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Scotland: Legal Issues on Proposed Independence

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On 18 September 2014, the referendum on Scottish independence will take place. Opinion polls suggest that the outcome is too close to call. This note highlights various legal issues related to the referendum and Scottish independence, in particular those related to the location and status of financial institutions, membership of the European Union, possible structures for a new currency and the national debt. Issues connected with credit default derivatives are addressed in a separate client note.

The Referendum

The referendum is governed by the Scottish Independence Referendum Act 2013. This legislation was passed by the UK Parliament, following an agreement between the UK and Scottish Governments in October 2012 that a referendum on Scottish independence could take place. The Act sets out the key provisions governing the referendum, including the question – “Should Scotland be an independent country?” The Act also prescribes the procedures and processes for the referendum.

If the result of the vote is “no,” then no further steps would take place. If the result is “yes,” then further legislation would be required to cede Scotland as an independent country. In the meantime, again, nothing would happen immediately following the vote. The process of cessation would require further legislation by the UK Parliament. All of the UK’s three main political parties have committed to respect the outcome of the referendum, but oppose independence. This may mean that the details of any cessation will take a long time to agree and longer to become effective. Many of the key details of independence, such as a currency, are unknown. In the following sections, various possible ramifications of independence are discussed, but the ultimate outcome on any matter is subject to uncertainties.

UK Constitutional Arrangements and Nomenclature



The British Isles, in the geographical sense, includes two independent countries: the United Kingdom (comprising England, Wales, Scotland and Northern Ireland) and the Republic of Ireland. The Channel Islands (Guernsey, Jersey, Alderney, Sark and others) and Isle of Man are crown dependencies or possessions. None of these smaller islands are part of the United Kingdom, though they enjoy various beneficial treatments in terms of trade and immigration law. If Scotland becomes independent, then England, Wales and Northern Ireland would comprise the “rest of the UK” or “rUK.” The London-based rUK parliament would no longer have Scottish MPs. Based on past election results, this is likely to mean more regular Conservative governments in Westminster; and Labour or SNP in Scotland. There are uncertainties as to how maritime territory would be separated, an issue relevant to the status of some North Sea oil fields and related pipelines.

Membership of the European Union and other European Free Trade Associations

Scotland’s future status as part of, or outside the EU (or other European institutions), is relevant to the likely legal and financial sector impacts of independence for various businesses. The rUK would presumably accede to the UK’s membership and, as a new country, Scotland would need to apply for new membership of international bodies.

Because the structure for separation of Scotland from the rUK is unclear, it is similarly unclear as to whether Scotland could be automatically co-opted into the EU or otherwise fast-track an application for membership. Because the relevant treaties do not cover this situation and there is no obvious precedent, it is difficult to predict how such a process would be handled. Other EU countries with separatist movements (e.g. Spain) might not want to simplify the process of accession and could even exercise their veto rights to prevent this.

As has been experienced by Eastern European countries, the formal process for becoming a member of the EU is complex and can be lengthy. Membership is subject to the unanimous approval of the Council of the European Union on the basis of an opinion issued by the Commission and approved by the EU Parliament. Criteria for membership include having “(i) stable institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities; (ii) a functioning market economy and the capacity to cope with competition and market forces in the EU; and (iii) the ability to take on and implement effectively the obligations of membership, including adherence to the aims of political, economic and monetary union.”¹ It is frequent today for a referendum to be part of the application process, but Parliamentary approval would be sufficient and might be considered appropriate for a

¹ See. http://ec.europa.eu/enlargement/policy/conditions-membership/index_en.htm.

territory that has historically been part of an EU member state. There are various other European countries currently being considered for EU membership.

Scotland would need to implement EU laws and regulations. Depending on timing, it might be possible to do this by ensuring that up to a particular date, UK parliamentary legislation applies. Certain infrastructure requirements, which Scotland currently meets as part of the UK, would need to be addressed in advance of any accession.

An alternative or interim option would be to adopt the Norwegian model of joining the European Free Trade Association (“EFTA”) and obtaining access to EU internal market through the European Economic Area (“EEA”). This involves compliance with and implementation of all the directives and regulations adopted in the EU, but with only a limited ability to influence them. Once in the EEA, however, the main benefits to businesses and the financial sector of accessing European markets become available. Alternatively, Scotland could join the EFTA and conclude bilateral sectoral trade agreements without joining the EEA (as Switzerland has done). Otherwise, Scotland will be treated like a third country, such as the US, with limited access to the EU and its markets.

Accession to the EFTA (which allows access to the EEA) is at the discretion of EFTA’s council, which may impose terms and conditions. Generally speaking, however, EFTA looks to the implementation of laws equivalent to EU directives and regulations. As with the EU, applications can take some time, as Croatia has experienced.

Legal Jurisdictions

Scotland is already a separate legal jurisdiction with its own case law and judicial system. England & Wales and Northern Ireland are two further separate legal jurisdictions. Many Acts of Parliament apply equally to English, Scots and Northern Irish laws in policy terms, with only minor technical differences in implementation. Presumably, UK parliamentary Acts prior to independence would have to be given validity in Scotland.

