IRSG
INTERNATIONAL
REGULATORY
STRATEGY GROUP

Produced with support of

Hogan Lovells

A NEW BASIS FOR ACCESS TO EU/UK FINANCIAL SERVICES POST-BREXIT

EXECUTIVE SUMMARY

September 2017

www.irsg.co.uk

The International Regulatory Strategy Group

The International Regulatory Strategy Group (IRSG) is a practitioner-led group comprising senior leaders from across the UK-based financial and related professional services industry. It is one of the leading cross-sectoral groups in Europe for the industry to discuss and act upon regulatory developments.

With an overall goal of promoting sustainable economic growth, the IRSG seeks to identify opportunities for engagement with governments, regulators and European and international institutions to advocate an international framework that will facilitate open and competitive capital markets globally. Its role includes identifying strategic level issues where a cross-sectoral position can add value to existing views.

The IRSG is co-sponsored by TheCityUK and the City of London Corporation

CITY OF LONDON

TheCityUK

FOREWORD

This is the IRSG's third report setting our thinking on the basis of the future trading relationship between the UK and EU post-Brexit. Its starting point is that it is in the mutual interest of the EU27, the UK, businesses and the financial services sector for the existing, heavily integrated, cross-border flows in finance to continue in order to sustain jobs and growth across the whole of Europe. Our challenge has been to find a model that takes into account both the deep integration of businesses across the EU today and the realities of the UK no longer being a member of the Single Market.

Membership of the Single Market guarantees access by business to cross-border services underpinned by a legislative and judicial framework for the development and enforcement of the Single Rulebook. We recognise that once the UK leaves the EU, it will no longer be a member of the Single Market and therefore a new basis is needed to enable businesses to trade cross-border. Our first report made that the case that the existing third country/equivalence regime is not sufficiently robust to support those flows. In our second report, we started to explore various options around a free trade agreement ("**FTA**"). This report is a more in-depth analysis of principal components of a financial services chapter in a FTA.

The model we propose is ambitious. It is both familiar and novel. It poses challenges to both the EU and the UK Government in its design. It builds on existing FTAs, but applies them to financial services. It provides a framework to maintain access to services for businesses in the EU27 and the UK: access that is contingent upon achieving shared regulatory outcomes. Although the EU27 and UK deliver these now through the Single Rulebook and other mechanisms, over time regulation will continue to evolve, and may diverge. Our model facilitates divergence by both the EU27 and UK, but if that divergence is material and puts achieving those shared outcomes at risk, then access to each other's markets could be lost.

Our FTA model provides a more robust framework for access than the third country regime, but it is contingent on managing divergence through co-operation and dispute resolution; access is therefore less certain than within a Single Market Framework.

The IRSG's members reflect the diverse nature of financial and related professional services firms operating in London. Its members are headquartered across the world – in the UK, Europe, the US and the Far East. As negotiations progress, our report should therefore be seen as a resource for all those interested in expanding FTAs to cover services, particularly financial services. In the context of the current debate in Europe, it could also be seen as providing some thinking for other heavily regulated sectors where Brexit will disrupt the existing basis of trade and where new models are needed.

This is an ambitious proposal, but it needs to be. The UK and EU27 have both called for a broad and deep relationship after Brexit. To deliver that they will need an ambitious agreement. I hope that this report will be seen a resource to draw upon for all of those who share that ambition.

Mark Hoban
Chair, IRSG Council

IRSG
INTERNATIONAL REGULATORY STRATEGY GROUP

INTRODUCTION

The task the IRSG set itself for this third Report was to suggest a new model which facilitates continued cross-border trade in financial services between the EU and the UK. Central to this is the ability for firms in each territory to have licence-free access to the financial services market in the other territory – "Mutual Access". Unrestricted capital flows across Europe and the ability of European businesses to access financing are key to maintaining a robust economy.

While the UK is a member of the EU, such access is facilitated via the passporting regime in the Single Market Directives. Post-Brexit, that regime will no longer apply to the UK in the absence of agreement to the contrary. Incoming EU firms will need a licence to continue to provide services in the UK and the same will apply to UK firms in respect of their European operations. A different mechanism must be found if frictionless cross border access is to be continued.

What is the appropriate mechanism within which such an arrangement could operate? Free Trade Agreements (FTAs) are a well-trodden way of facilitating trade between nations around the world. They provide a very useful framework. Although they mainly deal with tariff-free trade in goods, they also cover services – and in some cases they cover financial services. To a large extent, therefore, the work is done for us – the precedent exists.

FTAs do not, however, provide the core element that is needed here: licence free access for firms across the EU/UK border. FTAs tend to be between countries whose laws are not aligned and achieving alignment tends to be their ambition; they generally do not aim to provide Mutual Access. In that respect, therefore, an FTA between the EU and the UK would be breaking new ground. It is, as Mark says, an ambitious proposal.

What distinguishes the position of the EU and the UK from those of other parties to existing FTAs is the extent to which the usual concerns are already addressed through existing structures. The EU and the UK already have aligned legal and regulatory regimes, as well as a system of supervisory co-operation between regulators to ensure those rules are enforced. These elements are all necessary in order to give each party comfort that allowing firms from another territory to operate in its territory does not pose undue risk to market stability and consumer protection.

There are elements that will require a new approach on the part of the EU and UK – such as how we agree a robust dispute resolution mechanism without crossing the red lines of both parties in relation to the Court of Justice of the European Union.

Negotiating an FTA will also require us to get to grips with some new concepts. The scope of FTAs tends to be wider, in that they typically cover a wide range of goods and services; the proposals for Mutual Access for financial services will have to fit within that wider framework. FTAs also usually contain a "Prudential Carve Out" – a sort of emergency brake allowing a suspension of access in certain situations. The Most Favoured Nation provisions commonly found in existing FTAs might also require the EU and UK to consider carefully the scope of their FTA and its exemptions, so that it does not trigger a requirement to offer the same terms to parties under existing FTAs to which they are a party.

