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The Irrelevance of Brexit for the European Financial Market

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Abstract.

Among participants in the global financial market, Brexit is commonly painted as an almost Apocalypse-like scenario. The threat of a British exit from the European Union arguably involves a significant disruption to financial integration in Europe, will threaten the pre-eminence of London as a global financial centre, and will impose significant costs on all market participants.

This paper takes a different position on the significance of Brexit for the European financial market. I argue that, in reality, the impact of Brexit for financial services will be minuscule, if not irrelevant. Such optimism is grounded in the economic stakes for both sides, the UK and the EU27, in retaining the benefits of the European Single Market for financial services. Given the joint economic interests, a likely outcome of the Brexit negotiations will be a solution that formally satisfies the 2016 referendum result, but in substance keeps Britain closely involved in the EU financial market.

The paper borrows from past examples in EU financial market integration that saw ingenious creativity at work in facilitating a desired outcome within the existing convoluted legal framework. These past experiences lead us to predict a similar approach being used for accommodating Brexit. The broader point is then that the EU financial services framework repeatedly sees a victory of politics or economics over the law – that is, formal legal problems or structures are brushed aside when political necessities or economic exigencies so require.

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I. Introduction

There is no doubt that the result of the 2016 referendum result for the UK to leave the European Union is of epochal significance. For a first time in its history, one of the EU's Member States has deliberately decided to end its membership. After 60 years of European integration, is this now the first step towards the bloc's disintegration?

Prime Minister Theresa May has promised to respect the outcome of the referendum and to set in motion the process of withdrawing from the EU.[1] This prospect has triggered the alarm bells in the City of London, as the priced access to the EU Single Market is under threat. How exactly the future of the British relationship with the EU will look like is presently still unclear. Among the possibilities on the table is a so-called 'Norway' option, meaning membership in the European Economic Area but not in the EU.[2] An even looser attachment to the EU would be a 'Swiss option' to conclude a number of bilateral trade agreements with the EU rather than a multilateral agreement. Most radical appear strategies to position a post-Brexit UK as a 'New York' or 'Singapore', completely freed from any EU attachment, and seeking to position itself as an alternative, de-regulated jurisdiction in close proximity to the EU.[3]

In political terms, the current debate appears to be polarised between a 'hard' type of a Brexit versus a 'softer' version of the same. Whereas the exact content of

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[1] This is under the famous Article 50 procedure. TEU Article 50 provides that:

(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.

(4) For the purposes of paragraphs 2 and 3, the member of the European Council or of the Council representing the withdrawing Member State shall not participate in the discussions of the European Council or Council or in decisions concerning it. A qualified majority shall be defined in accordance with Article 238(3)(b) of the Treaty on the Functioning of the European Union.

(5) If a State which has withdrawn from the Union asks to rejoin, its request shall be subject to the procedure referred to in Article 49.

[2] See in more detail below, section II.2.

[3] For a comprehensive overview and discussion of the various options, see John Armour, 'Brexit to the European Economic Area: What Would It Mean?' Oxford Business Law Blog 19 July 2016, available at <https://www.law.ox.ac.uk/business-law-blog/blog/2016/07/brexit-european-economic-area-what-would-it-mean>.

these two terms in not entirely clear, proponents of a soft Brexit seem to favour some form of attachment to the Single Market, whereas hard Brexiteers call for a more radical end to any EU involvement altogether. If we map the four scenarios discussed above on this two-dimensional choice, it appears that 'Norway' and 'Switzerland' would be versions of soft Brexit, whereas 'New York' and 'Singapore' would be variants of a hard Brexit. The government currently appears to be poised to steer into the 'hard' Brexit direction.[4]

Whatever the outcome, the common element of all of these perspectives is that Brexit would mean a threat to the UK membership in the Single Market. It is precisely this threat which prompts serious critique from many financial market participants. Since the UK economy is so dependent on the financial sector, and since the City of London is the largest financial centre in Europe, a British exit from the European Union arguably involves a significant disruption to financial integration in Europe, will threaten the pre-eminence of London as a global financial centre, and impose significant costs on all market participants.

It is at exactly this point that this paper takes a different position on the significance of Brexit. I argue that, in reality, the impact of Brexit for financial services will be minuscule, if not irrelevant. Such optimism is grounded in the economic stakes for both sides, the UK and the EU27, in retaining the joint benefits of the EU Single Market for financial services. Given the joint economic interests, a likely outcome of negotiations will be a solution that formally satisfies the letter of the 2016 referendum result by delivering Brexit, but in substance keeps Britain closely involved in the EU financial market.

The paper borrows from past examples in EU financial market integration that saw ingenious creativity in facilitating a desired outcome within the existing complicated legal framework. The broader point is then that the EU financial services framework repeatedly witnesses a victory of politics or economics over law – that is, formal legal problems or structures are brushed aside when political necessities or economic exigencies so require.

The remainder of this paper is organised as follows. Section II. sets out by describing the worst-case scenario of a complete end to single market access and why many commentators in the present discourse fear this scenario could materialise. In contrast, section III. turns to the economic incentives of both negotiating parties and explains how a continued access to the single market would be beneficial both sides. Section IV. borrows from the historical development of EU financial integration and shows how it has repeatedly been possible to implement a desired outcome into the existing legal framework. This development suggests that

[4] Joe Watts, 'Theresa May indicates "hard Brexit" and dismisses free movement deal to keep single market access', *The Telegraph* (2 October 2016), available at <http://www.independent.co.uk/news/uk/politics/theresa-may-hard-brexit-soft-article-free-movement-deal-single-market-access-a7341886.html>.

economic imperatives will eventually trump legal formalities, and the same should be expected of Brexit. Sections V. and VI. conclude by exploring how a concrete solution may look like.

II. The doom scenario

1. No More Passporting Post Brexit

As explained above, the greatest concern for the City of London is to lose access to the Single Market. In particular, the most cherished element of it is the principle of 'passporting' for providers of financial services, which allows them to offer their products across the entire market.[5]

This principle is enshrined in the rules on free movement, as specified in the EU Treaties. Depending on the context, most relevant will be the free movement of capital, but freedom of establishment and of services may also be relevant. To illustrate, the concept of free movement of capital, governed by Articles 56-65 of the TFEU[6], holds that all restrictions on the movement of capital between EU Member States and third countries are prohibited. Put differently, EU Member States must accept capital movements from each other without imposing any restrictions on them. This requirement has long been understood as going beyond a pure discrimination-based approach to capture any potential impediments that are found to make market access more difficult.[7]

Common to all four EU freedoms – goods, services, persons, and capital – is the idea of 'home State control', according to which a product, service, or investment may be freely traded or operate across the EU once it has been lawfully admitted in one Member State. The country of origin is thus responsible for admitting a certain product, entity or service to the market, and other Member States have to trust that decision and may not impose any additional requirements themselves.

This concept has found further support and has been reinforced by a number of pieces of EU secondary legislation concerning the financial market. All major relevant laws in this field now allow passporting in the sense that once a provider of financial services has been authorised in one country, no further scrutiny elsewhere is permitted. UK authorised financial institutions can thus carry out their activities across the EU without setting up a separate entity at the destination market and/or

[5] Gavin Finch, 'Banks' Brexit Future Hinges on Passporting Rights', *Bloomberg* (20 October 2016), available at <http://www.bloomberg.com/news/articles/2016-10-19/u-k-banks-brexit-hopes-boil-down-to-one-word-quicktake-q-a>.

[6] Treaty on the Functioning of the European Union.

[7] See, for example, case C-98/01 *Commission v UK* [2003] ECR I-4641 (the BAA case) concerning a rule which limited the acquisition levels in shares. This was not discriminatory, but held to deter foreign investment.

obtaining authorisation in each EU Member State. This allows the financial services industry to operate with a branch structure across Europe, or even to offer cross-border services directly to clients. Once a financial product has been authorised by one Member State, it can be marketed freely across the Union. Examples are the well-known cornerstones of the EU financial market framework known as the Markets in Financial Instruments framework (MiFID/MiFIR)[8], the Capital Requirements Directive IV (CRD IV)[9], the Payment Service Directive II (PSD II)[10], the Second E-Money Directive (2EMD)[11], the Insurance Distribution Directive (IDD),[12] the UCITS framework for funds[13], and the Alternative Investment Fund Managers Directive (AIFMD)[14].

The passport concept has been very attractive for financial institutions based in London, as it contributes to substantial costs savings for pan-European groups. In fact, the regime has even allowed third-country operators, for example from the US or from Japan, to set up a single subsidiary in London and serve the entire EU from there. For example, it is estimated that the top five US investment banks (Goldman

[8] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (MiFID II), [2014] OJ L173/349; Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (MiFIR), [2014] OJ L173/84. Both instruments are due to apply from 3 January 2018.

[9] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (CRD IV), [2013] OJ L176/338.

[10] Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC (PSD II), [2015] OJ L337/35, due to apply from 13 January 2018.

[11] Directive 2009/110/EC of the European Parliament and of the Council of 16 September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC (2EMD), [2009] OJ L267/7.

[12] Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution (recast) (IDD), [2016] OJ L26/19, due to apply from 23 February 2018.

[13] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast), [2009] OJ L302/32, as amended by Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions, [2014] OJ L257/186.

[14] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (AIFMD), [2011] OJ L174/1.

Sachs, JP Morgan, Citigroup, Morgan Stanley, Bank of America Merrill Lynch) locate about 90% of their European operations in the City.[15]

Against this backdrop, it is understandable that the loss of passporting rights is one of the greatest worries of UK-based financial institutions and of third-country firms which operate through London.[16] A formal exit from the EU would bring the application of the passporting framework to an end, and UK-based institutions would have to encounter much higher costs of operation – for example, by setting up another subsidiary within the remaining EU27.

2. No alternative – EEA membership or bespoke arrangement

By some accounts, the 'Norway model', or some variant on it, has been put forward as an alternative and viable destination for post-Brexit Britain.[17] As a member of the European Economic Area (EEA), Norway (along with Iceland and Liechtenstein) has full access to the EU Single Market. At the same time, Norway is not part of the political structures of the EU, an arrangement which should also appear attractive to the UK. So the country does not subscribe to justice and home affairs, it is not under the obligation to join the single currency and is not part of the common agricultural policy nor fishing. And Norway is also free to agree its own bilateral trade deals with third countries. It has control of its fisheries too.

