IRSG
INTERNATIONAL
REGULATORY
STRATEGY GROUP

Produced with support of
Hogan Lovells

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

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.

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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

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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

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SECTION 1

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 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.

(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 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).

The Annexes 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

- o *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)

SECTION 2

FINANCIAL SERVICES IN THE EU/UK AGREEMENT

SECTION SUMMARY

- The UK government is aiming for the freest possible trade in financial services. The EU is also committed to a bold and ambitious FTA.
- FTAs commonly provide for four modes of supply in relation to services. The EU/UK Agreement should seek to include all four modes of supply.
- While the UK and several Member States permit (as a matter of domestic law) non-EU firms to supply services into their territory without having to obtain a licence from the local regulator, we are unaware of an existing FTA that commits the parties to the level of access proposed here. The EU/UK Agreement would need to go further in this regard than any existing FTA.
- Where financial services are described in FTAs, the scope of the definition is very wide – and indeed wider than the definitions for passporting. The wider definition from the FTAs should be used in the EU/UK Agreement in order to secure the continued application of principles such as 'national treatment'.
- Most existing FTAs contain reservations from, and exceptions to, the rights they confer – which means, in practice, that existing EU FTAs offer less comprehensive access rights than some of the operative provisions appear on their face to have. For the EU/UK Agreement, the starting point should be to limit reservations and exceptions as far as possible.
- FTAs commonly contain a "prudential carve-out" ("PCO"), which gives a party the ability – where justified for prudential reasons – to introduce measures in its national law which would otherwise have put the party in breach of the FTA. The use of any PCO in the EU/UK Agreement should be subject to strict parameters, through having restrictions on the scope of any PCO and procedural restrictions regarding how it is applied.
- There is scope under existing FTAs for each party to define terms in its regulatory framework (such as "doing business" and "solicitation") that can act as a practical barrier to cross-border access – e.g. if such definitions are drafted narrowly. The EU/UK Agreement should seek to avoid this by either defining such terms itself (which would be the preferable approach) or creating a process under which the terms can be defined by agreement.
- Firms will need to comply with the prudential rules in their home state. However, the position in relation to conduct of business rules varies under passporting, and the EU and UK will need to decide whether a firm that uses the cross-border mutual access rights under the EU/UK Agreement will be subject to the conduct of business rules of the other party (the host state) in relation to activities conducted there or whether it will be subject only to the rules in its home state.
- It may be appropriate to have different bases for mutual access in relation to different scenarios. These could include:
  - mutual access based on regulatory alignment (see section 3);
  - mutual access to qualified counterparties not based on alignment (see section 4); and
  - other bases, such as "consent to jurisdiction" or special arrangements made for particular types of firm, such as market infrastructure firms (see section 5).

2.1. Background

Within the EU, cross-border access for firms is achieved through passporting rights under the Single Market Directives. One of the key benefits of these Directives is that they give rise to a simplified licensing system for financial services in the EU. A financial service supplier can obtain authorisation from the regulator in its home state, and then "passport" that authorisation around the rest of the EU. Passporting allows the financial institution to operate in another Member State without having to obtain a separate licence from the local regulator. This can be done either by providing services into that Member State from an office elsewhere in the EU or by establishing a branch in that Member State.

2.2. Ways of obtaining access

Under the Single Market Directives, there are two types of right which are available to passporting firms:

(a). freedom of establishment – i.e. a right to establish a branch in another Member State; or

(b). freedom of services – i.e. a right to provide services from one Member State into another without setting up a branch.

In each of these cases, the passporting firm is able to rely on its home state authorisation and does not need to seek local authorisation in the Member State in which it wishes to do business.

As noted in Annex 3, the model developed in the WTO for services and which is commonly used in FTAs involves four distinct modes for the supply of services:

(a). **Mode 1 – Cross-border trade:** supply from the territory of one WTO member into the territory of any other WTO member.

(b). **Mode 2 – Consumption abroad:** supply in the territory of one WTO member to the service consumer of any other WTO member.

(c). **Mode 3 – Commercial presence:** supply by a service supplier of one WTO member, through commercial presence in the territory of any other WTO member.

(d). **Mode 4 – Presence of natural persons:** supply by a service supplier of one WTO member, through presence of natural persons of a WTO member in the territory of any other WTO member.

There are obvious parallels between the GATS Modes and the passporting regime: Mode 1 is similar to the freedom to provide services, and Mode 3 is similar to the freedom of establishment. (Modes 2 and 4 and certain aspects of Mode 3 would also be covered under general principles of EU law and so would also apply to a UK firm currently using its passport.)

In the light of these parallels, an EU/UK Agreement which adopts these Modes could potentially put EU and UK firms in a similar position to that which they are in under passporting (although the exact degree of access available would depend on the scope of the agreement and the commitments undertaken by the parties).

We recommend that, for financial services, the EU/UK Agreement should include all four of the modes mentioned above – and that firms from the EU should be able to both establish branches and subsidiaries within the UK and provide services into the UK from the EU – and vice versa, in both cases.

It is acknowledged that not all of the modes of access under GATS would necessarily be treated the same way under the EU/UK Agreement. For example, in relation to branches, although some Member States – including the UK – currently allow the direct authorisation of branches of non-EU firms (as considered in more detail in sections 7.19 to 7.26 and section 10 of the Phase 1 Report), it may be necessary to consider additional issues and to apply different terms if an overseas entity is to be able to set up an establishment in and operate in the territory of either the EU or UK without obtaining a local licence. The regulator in the host territory may potentially be concerned about relying only on the firm's home regulator to supervise the activities of that firm in the host territory. If all four modes of access are granted, therefore, it may be that some would involve obtaining licences in the home state and others would not. The EU and UK should at least explore, however, the possibility of access without licences and consider whether the challenges regarding supervision can be overcome.

In this Report, we use the term "mutual access" to mean the situation where each party to the EU/UK Agreement allows firms from the other party the right to establish branches in their territory and/or provide services from their home territory directly into the other territory without having to obtain local authorisation.

2.3. No precedent for access without a licence

In contrast to passporting (whether under EU membership or under the EEA Agreement), existing EU FTAs do not go as far as to dispense with the need for financial services suppliers from one party to obtain licences from the local regulators of the other party. Indeed, many FTAs explicitly anticipate that financial services suppliers may need to obtain licences in order to provide services in the other party's territory (albeit that this is invariably in the context of an arrangement where the respective regulatory regimes of the parties are not aligned).

FTAs do generally, however, recognise that licensing requirements could be used as a barrier to trade in services and contain provisions which are designed to prevent that happening. This follows the example of the GATS itself, which contains provisions aimed at ensuring that licensing requirements are based on objective and transparent criteria, are not more burdensome than necessary to ensure the quality of the service and are not in themselves a restriction on the supply of the service.

In order to deliver "mutual access" of the nature described above, the EU/UK Agreement would need to go further than existing FTAs and would need to include rights of access without a licence.

The CETA offers an example of FTA provisions that resemble mutual access (in the manner of the regime considered in section 4 of this Report that does not depend on alignment). Article 13.7.6 of the CETA provides that each party shall permit a person located in its territory, and a national wherever they are located, to purchase a financial service from a cross-border financial service supplier of the other party located in the territory of that other party. The provision is subject to certain caveats which would allow it to be interpreted restrictively (see paragraph 5 of Annex 3) and the scope of the financial services to which the Article applies is in any event very narrow. Nevertheless, it offers a precedent as to how a mutual access provision might be framed in the EU/UK Agreement.

It is recognised that it would be a very significant step for the EU and UK to agree to allow access without a licence based only on the terms of an FTA. However, such an approach would be in the interests of both parties, whose financial institutions currently passport using branches. It is worth seeking to agree such an approach, but if agreement cannot be reached, the parties should aim to ensure that such a requirement only applies where strictly necessary. It might, for example, be appropriate for licensing requirements to apply only where the firm wishes to set up a branch. Alternatively, it might be appropriate to have a licensing requirement for a firm dealing with retail clients, but inappropriate for such a requirement to apply to a firm wishing to deal in the wholesale markets only.

2.4. FTAs in relation to financial services

As noted above, existing FTAs generally do not provide that firms may have access to another territory without a licence, and in any event the FTAs tend to include reservations and exceptions.

The position in relation to financial services under current FTAs is as follows:

(a). Activities and entities in scope

The definition of the term “financial services” that is most commonly adopted in FTAs – including FTAs involving the EU – is the definition in the GATS (which is set out in the box below).

Financial services in the GATS

“Financial services” is defined in the GATS as “a service of a financial nature” that is provided by a financial services supplier.

A financial service supplier means any natural or juridical person wishing to supply or supplying financial services.

Insurance

- direct insurance, including co-insurance for life and non-life;
- reinsurance and retrocession;
- insurance intermediation, such as brokerage and agency; and
- services auxiliary to insurance – such as consultancy, actuarial, risk assessment and claim settlement services.

Banking and other financial services

- the acceptance of deposits and other repayable funds from the public;
- lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transactions;
- financial leasing;
- all payment and money transmission services, including credit, charge and debit cards, travellers cheques, and bankers drafts;
- guarantees and commitments;
- trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following: (A) money market instruments, including cheques, bills or certificates of deposits, (B) foreign exchange, (C) derivative products including, but not limited to, futures and options, (D) exchange rate and interest rate instruments, including products such as swaps and forward rate agreements, (E) transferable securities, and (F) other negotiable instruments and financial assets, including bullion;
- participation in issues of all kinds of securities, including underwriting and placement as agent (whether publicly or privately) and provision of services related to such issues;
- money broking;
- asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial, depository and trust services;
- settlement and clearing services for financial assets, including securities, derivative products, and other negotiable instruments,
- provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services; and
- advisory, intermediation and other auxiliary financial services on all the above categories, including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy.

The language used in that definition in some cases appears to follow very closely the descriptions of passportable activities under Single Market Directives (the language of the banking section of the GATS appears, for example, to mirror that in the Capital Requirements Directive). However, the definition actually goes wider than the passporting regime and includes:

(i) some activities which are not passportable – such as the provision and transfer of financial information, or the provision of consultancy and actuarial services; and

(ii) certain assets which are not regulated investments under the Single Market Directives – such as "other financial assets including bullion".

The GATS also applies to a wider range of entities than the Single Market Directives do. In particular, the GATS applies to "financial services suppliers" (see endnote 1), which may include entities who provide important services that relate to financial services but which may not actually require authorisation (in the way that entities carrying on activities within the scope of the Single Market Directives do).

If the EU/UK Agreement is an FTA, it is likely that it will follow the GATS and that the starting point for the drafting will be to use concepts that are wider than the current passporting regime allows.

(b). Reservations and exceptions

In most existing FTAs, certain sectoral chapters (including the Financial Services Chapter) contain reservations, exceptions, carve-outs and other provisions which enable one party to, in effect, create barriers for the other party. The nature of these reservations and exceptions depends on the commitments that the parties are willing to agree to.

In the area of financial services, existing EU FTAs allow for a significant number of "non-conforming measures", which are set out in the schedules to the FTAs. These can include:

(i) "horizontal" reservations or exclusions which apply generally (i.e. they apply in relation to the EU and all Member States); or

(ii) reservations in relation to specific commitments, applied by individual Member States).

The reservations at (i) and (ii) can be reservations preserving existing restrictions (i.e. allowing the EU or a Member State to retain a restriction existing prior to entering into the FTA) or reservations for future measures (i.e. under which the EU or a Member State reserves the right to adopt a measure in the future).

In practice, the use of these reservations and exceptions means that existing EU FTAs offer considerably less access for firms than passporting.

A key issue for the EU/UK Agreement is therefore going to be the extent to which it permits reductions in the mutual rights of access to arise through the application of reservations and exceptions.

Reservations and exceptions are understandable in the context of most existing FTAs. They should, however, be less justifiable in the context of the EU/UK Agreement, since the both the economies and the legal and regulatory systems of the two parties are intertwined through 45 years of shared history. In many areas of financial services, the underlying law of the UK and the EU is the same.

As part of the Single Market, Member States have foregone their ability to impose restrictions on the ability of institutions from other Member States to do business in their territory (except in very limited circumstances, where so-called "gold plating" of the rules is permitted under the Single Market Directives). When the UK leaves the EU, it would be open to the EU and its Member States to begin imposing such restrictions again – or the UK to do likewise to EU Member States. However, as the criteria for access would continue to be satisfied, each party would be in no worse a position than before vis-à-vis the other party – and therefore exceptions and carve-outs are either entirely unnecessary or should be restricted in scope.

(c). The prudential carve-out

FTAs commonly contain a PCO, which gives a party the ability – where justified for prudential reasons – to introduce measures in its national law which would otherwise have put the party in breach of the provisions of the FTA (e.g. a measure that would violate the "national treatment" principles or the access commitments ostensibly given). The PCO concept is considered in more detail in paragraph 4 of Annex 3.

The "prudential reasons" referred to in PCOs are usually framed in such broad terms that it would be easy for one party to the FTA to claim prudential grounds for imposing a restrictive measure. Such a measure could, in practice, act as a barrier to entry for firms from the other party's territory even where the agreement provides for access to be given.

To reduce this risk, the objective of maximum market access would require that the use of any PCO be subject to strict parameters. In the case of an FTA between the EU and UK, a limited PCO should be acceptable, since the high degree of regulatory alignment between the parties should ensure that prudential concerns for either party are significantly less likely. (It will also be easier for the parties to agree to place limits on the use of PCOs if they have reached agreement on supervisory co-operation – in relation to which, see section 7 – because there would be still less need for one party to introduce a prudential measure which would operate in addition to the co-operation on supervision.)

There are two broad ways of restricting the potential risks inherent in any PCO:

(i). Restrictions in scope of the PCO

Both the GATS and various FTAs have tried to limit the extent to which the PCO can be used to frustrate the relevant FTA provisions. For example:

(1) the GATS provides that the measures taken using a PCO "shall not be used as a means of avoiding the Member's commitments or obligations under the [FTA]";

(2) the CETA provides that the parties may take "reasonable measures" for prudential reasons; and

(3) the EU-Singapore FTA and the draft offer made in the TTIP negotiations both required that the measures taken using a PCO "shall not be more burdensome than necessary to achieve their aim".

In addition, although this does not currently feature in any current FTA, it would be possible to limit the PCO so that it only applied to certain market segments or products.

(ii). Procedural restrictions

In addition to restricting the scope of a PCO, it would be possible to restrict or delay recourse to it by requiring prior procedural steps to be taken, on an agreed footing. These might include, for example, that a party seeking to rely on a PCO has to give prior notice before it can do so and the other party has to have the opportunity to make representations and/or escalate the matter.

> Given that recourse to the PCO would imply a divergence in regulatory regimes, the prior procedural steps could be the subject of discussion in the Forum for Regulatory Alignment (see section 6) and/or included in dispute resolution procedures (see section 8).

Provisions of this nature should be considered for the PCO contained in the EU/UK Agreement – and, in view of the existing degree of regulatory alignment, the EU/UK Agreement should go further in restricting the use of the PCO than any EU FTAs have done until now.

Nevertheless, both the EU and UK are likely to have reasons for wanting to have a PCO, so the question will be how the correct balance can be maintained between giving effect to principles of market access and having adequate safeguards in prudential matters. Part of the answer may lie in ensuring that procedures for the use of the PCO are closely aligned with analogous procedures under the EU/UK Agreement for addressing regulatory divergence and dispute settlement.

It may also be appropriate to have different PCOs in relation to different sub-sectors of financial services, to reflect the different prudential concerns that may arise.

(d). Other constraints in relation to highly regulated services

Under the Single Market Directives, the scope of access rights is determined using common terminology, and guidance on the meaning of provisions is given at a European level. This means that terms used in the Single Market Directives should apply uniformly and be interpreted the same way in Member States, thus reducing the scope for regulatory arbitrage.

FTAs do not operate in the same way. There is scope for terms to be interpreted differently, and in some cases it is expressly stated that the parties are at liberty to interpret clauses in their own way: an example is Article 13.7.6 of CETA, which allows for the provision of financial services on a cross-border basis but expressly does not require a party to permit suppliers from the other party to "do business" or "solicit" in its territory and says that each party may define what it means to "do business" and "solicit" for these purposes.

The result of including such a provision in an FTA can, for example, be that even where a service supplier from another jurisdiction has been granted access, and even where the regulator recognises the regulatory regime in the other jurisdiction as satisfactory, the service supplier may be excluded from the market if the host regulator's definition of "doing business" excludes the services that the service-supplier wishes to offer or the mode of supply by which the supplier intends to offer them.