So, in the absence of any other agreement, passporting will fall away. An FTA presents a structure for a completely different relationship. The precedents exist into which the new concepts of access, alignment and supervisory co-operation can be built. This Report describes how that can be done.

Rachel Kent
Global Head of Financial Institutions Sector, Hogan Lovells

Hogan Lovells

EXECUTIVE SUMMARY

1.1. Background to this Report

The UK and the EU have begun negotiations, working together to determine the basis of the UK's withdrawal from the EU and also shape the framework for their future relationship. The negotiations will cover the whole UK/EU relationship across all sectors. Businesses in each sector will play their role in supporting the EU and UK teams by helping them to understand and factor in their key priorities and complexities.

The IRSG is contributing to that process through its series of reports focussing on the implications of Brexit for the financial services sector in the EU (including the UK). The aim is to help both the UK and EU negotiators understand the options available in advance of setting their positions for the second phase.

It will be critical to develop a sound foundation for the new EU/UK relationship, built on securing mutuality of interest. This will allow both parties to work together to deliver growth across Europe, building stronger markets for each other's products. A strong financial services sector in the UK also supports the EU by mitigating the twin risks of fragmentation and diversion of capital flows to other global hubs.

This is the third report produced by the IRSG in relation to Brexit.

The first IRSG report, on Third Country Regimes and Alternatives to Passporting (published on 23 January 2017) (the "**Phase 1 Report**") considered whether the existing EU third country equivalence regimes, or any other access rights available on a "no deal" scenario, offered sufficient rights of access to the EU markets for UK-based financial services firms.[1] The Phase 1 Report concluded that neither the third country regimes nor any other residual access rights would provide an optimal long-term, sustainable solution for such firms to access EU markets and that the preferable model for a future relationship between the EU and UK is to have a bespoke arrangement under which mutual rights of access to each other's markets would be allowed.

Since the publication of the Phase 1 Report, the emphasis has shifted towards having a bespoke arrangement of this nature. In its White Paper, the UK government said that it would be:

> *"aiming for the freest possible trade in financial services between the UK and EU Member States."*

and that the agreement between the EU and UK:

> *"may take in elements of current Single Market arrangements in certain areas as*

1 In this Report, we use the term "**firm**" to mean a financial services firm incorporated in an EU Member State which is currently able to use passporting rights under the Single Market Directives to provide regulated financial services in EU Member States other than its home Member State. We also use the term "**financial services supplier**" to mean a wider category of person who supply services which are related to financial services and which includes not only "firms" in the manner described above but suppliers who provide services that do not in themselves require authorisation from the local regulator. An example of the latter category would be the service of providing financial information (e.g. in the manner of Thompson Reuters or Bloomberg).

it makes no sense to start again from scratch when the UK and the remaining Member States have adhered to the same rules for so many years. Such an arrangement would be on a fully reciprocal basis and in our mutual interests."

Similarly, the EU has said that it intends to negotiate "a bold and ambitious but also fair free trade agreement".[2] Its recently announced agreement in principle on a trade deal with Japan also emphasises the EU's commitment to free trade. The EU's statement on the deal noted that it:

"would send a powerful signal to the rest of the world that two large economies are resisting protectionism and that openness to trade remains one of the best tools to shape globalisation. This can lead to more growth, and more growth can mean more jobs. The EU's other recent trade agreements, e.g. with South Korea and Canada, send the same message."[3]

In support of agreeing a free trade agreement ("**FTA**"), the second IRSG report, on Mutual Recognition – A Basis for Market Access After Brexit (published on 11 April 2017) (the "**Phase 2 Report**") considered various options for some of the key concepts that would need to feature in any bespoke arrangement based on mutual recognition and which would form part of a wider mutual access agreement between the EU and UK.

1.2. Objectives

The objective of this Report (the "**Phase 3 Report**") is to make specific proposals on the terms of an agreement under which financial services suppliers in the EU and UK would have access to each other's markets after Brexit, in furtherance of the stated objectives of both the EU and UK (as set out above). That agreement is referred to in this Report as the "**EU/UK Agreement**". That said, it is acknowledged that access via a FTA will always be less comprehensive than access via EU membership and the Single Market Directives. Although access may be permitted, the arrangements surrounding that access will result in an inferior position when compared to the current position. In particular, the UK would no longer contribute directly to the development of EU Law and the arrangements may be terminated in future.

In relation to the Phase 3 Report:

(a). The proposals in the Report are intended to achieve a level of mutual access for EU and UK firms that is as close as possible to the current levels of access that exist for such firms within the EU framework.

(b). The IRSG is aware that there will be challenges associated with developing the EU/UK Agreement. While existing FTAs provide a relevant framework, they can serve as precedents only to a certain degree. This is because the EU/UK Agreement will require the parties to reach agreement on more ambitious commitments than are contained in existing FTAs – in particular, with regard to allowing a firm from the other party to have access to their markets without having to obtain a local licence.

2 Speech by Michel Barnier to the Irish Parliament, 17 May 2017.

3 http://trade.ec.europa.eu/doclib/press/index.cfm?id=1690

(c). The IRSG recognises that wider political concerns will have a major influence on the terms of the EU/UK Agreement. This Phase 3 Report does not consider those issues, but instead focusses on the mechanisms for agreeing an FTA and what the legal content of the FTA might be if those issues are resolved. The intention is to demonstrate that, if the political concerns can be addressed, it should be possible to construct a broad and comprehensive agreement for mutual access for financial services.

(d). The UK government stated in its White Paper that the UK will not seek to retain membership of the Single Market. This indicates that, in addition to leaving the EU itself, the UK does not intend to seek market access based on EEA membership. As long as this remains the position of the UK government, this Report does not address in detail the possibility of EEA membership and the rights and obligations that would entail. If the UK government should change its position, the IRSG would be prepared to consider these matters in more detail.

