).[25]
- Freedom to set own agricultural policy by virtue of not participating in the EU Common Agricultural Policy.
- Freedom to set own fisheries policy by virtue of not participating in the EU Common Fisheries Policy.
- Freedom to establish own VAT regime.
- Other areas are excluded from the EEA Agreement, such as participation in the Schengen free-movement zone, Justice and Home Affairs cooperation and Defence (although EEA/EFTA states have negotiated participation in such arrangements individually).
- UK nationals, as citizens of an EEA member state, would benefit from the provision on free movement of persons and institutions.[26]

Obligations

- To abide by EU law in relation to the EU Internal Market.
- To abide by EU ROO. This is the corollary of not being a member of the EU's Customs Union and therefore not having to apply the common external tariff.
- To permit the free movement of persons from other EEA member states.
- To contribute to the EU budget.

Analysis

The EU Internal Market constitutes a very significant body of laws, which has a huge impact on the UK. By joining EFTA and the EEA, the UK would maintain access to the EU's Internal Market, but would lose all formal legal influence over legislation while still having to implement the bulk of it. A report commissioned by the Norwegian government concluded that Norway has had to implement about 75 per cent of EU law.[27] The UK would have to

[22] Electoral Commission, 'Referendum on the United Kingdom's membership of the European Union: Advice of the Electoral Commission on the referendum question included in the European Union (Referendum) Bill', October 2013.

[23] See EFTA website for full text of EEA agreement, accessed on 10 April 2014 at: http://www.efta.int/media/documents/legal-texts/eea/the-eea-agreement/Main%20Text%20of%20the%20Agreement/EEAagreement.pdf.

[24] Article 99(1) EEA: "As soon as new legislation is being drawn up by the EC Commission in a field which is governed by this Agreement, the EC Commission shall informally seek advice from experts of the EFTA States in the same way as it seeks advice from experts of the EC member states for the elaboration of its proposals".

[25] See EFTA webpage 'Influencing the EU – EEA Decision Shaping' for more details on how EEA and EFTA influences decision making, accessed on 10 April 2014 at: http://www.efta.int/eea/decision-shaping.

[26] House of Commons Library Research Paper, 'Leaving the EU', 1 July 2013.

[27] Report by the EEA Review Committee, 'Outside and Inside: Norway's agreements with the European Union', 7 January 2012, Official Norwegian Reports NOU 2012: 2, p 6.

continue to implement all rules that related to the Internal Market including rules related to employment, consumer and investor protection, environmental policy and competition law rules. The UK would lose all its voting rights in the Council of the EU (including, obviously, the right of veto over legislation requiring unanimity), it would lose its directly elected members of the European Parliament, its nominee to the European Commission and it would not participate in meetings of the European Council.

In principle, financial services are covered by the EEA Agreement, but developments since the global economic crisis of 2007 have meant that, in practice, the Internal Market for financial services between the EU and the EEA/EFTA members is fracturing. This is mainly due to the advent of the ESAs. The ESAs were put in place in 2010 to help oversee the financial services market and set universal standards on supervision. However, the ESAs also play a supervisory role themselves in relation to financial services. The EEA Agreement does not cater for this and, as a result, all measures taken in the field of financial services since 2010 which provide for any role played by the ESAs (which is nearly all of them) have not extended to the EEA/EFTA states. This has remained the case even after four years of negotiation to reconcile this problem.

Accordingly, if the UK were to go down the EEA/EFTA path, like Norway, there would be a risk that it might, over a period of time, lose access to the EU's Internal Market in financial services as EU legislation develops (in particular the revision of MiFID – which acts as the backbone for much of the Internal Market in financial services – will entail a role for the European Securities and Markets Authority). Even if this issue were to be resolved, the UK's exclusion from crafting EU financial services legislation would mean that the EU could make new regulations which the UK would then have to adhere to if it wished to maintain full access to the EU financial services market.

The UK would no longer be bound by EU measures in areas such as agriculture and fisheries, and would gain the freedom to establish its own VAT regime. The merits or otherwise of these aspects are outside the financial services arena and are not discussed in this paper.

The UK would be free to conclude its own trade agreements with third countries, as it would no longer be a part of the EU Customs Union and Common Commercial Policy. The potential benefit of the power of independent action in this area should be balanced against the risk of not being able to conclude as favourable terms due to the UK's relatively smaller market and therefore lesser bargaining power compared to the EU, and the fact that the UK would not be entitled as of right to retain the benefits of some 50 trade and association agreements it enjoyed as a member of the EU by virtue of the fact that those agreements were signed between third countries and the EU. The UK would also no longer be involved in the EU trade negotiations with the USA on a Transatlantic Trade and Investment Partnership (TTIP), Japan and others.

The UK would have to comply with EU Rules of Origin regulations that are more complex than the current Internal Market arrangements, which do not distinguish between products from different member states within the EU.

The UK would contribute less to the EU budget, but it is likely that it would continue to pay a substantial amount (for instance, because Norway pays towards a number of EU social programmes, the Norwegian per capita contribution is about €100 per year, compared to the current UK per capita contribution of €180 per year).[28]

It is these advantages and disadvantages that must be weighed against each other in assessing the merits of the Norwegian model against the UK's current membership. The right to craft and vote on Internal Market measures as well as veto employment law and social measures is a fundamental benefit of EU membership, as is influence over the increasing role played by the implementation and monitoring of such legislation. If the UK were to leave the EU for the EEA/EFTA, there is a material risk that it would have to implement EU rules that ignored or even damaged UK interests where otherwise the UK would have had a vote or possibly veto.

As this paper discusses in part two, financial services are a very significant part of the UK economy, and departure from the EU would entail considerable loss of influence over rules which UK financial services would have to follow if they wished to continue to provide services into the EU.

[28] CBI, 'Our Global Future: the business vision for a reformed EU', 2013, p 142.

V. BILATERAL AGREEMENTS + EFTA

Summary

The UK could leave the EU using Article 50 TEU as described in scenario IV and, instead of joining EEA/EFTA, it could apply just to join EFTA alone and seek to conclude a range of bilateral agreements with the EU in the same way that Switzerland has.

In 1972 Switzerland signed a Free Trade Agreement (FTA)[29] with the then European Community, followed by two large tranches of bilateral agreements in 1999 and 2004 respectively, referred to as 'Bilaterals I' and 'Bilaterals II', along with other agreements in areas such as insurance. There are currently over 120 bilateral agreements in force between Switzerland and the EU.

Unlike Iceland, Liechtenstein and Norway, Switzerland has decided not to automatically implement EU Internal Market legislation. It has decided to conclude agreements on a case-by-case basis. The enforcement of the agreements within Switzerland is also solely in Swiss hands as there is no agreed enforcement mechanism. This piecemeal approach to these arrangements causes tension. In 2010, the Council of the EU stated:

"Since Switzerland is not a member of the European Economic Area, it has chosen to take a sector-based approach to its agreements in view of a possible long-term rapprochement with the EU. In full respect of the Swiss sovereignty and choices, the Council has come to the conclusion that while the present system of bilateral agreements has worked well in the past, the challenge of the coming years will be to go beyond this complex system, which is creating legal uncertainty and has become unwieldy to manage and has clearly reached its limits. In order to create a sound basis for future relations, mutually acceptable solutions to a number of horizontal issues … will need to be found."[30]

This is therefore not an "off-the-peg" solution, but one that is very specific to Switzerland. It has developed by accretion, as extra layers of treaties have been added over a period of over 40 years. The EU does not consider the Swiss arrangement to be viable on a continuing basis. In 2010, the Council of the EU stated:

""...the approach taken by Switzerland to participate in EU policies and programmes through sectoral agreements in more and more areas in the absence of any horizontal institutional framework, has reached its limits and needs to be reconsidered. Any further development of the complex system of agreements would put at risk the homogeneity of the Internal Market and increase legal insecurity as well as make it more difficult to manage such an extensive and heterogeneous system of agreements. In the light of the high level of integration of Switzerland with the EU, any further extension of this system would in addition bear the risk of undermining the EU's relations with the EEA/EFTA partners."[31]

> "THIS IS NOT AN OFF-THE-PEG OPTION, AND MIGHT NOT EVEN BE AVAILABLE. THE SWISS MODEL IS ARGUABLY UNIQUE. FAR MORE IMPORTANTLY FOR THE UK, IT IS ALSO CONSIDERED BY BOTH THE CURRENT EU MEMBER STATES (INCLUDING THE UK) AND THE COMMISSION TO BE HIGHLY FLAWED.

Based on this, it is unlikely that the Swiss option would be open to the UK; and if it were, it is not a comprehensive solution and may take many years, if not decades, to achieve the same level of market access as Switzerland currently has.

Rights

- The UK would be free to conclude trade agreements with third countries either independently or jointly with the other four members of EFTA.
- The UK would not be bound to transpose EU Internal Market legislation automatically into UK law.
- The UK would not be bound by the provisions of, or be required to, contribute to the CAP, CFP and structural funds.

[29] A Free Trade Agreement is a type of international agreement which seeks to, often amongst other things, eliminate or reduce tariffs and import quotas.
[30] European Council, Conclusions on EU relations with EFTA countries, 3060th General Affairs Council meeting Brussels, 14 December 2012, para 6.
[31] European Council, Conclusions on EU relations with EFTA countries, 3213th Transport, Telecommunications and Energy Council meeting Brussels, 20 December 2012, para 31.

- The UK would only be bound by EU social legislation in so far as it chose to be under bilateral agreements.

Obligations

- UK exports to the EU would be subject to EU ROO.
- UK goods exports to the EU would have to comply with all relevant EU standards.
- Whilst not an obligation, Switzerland contributes to reduce the economic and social disparities in an enlarged EU.

Analysis

This is not an off-the-peg option, and might not even be available. The Swiss model is arguably unique. Far more importantly for the UK, it is also considered by both the current EU member states (including the UK) and the Commission to be highly flawed. One of the main reasons for this is the lack of a proper shared dispute resolution mechanism. There is also no institution to give a single interpretation of sectoral agreements. This creates considerable legal uncertainty.

The EU has been working with Switzerland to bring together the current disparate agreements into a single instrument. However, recent developments in Switzerland whereby voters have decided to reject certain free movement aspects of the bilateral relations with the EU have raised the prospect of the entire series of agreements being repudiated. The EU has not been willing to separate the four freedoms – the free movement of people, goods, services and capital; there is no indication that this is likely to change.

It is therefore unlikely that the EU would be willing for a country much larger than Switzerland to enter into what it already considers to be a flawed arrangement.

The EU-Switzerland arrangements do not provide for bilateral agreements to be automatically – or dynamically – updated with EU legislation. This gives the Swiss full autonomy, but it also means that if EU regulation in a particular area is revised with new provisions, then the Swiss must renegotiate those provisions. This could be to the detriment of businesses which may have to wait for the regulatory regimes to be re-synchronised, or incur costs by producing to separate standards or implementing separate procedures for products destined for the EU compared to the domestic market.

The UK would only be bound by EU social legislation only in so far as it chose to be under bilateral agreements. However, the EU could make access to its markets conditional on the UK agreeing to certain social and employment provisions to safeguard against "social dumping". The EU has not required this of Switzerland, but could prove more cautious before allowing full access to its market to the UK, which may introduce more liberal rules for its 30 million strong workforce than those currently applying across the EU.

The current set of bilateral agreements between the EU and Switzerland do not provide for Swiss access to the EU Internal Market in financial services (other than some access for branches and agencies of non-life insurance business). In particular, Swiss firms face licensing and other barriers in many member states (that do not apply to EU incorporated and authorized firms that benefit from one of the EU passport regimes) if they wish to conduct cross-border business from Switzerland with clients or counterparties situated in those states. A number of Swiss banks operate their EMEA investment banking business through subsidiaries set up in the UK which can take advantage of the UK's EU membership and the EU passport rights available to UK incorporated and authorized firms. While there are some recent EU initiatives to provide some access to the EU market to firms from non-EU jurisdictions which have equivalent legal regimes and which provide reciprocal access to EU firms, these depend on the ability of the non-EU regime to pass an equivalence assessment by the European Commission (which may require the non-EU jurisdiction to conform all or part of its legislation to EU standards) and in event are limited in scope and may not be available longer term to the UK if it were outside the EU.

VI. CUSTOMS UNION

Summary

The UK could leave the EU using Article 50 TEU as described in scenario IV and pursue a similar relationship to the one enjoyed by Turkey by seeking to establish a customs union with the EU.

Rights

- Access to the EU Internal Market for goods without the need to comply with EU Rules of Origin for non-EU countries.
- The UK would not be obliged to contribute to the EU budget, or participate in common policies such as CAP, CFP and regional funding.
- The UK would not be obliged to implement EU social and employment law.
- The UK would be free to regulate its own financial services sector.

Obligations

- To impose the EU common external tariff on imports from outside the UK/EU customs union.
- The UK would have to abide by EU regulations in relation to goods, i.e. product standards.
- The UK would have to abide by significant portions of the EU's common commercial policy.

Analysis

Essentially, this option is limited to trade in goods. It would allow continued tariff-free access to the EU for UK manufactured goods, but the UK would lose the right to participate in standards setting in relation to the regulation of that trade. The UK would also have to abide by EU state aid and competition rules. The UK would also need to abide by the EU's common commercial policy and common external tariff regime, for example the implementation of the Customs Union with Turkey[32] has required Turkey to apply: the common customs tariff, common EU rules for imports, the EU procedure for administering quantitative quotas, EU protective measures against dumped and subsidised imports, common rules for exports, common rules for export credits, and common rules on textile imports and exports. Such a situation would not cover external trade in services with third countries that the EU negotiates free trade arrangements with.

In the EU market, the UK would lose its current right to provide services, including financial services, on equal terms with EU members. Apart from its obvious disadvantages, this could have serious and unexpected consequences, given the extent to which trade in goods – whether within or outside the EU – is now intertwined with services in modern supply chains.[33]

If the UK wished to gain preferential access in relation to services (including financial and professional services) and public procurement it would have to conclude additional agreements with the EU. Such agreements would take time to negotiate, and would probably not provide the same levels of access as currently enjoyed. This could severely damage the relevant sectors. In terms of services, the UK would rely on its rights under the General Agreement on Trade in Services (GATS), which is discussed further in scenario VIII on the WTO.

[32] Decision No 1/95 of the EC-Turkey Association Council of 22 December 1995 on implementing the final phase of the Customs Union.
[33] See Kommerskollegium, Swedish National Board of Trade, 'Servicification of Swedish manufacturing', March 2010.

The UK would make savings by virtue of not having to contribute to programmes such as the CAP or structural funds, and would regain exclusive control of regulation of financial services and services. However, if this would be at the expense of free access to the EU's Internal Market in financial services.