In order to avoid such issues arising, the EU/UK Agreement should either define the relevant terms itself or contain a process under which the terms can be defined by agreement. This will prevent the parties to the EU/UK Agreement from approaching questions of interpretation on a piecemeal basis and creating the possibility of regulatory arbitrage.

2.5. Conduct of business rules – home state or host state?

If the EU/UK Agreement gives rights of mutual access to firms, the question then arises as to which territory's conduct of business rules should apply to the activities carried on by those suppliers.

Within the Single Market Directives, the position is not straightforward. For example, under MiFID, a firm providing services from a branch will have to comply with the local conduct of business rules in the host state (i.e. the state where the branch is located), whereas a firm providing services on a cross-border basis without a branch would have to comply with the conduct of business rules in its home state. The rationale for allowing a firm to comply with its home state rules only is that MiFID is a maximum harmonisation Directive, which means that each Member State ought to have implemented the Directive without adding further rules of its own (other than in very limited circumstances) – and that the rules in each Member State ought to be substantively the same.

This approach is also followed in other Directives, but the extent to which the rules are harmonised may vary, as the tests under which Member States are permitted to "gold plate" the rules – i.e. add local requirements in addition to those specified in the Directive – vary as between the Directives. It is considered easier, for example, for a Member State to satisfy the test for gold plating under the Insurance Distribution Directive than it is for MiFID. Even within the EU, therefore, passporting firms are faced with a patchwork of regulation and often have to consider both the home state and host state rules.

In agreeing which state's conduct of business rules apply, the EU and UK would probably choose one of the following alternatives:

(a). Follow the approach under the Single Market Directives

Insofar as an access right under the EU/UK Agreement applies in relation to a service that is also covered under the Single Market Directives, the EU/UK Agreement should follow the approach taken under the relevant Single Market Directive – i.e. whichever conduct of business rules applied to a passporting firm would also apply to a firm relying on mutual access under the EU/UK Agreement.

This approach would have the advantage of preserving the current approach, which would provide continuity for both UK firms providing services into the EU and EU firms which wish to continue providing services into the UK. It would also avoid the possibility of consumers in a particular EU Member State being treated differently depending on whether the financial service supplier they were dealing with was from another EU Member State or from the UK.

(b). Host state conduct of business rules to apply

Under this approach, home state regulation would apply in relation to matters of prudential regulation but the host state conduct of business rules would 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

It is also worth taking into account that the regulatory landscape will change over time. For example, within the EU it is likely that the ESAs will have increasing amounts of power and supervisory responsibility, in place of national regulators. This may, in due course, help

facilitate a more harmonised approach to conduct of business rules within the EU/UK Agreement.

2.6. The basis for access

Even just within the financial services sector, the EU/UK Agreement will need to cover a broad range of activities, encompassing different types of business, different types of financial services supplier and different types of customer. It may be appropriate to have different bases for mutual access in relation to different scenarios, where the nature of the regime is proportionate to the risks involved. For example, in relation to wholesale business carried out between financial institutions, it would be proportionate to have a less onerous regime, whereas that would be less appropriate where retail consumers are involved.

In the sections below, we have set out a number of options which could be considered for inclusion in the EU/UK Agreement:

(a). Mutual access based on regulatory alignment

The core element of our proposal is for the EU and UK to allow mutual rights of access based on the fact that their financial services regimes are aligned and have not diverged materially.

The details of this proposal, including the basis for assessing divergence between the regimes, and the arrangements for monitoring divergence and resolving disputes, is contained in sections 3, 5 and 7 of this Report.

(b). Mutual access without a requirement of regulatory alignment

In relation to certain types of cross-border financial services, access can be given without the parties considering whether alignment-based criteria are satisfied. Instead, in respect of business within agreed parameters, the firms would be subject only to limited obligations, and they would not need a licence to carry on cross-border activities with eligible participants from the other territory. See section 4 of this Report.

(c). Standstill arrangements in relation to exemptions currently available under local law within the EU and the UK

As identified in the Phase 2 Report and in section 7 of this Report, a number of EU Member States currently have regimes under their local laws in which they allow access to third country firms – such as the UK's overseas persons regime.

As part of the EU/UK Agreement, the parties could agree that any pre-existing regimes of this nature become subject to a "standstill" commitment – i.e. so that the relevant states agree to maintain access on the basis of their existing domestic exemptions and agree not to change those laws in a way that reduces market access (or not to change them without giving a defined period of notice to allow firms from the other party to react to the change). In addition, the parties could argue that, after the EU/UK Agreement enters into force, if a state establishes a national regime to permit cross-border access, or expands access under an existing regime, the state will commit to allow and maintain such access. As it is likely in practice that the terms of the EU/UK Agreement will need to be approved by each EU Member State, each Member State could individually agree (as part of giving that approval) to preserve existing domestic access rights.

(d). Consent to jurisdiction

Under a "consent to jurisdiction" regime, a firm from one territory can access the relevant parts of another territory's market if the supplier consents to the jurisdiction of the regulatory authorities in that other territory.

US regulation uses the "consent to jurisdiction" approach in the context of clearing houses. A non-US clearing house from a country whose standards are accepted by the US regulators as equivalent to those of the US can apply to become an exempt DCO. The exempt DCO firm must – at an entity level – agree to accept the jurisdiction of the US regulators. The firm's home state regulator must also enter into a memorandum of understanding with the US regulators in relation to matters such as on-site visits and notification obligations.

Such a model could potentially form part of the basis of an EU/UK Agreement. For example, in the same way that a UK clearing house could apply to become an exempt DCO in the US, and accept the jurisdiction of the US regulators, so it could accept the jurisdiction of the EU regulatory authorities. This model is likely to be of particular use in relation to areas such as financial market infrastructure, where there are relatively few entities that would need to be regulated and where the EU authorities may consider that they have the necessary resources to regulate non-EU firms. It might also help address concerns of EU regulators regarding the supervision of euro clearing.

A "consent to jurisdiction" model has not been included in any existing FTAs but could nevertheless be included as part of an EU/UK Agreement as part of the basis of access for financial services. Given its usage elsewhere in the world, it may lend itself in particular to market infrastructure.

If such a model was included in the EU/UK Agreement, it may need to be complemented by further procedural steps (including, possibly, the passing of legislation in either or both parties and the entering into of detailed memoranda of understanding).

(e). Arrangements for market infrastructure

The EU/UK Agreement should include a provision that automatically gives day one recognition to UK CCPs, CSDs, trading venues and trade repositories that are currently authorised in the EU (like a grandfathering clause). This would sit alongside the provision in the EU/UK Agreement that confirms that the UK regulatory regime is considered to be fully aligned with that of the EU. The first step in the recognition process under the EU regime is usually equivalence, and that an acknowledgment of alignment would be consistent with that.

The EU/UK Agreement is meant to be symmetrical and mutually beneficial, so the same concessions that would be afforded to UK market infrastructure providers should also be provided to EU market infrastructure providers seeking to do business in the UK.

The actual solution for the EU/UK Agreement is likely to be a combination of these options. We anticipate that the two mutual access regimes outlined above – i.e. the regime based on alignment and the narrower regime where alignment is not required – will provide the basis for access for most firms and most types of business. However, those regimes may need to be complemented by more bespoke arrangements, in particular for market infrastructure. In agreeing the EU/UK Agreement, the parties should be flexible in their approach and consider combining different options in order to ensure a mutual satisfactory arrangement for access.

2.7. Are there are any areas of law or regulation where alignment is not necessary?

It is possible that the EU and UK may identify areas of the law or regulation where they agree that it is not necessary for the respective regimes to be aligned. In relation to such areas, it would be open to the parties to adopt different approaches without this calling into question whether the criteria for access have been satisfied. This could apply to particular rules or to discrete segments of the market.

Areas where such an approach may be appropriate include those where:

(a). There are no current EU standards. For example, in relation to consumer lending there are significant local differences in how firms would verify the identity or creditworthiness of borrowers, make assessments of affordability and recover debt. In such a context, it would be possible to have rules that were specific to either the UK or the EU (or of individual Member States) with little or no impact on the industry. Firms which wished to do business cross-border could simply comply with the rules of the host territory.

(b). There are EU standards that operate on a minimum harmonisation basis (i.e. where the EU sets a minimum standard that must apply in all Member States, but individual Member States are free to go beyond the minimum standard when enacting the rule in their own territory).

Similarly, even in areas where alignment is necessary, it may be possible to have a certain amount of regulatory divergence without adverse consequences – such as a concept of "managed divergence", under which divergence in relation to certain issues or divergence to a pre-determined degree would not permit either party to deny cross-border market access. This would allow divergence to occur incrementally over time, with the agreement of the parties, without either party prejudicing their rights of mutual access.

It is worth noting that full alignment is not required within the EU itself. Although recent EU financial services legislation has seen a trend towards increased harmonisation between Member States, it is nevertheless permissible in certain circumstances for Member States to supplement the EU rules with additional requirements of their own. This concept is known as "gold plating". There are limits on the ability of Member States to gold plate the EU rules, but the fact that non-alignment is accepted even within the EU suggests that it should be possible for the EU/UK Agreement to include some flexibility on the question of alignment as well.

2.8. Regulatory processes

The introduction of mutual access regimes should also bring with it certain regulatory processes. For example, under the passporting rules, when a firm wishes to exercise its passporting rights, it notifies its home state regulator, which notifies the host state regulator. The host state regulator is therefore aware of the identity of every firm that is using passporting rights in its territory.

We expect that such an approach would be appropriate under the mutual access regimes as well – so that the regulators in each party to the EU/UK Agreement know the identity of all the firms who are making use of the rights of access in their territory. This would be the case for all of the access regimes considered in this Report, whether on the basis of the regimes being aligned or not.

SECTION 3

MUTUAL ACCESS BASED ON ALIGNMENT

SECTION SUMMARY

- At the date of Brexit, by virtue of the Withdrawal Bill, the legal and regulatory position in the UK will be the same as that in the EU in relation to financial services matters (subject to a few necessary exceptions). On that basis:
    - The EU/UK Agreement should explicitly acknowledge and confirm that the regulatory regimes of the UK and EU are sufficiently aligned at the date of Brexit to be a basis for mutual access rights – without the need for either party to undergo any kind of formal assessment.
    - The financial services provisions of the EU/UK Agreement would focus primarily on how two regimes can continue to remain sufficiently aligned. The focus of the mutual access arrangement would therefore be on assessing divergence.

  In the context of alignment, the questions of how regulators supervise firms and enforce rules against them would also be relevant; see section 7.
- In considering whether divergence has occurred, it will be necessary to have a process for determining whether the regimes remain sufficiently aligned. There are a number of possibilities (which were also considered in the Phase 2 Report). It would be preferable not to have a line-by-line, legalistic test but instead to frame the criteria for access as being that the two regimes are sufficiently aligned, having regard to the chosen outcomes and the degree of flexibility that the parties have agreed to incorporate into the arrangements.
- It is likely that assessments will (at least to some extent) be made by reference to outcomes. There are precedents for outcomes-based assessments, such as proposals produced by CETA and the "comparable regulatory scheme" used by the CFTC, which could be drawn on in developing any arrangement between the EU and UK.
- Not all divergence should lead to adverse consequences. The assessment should consider whether the divergence is material and goes beyond the parameters of whatever levels of flexibility the parties have agreed to incorporate into the agreement in relation to the degree of alignment that is required.
- Whatever criteria are used to assess alignment, direct textual comparisons should be avoided. It is likely that assessments will (at least to some extent) be made by reference to outcomes. The exact nature of those 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.
- The EU and UK should consider in detail the separate global standards that are available and determine whether or not to include adherence to them in any criteria for access.
- The EU and UK may identify discrete areas where they agree that it is not necessary for the respective regimes to be aligned. Similarly, even in areas where alignment is necessary, it may be possible to have a certain amount of regulatory divergence without adverse consequences – such as a concept of "managed divergence".

- One of the key methods of maintaining ongoing alignment would be for both parties to agree to proactively engage with each other in the development of new laws and regulations, in order to prevent problems arising rather than having to react when divergence occurs.
- Existing EU FTAs contain provisions for transparency, consultation and co-operation. However, the EU/UK Agreement should, in recognition of the degree of current alignment, be more ambitious in its scope and it should also include provisions to:
  - proactively encourage continuing alignment (and thereby reduce the risk of divergence occurring in the first place). In addition to provisions for reporting and consultation, the EU/UK Agreement should also include:
    - information sharing obligations (including a duty to notify proposed changes to the law);
    - participation in the development of material new laws and regulations by the other party; and
    - mechanisms for considering key issues arising under the EU/UK Agreement (e.g. whether divergence has occurred);
  - monitor divergence – e.g. carrying out surveillance in order to identify if divergence is actually occurring; and
  - address the consequences of divergence (in order to prevent the matter going to dispute resolution).
- The EU/UK Agreement should include mechanisms in relation to supervisory co-operation which reflect the new nature of the relationship but support an ongoing close working relationship in relation to supervision where relevant.
- All of these matters should take place within appropriate and defined timescales.
- The consequences of divergence should be set out in the EU/UK Agreement.
- In order to give effect to these proposals, the parties should establish a Forum for Regulatory Alignment, which would have a clearly defined scope, structure and processes.
- If the regimes cease to be aligned in a particular area and rights of access are withdrawn as a consequence, the parties should remain open to the possibility that the regimes could become realigned in the future.

3.1. Background

This section considers the aspect of a mutual access regime based on there being ongoing regulatory alignment between the EU and the UK.

3.2. The criteria for assessing divergence

(a). The UK's position at the date of Brexit – acknowledged alignment

As a matter of general principle, at the date of Brexit the legal and regulatory position in the UK ought to be the same as that in the EU in relation to all financial services matters (whether regulation or supervisory practice) which are the subject of the Single Market Directives. In addition, the intention of the Withdrawal Bill is to transpose the relevant provisions of European law directly into UK law, so that they continue to apply in the UK with effect from Brexit unless and until the UK takes steps positively to depart from them.

There will be some areas in which this general principle may be unworkable and therefore change is required – for example, where EU regulatory bodies currently have direct regulatory authority over UK firms (such as in relation to credit ratings agencies) and a UK body will have to be substituted for the EU body. Nevertheless, any discrepancies as at the date of Brexit are likely to be minor, and there are likely to be other ways to address this issue (see paragraph 3 of Annex 2). There will also be some elements of supervisory co-operation which will need to be supplemented and this can be achieved by the mechanisms agreed in the EU/UK Agreement.

On that basis:

(i). the regulatory regimes of the EU and UK should be acknowledged by each party as sufficiently aligned at the date of Brexit to be a basis for mutual access rights on terms set out in EU/UK Agreement – without the need for either party to undergo any kind of formal assessment by reference to any criteria (whatever those criteria might be). The EU/UK Agreement itself should explicitly confirm that the EU and UK are aligned as at the date of Brexit; and

(ii). the relevant provisions of the EU/UK Agreement in relation to financial services would focus primarily on how the UK's and EU's respective systems can continue to remain sufficiently aligned and on steps to be taken in the event of any divergence. The criteria for assessing regulatory alignment that are agreed between the parties would only come into play in order to help consider cases of possible divergence. As noted elsewhere in this Report, the need for alignment should be proportionate in relation to the degree of access granted.

It is unlikely in practice that the EU/UK Agreement would provide for rights of access which are as broad as the Single Market Directives, but insofar as rights of access are agreed, the principles outlined above are likely to apply.

(b). What should the test for alignment be going forwards?

Even if the EU and UK regimes are aligned as at the date of Brexit, there is the possibility that the regimes may diverge in the future. Where that is the case, there should be a means of determining whether the regimes have ceased to be sufficiently aligned.

In the Phase 1 Report, we considered in detail the third country regimes ("**TCRs**") under which third country firms can be allowed access to the EU market under the terms of existing Single Market Directives. Those TCRs normally depend upon the relevant third party satisfying an "equivalence" test. We concluded that there were a number of concerns regarding the TCRs in general, and that there were specific concerns around the equivalence test – including, in particular, a lack of clarity over what the term "equivalent" means and the extent to which it permits divergence of the respective regimes.

In the Phase 2 Report, we identified a number of potential approaches towards criteria for access, based on existing precedents and approaches already in use. We considered a number of concepts that are used in existing arrangements, such as equivalence (as used in the TCRs), regulatory approximation (as used in association agreements with potential future members of the EU), deference (as used at a G20 level in the context of derivatives), "mutual recognition" (as used specifically in the Solvency II Directive) and "substantially the same regulatory impact" (as used in the US/EU Covered Agreement relating to insurance).

