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> ALTERNATIVES TO MEMBERSHIP

> PROSPECTS FOR RENEGOTIATION

AUGUST 2015

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ALTERNATIVES TO MEMBERSHIP
PROSPECTS FOR RENEGOTIATION

In light of the upcoming referendum on the UK's membership of the EU, it is important to understand the nature of the UK's current status within the EU, and the alternatives. This briefing consists of a critical analysis of the alternatives to EU membership and the prospects of success for the UK's stated negotiating objectives.

Executive Summary

This paper examines eight scenarios – three where the UK remains a member of the EU and five where it is no longer a member. This paper also undertakes a critical, technical analysis, of the prospects of success for the UK's stated negotiating objectives and their implications.

Some key points that emerge from this analysis are as follows:

- The UK's current membership of the EU is already highly tailored. While the phrases "Swiss option" and "Norwegian option" are commonly used in the debate about Britain and Europe, one could just as well add "UK option" on the grounds that it is unique to Britain. The UK has full access to the Internal Market, can vote and has the right to be represented in the EU's institutions, but has secured opt-outs from policy areas such as the Single Currency, the Schengen free movement area and various Justice and Home Affairs measures.
- The UK's negotiating objectives fall under four headings: jobs and growth, safeguards for non-euro members, more powers for national parliaments and reforms in relation to migration. Reforms in all of these areas are feasible. The most legally challenging area is migration, as many of the changes proposed by the UK would require changes to the EU Treaties, which in turn would require unanimous agreement of the EU's 28 Member States. A possible way of securing the reforms would be to agree a legally binding protocol, similar to the "Edinburgh Agreement" signed in favour of the Danish in 1992, which would have immediate effect and be fully integrated into the Treaties at a later date.
- The EU is continuously changing and reforming, in terms of its institutional make-up, legal basis and policies. Reform or renegotiation is not a one-off exercise, however the UK's strategy of renegotiation has the opportunity to feed into that process, and any UK agreement could be the basis for a significant "reset" of the UK's troubled relationship with the EU.
- The UK has a strong track record of being able to influence the EU in areas where the UK has strategic interests, for example in being instrumental in creating the Internal Market, and more recently in reducing the EU's budget and achieving voting rules designed to protect the interests of non-euro members in the European Banking Authority.
- None of the alternatives to full EU membership would afford the UK the same level of market access, rights or legal protections that it is currently entitled to. The other common feature of the "out" scenarios is that each comes with a high risk of uncertainty for financial services and other areas of the UK economy as the period required to arrive at a new settlement with the EU would be complicated and extremely time consuming.

Alternatives to EU membership

	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		Partial						Partial[5]		Partial[7]		
2 EU Minus		Partial						Partial[6]		Partial[8]		
3 EU Plus		Partial										
4 EEA + EFTA	Partial[3]											
5 Bilateral agreements + EFTA	Partial											
6 Customs Union	Partial[4]	Partial										
7 UK/EU FTA												
8 WTO												

Yes No Partial

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 Access to the EU Internal Market for goods without the need for Rules of Origin.

5 The UK has the right to opt in/out of certain measures.

6 The UK would have a right to opt in/out as it saw fit.

7 The UK has a protocol that clarifies that the CFR does not create rights in UK courts.

8 The UK would retain a protocol that clarifies that the CFR does not create rights in UK courts.

Scenario 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 labelled '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.[9] 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

[9] 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.

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 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 competences[10] 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 originally signed in Rome in 1957, and often referred to as the Treaty of Rome. 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

[10] 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.

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 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 is not participating in the Single Supervisory Mechanism[11] or The Single Resolution mechanism.[12] 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.[13] These groupings could become more effective given that the Lisbon Treaty introduced 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 is increased under DMV and indeed is 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 became operational on 1 November 2014 however Member States can ask for the old system to be used until 31 March 2017. 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.

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

[11] 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.

[12] 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.

[13] 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.

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.[14] 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, with varying degrees of success.

- WON: The UK won a challenge in relation to the ECB's location policy for clearing houses dealing with large euro-based transactions in 2015.
- LOST: The UK lost a challenge in relation to the powers conferred on ESMA in the short selling regulation in 2014.
- LOST: The UK lost a challenge in relation to the legality of the Financial Transactions Tax (FTT) when it was dismissed in 2014 on the grounds that it was premature.
- WITHDRAWN: The UK withdrew a challenge in relation to the remuneration provisions contained in the Capital Requirements Directive IV.

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

[14] 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.

objectives in relation to the financial services and professional services industry.