Although all EU Member States presently are members of the EEA, the EEA agreement is formally separate from the EU Treaties. The UK thus would have to also withdraw from the EEA agreement if it wanted to undo Single Market access entirely.[18] An attempt to prevent the government from doing so was recently unsuccessful in the High Court.[19]

Despite all of this, the Norway option does not seem to be attractive to the large majority of the UK public nor its policy makers.[20] Most importantly, membership

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[15] Dirk Schoenmaker, 'Lost passports: a guide to the Brexit fallout for the City of London' Bruegel (30 June 2016), <http://bruegel.org/2016/06/lost-passports-a-guide-to-the-brexit-fallout-for-the-city-of-london/>.

[16] See DLA Piper Client Alert, 'No more passporting post-Brexit', Financial Services Regulation Alert (27 July 2016), <https://www.dlapiper.com/en/uk/insights/publications/2016/07/no-more-passporting-post-brexit/>.

[17] For an analysis of the various different options, see European Parliament (Economic and Monetary Affairs), *Potential Concepts for the Future EU-UK Relationship in Financial Services – Study for the ECON Committee* (January 2017).

[18] See Ulrich G. Schroeter and Heinrich Nemeczek, 'The (Uncertain) Impact of Brexit on the United Kingdom's Membership in the European Economic Area' (2016) 27 European Business Law Review 921.

[19] Jane Croft, 'High Court throws out second legal challenge to UK's exit' *Financial Times* (4 February 2017) 3.

[20] See Christian Oliver and Richard Milne, 'Norway's offshore drilling fight with EU a cautionary tale for UK' *FT Online* (18 January 2016), <https://www.ft.com/content/9ed984b0-bab0-11e5-b151-

of the EEA and the Single Market mean that EEA countries also need to comply with EU law concerning the Single Market. It is for this reason that Norway implements most EU laws domestically. Yet as a non-EU state it has no influence on shaping those same laws, or the evolution of the single market. Norway has no representation on the European Commission, no European parliamentarians, no spot around the European Council table of ministers. Many Norwegian officials have long deplored their position. Erna Solberg, Norway's Prime Minister, even actively discouraged the UK from copying her country's position by saying that 'You will hate it'.[21] To the UK public, such an arrangement would indeed be hard to sell – and it would difficult to reconcile with the Leave Campaign's referendum slogan of 'taking back control'.

Apart from this principal issue, there are a number of other problems with the Norway model. For example, Norway is still obliged to contribute to the EU budget. The EEA member contributions are not as high as the contributions by full EU members, but the UK could still expect to face a substantial sum to pay every year.[22]

Finally, membership of the EEA brings the benefits of the Single Market, but also means subscribing to free movement of persons.[23] Arguably, one of the main motivating factors behind the UK referendum outcome was the objective of controlling immigration again. This goal would not be fully under the control of a UK as EEA member. There is, admittedly, an emergency brake under the EEA agreement on immigration when 'serious economic, societal or environmental difficulties' arise.[24] But this safeguard provision is only of temporary character and has never been tested. Indeed, Norway currently has higher levels of immigration from the EU per head than the UK.

Alongside these disadvantages with EEA membership, the perhaps most surprising obstacle is that Norway appears critical of accepting a potential UK membership in EFTA.[25] The fear is that integrating a much larger new member to the small club would jeopardise the power balance within EFTA.[26] Another concern is

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8e15c9a029fb>; Jean Pisary-Ferry and others, *Europe after Brexit: A proposal for a continental partnership* (25 August 2016) available at <http://bruegel.org/2016/08/europe-after-brexit-a-proposal-for-a-continental-partnership/>.

[21] Anca Gurzu, 'Norway to Britain: Don't leave, you'll hate it', *Politico* (15 June 2016), <http://www.politico.eu/article/eu-referendum-look-before-you-leap-norways-pm-tells-brexiteers/>.

[22] Norway currently contributes more than €800m a year to the EU budget. See Norway Mission to the EU, 'Norway's financial contribution' (last updated 10 August 2016), available at <http://www.eu-norway.org/eu/Financial-contribution/#.WBtLMi0rJhE>.

[23] EEA Agreement, Article 28.

[24] EEA Agreement, Article 112.

[25] Singing EFTA, the European Free Trade Agreement, would be vital, as only EU or EFTA members may be part of EEA.

[26] Ole Ask, 'Norge er skeptisk til å slippe britene inn i EFTA' Aftenposten, 9 August 2016, <http://www.aftenposten.no/verden/Norge-er-skeptisk-til-a-slippe-britene-inn-i-EFTA-601643b.html>;

that EFTA's trade agreements with many countries worldwide might have to be renegotiated and future trade deals would become more complex.[27]

In sum, EEA membership for the UK looks like a rather unlikely if not unattractive option. If not the EEA, other commentators argue, the UK could seek its own, tailor-made agreement with the EU. The difficulty with this appears to be the starkly contrasting standpoints that both sides currently take. Media report that the UK government would prefer a solution whereby free movement of services and capital could be maintained, but would seek an end to free movement of workers – in line with the demand to regain control over immigration. The EU, by contrast, has made it abundantly clear that the four freedoms only come as a package – and that cherry picking will not be permissible.[28] EU officials seem so determined about this that agreement currently does not appear possible.

3. Anticipatory action and fait accompli

By some accounts, both camps are already moving to create facts – both the UK and the EU have over the past few months implemented policies or announced proposals to present the other side with a *fait accompli* that promises advantages or benefits for the respective side.

For example, the EU in November 2016 proposed new rules on bank capital, revising the CRD IV package.[29] One of the elements proposed is the controversial requirement for a non-EU bank with two or more affiliates within the EU to establish an "intermediate parent undertaking", in effect a holding company that would be subject to EU capital requirements.[30] Simultaneously, the EU implementation of the G20 TLAC standard to facilitate bail-in would be extended to subsidiaries of non-EU banks that are globally systemic or those with total assets of more than €30bn.

While these proposals have primarily been drafted as a retaliation to the US rules on 'intermediate holding companies' for foreign banks, they would potentially

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Patrick Wintour, 'Norway may block UK return to European Free Trade Association' The Guardian (9 August 2016) <https://www.theguardian.com/world/2016/aug/09/norway-may-block-uk-return-to-european-free-trade-association>. But see Raoul Ruparel, 'Norway has little to lose from having the UK in EFTA' Open Europe Blog, 10 August 2016, available at <http://openeurope.org.uk/today/blog/norway-has-little-to-lose-from-having-the-uk-in-efta/>.

[27] Wintour ibid.

[28] See, for example, the Statement after an Informal meeting of the Heads of State or Government of 27 Member States, as well as the Presidents of the European Council and the European Commission at Brussels (15 December 2016), available via <http://www.consilium.europa.eu/press-releases-pdf/2016/12/47244652443_en.pdf>: 'We reiterate that any agreement will have to be based on a balance of rights and obligations, and that access to the Single Market requires acceptance of all four freedoms'.

[29] European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures, COM(2016) 854 final (23 November 2016).

[30] See proposed CRD IV article 21b.

affect the UK once it is no longer part of the EU. Such rules would add costs and complexity to UK-based banks by forcing them to establish a separate capitalised subsidiary in the EU after the country leaves. Moreover, the need for a separately capitalised holding company in the EU27 would make London less attractive as the headquarter for European operations of third-country banks.

As part of a separate exercise, the EU Commission is currently re-evaluating the process of granting single market access to non-EU financial institutions under the so-called third country passport. The outcome of this review will potentially make it harder for UK financial services to use the EU's 'equivalence' arrangements to maintain Single Market access as a third country. Whilst Commission officials insist that this review is unrelated to Brexit, commentators believe that this assertion is not convincing.[31] It appears that in particular France is driving the hard line on third-country access, and other Member States do not oppose the move. Interestingly, some argue that the UK should strive to achieve the exact opposite: a 2016 Politeia policy report argues that the UK should use its remaining time as an EU member to strengthen the equivalence regime with the goal of profiting from it once the country has left.[32]

A third leg of current activities could come through more explicit 'location' policies, restricting where EU-related financial activities can take place. The Commission recently released proposals on the recovery and resolution of clearing houses.[33] These include no additional territorial restrictions affecting the lucrative clearing of euro-denominated securities trading in the UK. But France, Germany and many MEPs support the relocation of euro clearing to the Eurozone; proposed amendments to this effect are likely as the legislation is debated.[34] Under the plans, the ECB could receive powers to repatriate clearing of Euro-denominated securities to the Eurozone even pre-Brexit.[35]

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[31] Charles Grant, director of the Centre for European Reform, said Commission officials insist 'not entirely convincingly' that this tightening is unrelated to Brexit.

[32] Barnabas Reynolds, *A Blueprint for Brexit: The Future of Global Financial Services and Markets in the UK* (Politeia 2016), available at <http://www.politeia.co.uk/wp-content/uploads/2016/11/Barnabas-Reynolds-A-Blueprint-for-Brexit-2.pdf>.

[33] European Commission, Proposal for a Regulation of the European Parliament and of the Council on a framework for the recovery and resolution of central counterparties and amending Regulations (EU) No 1095/2010, (EU) No 648/2012, and (EU) 2015/2365, COM(2016) 856 final (28 November 2016).

[34] Alex Barker and Jim Brunsden, 'EU plan to curb City's euro clearing set to be flashpoint in Brexit talks' *Financial Times* (16 December 2016) 1.

[35] ibid. The lack of competence was the reason the UK successfully challenged the first ECB location decision back in 2011.

4. Conclusion: end of access to financial market?

Drawing all of these issues together, the consequence would be that the UK is inevitably drifting towards EU exit without any safety net. This would indeed mean the end of passporting and Single Market access, and would indeed be a dramatic turning point for the UK economy. It would hit the financial sector particularly hard. The assumption of such an outcome of Brexit is wide-spread: in a recent survey conducted by PwC among UK-based investment professionals, 70 % believed that UK asset managers would not be able to rely on passporting rights after Brexit.[36]

III. A more realistic scenario

Against this pessimistic outlook, let us know turn to assess a more realistic picture of the future EU-UK relationship. As we will see, the economic incentives of both the UK and of the EU27 are strongly in favour of maintaining Single Market access for financial services. Political considerations also push the two sides into this direction.

1. The economic case for access to the internal market – for the UK

To understand what a hard Brexit would mean for the UK, one first needs to understand the importance of the financial sector for the UK economy. Financial services are undoubtedly the UK's biggest industry sector, worth almost 10 per cent of national GDP.[37] Data from the Office for National Statistics (ONS) suggest that the sector annually earns approximately £190-205 bn in revenues, contributes £120-125 bn in Gross Value Added (GVA), and, together with the 1.1 million people working in financial services in the country, generates an estimated £60-67 bn of taxes each year. It contributes a trade surplus of approximately £58 bn to the UK's balance of payments.

