

INTRODUCTORY STATEMENT

The Future Constitutional Relationship of the UK with the EU with a special view to economic governance and the internal market

Workshop of the Constitutional Affairs Committee of the European Parliament (AFCO) on the 'Future Constitutional Relationship of the United Kingdom with the European Union'

Monday, 5 September 2016

Good afternoon, Madam Chairwoman Hübner, and dear Members of the Constitutional Affairs Committee. I would like to thank you for inviting me to participate in this workshop on the 'Future Constitutional Relationship of the United Kingdom with the European Union'. The path to this workshop began in February when Fabian Amtenbrink, Anastasia Karatzia and me from the European Research Centre for Economic and Financial Governance of the Universities of Leiden, Delft and Rotterdam accepted to draft an in-depth analysis on the impact of the new settlement for the United Kingdom on economic and financial governance. The findings of our analysis are now only material for legal historians. Yet – and this statement should also be allowed in today's workshop – the British referendum of 23 June has at least one positive outcome: The new settlement is off the table and its negative impact on the EU's economic and financial governance, which would have been beyond mere rhetorical cosmetics, won't materialise.

But let me now turn to today's subject: The future constitutional relationship of the United Kingdom with the European Union with a special but not exclusive view to economic governance and internal market.

THE LEGAL FRAMEWORK OF THE FUTURE CONSTITUTIONAL RELATIONSHIP: ARTICLE 50 TEU

Let me first address the legal framework of the future constitutional relationship before I will turn to special aspects relating to economic governance and the internal market. The legal framework of the constitutional relationship of the UK with the EU is at the moment difficult to describe as major policy choices are not yet made. Nevertheless we can outline several options. A brief look into Article 50 TEU tells us that the constitutional relationship will be determined by an agreement of the Union with the UK 'setting out the arrangements for its withdrawal'. This agreement has to be negotiated within a period of two years following the formal notification of the UK to withdraw from the Union. If there is no agreement after the expiry of the two years, the Treaties including the secondary Union law cease to apply without any arrangements. There is hence no obligation for the Union to conclude a withdrawal agreement. A prolongation of the negotiation period requires a unanimous vote within the European Council. The ultimately negotiated agreement is concluded after a qualified majority vote in the Council and the consent of the European Parliament. So far, so clear.

The wording of Article 50(2) TEU does now further specify what is meant by 'setting out the arrangements for its withdrawal' when it requires that these arrangements are 'taking account of the framework for its future relationship with the Union'. The reference to the 'framework for its future relationship' links the withdrawal agreement with the future framework and, by that, with the policy choices that are to be made by the UK concerning its future position in Europe.

Before going into details what this reference could mean, one should recall the several options for the UK's future in Europe outside the Union: First, there is the so-called 'Norwegian model', according to which the United Kingdom joins EFTA and may afterwards apply to become a member of the European Economic Area (EEA). Second, there is the option to conclude a set of tailor-made agreements between the EU and the UK defining their relationship. There are several names on the market describing this option like 'Swiss option', 'Turkey option' or 'Canada option'. The choice of the name of the country

reflects the intensity of the desired relationship with the Union. From a legal point of view, all those options would require the negotiation and conclusion of international agreements with the Union and its Member States. Finally, there is the 'WTO option', according to which the UK may require access to the Internal Market based on the 'Most-Favoured Nation' clause and the non-discrimination principle under WTO law.

THE MEANING OF 'TAKING ACCOUNT OF THE OF THE FRAMEWORK FOR ITS FUTURE RELATIONSHIP WITH THE UNION' FOR THE WITHDRAWAL AGREEMENT UNDER ARTICLE 50 TEU

Now the question arises as to the extent to which the future relationship has to and can be determined by the withdrawal agreement under Article 50 TEU. The following elements of an answer can be sketched: First, the withdrawal agreement has to cover aspects of the future relationship between the UK and the Union. Otherwise the withdrawal agreement could not take account of the framework relating to this future relationship. A position stating: First the withdrawal and then negotiations about the future relationship appears against this background at least questionable. Second, the withdrawal agreement under Article 50 TEU does not define the future relationship between the UK and the Union itself as this would go beyond the meaning of 'taking account of'. To draw now a precise borderline between these two antipodes appears difficult and can only be undertaken once the UK took the policy decisions on its future position in Europe. Under the EEA option, the framework of the future relationship will be defined by EEA law so that an EEA membership, which is conditional upon the entry into force of the withdrawal agreement, appears to be a possible solution. Under the WTO option, no detailed rules on the future relationship between the UK and the Union within the WTO framework would be needed so that simply concluding a withdrawal agreement appears to be a suitable solution.