Rationalising the European Commission

In 2014 the UK and others called for the European Commission to become more efficient. The new Commission President, Jean Claude Juncker, went a long way towards meeting that objective both in how he has organised the new Commission, and the way that the new Commission has approached its work programme. In relation to the former, there is now a "First Vice President" for Better Regulation, a post held by Frans Timmermans and five Vice Presidents, including one for "Jobs, Growth, Investment and Competitiveness", a post held by Jyrki Katainen. The New Commission's work programme differs radically to the previous work programme in that it launches only 23 new initiatives compared to an average of 130 new proposals in previous years.

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.[15] Currently, UK nationals represent 4.6 per cent of Commission staff compared to an overall population of 12.5 per cent of the EU.[16]

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.[17] 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.[18]

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.[19]

In order to increase the ability for the European Commission to further strengthen the Internal Market and respect the positions of both

[15] House of Commons Foreign Affairs Select Committee, 'The UK staff presence in the EU institutions', 25 June 2013.

[16] Ibid.

[17] Ibid.

[18] Ibid.

[19] Ibid.

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".[20]

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.

[20] 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.

Scenario II: Reform that involves 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 Prime Minister formally begun the process of being referred to as "renegotiation" at the European Council which took place on 25/26 June 2015. The UK Government has not set out its detailed negotiating objectives in public. However, the Prime Minister, Chancellor and Foreign Secretary have made various speeches and written various articles in the press setting out those objectives. Those sources, read alongside the Conservative Party manifesto provide the following objectives:

Focus on jobs and growth

Focus on jobs and growth. Continue to work towards completing the Internal Market, especially in services. Complete trade agreements, reduce the burden of regulation.

Safeguards for non-euro members

Reforms that will allow those countries that want to integrate further to do so, while respecting the interests of those that do not. It is under this heading that the UK puts its objective of no longer being subject to "Ever Closer Union" set out in Article 1 of the EU's founding treaty, the Treaty on European Union. The UK is also seeking safeguards for the Internal Market to ensure that there is no discrimination against non-euro area Member States' interests.

More powers for national parliaments

Reforms to allow national parliaments to work together to block unwanted European legislation. (Cameron Daily Telegraph article, March 2014).

Controls on migration

- EU migrants who want to claim tax credits and child benefit will have to live in the UK and "contribute to our country" for a minimum of four years.
- A new residency requirement for social housing, so that EU migrants cannot be considered for a council house unless they have been living in an area for at least four years.
- If an EU migrant's child is living abroad, then they should receive no child benefit or child tax credit.
- EU jobseekers will not be able to claim any job-seeking benefits at all.
- If jobseekers have not found a job within six months, they will be required to leave.

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 EU and the general court of the European Union.

- To contribute to the EU budget. The UK is currently a net-contributor.

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.

Analysis

The UK's stated negotiating objectives are a mix of the general and specific. If the UK were to succeed in achieving its objectives, it 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.

Focus on jobs and growth

This is not an area where reforms require changes to the treaties. Reforms in this area might include a review of the implementation of the Services Directive, completion of the Single Market in Financial Services, the development of a Single Capital Market and improved Impact Assessment procedures.[21]

Safeguards for non-euro members

A number of possible measures have been mentioned in this area. One such measure is to **remove the principle of "ever closer union" from the EU treaties or exempt the UK from its application**. Removing this would involve an amendment to the treaties. This is a totemic provision from the original treaty of Rome currently enshrined in Article 1 TEU. A previous attempt to remove it during the negotiations on the Lisbon treaty failed. In any

[21] For details of how these and many other possible reforms might operate, see *EU Reform, Detailed proposals for a more competitive Europe*, TheCityUK, June 2015, with input from Clifford Chance LLP and other interested parties. http://www.thecityuk.com/research/our-work/reports-list/eu-reform-detailed-proposals-for-a-more-competitive-europe/

event this provision has greater political than legal significance, given its general nature. At the time of writing, "ever closer union" appears 20 times in CJEU judgments.[22] Most of the cases are cited because of the reference to "ever closer union" in recital 4 of Regulation (EC) No. 1049/2001 on access to documents. 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.

However, a solution which falls short of treaty but would nonetheless be legally binding would be to enshrine what has already been said in European Council conclusions in a protocol. The June 2014 European Council conclusions included the following:

"*the European Council noted that the concept of ever closer union allows for different paths of integration for different countries, allowing those that want to deepen integration to move ahead, while respecting the wish of those who do not want to deepen any further*."

Another UK objective is to **achieve 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.

Applying this system to votes in the European Council would however require treaty change. Protection of the integrity of the Internal Market is already established in the treaties. Recently, the UK has pushed for such language to also be included in particular regulations or directives, and it was included, for example, in MiFID II. This practice could be adopted more consistently in the future[23].

One way of safeguarding non-euro members would be to create an "**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 would require treaty change. An emergency brake 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.