(e). For reasons explained in this Report, it is likely that the EU/UK Agreement itself will cover other sectors in addition to financial services. It is possible that some of the concepts discussed in this Report would be equally relevant to parts of the EU/UK Agreement that relate to other sectors.

(f). It is also possible that some of the concepts in this Report could apply in relation to trade relationship with parties other than the EU or UK – such as the USA and China. From the UK's perspective, the Chancellor of the Exchequer has said[4] that he wants the UK to lead a global initiative for liberalisation of services. In considering the terms of the EU/UK Agreement, both of the parties should bear in mind the extent to which those terms could also be used in future agreements with other countries. Given the limited commitment to the cross-border supply of financial services in FTAs to date, using the UK and the EU's uniquely aligned starting point to develop a template could be a catalyst for accelerating other discussions.

The IRSG is keen to promote global higher standards in financial services regulation. As a result, work is underway as part of the regulatory coherence workstream to consider specifically the current international regulatory architecture and how that architecture might evolve to improve standards to better facilitate international trade and capital flows.

1.3. Overview

This Report considers in particular:

(a). the key issue of the EU and UK having mutual access to each other's markets after Brexit – and in particular the basis (or bases) on which such access might be granted (see sections 3, 4 and 5);

(b). how to manage changes in the law of one party that might mean that a party ceases to satisfy the relevant criteria for a certain type of access (see section 6);

(c). how supervision of firms could operate in the context of the EU/UK Agreement (see section 7); and

(d). how disputes relating to the EU/UK Agreement could be resolved (see section 8).

4 Annual Mansion House speech by Chancellor of the Exchequer, Philip Hammond MP, 20 June 2017.

The Annex to this Report consider in more detail:

(a). the context and constraints within which an agreement regarding mutual access must be reached – in particular, under the WTO rules (see Annex 1) and under EU law (see Annex 2); and

(b). existing FTAs to which the EU is a party, and some of the key concepts that commonly feature in those FTAs (see Annex 3). We consider in particular how those concepts might apply in the context of the EU/UK Agreement.

We propose that, where possible, the form and content of the EU/UK Agreement should follow existing EU FTAs, in order to draw on positions and terms already approved by the EU in other contexts. In this Report, we have included references to provisions used in existing FTAs (such as the prudential carve-out) – but as existing FTAs do not provide the level of access that the EU/UK Agreement should be aiming for, it will be necessary in certain areas to go beyond existing precedents and develop new approaches, within the overall framework of an FTA.

Developing new approaches in relation to the EU/UK Agreement should be easier than it would be for other FTAs because the EU and the UK will start from a fundamentally different position than the parties to other FTAs do. Other FTAs look at regulatory regimes which may be substantially different and focus on bringing them into closer alignment. The EU and UK will be starting from a position where the regulatory regimes are essentially the same, and so the approach in the EU/UK Agreement will be aimed at keeping the parties together from a common position rather than trying to bring them together from positions which are much less closely aligned.

1.4. Key issues in relation to mutual access

This section contains a summary of the key issues relating to mutual access, together with proposals for a possible approach that the EU and UK could take in relation to each of those issues.

(a). Multi-sector context

Brexit will affect all sectors and so the EU and UK will need to consider a new strategic partnership which secures the optimum position for both parties across all of them.

The issues that arise on Brexit differ between sectors, so the specific approaches needed may vary, but there will also be common issues e.g. managing change and dispute resolution.

Proposed approach:

Agree a wide-ranging FTA, covering substantially all trade in goods and services, including financial services.

This Report focusses on the financial services chapter of the proposed EU/UK Agreement, but some of its proposals could address issues that may arise in relation to sectors other than financial services, such as aviation or life sciences.

(See section 2 and Annex 1 of the Report)

(b). Position under existing FTAs

In relation to the provision of services (whether of financial services or other types of service), FTAs typically contain relevant provisions – such as the provisions for "national treatment" (e.g. giving the same treatment to the FTA partner as it gives to its own service suppliers) and "market access" (e.g. not imposing numerical limits on the supply of services). (Further information on FTAs can be found in Annex 3.)

However, while the laws and regulations of many individual jurisdictions (both inside and outside the EU) permit foreign financial services suppliers to supply services cross-border without having to obtain a licence from the local regulator – for example, through the use of exemptions in domestic law – we are unaware of an existing FTA that requires that level of access to be permitted.

Proposed approach:

The provisions of existing FTAs relating to access – including the principles of national treatment and market access – should be enshrined in the EU/UK Agreement.

In relation to the question of licensing, the EU and UK should expressly take a step beyond the commitments made in existing FTAs and agree a regime for mutual access without licensing requirements, in order to provide frictionless, cost-efficient access for financial services.

(See section 2 and Annex 1 of the Report)

(c). Alternative cross-border access mechanisms

Existing passporting rights based on EU membership will automatically cease to apply on the date of Brexit. This will potentially affect both UK firms looking to deal with EU counterparties and vice versa.

Both parties therefore need to find a way of securing access to each other's markets after Brexit. That could include mutual access rights in different forms.

Proposed approach:

Agree on replacement access mechanisms so EU and UK firms can continue to provide services cross-border post-Brexit without having to obtain licences in the territory of the other party.

*The EU/UK Agreement will need to develop and articulate its own access rights. In doing so the parties should consider whether existing FTAs contain provisions which may be helpful (e.g. as certain provisions of the EU/Canada FTA ("***CETA***") do), those provisions can be adapted. Given that the objective is to secure rights of access that are as broad as possible, the parties should also consider the extent to which the language of the Single Market Directives could be used for this purpose.*

There may be more than one mechanism for achieving access. For example, the following could be considered for inclusion in the EU/UK Agreement:

- *mutual access on the basis of there being regulatory alignment and supervisory co-operation between the EU and UK;*

- *mutual access that would not depend on alignment – under which firms dealing with certain types of qualifying counterparty in relation to certain types of business would not be subject to local licensing requirements;*
- *standstill arrangements in relation to exemptions currently available under domestic law within the EU and the UK;*
- *"consent to jurisdiction" – where the firm consents to the jurisdiction of the local regulator in the territory where it wishes to do business; and*
- *bespoke arrangements for specific types of firm (such as CCPs).*

(See section 2 of the Report)

(d). Range of activities to be covered

The EU/UK Agreement will need to specify the types of financial services activities for which cross-border access will be permitted and the ways in which access will be given. Existing FTAs categorise rights of access by reference to four "modes" of supply.

