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BREXIT, THE DAY AFTER : WHAT NOW?

A few days after the political tsunami that was the UK's majority vote to leave the European Union, it is clear that few leaders or political organizations had really thought through Thursday's vote or its consequences. The statements and analyses that have been made since then have mostly been motivated by a concern with occupying the communication space.
The different approaches will evolve as discussions are held, while for the time being the protagonists are simply looking to take advantage of the situation and further their own political agenda. The German and French left and right have already begun their bickering, ahead of their respective forthcoming elections in 2017 (Presidential and legislative in May and June for France, legislative this autumn for Germany), which will not simplify future discussions.
The purpose of this paper is to outline the legal and institutional framework which the protagonists will be navigating in the months to come (1), the possible institutional scenarii for the UK's exit from the European Union (2) and an overview of the specific stakes affecting the financial sector (3).
It will be supplemented and updated as the situation unfolds. It will also be followed in the coming days by a specific paper on French positions and changes and by a paper from our European network, the *Financial Policy Advisor* (FPA) on th situation in other capitals.

1/ The legal and institutional consequences of the UK's exit from the EU (*Brexit)*

The Treaty on European Union (TUE) provides for the possibility for a Member States to exit the European Union (EU), but leaves the terms and conditions of this withdrawal largely open to political negotiation.

- **UK's withdrawal procedure as provided by the TUE:**

Article 50 of the TUE provides for a three-phases¡ withdrawal procedure:

1) **Notification of intent**: the UK must notify its intent to withdraw from the EU to the European Council;
2) **Negotiation**: The European Council is in charge of negotiating with the UK an agreement setting out the arrangements for withdrawal. This agreement will also lay down the framework for the future relationship between the UK and the EU.
3) **Approval of the withdrawal agreement**: The agreement is concluded on behalf of the EU by the Council, acting by a qualified majority, after the approval of the European Parliament.

The Council is mandated to negotiate with the UK on all areas of cooperation with the EU (agriculture, industry, services etc).

Co-decision maker, the European Parliament (EP) will play a key role. It will be able to request information from the Council as the negotiations proceed. The Parliament might ask the Council Presidency to present the state of play of the negotiations sector by sector in front of each EP Committee and for a small group of MEPs (representing all the political groups) in every Committee to be specifically in charge of monitoring the UK's withdrawal agreement.

➢ Exit Agreement or No Agreement: what then?

The effective date of withdrawal of the UK will be negotiated: the withdrawal agreement adopted by the Parliament and the Council will set its effective date.

As of that date, the provisions negotiated and formulated in the agreement between the UK and the EU enter into force. At the same date, the Treaty, the legislative acts and other European agreements between Member States and those between Member States and third-countries (USA, Canada, Japan…) cease to apply in the UK.

If no agreement is found two years after the UK's notification of withdrawal from the EU, or in case of blocking by the European Parliament, and except in case of extension of this time period decided by the European Council acting unanimously in agreement with the concerned Member State, the EU **Directives, regulations and other treaties cease to apply for the UK**.[1]

The relations between the EU, the Member States and the UK are then ruled by the EU treaties' provisions on relationships with the "third-countries". For its part, the UK is released from all obligations provided in the European texts.

The UK exit from the EU could therefore be effective in several months, 2 years or even more. While the institutional framework provides for a two-year period (extendable) from the notification of withdrawal in which to conduct the negotiations, before the exit becomes effective, it does not impose any constraints regarding the starting date for the negotiations (the UK is free to start the countdown to its exit), or set the date of the date of effective entry into force of the withdrawal agreement, which can be before or after the end of the 2-year period.

➢ The first signs of political divergence within the EU on how to act towards the UK

Diverging voices can already be heard on the Council's side. France wants a quick Brexit and a relocation of the "continental" players (notably investment banks, markets structures, insurances etc.) and economic activities currently established in London, while Germany, through Chancellor Merkel[2] and the Netherlands have asked for some time to reflect about the next steps (so as not to draw "*quick and simple conclusions*") and seem to lean towards a balanced agreement with the UK.

The German, French and Italian Heads of State have however found a common position, on Monday June 27th in the evening, consisting in **refusing to open negotiations with the UK until the country has formally "triggered" the article 50 of the TUE** (i.e. notified its intention to withdraw from the EU), and thus to refuse to hold informal discussions in the meantime.