We concluded that in the event that the EU and UK agree to use one or more of these tests as the basis for access under an FTA, the UK should seek the inclusion of provisions in the EU/UK Agreement that:

(i). reflect the very high degree of alignment that will exist between the EU and UK as at the date of Brexit; and

(ii). expressly provide that neither party need go through any formal process in order to determine whether its regime is sufficiently aligned.

In any event, it would be preferable to move away from a formal legalistic test involving interpretation of a term like "equivalence", and instead to frame the criteria for access as being that the two regimes are sufficiently aligned, having regard to outcomes.

It is likely, whatever criteria are used to assess alignment, that assessments will (at least to some extent) be made by reference to outcomes. Even in relation to tests such as equivalence, which are perceived as being more likely in practice to involve granular comparisons of respective rulebooks than other tests, the existing legislation suggests that an outcomes-based approach should be taken.[5]

When an outcomes-based approach is taken, some questions arise: what are the common outcomes that the parties are seeking to achieve, and how can they be measured?

The IOSCO Report considered the question of cross-border regulation and alignment of regimes in some detail. Among the issues that the IOSCO Report considered was

the challenge of assessing outcomes. The IOSCO Report suggested a four-stage approach to this question:

(i). Identifying regulatory outcomes

First, the parties would identify the outcomes that they were trying to achieve. The suggestions in the IOSCO Report for the outcomes were: (1) domestic investor protection; (2) maintenance of local market integrity; (3) the reduction of regulatory arbitrage; (4) the reduction of systemic risk, crime and misconduct in the domestic financial system; and (5) effective AML and protection against financial crime.

In the context of the EU/UK Agreement, the test would be whether a legal or regulatory change which is proposed or has occurred would have a material impact on achieving these or other agreed regulatory outcomes.

(ii). Selecting measures to assess such outcomes

Once the outcomes themselves are determined, the parties need to agree how those outcomes can be measured. The IOSCO Report suggested eight common measures:

- general analyses of foreign securities laws, regulations, requirements, and standards;
- specific analyses of foreign securities laws, regulations, requirements, and standards, both as written and implemented, with respect to the cross-border activity considered under the proposed unilateral or mutual recognition arrangement;
- the level of investor protection in the foreign jurisdiction;
- enforcement capability of the foreign jurisdiction;
- the level of supervisory oversight in the foreign jurisdiction;
- legal framework for and implementation of international co-operation;
- analysis of results from standardised assessments by international organisations; and
- membership and status in international organisations, regional communities, or groups.

These measures may provide a useful framework, but it is worth bearing in mind that they were designed for an arrangement which would apply to disparate regulatory regimes. The EU and UK are wholly or substantially aligned in relation to most of the IOSCO common measures and it should not be difficult to demonstrate this.

For the EU/UK Agreement, the assessment would turn on whether changes in such areas (or other agreed areas) are likely to have a material impact on the achievement of the regulatory outcomes and so may be limited to looking at an impact assessment of the relevant change.

(iii). Gathering materials to evaluate comparability

Once the outcomes and the measures have been determined, the relevant regulator will need to gather materials for evaluation of whether or not the

outcomes are comparable. This information is usually gathered by observing foreign regulatory and market developments, participating in international regulatory forums and other sources.

(iv). Evaluation and use of "benchmarks"

The IOSCO Report notes that regulators find it useful to set "benchmarks", where possible, to determine the extent to which the foreign regulatory regime meets the predetermined regulatory outcomes. These could be benchmarks that reflect international standards (of the types considered in section 3.2(c)) or those that reflect domestic requirements.

Given that this process is limited to managing change, it may not assist to introduce benchmarks where they do not otherwise exist. To the extent that international benchmarks emerge or exist, it is likely that both regulatory frameworks would be considering meeting them. If the parties agreed on the applicability of an international benchmark, that benchmark could become a factor in the assessment of whether a change would result in a material impact on the ability to meet the same regulatory outcomes (e.g. if a change would mean that one of the regulatory regimes no longer met the particular benchmark).

Although the IOSCO Report, being concerned with global standards, has obvious appeal, it is not the only source of guidance in relation to the question of outcomes.

For example, in the USA, the CFTC allows intermediaries and foreign brokers to directly solicit US investors without being registered by the US when they come from a country which is determined to have a "comparable regulatory scheme" to that of the CFTC. At a minimum, the CFTC will consider a jurisdiction to have a comparable regulatory scheme where there are the following features:

- minimum financial requirements for persons accepting customer funds;
- protection of customer funds from misapplication;
- recordkeeping and reporting requirements;
- minimum sales practice standards, including disclosure of the risks of futures and options;
- transactions and, in particular, the risk of transactions undertaken outside the jurisdiction of domestic law; and
- supervision, monitoring and enforcement by a regulatory authority for compliance.

Approaches such as this could be drawn on in developing any arrangement between the EU and UK.

Any articulation of the relevant outcomes could also include data privacy and confidentiality, which is increasingly a key consideration in outcomes-based assessment.

A framework for outcomes-based assessment will not only be valuable in itself; it will also become increasingly important over time as the EU and UK financial services regimes evolve, because it will help anchor considerations based on outcomes rather than on line by line assessments.

(c). The use of global standards

Certain elements of the regulatory regime that will apply in both the EU and UK after Brexit are derived from standards which are developed at a global level, such as the Basel Committee prudential standards, guidelines and sound practices for banking, the standards for securities of the IOSCO, various standards produced by the IAIS and the FSB standards. The EU and certain of its Member States, including the UK, contribute to setting these global standards, together with other G20 countries.

The global standards are primarily aimed at financial stability and preventing regulatory arbitrage, but could also form a sound basis for a mutual access regime founded on common approaches to key issues. The nature of these global standards is that they establish a framework and set out principles or minimum standards which need to be enacted in local regulatory regimes.

A focus on global standards, where appropriate, could potentially offer an alternative means of satisfying an "outcomes-based" test. Parties could agree that compliance with the global standards for a specified activity will demonstrate that the "outcomes-based" test had been satisfied. This could be the case even where one party goes beyond the minimum required by the international standard (which would in turn mean that the two regimes do not need to be fully aligned).

Recent EU legislative developments have indicated that the EU recognises the benefits of using global standards, such as those of IOSCO, when framing regulatory obligations. For example, under the Benchmarks Regulation one of the criteria for allowing certain forms of access for benchmark providers from third countries is whether the domestic regime in the third country complies with the IOSCO principles on benchmarks.

There are some limitations on the scope for including adherence to global standards in the criteria for mutual market access:

(i). Global standards may vary in quality. Although global standards are well developed in some areas (e.g. prudential regulation of banks, recovery and resolution of systemic institutions, and critical market infrastructure), there are other areas – such as insurance – where they are less well-developed and could not be used to frame the basis for mutual access. In some areas, there are significant global differences in regulation and it may be difficult to develop a global standard that is acceptable to all.

(ii). The existing global standards were not designed to underpin comprehensive rights of mutual access between trade partners. They tend to be more general and less comprehensive than the standards that are applied by national regulatory authorities domestically. The EU and UK would probably not wish to rely solely on common adherence to a global standard as the basis for mutual market access unless it was sufficiently robust and detailed.

(iii). Global standards usually represent a minimum standard. Either party to the EU/UK Agreement may wish to apply a higher standard than the minimum, and not be regarded as not complying with the EU/UK Agreement.

(iv). There may be areas where the EU and UK have decided against full adherence to a global standard. The EU has not, for example, implemented

all of the Basel III requirements, and the attempts to introduce global standards for insurance face the challenge of significant differences in local regimes.

The EU and UK should therefore consider in detail the separate global standards that are available and determine whether or not to include adherence to them in any criteria for access.

They should also consider whether to enshrine in the EU/UK Agreement a principle that the parties should seek to be guided by global standards (where appropriate) or consider adherence to them by both parties to be a factor indicating alignment.

(d). Acceptable divergence

As noted in section 2.7, alignment is not necessary in all situations.

Similarly, even where alignment is appropriate, not all divergence should lead to adverse consequences. The parties should incorporate an element of flexibility in relation to the degree of alignment that is required.

The assessment of alignment should consider whether the divergence is material and goes beyond the parameters of whatever levels of flexibility the parties have agreed to incorporate into the agreement.

3.3. Assessing ongoing alignment and divergence

As considered in section 3.2(a), whatever criteria for access are used in the EU/UK Agreement, the EU and UK will satisfy those criteria in the area of financial services at the date of Brexit. If so, any concern about whether the parties to the EU/UK Agreement comply with the criteria for access is therefore likely to arise only after the date of Brexit if and to the extent that the respective regimes begin to diverge. The parties therefore need a process to deal with subsequent divergence.

Examples of future divergence might include:

(a). the EU and UK seeking to implement new global standards that apply to them both, but doing so in different ways;

(b). the EU seeking to further the European Banking Union and Capital Markets Union, and to provide for new approaches to the oversight of banks and of wholesale markets and enforcement of relevant regulation;

(c). the UK seeking to go further than the minimum requirements under EU law – as it has already done (within the boundaries of EU law) in areas such as the prudential regulation of banks, ring fencing, and benchmarks;

(d). either party seeking to develop rules independently which could be better tailored to the specific nature of its domestic products and firms; and

(e). the EU or UK seeking to develop specific new areas of regulation in response to developments, such as those relating to FinTech.

An agreed approach to addressing questions of potential divergence will therefore be important. Going forwards, the emphasis should be on determining whether the divergence is material and would mean that mutual access rights should be reconsidered.

As part of an EU/UK Agreement, the parties should establish mechanisms to:

(a). proactively encourage continuing alignment (and thereby reduce the risk of divergence occurring in the first place) e.g. through reporting and consultation;

(b). monitor divergence – e.g. carrying out surveillance in order to identify if divergence is actually occurring; and

(c). address the consequences of divergence (in order to prevent the matter going to dispute resolution)

These issues are considered in sections 3.4 to 3.8. The conclusion is that, in order to provide these mechanisms, the EU and UK should agree to establish a forum or committee, known as the Forum for Regulatory Alignment. The way in which such a forum might operate is considered in section 6.

3.4. Proactively encourage continuing alignment

One of the key methods of maintaining alignment would be for both parties to agree to proactively engage with each other in the development of new laws and regulations in order to minimise divergence (possibly in the context of wider global initiatives). This engagement should be aimed at preventing problems arising rather than at having to react when divergence occurs. It should also recognise that access is based on alignment of outcomes, so some divergence over time is permissible within parameters agreed between the parties.

Many EU FTAs contain provisions regarding:

(a). Transparency

The parties to the FTA agree that their laws, regulations and administrative rulings shall be promptly made available to the other party, and where (to the extent possible) each party agrees to:

- The parties to the FTA agree that their laws, regulations and administrative rulings shall be promptly made available to the other party, and where (to the extent possible) each party agrees to:
- publish in advance any relevant measures that it proposes to adopt;
- provide the other party a reasonable opportunity to comment on these proposed measures; and
- allow reasonable time between the final publication of the measures and the date they become effective.

(b). Consultation

FTAs typically state that a party may request consultations with the other party regarding any matter arising under the FTA – and hence including financial services. The other party is required to "give sympathetic consideration to the request" (which follows the wording in the GATS).

(c). Co-operation

EU FTAs typically contain provisions for the parties to establish a committee to

supervise the implementation of the FTA and to act as a forum for dialogue. The CETA, for example, establishes a Financial Services Committee to meet annually (or as it shall otherwise decide) which supervises the implementation of the CETA in relation to financial services and aims to:

> *"carry out a dialogue on the regulation of the financial services sector with a view to improving mutual knowledge of the Parties' respective regulatory systems and to co-operate in the development of international standards as illustrated by the Understanding on the dialogue on the regulation of the financial services sector contained in Annex 13-C"*

TTIP, TPP and NAFTA also contain similar provisions. EEA-EFTA States also have observer status in relation to the development of EU law. Although they cannot vote on legislation, they do have the ability to make representations regarding its content. The EEA Agreement contains provisions for input from the EEA/EFTA States at various stages before legislation is adopted, including consent at the EEA Joint Committee.

Provisions of this nature should be included in the EU/UK Agreement. However, these provisions would not go far enough to reflect the nature of the EU/UK Agreement, which would include a level of mutual access that does not exist under any current FTAs. In addition, they arise from a different context – i.e. existing FTAs contemplate the closer alignment of regimes that were different to begin with, whereas the EU/UK Agreement would be considering how two identical regimes might diverge from each other in the future.

In view of these considerations, the EU/UK Agreement should be more ambitious in its intent than FTAs generally, and its provisions for proactive alignment should also include the following:

(i). Information sharing and co-operation

There should be clear and comprehensive arrangements for sharing information and co-operating in relation to regulatory alignment. The obligations on the parties should include:

- the promotion of timely and faithful domestic implementation of international standards;
- the sharing of information on intended new regulations;
- consultation if legislation is introduced which might lead to divergence; and
- exchanges of views on regulatory issues in a bilateral context.

The EU/UK Agreement should also include data sharing arrangements to ensure that EU regulators receive appropriate data on UK firms accessing the EU markets and vice versa.

(ii). Participation in the development of new laws and regulations

Each of the parties should formally involve the other party in the development of its laws. It is a principle of FTAs that participants should be open and transparent in relation to the development of laws, and financial services regulation in both the EU and UK usually involves detailed processes of public and industry consultation.

In relation to the EU/UK Agreement, we suggest that each party:

(i). be under a duty to notify the other of any changes that are proposed to be made to their respective regulatory regimes; and

(ii). formally recognises that the other party is entitled to make representations as part of the consultation process for the enactment of new regulation.

Under the EEA Agreement, EEA-EFTA states have a right of co-determination in relation to the initiation and development of EU legislation and there is an EEA Joint Committee mechanism for considering how such EU laws should be enacted in their territories.[6] This enables the EEA-EFTA states to be involved in the progress of EU legislation but does not give them the right to vote on it. The extent of this involvement reflects the EEA-EFTA states' commitment to enact all relevant EU legislation into their domestic law (sometimes known as the "rule-taker issue"). Although the UK will want to retain discretion on whether to align its own laws and regulations with those of the EU (recognising there may be a risk of a loss of access), the co-determination procedure from the EEA Agreement may give some practical assistance in developing a way of allowing each of the EU and UK to participate in each other's regulations.

(iii). Co-operation on supervision and enforcement

Divergence could occur as a result of the respective regulators taking different approaches towards supervision and enforcement in their own territory. If one regulator diligently supervises its firms and enforces a rule against them, while another regulator did not, the practical effect may be that the two regimes operate differently and produce different behaviours among their firms – which could amount to a form of divergence and lead to regulatory arbitrage.

The EU/UK Agreement should include an agreed approach to enforcement (in addition to supervision – see section 7). A co-operation arrangement on enforcement could be based on existing IOSCO Memoranda of Understanding, which ensure co-operation between both the EU and UK for enforcement against individual firms.

There is no mechanism for enforcement of global standards at a global level. Even where global standards could be used as the basis for a bespoke arrangement, it would still be necessary for each of the parties to agree mechanisms by which both parties can be held to those standards.

3.5. Monitoring divergence

Existing FTAs do not necessarily contain formal arrangements for the active monitoring of compliance with the terms of the agreement.

As noted above, in certain contexts there are mechanisms in place – such as the Regulatory Consistency Assessment Programme of the Basel Committee – for a party's compliance with the criteria for access to be formally assessed and reported on. Similarly, the Financial Sector Assessment Program of the IMF and the World Bank involves assessments of financial stability and financial development.

Within the EU context, the EFTA Surveillance Authority exists to monitor whether

EEA-EFTA States are observing their obligations under the EEA Agreement. The EFTA Surveillance Authority can investigate possible infringements of EEA provisions, either on its own initiative, or on the basis of complaints, and can impose fines on individual undertakings and assess mergers between undertakings where certain thresholds are met. The EFTA Surveillance Authority operates independently of the EEA-EFTA States and has a permanent staff of its own. It is led by a College which consists of three members, each appointed for a period of four years by the three participating EEA-EFTA States. If the EU and UK were minded to create a body to monitoring divergence under the EU/UK Agreement, the EFTA Surveillance Authority may provide a useful model.

Regardless of whether there is independent monitoring of divergence, the parties themselves will have a good sense of whether or not there is divergence (particularly given the obligations to share information and co-operate in relation to forthcoming regulatory changes that the EU/UK Agreement is likely to contain).