Given the asymmetry of trading volumes between the UK and the EU, membership of the EU customs union would be most sensible as a step towards EU membership, not as a permanent model for engagement. It is true that the UK would be able to negotiate agreements with non-EU third countries on trade in services where it currently negotiated as part of the EU. For goods, however, the UK would have to follow the EU's overall trade policy as a member of its customs union, resulting (as in the case of Turkey) in loss of independence and influence in this area. The EU would retain the ability to conclude trade agreements (whether multilateral, plurilateral or bilateral) with third countries without any input from the UK. That would give those countries access to the UK goods market, on the terms the EU had negotiated to suit itself, not the UK.

This would risk having an adverse impact on UK interests given that, in the case of bilateral FTAs, the EU's negotiating strategy is generally to offer access to its market for goods in return for the third country offering access to its market for services. The UK would then have to negotiate, after the fact and from a position of weakness, separate FTAs with the same third countries to gain reciprocal access for UK goods and, more importantly, services.

This scenario would risk disadvantaging the UK financial services sector as it is largely focused on the trade in goods and does not provide for special arrangements in other areas.

VII. UK/EU FTA

Summary

The UK could leave the EU using Article 50 TEU as described in scenario IV and seek to conclude a comprehensive Free Trade Agreement with the EU.

Rights

- Right to set own commercial policy, i.e. customs tariff.
- The UK would not be obliged to contribute to the EU budget, or participate in common policies such as CAP, CFP and regional funding.
- The UK would not be obliged to implement EU social and employment law.
- The UK would be free to regulate its own financial services sector.
- The UK would be free to conclude FTAs with third countries.
- The UK would not be bound by any automatic transposition of EU Internal Market legislation into UK law.
- The UK would have freedom to establish its own VAT regime.

Obligations

- UK exports to the EU would be subject to EU ROO.
- UK goods exported to the EU would have to comply with all relevant EU standards.

Analysis

This scenario resembles the Swiss model, in that it would involve a bilateral agreement with the EU, but be on the basis of a single comprehensive agreement instead of many sector-by-sector agreements. The Swiss agreed their first bilateral agreement with the EU in 1972, followed by two large groups of bilateral agreements in 1999 and 2004, covering areas such as goods, product standards and insurance. The UK and EU would almost certainly seek to conclude an FTA of the more recent comprehensive type based on WTO/GATS principles, probably along the lines of the EU South Korea FTA, and not involving EFTA membership.

The UK would be free to set its own commercial policy, agricultural and fisheries policy, and internal UK market and employment rules. It would be free to regulate its own financial services sector. A comprehensive agreement could provide better access to the EU Internal Market in financial services and it would be preferable to simply relying on WTO/GATS membership alone.

The UK would, however, lose the right to influence the rules of what is currently its home market. The disadvantages of this are set out in scenario VIII on the WTO. In particular, it should be reiterated that the negotiation process could be very lengthy and have an uncertain outcome.

VIII. THE WTO OPTION

Summary

The UK could leave the EU using Article 50 TEU as described in scenario IV. The UK has in its own right been a member of the General Agreement on Tariffs and Trade (GATT) since 1947 and of the WTO since its creation in 1995. WTO membership is composed of countries, territories and customs territories such as the EU. The WTO most MFN principle underpins today's multilateral trading system. Customs unions are exceptions; their members can remove tariffs among themselves and impose a single tariff for third countries.

Rights

- Control over trade policy.
- Control over own borders – no obligation of freedom of movement. Freedom to regulate and legislate independently, within existing WTO rules, although the General Agreement on Trade in Services (GATS) contains provisions on "Temporary Presence" (one of the four GATS "Modes" of service provision) covering the provision of economic services by natural persons.
- The UK would no longer contribute to the EU budget, nor would it be likely to receive direct or indirect EU funding.
- The UK would lose all EU legislative rights and formal channels of influence.

Obligations

- UK businesses exporting goods and services into the EU would have to follow its product standards, as they would for any other jurisdiction they sought to export to.
- The UK would be subject to the EU's Common External Tariff when trading with EU member states.
- The UK would continue to be bound by WTO and related agreements at the global level, e.g. the G20 level on, for example, derivatives reform or capital requirements.

Analysis

This is the purest form of the "out" scenario, with no formal connections or independently negotiated agreements with the UK's former European partners. The UK would regain the ability to act independently and unilaterally without being directly subject to any EU law. This would certainly mean that the UK would be able to act with sovereignty, but it must be considered to what extent "full" sovereignty would be a reality. Freedom of action cannot necessarily be equated with effective power. A key question in this scenario is not whether the UK would be able to do what it wanted, but whether it would be better able to get what it wanted than as a member of the EU.

For financial and professional services, it can be said that if the UK had to rely on its WTO membership alone to enforce its trade rights, it would lack the negotiating strength that it enjoys as one of the EU's 28 members. Assuming that the UK were not an EU member, it would also have to conduct all its own trade negotiations, taking its place in the WTO pecking order to do so. As regards financial services, it could not be taken for granted that the WTO and the GATS would offer an automatic means for the UK to enforce a right to its current trading advantages for financial services within the Internal Market: the "prudential carve-out" under the GATS Annex on Financial Services would allow EU regulators to take whatever prudential measures they deemed necessary to intervene in trade in financial services between the UK and the EU so as "to protect investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system".

What is more, the WTO is only concerned to a limited degree with regulatory issues (to the extent that they affect market access and national treatment): WTO membership would not, by itself, provide a means of approaching regulatory disputes in the way that is offered in, for instance, a number of the EU's FTAs. True, the UK would be free, outside the EU, to negotiate its own FTAs which might contain similar provisions; but this would depend on substantial diplomatic effort with reduced negotiating weight due to the fact that the UK would be offering access to a reduced market compared to that of the EU.

The UK would no longer automatically be party to existing EU trade agreements or to negotiations for prospective agreements. Even though Opinion 1/94 of the CJEU concluded that WTO agreements in goods were an exclusive EU competence and those in services were partly a member state competence, this situation has been changed by the Lisbon Treaty and both are now considered EU competences (except for certain transport and audio-visual services).[34] The movement to trade agreements being largely an EU competence has an impact on the status of what are known as "mixed agreements" – where international treaties are signed by both the EU and its constituent member states.[35] For trade agreements signed as part of the EU's exclusive competence it is very difficult to maintain with any certainty that the UK would remain subject to the rights and obligations in such agreements and with mixed agreements there are some grounds to suggest that the UK may remain bound by certain aspects of these agreements but this is very uncertain and without legal precedent.

The analysis of both exclusive and mixed agreements relies upon the concept of a "successor" state and the "continuing" state under international law. The normal premise within conventional international law is that where a smaller proportion of the state decides to secede, the remainder of the state will normally be treated as a "continuing state" and the seceding state as a new state (for example the potential situation with Scotland and the Rest of the UK).[36]

Under conventional international law the continuing state will succeed to all the treaty rights and obligations of the original state and the seceding state may or may not continue to be subject to existing treaty obligations. Historically practice has varied and the key question is how other states/organisations will choose to treat the seceding state. There is no persuasive precedent to suggest that the rights and obligations of the UK under EU agreed free trade agreements would be maintained. In particular, for those agreements where the EU has exclusive competence the contracting parties may take the view that the agreement would not extend to an independent UK on its own, especially if the terms of market access granted had been negotiated on the basis of a wider EU market and not the UK independently. Absent any real precedent, it would be very difficult to contend, for agreements with exclusive EU competence that the UK would maintain its rights/obligations, especially since the Vienna Convention on the Law of Treaties between States and International Organizations or between International Organizations[37] has not been ratified sufficiently to come into effect and neither the UK, EU nor WTO are signatories to it.

Currently, about 50 agreements have been concluded, with negotiations in progress with the USA, Japan, India and a number of ASEAN countries, among others.[38] In the case of existing agreements, there would at best be a great deal of uncertainty to whether these agreements would continue vis-à-vis the UK and the other contracting parties, a positive statement of acceptance would probably have to be sought from the EU and other contracting parties, failing which the UK would, at worst, either have to negotiate fresh bilateral FTAs with those countries, or fall back on its generic WTO rights (e.g. MFN tariffs and GATS rules for services). The UK would have to rebuild the capacity to carry on a large number of simultaneous negotiations with partners who might not feel obliged to give the UK as generous market access and national treatment as they did to the EU, given the UK's much smaller relative bargaining power and offered market access. The process could also be a lengthy one. For example, the EU began free trade negotiations with India in 2007 and negotiations were ongoing in 2014. Even simple agreements have taken two to three years to negotiate.

In the case of current negotiations, UK departure from the EU would leave the Commission, as EU negotiator, free to say that it no longer represented the UK, which was no longer involved; and it is hard to see how the UK could gainsay that contention. The UK would then be excluded from further participation in ongoing negotiations with key partners such as the USA and Japan, where it is currently a leader in setting the agenda. The EU / USA TTIP negotiations are of particular importance in the

[34] See Article 207, TFEU.

[35] The legal landscape around mixed agreements under EU law is very complicated and cannot be discussed fully in this paper. However, please see, amongst others, A Rosas, 'The European Union and Mixed Agreements' in Dashwood and Hilton (eds), The General Law of EC External Relations (Sweet & Maxwell, 2000).

[36] See Sir David Edward, KCMG QC, written evidence to the European and External Relations Committee of the Scottish Parliament, 23 January 2014.

[37] http://legal.un.org/ilc/texts/instruments/english/conventions/1_2_1986.pdf

[38] European Commission Memo, 'The EU's bilateral trade and investment agreements – where are we?', MEMO/13/1080, 3 December 2013, accessed on 10 April 2014 at: http://trade.ec.europa.eu/doclib/docs/2012/november/tradoc_150129.pdf

international trade and standards setting agenda. If the UK were to be outside the EU, the relatively smaller size of its economy would risk disadvantaging it in negotiations with much larger economies such as the USA.

Trading with the EU as a member of the WTO would involve the UK and EU imposing MFN tariffs on each other's goods. A House of Commons Library study has estimated that about 90 per cent of UK goods would be covered.[39] The risk is that this would have detrimental consequences on UK consumers and trade; for example, the current average MFN EU tariff for motor vehicles is around 10 per cent, which would increase the costs of UK automotive imports into the EU. A further risk is that UK producers would put pressure on the government to raise tariffs on its competitors in order to protect their own interests, not just in Europe but globally, by increasing certain MFN tariffs. This would increase costs for consumers, and ultimately reduce the volume of trade. Indeed, the desire to mitigate the dynamic of raising barriers to trade in order to protect what may otherwise be uncompetitive domestic interests is one of the animating forces behind the creation of the EU Internal Market. Examples of recent international trade disputes have seen the USA impose tariffs on UK steel producers and disagreements between China and the USA about disputed solar panel subsidies.

Free movement of capital would not, technically, be affected by UK departure from the EU. The Maastricht Treaty removed all restrictions on capital movements between EU members and also between the EU and third countries from 1994. However, the status of the UK as Europe's leading financial centre may be endangered by departure from the EU. London accounts for between over three quarters and just under half of, variously, EU foreign exchange trades, global trade in the euro, EU private equity funds, investment banking, pension assets and international insurance premiums.[40] The financial services "single passport" mechanism, which allows providers established in one member state to provide their services in all, is not available to a country outside the EEA. Furthermore, other EU governments might no longer feel comfortable allowing such a large proportion of the activity of their firms to take place in what could be characterised (more easily than in the past) as an offshore centre. Research into the views of financial and professional services firms carried out by Ipsos MORI for TheCityUK revealed that 95 per cent of those polled believed that access to the Single European Market, particularly as a gateway for international business, is important to the UK's future competitiveness.[41]

More importantly for the financial services industry, the WTO regime, and GATS in particular, does not deal with non-tariff barriers in any great detail. Instead, the focus on non-tariff barriers tends to be concerned with whether they are discriminatory in nature and whether they can be objectively justified. The existence of non-tariff, behind-the-border barriers is perhaps the most significant obstacle to market access and national treatment faced by the financial services industry globally.

It is also worthwhile comparing the UK's trade performance with that of other EU members equally subject to EU rules. Germany's share of global exports went up from 8.9 per cent to 9.3 per cent in the previous decade, compared to a British decline from 5.3 per cent to 4.1 per cent between 2000 and 2010. The fact that other EU members are increasing their global exports does not support the claim that EU membership hinders members' ability to export to third countries. It is also worth noting that this poor UK export performance is despite a sterling devaluation of 10 per cent between 2003 and 2010, with a large fall of around 20 per cent between 2008 and 2010.[42]

Departure from the EU would allow the UK to set its own regulatory framework. However, it could face restrictions in the EU and globally. While there is a general aspiration in the GATS framework to gradually liberalise trade in services to the greatest extent possible, this is balanced by recognition of "the right to regulate". As discussed, the prudential carve-out does not prevent a WTO Member from taking measures for prudential regulation and supervision of financial institutions. It is generally

[39] House of Commons Library, 'Leaving the EU', Research Paper 13/42, 1 July 2013.
[40] TheCityUK, 'Key Facts about UK Financial and Professional Services', August 2013.
[41] TheCityUK/IPSOS Mori, 'The City Speaks', October 2013.
[42] Google Finance, accessed on 6 January 2014 at: https://www.google.com/finance?q=GBPUSD&ei=GbvKUqqVOuWVwQPdwAE

considered to be quite wide provided such measures are not "used as a means of avoiding the member's commitments or obligations under the GATS" (i.e. provided that they are not taken for protectionist reasons). Given that most measures taken in financial services regulation can be justified on this basis, relying upon the GATS would not provide to the UK financial services industry any guarantee of access to the EU Internal Market in financial services on a comparable basis to EU membership. Sydney J. Key, former member of the Board of Governors of the Federal Reserve Bank of Chicago, explains the difference between the European method of liberalisation of financial services and the GATS model in saying:

> *"The international framework for dealing with trade liberalisation and prudential regulation in the financial services sector is much more fragmented than that within the EU, where everything is being done within one institutional framework. That is, the European Community deals with all aspects of trade in financial services among the member states, including liberalisation aimed at non-discriminatory as well as discriminatory barriers, removal of restrictions on capital movements, and harmonisation of essential national rules such as capital standards and consumer protection measures. Beyond the EU, international efforts must proceed without a supranational structure comparable to that of the EC and without the broad scope of its legislated harmonisation of essential national rules."*[43]

The presumed right of commercial establishment that comes with EU membership would also be lost on departure from the EU except to the extent that it is replicated under the EU's GATS commitments to third countries or through other instruments such as EU members' participation in the Organisation for Economic Cooperation and Development (OECD) Investment Guidelines. Dispute resolution and the enforcement of competition law through the ECJ is also stronger in the EU and provides considerable protection to EU members against anti-competitive practices.[44]

There are elements of this scenario which are uncertain (see scenario IV for a more detailed discussion of the steps that could unfold following a choice by the UK to leave the EU.) Would there be a transition period and, if so, would the UK be bound by rulings of the ECJ during that period? What would happen to EU citizens and businesses based in the UK, and vice versa? The latter question relates to what are variously known as vested, executed or acquired rights, and the degree to which they are "grandfathered" (i.e. accepted as pre-existing and not to be disturbed).