The **European Parliament** and the **European Commission's President** have called for the UK to file a notification of withdrawal quickly, for negotiations to begin soon and for a quick agreement to be found with the UK. The main political groups in Parliament (EPP,[3] S&D,[4] ALDE[5]) wish to channel the Brexit effects in order to avoid giving Eurosceptic MEPs across the political spectrum

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[1] This leads to the end of the free movement of persons, goods, services and capital provided to the EU Member States, notably the benefit of the European "passport" for the financial instruments and services provided in texts such as MiFID, AIFMD, UCITS…

[2] The SPD (German Social-Democrat Party) seems to favor a quick exit, a position closer to the French one.

[3] European People's Party, center-right.

[4] Socialists and Democrats, center-left.

[5] Alliance of Liberals and Democrats for Europe, centrist.

an opportunity to become stronger or or spread the idea of national referendums on the UK model ("chain reaction").

The EP, which will have to approve the agreement negotiated between the Council and the UK for it to apply, is therefore, at this stage, taking an opposition stance to an agreement that would facilitate broad and open economic cooperation with the UK. While positions may evolve, in view of their reaction since Friday June 24th, a coordination of the main political groups' declarations can be expected throughout the negotiating process.

- **The reorganization of the EU institutions' political agenda**

The Commission and the Parliament have clearly stated their intention not to let the UK referendum interfere with the EU's agenda which should not, in their view, slow it down or call it into question.

Initial statements made by the Commission, the Parliament and France call for a rapid exclusion of the UK's representatives from all European-level political and technical negotiations. Given that the UK will not be bound by the EU rules as of the day it exits, their position is that **the UK has no legitimacy to participate in political discussions regarding the EU's future, nor in the elaboration of future EU rules**.

The UK representatives will, however, **legally** remain members of the EU institutions until the implementation of the withdrawal agreement (or at the end of the 2 years following the notification of intent by the UK, except in case of extension of this period, in accordance with Article 50 of the TUE).

Even if **the Council** has not yet expressed its position on the topic at the time of writing, the scenario of rapid exclusion of the UK representatives from the political discussions in all decision-making bodies/meetings is possible.

This is indeed the rationale behind the **resignation of the UK Commissioner in charge of Financial Stability, Financial Services and Capital Markets Union since 2014, Jonathan Hill, two days after the vote**. The President of the Commission immediately reallocated his portfolio to one of the Vice-Presidents of the Commission in charge of Euro and Social Dialogue, Valdis Dombrovkis (PPE, Latvia).[6]

At the European Parliament, the **four major political groups (PPE, ALDE, S&D, Greens) wasted no time in filing, on Friday June 24th, a motion for a resolution aimed at excluding the UK MEPs**, who currently account for 10% of the Parliament, from all discussions and votes as soon as possible. This motion was adopted during an EP extraordinary session on Tuesday June 28th by 395 in favor of the resolution, 200 against, and 71 abstentions.

Another consequence of the UK withdrawal, as soon as the agreement enters into force, is that the **UK voting rights** in the Parliament and in the Council will have to be either eliminated or reallocated to other Member States.

The withdrawal of the UK from the European Union should reinforce the political influence of the countries with the largest populations: France, Germany and Italy. Reaching a "blocking minority" within the Council, which requires at least 4 Members States representing more than 35% of the EU population, will thus be more difficult. Joint Franco-

[6] The former Prime Minister of a country with little weight in the Council and without, or with only few, domestic financial services, Valdis Dombrovkis' nomination could be contested by the MEPs in the coming days.

German initiatives will therefore "mechanically" be less likely to be called into question by other Member States than before the Brexit.

- **The reorganization of the institutions' functioning ("technical" level):**

The UK's withdrawal will have a number of direct effects linked to the right of each Member States to participate in the functioning of the institutions.

The European Commission had indicated (unofficially) prior to the vote, that it would keep on UK civil servants but would no longer promote UK nationals to the level of Director and above. The contracts of Seconded National Experts (SNEs) and temporary agents who are UK nationals, who form a large pool within DG FISMA for example, are unlikely to be renewed at the end of their initial period (1 or 2 years maximum for SNEs). The status and compensation of civil servants and former civil servants from the UK should in fact also logically be included in the exit negotiations.

The nonrenewal of the UK experts could mechanically lead to strengthening the experts from the other "big" Member States: French, German and Italian.

The permanent representation of the UK with European institutions and UK officials will lose their accrediations and access rights to EU institutions.