Insofar as the parties themselves do not identify instances of divergence, we anticipate that financial service suppliers or customers may themselves become aware of a potential difference in regimes or regulatory practices governing the provision of financial services, and that they will report matters to the relevant authorities (e.g. the national competent authorities or the government of one or both parties). This situation seems to be equally likely where divergence is less overt – for example, where it occurs through differing approaches to enforcement as between the parties.

Once an issue of potential divergence is identified, it would then be open to the party which alleges divergence to escalate the matter. In the first instance, escalation would be to the Forum for Regulatory Alignment (see section 6) to attempt to determine whether or not divergence has occurred and whether it is material.

3.6. Addressing the consequences of divergence

If both parties agree that regulatory changes have resulted in material divergence – or if an independent expert appointed to consider the matter (see section 6) reaches the same conclusion – it is then necessary to consider what the consequences would be.

The possibilities are as follows:

(a). If the party which has introduced the regulatory change that led to divergence wishes to attempt to remedy the divergence, it should be given the opportunity to do so. In relation to this, there should be a clear and transparent process, which should include:

- a way of determining what level of further change would be necessary to restore matters to their normal equilibrium. In the first instance, the parties should try to resolve this between themselves (see section 6) – or, if they cannot, the matter could be referred to a dispute resolution mechanism (see section 8); and
- provisions for the timing of next steps – such as the length of time allowed for divergence to be remedied.

(It is also possible that the party which is not responsible for the material divergence might want the opportunity to change its law to realign itself with the other party – if, for example, the divergence actually represents an enhancement. The processes under the EU/UK Agreement should also allow for this possibility.)

(b). If divergence has occurred (or has been alleged and the materiality of the divergence has not been agreed), the parties may be entitled to take measures pending resolution of the issue. Following the model used in the EU-Turkey Customs Union Agreement, measures might includ

- o "protection measures" – i.e. measures to protect the non-Diverging Party from the effects of divergence;
- o "safeguard measures" – i.e. more serious protective measures if serious disturbances occur in a sector of a party's economy or prejudice its external financial stability, or difficulties arise that affect the economic situation in a region of either party (although such measures would typically only be available in exceptional circumstances); and/or
- o "rebalancing measures" – i.e. measures that may be taken by the diverging party, if safeguard or protection measures taken by the non-diverging party create an imbalance between the rights and obligations under the EU/UK Agreement.

In each case, the Financial Services Forum (see section 6) would have a role to play in considering the validity and proportionality of these measures. However, the views of the Financial Services Forum would not be binding. Disputes in relation to these matters could ultimately be referred for formal dispute resolution.

(c). If divergence has occurred, and neither party wishes to change its position, it will be necessary to consider the extent to which the commitments undertaken by the parties of the EU/UK Agreement could be modified or withdrawn in respect of areas where the criteria for access are not met, but could continue in relation to other areas. The EU/UK Agreement will not merely govern the provision of financial services, but other goods and services too. In relation to this:

- o It is unlikely that the EU or the UK will want the entire EU/UK Agreement to stand and fall around a single issue of divergence.
- o Even within the financial services sector, however, the parties should consider the extent to which the criteria for access not being met in relation to one area of financial services could lead to loss of access to in relation to financial services more widely – so that, for example, non-compliance in relation to the capital position of insurance companies means that access is withdrawn in relation to other aspects of financial services as well (such as banking).
- o One possible solution might be to provide that, subject to the agreement of both parties, market access commitments in relation to a particular sector or activity (or a sub-set of it) could be withdrawn, amended, or made subject to conditions if the criteria for alignment of regulation governing such a sector or activity were no longer met. Any such changes in commitments would then be reflected in the schedules to the EU/UK Agreement, in language to be agreed between the parties.

(d). If there is no agreement regarding the materiality of the divergence, either party may wish to refer the matter to formal dispute resolution. See section 8.

Each of the steps outlined above should have a proper process built around it, under which each party will have an opportunity to provide input and will have adequate time to consider its position, consult with stakeholders and develop proposals, in order that the matter can be properly considered before it is referred for dispute resolution.

3.7. Re-establishing alignment

If the regimes of the parties cease to be aligned in a particular area and rights of access are withdrawn (as a last resort), the parties should at least remain open to the possibility that the regimes could become realigned in the future. This might occur because, for example, one of the parties decides subsequently to follow the same approach as the party that originally diverged, or because both parties are implementing a new global standard that will supersede their existing arrangements.

If divergence has occurred, the EU/UK Agreement should contain provisions which support a future re-assessment of divergence and the possible restoration of access rights.

3.8. Appropriate and defined timescales in relation to alignment

Given the comprehensive nature of the mutual access rights that would be contained in the EU/UK Agreement, and the high degree of reliance that firms are likely to have on such rights, it is important to ensure that the timescales for considering alignment-related matters are appropriate. In particular, outcomes that could have serious consequences for the ability of firms to do business in the territory of the other party should not be implemented without following an appropriate process.

In order to protect against this, the EU/UK Agreement should prescribe timescales for each of the processes which will be undertaken. The prescribed periods would potentially apply to all the relevant procedures under the EU/UK Agreement – from giving the other party a prescribed period of notice of impending changes to the law (subject to appropriate caveats) so that the other party has a fair opportunity to consider its position and make representations – to giving each party a fair period of time to consider the outcomes of the dispute resolution process before any steps are taken to impose adverse consequences on one of the parties.

SECTION 4

MUTUAL ACCESS THROUGH A NON-ALIGNED REGIME

SECTION SUMMARY

- For certain types of financial services, it may be appropriate to allow access without the parties considering alignment-based criteria. Instead, financial services suppliers dealing with qualifying counterparties from the other territory could supply cross-border services and would only have to comply with limited rules, as described further below. An analogy could be drawn with existing approaches taken in the UK and other Member States (e.g. Germany).
- This element of the EU/UK Agreement should:
  - apply to a broad range of services, including banking services, investment services within the scope of MiFID, funds and asset management, insurance and reinsurance;
  - apply when services are supplied by a firm cross-border (without establishing a branch) to a "qualified counterparty" – e.g. a regulated financial institution, large corporate (within pre-determined parameters) or governmental entity;
  - only be available to regulated firms (i.e. firms that are regulated in their home state);
  - allow a firm to provide services from its own territory directly to qualified counterparties within the other territory without establishing a branch (but without prejudice to the possibility that the firm might also have a branch in that territory that provides services that would not come within this regime); and
  - take firms outside the scope of certain host state requirements, such as requirements to obtain a licence, as well as the host state's capital and prudential regulation, reporting requirements, and rules related to internal organisation and operations – but should not disapply host state rules relating to market integrity or market structure (e.g. rules providing pre- and post-trade transparency).

4.1. Background

In section 2.6, we noted that it may be appropriate for the EU/UK Agreement to have different bases for mutual access in relation to different activities or with different counterparties – where the nature of the regime is proportionate to the risk involved.

4.2. A non-aligned regime

In relation to certain types of cross-border financial services, it may be appropriate for access to be given without the parties considering alignment-based criteria. Instead, in respect of business within agreed parameters, firms would be regulated in their home state but not need a licence in the host state to carry on cross-border activities with qualifying counterparties from the other territory. Notification of the host state would be necessary.

An analogy could be drawn with exclusions and exemptions that exist in the UK and other Member States. Section 9 of the Phase 2 Report contains an analysis of such regimes. They include regimes that allow non-EU firms to obtain local licences and regimes that allow non-EU firms to deal with counterparties in a Member State without obtaining a licence.

Under the UK's "overseas persons exclusion" ("OPE"), firms who can benefit from the exclusion do not need a licence from the PRA or FCA (or indeed a home state regulator) to carry on their activities and can operate without being subject to the FCA's rules.

The rationale behind regimes of this nature is normally that the types of customer or counterparty in question are considered capable of looking after their own interests and do not need the protection of regulations. The likely focus of such a regime on the more sophisticated type of client may reduce any concerns that the EU or the UK might have in relation to such a regime.

4.3. Precedents for access in FTAs that do not depend on alignment

There is also a potentially helpful precedent in the CETA.

Article 13.7.6 of the CETA provides that each party shall permit a person located in its territory (and a national, wherever they are located) to purchase a financial service from a cross-border financial service supplier of the other party located in the territory of the other party. On the face of it, this allows the parties to access each other's markets either through the provision of cross-border services or by permitting the sale of products to visitors from the other territory – in both cases without the need for local authorisation, as long as the firm from the other territory does not establish a physical presence (e.g. a branch office).

At first sight, this has similarities to the exemptions that exist in various Member States for access via reverse solicitation, and to the OPE. The provision could be read so that it would allow an EU person to purchase a product from a Canadian financial service supplier without the Canadian financial service supplier needing a licence in the Member State in which the customer is based. (The CETA was only concluded in October 2016 and is not yet in force, so it may be some time until the meaning of the provision is properly tested.)

Even if this reading of Article 13.7.6 is accepted, there are other provisions of the CETA that could prevent it being used as the basis for a right of access for firms. In particular, Article 13.7.6 states that it does not require a party to permit suppliers from the other territory to do business or solicit in its territory – and it allows each party to define what it means to "do business" or "solicit" in this context. This definition has to accord with the other principles of the CETA (so that it cannot conflict with free trade principles such as "national treatment"). Nevertheless, a party to the FTA could negate the wide interpretation of Article 13.7.6 by defining such terms in such a way as to materially restrict its scope and thereby prevent its citizens from purchasing financial services from a supplier regulated only in the other territory. A party to the FTA could also rely on the prudential carve-out in the CETA (see paragraph 4 of Annex 3) in appropriate circumstances.

Notwithstanding these limitations, Article 13.7.6 is significant because it shows a willingness on the part of the EU to agree in an FTA to the concept of access without alignment – albeit that CETA itself contains substantial carve-outs. The fact that the EU and UK already have a very high degree of regulatory alignment should put them in a good position to agree a less restrictive arrangement as part of the EU/UK Agreement.

4.4. The scope of a non-aligned regime in the EU/UK Agreement

Our recommendations for the provisions of the EU/UK Agreement that do not depend on alignment are as follows:

(a). Activities

The provisions that do not depend on alignment should apply to the cross-border supply of:

(i) banking services, including deposit-taking, lending, payment and money transmission services and custody and depositary services;

(ii) investment services within the scope of MiFID, including trading, underwriting, settlement and clearing, investment management and advisory services;

(iii) funds and asset management;

(iv) insurance; and

(v) reinsurance.

The definition of "financial services" from FTAs (as set out in Annex 3) would provide a sufficiently granular list of the banking, investment and insurance services that would potentially be in scope.

(b). Counterparty

The provisions of the EU/UK Agreement that do not depend on alignment should apply when services are supplied cross-border to a "qualified counterparty" – e.g. a regulated financial institution, large corporate (within pre-determined parameters) or governmental entity.

(c). Financial services providers

The provisions of the EU/UK Agreement that do not depend on alignment should apply when services are supplied cross-border to a "qualified counterparty" – e.g. a regulated financial institution, large corporate (within pre-determined parameters) or governmental entity.

(d). Branch or services

The provisions of the EU/UK Agreement that do not depend on alignment should allow a firm to provide services from its own territory directly to qualified counterparties within the other territory without establishing a branch (but without prejudice to the possibility that the firm might also have branch in that territory that provides services that would not come within that regime).

(e). Applicable regulation

The provisions of the EU/UK Agreement that do not depend on alignment should operate to take firms outside the scope of certain host state requirements, such as requirements to obtain a licence, as well as the host state's capital and prudential regulation, reporting requirements, and rules related to internal organisation and operations.

It would not, however, act to disapply the host state's market integrity rules – such as restrictions on short selling, prevention of insider dealing, market manipulation and fraud, and reporting of long and short positions – or the host state's market structure rules (e.g. providing pre- and post-trade transparency).

SECTION 5

INVESTMENT EXCHANGES AND FINANCIAL MARKET INFRASTRUCTURE

SECTION SUMMARY

- Investment exchanges and financial market infrastructure do not exercise passporting rights in the way that is understood for other financial institutions. Instead, EU law provides a number of means of protections for such providers, including preventing Member States restricting access, providing for authorisation in one member state to be effective across the EU and in some cases appointing an EU body as the central regulator and permitting access across the EU.

- Third country investment exchanges and market infrastructure can apply for recognition by ESMA, which allows their facilities to be used by EU firms. However, there are some disadvantages to this approach, as outlined in the Phase 1 Report.

- Investment exchanges and financial market infrastructure have a systemic importance for the markets that they operate or support. If EU firms ceased to have access to UK investment exchanges and market infrastructure (particularly CCPs), and vice versa, there could be significant adverse for such firms and for the EU and UK markets.

- One solution would be for the EU/UK Agreement to give automatic recognition to UK CCPs, CSDs, trading venues and trade repositories that are already authorised in the EU – and for the UK to give corresponding access for EU CCPs, CSDs, trading venues and trade repositories.

- There is a potential complication, in the light of the EU's proposals to change the recognition regime for third country CCPs. The proposal is that CCPs which are of "specifically substantial systemic significance" for the EU financial system cannot be recognised but would need to be authorised and established in a Member State. This could affect some UK CCPs. If suitable arrangements can be agreed in the EU/UK Agreement, the EU may not consider it necessary to impose such requirements in relation to UK CCPs. However, given that the EU's proposed changes would apply to all third-country CCPs generally (and not just UK CCPs), it is also possible that the EU may continue to insist on the introduction of the new CCP regime.

- Consideration should be given to alternative access models, such as.
  - a "consent to jurisdiction" model; and
  - mutual access based on alignment – like the regime outlined in section 3.

5.1. Background

Arguably, investment exchanges and financial market infrastructure represent a class of regulated entity that could be treated differently from other financial institutions. In this section, we use the term "investment exchange" to refer to regulated markets, multi-lateral trading facilities and the new form of organised trading facility that will become regulated under MiFID II. "Financial market infrastructure" includes central counterparties ("**CCPs**"), central securities depositories ("**CSDs**") and trade repositories. Investment exchanges and financial market infrastructures are typically located only in one jurisdiction and, whilst their services are made available to users that may be based in other jurisdictions, their own activities tend to be undertaken from a platform based in their country of incorporation.

5.2. Access between Member States: a different regime from passporting

Investment exchanges and financial market infrastructure do not exercise passporting rights in the way that is understood for other types of financial institutions. Instead:

(a). some EU laws provide that Member States should not introduce restrictions to prevent access by financial institutions in their jurisdiction to investment exchanges authorised in other EU Member States (as is the case for regulated markets under MiFID II);

(b). some EU laws provide that the authorisation of market infrastructure in one Member State, in accordance with the requirements of EU law, results in an authorisation that is effective throughout the EU, such that that market infrastructure can offer its services to recipients in other Member States without the need for further regulatory approvals (as is the case for CCPs under EMIR); and

(c). some EU laws provide for a central EU-level authorisation, with an EU body as the regulator of the market infrastructure, and which also enables that market infrastructure to offer its services to recipients in any Member State (as is the case for trade repositories under EMIR, which are regulated directly by ESMA).

5.3. Access from outside the EU: Third Country Regimes

Upon Brexit, these mechanisms, which currently facilitate the availability of UK investment exchanges and market infrastructures to EU-based users, will cease to apply. Instead, UK investment exchanges and market infrastructures would be treated as "third country" platforms, and – in the absence of a deal between the EU and UK – would

need to apply for recognition by ESMA under the various third country "equivalence" regimes that apply under EU law.

Recognition of an investment exchange or market infrastructure would typically involve a process under which:

(a). the EU assesses whether the law of the third country governing the investment exchange or market infrastructure provides equivalent protections to that under the corresponding EU law (and in some cases also seeks to assess whether the third country offers some form of reciprocity of access to its own market);

(b). the third country entity is assessed as being authorised and subject to effective supervision and enforcement by its home state regulator; and

(c). there needs to be a cooperation agreement in place between the relevant EU regulator(s) and the home state regulator.

The requirements of the EU's third country regimes in relation to investment exchanges and financial markets infrastructure were considered in detail in the Phase 1 Report (see, in particular, sections 3 and 4.19 to 4.22 of the Phase 1 Report).

The Phase 1 Report also noted some of the inherent disadvantages for non-EU firms in relying on TCRs for access to the EU market.

5.4. Systemic importance

Investment exchanges and financial market infrastructure have a systemic importance to the markets that they operate or support. In the event that the current users of those systems were to suddenly become unable to use them, it would have a material impact on those users, and the wider population of the users' clients who benefit from the services they provide. Simply ceasing cross-border access to such systems would be disruptive to the wider financial system. This could have potentially sudden and negative impacts on the financial stability of a range of institutions on both sides of the EU/UK border.