> "THE UK WOULD HAVE TO REBUILD THE CAPACITY TO CARRY ON A LARGE NUMBER OF SIMULTANEOUS NEGOTIATIONS WITH PARTNERS WHO MAY NOT FEEL OBLIGED TO GIVE THE UK AS GENEROUS MARKET ACCESS AND NATIONAL TREATMENT AS THEY DID TO THE EU, GIVEN THE UK'S MUCH SMALLER, RELATIVE BARGAINING POWER AND OFFERED MARKET ACCESS.

[43] Sydney J. Key, 'Trade liberalization and prudential regulation: the international framework for financial services', International Affairs 75, 1999, p 74.
[44] CEPS Special Report, 'Access Barriers to Services Markets: Mapping, tracing, understanding and measuring', June 2013.

PART 2

AN EFFECTIVE INTERNAL MARKET FOR FINANCIAL SERVICES

I. THE ESTABLISHMENT OF THE INTERNAL MARKET AND THE ROLE OF THE UK

The Internal Market is at the core of the development of the EU. Most studies recognise that the Internal Market has brought appreciable benefits to the EU economy as a whole, including that of the UK. The Internal Market has developed gradually since its inception, and it continues to develop. It currently includes around 500 million people and, in 2011, it accounted for approximately £11 trillion in GDP[45], making it the largest Internal Market in the world.

A brief history of the Internal Market

The forerunner to the Internal Market was established in 1957 through the Treaty of Rome which provided that:

> *"the Community shall have as its task, by establishing a common market and progressively approximating the economic policies of member states, to promote through the Community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an accelerated rising of the standard or living and closer relations between the states belonging to it"* [46]

While this common market took significant steps in order to increase trade between member states, there were still many barriers in place between them which prevented it from being a cohesive and competitive integrated marketplace. In 1985, the European Commission presented a White Paper to the European Council on "Completing the Internal Market" (the "Internal Market White Paper"), which set out principles of mutual recognition and legislative harmonisation. It proposed 279 specific legislative measures to be brought into force by 1992, along with a raft of changes to the treaty in order to advance the completion of the Internal Market. This was aimed at the removal of thousands of divergent national regulations.

The Single European Act, which came into force in 1987, committed the EU to creating a functional Internal Market, allowing for the free movement of goods, persons, services and capital (the so-called "Four Freedoms"), which were set out in the Treaty of Rome. It also aimed to implement some of the measures set out in the Internal Market White Paper. The establishment of the Internal Market was formally completed on 31 December 1992, by which time almost all of the original 279 measures provided in the Internal Market White Paper had become law. The Maastricht Treaty in 1993 added new EU competences in areas relevant to the Internal Market, such as consumer protection and the creation of trans-European networks (such as infrastructure and energy), and also provided the legal context for the 1998 legislation which largely abolished controls on capital and payment transfers between member states. For financial services, the Maastricht Treaty also committed member states to the process of economic and monetary union which proved to be a significant catalyst for the further development of the Internal Market in financial services.

In parallel, the jurisprudence concerning the Internal Market was also developed through a number of important judgments of the Court of Justice of the European Union, building on the famous *Cassis de Dijon*[47] case which legally reinforces the principle of mutual recognition, having concluded that full harmonisation was not required for movement towards an Internal Market in all circumstances.

The role of the UK in the development of the Internal Market

The UK has been a driving force in the development of the Internal Market. Lord Cockfield, who was a British European Commissioner in 1984, led the Commission initiatives which resulted in the publication of the Internal Market White Paper in 1985, and ultimately the adoption of the Internal Market Act in 1987. Lord Cockfield also negotiated the adoption of the 279 legislative measures designed to achieve the Internal Market.

UK nationals have often held key posts such as that of Director-General responsible for the Internal Market and

[45] HM Government, 'Twenty Years On: The UK and the Future of the Single Market', 18 October 2012, p 12; Eurostat: National Accounts and Exchange Rate data.
[46] European Union, Treaty Establishing the European Community (Consolidated Version), Rome Treaty, 25 March 1957, Article 2.
[47] Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein (Cassis de Dijon) (Case 120/78) [1979] ECR 649.

Services. This was a position held by UK nationals for 12 out of 41 years since the UK acceded to the EU in 1973, reflecting the importance of the Internal Market to the UK.

Finally, the Internal Market, and in particular the principles of free movement of services and capital, as well as the UK's relationship with the EU, have all shaped the role of the UK financial services sector in both the national and global economy. Indeed, key aspects of EU financial services law are modelled on that of the UK, such as large parts of the Markets in Financial Instruments Directive (MiFID) and the Market Abuse Directive. The UK has thus been highly influential in establishing EU-wide norms concerning the development of EU financial services regulation as acknowledged by the UK government, which explained:

> *"the UK's own relative economic success over the period in which the Internal Market has been developing has been a powerful soft power element in projecting the UK's influence more broadly".*[48]

II. PROGRESS IN THE DEVELOPMENT OF THE INTERNAL MARKET FOR FINANCIAL SERVICES

Despite the Internal Market having been "completed" on 31 December 1992, still existing barriers in the financial sector have meant that the Internal Market for financial services has developed at a slower pace than other markets.[49] The advent of the single currency gave renewed impetus to the creation of an Internal Market in financial services as a logical counterpart to it in that area.

The 1998 Cardiff European Council called upon the Commission:

> *"to table a framework for action....to improve the Internal Market in financial services, in particular examining the effectiveness of implementation of current legislation and identifying weaknesses which may require amending legislation".*[50]

As a result, in 1999, the EU launched a number of regulatory initiatives aimed at overcoming legal barriers to cross-border banking activity within the EU, and, since the early 2000s, it intensified policy action aimed at fostering the integration of EU financial markets, in particular the Commission Paper, "Implementing the Framework for Financial Markets: Action Plan",[51] which would later form the basis for the Commission's Financial Services Action Plan (FSAP).

The Financial Services Action Plan formed the backbone of the push in development of EU financial services integration and was focused on the delivery of four strategic Internal Market objectives:[52]

- A single EU wholesale market – to provide for cheaper and more flexible financing arrangements for corporate borrowers and to remove legal and administrative barriers to creating EU-wide capital markets.

[48] HM Government, 'Review of the Balance of Competences between the United Kingdom and the European Union: The Single Market', July 2013, para 3.34.

[49] Almudena de la Mata Muñoz, 'The future of cross-border banking after the crisis: facing the challenges through regulation and supervision', European Business Organization Law Review (EBOR) (No. 4/2010), page 580.

[50] Cardiff European Council of 15 and 16 June 1998, Presidency Conclusions, SN 150/1/98 REV 1.

[51] COM(1999) 232, 11 May 1999.

[52] Ibid.

- Open and secure retail markets – to address the conditions under which financial products are sold to allow cross-border trading to flourish and to roll back unjustified conduct of business rules.
- Prudential rules and supervision – to set rigorous standards for the EU banking sector, the development of EU-wide supervisory standards and identification of risks and mitigations of such risks as part of EU-wide rules and supervisory practices.[53]
- Wider conditions to create an optimal single financial market – covering a range of issues from addressing disparities in tax treatment of financial services to promoting efficient and transparent systems of corporate governance.

To achieve these objectives, the Financial Services Action Plan proposed 42 measures (some legislative and some industry-led) from 1999 to 2004 to address the strategic objectives of building an Internal Market in financial services. These included in respect of wholesale markets:

- Establishing a common legal framework for integrated securities and derivatives markets – this meant updating the Investment Services Directive (this becoming MiFID) and measures to tackle insider dealing and market manipulation.
- Removing the remaining barriers to raising capital on an EU-wide basis through the harmonisation of rules related to the exchange of financial collateral.
- Establishing a single set of financial statements for listed companies – helping companies to raise capital across the EU by adopting a single set of reporting standards.
- Creating a coherent legal framework for supplementary pension funds – responding to the development of funded pension schemes by creating proper safeguards.
- Providing the legal certainty to underpin cross-border trading in securities – ensuring that collateral could be accepted on a cross-border basis.
- Secure and transparent environment for cross-border restructuring – requiring legislation on takeovers and a common framework of company law.

The proposed measures on retail financial services were mostly focused on removing the administrative and other barriers to customers purchasing such services across borders. They included information and transparency measures, better redress procedures, regulation of electronic commerce and reducing the cost of cross-border retail payments.

The outcome of this action in wholesale markets, retail markets and supervision was a large quantity of subject-specific legislation, which resulted in financial services markets reaching higher levels of integration in Europe.[54]

In 2009, an independent evaluation of the impacts of the Financial Services Action Plan by CRA International[55] identified a number of evidential benefits of the Financial Services Action Plan, including an around 100 per cent increase in the number of passported prospectuses to raise capital throughout the EU,[56] the creation of new trading venues leading to a 150 per cent increase in trading volumes and reduction in both trading and post-trading costs[57] and removal of some national restrictions on occupational pensions (especially related to asset allocation rules) and barriers to cross-border activity has clearly enhanced the possibility of a single wholesale market in pensions.[58] They also pointed to a 90 per cent reduction in the cost of cross-border retail payments[59] and more use of professional insurance intermediaries and increased quality of insurance advice.[60] The UK Government has concluded that:

> *"the wholesale financial services sector in particular is one of the most integrated parts of the Internal Market. There is a high degree of integration of money markets, considerable integration of bond markets and increasing integration of equity markets, under the supervision of the recently constituted European Supervisory Authorities."*[61]

The Commission continues to focus on promoting further integration of the Internal Market in the financial services

[53] HM Treasury, 'Single Market: Financial Services and the Free Movement of Capital - call for evidence', October 2013, para 2.14.
[54] Supra, fn 41.
[55] CRA International, 'Evaluation of the economic impact of the FSAP', July 2009.
[56] Ibid, p 8.
[57] Ibid.
[58] Ibid, p 23.
[59] Ibid, p 7.
[60] Ibid.
[61] HM Government, 'Review of the Balance of Competences between the United Kingdom and the European Union: The Single Market', para 2.42.

sector. In its Communication on the Internal Market Act of October 2010, it identified 50 measures aimed to "re-launch" the Internal Market.[62] A number had implications for financial services. The measures included, for instance, the adoption of a new action plan for improving small and medium sized enterprise (SME)[63] access to capital markets in 2011, which would, amongst other things, cover measures to make investors more aware of SMEs; to develop an efficient stock exchange network or specific regulated markets which focus on SMEs; and to adapt listing and disclosure requirements to SMEs. The measures identified also included further research encouraging private investment, particularly in the long term. Measures identified as having the potential to encourage private investment included the reform of corporate governance and incentivising sustainable and responsible investment as required by smart, green and inclusive growth. In addition, the Commission provided for the adoption of measures to ensure that venture capital funds set up in any member state can operate and invest freely within the EU, a measure aimed at eliminating any tax disadvantages for cross-border activities. Other initiatives covered by the Internal Market Act of 2010 concerned access to certain basic banking services, as well as legislation supporting the creation of a single, integrated mortgage market with a high level of consumer protection.

As part of its agenda on promoting integration in the financial services sector, the Commission has also focused its attention on the payments sector. In 2007 the entry into force of the Payment Services Directive ("PSD") was aimed at harmonising practices across member states, by requiring them to implement its provisions into their national laws. The PSD operated as a basis on which the Single European Payments Area was built and standardised the content requirements of terms and conditions, ensuring that these are adequately transparent. Moreover, the PSD streamlined operational rules around the execution of payments and promoted payments efficiency and reduced costs across Europe. Similarly, in 2012 the Commission introduced the SEPA Regulation, which was designed to achieve a harmonised euro payments market in respect of most credit transfer and direct debit transactions denominated in euros within the EU. Among other things, the SEPA Regulation standardises technical requirements (including message format and data) and empowers payers with new rights to instruct their payment service providers to impose restrictions on direct debits.

The Commission has already driven a number of the aforementioned initiatives forward, and legislative proposals have, amongst other things, been submitted to the European Parliament and the Council for adoption in order to deepen EU financial integration further.

[62] European Commission Communication, 'Towards a Single Market Act – for a highly competitive social market economy, 50 proposals for improving our work, business and exchanges with one another', COM(2010) 608, Brussels, 27 October 2010.

[63] Small and medium sized businesses are broadly defined in the EU as a business employing between 10 and 250 people.

III. THE IMPACT OF THE FINANCIAL CRISIS ON THE DEVELOPMENT OF THE INTERNAL MARKET FOR FINANCIAL SERVICES

Since the late 1990s, the EU has pushed the development of the Internal Market for financial services with several high profile strategies. Integration in wholesale banking, as well as in certain areas of corporate finance, has progressed more than integration in retail banking.[64] However, while the EU's past intention was to continue to support further integration in this field, progress on the removal of the remaining barriers has been slower since the economic crisis, as the current focus is on ensuring stability in the 18 euro area countries. In particular, during the beginning of the crisis, the EU shifted its focus to bolstering financial stability and consumer and investor protection, and addressing the risk of regulatory arbitrage.[65]

The financial crisis has highlighted the fact that the benefits of a large, inter-connected financial services sector also come with risks, especially if adequate rules, safeguards and supervision are not in place. The financial crisis confirmed that in order for financial stability to exist a greater degree of regulatory and supervisory co-ordination is required.

More specifically, the financial crisis has shown that the legal structure used for cross-border financial institutions does matter, and that it has an impact on systemically relevant aspects such as risk evaluation and oversight, deposit coverage and crisis management.[66] During the crisis, many market commentators argued that some large and complex EU banking groups faced a number of problems surrounding balance sheet expansion, high leverage, lack of market discipline and excessive risk-taking, as well as problems related to trading and market-based activity, implicit bail-out expectations, competitive distortions, and conflicts of interest. As acknowledged by the Commission itself:

> *"[t]hese intertwined problems have a clear link with the way some large banking groups are structured, which makes them too big, too important, too complex, and too interconnected to fail".*[67]

It was for these reasons that the Commission looked into the issue of structural reform of the EU banking sector through the Liikanen Report, which in some respects echoed the UK's Vickers report. Liikanen proposed the separation of high risk trading activity or ring fencing of proprietary trading and third-party activity, in order to establish a "stable and efficient system" which would serve the needs of the Internal Market.[68]

Furthermore, as a way to address perceived weaknesses of national supervision brought to light during the financial crisis, the EU pushed for the transfer of certain supervisory powers from national to EU level.[69] The EU has also presented banking union as an EU policy response to the challenge of raising capital for banks, especially in those euro areas which are fiscally stretched.[70] This increase in the tendency towards harmonisation following the crisis has caused tension between the UK and both the euro area and the EU.

