

June 25, 2015

The basic facts

The United Kingdom (UK) government (Government) is committed to negotiating a new relationship between the UK and the European Union (EU), and holding an in / out referendum, before the end of 2017.

The basic legal position – holding a referendum

The Government's European Union Referendum Bill was introduced into the House of Commons and had its first reading on 28 May 2015. Its second reading debate took place on 9 June 2015; and it was considered in Committee on 16 and 18 June 2015. A report and third reading are pending. When they have taken place, the Bill will move to the House of Lords, and the process will be repeated.

There is more information about the Bill and its current status here.

The basic legal position – staying in the EU

If the UK decides to stay in the EU, some of the EU's Regulations and Directives might need to change, and some of the UK's EU Directive implementing laws will probably need to change.

The nature and extent of the EU Regulation and Directive changes will probably depend on the UK's post-referendum EU status. For example, if the UK is still a member of the EU, but (say) the EU's insurance and banking Directives will no longer apply in or to the UK, an EU Omnibus Directive might be used to amend every reference to "the member states of the European Union" in these Directives, to "the member states of the European Union, excluding the United Kingdom" (or something similar).

The nature and extent of the UK Directive implementing law changes will probably depend on how the relevant Directives have been implemented into UK law, and whether the intention is to retain, amend or revoke the relevant laws. In all probability, primary and secondary legislation, and PRA and FCA rules, will be used to maintain the whole of the relevant UK Directive implementing statutes, statutory instruments and rules, on a transitional or grandfathering basis, until the Government, PRA and FCA (as the case may be) have had an opportunity to consider whether to retain, amend or revoke each relevant law or rule, so that it properly matches the Government or regulators' own policies in the relevant areas. For the PRA, for example, this might mean developing, consulting on, and then implementing a supplement to, or a replacement for, some or all of the Solvency II Directive, and/or some or all of CRD III and IV – an undertaking that is likely to take several years to complete.

These transitional or grandfathering rules could also be used to implement relevant EU Regulations into UK law, with effect from the moment that (for example) the European Commission's Solvency II Delegated and CRD IV Implementing Regulations cease to apply in and to the UK, to prevent "gaps" appearing in the UK's legislative framework, unless and until the Government and regulators have had an opportunity to consider whether, and if so how, they would like to fill these "gaps" overtime.

If this is right, it suggests a period of material uncertainty while we wait to see whether the UK will remain in the EU; and, if it will, when and how the UK's law will change in those particular areas that have been governed or harmonised by EU law, where EU law will no longer apply, and the UK has a free hand.

The basic legal position – withdrawing from the EU

If the UK decides to leave the EU, it will be required to give notice to the European Council² (Council), and

withdrawal negotiations will follow.

It appears³ that, if this notice is given, (a) the European Commission (**Commission**) will make recommendations to the Council for the conduct of negotiations with the UK; and (b) the Council will consider these recommendations, before nominating an EU negotiator, agreeing negotiating guidelines, and authorising the opening of EU / UK negotiations.

If the EU and UK Government reach an agreement, that agreement will be subject to adoption by a qualified majority of the Council, acting on behalf of the EU, after it has obtained the consent of the European Parliament (Parliament). This agreement may also be subject to ratification by the UK's Parliament, although the details are from clear.

(At least from an EU perspective), the purpose of the EU / UK negotiations would be to seek to agree (a) the terms of the UK's withdrawal from the EU, taking into account the nature of the relationship the UK will have with the EU after its withdrawal takes effect (if any); and (b) the extent to which EU legal rights and obligations will continue to apply to the UK, and to and between the legal and natural persons of the UK and EU, after the withdrawal takes effect.

If an agreement is reached, the European Treaties will cease to apply to the UK when the agreement comes into force on a date to be agreed between the parties. If there is no agreement, the Treaties will cease to apply to the UK two years after the UK gives notice of its intention to withdraw. It is therefore at least possible that, if the UK chooses to leave the EU, its law will remain stable until (at least) 2019, even if the UK's international relationships, economy and political environment begin to change before the end of 2017.

The range of legal options, if the UK chooses to leave

The UK might choose to withdraw from the EU absolutely. If this happens, then it is at least possible that (a) the EU's Treaties and Regulations will immediately cease to form part of UK law, unless the UK uses "saving" or "grandfathering" legislation to give itself the time it needs to consider, and then vary or revoke them, without "gaps" suddenly appearing in the UK's legal system; (b) the UK's Directive implementing laws, and those parts of UK law that rest on the jurisprudence of the EU Courts, will probably remain valid and effective, unless and until they are repealed, or a UK Court finds they no longer have legal effect, generating significant uncertainty about what is valid, and what is not; as well as about how law that was previously European should be interpreted now that it is not; and (c) the UK will no longer be obliged to implement the EU's Directives, or comply with the jurisprudence of the EU Courts, although it might still choose to do so.

At the other extreme, the UK might become a non-EU member of the European Economic Area (EEA). If this happens, EU law will probably continue to apply in and to the UK, in materially the same way that it applies today, but the UK's EU membership levies will fall or cease; the grants paid by the EU to parts of the UK will fall or cease; and the UK will no longer have a right to negotiate, or seek to influence, the terms of EU law and policy.

The UK could also (a) cease to be a member of the EU, but decline to become a member of the EEA; and/or (b) seek to negotiate bi-lateral trading arrangements with one or more of the members of the EEA, if that can reasonably and lawfully be done.

What legal and practical risks does this generate for UK (re)insurers, banks, fund managers and other regulated firms?