This remarkable sector is closely linked to UK's role in and access to the EU-wide market. Nearly 11 per cent of the City's employees come from elsewhere in the EU, according to the latest census.[38] And nearly 5,500 British registered companies use the 'passporting' mechanism as described above to access the EU market.[39] Consultancy firm Oliver Wyman estimates that around 20 % of the UK's financial

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[36] Chris Flood, '70% of asset managers fear Brexit fund passport loss' *Financial Times* (5 December 2016) FTfm 1.

[37] Stephen Burgess, 'Measuring financial sector output and its contribution to UK GDP' (2011) 51 Quarterly Bulletin of the Bank of England 234; Gloria Tyler, 'Financial Services: contribution to the UK economy' House of Commons Standard Note (26 February 2015).

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[39] Financial Conduct Authority, Letter to Andrew Tyrie, Chairman of the House of Commons Treasury Committee (17 August 2016), available at <https://www.parliament.uk/documents/commons-committees/treasury/Correspondence/AJB-to-Andrew-Tyrie-Passporting.pdf>.

sector's annual revenue – between GBP 23 and 27 billion – is based on passporting access.[40]

Numerous studies have been undertaken to assess the potential impact of what a *Brexit* would mean for the financial sector. In a comprehensive assessment, consultancy firm Oliver Wyman comes to the conclusion that a UK exit from the Single Market could jeopardise 40-50% of EU-related activity (approximately £18-20 bn in revenue) and up to an estimated 35,000 jobs, along with approximately £3-5 bn of tax revenue per year.[41] Individual firms, such as Credit Suisse, for example, have calculated that the loss of passporting would affect up to 20 % of their London activity.[42] Indeed, third country banks with a comparably smaller base in the UK than domestic banks and with a presumably less strong emotional attachment to Britain are most likely to move first.

Crucially, the Oliver Wyman report suggests that knock-on effects would have to be added to this calculation.[43] This is because leaving the Single Market could result in the loss of activities that operate alongside the leaving parts of business, the shifting of entire business units, or the closure of lines of business due to increased costs. When taking this into account, an estimated further £14-18 bn of revenue, 34-40,000 jobs and around £5 bn in tax revenue per annum might be at risk.[44] These estimations are conservative by comparison. Former Chancellor of the Exchequer George Osborne even more dramatically claimed pre-referendum that 285,000 jobs in the City were linked to Europe and might be at risk.[45]

It is not only the threat of losing passporting rights that accounts for these figures. As we saw above, London is the world's principal place for trading and clearing euro-denominated securities, an enormous market worth about $2tn per day. Other EU financial centres have long sought to get their piece of this lucrative cake. Even under the present, pre-Brexit setup, the ECB launched an (unsuccessful) legal attack on this business, claiming that clearing of Euro-denominated securities must be carried out within the territory of a Member State that is part of the

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[40] Oliver Wyman, *The Impact of the UK's Exit From the EU on the UK-based Financial Services Sector* (October 2016).

[41] ibid 3.

[42] Donal Griffin and Oliver Suess, 'Thiam Says Passport Loss Risks 20% of His Bank's U.K. Volume' *Bloomberg* (28 September 2016), available at <http://www.bloomberg.com/news/articles/2016-09-28/credit-suisse-ceo-says-no-passporting-risks-20-of-london-volume>.

[43] Oliver Wyman (n 40) 4.

[44] Oliver Wyman (n 40) 4.

[45] George Parker and Jim Pickard, 'Osborne warns Gove of economic "catastrophe"', *Financial Times* (London, 10 May 2016) 3.

Eurozone.[46] Should the UK decide to leave the EU altogether, it is to be expected that these attempts will be resumed.[47] Xavier Rolet, CEO of the London Stock Exchange, has already claimed that as many as 100,000 City jobs could be lost if Britain left the EU, linked to moving the clearing of euro-denominated securities out of London.[48]

The problem is that all of these startling numbers did not matter much during the referendum. The debate exhibited strong elements of post-truth politics and culminated in Michael Gove, a leading Brexiteer, saying in an interview that 'People in this country have had enough of experts'.[49] The reasons are manifold and do not need to be discussed here in detail – suffice it point out that referenda may frequently tend to lead to emotional rather than rational decisions, and that the June 2016 referendum was probably mostly about reclaiming national sovereignty, anti-establishment feelings, a rejection of uncontrolled immigration and dissatisfaction with EU bureaucracy.[50]

Crucially, however, the post-referendum government is not the 'man in the street' who is immune to economic outlook scenarios or does not understand them. The present decision-makers are accountable to the economic success of the country and will mostly stand for re-election in the future. That makes them much more susceptible to economic realities than a plebiscite which was tainted by emotions.

2. The case for continental Europe to stay with Britain

After discussing the UK's economic exposure to the European Union, it is important to also understand that the EU27 is equally dependent on the UK. This is frequently underestimated and not fully understood in the present policy debate. Some officials hope the EU's position will soften once the collective costs of retrenchment become clear.

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[46] Case T-496/11 *United Kingdom of Great Britain and Northern Ireland v European Central Bank* (ECB) ECLI:EU:T:2015:133.

[47] Stéphane Boujnah, chief executive of Euronext, has already said that, at present, 30-45 per cent of trading in euro-denominated assets is done out of London, which is 'only acceptable while the UK is part of the EU and the single market'. See Michael Stothard, 'Brexit would end City's dominance of euro trading', *Financial Times (online)* (20 June 2016), <https://www.ft.com/content/9a52a97c-36ba-11e6-a780-b48ed7b6126f>. See also Barker and Brunsden (n 34).

[48] Parker and Pickard (n 45).

[49] Philip Stevens, 'The perils of a populist paean to ignorance' *Financial Times* (24 June 2016) 13.

[50] Sara Binzer Hobolt, 'The Brexit vote: a divided nation, a divided continent' (2016) 23 Journal of European Public Policy 1259.

For example, we saw above that 5,500 UK firms enjoy passporting rights when engaging with European clients. For the EU27, this number is even higher: About 8,000 EU firms use passporting to access the UK market.[51] Some of these are large groups. Deutsche Bank and Commerzbank, for example, use passporting to run their businesses as 'branches' in the UK, rather than as separately capitalised subsidiaries. Evidently, passporting is therefore a 'two-way street'[52], where European firms benefit as much if not more than UK firms. Fragmenting a complex financial ecosystem inevitably puts up finance costs across Europe, and the risk is that both Britain and the EU lose out as barriers go up.

More than this, Brexit threatens to derail the entire process of EU financial integration. The willingness of continental jurisdictions to subscribe to a single market for financial services has partly been related to the expectation to profit from alignment with the most developed European market-based system, the UK.[53] Following Brexit, the appetite for further integration will be lower. The prospect of continuing the present project of a 'Capital Markets Union' (CMU) without the continent's most developed capital market appears daunting, to say the very least, although Commission officials claim that the project is now 'more important than ever'.[54] Clearly, the political momentum has been lost already, and the bargaining power between industry and Member States is changed with the prospect of the UK's departure.[55] Market integration project critically depend on the size and the depth of integration, and pursuing the project without the most advanced of its number, the CMU project looks less promising.[56] Some commentators even suggest that the entire project is now thrown into jeopardy.[57]

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[51] FCA (n 39).

[52] Borrowing from Anthony Browne, chief executive of the BBA.

[53] See John Armour and Wolf-Georg Ringe, 'European Company Law 1999–2010: Renaissance and Crisis' (2011) 48 Common Market Law Review 125, 155.

[54] Jim Brunsden, 'EU finance pact "more urgent" since Brexit' *Financial Times* (15 September 2016) 28. Other commentators agree and opine that Brexit will give a positive push to the remaining Member States to carry on with implementing CMU. See Edward Price, 'Why the CMU could benefit from Brexit', International Financial Law Review (18 July 2016) 1.

[55] Attracta Mooney, 'Fears Brexit will slow Capital Markets Union' *Financial Times* (18 July 2016) FTfm 3; Tim Burke, 'Deutsche economist: Brexit could "seriously hurt" EU's capital markets', Financial News (20 October 2016) <http://www.efinancialnews.com/story/2016-10-20/david-folkerts-landau-deutsche-bank-brexit-european-capital-markets>; Davis Polk Client Memorandum, 'Lex et Brexit – the Law and Brexit' (Issue 5, September 1, 2016) <https://www.davispolk.com/sites/default/files/2016-09-01-lex-et-brexit-the-law-brexit-issue-5.pdf>.

[56] Steven Maijoor, chairman of the European Securities and Markets Authority (ESMA), speaking at a Reuters regulation summit: see Huw Jones, 'Brexit would damage EU capital markets union: watchdog says', Reuters (18 May 2016), <http://www.reuters.com/article/us-finance-summit-britain-eu-idUSKCN0Y91J8>.

[57] Michael Cole-Fontayn, chairman of the Association for Financial Markets in Europe (AFME), in an interview with *Handelsblatt Global Edition* (13 June 2016), available at <https://global.handelsblatt.com/finance/brexit-threatens-e-u-financial-union-539886>.

Beyond passporting, it is obvious that the EU27 cannot be interested in looser economic ties with the UK, as higher costs of doing business would negatively affect continental firms. A weakened British demand for goods would severely hit European exports to the UK.[58] Moreover, UK banking services are vital for the industry all over Europe, leading Mark Carney, Governor of the Bank of England, to aptly call London 'the investment banker for Europe'.[59] Carney pointed out that over half of the equity and debt raised by Eurozone firms was issued 'in the UK, by firms based in the UK, quite often to investors in the UK'.[60] It is this close relationship of mutual economic dependency between the UK and the EU27 which underlies much of their common interests.[61]

Another important consideration to understand is the threat of competition that a de-regulated City of London could pose to the rest of Europe. The problem of regulatory competition in financial markets regulation has long been understood as a threat to lawmakers, as the stakes of keeping banks and other financial institutions in the country are very high.[62] In the context of Brexit, the risk is that a UK financial regulator, freed from any EU requirements, might be tempted to deregulate the sector even more, with the goal of further luring EU business to Britain. Brexit minister David Davis has already warned that if the EU pushed for a punishing settlement, Britain would switch to a tougher 'alternative strategy', looking to fight for business with 'lower tax, softer regulation and other strong business incentives'.[63] This could undermine the standards agreed in the EU and pose a serious threat to the balance of powers on the European continent. A deregulated City of London at its gates would be an even more attractive jurisdiction to relocate to and might entice away even more financial services from Paris and Frankfurt.[64]

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[58] Fuest 2016.