Banking union will pose a particular challenge to policy makers in the UK and EU as they seek to accommodate two global currencies and overlapping prudential, competition, resolution and central bank regimes. The UK has supported the creation of a banking union while insisting that the UK not be financially liable for the resolution on any euro area financial institutions. The UK has also said that it is crucial that the new structures work well together and do not undermine the integrity of the Internal Market.

This further integration needs to be considered against the other parallel concern that the financial crisis has also resulted in member states increasing barriers at national level. These, for example, include costly "re-subsidiarisation" of branches of banks, and a return to some of the features present in the situation pre-Internal Market.

There are genuine concerns about the responsibilities of individual states to supervise financial entities and protect their taxpayers from funding failing entities, and that fragmentation of the Internal Market in financial services will significantly increase the cost of capital, harming both economic growth and consumer choice. These must be balanced against the overriding principles of proportionality and subsidiarity, and the consideration that harmonisation will not always be the best answer.

[64] HM Government, 'Twenty Years On – The UK and the Future of the Single Market', 18 October 2012, p 18.
[65] Supra, fn 46, para 2.22.
[66] Supra, fn 42, p 589.
[67] European Commission, Directorate General for Internal Market and Services, 'Reforming the structure of the EU banking sector: Consultation paper', May 2013, p 2.
[68] European Commission, 'High-Level Expert Group on reforming the structure of the EU banking sector chaired by Erika Liikanen', Final report, 2 October 2012, p 6.
[69] Supra, fn 46, paragraph 2.21.
[70] Ibid, at para 2.24.

IV. EXISTING AND FUTURE LEGAL AND PRACTICAL BARRIERS WITHIN THE INTERNAL MARKET FOR FINANCIAL SERVICES

As outlined in Section II of this Paper, significant progress has been made over the last few decades towards the strengthening of the Internal Market in the financial markets sector. There are still areas where there is the potential for further progress and where barriers still exist.

Examples of where there are still barriers in the Internal Market in financial services include insurance, EU securities law, SMEs, the ability of financial institutions to provide long-term finance and areas where the market may develop in the future such as so-called "Shadow Banking." They are discussed in turn below.

1. Insurance

Large wholesale insurance, commercial property, liability, transport and reinsurance risks are written freely within the EU, on both an establishment and cross-border basis. Retail Insurance, however, remains highly fragmented across the EU. For example, a house or car in the UK cannot readily be insured from France. Differences in insurance contract law limit the cross-border opportunities, leading to costs being incurred in checking compliance with local law (and also potentially related to the re-design of those products) or even expose the insurer to additional risk; availability of the statistical data necessary to populate the actuarial models underpinning the calculation of premiums is also perceived to be an issue in at least some markets; and cross-border claims management remains complex and expensive for insurers.[71] These types of barriers are so significant that market studies have found no evidence of insurance products currently being sold to consumers on a pan-European basis. Whilst products are offered that provide cross-border coverage many insurers are reluctant – as a matter of course – to incorporate such offerings into their standard product line.[72]

As in the field of retail financial services, it is important to bear in mind that structural factors such as consumer preferences can be a significant factor in existing market fragmentation as opposed to insufficient harmonisation. Insurance businesses therefore tend to set up local subsidiaries to brand and market themselves in light of such consumer preferences. Claims handling varies significantly by member states according to cultural and consumer preferences, language, tax and legal differences.

Harmonisation essentially deals with the rules and mechanisms of operation for the service providers themselves and may not have a material effect on consumer behaviour, whilst potentially increasing compliance and/or product costs. Therefore, a variety of potential mechanisms have been put forward to enhance cross-border insurance and claims management:

- Improved awareness of consumer rights (eg. through factsheets).
- Improved, or more consistent, access to Alternative Dispute Resolution.
- The harmonisation of EU consumer disclosure obligations and other consumer laws (i.e. common law of misrepresentation and unfair contracts regime, etc).
- Improved relationships between the claims representatives and the company.
- The harmonisation of claims handling procedures and standards (e.g. compensation time limits and improved enforcement) in order to reduce consumer uncertainty.
- Amendments to data protection rules to enable the improved exchange of information about fraud (a reduction in the perceived risk should streamline the process for insurers).[73]

There is also the possible new "optional" system of European insurance contract law, which parties to the insurance contract could select as the governing law of the contract.[74]

Whilst it can be difficult to legislate for consumer preference, and harmonisation of laws should not necessarily attempt to do so, EU and industry action should be focussed on eliminating barriers to market access and allow financial service providers to compete for consumers and offer the best products to serve their needs, regardless of what member state they live in.

[71] Europe Economics, 'Retail Insurance Market Study', MARKT/2008/18/H, 26 November 2009, p vii.
[72] Ibid.
[73] Ibid, p viii.
[74] This suggestion is currently under a pre-proposal expert group stage; see also HM Treasury, 'Single Market: Financial Services and the Free Movement of Capital: call for evidence', October 2013, Table B.2: Insurance and pension sectors.

2. EU securities law

Various obstacles (i.e., technical, regulatory, fiscal, and legal) related to clearing and settlement continues to hold back the integration of the secured market segments (e.g., commercial paper and treasury bills).[75] The EU has itself acknowledged the existence of several problems with the integration of the Internal Market in this area. Technological developments have resulted in securities such as shares and bonds being held and transferred through a complex and sophisticated international network of financial intermediaries. In a paperless environment, they have also become intangible, with the only evidence for their existence and ownership being a computerised account known as a book-entry, yet such instruments are the lifeblood of financial markets as they are key to providing liquidity. Legal systems have struggled to keep pace with this change and market participants and regulators alike are exposed to the risks created by legal uncertainty over who owns what.

The EU has aimed to build on international efforts to find a solution, and has already agreed a series of legislative measures. It has agreed the European Market Infrastructure Regulation (EMIR) and the Markets in Financial Instruments Directive Review (MiFID II) and the Securities Law Directive is still under consideration. The objective has been to:

> *"render the EU Internal Market for capital and for financial services safer in terms of stabilising the financial system and increasing investor protection; … make the investing in and issuing of securities easier, thereby decreasing the cost of capital; and … improve the competitiveness between account providers."*

3. Small and Medium sized Enterprises

Providing finance to SMEs has been an area where the Internal Market in financial services has not been as successful as in larger-scale wholesale capital markets. Currently, SMEs are largely reliant on funding from bank loans for external financing and it is thought that, especially with the current retreat in bank lending, that suitable alternative funding should be more accessible to SMEs.[76] Potential steps that can be taken to help address this include:

- Measures to promote the ability of venture capital funds and asset managers to operate across borders and provide financing in other member states on the basis of a passport-style regime where only authorisation in their own member state is necessary and conduct of business rules are simplified, via a mix of mutual recognition and harmonised standards. This, as well as simplifying tax regimes and eliminating double-taxation loopholes would be relevant to reducing barriers to venture capital funding.
- The review of MiFID also opens the possibility for the creation of new 'SME Growth Markets', enabling a more targeted approach to investors seeking to find and invest in SMEs. The Commission has indicated that it will explore this idea with the aim to of finding an adequate balance between proportionate requirements for SMEs, and a high level of investor protection.[77] Such SME Growth Markets could potentially allow for the development of more standardised tools (indexes, specialised funds investing in those markets), to create networks between Multi-lateral Trading Facilities (MTFs) and to follow industry best practices.[78]
- Reduced burdens for listing on capital markets are another key element of SMEs' ability to raise funding. Recent amendments to the Prospectus Directive reduce the threshold required for SMEs and companies with smaller market capitalisation. However, other less apparent measures are also supportive of this, including reduced accounting requirement burdens for SMEs under the EU's revised Accounting Directive.[79] The Directive simplifies the preparation of financial statements for small companies, where only a balance sheet, a profit and loss account and notes are to be prepared to satisfy regulatory requirements.[80]

[75] Fabienne Ilzkovitz, Adriaan Dierx, Viktoria Kovacs, and Nuno Sousa, 'Steps towards a deeper economic integration: the Internal Market in the 21st century: A contribution to the Single Market Review', European Economy, Economic Papers, no 271, January 2007, p 67.

[76] Commission Communication, 'An action plan to improve access to finance for SMEs', December 2011, p 1.

[77] Ibid, p 5.

[78] Ibid.

[79] Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC.

[80] Ibid, Article 4.

4. The ability of financial institutions to provide long-term finance

In the context of strengthening and exploiting the full potential of the Internal Market, the Commission has stressed the importance of considering appropriate action to support long-term financing. The majority of long-term investment is in infrastructure such as transport, energy and ICT, which display network characteristics. Therefore, the EU stresses that "coordination at the European level is required in order to account for the spillovers and ensure the maximum overall benefit to European citizens", and notes that:

> *"the potential of the Internal Market in bringing additional financing to long term investments is largely unexploited".*[81]

5. Future Barriers

Barriers to the Internal Market can emerge as new areas of economic activity emerge or come under scrutiny. The risk is that EU member states initiate their own regulatory response, causing fragmentation of business access across borders. One of the EU's strengths is that is tends to prevent this fragmentation. An example of this is "Shadow Banking." The FSB defines it broadly as non-bank credit intermediation.[82] This can include systems of non-deposit taking financial intermediaries comprising investment banks, hedge funds, monoline insurance firms and other securities operators. The G20 leaders have identified the need to *"strengthen regulation and supervision of shadow banking"*. While a number of legislative instruments exist at EU level that cover shadow banking, the EU has acknowledged that there are still outstanding issues which need to be resolved, especially regarding the scope of EU regulations concerning banking, asset management, securities lending and repurchase agreements, and securitisation. The Commission has said it intends to assess the impact of these outstanding issues, and to make a proposal to ensure comprehensive supervision of the shadow banking system.[83] Since shadow banking largely relates to services that allow credit risk transfer, but are performed by entities outside of the regular banking system, there is a gap where regulatory arbitrage can be relevant. Considering that policymakers' attention has turned to this area, it is likely that a patchwork of divergent and conflicting rules will start to appear. Therefore, action at EU level may have the effect of establishing a level playing field in the shadow banking sector coupled with regulatory reforms to bolster its prudential supervision. Provided it is legislated for mindfully, this would be a preferred option to fragmented and potentially conflicting approaches by national regulators.

This list of existing and future legal and practical barriers for financial services within the Internal Market is by no means exhaustive. In any case, despite these barriers remaining the progress made in further deepening the Internal Market benefits both the EU as a whole and the UK in particular.

[81] European Commission Roadmap, 'Possible follow up to Green Paper on long term finance in 2012 – Providing long-term finance through actions to ensure the effectiveness of financial institutions, markets and instruments', accessed on 10 April 2014 at: http://ec.europa.eu/governance/impact/planned_ia/docs/2013_markt_018_long_term_finance_en.pdf.

[82] Financial Stability Board, Strengthening Oversight and Regulation of Shadow Banking: Policy Regulations, 2013, p iv.

[83] European Commission, Green Paper on Shadow Banking, Brussels, 19 March 2012, COM(2012) 102 final, p 10 et seq.

V. THE BENEFITS OF THE INTERNAL MARKET FOR FINANCIAL SERVICES FOR BOTH THE EU AND THE UK

The principles of the Internal Market are central to the strengthening UK financial services

The free movement of capital underpins the Internal Market and allows for the import and export of goods and services, facilitating the efficient use of capital and enabling firms and individuals to increase the returns on their investments and, through diversification, to reduce risks. There is considerable evidence, some of it discussed below, showing that the creation of the Internal Market has had broad benefits across the economy of the UK and the EU. The aim of this section is to examine those benefits from a financial services perspective.

The free movement of capital and payments has been critical for the UK financial services industry. Over the last 20 years, there has been an increase in the geographical diversification of UK citizens' assets, and over 40 per cent of the investments by UK pension funds, insurance firms and investment trusts in the corporate sector are now held in overseas corporations.[84]

Moreover, many UK firms have benefited hugely from having a single EU regulatory framework in terms of access to EU markets. For instance, the EU framework for financial services has had a "very marked and highly positive effect"[85] on major UK financial services businesses and their clients. The simplification and unification of the regulatory framework has made it easier for firms from one member state to operate in another. This has also been the result of many legislative initiatives that provide for the liberalisation of the markets, and aim to reduce barriers to entry by new players. This has inherent pro-competitive effects, has the ability to bring down costs overall, and provides benefits to consumers.

One of the key elements in this regard has been the EU financial services "passport" which allows firms authorised in one member state to offer services to customers in another member state, either through cross-border services or through the establishment of a branch, on the basis of their home state authorisation and not be forced to apply for separate authorisation in the recipient member state. The EU financial services passport is relevant to the following areas of financial services:

- Banking services
- Non-life insurance
- Life assurance
- Reinsurance
- Insurance mediation
- Investment services
- Management and offering of UCITS
- Alternative investment funds
- Payment services
- Electronic money

With the use of the EU financial services "passport" UK financial firms have a powerful tool for accessing markets either on a temporary or permanent basis elsewhere in the EU. UK Consumers of financial services also have access to a wider range of financial providers throughout Europe (thereby promoting increased competition) with the confidence that they are subject to a comparable regime to the UK. Furthermore, it is an attractive proposition for non-EU institutions to headquarter their operations and invest in the UK, as it gives them access to the entire EU market from this single foothold.

Quantifying the benefits of the Internal Market to the EU and the UK economy

The UK is the EU's largest financial centre, with financial services accounting for around 9 per cent of UK GDP in comparison to less than 6 per cent for the rest of the EU.

More generally, there have been numerous attempts to quantify the benefits of the Internal Market to the EU economy. In 1988, the Cecchini Report was one of the first attempts to quantify the benefits of the Internal

[84] Supra, fn 46, para 1.23.
[85] TheCityUK's response to the consultation relating to the review of the balance of competences between the United Kingdom and the European Union, Appendix, p 6.