Uncertainty

Anecdotal evidence suggests that UK Plc is already devoting a significant amount of time and resource to the identification and possible mitigation of the risks associated with a *Brexit* (both independently, and at the behest

of the regulators, which are contingency planning in materially the same way).

The result is that UK PIc is beginning to delay material investment and other decisions, because management time and attention is focussed, and resources are being spent, on contingency planning and related issues; and/or because business is gradually becoming concerned that a decision taken ahead of the referendum may be regretted afterwards.

As the date of the in / out referendum approaches, the amount of time and resource being devoted to contingency planning is likely to increase (at least up to the point where the planning is substantially done); and more investment and other decisions are likely to delayed. Some of this may continue after the referendum result has been published, even if the UK decides to stay in the EU, given the uncertainties described above.

Each of these risks generates risks of its own. For example (a) the risk that individual business, macro-economic, security and other risks will begin to emerge, unnoticed and unmitigated, whilst the UK contingency plans against the risk of a *Brexit*,⁴ (b) the risk that product and market innovation will slow; and the level of M&A and other corporate activity will fall, as time and resources are devoted to other things; and (c) the risk that Financial markets will falter as the referendum approaches and investors worry about the result, adversely affecting the value of their assets.

If the UK votes to leave the EU, the uncertainty generated by *Brexit* negotiations may be complicated by a second Scottish Independence referendum, and Scotland's subsequent attempts to remain in the EU (if Scotland votes for independence on this occasion), whilst the rest of the UK negotiates the terms of its exit.

Losing the passport

One of the biggest risks to UK domiciled (re)insurers, banks and other regulated firms is likely to be the possible loss of the European passport, and the single European market in financial services, (in each case) if the UK leaves the EU and does not remain within the EEA on terms which secure the future of the passport.

The passport and single European market give EEA domiciled regulated financial services firms the right to trade freely, on a cross-border services basis, across the EEA, (often) without having to register in or comply with the laws of the other EEA member states, and without having to establish a physical presence there either. The passport also gives these businesses the right to establish one or more branches in any or all of the other EEA countries; and a broadly level playing field on which to compete.

The passport, and the right of UK domiciled financial services firms to access to the EEA market on level playing field terms, could be lost in the event of a *Brexit*. Even if these rights entirely lost, they may be restricted, and that might mean that some UK businesses and/or their counterparties will choose to relocate into the EEA, rather than lose some or all of the regulatory and competitive benefits associated with being domiciled there. If this happens, it could make it more difficult, or more expensive, for those that stay in the UK to do business, when compared with things as they are.

Each of these things generates a second layer of risk. Many of the UK's prudential rules are generated in Europe. At the moment, the UK is in a position to influence these rules, and it often "holds the pen", so European Regulations and Directives often suit the UK, to a material degree. However, the EU sometimes makes rules which the UK regards as insufficiently prudent, or too harsh. The result is that, if there is a *Brexit*, the UK may take the opportunity to relax some rules (for example, the cap on bankers' annual bonuses), and tighten others (for example, Solvency II's capital requirement, and the senior insurance managers regime), generating a second layer of risk, which is more difficult to predict.

The impact on contractual relationships

It is perhaps unlikely that a UK vote to leave the EU; the beginning of EU / UK exit negotiations; or the success or failure of these negotiations, will trigger (for example) an ordinary force majeur or material adverse change clause, or give contractual parties the right to terminate a pre-existing agreement between them. But it might be worth expressly providing for any or all of these things in contracts that are still to be negotiated and entered into. It might also be worth including an additional interpretation clause, if a contract depends on or refers to EU law, or UK law with EU roots, in each case to mitigate the risks of uncertainty that might follow if, for example, an

EU law no longer has effect in the UK, but it is replaced by a UK law (or vice versa) (in either case, does the new law apply, or not?); and/or that the relevant law will be interpreted and applied in accordance with European or UK legal principles, according to the preference of the parties.

Other risks, issues and opportunities

A Brexit could also:

- Lead to a short or medium-term decline in the UK's economy and the health of the public finances, if banks, insurers, brokers, PE/VC find managers and others choose to relocate to stay inside the EU;
- · Make it more difficult for UK domiciled (re)insurers to recruit and retain appropriately qualified and experienced staff;
- Generate an opportunity for those insurers that are willing and able to insure other businesses against some of the most clearly identifiable risks associated with a possible Brexit; and/or
- Push some (re)insurers and/or some books of business into run-off, as live carriers adjust their target market(s) to suit their
 new circumstances; and/or relocate to stay inside the EU, rather than risk losing the passport and other benefits that EU
 membership seems to bring.

Notes

- 1. The UK's Directive implementing laws might survive the disapplication of the EU's relevant Directives to the UK. But this disapplication is likely to create uncertainty, which the transitional or grandfathering legislation and rules can be used to resolve. For example, it might not always be the case that the implementing law will survive the disapplication of the relevant Directive. And, if an implementing law does survive, there are likely t be questions about whether they should be interpreted in a way that is consistent with the interpretation and development of EU law; or UK law, with or without subsequent EU law developments to be taken into or left out of account.
- 2. See article 50 of the Consolidated Treaty on European Union, and the Treaty on the Functioning of the European Union.
- 3. From articles 50 and 218(3) of the Treaty on European Union, and the Treaty on the Functioning of the European Union.
- 4. This is a real risk. For example, it is thought that the Royal Bank of Scotland failed, at least in part, because the Bank and the Regulators had correctly identified the problems that caused its downfall, and they had started to address them; but their attention switched almost entirely to the implementation of and compliance with Basel II. When this happened, the original risks were abandoned, until it was too late to avoid crystallisation.

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