[59] Chris Giles, 'Carney warns EU over "crucial" City', *Financial Times* (1 December 2016) 2.

[60] Giles (n 59).

[61] Clemens Fuest, Interview with Bloomberg, 20 September 2016, available at <http://www.bloomberg.com/news/videos/2016-09-20/an-easy-brexit-break-up-best-for-both-sides-says-fuest>: 'If there is limited or no access to the internal market for British industry and banks it would be bad for Britain but it would also be bad for Europe. Exports to Britain would suffer because, if London suffers as a financial centre, German and French exports to Britain would suffer. So we have a common interest in limiting the economic damage'.

[62] See, for a recent discussion, W. Georg Ringe, 'Regulatory Competition in Global Financial Markets – The Case for a Special Resolution Regime', (2016) 1 Annals of Corporate Governance 175.

[63] This is according to a leaked memo of a conversation between Mr Davis and City representatives in mid-November 2016, published by the Financial Times

[64] For example, the UK's secret arrangements with carmaker Nissan and speculation about sweetheart terms to convince the firm to build new models in the north of England have touched a nerve with continental rivals. See Alex Barker, 'UK ally takes hard Brexit line' *Financial Times* (21 November 2016) 11, reporting on Denmark's position: 'Denmark is also fixated on its competitiveness. Britain is seen as a rival for investment, whatever direction it takes with Brexit. Danes fear London will relax regulations, standards or taxes to entice business'.

Continental financial centres (like Frankfurt and Paris) try to turn the problem into a virtue: they actively promote themselves as a substitute for London with Single Market access, hoping to lure business away to the continent.[65] This competition heralds the possibility of a downward spiral in regulatory and supervisory standards, which would be fatal to the stability of global financial markets. It may also be accompanied by protectionism and retaliation sentiments, as the example of a requirement for holding companies in international banking groups illustrates. Moreover, it is certainly possible that the 'winner' of such competition may be neither of the two or three direct competitors, but an outsider – such as New York. There are many reasons to believe, therefore, that the much-discussed 'competition' by the likes of Frankfurt and Paris is nothing more than a welcome opportunity for city marketing, rather than aggressive competition, undermining the business model of others.

Maybe the best example to understand how Brexit would be a lose-lose situation is the attempt by Eurozone officials to repatriate clearing activities of Euro-denominated securities, as mentioned above. Following the UK referendum, leading politicians have renewed their calls to move all Euro clearing business from the City to the EU27, in revenge for a failed attempt by the European Central Bank to repatriate clearing activity in 2015.[66] However, it has now been revealed that such a new move would substantially weaken the Euro's attempts to become a global reserve currency. A report by Standard & Poor's, released in November 2016, found that it would impose a massive extra burden of margin collateral on market participants and heap pressure on financial institutions on both sides.[67] And a policy paper released by the Intercontinental Exchange (ICE) claims that 'forced repatriation' of euro clearing to the Eurozone would 'deprive European banks of access to liquid trading and clearing facilities and create fragmentation'.[68] Repatriation to mainland Europe would result in additional costs and lower efficiencies for all of the affected global clearing houses, and could also vastly increase margin collateral requirements for their clearing members, 'at a time when collateral requirements are already rising and high quality collateral is becoming more scarce'.[69] In other words, the repatriation would not just hurt the City of

[65] See, for example, Rhea Wessel, 'With Brexit on the horizon, Frankfurt's star is on the rise', *BBC Capital* (27 October 2016), available at <http://www.bbc.com/capital/story/20161025-with-brexit-on-the-horizon-frankfurts-star-is-on-the-rise>.

[66] Alex Barker and Jim Brunsden, 'EU plan to curb City's euro clearing set to be flashpoint in Brexit talks' *Financial Times* (16 December 2016) 1.

[67] S&P Global Ratings, *Requiring Euro-Denominated Contracts' Clearing Within The EU Would Be Disruptive But Could Have Limited Impact On Ratings* (17 November 2016), available at <https://www.globalcreditportal.com/ratingsdirect/renderArticle.do?articleId=1758126&SctArtId=408068&from=CM&nsl_code=LIME&sourceObjectId=9876220&sourceRevId=3&fee_ind=N&exp_date=20261117-15:33:02>.

[68] Cited according to Barker and Brunsden (n 66).

[69] S&P Global Ratings (n 67).

London, but also EU27 banks as the costs for all financial market participants will soar.

3. Avoiding a precedent?

Taken together, we can conclude that the EU27 side has as much interest in keeping the UK in the Single Market as the UK has in staying. The only serious obstacle for European policymakers to confessing this attitude in public is the powerful imperative that is constantly reiterated in Europe: allowing a bespoke arrangement for the UK would set a dangerous precedent – with potentially inviting other European jurisdictions to come with their own demands later. Thus, EU officials have warned against allowing the UK to 'cherry-pick' parts of the Single Market architecture for fear of becoming a menu à la carte. More than that, there may be a temptation to apply punitive terms to the UK's exit and the EU-UK relationship. This also explains the insistence, on the EU side, to emphasise that the four freedoms are indivisible and cannot be selected or adopted in part.[70]

As much as this rhetoric makes sense in political terms, the threats depicted by its supporters do not stand up to the realities. The truth is that cherry-picking is and has always been present in EU integration over time, and has not had the disastrous consequences that its opponents claimed.

Take the case of the British 'rebate' or 'discount' for its contributions to the EU budget. During the 1980s, then Prime Minister Margaret Thatcher fought hard to achieve a special treatment for the UK's contribution to the common EU budget. She was successful at the European Council in June 1984, held in Fontainebleau, and a substantial 'correction' in favour of the UK contribution was adopted by a 1985 Council decision.[71] It has been in place ever since.[72] Critics at the time were scared of the same thing as the EU Brexit negotiators are today – that once you allow a special treatment for one country, other will ask for the same. Yet despite all prophesies at the same, there has not been another case of budget adjustment for another Member State ever since.

[70] See, for example the Statement after an Informal meeting of the Heads of State or Government of 27 Member States, as well as the Presidents of the European Council and the European Commission at Brussels (15 December 2016), available via <http://www.consilium.europa.eu/press-releases-pdf/2016/12/47244652443_en.pdf>: 'We reiterate that any agreement will have to be based on a balance of rights and obligations, and that access to the Single Market requires acceptance of all four freedoms'.

[71] Council Decision of 7 May 1985 on the Communities' system of own resources, [1985] OJ L128/15, Article 3.

[72] The rebate is negotiated as part of the Multiannual Financial Framework (MFF) every seven years and must be unanimously agreed. See European Commission, *Commission Working Document on calculation, financing, payment and entry in the budget of the correction of budgetary imbalances in favour of the United Kingdom ("the UK correction") in accordance with Articles 4 and 5 of Council Decision 2014/xxx/EU, Euratom on the system of own resources of the European Union*, COM(2014) 271 final.

In truth, all comes down to the strength of the relative bargaining positions. The UK and its exceptionally sized financial market are unmatched in any other Member State, and will be a decisive bargaining chip in the Brexit negotiations. Other Member States have too much political capital tied up in the joint European project and too much to lose economically to risk walking out. An exceedingly unfavourable deal with the UK would be liable to damage everybody and would not achieve cohesiveness within the EU27 itself. The prediction is thus that the EU27 will most probably jump over its shadow and grant the UK yet another 'special treatment'.

Further, whoever argues that cherry-picking has no place in the EU framework does not realise that a multi-speed Europe with a complex web of different treaties, exceptions, and principles, has long been a reality. The European Monetary Union is the most prominent example, where the UK and Denmark have negotiated a permanent opt-out.[73] But a number of other Member States are presently not part of the Eurozone either.[74] To take a few other examples, the Banking Union is, at its core, a Eurozone project: so all Eurozone Member States are automatically part of the Banking Union. But the Banking Union is open for other Member States, and a number of non-Euro countries are planning to join, while others preferred to remain outside.[75] The European Stability Mechanism is a European bail-out found set up at the height of the sovereign debt crisis, in 2012. The ESM is formally not part of the EU legal framework, as it is enshrined in a separate international treaty, signed by the Eurozone members only.[76] By contrast, a number of instruments concerning fiscal coordination in the EU were adopted over the past few years. They all apply with different intensity to a different group of members, creating a complex and intransparent web of commitments and obligations.[77]

These examples are all drawn from the sphere of the financial market; when broadening the view, it becomes apparent that the same phenomenon can be observed for the EU architecture as a whole – the EU Treaties TEU and TFEU with

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[73] See the Protocols attached to the TEU: Protocol (No 15) on Certain Provisions Relating to the United Kingdom of Great Britain and Northern Ireland, and Protocol (No 16) on Certain Provisions Relating to Denmark.

[74] Formally, however, these other 'Outs' are obliged to join the common currency once they fulfil the legal criteria for Euro membership.

[75] Pia Hüttl and Dirk Schoenmaker, 'Should the "Outs" join the European Banking Union?', Bruegel Policy Contribution 2016/03 (February 2016), available at <http://bruegel.org/wp-content/uploads/2016/02/pc_2016_03.pdf>.

[76] Formally, the ESM is an intergovernmental organisation located in Luxembourg, which operates under public international law for all Eurozone Member States.

[77] The most prominent examples are Euro Plus Pact 2011; the "Six Pack" 2011 (which applies to all EU Member States but with some special rules for the Eurozone); the Fiscal Compact 2013 (an intergovernmental agreement, involving all EU28 except the UK and the Czech Republic); and the "Two Pack" 2013 (mostly concerning the Eurozone).

their numerous exceptions, opt-outs and protocols,[78] the existence of sister frameworks like the European Economic Area and EFTA, the Schengen Agreement guaranteeing passport-free travel,[79] and the European Customs Union. This list could be continued indefinitely, and is expression of the fact that 'special deals' have always been struck as long as European integration has existed. Although formally insisting on an 'ever closer Union', most officials nowadays accept the realities of a multi-speed Europe and put their hopes in a 'coalition of the willing' to move forward and to inspire others.

All of this suggests that the current EU position to not allowing the UK a tailor-made solution are nothing more than an attempt to build up a negotiating position. To claim that the four freedoms are indivisible is simply an axiomatic postulation, but nothing more. I would even go further: the EU27 negotiating team has as much to fear from a failure of the Article 50 talks as the UK, since a failure to conclude a deal with the two years after negotiations were started would mean a UK exit from the single market with disastrous consequences for mainland Europe too. This is where the real risk of setting a precedent lies.