5.5. Difficulties in replicating existing systems

It is difficult to see that the activities performed by one investment exchange or financial market infrastructure could easily and rapidly be replicated by another body in another jurisdiction: these are complex systems, with multiple participants, operating with sophisticated rulebooks and other documentation that have been subject to extensive legal and regulatory due diligence. In some instances, UK investment exchanges and financial market infrastructure provide a service where there is currently no equivalent in other EU Member States, and it would take a considerable amount of time to create a replacement body within the EU.

Other types of UK financial institution may be able to address the absence of a cross-border regime allowing them access to counterparties or customers in the EU by establishing a locally-regulated branch or subsidiary in the EU. However, such an arrangement is not feasible for investment exchanges or market infrastructure. Such entities are multi-lateral systems that, by their nature, operate as single-location platforms for use by their various participants. For example:

(a). an investment exchange is a market place for potential counterparties to come

together to trade with each other, with their trades arranged via the systems of the exchange. The establishment of a separate exchange location within the EU would effectively amount to the creation of a separate exchange, which would result in a reduction in the overall liquidity of the (now fragmented) market; and

(b). a CCP is a system that interposes itself between counterparties to trades, so that it becomes the buyer to every seller and the seller to every buyer, and takes collateral from all of these counterparties. This enables the CCP to manage the risk of default of one counterparty, whilst enabling the trades of the remaining counterparties to continue to settle. CCPs are an increasingly important mechanism for managing systemic risk. They also have the benefit that, as the "central counterparty" to a large number of trades and counterparties, they can facilitate netting of positions, which results in significant cost-savings for their users – both in terms of the amount of collateral that needs to be held with the CCP and in terms of settlement costs. A CCP's primary benefit derives from the fact that it is a single legal entity that sits at the centre of a web of transactions. A decision not to recognise a third-country CCP on systemic risk grounds must be approached with caution. It would result in a fragmentation of liquidity, but derivatives are global markets and fragmentation benefits nobody. Transferring positions between CCPs in different legal jurisdictions would be complex and expensive for the end-users of the markets.

5.6. Indirect consequences

There would also be indirect consequences of UK investment exchanges and market infrastructure ceasing to retain their current status under EU law. These consequences would be "indirect" in that they would affect other firms that currently access these systems, rather than the systems themselves.

For example:

(a). Under MiFID II, EU investment firms and financial counterparties will be restricted in their ability to trade in derivative contracts that are subject to the EU's trading obligation on third country markets unless the Commission has determined the third country market to be equivalent.

- o If the UK was not determined to be equivalent, this could lead to the loss of derivatives trading by EU financial services providers on UK trading venues.
- o If EU firms cease to be able to access certain UK trading venues may result in those EU firms being unable to continue to trade in the types of financial instruments that they currently trade, as it is often the case that certain instruments are only traded on those UK trading platforms.

(b). Under EMIR, CCPs are only able to offer their clearing services to EU clearing members and trading platforms if they are either incorporated and authorised in the EU under EMIR, or (if they are located in a third country) recognised under the third country equivalence regime by ESMA.

- o If EU clearing members cease to be able to continue to have access to UK CCPs this could result in those clearing members or their clients being unable to clear trades in the financial instruments that are cleared by those UK CCPs, at least until an EU CCP develops the capability to clear those instruments.

- o If a UK CCP is no longer authorised or recognised under EMIR, the CCP may also need to require EU clearing members to resign their membership and to access the CCP via a non-EU clearing member, due to the fact that, under EMIR, as a third country CCP, it would not be able to have clearing members established in the EU.

(c). Under the Capital Requirements Regulation, EU credit institutions and investment firms must, when calculating their capital requirements, apply a risk weighting to their assets, so that a riskier asset requires more capital to be held against it than a less risky one. Exposures that the EU firm has to an EU-authorised CCP are given a lower risk weighting than an exposure that the EU firm has to a third country CCP, unless the third country has been assessed as equivalent and the CCP recognised by ESMA.

- o If the UK is not determined to be equivalent, this will mean that EU firms will need to hold significantly more regulatory capital if they continue to use UK CCPs to clear their trades.
- o There would also be significant implications for the regulatory treatment, including capital requirements, of trades that have already been accepted into the UK CCP's system from such EU clearing members.

(d). Under EMIR, in order to provide trade repository services to financial counterparties that are required by EMIR to report their derivative trades, a trade repository must be either incorporated and authorised in the EU under EMIR, or (if they are located in a third country) recognised under the third country equivalence regime by ESMA.

- o If EU firms cease to be able to use UK trade repositories for the purposes of fulfilling their obligations to report derivative transactions under EMIR this may mean that they are left with no means of discharging those obligations. Of the seven trade repositories in the EU, five are located in the UK.

Without some form of arrangement to enable EU firms to continue to use UK investment exchanges and market infrastructure, there is potential for significant disruption to EU firms and their customers, which could also lead to wider disruptive effects within the wider financial system. These issues would also potentially be of concern with respect to access by UK firms to EU investment exchanges and market infrastructure if the UK simply adopts EU laws (such as MiFID II, EMIR and the Capital Requirements Regulation) in their current form, including the restrictions that apply to the use of third country systems.

5.7. CCPs are a particular concern

Concerns regarding the cross-border access regime are particularly acute in the context of UK CCPs and the EU clearing members that use UK CCPs. EMIR already has a third country regime for CCPs, which has been used extensively to enable 28 third country CCPs to obtain recognised status under EMIR (as described under sections 5.3.2 and 5.6.2(b)).

The third country regime requires an equivalence assessment of the third country, plus approval by ESMA of an application for recognition by each CCP seeking access. There is no mechanism through which ESMA can forbear from undertaking such an analysis, so it is important to find an alternative approach.

Under the current EMIR framework, the equivalence assessment would need to be

undertaken in relation to the UK after the UK becomes a "third country", and the UK CCPs would not be recognised until both the equivalence assessment of the UK and their own recognition applications are completed. This would result in a significant period when UK CCPs would not be available to EU clearing members and any trading platforms supported by such UK CCPs.

As described above, under EMIR, a third country CCP is not permitted to provide clearing services to clearing members or trading venues established in the EU, unless the CCP is recognised by ESMA. If the CCP is not recognised, EU-established clearing members would need to resign their clearing membership and establish arrangements to access the CCP via non-EU based clearing members. Furthermore, as described in section 5.6.2(c), EU banks with exposures to third country CCPs that are not recognised under EMIR will be subject to higher capital requirements under the Capital Requirements Regulation in respect of their exposures to those CCPs.

5.8. The importance of continuing access

The continuation of cross-border access of EU firms to UK investment exchanges and financial market infrastructure would be in the interests of both the UK's investment exchanges and financial market infrastructure and the EU firms and their clients that currently use them.

If rights of cross-border access were lost:

(a). EU firms would lose access to UK CCPs and the international pool of liquidity that trades there. This would potential have an adverse impact on the ability of end-users to manage risk effectively.

(b). Likewise UK firms would potentially lose access to EU CCPs. Those firms may need to trade and clear certain assets in specific locations and not having such access could impact their ability to trade and manage risk.

(c). UK CCPs would no longer be considered Qualified CCPs (QCCPs) for the purposes of Capital Requirements Regulation (CRR). As a result, EU27 credit institutions and investment firms would be required to apply a significantly higher capital treatment to their exposures to UK CCPs.

(d). For products subject to the clearing mandate, there may only be one EU27 CCP available, which leaves no contingency in the case that a such a CCP is under stress.

5.9. Automatic recognition

It would be desirable for the EU/UK Agreement to facilitate continuation of access in the manner described in section 5.8.1. One way to do that would be for the EU/UK Agreement to include a provision that automatically gives recognition to UK CCPs, CSDs, trading venues and trade repositories that are already authorised in the EU (like a grandfathering clause). This would sit alongside the provision that confirms that the UK regulatory regime is considered to be fully aligned with that of the EU. The first step in the recognition process under the EU regime is usually that of equivalence, and an acknowledgement of alignment would be consistent with that.

The EU/UK Agreement should be symmetrical and mutually beneficial, so the same

arrangements that would apply to UK trading platforms and financial market infrastructure providers should also be provided to EU trading platforms and financial market infrastructure providers seeking to do business in the UK.

This proposal would work on the basis of the third country recognition regimes, as currently stated in EMIR (for CCPs and trade repositories), MiFID II (for investment exchanges) and CSDs (under CSDR). In the event that this arrangement is agreed, the EU would need to take steps to ensure that such an arrangement is treated as effective under MiFID II, EMIR and the Capital Requirements Regulation (so that such automatically recognised CCPs are treated as "qualifying CCPs" for the purpose of EU banks' capital calculations).

However, there is a potential complication in the context of CCPs, which arises due to the recent EU proposals to modify the EMIR recognition regime for third country CCPs.

5.10. The EU's proposals for changes to the recognition regime for third country CCPs

On 13 June 2017, the Commission published proposals for the reform of the third country regime for CCPs under EMIR. The Commission's stated rationale for the changes is as follows:

(a). the Commission notes that due to the systemic importance of CCPs, the increased volume of CCP activity in the EU and globally since EMIR was adopted has led to concerns;

(b). the failure of a CCP is a low probability, but extremely high-impact, event. Following international commitments to push more transactions through CCPs, CCPs have increasingly become a source of macroprudential risk, whose failure could have systemic effects;

(c). a significant volume of euro-denominated financial instruments are cleared by third country CCPs, and this represents a growing concentration of risk for the EU. ESMA recognises 28 third country CCPs, and this number is growing; and

(d). the EU intends to improve existing supervision of CCPs, especially third country CCPs.

The Commission proposes that third country CCPs should be treated differently depending on the systemic risk which they represent. ESMA will assess this, based on "objective and transparent" criteria, which will be detailed in a Commission delegated act. The criteria will include the scope and type of transactions cleared by the CCP as well as the volume of their clearing activity.

The Commission proposes the following distinction:

(a). "Non-systemically important" third country CCPs (Tier 1): These are lower risk CCPs; the Commission provides the example of a relatively small third country CCP that clears only a limited number of contracts that are denominated in local currency. Tier 1 CCPs will continue to be subject to the current equivalence regime which allows ESMA to recognise third country CCPs. ESMA will have new responsibilities for supervising recognised Tier 1 CCPs.

(a). "Systemically important" CCPs, or CCPs which are likely to become systemically important to the financial and economic stability of the EU (Tier 2): ESMA will look at:

- o the nature, size and complexity of the CCP's business;
- o the effect of its failure on the financial system;
- o the CCP's clearing membership structure; and
- o its interactions with other financial market infrastructure.

Tier 2 CCPs will be subject to additional conditions before they can be recognised by ESMA. These additional conditions include:

(a). compliance with the same EMIR prudential requirements that apply to EU CCPs;

(b). compliance with any conditions imposed by EU central banks; and

(c). consent to allow ESMA to access any information held by the CCP as well as its premises.

The Commission is planning to introduce a system of comparable compliance for Tier 2 CCPs, under which ESMA may disapply some or all of the EMIR requirements if the third country has comparable regulation and supervision to that of the EU. This reflects a similar system applied by the US authorities.

Beyond the Tier 2 CCPs, some CCPs may be of "specifically substantial systemic significance" for the EU financial system. ESMA and the EU central banks may agree that these CCPs are of such significance that even full compliance with EMIR is not sufficient to mitigate the risks, and that these CCPs cannot be recognised by ESMA. Instead, the Commission may decide that, if the CCP wishes to provide clearing services within the EU, it should be authorised and established in one of the EU member states. As explained in section 5.5.2(b), a CCP is an indivisible entity, so the implications of this location requirement would be that a CCP would either need to transfer its functions in their entirety to a new EU-incorporated entity, or it would need to establish a separate CCP entity to service EU-related business.

These proposals give rise to a number of concerns, including the following:

(a). the "objective and transparent" criteria to be applied in determining whether a CCP is "systemically important" (and therefore falling within the Tier 2 requirements) have not yet been published, and it may be some time before we see any drafts of the delegated acts containing these requirements. This means that UK CCPs are uncertain as to which category they may fall within following the introduction of the regime. This is not an insignificant concern for those CCPs whose scale of activities is such that they could potentially be of "specifically substantial systemic significance" to the EU, and therefore at risk of the application of the location requirement;

(b). Tier 2 CCPs would need to comply with conditions imposed by relevant EU central banks. These could include, for example, additional requirements to address risks for liquidity and could concern "the availability and specific type of collateral held within a CCP, the level of any 'haircuts' applied to collateral, investment policy or collateral segregation". It is therefore envisaged that EU central banks may have authority to dictate the manner in which a third country CCP sets its collateral requirements. This could create tension for the CCP between the need to comply with the requirements of the EU central bank (which could, for example, be driven by a desire to limit the impact that the CCP's collateral calls could place on the liquidity of instruments denominated in that central bank's currency) and the requirements of the CCP's domestic regulator (which would be concerned to

ensure that the CCP is at all times fully collateralised against the risks to which it is exposed). Any co-operative approach agreed between the Bank of England and relevant EU central banks, therefore, must confirm that in the interest of financial stability CCPs are expected to act in accordance with their risk policies and prudential requirements, provided these are consistent with International standards;

(c). unlike the US "consent to jurisdiction" regime (see below) for exempt Derivatives Clearing Organisations, the proposed EU regime for Tier 2 third country CCPs would appear to grant the EU authorities oversight over the whole of the CCP's operations, and not just to those activities that relate only to EU clearing members or EU-denominated instruments;

(d). the proposed power of the EU authorities to determine that a CCP is of "specifically substantial systemic significance" for the EU financial system, such that the CCP must be located in the EU is broad and does not appear to be subject to any particular constraints; and

(e). if the EU decided not to recognise a third-country CCP on systemic risk grounds, this would not necessarily result in that CCP relocating to the EU. For example, while the business cleared for EU participants by a third-country CCP might be considered of systemic importance to the EU, it is not necessarily the case that such activity would be material for the overall business of the CCP. It is implausible to suggest that a third-country CCP would necessarily relocate its entire business to the EU in order to continue clearing for EU participants; it could plausibly choose instead to cease offering clearing services to EU participants. The consequence of declining to recognise it, therefore, would be to deny EU banks access to the full range of derivatives offered for clearing in the market. However, non-bank end-users could continue to access these derivatives by clearing through non-EU banks.

Consequently, a potential disadvantage to the automatic recognition approach would be that UK CCPs would still be subject to the EU's proposed modifications to the EMIR third country regime, which (as noted above) would expose UK CCPs to potentially unhelpful requirements imposed by EU central banks and, importantly, the risk of the imposition of a requirement for some CCPs to be located in the EU.

5.11. Alternative Access Model for CCPs

Taking into account the approach that the EU plans to take to third country CCPs (as described in section 5.10), consideration should be given to the basis on which UK CCPs should continue to be able to offer their services to EU clearing members, and whether alternative access models might be included in the EU/UK Agreement.

The following models might be considered:

(a). "Consent to jurisdiction"

As an alternative to reliance upon the EMIR third country regime, the EU could develop a "consent to jurisdiction" regime for UK CCPs (as described in section 2.6.2(d)). Such a regime would grant the EU authorities supervisory rights over only those aspects of the UK CCP's activities as are directly relevant to the EU, and not over the whole of the UK CCP's activities.

However, given that a "consent to jurisdiction" regime has many similarities to the EU's proposals for modifying the EMIR third country regime, it is difficult to see how a compelling argument could successfully be made for adopting a similar, but different, regime specifically for UK CCPs under an EU/UK Agreement.

(b). Mutual access based on alignment

The application of a mutual access regime based on alignment (as described in section 3) could be a preferable approach to reliance on the EMIR TCR (as modified pursuant to the EU's proposals described in section 5.10). This would not involve the application of a third country regime, or a form of passporting. Instead, the mutual access regime for CCPs would:

(i). acknowledge that the EU and UK are both working to achieve the same financial stability objectives under the same international regulatory standards (e.g. the CPMI-IOSCO Principles for Financial Market Infrastructures);

(ii). acknowledge that the UK and EU regimes for CCPs are, as at the date of Brexit, essentially identical (on the basis that the UK has adopted the EMIR standards, with which all UK CCPs are currently compliant);

(iii). facilitate access both by UK CCPs to the EU, and by EU CCPs to the UK;

(iv). implement a process for maintaining alignment between the UK and EU in the context of CCP regulation;

(v). facilitate regulatory co-operation in the context of CCP regulation, including sharing information and considering the materiality of potential regulatory divergence;

(vi). facilitate clear demarcation of responsibilities for the supervision of CCPs impacting each jurisdiction on a cross-border basis;

(vii). include a dispute resolution mechanism; and

(viii). include a mechanism for withdrawing cross-border access for CCPs in specified circumstances, such as where the respective CCP regimes of the jurisdictions cease to be aligned.