Market to the European economy. It claimed that the benefits would be in the region of 4.25 to 6.5 per cent of GDP.[86] In 1996, Monti and Buchan found that the Internal Market had increased output by 1.1 per cent by 1996.[87] In addition, Ilzkovitz, Dierx, Kavocs and Sousa suggested that in 2006, EU GDP was 2.2 per cent higher than it would have been in the absence of an Internal Market, with an additional 2.75 million jobs created, and a 0.5 per cent boost to total factor productivity. In 2008, Boltho and Eichengreen concluded that, taking into account the whole period since the creation of the original Common Market, i.e., a longer period than other studies, EU GDP was 5 per cent higher than it would otherwise have been. Gains have come from greater competition, increased market access, higher productivity, investment and innovation levels, and consumers have also benefited from increased variety and lower prices.[88]

In particular, with respect to financial services, earlier studies suggested that there could potentially be significant gains from a more integrated Internal Market for financial services. In 2002, London Economics estimated that fully integrated financial markets could raise the level of EU GDP by 1.1 per cent in the long run, as well as raising the level of business investment by 6 per cent, private consumption by 0.8 per cent and employment by 0.5 per cent. The study noted that benefits would arise from improved allocation of capital and through more efficient intermediation between savers and investors – the reduction in the cost of equity finance alone accounts for 0.5 percentage points of the 1.1 percentage point increase.[89]

It is estimated that further integration in the EU Internal Market could produce further economic gains. In particular, full liberalisation of all areas where there are significant non-tariff barriers could increase EU GDP by 14 per cent, and UK GDP by 7 per cent.[90]

Foreign Direct Investment

One other important area to be considered when assessing the economic benefits of the Internal Market is Foreign Direct Investment (FDI). Outward investments help companies benefit from new opportunities to increase their productivity and profitability. In addition, inward investment tends to lead to higher productivity, assist in improving competition, and enable extra knowledge and skills transfers.

The EU is the largest destination for UK exports of financial services with around a third of the UK's trade surplus in financial and insurance services in 2012 coming from trade with other EU member states – of the total £46.3 billion UK financial and insurance services trade surplus, £15.2 billion was with the EU, £14.5 billion with the US and £1.7 billion with Switzerland. The UK's membership of the EU Internal Market is a contributory factor to this relationship in that it has facilitated UK access to the world's largest Internal Market.

Moreover, the UK's membership of the Internal Market acts as a magnet for business that draws investment from outside the EU and into the UK and the EU. The UK is the top destination for firms looking to establish their European headquarters: half of all European headquarters of non-EU firms are based in the UK, and the UK hosts more headquarters of non-EU firms than Germany, France, Switzerland and the Netherlands put together. The convenient location in terms of time zone, the broader economic and legal environment in the UK, and the use of the English language, attract foreign investment to the UK, compared to other EU member states, as these investors aim to benefit from access to the 28 EU markets via the EU passport for financial services.[91]

[86] Paolo Cecchini with Michel Catinat and Alexis Jacquemin, The European Challenge 1992: The benefits of a Single Market, for the Commission of the European Communities, (Wilwood House Limited, 1988) accessed on 10 April 2014 at: http://ec.europa.eu/economy_finance/emu_history/documentation/chapter12/19880301en127eurochallenge92_a.pdf.

[87] European Commission, 'The Impact and Effectiveness of the Single Market – Communication from the Commission to the European Parliament and Council', 30 October 1996.

[88] HM Government, 'The European Union Single Market – what has been achieved in twenty years?' in 'Twenty Years on – the UK and the Future of the Single Market', p 14.

[89] Ibid, p 18.

[90] Supra, fn 41, para 4.15.

[91] Supra, fn 41, para 3.15.

VI. THERE IS MORE TO BE GAINED

The UK has benefited substantially from its membership of the Internal Market, especially in the area of financial services, but there is more to be gained. Firstly, if the UK does not continue to push for the completion of the Internal Market as a member of the EU, it is likely to remain incomplete and attention will shift elsewhere. There is also a risk of damage to the European and global markets if the EU becomes less liberal due to UK disengagement.

Secondly, as a result of the financial crisis, euro area member states have taken steps to reinforce both their political institutions and decision-making apparatus, in particular through the creation of euro summits and stronger support for the Eurogroup (the meeting of finance ministers of the euro area), as well as through the financial, fiscal and economic rules of the single currency, such as the Treaty on Stability, Coordination, and Governance and the Single Supervisory Mechanism. The logic of the Economic and Monetary Union points to the eventual development of closer fiscal integration, and greater financial and economic policy coordination within the euro area.

The risk, however, is that the Internal Market could fragment further if the euro area were to develop into a political entity. The Internal Market could become dominated by euro area member states to the extent that, while the market remained coherent, the norms in practice would be set by the euro area.[92]

Two specific examples of developments indicating the influence of euro area member states include bank supervision and the Financial Transaction Tax. In relation to the former, the direct supervision of major banks in euro area countries by the ECB will cover UK-based banks with subsidiaries in euro area markets. In relation to the latter, certain euro area member states are supporting a Commission proposal for a Financial Transaction Tax to be put into effect by means of a formal enhanced cooperation procedure.[93] As discussed in scenario I, it is important to bear in mind that the euro area is by no means a homogenous group and differences of perspective are often considerable.

> “WITH THE USE OF THE EU FINANCIAL SERVICES “PASSPORT” UK FINANCIAL FIRMS HAVE A POWERFUL TOOL FOR ACCESSING MARKETS EITHER ON A TEMPORARY OR PERMANENT BASIS ELSEWHERE IN THE EU.

[92] Ibid, paras 4.7 and 4.8.
[93] Ibid, at para 4.11.

PART 3

THE REALITY OF FINANCIAL SERVICES REGULATION IN THE EU

INTRODUCTION

The system of financial services regulation in Europe is a myriad of overlapping and complementing regulatory structures and various external influences. This section attempts to shed light on how regulation and supervisory relationships in financial services function between the UK and the EU. It also takes into account the way certain non-EU actors relate to the EU regulatory and supervisory structure. This part examines the following:

1. The role of national regulators. This section looks at the basic foundation for the EU financial services Internal Market, which relies upon the underpinning of competent national authorities.

2. The role of EU regulators. This section looks at the role of EU-level regulators and the increasingly important role that they have played in the oversight of the Internal Market in financial services since 2010, in particular, the role of the European Supervisory Authorities.

3. The EU legislative cycle. This section looks at how EU legislation in financial services is developed. The legislative cycle of the EU is often more regimented than that of national legislatures and review periods are often built into legislation, in particular in financial services; moreover, the increasing role of delegated acts in the financial services area means that the legislative cycle is more consultative and transparent, but can take a long period of time with matters running in parallel.

4. EEA + EFTA access to the EU's Internal Market in financial services. This section looks at the relationship between the EU regulatory structure and the regulatory structure of the EEA/EFTA States. This is especially relevant as access to the EU's Internal Market in financial services under the EEA Agreement is fractured and increasingly fraught. This section explores these issues and how access to the EU's Internal Market in financial services is at risk.

5. The importance of the G20 and Basel financial accords. Finally, the EU increasingly is playing a role in the implementation of agreed G20, Financial Stability Board (FSB) and Basel financial arrangements with other international actors. This section examines how these arrangements interact with domestic policymaking and the role the EU plays in this arena as well as how the UK currently exercises, and may in the future exercise, influence on such accords.

I. THE ROLE OF NATIONAL REGULATORS

Domestic role

National regulators have historically been the cornerstone of the EU's financial services regulatory landscape. Supervision by member-state regulators enables the EU regulatory framework to operate across all member-states. In understanding the role that national regulators play, one should first conceptualise the nature of the work of a supervisory body. This usually consists of four separate roles:

- Licensing – the granting of permission for a financial institution to operate within its jurisdiction.
- Oversight – the monitoring of asset quality, capital adequacy, liquidity, internal controls and earnings.
- Enforcement – the application of monetary fines or other penalties to those institutions which do not adhere to the regulatory regime.
- Crisis management – including the institution of deposit insurance schemes, lender of last resort assistance and insolvency proceedings.[94]

Historically, all of the above supervisory roles have been fulfilled to a greater or lesser degree by national regulators. In the UK, for example, permission to conduct regulated activities in the UK has been through Part 4 and later Part 4A of the Financial Services and Markets Act 2000 and such permissions are granted by the competent national authorities. Oversight and enforcement have again been the mainstay of competent national authorities and, while matters such as capital adequacy or sanctions regimes may originate from supranational law or international accords, it is a matter for competent national authorities to actively enforce such obligations within their jurisdictions. This reliance is understandable given that oversight and enforcement are both resource-intensive activities and rely upon regulators being both sufficiently resourced and having a thorough knowledge of the persons and institutions they are supervising. Finally, crisis management has been a key feature of national regulators and governments, even during the global financial crisis since 2007 where national regulators (along with government treasury departments) stepped in to ensure the effective winding up of certain financial institutions while also ensuring that certain types of deposits were protected. The speed and financial backing required for such measures has meant that national authorities have often taken the lead in this area.

In parallel to EU policy and the development of the Internal Market in financial services, national regulators have primary supervisory responsibility for the conduct of business in their jurisdictions and this means that much of the attention of national regulators is also directed towards conduct issues, including the appropriateness of selling practices in relation to financial products. This is seen as largely a role for national regulators as they are related to specific product types and/or market practices in a particular area. This close connection to local markets and practices, often in combination with legal practices and historical developments, means that national regulators often have greater visibility of these issues and have the regulatory tools and domestic legal resources to pursue such policies effectively: more so than EU-level regulators.

Effectively, national regulators perform the main day-to-day function of supervision for the bulk of financial services regulation due to the connectivity between the main domestic marketplace, the significant resource requirements needed and the more intimate understanding of micro-prudential issues with the entities supervised.

EU role

National regulators play an important role in terms of the EU regulatory landscape in addition to their "domestic" role. The EU role of national regulators is focused on two aspects, developing pan-European regulatory standards and implementing agreed measures in a coherent and consistent manner.

The first role that national regulators play in EU supervision of financial services is the fostering of convergence between both the European Commission and other national supervisory authorities. This is reflected in Level 3 of the Lamfalussy structure where

[94] House of Lords, European Union Select Committee, 'The Future of EU Financial Regulation and Supervision', 14th Report of Session 2008-2009, 9 June 2009, para 26.

historically the Level 3 committees brought together national supervisors and the European Commission to act as fora for information exchange between supervisors, foster supervisory convergence and formulate best practice. This was necessary in order to develop a common approach to regulatory practice and implementation of measures taken to build the Internal Market in financial services. Without a consistent approach by national regulators it would be difficult for financial services business to operate across national borders and, in some instances, divergent national implementation and approaches could lead to a dismantling of the Internal Market by the back door.

This consultative and standard-setting role has been somewhat modified by the introduction of the ESAs. By developing more technical standard setting and regulatory guidance at the level of the ESAs, national regulators have a less official role to play in this area. Instead of being the entities responsible for setting standards, national regulators will feed into the ESA structure and provide knowledge resources for the development of European-level practices and standards. This was thought necessary following the 2007 financial crisis wherein the patchwork approach to standard setting by national regulators, with an implicit focus on their own jurisdictions, meant that more systemic concerns were not addressed and led to a number of unsustainable business practices in the financial services sector going unnoticed prior to the crisis. This is an important development as member states have decided to move regulation and rule making from the national to the EU level, leaving national competent authorities in a more supervisory role.

Regardless of any role in standard setting, national regulators continue to play the main role in implementation and enforcement of EU measures taken to develop the Internal Market in financial services. As discussed, national regulators have a significantly higher level of resources and connection to their local marketplace than the European Commission or the ESAs. In addition, national regulators have the legal enforcement powers required in order to ensure compliance with EU Internal Market legislation which is not made available to EU-level regulators under the current treaty structure. While this undoubtedly increases the breadth of regulatory reach and enforcement of EU measures, it does have the effect that EU Internal Market measures are almost wholly reliant upon national authorities for their enforcement.

Analysis

National regulators have historically played a key role in the implementation and oversight of financial services regulation in the EU, in particular for micro-prudential regulation. This micro-prudential focus is largely appropriate as national regulators tend to have the closest connections to both the locally regulated entities and the local market practices in their jurisdiction. Most importantly, national regulators have the resources and legal tools available to act effectively as a supervisory enforcement agency to a much greater extent than European-level regulators. Therefore, national regulators remain the backbone of financial services regulation in the EU and perform a pivotal role in implementing and policing the Internal Market in financial services.

In spite of the large role that national regulators play in the EU financial services landscape, the dynamics of the EU's Internal Market in financial services are changing and the increased role of the EU in standard setting and the increased use of hybrid legislation which is part directive and part regulation has meant that a degree of regulatory flexibility and discretion has been taken away from national regulators. National regulators are becoming the competent authorities responsible for supervision but not regulation.

II. THE ROLE OF EU REGULATORS

Summary

The role of EU level regulators has changed dramatically in the years since the global financial crisis began in 2007. The establishment of the European Supervisory Agencies from their predecessors in the Lamfalussy Process has meant that a greater level of standard setting and regulatory convergence is occurring at European level. This can be welcomed from the point of view of a single European rulebook and consistent implementation of financial services measures. However, the increased role of regulation at the EU level, in particular with respect to the euro area and banking union, means that there are a number of potential conflicts between the supervisory aspect of EU level regulation and the standard setting and regulatory convergence aspect of creating a coherent Internal Market in financial services within the EU. This tension is of paramount concern and one where the UK should play an active role in ensuring the integrity of the Internal Market.

Historic role

Before the 1992 programme in financial services, the role played by EU regulators was minimal. The European Commission maintained an oversight role in terms of its position as guardian of the Treaties and could take action against national governments for failure to implement legislation properly and also provide guidance on certain regulatory topics to encourage a common approach to regulatory issues. However, this system had its limits in terms of efficacy and, with the introduction of the Financial Services Action Plan in 1999, it was thought that a better system of EU regulatory practice was needed. At this point Alexandre Lamfalussy, the Belgian central banker who was President of the European Monetary Institute (the forerunner to the European Central Bank) from 1994 – 1997 and the Chair of the Committee of Wise Men from 2000 – 2001, oversaw the creation of a legislative process to help improve the creation and functioning of EU legislation, including developing the role for EU level regulatory convergence to supplement the Internal Market measures being taken at the time; this became known as the Lamfalussy Process.

The Lamfalussy Process

The process was launched in 2001 with the purpose of strengthening and harmonising the supervisory framework for the European regulatory and financial sector, and streamlining the approach to adopting financial services legislation. It originally consisted of four 'levels', with an additional level introduced by the Lisbon Treaty. Level 1 is the adoption of framework legislation by the European Parliament and Council of the EU. The concept of framework legislation is that the lawmakers set out the political and legal objectives of the legislation itself but leave the detailed technical implementation to Levels 2 and 3.