4. Political constraints

Alongside economic considerations, there are also a number of powerful political circumstances that are nudging the UK away from moving towards a 'hard' form of Brexit. This is a common phenomenon of any complex process. The decision about leaving the European Union is multi-faceted, involves many different decision-makers and players, and spans a significant period of time. Such complex processes typically end up with some form of compromise.

The most well-known conflict over Brexit is the rivalry between UK Government and Parliament over which institution is entitled to start the process of leaving the EU under TEU Article 50. When it became apparent that the Government leant towards hard Brexit, Parliament began with what may be termed a soft 'rebellion'.[80] Many MPs feared the consequences for UK trade that Brexit might entail, demanding a vote on the terms of the EU exit. In any case, they protested again the risk of being side-lined in the decision and against the Government's penchant for secrecy on the different exit options.

This led to the widely-reported decision by the Supreme Court, holding that the right to give notice under Article 50 is within the prerogative of Parliament, thus quashing the hopes of Prime Minister Theresa May to control the process all

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[78] For example, concerning the Area of freedom, security and justice and the Charter of Fundamental Rights are both subject to numerous opt-outs.

[79] The UK and Ireland opted out from Schengen when it became part of EU law in 1997.

[80] James Blitz, 'Commons rebellion over Brexit', *Financial Times Brexit Briefing* (10 October 2016).

herself.[81] The government was thus forced to seek parliamentary authorisation for the move to trigger the Brexit negotiation process. As at the time of writing, the government secured a large majority in its favour in the House of Commons, and there is no doubt that the House of Lords will eventually concur. Although most MPs are pro-remain,[82] few sought to pursue a complete reversal of the Brexit decision for fear of angering the public by defying a clear referendum decision. Therefore, it was expected that the *Miller* decision did not stop the Brexit process, but that it would encourage parliamentary reflection and debate.[83] Moreover, the ruling gave some momentum to the view that the government must be more explicit about the type of Brexit it is seeking, and that it needs to provide that clarity before Article 50 is invoked.

The battle between Government and Parliament is however not the only internal conflict. Of similar quality is the divergence of views between the UK government and policymakers in Scotland. It is well-known that the Scottish public is more sympathetic to the EU than the rest of the UK, and 62% of the Scottish electorate voted Remain in the referendum. This has prompted Scottish politician to explore ways of obstructing Brexit. One potential avenue would be to hold another Scottish independence referendum, but the outcome of that would be very uncertain according to pollsters.[84] In the *Miller* case, First Minister Nicola Sturgeon intervened in the Supreme Court hearing, seeking a declaration that Scotland must be consulted before Brexit.[85] Whilst this claim did not succeed in *Miller*, Scottish officials still explore ways of securing an alternative position for Scotland towards the EU. The Scottish government recently adopted an official proposal for maintaining access to the single market.[86] A similar proposal has been put forward by political leaders in Wales.[87]

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[81] *R (Gina Miller) v Secretary of State for Exiting the European Union* [2016] EWHC 2768 (Admin).

[82] In the House of Commons, there were about 480 MPs in favour of Remain just before the Brexit referendum compared with 150 opposed. The House of Lords was also highly supportive of the Remain camp.

[83] Alison Young, 'R (Miller) v The Secretary of State for Exiting the European Union [2016] EWHC 2768 (Admin): Constitutional Adjudication – Reality over Legality?', *UK Constitutional Law Blog* (9 November 2016) (available at https://ukconstitutionallaw.org/).

[84] Alastair Jamieson, 'Scotland Seeks Independence Again After U.K. "Brexit" Vote', *NBC News* (24 June 2016), <http://www.nbcnews.com/storyline/brexit-referendum/scotland-could-seek-independence-again-after-u-k-brexit-vote-n598166>.

[85] Jamie Ross, 'Sturgeon Launches Legal Case To Stop The UK Government Triggering Article 50' (8 November 2016), <https://www.buzzfeed.com/jamieross/sturgeon-launches-legal-case-to-stop-the-uk-government-trigg>. See also Guy Faulconbridge and Michael Holden, 'In a battle over Brexit, court challenger fears Britain's demons have been unleashed' Reuters (30 November 2016), <http://uk.reuters.com/article/uk-britain-eu-article50-miller-idUKKBN13P1SI>.

[86] The Scottish Government, *Scotland's Place in Europe* (December 2016), <http://www.gov.scot/Resource/0051/00512073.pdf>.

[87] Welsh Government, *Securing Wales' Future: Transition from the European Union to a new relationship with Europe* (January 2017), <https://beta.gov.wales/sites/default/files/2017-01/30683%20Securing%20Wales%C2%B9%20Future_ENGLISH_WEB.pdf>.

A third and perhaps most significant conflict line lies between the UK Government and the British public in general. The outcome of the referendum was clear, and it seems that the public (although still divided) has no regrets over the decision to leave the European Union. But the course on what to pursue instead is ultimately very controversial. In a revealing independent study from November 2016, it emerged that an overwhelming 90 percent of the public are in favour of continuing free trade with the EU.[88] The Government will find it difficult to ignore this position, in particular as most of the actors will face re-election at the latest in 2020.

5. Currently hardening stances

The essence of our argument so far has been that both sides, UK and EU27, have powerful incentives to seek an agreement about continued Single Market cooperation.

On the face of it, this conclusion seems to run against the current political climate. The UK government is sharpening its rhetoric and appears to be drifting towards a 'hard' version of a Brexit. At the Birmingham Conservative party conference in October 2016, Prime Minister May made it clear that she preferred to maintain Single Market access, but that she was adamant to restrict immigration and to strive off the jurisdiction of the European Court of Justice. If given a choice between the two – if they are irreconcilable – she suggested to prefer the latter. This speech has widely been interpreted as her first true announcement of a hard Brexit.[89] The Prime Minister's Brexit speech in January 2017 reiterated the UK's readiness to 'walk away' from negotiations if no deal can be achieved.[90] And the ensuing Government White Paper explicitly rejects any future Single Market membership.[91]

Other government ministers have gone beyond this and made hawkish remarks, suggesting their readiness to leave the EU at all costs. A number of comments have even ridiculed their EU partners' economic position.[92] And finally, in the run-up to the start of the official negotiations, the British EU ambassador

[88] John Curtice, *What do Voters Want from Brexit?* (NatCen, London 2016), available at <http://whatukthinks.org/eu/wp-content/uploads/2016/11/Analysis-paper-9-What-do-voters-want-from-Brexit.pdf>.

[89] George Eaton, 'Theresa May signals that the UK is heading for hard Brexit' *New Statesman* (2 October 2016), <http://www.newstatesman.com/politics/uk/2016/10/theresa-may-signals-uk-heading-hard-brexit>; Kate Allen, George Parker, and Alex Barker, 'May sets Brexit course with hint of clean break from single market' *Financial Times* (3 October 2016) 1.

[90] George Parker and Alex Barker, May eases Brexit fears but warns UK will walk away from "bad deal"' *Financial Times* (18 January 2017) 1.

[91] HM Government, *The United Kingdom's exit from and new partnership with the European Union* (Cm 9417, February 2017) 35.

[92] For example, foreign secretary Boris Johnson claimed it is 'baloney' that the UK cannot get a free trade agreement if it ends free movement for EU workers.

surprisingly quit his post, explaining his frustration with the lack of engagement of the UK government with Brussels. This move was also interpreted as heralding an unamicable variant of Brexit.[93]

Conversely, on the European side, policy makers are also uniting behind a hard bargaining line. To the frustration of UK officials, EU diplomats have so far refused British overtures to start informal talks on the shape of a potential deal before Article 50 is triggered; this has even included rejecting offers to establish technical working groups on Brexit. In substance, EU policy makers across the board are constantly insisting that the four freedoms are indivisible and that a restriction on free movement of workers means an end to Single Market membership.

These positions, as reported by the press and as irreconcilable as they seem, should be interpreted as what they are: pre-bargaining rhetoric. It is common knowledge in negotiation strategy to not put one's demands too low. The negotiating strategies on both sides to be expected are therefore to aim for the 'best' outcome first, and scale down their expectations once these prove unattainable.[94]

Prime Minister Theresa May's dilemma is the following: domestically, she needs to speak tough to honour the outcome of the referendum and to pacify conservative backbenchers and to fend off the UK Independence Party. This explains her tough talk on controlling immigration, reclaiming lost sovereignty, and escaping from the jurisdiction of the ECJ.[95] However, such radical positions provoke a backlash in Europe and prevent her from getting a favourable deal with her European partners. Worse, they create counter-reactions and even tougher rhetoric from the EU27 side, which in turn hardens the UK position even more. This vicious circle explains the phenomenon of seemingly irreconcilable positions on both sides of the Channel.

How are we then to overcome this dilemma? There are good reasons to expect an appeasement process once negotiations begin in earnest.[96] For the most part, Article 50 negotiations on a daily basis will be led by technocrats, who are to work out the details of a leaving pact. These are free to populist pressure and will be driven to produce by workable outcomes. But even the main political figures in charge of Brexit will moderate their stances, given the high economic and political costs involved in an unfavourable Brexit deal. Accountability to the public, pressure

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[93] Ian Wishart Timothy Ross, 'A Hard Brexit Looms Large With Resignation of U.K. Envoy to EU' *Bloomberg* (4 January 2017) <https://www.bloomberg.com/politics/articles/2017-01-03/a-hard-brexit-looms-large-with-resignation-of-u-k-envoy-to-eu>.

[94] See Horst Eidenmüller, 'Negotiating and Mediating Brexit' Working Paper 2016, available at <http://ssrn.com/abstract=2854829>.

[95] Her speech at the Birmingham party conference is available in full length at <http://www.independent.co.uk/news/uk/politics/theresa-may-speech-tory-conference-2016-in-full-transcript-a7346171.html>.

[96] See Eidenmüller (n 94).

group influence and looming elections mean that politicians will not score in the long run with producing a Brexit that triggers disastrous economic consequences. A realistic expectation is therefore that official Brexit negotiations under Article 50 will show common ground to both sides.