The application of such an arrangement for CCPs would have the advantage over the automatic access regime that it is mutual in nature, and is not susceptible to sudden changes in the terms of access to the EU that would be the case if UK CCPs were to be reliant on the EU's proposed modified EMIR regime for third country CCPs.

As with the automatic recognition regime, in the event that a mutual access regime based on alignment is agreed, the EU would need to take steps to ensure that such an arrangement is treated as effective under EMIR and the Capital Requirements Regulation.

SECTION 6

REGULATORY CO-OPERATION THROUGH THE FORUM FOR REGULATORY ALIGNMENT

SECTION SUMMARY

- The EU and UK should establish a joint committee (the "Forum for Regulatory Alignment") for the purpose of ensuring a strong working relationship, promoting regulatory alignment and addressing questions of divergence.
- The remit of the Forum for Regulatory Alignment should include:
    - proactively encouraging continuing alignment through information sharing and co-operation and through participating in the development of new laws and regulations;
    - assessing divergence, and in particular whether any divergence is material and adverse to mutual access. It would be able to comment on the extent to which a new law was outside the criteria for access, and to suggest possible actions to be taken in response – but it would not be able to require a party to make changes to its law. If the Forum for Regulatory Alignment was unable to resolve an issue of divergence, the matter could be taken to formal dispute resolution;
    - acting as a forum for co-operation with regard to supervision and enforcement at a macro level;
    - considering other matters under the EU/UK Agreement; and
    - re-assessing alignment where access rights have been withdrawn but where the regimes may have become re-aligned.
- The structure of the Forum for Regulatory Alignment would need to be determined, but it is likely to include separate sub-committees specialising in different areas. It may be appropriate for the Forum for Regulatory Alignment to appoint experts to assist it.
- The processes of the Forum for Regulatory Alignment should be transparent and any assessment of divergence should be based on a technical assessment of adversity and materiality. They should also include appropriate timescales, designed to encourage agreement.
- The Forum for Regulatory Alignment should be appropriately resourced by the parties with representatives with suitable expertise in financial services and potentially from regulators.
- There is likely also to 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.

6.1. Background

In order to support and give effect to the proposals outlined in the sections above, the EU and UK should establish a joint committee for the purpose of promoting regulatory alignment and addressing questions of divergence. In this section, we refer to this committee as the "Forum for Regulatory Alignment".

6.2. Precedents for regulatory forums

There are precedents for similar arrangements under FTAs and draft FTAs. For example:

(a). The CETA establishes a Financial Services Committee, which will:

(i). supervise the implementation of the financial services chapter of the CETA;

(ii). carry out a dialogue on the regulation of the financial services sector with a view to improving mutual knowledge of the parties' respective regulatory systems and to co-operate in the development of international standards; and

(iii). determine whether the prudential carve-out is a valid defence to investor-state disputes.

(b). In the TTIP negotiations between the EU and the US, the EU put forward a proposal for a transparent, accountable and rule-based process which would commit the two parties to work together towards strengthening financial stability. It was proposed that such regulatory co-operation would be based on a number of principles:

(i). joint work to ensure timely and consistent implementation of internationally-agreed standards for regulation and supervision;

(ii). mutual consultations in advance of any new financial measures that may significantly affect the provision of financial services between the EU and the US and to avoid introducing rules unduly affecting the jurisdiction of the other party;

(iii). joint examination of the existing rules to examine whether they create unnecessary barriers to trade; and

(iv). a commitment to assessing whether the other jurisdiction's rules are equivalent in outcomes.

The EU proposed that these general principles would be backed up by specific arrangements for the governance of the EU-US regulatory co-operation, guidelines on equivalence assessments and commitments to exchange necessary

and appropriate data between regulators. The core element of the EU proposal was a commitment to outcome-based assessments of whether the other party's regulatory and supervisory framework is equivalent, which could potentially lead to mutual reliance on the rules of the other party. The EU did not envisage each party making binding declarations of the equivalence of the other's entire regulatory and supervisory framework, but rather carrying out a detailed assessment of the consistency of the implementation of each standard.

Following a process such as that proposed in TTIP might be worth considering, on the basis that it could potentially be consistent with the approach that might be agreed with the USA if the TTIP negotiations are revived.

Even outside the formal constructs of an FTA, there are examples of regulatory co-operation forums. The EU and the US already have a framework known as the Joint EU-US Financial Regulatory Forum, through which they engage in detailed discussions on rules for derivatives, insurance and a number of other areas including bank resolution and audit.

6.3. The Financial Services Forum under the EU/UK Agreement

The Financial Services Forum should have the following characteristics:

(a). Remit

The Forum for Regulatory Alignment under the EU/UK Agreement should have the following functions:

(i). Proactively encouraging continuing alignment

The Financial Services Forum would proactively encourage continuing alignment through:

- information sharing and co-operation; and
- participating in the development of new laws and regulations.

The Forum for Regulatory Alignment should be the vehicle through which the EU and UK formally co-operate and make representations to one another regarding the development of new laws.

(ii). Co-operation with regard to supervision and enforcement

The Forum for Regulatory Alignment would not assist with the supervision of individual firms (in relation to which, see section 7) but it would be able to monitor at a macro-prudential level whether the parties are taking consistent approaches to supervision and enforcement and act as a forum in which such approaches can be developed and enhanced.

In performing this role, the Forum for Regulatory Alignment would be providing some of the support functions performed by (1) the ESAs for the relationships between EU Member States and (2) the EFTA Surveillance Authority in relation to and between the EEA-EFTA States and the EU. The mechanisms in place between the EU and Switzerland are also examples of arrangements of this nature.

(iii). Assessing divergence

The Forum for Regulatory Alignment would be the first port of call for considering questions of divergence. Its role would be to assess whether, by reference to the criteria and outcomes specified in the EU/UK Agreement, the divergence is material and adverse to mutual access. In that regard, it would be critical that the scope of the assessment is properly defined.

The Forum for Regulatory Alignment would make an assessment of the materiality of any divergence, including the impact on the EU single market and on the UK and, having regard to the outcomes identified in section 3.2(b), consider whether divergence has occurred and whether mutual access should be affected.

If, following the assessment by the Forum for Regulatory Alignment, the parties agreed (without the need for formal dispute resolution) that the regulatory changes have resulted in material divergence, the consequences set out in section 3.6 would apply.

If the parties could not agree on the question of whether the regulatory changes have resulted in material divergence, the Forum for Regulatory Alignment could instruct an independent body to make an assessment of the matter and report to the Forum for Regulatory Alignment. This would be similar to appointing an independent expert to make an assessment, in the manner seen with arrangements such as the Regulatory Consistency Assessment Programme of the Basel Committee (which monitors the adoption by states of the Basel requirements and analyses the quality of intended regulatory outcomes).

The Forum for Regulatory Alignment would not be empowered to require amendments to the financial services regulation of either the EU or the UK but it would be able to comment on the extent to which a new law had resulted in material divergence, and to suggest possible actions to be taken in response – i.e. what level of further change would be necessary to bring the parties back into alignment.

If the deliberations of the Forum for Regulatory Alignment did not resolve the issue, the matter could be taken to formal dispute resolution (in relation to which, see section 8).

In addition to considering questions of divergence, the Forum for Regulatory Alignment could also consider other issues relating to the EU/UK Agreement – such as whether measures taken by one party in relation to the PCO are disproportionate (and therefore in breach of the EU/UK Agreement) or whether any prior procedural steps under the PCO (see section 2.4.2(c)) have been taken (or are justified).

Where divergence has occurred or been alleged, the Forum for Regulatory Alignment should also have a role in determining the validity and proportionality of any measures that the other party takes in response to that situation – see section 3.6.

If the Forum for Regulatory Alignment cannot resolve a matter to the satisfaction of both parties, the matter could be referred to dispute resolution.

(iv). Re-assessing alignment

As considered in section 3.7, if access rights are withdrawn because the regimes have ceased to be sufficiently aligned, the parties should be open to the possibility that the regimes might become re-aligned and that access rights could be restored promptly.

The Forum for Regulatory Alignment could have a standing brief to consider whether such a situation has arisen and should be able to reconsider (at the request of either party) whether the regimes are aligned or not.

(b). Structure

The exact structure of the Forum for Regulatory Alignment would need to be considered carefully, but in view of the complexity of the financial services sector the IRSG working group expects that it would be appropriate for the Forum for Regulatory Alignment to include sub-committees which specialise in each sub-sector covered by the EU/UK Agreement – such as banking, insurance, asset management and market infrastructure.

It may also be appropriate to have forums or committees above it – perhaps in a similar way to the EEA Joint Committee – but this is likely to depend on the overall relationship established across the multiple sectors that the EU/UK Agreement is likely to cover.

(c). Processes

The processes of the Forum for Regulatory Alignment should be transparent and any assessment of divergence should be based on a technical assessment of adversity and materiality.

It may be appropriate for the Forum for Regulatory Alignment to appoint experts to make determinations on matters of divergence. Experts could come from members of the Forum for Regulatory Alignment and the related working groups of regulators and supervisors. The EU and UK could each invite experts from third countries to participate, where appropriate.

In making its assessments, the Forum for Regulatory Alignment should be obliged to consult with market participants from the UK, EU and other countries outside the EU (where appropriate) and with global standard setters such as the FSB and IOSCO. This is particularly important, as private firms may have technical data and market evidence to help judge the impact of the amendments. Market participants might also suggest technical solutions that achieve the legislative objective of the amendment without undermining compliance with the EU and UK regulatory outcomes. Importantly, they should be asked to provide evidence of the consequences for businesses and individuals in the EU and UK were mutual access to be withdrawn in that particular sector, and (if access is to be withdrawn) to recommend the length of time required by firms to adjust before mutual access is withdrawn.

(d). Appropriate and defined timescales

As noted in section 3.8, the processes connected with mutual access should be appropriate and clearly defined and, in particular, should not lead to any outcomes that could have serious consequences for the ability of firms to serve their customers in the territory of the other party without following an appropriate process.

The EU/UK Agreement should prescribe timescales for each of the processes that will apply to the Forum for Regulatory Alignment.

(e). Resourcing

It will be important to ensure that the Forum for Regulatory Alignment is properly resourced, in terms of both budget and expertise. The EU/UK Agreement should contain commitments on the part of both parties to ensure that the Forum for Regulatory Alignment is appropriately resourced.

6.4. Wider context

As noted elsewhere in this Report, the EU/UK Agreement will apply to other sectors as well as financial services.

The development of the Forum for Regulatory Alignment will need to take into account wider considerations under the EU/UK Agreement. In particular, if there are other sectors where mutual access depends on there being ongoing alignment of regulation between the EU and UK, those sectors may need to have principles and processes similar to those suggested above for the Forum for Regulatory Alignment. This could mean that considerations arising from those other sectors could come into play in relation to financial services matters.

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 a multi-sector forum 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.

SECTION 7
SUPERVISION OF FIRMS

SECTION SUMMARY

- An agreement for mutual access is likely to require a legal framework that promotes sound, efficient and consistent supervision of the firms who seek to make use of access rights. Both parties to the EU/UK Agreement will need to be satisfied that the other party operates a similar approach in relation to supervision (including enforcement), both a macro-prudential level and at the level of individual firms.
- Such a framework would have to have a clear allocation of supervisory responsibility and also structures for supervisory co-ordination in relation to individual firms.
- Within the EU, the Single Market Directives provide a framework for supervisory co-ordination, but there are concerns within the EU itself that the co-ordination of supervision could be improved.
- There is no existing model which in itself adequately addresses all of the potential needs of the EU/UK Agreement, but there are aspects of existing models which can be used or adapted.
- It is 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 – for example, the Forum for Regulatory Alignment. In relation to this:
    - There should be a formal framework to co-operate and to co-ordinate on supervisory matters at a macro-prudential level 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 may not directly regulate that firm itself).
    - There should be active co-operation in relation to the development of common standards and approaches in relation to supervision. This could build upon work that is being done at a global level, including most notably by IOSCO.
    - For the supervision of individual firms, the EU and UK could consider an arrangement based on the current approach involving colleges of supervisors with adaptations to reflect the fact that the EU Member States and the UK would no longer be operating under the common framework of the EU.
    - The supervisory framework should be proportionate to the level of access granted to firms. If a firm from one party has only limited access to the market of the party, the regulator in that market should have less involvement with the supervision of that firm.

7.1 Background

An agreement for mutual access is likely to require a legal framework that promotes sound, efficient and consistent supervision of firms who seek to make use of those access rights. Both parties to the EU/UK Agreement will need to be satisfied that the other party operates a similar approach in relation to supervision (including enforcement), both at macro-prudential level and at the level of individual firms.

Such a framework would have to have a clear allocation of supervisory responsibility and also structures for supervisory co-ordination.

For example, if a French bank operates a branch in the UK after Brexit, will it be the British or French regulators who would be responsible for the supervision of the branch? Or would they each be responsible for supervising different aspects of the branch's business (such as conduct of business on the one hand and organisational matters on the other)? If either or both consider that action is required, how will that be communicated and co-ordinated?

7.2 What is the current position within the EU?

The Single Market Directives contain provisions regarding the allocation of responsibility for supervising regulated entities which operate on a cross-border basis.

Broadly speaking, responsibility for the prudential regulation of an entity – i.e. the regulation of that firm's capital requirements and its internal governance and systems and controls – lies with its home state supervisor, even where it is providing those services to clients in another Member State. That principle applies regardless of whether the passporting firm is relying on freedom of establishment or the freedom to provide services (see section 2.2).

In relation to prudential regulation, the introduction of the Single Supervisory Mechanism ("**SSM**") in 2014 has considerably changed the approach to the supervision of banks within the euro area. The European Central Bank now has a directly supervisory role over "significant" banks (as defined in the SSM Regulations) and co-ordinates and co-operates with national supervisors as regards the supervision of less significant banks.[7] However, this only applies within the euro area.

As regards supervision of a firm's compliance with conduct of business rules, however, the position differs depending on how the services are provided. Where a firm establishes a branch in another Member State, regulation of conduct of business is usually a matter for the host state regulator. If services are provided on a cross-border basis but without the firm establishing a branch, the home state supervisor is often responsible for supervising a firm's compliance with conduct of business rules as well – depending on which Single Market Directive applies. Under MiFID, for example, a firm

passporting on a "freedom of services" basis is required to comply with the conduct of business rules in its home state.

Notwithstanding that there have been increased moves in recent years towards supervisory convergence between Member States – for example, through common standards and an increased role for the ESAs – there remain concerns within the EU about supervision. In February 2017,[8] Steven Maijoor (Chairman of ESMA) expressed concerns about a number of aspects of supervision, and in particular he noted that:

(a). experience showed that the current supervisory convergence tools are still too weak – as illustrated by the difficulties that the EU had in securing an appropriate level of supervision by the Cypriot regulators of firms established in Cyprus offering contracts for differences; and

(b). ESMA itself had very limited opportunities to see the specific risks that third country firms might be creating in the EU, as it has very limited powers regarding information collection and risk assessment, and no regular supervision and enforcement tools.

ESMA also expressed concerns about reliance on third country regulators (specifically in the context of CCPs). Mr Maijoor questioned whether the EU had sufficient assurance that risks of the third country firms' activities in the EU are adequately assessed and addressed by the home state regulator in that third country. While there might be excellent co-operation with third country regulators, the EU had no assurance that a third country regulator has the right incentives to appropriately assess and address the risks associated with the activities of its supervised entities outside its jurisdiction.

7.3 What would the supervisory concerns be under the EU/UK Agreement?

It is likely that the concerns of the EU and the UK regarding supervision under the EU/UK Agreement will involve the following issues:

(a). the potential for overlap between the responsibilities of the regulators and conflicts over supervision;

(b). the need for a formal framework to co-operate, co-ordinate and apply common standards to supervision;

(c). the lack of mechanism to resolve disputes between the respective regulators (unlike within the context of EU, where the CJEU would ultimately be able to resolve any such questions in accordance with EU law);

(d). having insufficient control over a firm from either party's territory that established a branch in the other party's territory;

(e). a practical concern (as noted by Mr Maijoor in his speech – see section 7.2.5) that the respective regulators may not be incentivised in the same way in relation to matters of supervision – e.g. that one may favour a lighter touch approach; and/or

(f). consumer protection.