Proposed approach:

In line with the overarching aim to achieve access rights as broad as possible, the EU/UK Agreement should adopt the existing scope of the financial services provisions in existing FTAs (This should ensure that the rights of access are determined from a sufficiently broad starting point.

The EU/UK Agreement should provide that financial services can be provided using all four of the modes of supply under existing FTAs.

(See section 2 and Annex 1 of the Report)

(e). Reservations and exceptions

EU FTAs typically contain reservations and exceptions which significantly curtail the scope of the agreement – for example carving certain types of service out of the scope of the FTA or providing that certain provisions do not apply to individual Member States.

Proposed approach:

The scope of reservations and exceptions in the EU/UK Agreement should be limited as far as possible. The EU/UK Agreement will not be like a typical FTA, where the respective parties start with different regimes and seek to find common ground. The EU/UK Agreement starts from a position where the two regimes are aligned to begin with. There should, therefore, be less need for reservations and exceptions.

(See section 2 and Annex 1 of the Report)

(f). Proposed "prudential carve-out"

FTAs typically include a "prudential carve out" ("**PCO**") – i.e. a provision allowing parties to restrict the scope of the FTA in relation to financial services for "prudential reasons". This recognises the particular nature of financial services

and that parties may have legitimate concerns in relation to preserving market stability and providing consumer protection. However, "prudential reasons" can be interpreted widely and so could operate to undermine agreed access commitments in the EU/UK Agreement if unrestricted. The possibility of the PCO applying means that rights of access are subject to limitations which are not part of the Single Market Directives (where there is no equivalent concept of a PCO).

Proposed approach:

The EU/UK Agreement should include a PCO but its scope should be limited to reduce the likelihood of it being used as a barrier to access. This could be achieved by:

- *imposing limitations on the circumstances in which the PCO can be used; and*
- *introducing procedural restrictions on its operation (e.g. requiring prior notice to be given).*

It may also be appropriate to have different PCOs in relation to different sub-sectors of financial services.

(See section 2 and Annexes 1 and 3 of the Report)

(g). Conduct of business – home state or host state?

As there is no precedent for comprehensive rights of access for financial services suppliers under an FTA, it would need to be determined whether firms exercising those rights of access would be required, when dealing with customers in the other state, to follow the conduct of business rules of their home state or those of the host state (i.e. the state where the customer is based).

Proposed approach:

The EU and UK should agree one of two alternatives – either:

- *replicating the approach currently used for firms which passport under the Single Market Directives (which can mean that different rules apply – i.e. either home or host state – depending on the circumstances); or*
- *providing for host state conduct of business rules to apply. That approach might – depending on the outcome of the negotiations – apply only to the operations of a branch or to both the provision of services cross-border and to branches.*

(See section 2 of the Report)

(h). Access based on current alignment

In order to agree to allow mutual access on the basis of a firm being licensed in the territory of one of the parties only, each of the UK and the EU will need to be satisfied that the firms from the other territory are appropriately regulated and subject to proper standards of supervision and enforcement.

Proposed approach:

Access under the EU/UK Agreement should be permitted on the basis of the

high degree of regulatory alignment that will exist after Brexit, plus the agreed supervisory co-operation mechanisms. These should be defined in the EU/UK Agreement, rather than through the application of a separate test (as would apply under the TCRs). Neither the UK nor the EU should need to go through any kind of formal assessment to determine this.

The UK's regulatory framework is currently the same as the EU's and the UK will import the EU's "acquis communautaire" and regulatory framework into UK domestic law under the Withdrawal Bill, to take effect on Brexit. The EU/UK Agreement will also establish mechanisms to support supervisory co-operation.

Although some structural differences will remain (because EU regulators have direct authority in some areas, and the UK will need to replace these regulators with domestic regulators), there will be a very high degree of alignment between the two regimes – and much greater than the "equivalence" test typically applied by the EU to permit cross-border access under the EU's existing third country regimes.

(See section 3 of the Report)

(i). Assessing divergence – materiality and outcomes

Even if there is no need to make a formal assessment of alignment at the outset, it will be necessary to have a process to determine whether at any time in the future the respective regimes of the UK and EU have diverged to an extent that there is no longer a basis for mutual access.

Divergence could arise for a number of reasons, such as where each party seeks to develop rules independently which are tailored to its specific circumstances, or where the EU or UK develop specific new areas of regulation in response to developments (such as those relating to FinTech).

Proposed approach:

Where an assessment of divergence is required, it is proposed that rather than have a legalistic test (such as "equivalence" under the third country regimes), the question be considered from the perspective of an agreed set of outcomes.

The exact nature of the outcomes, and how achievement of those outcomes is to be assessed, will have to be agreed, but existing IOSCO proposals provide a useful starting point from which a common approach can be developed.

Not every instance of divergence should mean that two regimes are regarded as being insufficiently aligned. Flexibility should be built in to allow for different approaches that remain consistent with the outcomes. Using a test of material divergence, assessed with regard to outcomes, should give the parties the flexibility to take different approaches in appropriate circumstances.

It should be possible to have a certain amount of regulatory divergence without adverse consequences – such as a concept of "managed divergence". The parties could agree that divergence in relation to certain

issues or that divergence to a pre-determined degree should not amount to a breach of the EU/UK Agreement. This would allow divergence to occur incrementally over time, with the agreement of the parties, without either party prejudicing their rights of mutual access.