IV. Malleable legal rules accommodate flexible solution

The cautiously optimistic line developed thus far faces one undeniable problem: 'Brexit means Brexit', meaning that the UK's leaving the EU as such is a near-certain fact that cannot be ignored or overcome. All faint hopes by some that the referendum decision may be reversible or that a second referendum could be held are rightly criticised as unrealistic. Reversing Brexit itself would provoke outspoken public anger. Former UKIP leader Nigel Farage and other Brexiteers have already hinted at a possible outburst of violent protests should the Brexit decision be reversed.[97]

Importantly, therefore, we should expect two things: First, the UK will formally and officially leave the EU. Prime Minister Theresa May has already announced that she will give formal notice to the EU under TEU Article 50 by the end of March 2017, with a view of leaving by March 2019. Secondly, however, this paper has demonstrated that both sides have powerful incentives to keep the Single Market for financial services intact. We should therefore expect a creative solution alongside the leaving decision to maintain the substance of the UK's financial services access to Europe.

Is it realistic to see such a combination between formal exit and economic substance? Historical precedent of the EU financial market framework confirms that creative solutions to formal problems are very common. Put into a broader context, economic or political considerations have frequently triumphed over formal legal positions, to an extent where 'the law' can be seen as the constant loser.

1. Lessons from EU financial integration

To understand this, it is worth exploring in some more detail one of the key lessons from EU financial integration: that politics and economics frequently trump formal rules. The EU legal system has proven to be particularly malleable during the process of building and EU financial market. This became particularly apparent during the 2008/09 Global Financial Crisis and the ensuing 2010-12 Sovereign Debt Crisis. One of the central tenets of policy-makers, regulators and supervisors has always been to put economic necessities over formal legal problems. As it was put

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[97] John Ashmore, 'Nigel Farage warns of unprecedented "political anger" after High Court ruling' *Politics Home* (6 November 2016), <https://www.politicshome.com/news/europe/eu-policy-agenda/brexit/news/80540/nigel-farage-warns-unprecedented-political-anger>.

by The Economist, “Given a choice between financial stability and the rule book, ditch the rule book”.[98]

The genesis of the EU financial market framework is full of such examples. Amongst the most well-known of them is the attitude towards the famous Euro convergence criteria. As is well known, membership of the third stage of the Economic and Monetary Union (EMU) requires certain criteria, among them that the ratio of the annual government deficit relative to gross domestic product (GDP) in each Member State must not exceed 3% at the end of the preceding fiscal year.[99] This requirement (and the other criteria) has constantly been violated by a number of Eurozone Member States, famously once including the heavyweights France and Germany. Yet, the various sanctions – the Treaty’s Excessive Deficit Procedure[100] and the separate Stability and Growth Pact – have never been properly used.[101] Member States have been very creative over time in convincing the EU institutions that violations of the criteria were due to exceptional circumstances, hardship, or internal crisis. Conversely, the Commission has mostly found it inappropriate to intervene for political reasons. In sum, the convergence criteria are now predominantly seen as political tools, not as a pure legal instrument.[102]

The 2007-09 Global Financial Crisis brought the weakness of the EU legal framework to the fore. Nowhere better can this be observed than when looking at the conflict between EU state aid rules and bank bail-outs.[103] The massive scale of taxpayer-financed rescue operations for domestic banks carried out by many EU MS ran directly against the prohibition to support local firms because of market distortion risks.[104] However, faced with an unprecedented risk of a global meltdown, the EU institutions had no other choice than to rubber-stamp all those bail-outs, using the exceptions provided by the Treaties.[105] The many decisions and communications on state aid during the Crisis arguably bent the state aid rules to almost no recognition.

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98 *The Economist*, ‘The Rule of Flaw’, 12 May 2016, <http://www.economist.com/news/leaders/21698650-italy-has-been-flirting-banking-crisisand-brussels-partly-blame-rule-flaw>.

99 See formerly EC Treaty Article 121, now modified to TFEU Article 140.

100 Now TFEU Article 126.

101 Victor Ngai, ‘Stability and Growth Pact and Fiscal Discipline in the Eurozone’, Working Paper (2012), <http://fic.wharton.upenn.edu/fic/papers/12/12-10.pdf>.

102 Paul de Grauwe, ‘The politics of the Maastricht convergence criteria’ Vox CEPR Policy Portal (15 April 2009), <http://voxeu.org/article/politics-maastricht-convergence-criteria>.

103 See on this Conor Quigley, ‘State Aid and the Financial Crisis’ in WG Ringe and PM Huber (eds), *Legal Challenges in the Global Financial Crisis: Bail-outs, the Euro and Regulation* (Hart Publishing, Oxford 2014) 131.

104 TFEU Articles 107, 108.

105 Initially, the Commission relied on Article 107(3)(c) to allow for exceptions. This requires the recipient to be in financial difficulty – as the crisis progressed, it became apparent that it did not work for wider systemic issues and liquidity problems. In consequence, the Commission’s approach shifted

Another major crisis player, acting in a grey area, turned out to be the European Central Bank. Arguably, the ECB was the only EU institution with serious powers and willing to use them. It has intervened numerous times during the crisis, starting with the traditional monetary policy tool of adjusting interest rates, over the so-called Long-Term Refinancing Operations for banks (LTRO) since 2008, to direct intervention in the securities market. The latter included a number of programmes, inter alia the Securities Markets Programme (SMP) of 2010, a purchase programme for bank-issued covered bonds in 2011, and the announcement of the controversial 'Outright Monetary Transactions' (OMT) in 2012 with the famous announcement by ECB President Mario Draghi to do 'whatever it takes' to preserve the Euro. This triggered a legal challenge by Germany as being beyond the ECB's mandate.[106] The challenge was ultimately unsuccessful, but the ECB's actions have been widely criticised by legal scholars as violating the rule of law and the European Treaties.[107] Tellingly, economists have underscored the pressing need to ECB activity.

The ECB went on to embark on an impressive quantitative easing programme since 2015, which is still ongoing to this day and which is also subject to a legal challenge in Germany.[108] Part of the problem is that the ECB itself is not able to mitigate imbalances in competitiveness within the Eurozone, it can ultimately only buy time.

Similar criticism was voiced against the creation of the European Stability Mechanism (ESM)[109], a European bailout fund with a maximum 'firepower' of €500 bn.[110] The mandate of the ESM was only to provide rescue operations for EU Member States that were in financial difficulties. Direct payments to banks were not allowed before the completion of the banking union. Another legal challenge was launched against the legality of the ESM, arguing that it violated the 'no bail-out' clause specified in Article 125 TFEU. Although the ECJ ultimately upheld the constitutionality of the ESM, many commentators believed that it was erected on shaky grounds.[111]

The most recent example is the attempt to circumvent bail-in legislation in various situations in the course of 2016. Ironically, this concerned a major piece of

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to use Article 107(3)(b) ('serious disturbance in the economy of a Member State') as the predominant exception, which granted more leeway.

[106] Case C-62/14 *Gauweiler* ECLI:EU:C:2015:400.

[107] See, inter alia, Paul Yowell, 'Why the ECB Cannot Save the Euro' in WG Ringe and PM Huber (eds), *Legal Challenges in the Global Financial Crisis: Bail-outs, the Euro and Regulation* (Hart Publishing, Oxford 2014) 81.

[108] Claire Jones, 'Legal complaint: German elite steps up pressure on ECB over bond buying' *Financial Times* (17 May 2016) 8.

[109] The ESM is the permanent successor to the interim solutions European Financial Stabilisation Mechanism (EFSM) and European Financial Stability Facility (EFSF).

[110] See also above n 76.

[111] Case C-370/12 *Thomas Pringle v Government of Ireland* ECLI:EU:C:2012:756.

the EU crisis response, the Bank Recovery and Resolution Directive (BRRD). The crucial part of this directive came into force in January 2016 and mandates the participation of private investors in the losses of a failing bank – before the taxpayer becomes liable for a public bail-out. The broader objective is to avoid the unpopular bail-outs of the crisis years. However, first practice tests during 2016 laid bare strong incentives to arbitrage around BRRD. The clearest example of this is the Italian banking crisis, notably encompassing Banca Monte dei Paschi di Siena. When it became clear in 2016 that this bank (and others) were struggling and nearing insolvency, the Italian government sought to secure a public rescue programme – going the correct way of bailing in private creditors under the BRRD seemed politically toxic, as many bondholders were in fact retail investors.[112] At some point, faced with the legal necessity to respect BRRD, the government openly considered simply ignoring the law.[113]

In a double irony, the same fate later in the same year reached Germany, one of the loudest critics of the Italian manoeuvre. In September 2016, it was reported that Deutsche Bank, the country's greatest lender, was in trouble and might need debt relief following the announcement of a possible high fine to be imposed by US authorities for Deutsche's business pre-crisis. If Deutsche Bank really had come into financial difficulties, Germany would have been bound by BRRD in the same way as Italy is. The German government insisted that no public injection of funds would be necessary; however, market rumours persistently held that the government in secret prepared a rescue operation.

This list could be continued indefinitely. Other examples from the rich EU financial history include the creation of the EU supervisory architecture on shaky legal grounds; the framework designed to ensure fiscal discipline (Sixpack 2011 and Fiscal compact 2013, among others); and the creation of the European Banking Union, the legal basis of which was unclear. The claim that the adoption of such legal instruments or institutions lies beyond the competence of the EU lawmakers may have legal force, but does not matter much in real life. The European Court of Justice has traditionally been generous in interpreting the Treaty powers widely.[114] Even the possibility of creating separate EU agencies with independent discretionary powers – a contentious area – has recently been made more flexible.[115] The

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[112] Alex Barker and Jim Brunsden, 'Failing banks regime faces tough test' *Financial Times* (6 December 2016) 4.

[113] Rachel Sanderson and Alex Barker, 'Renzi ready to defy Brussels over bailout for Italy's troubled banks' *Financial Times* (4 July 2016) 1; Steve Scherer, 'Renzi says wants to avoid EU's "bail-in" to restructure banks', *Reuters* (2 August 2016), <http://www.reuters.com/article/eurozone-banks-italy-idUSL8N1AJ38A>.

[114] In the 60 years of the EU's existence, there is only one single real ECJ decision where an EU legal act failed the test of competence: case C-376/98 *Germany v Parliament and Council (Tobacco Advertising I)* [2000] ECR I-8419 = ECLI:EU:C:2000:544.

[115] See case C-270/12 *United Kingdom v European Parliament and Council* ECLI:EU:C:2014:18, concerning a Regulation on Short Selling.

message is clear: pure legal arguments will not stand in the way of sensible economic choices or political deals.

2. Should we worry?

The more important question is this: should we be concerned that legal principles are frequently relaxed in the name of economic and political goals? This may certainly be so from a rule of law perspective.[116] In particular the German government has been seeking to establish a rules-based culture of the EU financial market and discourages every attempt to insert some flexibility into the system out of fear that the entire system might be undermined. This explains the long tradition of German officials against almost all of the initiatives discussed above, with the ECB probably being its most obvious target.