Yet, when it comes to tailor-made solutions, the meaning of the word 'taking account' becomes significant. Within this option the trade relations between the Union and the UK would have to be defined autonomously. This requires a comprehensive trade agreement such as CETA or TTIP, which are based on Article 207 TFEU. The conclusion of free trade agreements requires, depending on its content, a qualified majority or unanimity after obtaining the consent of the European Parliament, whereas the majority needed in the Council for concluding the withdrawal agreement under Article 50 TEU is, independently of the content, the qualified one. Furthermore, as legal academia stands today, comprehensive free trade agreements are considered mixed agreements. We will have more clarity in that matter once the Court of Justice issued its opinion 2/15 on the Free Trade Agreement with Singapore. The oral hearing for this opinion is scheduled for 12 and 13 September. For the time being, we have to assume that such comprehensive free trade agreements are mixed agreements, the conclusion of which requires the ratification by all EU Member States, in accordance with their respective constitutional requirements, whereas the conclusion of the withdrawal agreement depends only on the approval of the Council and the European Parliament. Already this comparison of the decision-making procedures makes clear that the tailor-made solution may not be achieved by a withdrawal agreement but requires a set of agreements, amongst which there would be a CETA/TTIP kind of comprehensive free trade agreement. This shows that, in sum, when it comes to the tailor-made solution, a withdrawal agreement may not be concluded without any reference to the future framework of the UK's relationship with the Union, but may, at the same time, also not serve as a basis for this future framework. Ideally, because of the interdependence of the withdrawal agreement and the framework of the future relationship, both should be concluded within the same period of time, which is defined by Article 50 TEU as two years provided that there is no unanimity in the European Council to prolong it. This is the beauty of Article 50 TEU, as it was designed by the Treaty-makers.

SELECTION OF SUBSTANTIVE ISSUES RELATING TO ECONOMIC GOVERNANCE AND THE INTERNAL MARKET

Having had a look at Article 50 TEU and its interplay with the policy decisions on the future relationship of the UK and the Union, let me now turn to some substantive issues relating to economic governance and the internal market. The following observations are based on the assumption that the UK leaves the Union without any specific arrangements. This approach will, by that, reveal some of the critical issues that will form the object of the upcoming negotiations. Since both areas are far-reaching and the state of integration is quite advanced, the following points are purely exemplary. A comprehensive list of issues would certainly require another in-depth analysis. In the following I will address the position of UK based financial institutions on the internal market, the clearing of euro denominated trading of derivatives, the taxation situation with regard to interests and royalties, and the free movement of UK incorporations.

THIRD-COUNTRY PASSPORT FOR UK INCORPORATED FINANCIAL INSTITUTIONS

First, regarding financial regulation, financial institutions established in EU member states can under the current legal framework obtain a so-called 'passport' that allows access to the markets of other EU member states without being required to set up a subsidiary or branch and to obtain a separate license to operate as a financial institution in that member state. UK financial services institutions, including subsidiaries of US and other non-EU parent companies, would in case of a withdrawal of the UK without any arrangements no longer benefit from this financial services passport. They would have to apply for a third-country passport under the 'Markets in Financial Instruments Regulation'. In order to obtain such a third-country passport, a firm could choose to register with the European Securities and Markets Authority. Such registration with ESMA is, however, only open for companies that are incorporated in a country, for which the European Commission issued a so-called 'equivalence decision' stating that the third country's prudential and conduct framework must have equivalent effect to the requirements under MiFID II. This third country passport does also not cover all financial services excluding, amongst others, deposit-taking, commercial lending, trade finance, payment services and management of alternative investment funds. Access to the internal market of financial services would against this background still require from the United Kingdom to somehow synchronise its own financial regulation with the one adopted by the EU, be it under EEA law or be it autonomously. The UK will therefore certainly look for a way out of this dilemma in the upcoming negotiations.