There will be areas of law and regulation where it is not necessary for there to be alignment. The EU/UK Agreement should include provisions for access that do not depend on alignment, based on the nature of the activity and the types of counterparty involved (see section 4 of the Report). In addition, the EU and UK could agree that there are certain discrete areas of law where alignment is not necessary, regardless of the nature of the counterparty.

Specific additional provisions may need to be included to cover new laws that are introduced by either the EU or UK after Brexit.

(See section 3 of the Report)

(j). Promoting ongoing alignment and regulatory co-operation

Mechanisms for addressing changes in circumstances are key in any long-term agreement. In particular, processes will be required to deal with any regulatory changes which either party may wish or need to make and which may alter the degree of regulatory alignment between the parties.

Promoting ongoing alignment is not only a question of making sure that the rules are aligned, but of ensuring ongoing co-operation between the respective regulatory authorities. (In relation to supervision of firms, see section 1.3.1(k).)

Some of the current EU structures which underpin regulatory co-operation, including on information sharing, joint inspections, enforcement action, regulatory transparency and resolution will cease to apply to the UK on Brexit. The parties will still need to co-operate with one another and each will need to have confidence in the supervision exercised by the other party (including in relation to matters of enforcement).

Proposed approach

Among the proposals in this Report is the creation of a Forum for Regulatory Alignment (considered in more detail in sections 3 and 6). The responsibilities of the Forum for Regulatory Alignment should include assessing and managing regulatory change. For example, where new global standards need to be implemented, the UK and the EU may seek to agree a co-ordinated and aligned regulatory response. The parties may also wish to introduce new concepts into their own law to deal with emerging issues.

The party proposing to introduce a regulatory change would have to assess its impact on alignment and would notify the forum if the change was potentially material. The forum would then consider whether the change could have an adverse impact on regulatory alignment based its potential impact on delivering the agreed set of outcomes.

The remit of the Forum for Regulatory Alignment should include:

- *considering cases of potential divergence, particularly assessing whether a potential divergence is material or not (on the basis that the parties can subsequently refer matters to formal dispute resolution if they cannot*

achieve resolution through the Forum for Regulatory Alignment);

- *sharing information;*
- *participating in the development of new laws and regulation; and*
- *co-operating in relation to supervision and enforcement.*

The processes of the Forum for Regulatory Alignment need to be thorough and able to ensure that the parties are able to have their concerns addressed properly and fairly.

There may be a role for a multi-sector forum to operate above or alongside the Forum for Regulatory Alignment to consider issues which may not be limited to financial services. Insofar as it does apply to financial services it should ensure that financial services expertise is represented at the highest level given its importance as a sector to ensuring stability and maintaining a platform for growth.

(See sections 3 and 6 of the Report)

(k). Supervision

A regime for mutual access requires a framework that promotes sound, efficient, and consistent supervision of individual firms – including a clear allocation of supervisory responsibility and structures for supervisory co-ordination, including resolution of disputes.

This would include allocating supervisory responsibility for compliance with prudential obligations (which will remain with the home state regulator who has authorised the firm and who will retain bail-out responsibilities) and for compliance with conduct of business rules (the responsibility for which may vary depending on the circumstances).

Within the EU, the Single Market Directives and the European Supervisory Authorities provide such a framework, but the EU has expressed concerns that the existing co-ordination of supervision could be further improved.

Proposed approach:

There is no existing model which in itself adequately addresses all the potential supervisory concerns for the EU/UK Agreement, but there are aspects of existing models which can be used or adapted.

It is therefore likely that the EU/UK Agreement will require a new form of body which has a clear remit designed for this relationship and powers relevant to this particular situation. In relation to this:

- *There should be a clear demarcation of the responsibilities of the regulators and the extent to which the host state regulator can influence the supervision of the firm (notwithstanding that it will not directly regulate that firm itself).*
- *There should be a formal framework to co-operate and to co-ordinate supervisory matters – e.g. through the Forum for Regulatory Alignment or a dedicated "supervisory co-ordination forum" which reports into it.*
- *There should be active co-operation in relation to the development of common standards and approaches in relation to supervision.*

(l). Resolving disputes

It will be necessary to have an agreed dispute resolution mechanism in case disputes cannot be resolved through the relationship management structures (such as the Forum for Regulatory Alignment).

Proposed approach:

The parties should agree a judicial structure for the resolution of disputes between them under the EU/UK Agreement. This would be similar to the approach taken under some existing FTAs.

The remit of the dispute resolution body should be limited to determining whether a party is in compliance with the EU/UK Agreement. The finding of the dispute resolution body would be binding on the parties and would require them to take any consequential steps outlined in the EU/UK Agreement (e.g. the withdrawal of access rights) but neither party could be compelled to change its law.

In addition to covering disputes between the parties to the EU/UK Agreement itself, the EU/UK Agreement could also include provisions such as an "investor-state dispute settlement" system, under which financial service suppliers from one party could bring claims against the other party – i.e. the contracting state. The UK Government's position is that UK citizens and businesses should have effective means to enforce their rights. Although this could be done via an ISDS-like mechanism, the UK Government has proposed another option. In essence, this is that the UK (and likewise the EU) should implement the EU-UK Agreement in its domestic law, and that businesses and individuals should be able to enforce rights under the agreement in accordance with the usual principles of UK (and EU) administrative law.

(See section 8 of the Report)

(m). Consequences of divergence

Not every form of divergence will be material or should necessarily lead to adverse consequences for the parties to the EU/UK Agreement.

Nevertheless, where there is material divergence, the EU/UK Agreement should specify what the consequences should be – which could, in appropriate circumstances, include permitting either or both of the parties to withdraw access in relation to a particular area of activity.