EU agencies located within the UK (such as the European Banking Authority – EBA) would have to be relocated back in the EU before the date of application of the withdrawal agreement.

2/ Exit scenarios:

Two scenarii are possible:

a. The UK becomes a member of the European European Economic Area (EEA)

Today, four countries are signatories of this agreement with the EU: Norway, Island, Liechtenstein and Croatia (since 2014).

i. The benefits for the UK:

The EEA permits its members to benefit from the four freedoms that are the basis of the single market in the European Union: **free movement of goods**; **free movement of services** (freedom to provide services and freedom of establishment: financial services, banks, insurance, telecommunications, transport…; **freedom of movement of capital** and **freedom of movement for persons.** To benefit from these freedoms, the countries of the EEA must adopt – on an ongoing basis – **the Community acquis** in the fields covered by the free trade agreement governing the four freedoms referred to above, in particular the rules on competition and State aids, the rules associated to financial services, the protection of inventors, of consumers, of the environment etc. Subject to adopting minor legislative changes, the City of London would be able to continue its current activiteis and benefit from the "European passport" for its financial services.

The UK would be free to design its own rules and enter into cooperation agreements in respect of its agricultural and fishery policies and the introduction of its customs policy with the EU and, more generally, with third countries.

ii. Constraints:

If it becomes a member of the EEA, the UK will have to regularly "update" its legislation enabling it to benefit from the "European passport" for its economic exchanges to stay in line with European legislative changes, without being able to take part in the negotiations reserved for EU Member States.

It will also have to pay contributions to the EU budget that it will have to negotiate with the EU, and which might prove substantial (some experts have announced a contribution in the region of 80% of what the UK currently pays).

The UK would have to apply to all texts adopted by the EU institutions in the areas covered by the EEA agreement, application that would be monitored by the European Commission.

No EEA member is present in the EU institutions but they can be given the role of observers within some EU agencies (such as the financial regulatory authorities ESMA,[7] EBA[8] andt EIOPA[9]).

b. Signature of multiple bilateral agreements between the EU and the UK: narrow or broad free trade?

Several scenarii are possible depending on the scope of the free trade with the UK contemplated by the Member States.

i. Broad agreements for a free trade area between the UK and the EU

Conditions of implementation of this scenario: in the scope of a requested withdrawal in the coming days or weeks, assuming that the Parliament and/or European leaders want a quick "legal and political" exit of the UK with broad economic cooperation.

In this context, specific agreements covering areas as broad as financial services, industry, agriculture etc. are unlikely to be drafted, negotiated and entered into <u>within a timeframe of 2 years</u>. This being the case, the exit agreement might simply lay down a **general political framework**, providing for a **longer transition period** (between 3 to 5 additional years) during which European rules will continue to apply to the UK and refer to future technical negotiations, on a sector-by-sector basis.

Countries favorable to this scenario: the UK exit agreement having to be approved by the Council, acting by a qualified majority, Northern European countries (e.g. Germany, Sweden, the Netherlands...) might seek to maintain the current economic balance. Without calling into question the British vote, an agreement creating a "de facto status quo", taking the form of a longer transition period would be a possibility.

The main obstacle to this scenario is the possible blocking in the Council by the "countries of southern Europe" (prompted by France) and by the European Parliament who might try to "play for time" right up until the end of the 2-year deadline in a bid to get the UK to accept a less favorable agreement.

ii. Signature of multiple cooperation agreements on specific topics

[7] *European Securities and Markets Authority*: headquartered in Paris.
[8] *European Banking Authority*: headquartered in London.
[9] *European Insurance and Occupational Pensions Authority*: headquartered in Frankfort.

The European Union is a signatory of many agreements with third countries. Their subjects and scope are expressly defined and limited. The EU and the UK would have to negotiate and sign a plethora of agreements covering the full range of current economic interactions. Some high-level agreements along the lines of the "Comprehensive Economic and Trade Agreement (CETA) between Canada and the European Union (EU)", covering key aspects of trade with the EU could serve as a baseline for negotiations.

That agreement covers products and services, investment and public procurement. The EU-Turkey customs union agreement might also serve as a starting point for negotiations with the UK. These agreements imply "regular updates" to reflect legislative changes affecting each of the signatories. Many of the international agreements the EU concludes contain periodic review mechanisms.

In view of the upcoming elections in 2017, the likelihood of France, Italy and Germany quickly negotiating access to the European internal market on more favorable terms than those already negotiated with third countries seems low.