Level 2 of the Lamfalussy Process envisaged the adoption of detailed implementing measures by the European Commission, advised by three advisory committees, The Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR) (together known as the "Advisory Committees"). These implementing measures set out technical details but are not intended to make substantive political decisions. Level 3 is the issuance of non-binding guidance by the Advisory Committees to facilitate the consistent implementation of legislation in the member states, ensuring effective cooperation between national supervisory authorities and convergence of their practices. Finally, Level 4 is enforcement of and compliance with the legislation, led by the Commission but also largely reliant upon member state competent authorities.

Post-crisis and De Larosière Report

Following the 2007 global economic crisis, the European Commission convened a group of experts to discuss how the regulatory structure in the EU could be improved following the financial crisis. This led to the publication of the De Larosière Report[95], named after Jacques de Larosière – former Managing Director of the International Monetary Fund (IMF) and Governor of the Banque de France – who chaired the panel.

The Report concluded that the EU needed better coordination of both macro- and micro-prudential regulation to establish a more efficient, integrated and

[95] The High Level Group on Financial Supervision in the EU, 25 February 2009.

sustainable European system of supervision and also to reinforce cooperation between European supervisors and their international counterparts. The Report proposed the creation of two bodies at EU level: a European Systemic Risk Council (ESRC) and a European System of Financial Supervision (ESFS). The ESRC would act as a macro-prudential supervisory body to analyse information on the macro-prudential situation and monitor risk in all financial sectors. Risk warnings would be passed on to micro-prudential supervisors to take action to ensure that risks are mitigated. The ESFS would be based on the upgrading of the Advisory Committees to perform a more active role in organising and guiding expanded colleges of supervisors (meetings of representatives of all national supervisors) and in reviewing the standards of national supervisors in the first instance. Then, a second stage would turn the Advisory Committees into three new authorities (Banking, Insurance and Securities), so the ESFS would consist of national competent authorities and the ESAs. Day-to-day supervision of financial firms would remain at a national level while the ESFS would play a largely coordinating role with a number of increased powers:

- Developing draft proposals for technical standards – to help to ensure more consistent rules within the EU, working towards a common rulebook.
- Facilitating exchange of information and agreement between national supervisory authorities, and where necessary, settling any disagreements, including within colleges of supervisors – to ensure supervisors take a more coordinated approach.
- Contributing to ensuring consistent application of Community rules – to ensure incorrect or inconsistent application is dealt with quickly and effectively;
- Exercising direct supervisory powers for credit rating agencies.
- Co-ordination and some decision-making in emergency situations.

The European Commission has described this type of system as a "hub and spoke" type of network of EU and national bodies. This is a much more formal relationship between EU level regulators and national regulators than hitherto.

In December 2010 a series of regulations were adopted to create the three ESAs, the EBA[96], the European Insurance and Occupational Pensions Authority (EIOPA)[97] and ESMA[98].

The ESAs are intended to safeguard the stability of the EU's financial system and are composed of expert representatives from each member state as well as their own permanent staff resources. The EBA is responsible for ensuring effective and consistent prudential regulation and supervision across the European banking sector in order to safeguard its integrity, efficiency and orderly functioning. The EIOPA is primarily responsible for protecting insurance policyholders and pension scheme members, as well as for ensuring the transparency of markets and financial products. ESMA is tasked with ensuring the proper functioning of securities markets, in particular by fostering supervisory convergence among securities regulators, and enhancing investor protection.

The "Omnibus Directive" of 2010[99] incorporated the ESAs into the new European System of Financial Supervision. In 2011, the Joint Committee of the ESAs was established to aid cooperation between the ESAs and to ensure consistency across their practices.

New roles

Since the development of the ESAs a number of measures have been taken to further bolster their role beyond pure standard setting and co-ordination. The most significant development in this area has been the expansion of ESMA's role into direct supervision of institutions. ESMA has been made exclusively competent for the registration and supervision of Credit Rating Agencies (CRAs) in the

[96] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority).
[97] Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority).
[98] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority).
[99] Directive 2010/78/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 98/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC and 2009/65/EC in respect of the powers of the European Supervisory Authority (European Banking Authority), the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority).

EU and, following the entry into force of the European Market Infrastructure Regulation (EMIR), ESMA has to assumed responsibilities in the area of post-trading, including direct supervision of trade repositories; saying which OTC derivatives should be subject to the clearing obligation; setting up and maintaining the register for the clearing obligation; participation in the supervisory colleges for Central Counterparties (CCPs); determining recognition of third country CCPs; and possible direct reporting to ESMA of derivatives transactions that cannot be registered by trade repositories.

Banking Union

"Banking union", comprises three core elements:

- A Single Supervisory Mechanism (SSM) to ensure that the supervision of banks in the euro area is equally effective in reducing the probability of bank failures and preventing the need for intervention by joint deposit guarantees or resolution funds.
- A Single Resolution Mechanism (SRM), with the aim of ensuring the orderly winding-down of non-viable institutions, thereby protecting taxpayer funds.
- A Single Deposit Insurance Scheme to strengthen the credibility of the existing arrangements and serve as an important assurance that eligible deposits of all credit institutions are sufficiently insured.

These elements are intended to eliminate the feedback loop between banks and sovereigns which encourages the concept of "too big to fail" and allows private bank solvency issues to affect the public finances of a state. banking union has been mooted as a step towards a "Genuine Economic and Monetary Union"[100] which may also at some stage include a euro area budget, a euro area finance minister and other elements.

The main aspect of banking union which has developed so far is the Single Supervisory Mechanism which was formally agreed in October 2013 through two regulations which confer supervisory responsibility on the ECB[101] and modify the role of the EBA[102]. The SSM will cover all (approximately 6,000) banks in the euro area. The degree of direct supervision by the ECB and the role played by national supervisors will vary according to the size of banks, but the ECB will be responsible for ensuring appropriate monitoring of all banks. In particular, the ECB will have responsibility for direct supervision of the three most significant banks in each euro area country, banks having assets of more than €30 billion or constituting at least 20 per cent of their home country's GDP or which have requested or received direct public financial assistance from the European Financial Stability Facility (EFSF) or the European Stability Mechanism (ESM).[103]

While the SSM will cover all banks in the euro area, national supervisors will have responsibility for day-to-day supervision of less significant banks. The work of national supervisors is integrated into the SSM: for instance, the ECB will send general instructions to national supervisors, and national supervisors have a duty to notify the ECB of supervisory decisions of material consequence. Non-euro members of the EU cannot become full members of the SSM but can enter into a "close cooperation agreement" whereby their banks would be supervised by the SSM and those members would have a seat on the ECB's Supervisory Board, but not its Governing Council.

Analysis

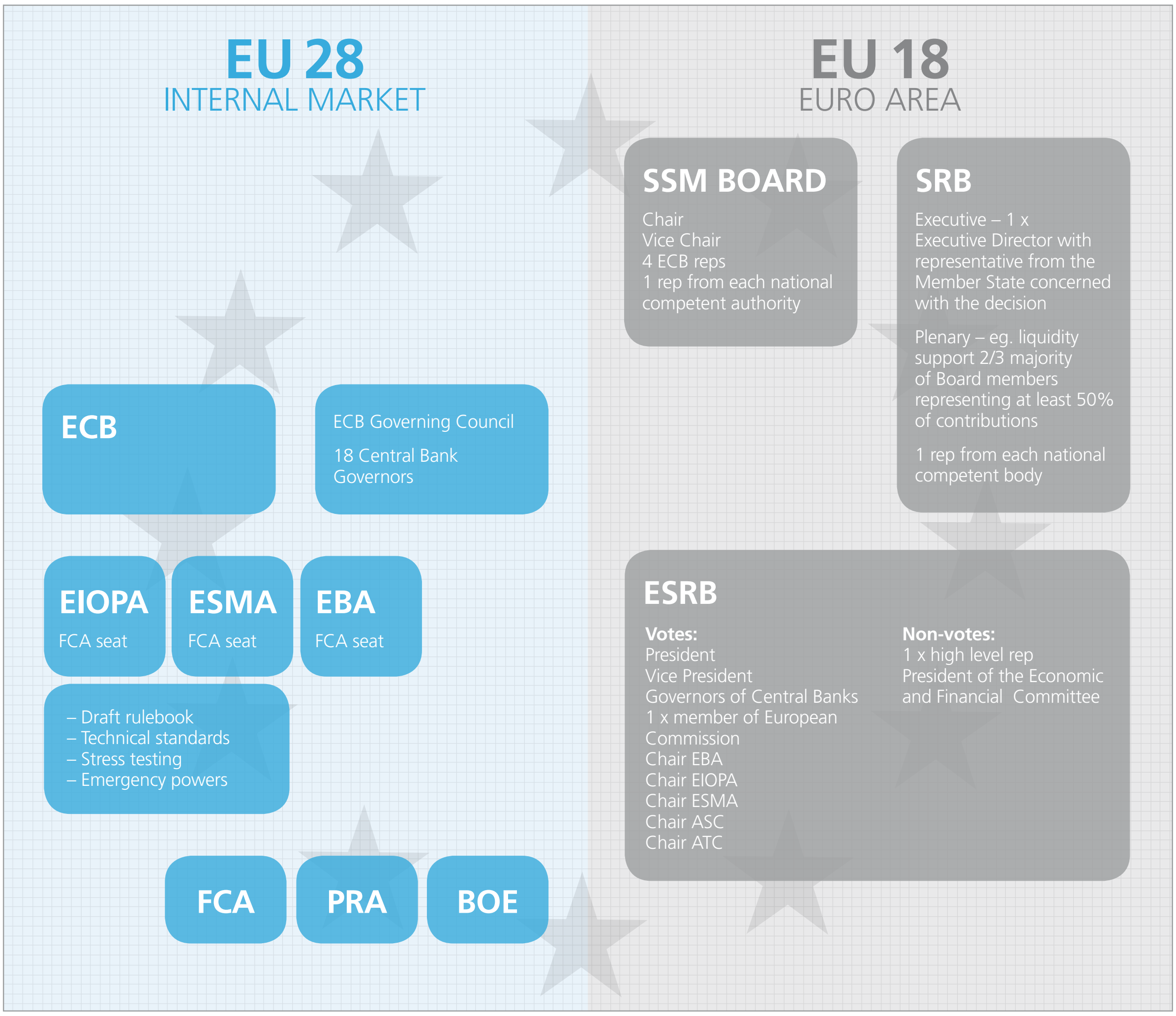
This move to European-level supervision is a significant shift from the historic norm of EU financial services regulation, in particular with respect to the supervisory role to be played by the ECB in the context of banking union. The development of the Lamfalussy Process into the ESRC and ESFS is a logical one and the development of a single rulebook could assist the development of the Internal Market in financial services. There are tensions inherent in the development of the Internal Market under the European System of Financial Supervision at the same time as the development of the Single Supervisory Mechanism. These are highlighted by the potential conflict between the supervision of the euro area and the role of the EBA in setting standards for banks throughout

[100] European Council, "Towards a Genuine Economic and Monetary Union", Report by the President, EUCO 120/12, 26 June 2012.

[101] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

[102] Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No 1024/2013.

[103] European Commission, 'Legislative package for banking supervision in the Eurozone – frequently asked questions', MEMO/13/780, 12 September 2013.



the EU's Internal Market. The safeguards secured by the UK government to protect the Internal Market through the adoption of double-majority voting in respect of key decisions, including on standards applying across the Internal Market – with the need to be approved by a simple majority of members of the EBA Board of Supervisors of both euro area and non-euro area member states, are important[104], however this is on the face of it a temporary solution since the double-majority voting mechanism will be reviewed once the number of non-euro area member states falls to four and it is also politically subject to change as the mechanism is subject to QMV in the ordinary legislative procedure.

[104] House of Lords, European Union Committee, '"Genuine Economic and Monetary Union" and the implications for the UK, House of Lords European Union Committee', 8th Report of Session 2013-2014, 11 February 2014, para 37.

III. THE EU LEGISLATIVE CYCLE

Summary

The EU legislative cycle can be both long and complex, especially in respect of financial services legislation. While the fundamental basis for EU legislation in this area is the "normal" co-decision procedure with legislation being passed jointly by the European Parliament and the Council of the EU, there are a number of features which make the legislative cycle for financial services unique. This is largely due to the existence of the Lamfalussy Process and the increased use of delegated and implementing acts to fill in large areas of technical detail in financial services legislation.

In addition to the complicated process of adopting and effecting EU legislation, the review process of legislation can sometimes mean that once a piece of legislation has bedded down within the industry, a review is taking place and new legislation in the area is being planned.

Both the complicated process of crafting legislation and the piecemeal approach to reviewing it can be difficult for financial services businesses to deal with. Therefore, consideration should be given to making the process as effective and proportionate as possible.

Framework of the legislative cycle

Overview of the legislative cycle

The European Commission has the "right of initiative" to propose new legislation to the European Parliament and the Council of the EU. The Commission is involved at every stage of the legislative process and maintains the right to amend or withdraw its proposal if it considers it is justified in the general interests of the Union. The European Parliament and the Council of the EU must agree on an identical text for a proposal to be adopted.

The Commission prepares legislative proposals both on its own initiative and at the request of others, including the European Parliament, the Council of the EU (also known as the Council of Ministers – which co-legislates with the European Parliament) or the European Council (the meeting of Heads of State and Government, which sets strategic direction but is not a legislator).

Proposals may arise from Green Papers, which are discussion documents published by the Commission that invite interested parties to contribute views and information on a particular topic. Key Green Papers in relation to financial services over recent years include papers on long-term financing of the European economy (published 2013), corporate governance in financial institutions and remuneration policies (published 2010), Retail Financial Services in the Internal Market (published 2007) and Financial Services Policy (2005-2010) (published 2005). The Commission conducts consultation before submitting any proposal, including an impact assessment and, as appropriate, consultations with experts, national organisations and non-governmental organisations. Additionally, different Commission directorates are consulted to ensure that all aspects of the issues to be addressed are considered. The Commission then presents the proposed legislation.

Under the ordinary legislative procedure, the Commission submits a legislative proposal to the European Parliament and the Council of the EU. The President of the Parliament will refer the proposal to a parliamentary committee, for financial services measures this is most often the Committee on Economic and Monetary Affairs, which appoints a rapporteur. The rapporteur is responsible for compiling a draft report containing proposed amendments to the proposal, including input from other committees as relevant. This report must be approved by the lead parliamentary committee and by the full Parliament at plenary session before being sent to the Council of the EU. The Council's position is prepared by a working party made up of representatives from each member state, which then reports to the Committee of Permanent Representatives (Coreper) for it to prepare the Council decision taken at ministerial level. Proposed financial services legislation is discussed and voted on by the Economic and Financial Affairs Council of the EU (Ecofin), composed of the member states' economic and financial ministers. If the Council of the EU agrees with the European Parliament's amendments, the proposal is adopted. Alternatively, the Council of the EU may adopt further amendments, requiring the proposal to be considered again by the European Parliament and, if the European Parliament proposes additional changes, the Council of the EU must consider these again. If the two bodies do not agree on a text during this second reading, the proposal is sent to a conciliation committee, comprised of representatives from the Parliament and Council, which must produce a joint text within six weeks or else the proposal falls.