Another view stands in stark contrast to this position. A number of scholars have argued that it is the precise genius of a legal framework to be flexible in exceptional crisis situations.[117] Katharina Pistor has argued that a conflict between a legal imperative and financial necessities tends to be resolved by suspending the full force of law. It is here that power rather than law becomes salient.[118] In the context of the global financial crisis, the malleability of the legal framework has proved critical for avoiding a complete financial meltdown. This is the substantial difference to the Great Depression of the 1930s, where the Federal Reserve's refusal to buy any assets apart from those which were stipulated in legal rules contributed to the system's collapse.[119]

3. Implications for Brexit

What does all of this mean for Brexit? We have seen how flexible legal rules can be. In fact, the higher the economic stakes, the more elastic they become. The prediction for Brexit is that the same considerations will apply. Given that the economic stakes are extremely high for both sides, as we saw above, we should expect that legal principles will not stay in the way of a reasonable deal between the UK and the remaining Member States.

The implication is of high importance for a number of issues that are relevant in the exit negotiations. It is relevant, for example, for the EU's mantra that the four freedoms (of goods, persons, services, and capital) are indivisible. We mentioned above already that this assertion is not God-given, and we should expect a reconsideration of this stance in the light of our experiences. At least partial exceptions from the freedoms will probably be on the negotiating table soon. Another

[116] For example, Yowell (n 107).

[117] See, for example, Katharina Pistor, 'A legal theory of finance' (2013) 41 Journal of Comparative Economics 315.

[118] ibid.

[119] Perry Mehrling, *The New Lombard Street: How the Fed Became the Dealer of Last Resort* (Princeton University Press 2010) 34-5.

implication is that substance will most likely triumph over form: while there is probably no way to reverse the decision over Brexit as such, expect that the formal legal exit from the European Union does not necessarily mean an exit of the substance of the Single Market.[120] This is the essence of the 'irrelevance' claim of the present paper.

As of yet, it is of course impossible to predict how exactly the negotiation will lead and what type of an agreements the parties will seek. There are, nevertheless, a few key considerations that are likely and that allow us to develop two main scenarios, to which we will now turn.

V. How could a solution look like?

1. 'Special deal' as most likely outcome

Following the logic of this article, a 'special deal' between the UK and the EU27 is the most likely scenario going forward. This would ensure that, on the one hand, the UK is formally leaving the bloc and thereby honouring the outcome of the referendum, and on the other hand still retains access to the Single Market, in substance. This is at least to be expected for the financial services sector, the topic of interest here, where the economic case is so compelling on both sides.

A 'sector by sector' approach appears likely in this context, whereby negotiators reach consensus on single market inclusion of particular industry sectors. Such an approach was first unofficially discussed for the car industry, following the secret agreement the UK government reached with carmaker Nissan. In this deal, Nissan is assumed to have been promised continued Single Market membership for the car industry. A similar status could be achieved for the financial sector.

However, as a quid pro quo it appears likely that the UK government will have to give ground on its position towards limiting immigration.[121] It is to be assumed that such a concession will officially be made with reluctance – but in secret Theresa May will be aware of the fact that such immigration is of actual benefit to the UK economy. The supply of workers and students from the EU has helped the UK grow faster than any other Member State in the past. To avoid suffocating the domestic industry, UK officials have already indicated that they may let in financial-services employees.[122] For example, Philip Hammond, the UK Chancellor of the Exchequer,

[120] The Government White Paper (n 91) also hints at this by proposing a 'new strategic partnership agreement' with the EU, which should include 'the freest possible trade in financial services between the UK and EU Member States'. ibid at para 8.25.

[121] 'The Road to Brexit' Leader, *The Economist* (8 October 2016).

[122] Ibid.

openly discussed the possibility of granting special work permit exemptions to EU citizens working in financial services.[123] In terms of legal design, different variations are possible, depending on the bargaining power and negotiation outcome. Either the UK opts out from free movement, but allowing for a number of back-exceptions, or the UK remains subject to free movement but is allowed to deviate in a number of pre-defined areas. In substance, both approaches would probably yield very similar outcomes.

The result would be a bespoke agreement between the UK and the EU, not entirely dissimilar from the relationship between Switzerland and the EU. A far-reaching Single Market access for the UK appears to be the optimal solution. Political forces and populist influence on both sides of the Channel may however jeopardise this outcome.

A concrete concept along these lines is a so-called ‘Continental Partnership’, proposed in a recent Bruegel policy paper. This is the idea of an idiosyncratic and innovative relationship between the UK and the EU, resting on the UK’s participation in a series of selected common policies consistent with access to the Single Market.[124] Although the details obviously need to be worked out, this idea may helpfully inform the debate and serve as a focal point and role model for future collaboration.

2. Alternative: Third country passport

If full market membership for the financial industry cannot be successfully negotiated, a second best scenario is conceivable. Such a Plan B would assume that the UK counts as a ‘third country’ for EU financial regulation; as such, it could still rely on being classified as an ‘equivalent’ legal system and thereby profit from a third country passport under relevant EU legislation.[125]

The EU utilises an equivalence test in many areas to reduce overlaps and capital costs for EU institutions that comply with rules in other countries.[126] To

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[123] George Parker and James Blitz, ‘Hammond draws fire for Brexit caution’ Financial Times (18 October 2016) 3.

[124] Jean Pisani-Ferry, Norbert Röttgen, André Sapir, Paul Tucker, and Guntram B. Wolff, *Europe after Brexit: A proposal for a continental partnership* (25 August 2016), available at <http://bruegel.org/2016/08/europe-after-brexit-a-proposal-for-a-continental-partnership/>.

[125] See European Parliament, Directorate-General for Internal Policies / Economic Governance Support Unit, *Briefing: Third-country equivalence in EU banking legislation* (7 November 2016); Vincenzo Scarpetta, ‘Understanding regulatory equivalence – an effective fall-back option for UK financial services after Brexit?’ OpenEurope blog post (19 October 2016), available at <http://openeurope.org.uk/today/blog/understanding-regulatory-equivalence-an-effective-fall-back-option-for-uk-financial-services-after-brexit/>. For an overview, see the equivalence table at <http://ec.europa.eu/finance/general-policy/docs/global/equivalence-table_en.pdf>.

[126] Eilis Ferran, ‘The UK as a Third Country Actor in EU Financial Services Regulation’, Journal of Financial Regulation, forthcoming 2017.

illustrate, Articles 46 and 47 of MiFIR[127] set out an elaborate system of conditions that are to be satisfied for 'third-country firms' to perform investment activities with or without any ancillary services to EU counterparties and to professional clients.

Central to the requirements is the condition that the Commission has adopted and equivalence decision in accordance with Article 47(1).[128] Under that article, the Commission may adopt a 'decision […] in relation to a third country stating that the legal and supervisory arrangements of that third country ensure that firms authorised in that third country comply with legally binding prudential and business conduct requirements which have equivalent effect to the requirements set out in this Regulation, in [the Capital Requirements Directive], in [MiFID 2], and in the implementing measures adopted under this Regulation and under those Directives and that the legal framework of that third country provides for an effective equivalent system for the recognition of investment firms authorised under third-country legal regimes'.

Such third country clauses have become the norm in many pieces of financial markets architecture, and the UK places high hopes on relying on them as a fall-back position or 'safety net'.[129] There are a number of problems attached to using a third-country status for the Single Market, however.

The first issue is that the third-country passporting rights tend to be restricted to wholesale financial services, whereas marketing of services to retail customers is typically not allowed. Thus, equivalence does not cover some core banking activities such as deposit taking and cross-border lending. That might not be a serious obstacle in practice, as the UK financial industry is arguably mostly focused on wholesale markets anyhow, and wholesale markets are the more lucrative part of the market overall.[130]

But two other considerations may make third-country access less palatable. First, the availability of third-country access is rather patchy. A number of pieces of EU legislation do include the principle, but others do not. For example, the legal framework for UCITS (mutual funds) in the EU does not allow third country passporting at all.[131] Even where it exists, the requirements and thresholds vary. This may jeopardise the possibility of a holistic Single Market access for the entirety of the UK financial sector. For example, in the field of hedge funds' access to the European market, whilst the relevant piece of EU legislation (the AIFMD) in theory

[127] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, [2014] OJ L173/84.

[128] See MiFIR Article 46(2)(a).

[129] See Scarpetta (n 125).

[130] European Parliament Economic Governance Support Unit, *Briefing – Brexit: the United-Kingdom and EU financial services* (9 December 2016) 3-4.

[131] Other examples of legal acts that do not provide for a passport are CRD IV and (in parts) Solvency II.

provides for an equivalence rule, the Commission has never used it to date – and it does not seem inclined to do so.[132]

Even more serious is the risk of *political* exploitation attached to the vetting process steered by the European Commission. The Commission is de facto the sole body responsible for assessing whether a third country system really is 'equivalent' to EU standards. Given that the UK has long been an EU member and has faithfully implemented all of EU financial legislation over past decades, one would assume that the UK must be the paradigm example of an 'equivalent' jurisdiction. However, the risk remains that the equivalence decision is hijacked for political motives, unrelated to substantial reasons.[133] Unlikely genuine Single Market access, equivalence is not an entitlement, but a privilege which can be unilaterally withdrawn by the European Commission at short notice.[134]

We already see signs of political tactics over equivalence emerging right now, before the UK has even left: recent press reports suggest that the EU is in the process of reviewing the equivalence regime overall, with a view of streamlining the process and toughening the approval criteria, in particular for systemically important financial institutions.[135] This suggests that equivalence may be an uncertain last resort indeed. Reportedly, EU officials are already wary of setting precedents for Brexit when deciding about the equivalence with third countries today.[136]

Add to this the general thrust of Brexit: to be precisely freed from EU legislation, and to reverse it where they can. This could mean that every step of the UK legal order away from the EU acquis could be interpreted – or serve as a pretext – that the UK regulatory and supervisory standards are *not* equivalent (any more) to the EU legal order. Moreover, if the EU financial laws change over time, the UK would have to constantly adapt its own legislation to maintain continued market access for its financial services sector. This would be a politically very daunting exercise.

The only relief could come from a legally binding agreement between the third country and the EU that the former's rules are deemed equivalent.[137] That might

[132] Sean Tuffy, 'Hedge funds in the UK need a hard-Brexit contingency plan' Financial Times (5 December 2016) FTfm9.