Government leaders are currently facing the rise in strengh of Eurosceptic parties and competition by movements within their own political families playing the sovereignty card (both on the left and right). Too favorable an agreement with the UK might play into the hands of their opposition and to the opponents of European integration. With Presidential and legislative elections looming in 2017 in France and legislative elections in Germany, and in a context of the recent electoral successes of the Five Star Movement in Italy, it seems unlikely that the signs that will be send out by the leaders of these 3 countries to their voters will in any way promote an exit from the EU. For their part, Europhobes (especially in France and Italy) and sovereignists will try and use the Brexit to strengthen their own positions.

The broad policy guidelines of any such bilateral agreements should only be laid down after the legislative elections in Germany in autumn 2017.

3/ Specific effects of the UK withdrawal on the digital sector

Digital policy makers and regulators' reactions to the result of the Brexit referendum

As policy makers in the EU institutions, Member States and UK set the stage for negotiations, the UK is about to find out who its "digital policy" allies may be throughout the uncharted territories of a potential EU-exit process.

Following the first announcements by the EU institutions' leaders, EU Commissioner for the Digital Agenda **Gunther Oettinger** and Commission Vice-President for the Digital Single Market **Andrus Ansip** called for a **quick split of the EU with the UK** so as to end the uncertainty for businesses and consumers, Mr. Ansip also wishing that the **UK remains a close partner of the EU**.

In the event of a Brexit, challenges may arise for businesses both in the UK and in the 27 EU bloc:

As large **EU digital industry associations**, *eg* CCIA, DigitalEurope, stated, the UK leaving the EU would mean **losing a strong ally in negotiations favoring pro-market rules**.

At the same time, the UK may have to negotiate **trade** agreements, notably to ensure the **free flow of data with the EU.** Yet, key MEPs **Jan Philipp Albrecht** (Greens, Germany), **Sophie In't Veld** (ALDE, Netherlands) already raised concerns that the **UK data protection and security legislation** may not pass the "adequacy" test of the EU.

The British regulator, the **Information Commission Officer (ICO)**, anticipated the difficulties ahead in a post-referendum statement that prompted UK businesses wishing to trade with EU countries to be in "adequacy" with the GDPR[10]. In other words, the regulator will push for the UK to adapt its data protection law to the GDPR, no matter the results of political negotiations.

Brexit: the specific digital industry concerns

The high level of uncertainty will have an impact on the European Commission's Digital Single Market (DSM) strategy, the data protection framework as well as other EU packages that concerns the digital industry. What that impact may be is not sure yet as it will depend of what is worked out at the highest political level in the coming months.

- **The DSM strategy**

The Commission set the milestones for the sixteen legislative and non-legislative initiatives that compose the DSM strategy in May 2015, and it will work to maintain them even in this uncertain situation, according to Director-General of DG CNECT **Roberto Viola**.

Though it is difficult to make any predictions, the few **ongoing legislative negotiations** may not be threatened, *i.e.* the revision of the Audiovisual Media Services Directive, the proposed Regulation on cross-portability, the two Directives relative to digital contracts.

In **other sensitive policy areas** such as **platforms' regulation, telecommunications**, data ownership and the Commission had decided to scrutinize the environment in 2016-2017 before coming up with any new pieces of legislation. The question now is whether the Commission will maintain this somewhat *laissez-faire* approach at a time when the **UK** will be quasi absent from negotiations, and whereas **France and Germany** are working to gather support for legislative changes.

- **Data protection framework**

Businesses, whether preparing for the implementation of the **GDPR** or wishing to trade within the EU, may lose a key pro-business national data protection regulator as an interlocutor, *i.e.* ICO. Nevertheless, the timeline for implementing the GDPR is up and running, no matter the results of the political negotiations.

However, the **Privacy Shield** negotiations may **face an even bigger impasse as now**. EU Member States have been quite opaque with regards to their position within the talk, raising the risk that the negotiation calendar suffers other delays. The next stage of the process, i.e. the vote of the Article 31 Committee on a second draft of the Privacy Shield, foreseen for the end of June / mid-July, seems compromised in spite of EU Commission officials' declarations.

The situations will need to be monitored closely as any current scenario predictions may be unrealistic in a few weeks.