More powers for national parliaments

The Prime Minister has said that he wants "**National parliaments [to be] able to work together to block unwanted European**

[22] Search conducted on EUR-Lex legal database at http://eur-lex.europa.eu/ on 14 August 2015.

[23] See r22, *EU Reform, Detailed proposals for a more competitive Europe, TheCityUK*, June 2015.

legislation." 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 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 increase or decrease the required threshold.

Controls on migration

The 2015 Conservative Party manifesto set out the government's objectives in relation to migration. They can be broken down into the following five points as follows:

- EU migrants who want to claim tax credits and child benefit will have to live in the UK and "contribute to our country" for a minimum of four years.
- A new residency requirement for social housing, so that EU migrants cannot be considered for a council house unless they have been living in an area for at least four years.
- If an EU migrant's child is living abroad, then they should receive no child benefit or child tax credit.
- EU jobseekers will not be able to claim any job-seeking benefits at all.
- If jobseekers have not found a job within six months, they will be required to leave.

For a detailed discussion of the issues arising in relation to repatriation of EU social and employment law, see our previous paper, *A legal assessment of the UK's relationship with the EU: A financial services perspective*[24].

In relation to **requiring EU migrants who want to claim tax credits and child benefit to live in the UK and "contribute" for a minimum of four years** the prohibition on discrimination on the basis of nationality in the area of freedom of movement of people and access to benefits is set out in the Treaties. Article 18 of the TFEU prohibits discrimination on the grounds of nationality, articles 20 and 21 set out the right to free movement of people and article 45 sets out the free movement of workers and article 45(2) prohibits "any discrimination based on nationality between workers as regards employment, remuneration and other conditions of work and employment." The effect of the Treaty provisions is that in-work benefits extended to UK nationals apply in the same way to other EU Member State nationals.

The key pieces of legislation are Directive 2004/38/EC on the right of citizens of the Union and their family members to move and reside freely within the territory of the Member States and Regulation (EU) 492/2011 on freedom of movement for workers within the Union. Article

[24] *A legal assessment of the UK's relationship with the EU: A financial services perspective*, Clifford Chance LLP published in partnership with TheCityUK, April 2014 http://www.cliffordchance.com/briefings/2014/04/a_legal_assessmentoftheuksrelationshipwit.html

7(1) of the 2011 Regulation states that "A worker who is a national of a Member State may not, in the territory of another Member State, be treated differently from national workers by reason of his nationality in respect of any conditions of employment and work, in particular as regards remuneration, dismissal, and, should he become unemployed, reinstatement or re-employment." Article 7(2) of the 2011 Regulation states that "He shall enjoy the same social and tax advantages as national workers." This change would require treaty change and change to Directive 2004/38/EC and Regulation (EU) 492/2011.

In relation to **limiting the receipt of tax credits and child benefit to the children of workers residing in the UK exercising a treaty right**, Article 67 of Regulation (EC) 883/2004 on the coordination of social security systems states: "A person shall be entitled to family benefits in accordance with the legislation of the competent Member State, including for his family members residing in another Member State, as if they were residing in the former Member State. However, a pensioner shall be entitled to family benefits in accordance with the legislation of the Member State competent for his pension." This change would therefore require, at the very least, an amendment to Regulation (EC) 883/2004. However, it is arguable that such an amendment would amount to indirect discrimination. If that were the case, treaty change would also be required.

In relation to **preventing EU job-seekers from claiming any job-seeking benefits at all**, Article 24(2) of Directive 2004/38 says that Member States are not obliged to extend benefits that amount to "social assistance". However, relying on Article 45 TFEU, the CJEU has held that benefits which are intended to facilitate access to the labour market cannot be regarded as "social assistance" as defined by Article 24(2) of Directive 2004/83 and are accessible to job seekers from other EU Member States who have "established real links with the labour market of that state."[25] The court went on to say, "It is for the competent national authorities and, where appropriate, the national courts not only to establish the existence of a real link with the labour market, but also to assess the constituent elements of that benefit, in particular its purposes and the conditions subject to which it is granted."[26] In order to achieve this objective, it therefore appears that amendment to the Treaties and relevant legislation would be required.

In relation to **requiring EU workers to be resident in the UK for four years before allowing them to be eligible for social housing**, the current position is set out in Regulation (EU) 492/2011. Article 9(1) states: "A worker who is a national of a Member State and who is employed in the territory of another Member State shall enjoy all the rights and benefits accorded to national workers in matters of housing, including ownership of the housing he needs." Article 9(2) states: "A worker referred to in paragraph 1 may, with the same right as nationals, put his name down on the housing lists in the region in which he is employed, where such lists exist, and shall enjoy the resultant benefits and priorities." This change would therefore require, at the very least, an amendment to Regulation (EU) 492/2011. However, it is

[25] *Case C-22 Vatsouras [2009] ECR I-4585, paragraph 40.*

[26] Ibid, paragraph 41.

arguable that such an amendment would amount to indirect discrimination. If that were the case, treaty change would also be required.