Any proposal for the EU/UK Agreement needs to take account of these concerns. The current passporting arrangements do incorporate certain checks and balances, and the parties should therefore consider whether these can be replicated in the EU/UK Agreement.

Given that the development of a common supervisory culture within the EU is still a work in progress, the EU might also have concerns about a mutual access regime based solely on regulatory alignment, where it would have even fewer means in place to secure supervisory convergence than it does within the EU context. The EU/UK Agreement will have to enshrine a strong degree of supervisory co-operation and co-ordination to allay such concerns.

The current lack of supervisory convergence within the EU could also create a problem for the UK after Brexit, in that it may not be clear that there is a single set of EU supervisory standards with which the UK should be seeking to remain aligned.

Given that ongoing rights of access are to be based on regulatory alignment, that should provide a strong foundation for the EU and UK to develop mechanisms which supplement that alignment in relation to matters of supervision.

The position in relation to supervision may differ depending on the nature of the business concerned. Less intensive supervision may be appropriate in the context of certain types of wholesale business, but allowing access in relation to retail business is likely to be accompanied by a more granular approach to supervision. In relation to retail customers, the provision of financial services by third country firms directly to EU retail customers on a cross-border basis is often precluded but the provision of retail products through intermediaries is not – although it does still require participation in common protection mechanisms. Determining and defining the boundary between retail and non-retail and between product and services can be difficult.

7.4 Models for supervision

The following models may provide some useful guidance for the EU and the UK in reaching agreement on supervisory arrangements to be used in connection with the EU/UK Agreement.

(a). Colleges of supervisors

Colleges of supervisors are permanent co-ordination structures that bring together regulators concerned with the supervision of a specific banking or insurance group. The focus of colleges of supervisors is therefore at the micro-prudential level rather than the macro-prudential remit of the ESAs or a proposed Forum for Regulatory Alignment.

In practice, colleges are a mechanism for:

(i). the exchange of information between home and host regulators;

(ii). the planning and performance of key supervisory tasks in a co-ordinated manner or jointly, including all aspects of ongoing supervision; and

(iii). the preparation for, and the handling of, emergency situations.

One of the fundamental tasks for regulators as members of colleges is reaching joint decisions on certain aspects of their remit – such as the risk-based capital adequacy of cross-border groups and their EEA subsidiaries.

Colleges put in place their own written co-ordination and co-operation agreements, which prescribe in more detail how the members of the college interact with each other.

EU law envisages the establishment of colleges of supervisors for EEA banks or insurance firms with subsidiaries or significant branches in other EEA countries. They may include supervisors in non-EEA countries, where relevant.

Colleges are convened for individual banking groups which operate in a number of jurisdictions, with the profile of the college dependent upon which jurisdictions the group undertakes activities in. For banking groups that undertake business only within the euro area under the SSM, there is no college (as the ECB represents all the regulators from within the SSM area). Where banking groups operate both within the SSM area and outside it, a college can be used, and in that situation the SSM regulators would be represented by the ECB in that college.

The structure of colleges reflects the areas of operation of the supervised entity and the number of jurisdictions it operates in. The frequency and intensity of college activities can also differ significantly depending on the size and complexity of the institutions.

The college of supervisors model is helpful in that it establishes a precedent for co-operation on the monitoring and supervision of cross-border groups by regulators from both inside and outside the EU as well as the sharing of information and consensus models for decision-making. However, it is apparent (for example, from the EBA Report on the functioning of supervisory colleges in 2016)[9] that there are still numerous respects in which the functioning of colleges can be improved.

Colleges of supervisors will continue to be required under EU laws post-Brexit. It will be important to ensure that the change of status of the UK from EU Member State to third country does not have an adverse impact on the effective operation of the colleges in which the UK currently participates. On the basis that current college arrangements can include supervisors from non-EEA countries, we assume that the UK will be able to continue to participate in colleges involving EU financial institutions.

(b). Current regulation of third country branches

In determining how the future arrangements for supervision might work, it is instructive to consider how the EU branches of third country firms are currently regulated.

Law and regulation at an EU level generally makes little provision in relation to the direct authorisation of non-EU firms, which means that it is up to individual Member States to determine in their own discretion whether they grant authorisation to non-EU firms.[10] In exercising that discretion, many Member States have introduced a requirement for a non-EU firm to obtain a local licence where it establishes a branch in a Member State. As considered in section 2.2, the proposal is that the EU/UK Agreement would allow financial institutions to have passporting-like rights in the territory of the other party **without** having to apply for a licence, so we would not expect them to have to apply for direct authorisation in the manner that third country firms currently do. Nevertheless the means through which regulators interact in relation to directly authorised branches of third country firms could provide an example of how the UK and EU regulators could interact under the EU/UK Agreement.

The UK itself currently has a well-developed regime for the direct authorisation of branches of third country firms, particularly in relation to credit institutions and

insurance companies. This regime is considered in more detail in section 7 of the Phase 1 Report. In relation to credit institutions, the PRA takes a "risk approach" to authorising branches of non-EU credit institutions. In summary, the PRA will consider the following questions:

(i). Is the home state supervisor sufficiently equivalent?

The PRA looks to see whether its threshold conditions for authorisation are met – looking in particular at the home state jurisdiction's rules, powers, consolidated supervision, information sharing, confidentiality, the competence and independence of supervision, and capital, liquidity and resolution regimes (where the PRA will assess if the regime is consistent with international standards).

(ii). Has the home state supervisor accepted responsibility for the branch?

Where the PRA has determined that the home state supervisor is sufficiently equivalent, it will rely where possible on the home state supervisor to supervise the branch. As part of this, the home state supervisor must accept responsibility for the branch and confirm that the PRA threshold requirements are met in relation to it. The PRA will also require the existence of a firm-specific agreement on the split of responsibilities for prudential supervision of the branch and an appropriate level of information sharing.

(iii). What are the arrangements for resolution?

The PRA would assess the resolution arrangements of the home state (i.e. the arrangements for the orderly resolution of the credit institution in the event that it becomes insolvent).

(iv). What activities will the branch be undertaking?

In considering the position of a third country branch, the PRA would consider whether the firm would be performing any "critical economic functions" which would have a significant impact on the UK market. The PRA has indicated that firms should not be providing retail services above a *de minimis* level and should focus on wholesale activities. In general, the greater the level of critical economic functions that the firm is undertaking, the greater assurance the PRA would require in relation to the arrangements in place for resolution of the firm.

Similarly, the PRA has issued rules relating to branches of third country insurance companies. A third-country branch entity is required to maintain adequate worldwide financial resources. Where the PRA assesses the home country regime of the insurer to be broadly equivalent to the regime applied to UK insurers, then compliance with the financial resources requirements of that prudential regime may be relied on by the third-country branch undertaking as tending to establish compliance with the PRA's worldwide financial resources rule. If the home state insolvency/resolution regime allows capital to be released to customers of the overseas branch customers, the PRA might not require capital to be held in the UK.

(c). ESMA's Supervisory Co-ordination Network

On 31 May 2017, ESMA published "General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union".[11] This paper introduced principles for EU regulators to follow when considering applications for authorisation by firms seeking to relocate from the UK into the EU following Brexit – which illustrates the absence of common supervisory approaches before that.

ESMA proposes to establish a forum, the Supervisory Co-ordination Network, whose remit will be to promote consistent decisions being taken on authorisations by Member States. This forum could conceivably have a role to play in supervisory co-ordination with the UK post-Brexit. However, ESMA's current position is that authorisation and supervision of, and potential enforcement against, supervised entities is and remains a competence of the national competent authorities.

7.5 Supervisory co-operation under the EU/UK Agreement

There is no existing model which would, by itself, address all the issues arising in the context of the EU/UK Agreement. However, aspects of the existing models can be used or adapted to create a regime for supervisory co-operation for the EU/UK Agreement.

It is likely that it will be necessary to have 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:

(a). The fact that the regulatory regimes of the EU and UK will be aligned at the date of Brexit is unlikely, of itself, to give the parties sufficient comfort that their concerns around supervision are met. For example, there are a number of supervisory functions currently performed by the ESAs, which the UK will no longer participate in.

(b). A formal framework to co-operate and to co-ordinate supervisory matters at a macro-prudential level should be considered – for example, to respond to new global initiatives or crises, or for developing common standards or agreed guidelines on interpretation of regulations which are already aligned. It may be appropriate to do this through the Forum for Regulatory Alignment or to have a sub-committee of relevant supervisors set up for this purpose, which specifically considers matters relating to supervisory co-operation. There could be co-operation in terms of developing strategy for responding to emerging technology or on enforcement policy. This active co-operation would be consistent with moves which are currently underway within the EU itself to improve supervisory co-ordination (as described in section 7.4.1(c)).

(c). How rules are applied may be as important as the rules themselves. The parties should consider building additional protections into the EU/UK Agreement to ensure rules are interpreted and applied consistently.

(d). The EU/UK Agreement should have a clear demarcation of the responsibilities of the respective regulators and the extent to which the regulator from the host state can influence the supervision of the firm (notwithstanding that it will not directly regulate that firm itself). This will be particularly important in relation to emergency situations. In the latter situation, there are precedents (for example, within the EBA)[12] for how colleges of supervisors can prepare in advance for

emergency situations, and such an approach could be built into the EU/UK relationship.

(e). From the EU's perspective, it may take comfort from the approach that the UK currently shows towards supervision of UK branches of third country firms – i.e. where it is willing to place a considerable degree of trust in the home state regulator as long as the home state regime satisfies the PRA's tests. If the EU is willing to reciprocate this approach, that may form a useful starting point for a regime regarding supervision. Tests like those currently used by the PRA could be built into the EU/UK Agreement. Other existing supervisory mechanisms, such as colleges of supervisors, could be adapted to provide support in this context.

(f). The Forum for Regulatory Alignment and the dispute resolution mechanism should be given sufficient remit and powers to address any concern regarding how disputes between the respective regulators would be resolved.

(g). The degree of sophistication of the supervisory framework should be proportionate to the level of access granted to firms under the EU/UK Agreement. If firms only have limited access to a particular territory, the regulator in that territory should expect to have less involvement with the supervision of that firm. Conversely, if extensive rights of access are granted, it may be appropriate for the regulator in that territory to have closer involvement with the supervision of the relevant firm.

(h). Similarly, the closeness of the supervisory arrangements may depend on the nature of the product and service and the target market. Closer supervisory co-operation may be appropriate where retail customers are concerned.

The increasing importance of international supervisory co-ordination has been the subject of work by various international bodies including IOSCO's Report on Principles regarding Cross-Border Supervisory Co-ordination[13] and the work of the Basel Committee on Banking Supervision, captured in its Progress report on the implementation of principles for effective supervisory colleges. The IOSCO report sets out "a set of principles designed to guide IOSCO members in developing co-operative supervisory arrangements amongst themselves, tailored to their own markets and circumstances and their own legal powers and requirements".

The EU and the UK could draw on the work by these bodies to put in place supervisory co-ordination structures which could address concerns over the change in the relationship when the UK ceases to be a member of the EU.

In relation to CCPs, the European Commission's proposal (see section 5) includes requirements under which systemically important CCPs will be required, amongst other things, to provide relevant information to ESMA and to allow on-site inspections. If the supervisory framework envisaged for the EU/UK Agreement contained agreement in relation to such matters, it may also help persuade the European Commission that the measures contained in its proposal are not necessary for UK CCPs (or for third country CCPs generally). However, it should be noted that the European Commission's proposals are not stated to be directed specifically at UK CCPs. They will apply to all third country CCPs and it is possible that the European Commission may not want to create a specific regime for UK CCPs that is different from a regime that is introducing for other third country CCPs.

SECTION 8

DISPUTE RESOLUTION

SECTION SUMMARY

- The future relationship between the EU and UK will need to be governed by a dispute resolution system covering the interpretation and enforcement of the terms of the EU/UK Agreement.
- Although there are numerous precedents for dispute resolution bodies under existing FTAs, it is likely that the EU and UK will need to develop their own arrangements.
- In relation to dispute resolution under the EU/UK Agreement:
  - Referring a matter to the dispute resolution body should be an act of last resort for either party. Before taking that step, the parties should be required to raise the matter in the Forum for Regulatory Alignment and to negotiate in good faith for an agreed solution to the dispute.
  - The dispute resolution body should be primarily judicial in nature rather than political or diplomatic.
  - The purpose of the dispute resolution body should be to reach a definitive and binding decision on a particular issue when the parties have been unable to agree a position between themselves.
  - The dispute resolution body should have a focussed remit – i.e. to make determinations regarding whether a party to the EU/UK Agreement has complied with it. It would not have jurisdiction over the laws of either party.
  - The consequences of a finding by the dispute resolution body should be considered carefully – in particular when the finding is that one party is in breach of the EU/UK Agreement. Drawing on examples in existing FTAs, consequences could include:
    - the payment of "compensation" (in the form of offsetting trade benefits or as otherwise agreed); or
    - retaliatory measures (e.g. introducing measures that affect an equivalent value of trade, or the temporary suspension of concessions given to a party).
  - In relation to the withdrawal of access rights, the preferred approach would be for the withdrawn rights to be restricted only to the areas where the material divergence has occurred – i.e. for access to be withdrawn in "tranches" and for the remainder of the access rights to remain intact.
  - The EU/UK Agreement should also include 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.

8.1. Background

Before any matter reaches the stage of needing to be dealt with under a formal dispute resolution mechanism, the parties ought to have taken steps to deal with the matter consensually (for example, through discussions in the Forum for Regulatory Alignment). Assuming that no consensus can be reached, however, the EU/UK Agreement would need to contain provisions for the resolution of such disputes.

In this section, we distinguish between two types of dispute:

(a). state to state disputes – for example, where the EU and UK disagree over whether material divergence in their respective regulatory regimes has occurred; and

(b). investor-state disputes – for example, where a financial services supplier from one party to the EU/UK Agreement wishes to make a claim directly against the other party for losses arising from that other party's breach of the agreement.

Each is considered separately below.

8.2. State to State Dispute Resolution mechanisms

In its White Paper, the UK has acknowledged that its future relationship with the EU will need to be governed by a dispute resolution system covering the interpretation and enforcement of the terms of the EU/UK Agreement. In its Guidelines, the EU has also recognised the need for this.

(a). Approaches to dispute resolution in existing agreements

Dispute resolution mechanisms, as they appear in existing international trade agreements, vary significantly in nature. At one end of the spectrum, there are agreements containing informal and diplomatic systems involving the negotiated settlement of disputes by the parties; at the other end are agreements providing for more formal resolution mechanisms, giving parties a right to take a dispute to standing or ad hoc tribunals or panels.

Matters of EU law can only be adjudicated by the CJEU. The UK has made clear that it does not wish to be bound by the CJEU and that any dispute resolution mechanism included in the EU/UK Agreement would have to "respect UK sovereignty, protect the role of our courts and maximise legal certainty". A formal system with a standing tribunal that is able to issue binding judgments would offer more certainty for a party seeking to enforce the terms of the EU/UK Agreement, without having an adverse impact on the sovereignty of the parties.

While neither party has publicly expressed a preference for a particular form of dispute settlement, the UK referred in its White Paper to a number of systems

included in existing bilateral and multi-lateral trade agreements. The White Paper clarified that these were cited merely as examples of existing practices and that the "correct approach for the agreement underpinning the future relationship between the EU and the UK will be matter for negotiation". The examples given highlight the range of possible approaches to dispute settlement. In particular:

(i). EU-Swiss bilateral agreements

The EU-Swiss bilateral agreements do not currently provide for a legal mechanism to adjudicate disputes between the parties. Under the Swiss model, each bilateral agreement provides for its own disputes system and, for the vast majority of agreements, a Joint Committee (made up of Swiss and EU officials) is tasked with resolving disputes using a purely diplomatic process. However, the EU has stated that it requires Switzerland to agree to put in place a formal dispute resolution forum and surveillance mechanism before it will agree to enter into any further bilateral agreements with it. (The European Council Conclusions regarding the EFTA States, Iceland, Liechtenstein, Norway and Switzerland of 2008, 2010, 2012, 2014, and 28 February 2017 have made clear that new market access agreements will only be reached if a surveillance and court mechanism is included). The 2010 Council's Conclusions, for example, state:

> *"In full respect of the Swiss sovereignty and choices, the Council has come to the conclusion that while the present system of bilateral agreements has worked well in the past, the key challenge for the coming years will be to go beyond that system, which has become complex and unwieldy to manage and has clearly reached its limits. As a consequence, horizontal issues related to the dynamic adaptation of agreements to the evolving acquis, the homogeneous interpretation of the agreements, an independent surveillance and judicial enforcement mechanisms and a dispute settlement mechanism need to be reflected in EU-Switzerland agreements."*

One item of particular significance here is the role of the EFTA Court. The EEA Agreement between the EU, Norway, Iceland and Liechtenstein provides for the EFTA Court to oversee and enforce its interpretation and application. The EFTA Court applies a principle of homogeneity with CJEU decisions – which means that it aligns itself with the CJEU rather than being subject to it. The EFTA Court has to follow CJEU decisions from pre-1992 but thereafter it can and does set its own thinking whilst maintaining consistency – which the CJEU then needs to be cognisant of. If neither court has considered a matter, the EFTA Court can set the parameters which the CJEU would need to distinguish if it wished to reach a different conclusion in a particular case. The EFTA Court's working language is English.