Proposed approach:

The EU/UK Agreement should include provisions similar to those from existing FTAs which manage the relationship and provide for appropriate escalation of matters. It should also provide for circumstances where withdrawal of access is necessary, and so mechanics should be included to allow for that. The process should be based on the narrowest adjustment possible to reflect the circumstances and should allow sufficient notice to enable firms to adapt and avoid disruption.

Other than in rare cases where an emergency measure by a regulator could have the effect of curtailing access, withdrawal of access should only be permitted if all agreed mechanisms have been utilised to avoid that

outcome – including working through all the processes under the Forum for Regulatory Alignment and taking the matter through the formal dispute resolution process.

If access is withdrawn, it should nevertheless be possible for access to be reinstated if the respective regulatory regimes subsequently become re-aligned. The remit of the Forum for Regulatory Alignment should include considering (at the request of either party) questions of whether re-alignment has occurred.

(See sections 3, 6 and 8 of the Report)

(n). Termination

In the same way that the UK has exercised a right to withdraw from the EU under Article 50, there will need to be a mechanism to regulate how either party could withdraw from the EU/UK Agreement. Therefore, unlike the EU's third country equivalence regimes, firms should be given the reassurance of sufficient notice periods for withdrawal from the EU/UK Agreement, to allow them to manage the consequences of termination.

Proposed approach:

The EU/UK Agreement should include clear mechanisms to regulate how the agreement could be brought to an end and establish a predictable framework to manage the consequences of it terminating.

Withdrawal of access rights should not be permitted without firms being given sufficient time to adapt to the potential loss of access (which might include allowing them enough time to relocate their business into the other party's territory or become licensed by the other party).

(See section 3 and 6 of the Report)

1.5. Key issues in relation to trade law and EU law

Both the EU and the UK are subject to existing obligations in their capacity as members of the WTO and by virtue of EU requirements. These obligations will need to be taken into account when designing the framework for the EU/UK Agreement. Detailed analysis is set out in Annexes 1 to 3, but the key points to note are as follows:

(a). GATS

The General Agreement on Trade in Services ("**GATS**") contains a number of important concepts which could form the basis of the EU/UK Agreement. In particular, trade in services is described by reference to four different "modes" of supply, and any access rights relating to financial services can be framed using similar concepts.

Proposed approach:

The EU/UK Agreement should follow the approach of GATS and include all four modes of supply.

(See Annex 1 of the Report)

(b). Most-favoured nation/substantial sectoral coverage

All WTO members are subject to the "most favoured nation" ("**MFN**") rule in the WTO Agreements – which means that, generally, any favourable terms of access offered to another WTO member by a WTO member must be offered to all WTO members.

There is a carve out to the MFN rule under the GATT and the GATS which permits differential terms to be offered if an FTA is put in place which is sufficiently wide in terms of scope of access permitted across sectors, and volume of trade, so as to have "substantial sectoral coverage" in WTO terms. (There are also different versions of the MFN – and, more importantly, carve-outs to them – under other FTAs, such as the CETA.)

Proposed approach:

The EU/UK Agreement should be structured and scoped so that it fits within the relevant carve-outs to all the relevant MFN provisions and that the access rights it contains do not need to be offered to all other WTO members.

The parties will also need to agree whether the EU/UK Agreement should itself contain an MFN provision.

(See Annex 1 of the Report)

(c). Positive list/negative list

FTAs can be created either on the basis of a "positive list" or a "negative list". The distinction is as follows:

(i). Positive lists

When using a positive list, a party has to explicitly (i.e. "positively") list the sectors and subsectors in which it gives commitments in respect of the GATS concepts of "national treatment" and "market access" (in relation to which, see Annex 3). As a second step, the party lists any exceptions or conditions to these commitments.

(ii). Negative lists

When using a negative list, the parties do not list the sectors for which they take commitments; instead, they list any sectors or subsectors which they limit or exclude by inscribing reservations for all measures which they consider would run counter to the "national treatment" and "market access" principles. All sectors or sub-sectors that are not listed with reservations are, by default, open to foreign service suppliers under the same conditions as for domestic service suppliers.

GATS operates on the basis of a positive list, and historically the EU's FTAs have tended to follow the same approach. However, the CETA was negotiated on a negative list basis – albeit that CETA offers only limited cross-border commitments in relation to financial services.

Proposed approach:

The EU and UK should approach the EU/UK Agreement on the basis of a

negative list. Although the scope of commitments will have to be negotiated, a starting position that (for example) all aspects of financial services are covered is more likely to result in broad mutual access. The fact that the two regulatory regimes will be aligned at the date of Brexit makes the negative list approach more realistic.

(See Annex 3 of the Report)

(d). EU law – matters of exclusive competence

If the subject matter of the EU/UK Agreement involves matters which are not in the exclusive competence of the EU to negotiate, the terms of the EU/UK Agreement will have to be approved by all Member States. (According to the recent CJEU decision with respect to the EU-Singapore FTA, portfolio investment and the investor-state dispute settlement mechanism are the only subjects in that agreement that are not within the exclusive competence of the EU.)

In addition, matters which are within the exclusive competence of the EU can be "provisionally applied" (i.e. take practical effect before full formalities are completed) whereas matters which are shared competence cannot.

Proposed approach:

If the EU/UK Agreement is to include any matters which the EU does not have exclusive competence to negotiate, the parties should ensure that this is taken into account. The comprehensive nature of the EU/UK Agreement suggests that it is likely to be a mixed agreement.

(See Annex 2 of the Report)

(e). EU law – limits on freedom to agree FTAs

Individual Member States are not permitted to enter into international trade agreements with third countries in relation to trade matters. The UK cannot therefore enter into FTAs with other countries before Brexit occurs. This includes the EU/UK Agreement itself. Furthermore, once the UK is a third country, it will not be able to conclude FTAs with individual EU Member States as the EU has exclusive competence over trade (although it will then be free to conclude FTAs with non-EU countries).