In practice, the Commission usually puts forward financial services legislative proposals to the European Parliament and Council of the EU for simultaneous review with the aim of reaching a "first reading agreement". The two bodies both prepare their positions as outlined above to enable the Commission, European Parliament and Council of the EU to hold informal so-called trilogue meetings with the aim of agreeing on a common position and text. This text must then be formally approved by the Parliament, at full plenary session, and the Council of the EU in its relevant ministerial committee.

The approved legislation is then translated into the 24 official languages of the European Union and usually enters into force 20 days after its publication in the Official Journal of the European Union (OJEU). Member states are required to transpose directives into national law, usually within two years. The Commission provides member states with further detail on the transposition of financial services legislation in order to facilitate consistency in implementation across the EU.

Delegated acts and implementing acts

The Lisbon Treaty introduced two key changes to the Lamfalussy Process: first, to redefine certain secondary legislation as delegated acts and, second, to give additional powers to the ESAs. Prior to the Lisbon Treaty, the European Parliament and the Council of the EU did not have veto rights over any implementing measure introduced by the Commission at Level 2 to provide extra detail to Level 1 legislation. The Lisbon Treaty redefined secondary legislation that is deemed to be of a "quasi-legislative" nature as delegated acts[105] and, as such, gave the European Parliament and the Council of the EU each the right to veto such acts.[106]

The ESAs may also be given the power to propose legally binding technical standards to support the Commission in developing level 2 legislation, introducing a so-called Level 2+ in the Lamfalussy Process. Additionally, implementing acts[107] provide the European Commission with powers to create binding legislation to give effect to legally binding EU acts. These technical standards co-exist with the detailed delegated implementing acts created by the Commission at Level 2 of the Process. The ESAs may be mandated by the European Parliament and Council of the EU to produce regulatory technical standards for delegated acts and implementing technical standards for implementing acts. Essentially, this power is intended to give the ESAs, who have specific technical expertise, the responsibility to establish harmonised rules. The ESAs' standards and guidelines are only recognised once they have been adopted by the Commission.

The Commission adopts delegated acts to make changes of general application which supplement and amend non-essential elements of a piece of legislation. The European Parliament and the Council of the EU have the power to veto or revoke delegated acts as, although they involve technical rather than political or strategic provisions, they are deemed to be of "quasi-legislative" character and can have significant practical impact on the nature and scope of implementation of the legislation. In line with this, the European Parliament and the Council of the EU may also reject regulatory technical standards proposed by an ESA. By contrast, the Commission uses implementing measures to provide uniform conditions for implementing Level 1 legislation; for example, to define technical requirements for a specific product or certain product codings and identifiers. The European Parliament and the Council of the EU have general rights to scrutinise any financial services businesses implementing measure introduced by the Commission, and any implementing technical standards proposed by an ESA; however, they do not have a right of veto over such measures.

[105] See Article 290(1), TFEU.
[106] See Article 290(2), TFEU.
[107] See Article 291, TFEU.

Reviews and updates to legislation

Apart from the range of measures taken to address the global financial crisis since 2007, there is often the perception that there is a seemingly endless flow of legislation from the EU in respect of financial services. Indeed, much of what has been adopted since 2007 has been to address perceived deficiencies in financial regulation following the crisis (for example, EMIR, CRD IV, and the Short Selling Regulation). However, a significant driver of EU financial regulation has been the reviews and updates to legislation adopted in the normal course of business. For example, the original MiFID contained a number of provisions requiring the European Commission to report on the application of the directive and whether any changes or updates would need to be made to the legislation.[108] As a result of this, the Commission has proposed a substantive revision of MiFID along with a new accompanying regulation to address certain perceived deficiencies in the original directive. Such review clauses are increasingly common and mean that legislation such as UCITS, CRD IV, EMIR and others have built in review clauses and the proliferation of these can be of significant difficulty for businesses in trying to navigate the constant cycle of reviews and updates to legislation.

Analysis

The use of ESAs to draft large amounts of technical detail for financial services legislation is likely to be the preferred way of working for financial services legislation for some time to come. This is understandable considering the agreement to develop a common EU rulebook in relation to financial services and develop the Internal Market. However, the use of the ESAs to develop this level of technical standard has been difficult for many market participants. The ability for firms to plan for change and adapt their systems and practices can only be undertaken once they have a clear idea of how the legislation will be implemented. Given that technical standards can take a long time to develop and legislators are increasingly placing reliance on the ESAs to fill in large gaps in legislation, it will be important for EU legislators and regulators to reflect on the increasing use of such technical standards and apply implementation deadlines appropriately in order to ensure that financial services firms can adapt their operations in a timely manner to ensure compliance with legislation.

There is an obvious need to have an effective process in place to review and update legislation to make sure it can keep pace with changing circumstances and address any deficiencies or unintended consequences. There is scope for a more cohesive approach to such reviews and updates. The European Parliament, for example, has requested the European Commission to undertake such reviews in a co-ordinated manner, highlighting the linkages between different legislation and reviews along with providing a more transparent roadmap of how these are to be undertaken.[109]

[108] See Article 65, MiFID.
[109] See the conclusions of the European Parliament, Committee on Economic and Monetary Affairs, 'Enhancing the coherence of EU financial services legislation', 10 February 2014.

IV. EEA + EFTA ACCESS TO THE EU'S INTERNAL MARKET IN FINANCIAL SERVICES

Summary

Historically the EU's Internal Market in financial services has extended to certain EFTA member states as part of the European Economic Area Agreement ("EEA Agreement"). However, this extension is not automatic and since 2010 and the establishment of the ESAs, there has been an increasing divergence between the EU's Internal Market in financial services and the access permitted to it under the EEA Agreement. Unfortunately, it is not clear how this will be resolved and there is a risk that continued access by EFTA members to the Internal Market in financial services could be in jeopardy.

Historical access

The EEA Agreement created the European Economic Area on 1 January 1994, which incorporated all EU Internal Market legislation in the non-EU states of the EEA, sometimes referred to as the EEA/EFTA States[110]. The EEA Agreement:

- Incorporates EU legislation relating to the four key freedoms and also includes "horizontal" policies such as those relating to consumer and investor protection, company law and entrepreneurship.
- Ensures that all EEA member states can enjoy equal rights and obligations associated with the four key freedoms.
- Includes observance of case law rulings given by European Court of Justice prior to the establishment of the EEA (i.e. before 1992) to assist with interpretation of the Agreement's provisions. The EEA Court must pay due account to the principles laid down by the European Court of Justice.
- Excludes EU legislation relating to the customs union, common trade policy, direct and indirect taxation and economic and monetary union.

Since the EEA Agreement is intended to cover the entirety of the Internal Market, historically it has included the Internal Market in financial services as "EEA relevant" legislation. However, EU law is only binding as EEA law once it is included in the relevant Annex or Protocol to the EEA Agreement by decision of the EEA Joint Committee. Key financial services legislation has been adopted in this manner throughout the EEA, including MiFID and the Banking Consolidation Directive which means that the Internal Market in financial services has traditionally extended to the EEA/EFTA States.

Post-2010 access

The regulations establishing the ESAs have not been submitted to the EEA Joint Committee for consideration. This seems to be because the increased regulatory and supervisory capacity of the ESAs are not catered for in the EEA Agreement, in particular since the three EEA/EFTA States do not have a role in the supervisory structure of the ESAs. Consequently, key EEA-relevant legislation (notably, EMIR, REMIT and the Short Selling Regulation) has not yet been adopted by the EEA.

The EEA Council, which convenes representatives from both the EU states and the EEA/EFTA States, has noted that there are serious constitutional challenges to the implementation of the ESA regulations in the EEA/EFTA States and until such constitutional considerations are resolved, the EU's Internal Market in financial services will remain fragmented and EEA/EFTA access will be inhibited.[111] This is illustrated by actions taken by certain EEA/EFTA clearing houses, such as Oslo Clearing, to seek recognition as a third country CCP under EMIR, instead of as an EEA authorised CCP. This suggests that financial services legislation which is in the process of being finalized such as AIFMD, CRD IV/CRR, MiFID2/MiFIR and MAD II/MAR would not be extended to the EEA/EFTA States and thus create a significant split in the European market for financial services.

Analysis

The divergence between the EU's Internal Market in financial services and the financial services measures implemented in the EEA/EFTA States poses a significant problem for the development of an expansive and

[110] These are Iceland, Liechtenstein and Norway.
[111] EEA Council, Conclusions of the 40th meeting of the EEA Council, EEE 1611/13, 19 November 2013, para 13.

open Internal Market. The role played by the ESAs is fundamental to the development of a single European rulebook and has the potential to simplify and strengthen the Internal Market in financial services. However, the ESAs' incompatibility with the EEA Agreement means that the interests of the EEA/EFTA States and their ability to participate in the Internal Market for financial services is seen as secondary in importance to the cohesiveness and unified approach taken within the EU itself.

In the context of the UK's position, it is noteworthy that membership of EEA/EFTA would not guarantee access to the EU's Internal Market in financial services.

There is an open question as to whether this is an example of what is increasingly likely to happen in circumstances where a cohesive inner group (namely the euro area) agrees to implement legislation which would effectively exclude those on the outside from certain aspects of the Internal Market.

V. THE IMPORTANCE OF THE G20 AND BASEL FINANCIAL ACCORDS

Summary

International standard-setting bodies and financial accords have always played a role in the landscape of financial stability and regulation as globalisation developed.

However, since 1999 and after the global financial crisis, there has been an increased drive to coordinate financial services regulation and strategic decisions at a global level. The increasing use of such fora for strategic decision-making poses both challenges and provides opportunities for the UK. Currently the UK enjoys double representation through EU membership in addition to being involved in its own right.

Role of international accords

International financial accords play an important part in the globalisation of financial services and have a significant impact upon the EU's Internal Market in financial services. There are an assortment of international organisations whose decisions, policies and guidelines have an impact on global financial markets, including the International Labour Organization (ILO), the IMF, the OECD, the United Nations (UN), the World Bank and the WTO. However, there are three organisations, in particular, which have had a significant impact on the EU's Internal Market in financial services and merit further discussion; namely the Group of Twenty (G20), the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) based out of the Bank for International Settlements (BIS).

G20

TThe G20 is now the main forum for international economic cooperation between its 19 member countries[112] and the European Union. The G20 started in 1999 as a meeting of finance ministers and central bank governors in the aftermath of the Asian financial crisis. In 2008, the first G20 Leaders Summit was held to respond to the global financial crisis. Since then G20 leaders have met annually, with additional meetings during the year

[112] Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom and the United States of America.

between finance ministers and central bank governors. These meetings discuss ways to strengthen the global economy, reform international financial institutions, improve financial regulation, as well as the key economic reforms that are needed in the member countries.

The G20 itself has no legal status in international law, in contrast to the World Bank or the International Monetary Fund which are established and enshrined by treaty law. The G20 does not have a permanent secretariat and the chair rotates between members and is selected from a different regional grouping of countries each year. Each chair establishes a temporary secretariat or taskforce for the duration of its term to coordinate the group's work and manage its meetings. In spite of this semi-permanent status and lack of legal foundation, it is an important international forum for global leaders, finance ministers and central bankers. It has also been the source of the strategic objectives that have led to a number of "commitments" in the area of financial services and has effectively required compliance with these commitments externally to any political process and decision-making within the participating member states. Although the "commitments" which stem from the G20 do not have any official legal status and are therefore informal, if one looks at these commitments in a wider sense, in particular as setting normative rules and public policy goals, then it is arguable that the G20 has a lawmaking role[113] and in effect legislates in the area of financial services. The legislation in response to the 2009 Pittsburgh commitments in creating requirements for OTC derivative clearing and bank capital resources show that this forum has significant weight behind it and can effectively direct financial services policy globally.

Financial Stability Board

The FSB has its origins in the Financial Stability Forum as founded by the G7 as an informal policy exchange based on best practice of regulatory authorities, treasuries and central banks. In 2009 the G20 replaced the Financial Stability Forum with a more institutional and permanent structure of the FSB, operating under the infrastructure of the Bank for International Settlements. The purpose of the FSB is to strengthen standard setting to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability. The FSB effectively acts as an implementation oversight body which tracks member jurisdictions' adherence to G20 and other international financial accords. As part of its members' commitments to adhere to international financial standards, members of the FSB[114] have committed themselves to implementing international financial standards and disclosing their level of adherence.[115] The reports on compliance with international standards, such as the G20's commitment to regulate OTC derivatives and push many contracts to regulated exchanges, is taken seriously by the FSB and it has produced a series of reports and guidance to help make progress with the reform agenda.

The FSB reports tend to be high-level reports examing how the various jurisdictions are progressing. This is due to the fact that the nature of the FSB means that such reforms will always need to be dealt with at the relevant legal and regulatory level of the jurisdictions which implement the measures. However, the FSB does act as another conduit through which the G20 and other international financial accords are pursued and jurisdictions held accountable to such commitments.

Basel Committee on Banking Supervision

The Basel Committee on Banking Supervision is the primary global standard-setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability. The BCBS Charter sets out that the BCBS is to achieve its mandate through the following activities:

- Exchanging information on developments in the banking sector and financial markets, to help identify current or emerging risks for the global financial system.

[113] Jan Wouters and Dylan Geraets, 'The G20 and informal lawmaking', Katholieke Universiteit Leuven, Leuven Centre for Global Governance Studies Working Paper No.86, 1 March 2012.
[114] Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Mexico, the Netherlands, the Republic of Korea, Russia, Saudi Arabia, Singapore, South Africa, Spain, Switzerland, Turkey, the United Kingdom and the United States of America.
[115] FSB, 'FSB Framework for Strengthening Adherence to International Standards', 9 January 2010.

- Sharing supervisory issues, approaches and techniques to promote common understanding and to improve cross-border cooperation.
- Establishing and promoting global standards for the regulation and supervision of banks as well as guidelines and sound practices.
- Addressing regulatory and supervisory gaps that pose risks to financial stability.
- Monitoring the implementation of BCBS standards in member countries and beyond with the purpose of ensuring their timely, consistent and effective implementation and contributing to a "level playing field" among internationally-active banks.
- Consulting with central banks and bank supervisory authorities which are not members of the BCBS to benefit from their input into the BCBS policy formulation process and to promote the implementation of BCBS standards, guidelines and sound practices beyond BCBS member countries.
- Coordinating and cooperating with other financial sector standard setters and international bodies, particularly those involved in promoting financial stability.