In relation to **requiring jobseekers who have not found a job within six months to leave**, the current position is set out in Article 14(4)(b): "citizens and their family members may not be expelled for as long as the Union citizens can provide evidence that they are continuing to seek employment and that they have a genuine chance of being engaged." The UK could adopt a practice whereby it would deem that if a job-seeker has not found work in six months, they do not have a genuine chance of being engaged. This would however be open to challenge in the CJEU. In order to minimise the risk of challenge, an amendment to Directive 2004/38/EC would be required.

In relation to all these negotiating objectives, it is important to bear in mind that 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 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 a route that involved substantial treaty change.

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.

A Modus Vivendi?

A possible way forward for the UK is indicated by the example of Danish protocol. In 1992 Denmark rejected the Treaty of Maastricht in a referendum. At the European Council meeting held in Edinburgh in December 1992, a decision was taken that Denmark should be granted various exemptions in the areas of, citizenship, Economic and Monetary Union, Defence Policy and Justice and Home Affairs. This was known as the Edinburgh Agreement.

Denmark went on to ratify the Maastricht Treaty with the appended agreement in a referendum in 1993. The agreement had immediate effect on the treaty's entry into force on 1 November 1993. Its substance was later fully incorporated into the EU treaties.

The main difference between the Danish and the British situation is that Denmark was seeking opt-outs and derogations just in relation to itself. The UK is purporting to seek changes to the treaties that would apply to all the EU's members. It would be a reasonable assumption however, that if other EU members are not willing or minded to accept certain changes in respect of the whole EU membership, the UK may, in the alternative, be willing to accept assurances in relation to the UK.

Scenario 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.

Scenario 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?[27]

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.

[27] 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.

Rights

- The EEA Agreement[28] 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.[29] 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).[30]
- 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.[31]

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

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[28] 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.

[29] 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".

[30] 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.

[31] House of Commons library Research Paper, 'leaving the EU', 1 July 2013.

has had to implement about 75 per cent of EU law.[32] The UK would have to 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

[32] 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.

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).[33]

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.

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

Scenario V: Bilateral agreements + EFTA

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)[34] 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."[35]

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."[36]

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[34] A Free Trade Agreement is a type of international agreement which seeks to, often amongst other things, eliminate or reduce tariffs and import quotas.

[35] Council of the European Union, Conclusions on EU relations with EFTA countries, 3060th General Affairs Council meeting Brussels, 14 December 2012, para 6.

[36] Council of the European Union, Conclusions on EU relations with EFTA countries, 3213th Transport, Telecommunications and Energy Council meeting Brussels, 20 December 2012, para 31.

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.
- 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.

Scenario 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[37] 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.[38]

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.

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[37] Decision No 1/95 of the EC-Turkey Association Council of 22 December 1995 on implementing the final phase of the Customs Union.

[38] See Kommerskollegium, Swedish National Board of Trade, 'Servicification of Swedish manufacturing', March 2010.

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.

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.

Scenario 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. However, any agreement would likely include a "prudential carve out" that would allow each party to take whatever regulatory actions it deemed necessary to protect investors. Article 7.38 of the EU-Korea FTA for example provides that each party "may adopt or maintain measures for prudential reasons, including the protection of investors, depositors, policy-holders or persons to whom a fiduciary duty is owed by a financial service supplier; and ensuring the integrity and stability of the Party's financial system.[39]

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.

[39] See Article 7.38, EU-Korea Free Trade Agreement.

Scenario 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).[40] 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.[41] 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).[42]

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 not the UK independently. Absent any real precedent, it would be very difficult to contend, for agreements with exclusive EU competence that

[40] See Article 207, TFEU.

[41] 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).

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

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[43] 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.[44] 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 2015. 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 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.[45] 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

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

[44] 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

[45] House of Commons Library, 'Leaving the EU', Research paper 13/42, 1 July 2013.

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.[46] 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.[47]

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. [48]

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 considered to be quite wide provided such measures are not "used as a means of avoiding the

[46] TheCityUK, 'Key Facts about UK Financial and professional Services', August 2013.

[47] TheCityUK/IpSOS Mori, 'The City Speaks', October 2013.

[48] Google Finance, accessed on 6 January 2014 at: https://www.google.com/finance?q=GBpUSD&ei=GbvKUqqvOuWvwQpdwAE

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."[49]

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.[50]

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).

[49] Sydney J. Key, 'Trade liberalization and prudential regulation: the international framework for financial services', International Affairs 75, 1999, p 74.

[50] CEPS Special Report, 'Access Barriers to Services Markets: Mapping, tracing, understanding and measuring', June 2013.

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J201507220047584