While the UK cannot conclude a trade agreement with third countries (such as the USA) prior to its withdrawal from the EU, there is no legal basis to prevent it from commencing exploratory talks in respect of such trade agreements. In relation to the UK/EU Agreement, the EU has outlined that following the first phase of withdrawal negotiations with the UK, which will cover the priority issues of citizens' rights, the UK's divorce bill and on the Irish border, a second phase of negotiations dealing with the scope of the UK/EU Agreement can commence.

Proposed approach:

The EU and UK should clarify the extent to which the UK can negotiate FTAs while it is still a member of the EU. As a minimum, it should have the ability to enter into exploratory discussions.

(See Annex 2 of the Report)

(f). Timing and transition

Timing is a critical issue for the financial services sector due to the long lead-time involved in becoming established and authorised in another jurisdiction (and effecting a business transfer into that jurisdiction) and the necessity of ensuring that there is no gap in service provided to customers. Putting an FTA in place can be a lengthy process (although in this case the EU and UK do start from the position of having aligned regimes).

Unless the sector has clarity that the current levels of access will be maintained for an appropriate period post-Brexit to allow adjustment to the new relationship framework then relocations and restructurings are likely to continue, which would potentially be an unnecessary and unproductive use of time and (potentially) capital and would cause disruption to individuals and businesses.

Proposed approach:

The parties should seek (as early as possible in the negotiations) to agree a framework for their future relationship, whether as part of the UK's withdrawal agreement or some other arrangement, which commits to preserving current access arrangements for financial services whilst the EU/UK Agreement is being negotiated and finalised and a phased period of implementation of the new relationship thereafter.

In relation to the withdrawal agreement, the EU is permitted to determine "transitional arrangements… to provide for bridges towards a foreseeable framework for the future relationship" with the UK. This may give the EU a basis for agreeing transitional arrangements which allow for continued rights of access for financial services (and other sectors) to act as a bridge to when the EU/UK Agreement comes into effect.

The UK will leave the EU on the date that the withdrawal agreement enters into force. Therefore, interim arrangements that are agreed as part of the withdrawal agreement will become binding on both parties on the day that EU law ceases to apply to the UK and it is no longer a Member State.

It would also be prudent to agree default transitional arrangements which would apply on Brexit if an agreement has not yet been put in place to minimise disruption of a "cliff edge" for both sides. These transitional arrangements could include continued rights of access which facilitate the continued servicing of customers cross-border after the date of Brexit. These should continue until the new EU/UK Agreement comes into effect, after which the new arrangements will apply.

Early agreement on these issues will be in both parties' mutual interest to preserve stability and to allow businesses in the EU and UK to focus on driving growth whilst the negotiations progress, in the knowledge that they will have time to adapt when the terms of the future relationship are settled. This is an absolute priority.

In the event that agreeing the withdrawal agreement is not possible within the prescribed two year withdrawal period, the parties could, if all Member States agree, extend the negotiation period (and delay the UK's withdrawal) beyond March 2019.

(See Annex 2 of the Report)

GLOSSARY

In this Report, we use the term "firm" to mean a financial services firm incorporated in an EU Member State which is currently able to use passporting rights under the Single Market Directives to provide regulated financial services in EU Member States other than its home Member State. We also use the term "financial services supplier" to mean a wider category of person who supply services which are related to financial services and which includes not only "firms" in the manner described above but suppliers who provide services that do not in themselves require authorisation from the local regulator. An example of the latter category would be the service of providing financial information (e.g. in the manner of Thomson Reuters or Bloomberg).

For simplicity, we refer throughout the Report to the EU rather than the EEA, except where we specifically intend to refer to the EEA as being distinct from the EU. Where in this Report we refer to the EEA, we mean the whole EEA (including the EEA-EFTA countries) as distinct from the EU.

The following terms have the meaning set out below.

Term	Meaning
AA	Association Agreement
AIFMD	the Alternative Investment Fund Managers Directive (2011/61/EU)
acquis communautaire	is the body of common rights and obligations that is binding on all the Member States. It is constantly evolving and comprises: • the content, principles and political objectives of the Treaties; • legislation adopted pursuant to the Treaties and the case law of the CJEU; • declarations and resolutions adopted by the European Union; • instruments under the Common Foreign and Security Policy; and • international agreements concluded by the EU and those entered into by the Member States among themselves within the sphere of the EU's activities
Basel Committee	the Basel Committee on Banking Supervision
Benchmarks Regulation	the Benchmarks Regulation ((EU) 2016/1011), which comes into effect on 1 January 2018
BITs	bilateral investment treaties
Capital Requirements Directive	the Capital Requirements Directive (2013/36/EU)
Capital Requirements Regulation	the Capital Requirements Regulation (EU/575/2013)
CCP	central counterparty
the CETA	the Comprehensive Economic and Trade Agreement, between the EU and Canada
CFTC	the Commodity Futures Trading Commission
CJEU	the Court of Justice of the European Union
the Commission	the European Commission
DCFTA	Deep and Comprehensive Free Trade Agreement
DCO	derivatives clearing organization
DSB	the Dispute Settlement Body, established under WTO law
EEA-EFTA State	those countries which are members of the EEA but are not also members of the EU, i.e. Iceland, Liechtenstein and Norway
ECB	the European Central Bank
EFTA	the European Free Trade Association, and intergovernmental organisation set up for the promotion of free trade and economic integration to the benefit of its four member states, who are Iceland, Liechtenstein, Norway and Switzerland