REGULATION OF 'CENTRAL CLEARING COUNTERPARTIES' (CCP)

Secondly, and somehow connected with just mentioned issue of access to the internal financial services market, there is the famous 'location policy' of the European Central Bank on so-called central clearing counterparties (CCP). Such a counterparty acts as the 'buyer to every seller and the seller to every buyer' in securities or derivatives transactions where the parties have agreed to clearing. The counterparty interposes itself between the two parties assuming the legal counterparty risk. Its purpose is hence to cushion the risk of settlement failures when trading financial derivatives. London is currently one of the most important centres for the clearing of all types of derivatives. It dominates the clearing of euro-denominated derivatives, having a daily turnover of transactions worth approximately 927 billion euros. In order to manage the threat of CCPs for the financial stability of the Euro area, the ECB adopted its so-called 'location policy', according to which clearing houses with daily exposures of more than 5 billion euros in euro-denominated derivatives have to be located in the Euro area. The General Court declared, upon an action for annulment initiated by the UK, this ECB policy to be void because of a lack of competence of the ECB. The Union legislator may, however, based on Article 129(3) TFEU amend the ECB statute, in accordance with the ordinary legislative procedure, in order to transfer the necessary competence upon the ECB, which could then again adopt its location policy. The consequences of this 'location policy' would be severe for UK incorporated firms dealing with euro-denominated trading and financial services as certain euro-denominated business and trading could then only be carried out in the euro area.

WITHHOLDING TAXES ON INTEREST, ROYALTY AND DIVIDEND PAYMENTS BETWEEN ASSOCIATED COMPANIES

Turning now, third, to taxation issues, besides the non-application of EU State Aid rules in the territory of the UK in case of a withdrawal, one should look at the Interest and Royalties Directive and the Parent-Subsidiary Directive. Both measures disapply withholding taxes on interest, royalty and dividend payments between associated companies in EU member states. Were the UK to leave the EU, such payments to a UK incorporated recipient company could be subject to withholding taxes levied by the remaining EU member states. Since both directives were adopted on the basis of Article 115 TFEU, the existence of an internal Union competence, which was exercised by the Union, has a pre-emptive effect on the conclusion of international agreements of EU Member States with third countries. Rules concerning withholding taxes on interest, royalty and dividend payments between associated companies may therefore only be established in relation to the United Kingdom as a third country by means of an EU agreement.

THE FREE MOVEMENT OF UK INCORPORATED COMPANIES

This just described taxation issue is embedded in the broader context of the application of the fundamental freedoms to incorporations established under UK law, which brings me to my fourth and last point. Since at least the European Court of Justice's judgment in 'Überseering', it is clear that incorporations benefit from the free movement rights as 'legal creatures' of their country of incorporation. This privilege has led to some sort of legal arbitrage within the EU: Economic operators establish a 'Limited Company' in the UK, while doing business anywhere else within the internal market, thereby being able to circumvent mandatory rules applying in their state of business such as laws on co-determination, minimum capital, or

mandatory insurance requirements. If now following a withdrawal of the UK from the EU the fundamental freedoms stop being applicable to UK incorporated companies, these companies can become subject to the corporate laws of their administrative seat. By that, a UK 'Limited Company' would, for example, in Germany be treated as an 'Offene Handelsgesellschaft' (OHG). Hence, UK incorporated companies would be well advised to convert into EU legal forms, which would still benefit from the free movement rights. The UK, however, might, once the fundamental freedoms won't be applicable in its territory anymore, also adopt rules requiring, for example, the consent by UK authorities before exiting the country, a situation, which was declared by the Court as incompatible with the fundamental freedoms in cases 'Cartesio' and 'VALE'. Against this background, the UK will have to face an exodus of UK incorporations that conduct businesses exclusively outside the UK and the continent will enter into new phase of regulatory competition with regard to legal forms.

CONCLUDING REMARKS

These was, Madam Chairwoman, dear Members of the AFCO committee, a small selection of some issues relating to economic governance and the internal market. They show that a withdrawal from the Union without any arrangements on the future relationship with the Union is not in the interest of the United Kingdom. On the Union's side, Article 50(2) TEU requires from the Union not only to negotiate a withdrawal agreement but also arrangements for its future relationship with the United Kingdom. Article 50 TEU is designed in a way to incentivise the search for some sort of close cooperation between the exiting state and the Union, although it does not impose a legal obligation on the Union to do so. If such future relationship is to be determined on the basis of tailor-made arrangements, Article 50 TEU won't serve anymore as a legal basis but Article 207 TFEU on the common commercial policy has to be exercised. Yet, a withdrawal agreement cannot be made a pre-condition for negotiations on the future relationship with the UK as the former has to take account of the framework for the future relationship of the UK with the Union.

I hereby want to conclude my introductory statement and I am very much looking forward to the upcoming debate of this workshop



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