When carrying out these activities, the BCBS does not have the status of any formal supranational authority and its decisions do not have legal force. Instead, its recommendations and policies should be implemented and applied by members in their domestic jurisdictions[116] within the pre-defined timeframe established by the Committee.[117] Therefore, even though the standards set forth by the BCBS have no weight in law, the BCBS members have committed themselves to adopting them and, while absent a ratification of such obligation at domestic level, it remains a powerful force in setting the regulatory agenda for bank supervision. This can be seen most influentially in the development of capital adequacy and liquidity standards in the Basel III financial accords. These have been adopted through domestic legislation in nearly all BCBS member jurisdictions and the CRD IV/CRR legislation package in the EU largely followed the Basel III standards, with a number of additions to supplement existing banking regulation in the EU.

Representation in international bodies

The UK has representation on all three of the G20, the FSB and the BCBS both in its own right and as a member of the EU. Membership of these organisations is somewhat fluid and largely mirrors the membership of the G20 itself, although the BCBS has a wider membership. It is not clear the extent to which the UK's representation has significant influence in these organisations since decisions are largely taken by common accord and behind the scenes. There is no formal avenue for the UK to exert its influence in these bodies and it must rely upon its own persuasiveness to be effective. The slight exception is in the fact that the FSB is currently chaired by Mark Carney, the Governor of the Bank of England, however this is not a formal channel of influence – Mark Carney held this position whilst he was Governor of the Bank of Canada.

In addition to the UK's own representation in these bodies, the EU itself has representation as a bloc and aims to put forward a unified position when dealing with these bodies. For example, preparations for G20 summits take place at the European Council where the EU position is coordinated and in the past the European Council has prepared for such summits by drafting "Agreed Language"[118] or "coordinated positions"[119]. These positions have the combined weight of the EU's population and GDP, representing the world's largest economy[120].

[116] The BCBS Charter clarifies that for this purpose "domestic" also means regional jurisdictions like the EU.

[117] BCBS Charter, Article 5.

[118] See Informal Meeting of EU Head of State or Government, European Council Presidency Conclusions, 7 November 2008, 'Agreed Language'; European Council Presidency Conclusions, 7880/1/09 REV 1, 19-20 March 2009, Annex 1: Agreed language with a view to the G20 Summit in London; Informal Meeting of EU Heads of State or Government, 'Agreed Language for the Pittsburgh G-20 Summit', Brussels, 17 September 2009.

[119] European Council Presidency Conclusions, EUCO 52/1/11 REV 1, 23 October 2011, Part II 'G20'.

[120] See World Economic Outlook Database, International Monetary Fund, "Report for Selected Countries and Subjects", October 2013 retrieved 19 March 2014.

Analysis

The role played by bodies such as the G20, FSB and the BCBS are increasing and their influence over the path of financial regulation has been significant in a relatively short period of time. This is despite none of these bodies having any formal regulatory or legislative power over the UK or the EU. However, in a globalised economy, financial services markets must maintain a degree of normative continuity in order to preserve market access and uniformity of approach which these regulatory bodies espouse.

The question for the UK is therefore twofold: (i) does its status as a member of the EU enhance or detract from its ability to influence decision-making in these bodies; and (ii) would an alternative approach increase regulatory convergence and promote market access through such bodies. The former question is one where, on the face of it, the UK currently has double representation in such bodies, once as the UK itself and again as a member of the EU. In the absence of evidence to support the assertion that the common positions which have been taken by the EU in such bodies is contrary to the position taken by the UK, there is no reason to assume that the UK would increase its influence in these organisations by removing the channel of influence derived through its EU membership. The economic weight of the EU combined is many times greater than that of the UK alone. A useful example is the proposed reform of the IMF as set out by the G20. This entailed a restructuring of voting weights towards developing economies and the removal of two of Europe's permanent seats on the IMF Board. This move towards acknowledging the economic weight of developing economies as opposed to continuing preference towards already advanced economies was striking. With reduced individual positions of privilege for European states, it may be the case that more influence is had in the G20 and associated entities by acting in concert than by acting independently, but this cannot be determined with any certainty.

The second issue is whether the UK could better promote increased regulatory convergence acting outside the EU as opposed to its current position. This is difficult to determine as there is no simple way of quantifying influence and the ability to promote regulatory convergence. Again, however, following the example of the FSB Framework for Strengthening Adherence to International Standards, by "leading by example" the UK and its EU partners promote regulatory convergence within their own supranational jurisdiction which seemingly provides a powerful force for regulatory convergence within these international bodies. While the UK would be able to promote regulatory convergence on its own outside the structure of the EU, it would be doing so on the basis of its own opinion and jurisdictional rules, rather than as a member of an entity which is actively undertaking regulatory convergence within a structure of 28 member states.

“ THERE IS NO REASON TO ASSUME THAT THE UK WOULD INCREASE ITS INFLUENCE IN THESE ORGANISATIONS BY REMOVING THE CHANNEL OF INFLUENCE DERIVED THROUGH ITS EU MEMBERSHIP. THE ECONOMIC WEIGHT OF THE EU COMBINED IS MANY TIMES GREATER THAN THAT OF THE UK ALONE.

CONCLUSION

It is easy, in principle, to posit the pros and cons of the eight different scenarios outlined in part one. In practice, however, it is far more difficult given the uncertainties and the interdependencies between them.

An important common feature of the three scenarios where the UK would remain an EU member is the extent to which the UK would retain a degree of control in exercising choices, and would retain freedom to change policy or tactics if it were in the UK's interest to do so.

The common feature of the five scenarios in which the UK would leave the EU is the pattern of risk, perhaps long term business uncertainty and lack of control. Leaving the EU would itself take time, and the process by which that would take place is by no means certain. After leaving, the UK would be put in a position of having to wait to learn the result of any subsequent EU treaty or regulatory changes, which could have a major impact on the terms of trade between the UK and EU.

The reality of the UK's relationship with the EU over the coming decades may borrow parts from a number of the eight scenarios examined here and it is possible any future scenario may take a different, as yet unknown, character.

At the same time, or after leaving the EU, the UK government would need to take policy decisions on post-exit adaptations to UK law. That would entail a legislative programme which could take the life of a whole Parliament or longer. The UK would have to embark on one or more of the post-exit options either by attempting to negotiate in advance, afterwards, or even possibly by a process of trial and error in negotiations for alternative solutions with the other member states themselves affected unpredictably by the UK's exit. All these consecutive steps would involve great political, technical and diplomatic difficulty, perhaps taking several years, during which the UK's overall commercial regime would risk being subject to uncertainty and doubt.

For financial services, would any of this represent a better option than EU membership? After all, the creation of the integrated EU framework for financial services has had a marked and highly positive effect for those UK-based financial services businesses with an EU-wide or global reach, and an equally positive effect for their clients. It is easy to take this common legal framework and set of legal freedoms, developed over 40 years, for granted. Without it, however, the commercial operations of UK-based financial services businesses might well not take place at all or else might take place in a non-EU centre. Without it, too, firms from other EU member states would have far less interest in establishing in the UK, and their home country authorities (who would then view the UK as an offshore jurisdiction) might not allow it without additional regulatory safeguards. The City as it exists today functions as a market place of firms from across the EU and outside. This is made possible by the framework of Internal Market legislation. The UK, backed by its expertise in financial services, is in a position to sustain its influence on the framework, provided it is seen as committed to it. To abandon this for some untried, unknown and unpredictable alternative would carry very significant risks.

This conclusion reflects the specific strengths of the Internal Market in financial services in the EU and the benefits that it brings. Its central – and globally envied – achievement is the creation of a progressively unified market. True, this market remains a work in progress. Its greatest advantages for financial services are most apparent in the context of passporting and the scope for businesses to gain ready access to a market of 28 states and 500 million consumers. But some areas remain fragmented and underdeveloped, particularly with respect to retail markets and providing capital to SMEs. The current degree of progress in the Internal Market has been attained through a deliberate mix of eliminating barriers at their source, where possible, but mostly through a tailored blend of mutual recognition and harmonisation. This mix of approaches has been able to cater for difficult and sometimes contentious policy areas such as financial services, where products can be complex and the need for consumer and investor protection is high. It will, however, continue to be important for the balance of different approaches to be constantly weighed and adjusted, if the strategy is to have optimum effects.

Maintaining the right balance is therefore critical, not only for the UK but for the EU as a whole. If it can be maintained, it has the potential to facilitate the further development of a fully functioning Internal Market in financial and related professional services which would deepen the pool of available capital for European enterprises and provide increased choice for consumers. Influencing this balance in line with the UK's commercial interests must remain a central objective, as it will determine the future of what is the UK's immediate neighbouring home market for goods and services. The UK financial and related professional services sector is best served by the UK Government and the sector retaining full engagement with the EU regulatory process as the best way for the UK to pursue its objectives.

The state of financial regulation within the EU and globally is in a state of flux. Political and regulatory structures are having to adapt to respond to the economic realities of globalisation and financial interconnectivity. This dynamic, plus the dictates of crisis management since 2007, have led to increased regulatory convergence at a global level and increased technical convergence at the European level. While national regulators still form the cornerstone of financial regulation throughout the world, their role is steadily changing from a combined function of regulation and supervision to a role that is increasingly confined to supervision in line with norms set at a regional or global level. This is a result both of the development of supranational regulators with legal authority, such as the ESAs, and the spreading influence of strategic decisions for financial services taken in international fora.

This emerging regulatory landscape poses a number of significant dilemmas and choices for the UK. How can the UK best continue to combine the objectives of regulating its own financial services industry, maintaining access to significant global marketplaces, and retaining influence over the standards that direct the trajectory of global financial regulation? As discussed in this paper, any approach has its risks and rewards, the more so as dynamic changes are taking place.

Within the EU, developments such as banking union could have an impact on how the Internal Market operates. Outside it, there are also challenges, such as the long-term prospect of the relative waning of the influence of advanced economies, as developing economies become increasingly assertive in global fora. Without allies and the collective strength that comes from coordinated regional economic interests the UK could find itself in a difficult and isolated position. It is of paramount importance that the UK gains and keeps the means to increase regulatory convergence, preserve market access and promote the UK's interests globally.

It is clear from the scenarios examined in this paper that from a legal perspective the interests of UK financial services are most effectively safeguarded through continued membership, and reform, of the EU.

LAST WORD

Over the last year, TheCityUK has been working with a range of experts to take our understanding of the UK's relationship with the EU to the next level. Given that everything the EU does ultimately comes back to its legal basis, we asked Clifford Chance to undertake a thorough and objective legal analysis of all aspects of the UK's current relationship, and to look at other possible scenarios. It was vital to do this from the perspective of financial services.

This work clearly shows that leaving the EU would pose very significant risks. The uncertainty about what a 'no' vote in any referendum would entail is perhaps one of the most significant downside risks that has not yet been the focus of enough debate in the UK.

It is also clear from this work that the framework of EU financial services regulation is crafted far more in the image of the UK than people think. Legislation like MiFID and the Market Abuse Directive will be familiar to UK based market participants precisely because they draw so much from their UK predecessors.

The possibilities of significant reform, particularly within the EU's existing treaties, to make the EU work more effectively and to continue to drive forward the completion of the Single Market, are also considerable.

The debate about UK participation in the EU is not going to get any less controversial, and it is for that reason that it should be based on facts and rigorous analysis.

Chris Cummings
Chief Executive, TheCityUK

LIST OF ABBREVIATIONS

ASC – Advisory Scientific Committee
ATC – Advisory Technical Committee
BCBS – Basel Committee on Banking Supervision
BIS – Bank of International Settlements
CAP – Common Agricultural Policy
CCPs – Central Counterparties
CEBS – Committee of European Banking Supervisors
CEIOPS – Committee of European Insurance and Occupational Pensions Supervisors
CESR – Committee of European Securities Regulators
CFP – Common Fisheries Policy
CJEU – Court of Justice of the European Union
Coreper – Committee of Permanent Representatives
CRAs – Credit Rating Agencies
CRD4 – Capital Requirements Directive IV
DA – Delegated Act
DMV – Double Majority Voting
EBA – European Banking Authority
ECB – European Central Bank
Ecofin – Economic and Financial Affairs Council of the EU
EEA – European Economic Area
EFTA – European Free Trade Association
EIOPA – European Insurance and Occupational Pensions Authority
ESA – European Supervisory Authority
ESCB – European System of Central Banks
EFSF – European Financial Stability Facility
EMIR – European Market Infrastructure Regulation
ESFS – European System of Financial Supervision
ESMA – European Securities and Markets Authority
ESRC – European Systemic Risk Council
EU – European Union
FDI – Foreign Direct Investment
FSAP – Financial Services Action Plan
FSB – Financial Stability Board
G20 – Group of Twenty
GATS – General Agreement on Trade in Services
GATT – General Agreement on Trade and Tariffs
GDP – Gross Domestic Product
GEMU – Genuine Economic and Monetary Union
IA – Implementing Act
MFN – Most Favoured Nation
MiFID – Markets in Financial Instruments Directive
MTF – Multi-lateral Trading Facilities
OECD – Organisation for Economic Cooperation and Development
OJEU – Official Journal of the European Union
OLP – Ordinary Legislative Procedure
OTC – Over the Counter
PSD – Payment Services Directive
QMV – Qualified Majority Voting
REMIT – Regulation on wholesale energy market integrity and transparency
ROO – Rules of Origin
SME – Small and Medium sized Enterprise
SRM – Single Resolution Mechanism
SSM – Single Supervisory Mechanism
TEU – Treaty on European Union
TFEU – Treaty on the Functioning of the European Union
TTIP – Transatlantic Trade and Investment Partnership
UCITS – Undertakings for the Collective Investment of Transferable Securities
WTO – World Trade Organisation

TheCityUK

TheCityUK champions the international competitiveness of the financial and professional services industry. Created in 2010, we support the whole of the sector, promoting UK based financial and professional services at home and overseas and playing an active role in the regulatory and trade policy debate.

TheCityUK has a global export focus with a commitment to help UK based firms grow their business in other parts of the world. The financial and related professional services industry accounts for around 13% of UK GDP. Financial services employs over one million people, more than 66% of whom work outside London, and underpins the businesses that drive jobs and growth. Added together with nearly one million employed in professional services, it is easy to see the importance of a sector that employs 7% of the working population.

TheCityUK provides constructive advice and is the practitioner voice on trade policy and all aspects of taxation, regulation, and other public policy matters that affect the competitiveness of the sector. We conduct extensive research and run a national and international events programme to inform the debate. Our senior team regularly engages with regulators and policymakers at home and overseas, ensuring the sector's views are represented at the highest levels. We are focused on supporting policymakers and business to deliver the new policy ideas which will help deliver growth.

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