- **European investments for research, development and innovation**

[10] General Data Protection Regulation, which entered into force on May 24th 2016 and will be applicable from May 24th, 2018

Until now, UK was the third biggest contributor to the EU budget. Its potential withdrawal from the EU would certainly have consequences for the multiannual programme for research, development and innovation that should follow **Horizon 2020**, the programme covering the 2014-2020 period.

In fact, the freshly launched discussions on the layout of the future programme were already haunted by the **threat of a reduced budget**, a policy that would fall in line with the public spending cuts that Member States also face. Drawing inspiration from the Juncker plan[11], other proposals push for transforming the research and innovation program **from a grant-based to a lending-based one**.

The possible exit of the UK from the EU raises the question of whether the EU Commission will use the opportunity to ask Member States to chip in more or to push for an overhaul of the programme so as to resemble the Juncker plan.

There is also a possibility that, similar to other 16 other countries, UK could pay to continue taking part in the future programme, especially as the British research community has raised alarm on the negative impact that the move will have on research in the UK.

4/ Specific effects of the withdrawal of the UK in the field of financial services.

The Economic and Monetary Affairs Committee (ECON) of the European Parliament should be making an announcement within the next few days, confirming whether it wishes to meet with the new Commissioner in charge of financial services and confirm the timeline for the adoption of legislation in the pipeline (Securitization, Money Market Funds, review of the Prospectus directive, CRD, MiFID level 2, MAD 2 etc.).

Members of the ECON Committee will doubtless want to show that the UK's exit will not affect discussions underway in their sector and there are reasons to believe that the timeline set will be respected.

Political groups will doubtless have to reallocate the rapporteur and shadow rapporteur roles of UK MEPs to other MEPs, and in particular: A. Dodds (S&D), N. Gill (S&D); N. Scott Cato (Green); Kay Swinburne (ECR) and Steven Woolfe (EFD).

The main topic that could well be affected by the UK's exit is securitization, a topic that is already being slowed down by the European Parliament which considers it to be dangerous and not very useful in terms of financing the economy, and which could fall even lower on the agenda.

More generally, the UK's exit from the discussions could have the following immediate consequences:

- Strengthen the Eurozone and more neatly align the level of common legislation;
- Strengthen the supervision of banking services through the Single Supervisory Mechanism (SSM).
- Revive discussions for a CCP resolution mecanism in the Eurozone;

[11] President of the Commission Jean-Claude Juncker launched the European Fund for Strategic Investments (EFSI) in 2015, to **mobilise private financing for strategic investments**. The EFSI has a total budget of **€16bn** (directed from EU funding instruments, complemented by a budget of **€5bn** allocated by the European Investment Bank, which should be used as a guarantee in order to **unlock additional investment of at least €315bn from 2015 to 2017.**

- Strengthen the coordination and supervisory role of ESMA and improve the French position (and that of the countries of "southern Europe") within the Board of Directors and working groups of ESMA;
- Significantly isolate countries who are not Eurozone members within the EBA (the system of a double Eurozone/non-Eurozone majority could be eliminated);
- A mandatory repatriation of certain financial services to "mainland Europe" or the Eurozone: namely, bodies directly supervised by ESMA: Credit Rating Agencies and Trade Repositories. Today, close to 80% of the ratings of European issuers are carried out in London and supervised by the FCA. The issue of strenghtening the supervision of Central Counterparty Clearing Houses (CCPs) by the Eurozone authorities should soon arise. The same applies for the supervision of major indexes used in many contracts and that are currently under the supervision of the FCA;
- Delay in equivalence decisions for third countries and the authorization of the European passport in the framework of the AIFMD (US, Canada, Japan etc.).

The most important stake will be, for financial institutions based in the UK, to benefit from an equivalent to the "passport" granted to EU countries so as to be able to carry out business in mainland Europe. To that end, European institutions are likely to require rules and supervision "*as stringent as"* those in the EU.

The EU might be able to take advantage of the UK's exit to rethink the EU regulatory model. As indicated above, EBA might leave the UK and it might be tempting for some to push for a rationalization of the constellation formed by the 3 agencies (banking, markets and insurance) and a "Twin-Peaks" system: one authority (ESMA) in charge of financial services based in Paris and the other (merger of EBA and EIOPA) in charge of banking and insurance, based in Frankfort.

UK nationals who are members of the *Stakeholders Groups* of the 3 authorities, appointed on an *intuitu personae* basis, should be able to remain in office until the end of their terms but without it being possible to renew their term of office.