If Scotland becomes independent, it is possible that over time there will be an increasing divergence between its laws, legal system and administrative institutions with those of the rUK. Upon independence, Scotland’s laws will be very similar to those of the rUK and its institutions will be based on UK ones. A degree of continued harmonisation is likely through EU/EFTA membership and for cultural and competitiveness reasons. Harmonisation of laws may be required if there is a currency union for pound sterling or if any administrative arrangements or government institutions are shared with the rUK. However, laws north and south of the border will doubtless diverge over time.

Impact on the Financial Sector

Two legal requirements mean that independence is likely to have a serious impact on financial companies. First, a “passport” under relevant European Directives permits access to investors throughout the European Union. A passport would be available for a business located in the UK (or rUK), but would not be available were Scotland to fall outside the EEA for any period. It is critical for the business of any financial institution doing cross-border business that such a passport is available. Secondly, under the EU’s Capital Requirements Regulation, a bank must have its registered office and principal place of business in the same EU member state.

The former Royal Bank of Scotland (RBS) has already announced plans to re-register its head office in London in the event of a “Yes” vote, reflecting the larger size of its London operations. Perhaps more surprisingly, most of the other main Scottish financial institutions (including the largest national banks such as Clydesdale) have announced plans to relocate their head office to the rUK in the event of a “Yes” vote. Such banks will have to treat Scotland as some form of outsourcing or operational centre and customer base, at least temporarily, in the event of a “Yes” vote.

For banks and other corporates with sizeable operations in the rUK which decide to change the place of their registered office but use the same registered company for their operations, few legal issues will arise. However, corporates which need to establish a new rUK head office as a separate legal entity would have to overcome various

obstacles to ensure that their counterparties continue to deal with the right legal entity. Court transfer schemes are potentially available to achieve smooth novations for banks, but not for corporates in other sectors.

If Scotland joins the EU or EEA, then there would be nothing to prevent former Scottish banks and other businesses from moving back again (assuming adequate central banking facilities are established). Banks, financial institutions and others would at that point be able to use passport rights to access counterparties and customers throughout the EEA. If Scotland is outside the EU and EEA, however, then the possibility of access to European markets and customers from Scotland would be much reduced. Fund managers based in Scotland would find themselves treated like any other managers based outside the EEA, potentially limiting the ability of those managers to market funds to EEA investors. The proposed new Markets in Financial Infrastructure Regulation (MiFID II/MiFIR) provides for a helpful new regime of access to third country investment firms such as brokers, exchanges and advisors whereby an “equivalence” decision in relation to a non-EEA member state’s laws, together with registration, could facilitate access to European markets. However, this involves a separate and potentially lengthy process of study and its own political elements – and there is currently no similar “equivalence”-based regime for fund managers under the Alternative Investment Fund Managers Directive (AIFMD). The access of third country institutions to the European markets is discussed in a separate client note.²

Currency

Pound sterling would remain the currency of the rUK. Scotland would be a new country and have to adopt its own currency. Possible options for a Scottish currency include:

- Retaining the pound sterling. This may require negotiation of a Euro-like currency union with the rUK. This option is currently disclaimed by the Bank of England and the three main UK political parties.
- Adopting the pound unilaterally (like Panama does with USD) with no influence over sterling monetary policy.
- Joining the Euro.
- A new currency, such as a Scottish pound, similar to the old Irish pound (punt).

The status of “lender of last resort” undertaken by the Bank of England and the availability of its liquidity facilities also requires consideration. Unless there is a change of tack and Scotland is allowed to use pound sterling, ultimately a Scottish Central Bank will need to take on this role. This might be in conjunction with the European Central Bank if Scotland adopts the Euro. Until a detailed proposal and timetable is produced, there will likely be an unfavorable economic environment for any Scottish banks that have not relocated, particularly medium to long-term credit ratings, because the time at which the Bank of England backstop will cease (and the credit quality of what will replace it) will be unknown.

National Debt

Scotland would need a separate credit rating and the ability to raise its own debts as a sovereign. Unless a restructuring takes place with creditors, existing national debt of the UK would in principle stay with the existing debtor, the UK (or its main successor, the rUK). Any proposal for a restructuring could be damaging: replacement of the UK as a creditor with a creditor of different risk profile could reduce confidence in UK debt as a whole. As a result, as a minimum, some sort of guarantee by rUK to existing creditors for debt assumed by Scotland might be needed. Alternatively, the rUK could maintain all the existing debt, with Scotland liable to the rUK for part of it under some sort of back-to-back reimbursement arrangement. The status of debt issued after a “Yes” vote would also be

² Extraterritoriality Revisited: Access to the European Markets by Financial Institutions, Funds and Others from Outside Europe, available [here](#).

interesting. It might be possible to offer different tranches that would convert into rUK or Scots debt, for example, but even in the latter case, an rUK guarantee might still be expected. An offer to take up some of the national debt is considered by the independence movement to be a “bargaining chip” in entering a currency union with the pound sterling, but the two points are not necessarily linked.

The debt to GDP ratio of rUK would increase unfavorably with Scottish independence if rUK remains as a guarantor or primary obligor of national debt. However, it is not clear if the ability of the rUK to pay the debt would be adversely affected, taking into account the net tax revenue (after allowing for public expenditure) of the two proposed countries.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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