[133] Scarpetta (n 125): the process 'can easily trespass into politics – not least because the Commission can wait as long as it wishes to issue its final verdict'.

[134] Jonathan Ford, 'Brexit equivalence deal could spare City pain of Morton's fork' *Financial Times* (12 December 2016) 20.

[135] Alex Barker and Jim Brunsden, 'EU review casts doubt on City's hopes for "equivalence" as Brexit last resort' *Financial Times* (7 November 2016) 1.

[136] ibid 3.

[137] John Armour, 'Brexit and Financial Services', forthcoming, Oxford Review of Economic Policy 2017. See, for example, the 'expanded equivalence' proposal made by Barnabas Reynolds, *A Blueprint for Brexit: The Future of Global Financial Services and Markets in the UK* (Politeia Report 2016).

help, at least in the interim.[138] However, it is uncertain whether such an agreement is acceptable to the EU.[139] In any case, it would take a long time to negotiate, and firms may have to endure a long period of uncertainty during this period. For example, it took the EU four years to negotiate a recent agreement with the US Commodity Futures Trading Commission (CFTC) on the equivalence of central counterparty clearing.[140]

3. Transition agreement

The dimension of time leads us to the broader problem that most of the agreements proposed or predicted here will take a significant period of time to negotiate. The two-year period set by Article 50 seems rather short, in particular since this period must include the ratification of the deal agreed by all 28 Member States.[141] It is further complicated by the fact that 2017 will see national elections in France and Germany, and negotiations will not start in earnest until after these are over. In sum, the window of opportunity for negotiations shrinks to just over a year.

Given the recent experience with negotiating free trade agreements generally, and the complications in the EU in particular, it is obvious that this time period is too short.[142] Crucially, Article 50 is constructed in a way that EU membership ceases automatically if no deal has been struck by the end of two years after notification of leaving intent is given. This means that the UK would risk ‘falling off the cliff’, i.e. ending up with no trade relationship to the EU at all. Transition terms are even more important in the case Brexit due to its unique character of leaving rather than acceding to an international agreement. Brexit is associated with economic disintegration where market players potentially lose their right of market access – this markedly differs from regular trade agreements which typically foster economic integration and create new rights. Without the assurance of a transition deal, businesses will be left in uncertainty over their future status and are likely to act on the basis of the worst case scenario, that is, they will assume a hard Brexit scenario and act accordingly.

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[138] See below Section V.3.

[139] For a critical comment, see Martin Wolf, ‘A post-Brexit transition must be the priority’ *Financial Times* (30 November 2016) 13.

[140] See Silla Brush and Benjamin Bain, ‘EU Banks Closer to $5 Billion Respite With SEC Clearing Rule’ *Bloomberg* (28 September 2016) <https://www.bloomberg.com/news/articles/2016-09-28/eu-banks-eye-5-billion-capital-reprieve-as-sec-votes-on-rules>.

[141] Peter Foster, ‘Brexit deal could be reached by October 2018, says lead EU negotiator Michel Barnier’, *The Telegraph* (6 December 2016), <http://www.telegraph.co.uk/news/2016/12/06/eu-brexit-negotiator-michel-barnier-reiterate-no-cherry-picking/>.

[142] A Davis Polk Client Memorandum, ‘Lex and Brexit – The Law and Brexit’ issue 9 (30 November 2016) expects negotiations to last between five and ten years.

It follows that the need for a transition agreement is compelling. A temporary arrangement would take the time pressure off the negotiations and yield more constructive results, freed from the pressure to deliver within a short period of time. This would also give businesses more time to adjust – in fact, it is common practice, in financial regulation or in trade, to phase in significant changes over several years. A transition agreement should thus be in both sides' interest.[143] The idea has been strongly supported for example by Mark Carney, Governor of the Bank of England.[144] Among Government ministers, Chancellor Philip Hammond has emerged as the top advocate of a transition agreement, claiming that there is an 'emerging view' in favour of it 'among business, among regulators and among thoughtful politicians'.[145] A report by the House of Lords EU Committee also concluded that a transition deal would 'almost certainly be necessary'.[146] The FT's lead commentator Martin Wolf has even argued that a transition deal should have top priority in negotiations.[147]

Such a temporary arrangement could take a number of different forms. For example, the parties could agree on temporary EEA membership for the UK, despite its downsides,[148] with a view of finding a more palatable and sustainable tailor-made arrangement over a couple of years. This would ensure continued single market access for the UK in the meantime and allow for substantial negotiations without impairing financial stability. Once a deal is reached, it could come into force within 4-6 years, which is a regular transition period for major revisions of the international framework in financial markets.[149]

In the alternative, an interim deal could ensure at the very least 'equivalence' for UK financial services standards so that the City firms can make use of the third country passport, as explained above. If equivalence is enshrined in an agreement, rather than a unilateral decision by the European Commission, it would involve much greater certainty for market participants. Such an agreement may further be beefed

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[143] Comment, 'A smooth path to Brexit is necessity, not betrayal – The prime minister will have to confront the right wing of her party' *Financial Times* (5 December 2016) 14.

[144] Mark Carney, giving evidence to the House of Commons Treasury Committee (HC 828, Tuesday 15 November 2016), <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/bank-of-england-november-2016-inflation-report/oral/43361.html>. See also Chris Giles, 'Mark Carney urges transitional Brexit deal' *FT.com* (27 November 2016), available at <https://www.ft.com/content/86393502-b48f-11e6-ba85-95d1533d9a62>.

[145] Chris Giles and George Parker, 'Hammond calls for transition deal to ease final break with Brussels', *Financial Times* (13 December 2016) 1.

[146] House of Lords European Union Committee, *Brexit: the options for trade* (5th Report of Session 2016–17, 13 December 2016) para 263.

[147] Martin Wolf, 'A post-Brexit transition must be the priority', *Financial Times* (30 November 2016) 13.

[148] See above Section II.2.

[149] See Carney (n 144), who discusses the Basel agreements and the Vickers reforms.

up by ensuring continued participation in the Single Market in areas where no third-country passport exists.[150]

4. Private solutions

Were the UK and the EU to fail reaching an agreement, and the UK ceases to be a Member State by way of a 'hard' Brexit, private solutions by market participants are to be expected. Financial services providers would almost certainly pursue some strategy to mitigate the loss of passporting rights, for example by setting up a subsidiary in another EU Member State that could provide financial services as a separately regulated and capitalised legal entity.

However, this would not be a cost-free exercise. The EU financial law framework has specific provisions to ensure that a subsidiary does not become a letterbox entity, where the company exists on paper and the work is done elsewhere.[151] In the case of banking, the subsidiary would require separate capitalisation, separate staff, and supervision by the host Member State.

Chances are that some large banking groups already have an EU subsidiary in place. For example, Credit Suisse CEO Tidjane Thiam explained that (despite substantial costs) the Swiss bank is in a 'reasonable position' to deal with any Brexit outcome thanks to its existing subsidiaries in Dublin and Luxembourg.[152] Likewise, insurance giant Lloyd's claims that the impact of Brexit on its operations will be minimal, and that contingency plans within its group structure are already underway.[153]

These two statements reveal an important point of information: size matters. Whereas large financial services groups are likely to already have an EU27-based subsidiary in place or to set one up at relatively low cost, the disruption of Brexit will most severely be felt by smaller and medium-sized financial institutions, for which the costs of adjusting will be grave. A report by the Boston Consulting Group estimates that a requirement to set up a subsidiary in the EU27 would increase

[150] Similarly, see Scarpetta (n 125): The UK 'should aim for bespoke deals to replicate passport-like arrangements in areas where equivalence is not available. The EU has done it in the past – see the bilateral agreement with Switzerland on the provision of direct insurance (not including life insurance) via branches'.

[151] For example, in the AIFMD (n 14).

[152] Donal Griffin and Oliver Suess, 'Thiam Says Passport Loss Risks 20% of His Bank's U.K. Volume' *Bloomberg* (28 September 2016), available at <https://www.bloomberg.com/news/articles/2016-09-28/credit-suisse-ceo-says-no-passporting-risks-20-of-london-volume>.

[153] 'This will not impact Lloyd's', Interview of Lloyd's Chairman John Nelson with *Versicherungswirtschaft* (21 October 2016), available at <http://versicherungswirtschaft-heute.de/dossier/this-will-not-impact-lloyds/>. In December 2016, Lloyd's announced to set up a separate subsidiary in Germany or the Netherlands. See Emma Dunkley and Martin Arnold, 'Lloyds eyes European arm if UK loses market access' *Financial Times* (28 December 2016) 17.

investment banks' global costs by 3% to 8%, depending on their current operational model.[154] Private solutions are clearly the second-best solution only.

VI. Conclusion

Brexit will inevitably come, but more in form than in substance. That is, in a nutshell, the central message of this paper for the future of European financial integration and the UK. This expectation is grounded in a combination of economic necessities and political constellations, on both sides, EU27 and the UK. Most importantly, the paper draws on the rich experience of the trajectory of financial integration in the EU, where legal formality has frequently bowed to political reasoning and economic necessities.

One recent example serves as an ideal illustration: Switzerland. In a parallel case to Brexit, Switzerland has long been in a similar conflict between market access and its own political exigencies. Whilst the political elite have sought to uphold an agreement guaranteeing free movement of people with the EU, a 2014 referendum demanded immigration quotas for foreigners.

Just recently, Swiss parliamentarians *de facto* undermined the outcome of the referendum by approving a carefully crafted package of measures aimed at boosting the employment prospects of locals without violating the free movement deal with the EU.

In a remarkably lucid analysis, on leading commentator summed up the outcome of the process very much along the lines of analysis pursued here: that 'we have created a Swiss exception — but tried to conform with the rules of the game, so it's not actually an exception'.[155] This, it is submitted, matches the course of the Brexit showdown expected here: Legal creativity will engineer a solution that both formally satisfies the referendum outcome but protects vital economic interests of business.

[154] Philippe Morel, Charles Teschner, Duncan Martin, Will Rhode, and Andreas Bohn, *Global Capital Markets 2016: The Value Migration (Part 2) — Assessing the Impact of Brexit* (BCG White Paper 2016), available at <http://image-src.bcg.com/BCG_COM/BCG-Impact-of-Brexit-on-Capital-Markets-July-2016_tcm9-38972.pdf>.

[155] Max Stern, cofounder of Foraus, a foreign policy forum (cited according to Ralph Atkins, 'Swiss head for EU immigration climbdown' *Financial Times* (14 December 2016) 8).