EFTA Surveillance Authority	the authority which monitors compliance with the EEA rules in Iceland, Liechtenstein and Norway, enabling them to participate in the Single Market
EEA	the European Economic Area. The members of the EEA are all the members of the EU, plus Iceland, Liechtenstein and Norway
EEA Agreement	the Agreement on the European Economic Area
EMIR	the European Market Infrastructure Regulation ((EU)648/2012)
ESA	a European Supervisory Authority (of which there are three: the European Banking Authority, the European Insurance and occupational Pensions Authority and ESMA)
ESMA	the European Securities and Market Authority, which is the ESA with responsibility for safeguarding the stability of the EU's financial system by enhancing the protection of investors and promoting stable and orderly financial markets
EU	the European Union
EUCCP	the EU Common Commercial Policy
EU/UK Agreement	the future agreement governing the EU-UK trade relationship post-Brexit
FCA	the Financial Conduct Authority
Forum for Regulatory Alignment	a joint committee established by the parties for the purposes of regulatory co-operation and promoting regulatory alignment as discussed in more detailed in section 6
financial service supplier	a category of person who supply services which are related to financial services and which includes not only firms, but also suppliers who provide services that do not in themselves require authorisation from the local regulator
FSB	the Financial Stability Board
FTA	free trade agreement
FTC	the NAFTA Free Trade Commission
the GATS	the General Agreement on Trade in Services
the GATT	the General Agreement on Tariffs and Trade
Guidelines	the Negotiating Guidelines adopted by the European Council on 29 April 2017, setting out the core principles that will apply throughout the negotiations for the UK's withdrawal from the EU
G20	an informal forum for international co-operation on financial and economic issues, consisting of 19 countries plus the EU
IAIS	the International Association of Insurance Supervisors
ICS	an Investment Court System
IOSCO	the International Organization of Securities Commissions, which is an international body consisting of securities regulators and which sets global standards for the securities sector
IOSCO Report	the report published by the IOSCO Task Force on Cross-Border Regulation, published in September 2015
Interim Arrangement	arrangements to govern the relationship between the EU and UK for an Interim Period
Interim Period	any period following the UK's ceasing to be a member of the EU and the entry into effect of the end-state future relationship
ISDS	Investor-State Dispute settlement
Member State	a member state of the EU
MFN	most-favoured-nation
MiFID	the Markets in Financial Instruments Directive (Directive 2004/39/EC)
MiFID II	the package of changes relating to MiFID that is due to come into effect on 3 January 2018
MiFIR	the Markets in Financial Instruments Regulation (Regulation (EU) No 600/2014), which is due to come into effect on 3 January 2018
NAFTA	the North American Free Trade Agreement
Negotiating Directives	the Council Decision adopted on 22 May 2017, authorising the Commission to open the negotiations for the UK withdrawal in light of the Guidelines
OPE	the UK's overseas persons exclusion
PCA	Partnership and Co-operation Agreement
PCO	a prudential carve-out in a FTA
Phase 1 Report	Third Country Regimes and Alternatives to Passporting, published on 23 January 2017

Phase 2 Report	Mutual Recognition – A Basis for Market Access after Brexit, published on 11 April 2017
PRA	the Prudential Regulation Authority
Single Market Directives	the EU legislation implemented with a view to promoting a Single Market in relation to financial services. The specific Directives are: • the Banking Consolidation Directive (to the extent it applies to CAD investment firms) (2006/48/EC); • the Capital Requirements Directive (2013/36/EU); • the Solvency II Directive (2009/138/EC); • the Markets in Financial Instruments Directive (2004/39/EC); • the Insurance Mediation Directive (2002/92/EC); • the Mortgage Credit Directive (2014/17/EU); • the UCITS Directive (2009/65/EC); and • the Alternative Investment Fund Managers Directive (2011/61/EU).
Solvency II	the Solvency II Directive (2009/138/EC)
SSM	the Single Supervisory Mechanisms for the supervision of banks within the euro area
SSM Regulations	the Single Supervisory Mechanism Regulation (1024/2013) and the Single Supervisory Mechanism Framework Regulation (468/2014)
TCRs	Third Country Regimes, meaning one of the regimes established under EU legislation which relates to the treatment of third countries and third country firms
TEU	the Treaty on European Union (2012/C 326/01), which established the European Union, as amended
TFEU	the Treaty on the Functioning of the European Union (2012/C 326/01), which is the main treaty governing the organisation of the EU
third country	any country that is not a member of the EU or the EEA
TiSA	the Trade in Services Agreement
TTP	the Trans-Pacific Partnership
TTIP	the Transatlantic Trade and Investment Partnership
Understanding	the Member States Specific commitments and Understanding on commitments in financial services
VCLT	the Vienna Convention on the Law of the Treaties
White Paper	the white paper on The United Kingdom's exit from, and new partnership with, the European Union published by the UK government on 2 February 2017
Withdrawal Bill	the European Union (Withdrawal) Bill – i.e. the parliamentary bill which will govern the UK's departure from the EU and as a result of which the UK will cease to be bound by EU law. One of the proposed provisions of the bill will enact into UK law certain provisions of EU law, in order to ensure continuity of the law
WTO	the World Trade Organization

The IRSG wishes to thank the members of the workstream which has overseen the production of the Report. Please note that this Report should not be taken as representing the view of any individual firm which took part in the discussions:

ABI
AIG
Allianz Global Investors
Aviva
Bank of America Merrill Lynch
Barclays
BlackRock
Bloomberg
BNY Mellon
BNP Paribas
Citi
City of London Corporation
CME Group
Credit-Suisse
David Green Consulting
Deutche Bank
DTCC
Goldman Sachs
Hogan Lovells
HSBC
ICE
Invesco
Investment Association
JP Morgan
London Stock Exchange
Morgan Stanley
Nasdaq
Nomura
Norton Rose Fulbright
Oliver Wyman
PIMFA
Prudential
PwC
RBS
Standard Chartered
Soc Gen
TheCityUK
UBS
UK Finance

The IRSG would particularly like to thank Rachel Kent, Dominic Hill and the team at Hogan Lovells for their extensive work on this Report.

IRSG
INTERNATIONAL REGULATORY STRATEGY GROUP

CITY OF LONDON

TheCityUK

For further information about this Report, please contact:
IRSGsecretariat@cityoflondon.gov.uk