The EU indicated in 2013 to Switzerland that it would accept the EFTA Court as a dispute resolution mechanism in the context for managing their relationship with the inclusion of a Swiss judge in matters related to the EU-Swiss bilateral agreements. This option was not pursued by Switzerland at that time (and the position remains unresolved, so that the EU has not been willing to enter into any new bilateral agreements with Switzerland).[14] The fact that the EU has shown itself is willing to submit disputes to a court

other than the CJEU, however, is a helpful precedent for agreeing something similar in the context of the EU/UK Agreement.

(ii). WTO dispute resolution

The White Paper also refers to the more judicial model used by the WTO. Under the WTO agreements, disputes are resolved by the WTO's Dispute Settlement Body ("**DSB**"), which has the power to establish panels to hear disputes between WTO members. Panels are constituted to adjudicate on specific complaints brought by a member and to make an award. If a WTO member state is found in breach of its obligations by the panel, and fails to comply with an award within a reasonable period, two sanctions are available to the complainant state:

- compensation (with the losing state offering additional trade concessions); or
- retaliation (which is only available where compensation cannot be agreed).

In its description of the WTO dispute settlement system, the UK Government noted that the DSB's rulings are binding in terms of the outcome they require but the means of achieving the outcome is not prescribed. There are various options for enforcement:

- withdrawal of the contravening measure by the party in breach;
- payment of compensation by the party in breach; or
- "retaliation" – which could include suspension of concessions by the complainant.

In the Guidelines, the EU stressed the need for

> *"appropriate enforcement and dispute settlement mechanisms that do not affect the Union's autonomy, in particular its decision-making procedures".*

As the CJEU has a defined role under the EU Treaties as the final authority on the interpretation and application of EU law, it would not be possible for the EU/UK Agreement to provide for a tribunal that could make rulings requiring changes to be made to EU financial regulation. However, questions as to interpretation and application of the terms of the EU/UK Agreement itself would not be questions of EU law, to the extent that EU law is not affected by the application of the EU/UK Agreement, and therefore could be subject to the jurisdiction of a dispute resolution mechanism other than the CJEU.

One body which may be worth considering further in relation to dispute resolution is the Board of Appeal of the European Supervisory Authorities. It is a court which exists to hear appeals regarding certain decisions of ESAs. Any natural or legal person (including national competent authorities) can appeal a decision of the ESAs in certain circumstances. The Board of Appeal has a specified number of standing members and is fully independent.

As discussed in more detail below, the dispute resolution arrangements would need to provide for a tribunal to make rulings on the extent to

which both parties comply with the terms of the agreement. If the EU/UK Agreement required both parties to maintain regulatory alignment (as measured against the criteria for access), the tribunal could make a binding ruling to the effect that a regulatory change introduced by either party meant that the criteria for access were no longer met. Once such a ruling had been made, remedies would be available.

(b). Dispute resolution for the EU/UK Agreement

In relation to the means for dispute resolution under the EU/UK Agreement, the following issues will be relevant:

(i). Steps to be taken before the matter is referred to a dispute resolution body

Referring a matter to the dispute resolution body should be an act of last resort for either party. Before taking that step, the parties should be required to raise the matter in the Forum for Regulatory Alignment (as considered in section 6) and to negotiate in good faith for a resolution of the dispute.

It should also be open to the parties to agree to enter into formal mediation as an alternative to referring a dispute to the dispute resolution body.

(ii). The nature of the dispute resolution body

The dispute resolution body should be primarily judicial in nature rather than political or diplomatic. The parties will have other means available to them to facilitate discussions regarding the EU/UK Agreement.

The purpose of the dispute resolution body should be to reach a definitive and binding decision on a particular issue when the parties have been unable to agree a position between themselves.

(iii). The remit of the dispute resolution body

The dispute resolution body should have a focussed remit – i.e. to make determinations regarding whether a party to the EU/UK Agreement is in breach of it.

Insofar as the dispute arose in relation to alignment-based access, the dispute resolution body would be able to determine whether or not, benchmarked against the criteria under the EU/UK Agreement:

- as a matter of fact, one party's regulatory system has diverged from the other; and
- if so, whether the divergence is material and adverse, so that the criteria for access are no longer satisfied.

A determination of that nature would give the parties clarity on whether one of them would need to change its regulatory system in order to remain compliant with the terms of the EU/UK Agreement – and that it would otherwise potentially suffer adverse consequences (see section 8.2.1(b)(iv)).

The dispute resolution body would also be able to make binding determinations in relation to other aspects of the EU/UK Agreement –

such as, for example, whether a party that was seeking to impose measures using the prudential carve-out had satisfied the requirements to do so.

(iv). Consequences of an adverse finding

The consequences of an adverse finding by the dispute resolution body should be considered carefully.

In relation to questions of alignment, there are two likely scenarios:

- the dispute resolution body determines that a measure taken by a party has led to a divergence that is material and adverse, so that the criteria for access are no longer satisfied; or
- the dispute resolution body determines that the regulatory divergence is not material.

If the parties accept the finding of the dispute resolution body, there would be no problems. Under (2) above, the party that alleged regulatory divergence would withdraw the allegation and the other party's recognition would be maintained and it would continue to have access.

However, if the party that alleged non-compliance with the EU/UK Agreement insisted on the allegation and withdrew recognition of the other party (either in relation to a specific sub-sector or generally), the EU/UK Agreement may need to provide for the consequences of withdrawing recognition which are likely to have an impact on access. These consequences could include:

- the party that withdrew recognition paying "compensation" (in the form of offsetting trade benefits or as otherwise agreed) to the other party; or
- the party that did not withdraw recognition being entitled to retaliate by introducing measures that affect an equivalent value of trade. (Authorised retaliation is the only penalty permitted under the WTO framework.) Retaliatory measures could include the temporary suspension of concessions.

If the parties do not accept the finding of the dispute resolution body, the parties may ultimately need to consider together in what circumstances the appropriate outcome would be for the EU/UK Agreement to fall away altogether or for a party to withdraw rights of access in a particular area. The possibility of this outcome should be taken into account in developing the dispute resolution process.

(v). Withdrawal of access rights

In relation to the withdrawal of access rights, the preferred approach would be for the withdrawn rights to be restricted only to the areas relevant to the divergence – i.e. for access to be withdrawn in "tranches" and for the remainder of the access rights to remain intact.

Where access rights are to be withdrawn, firms should be given sufficient time to adapt to the consequences of withdrawal. This should include allowing firms sufficient time to take alternative action, such as relocating their business into the other party's territory or applying for authorisation

by the relevant regulators of the other party. In practice, given the length of time it would take for a firm to plan and implement such actions, this could mean that the access rights would not be withdrawn for two years or more after one or both parties declared their intention to withdraw access rights.

(vi). The composition and governance of the dispute resolution body

The dispute resolution body should be convened on an ad hoc basis, as and when a dispute needs to be resolved, but there should be standing rules about how the dispute resolution body is convened and how it should be composed.

8.3. Investor-state dispute settlement

FTAs with an investment chapter (and bilateral investment treaties) typically contain an investor-state dispute settlement ("**ISDS**") mechanism. An ISDS mechanism allows investors[15] from one contracting state to bring claims against the national governments of other contracting states for alleged breaches of substantive obligations assumed by contracting states under a treaty with respect to investments of foreign investors.

The legal position in relation to ISDS mechanisms is considered in detail in Annex 1, but the main points to note are as follows:

(a). ISDS mechanisms have recently been included in FTAs entered into by the EU. The UK Government has published a Future Partnership Paper on enforcement and dispute resolution (23rd August 2017) which acknowledges that UK individuals and businesses should have effective means to enforce their rights. Although this could be done via an ISDS-like mechanism, the Government has proposed another option. According to the Government's paper, 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 their rights under the agreement in accordance with the usual principles of UK (and EU) administrative law.

(b). The UK is already a party to a number of bilateral investment treaties with other EU Member States (mainly eastern European EU Member States). It remains to be seen whether these treaties will remain in place, but they could affect the extent to which there would be uniformity in relation to ISDS – in that these treaties contain provisions which would put the relevant signatories in a different position with respect to investments in either party's territory from that of Member States who are not parties to these treaties.

(c). In the context of citizen's rights, the EU has also said that it wants to ensure that such rights are "directly enforceable". It is possible that something similar could be agreed in the context of financial services. The EU has in recent years suggested establishing an Investment Court System ("**ICS**"), which is conceived as an institutionalised investment dispute resolution system with permanent tribunals (a first instance body and an appellate body), both comprised of permanent adjudicators (rather than arbitrators appointed for a particular case). The ICS was included in the CETA and the EU-Vietnam FTA, and was proposed by the EU to the US in the course of the TTIP negotiations. Although the ICS is a recent concept, the EU seems to favour it as its preferred system for

investor-state dispute resolution, potentially subsequently multi-lateralised to encompass more than individual FTAs.

It is also worth noting (as discussed in Annex 2) that the establishment of an ISDS is a matter of shared competence between the EU and EU Member States. If the EU/UK Agreement contained an ISDS, it would be a "mixed" agreement and would therefore only be valid if concluded jointly by the EU and its Member States in their individual capacities – which means that it would be subject to the national ratification procedures in every Member State.

ANNEX 1

THE WTO LANDSCAPE

SECTION SUMMARY

- Both the EU and the UK are subject to existing obligations in their capacity as members of the WTO and as parties to existing agreements.
- The extent to which it is possible to agree the terms of the EU/UK Agreement will depend not only on the negotiations between the EU and the UK, but also the effect of these existing obligations.
- Under the most-favoured nation principle, the best terms that have been agreed with one country must automatically be extended to all other WTO members, unless terms have been conceded within an economic integration agreement (e.g. an FTA) permitted under the WTO rules. There are two important considerations under MFN:
    - In order to avoid having to apply MFN principles, it is likely that the EU and UK will have to agree a broad FTA that covers substantially all trade (i.e. has "substantial sectoral coverage") and which will therefore not be limited to financial services.
    - Some EU FTAs also contain a bilaterally agreed provision that any future treatment given to a third party that is more favourable than that offered under that FTA must be extended to the FTA parties.
- The GATS, and commitments made by WTO members under it, do not in themselves provide for deep market access in relation to financial services (e.g. without the firm having to obtain a licence from the state into which it proposes to provide services). The 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.

A1.1 Background

The extent to which it is possible to agree terms for the EU/UK Agreement will depend not only on the negotiations between the EU and the UK, but also the existing international legal and policy frameworks within which the agreement must be negotiated and concluded.

As a matter of international law, the UK, as a nation state, has the inherent capacity to enter into international agreements and is constrained only by the need not to breach its international obligations in other international agreements, such as the rules governing the WTO.

This section provides an overview of the rules of international trade law that will govern the form and content of an international agreement between the EU and the UK, namely the rules of the WTO and any other pre-existing agreements between the EU, UK and the rest of the world that will constrain the possible contents of the EU/UK Agreement and therefore must be taken into account.

A1.2 The WTO

The WTO provides a rules-based framework for trade between its members and a forum for negotiating agreements aimed at reducing obstacles to international trade. The WTO also provides a legal and institutional framework for the implementation and monitoring of these agreements, as well as for settling disputes arising from their interpretation and application. The current body of trade agreements comprising the WTO consists of 16 different multi-lateral agreements (to which all 164 WTO members are parties) and two different pluri-lateral agreements (to which only some WTO members are parties). WTO members can agree to further liberalise trade on a bilateral or regional basis subject to certain conditions.

Over the past 60 years, the WTO, which was established in 1995, and its predecessor organisation the GATT have liberalised trade – mainly in relation to tariffs on goods and non-tariff barriers.

The GATS is a relatively new agreement. It entered into force in January 1995 as a result of the Uruguay Round negotiations to provide for the extension of the multi-lateral trading system to services.

All 164 WTO members are signatories to the GATS. As stated in its Preamble, the GATS is intended to contribute to trade expansion "under conditions of transparency and progressive liberalisation and as a means of promoting the economic growth of all trading partners and the development of developing countries". However, the level of liberalisation of services, including financial services, has been very modest in particular when compared with the level of liberalisation of goods.

Both the EU as a legal entity, and the 28 Member States individually, are members of the WTO; the UK will, therefore, continue to be a WTO member following its withdrawal from the EU. This means that, pending a trade agreement between them, the relationship of the EU and the UK will be based on their WTO obligations.

A1.2.1 Most-favoured nation ("MFN") treatment

The MFN principle in Article II of the GATS is a cornerstone of international trade law. By virtue of the MFN principle, the best access conditions that have been agreed with one

member must automatically be extended to all other participants in the system. This allows all members to benefit, without additional negotiating effort, from concessions (other than permitted economic integration agreements) that may have been agreed between large trading partners with much negotiating leverage.

Subject to the GATT and GATS exceptions explained below, the effect of MFN would be that any treatment to the UK under the EU/UK Agreement that is more favourable than that offered by the EU to service suppliers in like situations under existing EU FTAs would potentially have to be offered to the counterparties of those EU FTAs (depending on the scope of the relevant agreement and the commitments of the parties under it).

In the context of the GATS, the MFN obligation (Article II) is applicable to any measure that affects trade in services in any sector falling under the agreement, whether specific commitments have been undertaken or not. Exemptions to this general principle are contained in country-specific lists (Member State reservations in the case of the EU) and their duration must not exceed ten years in principle.

Article XXIV of the GATT also provides an important exception to the MFN principle, by permitting countries to enter into preferential free trade agreements. A similar exception can be found in the GATS Article V. Under these exceptions, WTO members are allowed to adopt measures that would otherwise be inconsistent with the MFN principle where those measures are taken in the pursuit of economic integration through the conclusion of regional trade agreements. Under such agreements, the participating countries may offer each other treatment more favourable than the treatment they have committed to offer under their WTO obligations to other WTO members.

Article XXIV of the GATT provides for two conditions under which a measure otherwise WTO-inconsistent can be justified:

(a). if the measure is introduced during the formation of a customs union, a free-trade area or an interim agreement, as long as all requirements of WTO law are met; or

(b). if the formation of such a customs or free trade area would not be possible if such measures were not allowed.

In this regard, a customs union entails the elimination of duties and other restrictive measures between the constituent countries with regards to "substantially all the trade" between them. Moreover, a common external regime vis-à-vis third countries is applied, namely "substantially the same duties".

A further condition set out in the GATT is that the duties and other regulations of commerce imposed vis-à-vis third countries cannot be "on the whole" higher or more restrictive than the "general incidence" of the duties and regulations applicable in the constituent territories prior to the formation of such union. The requirement means that the evaluation of the general incidence of the duties before and after the formation of a customs union shall "be based upon an overall assessment of weighted average tariff rates and of customs duties collected". As for other regulations of commerce, their assessment essentially entails an economic test of the extent of the restrictions before and after the creation of the union.

A free-trade area is defined in the GATT as *"a group of two or more customs territories in which the duties and other restrictive regulations of commerce… are eliminated on substantially all the trade between the constituent territories in products originating in*

such territories." In a free-trade area the duties or other restrictions maintained by the each country cannot be higher or more restrictive than those that were in place before the creation of a free-trade area.

The main difference between a free-trade area and a customs union is that a free-trade area concerns the internal trade between the participating countries but not their external relations with third countries.

According to Article V of the GATS, an otherwise WTO-inconsistent measure is justified if the pertinent agreement has "substantial sectoral coverage" and removes "substantially all" national treatment discrimination. In relation to this:

(a). The term "substantial sectoral coverage" is understood in terms of number of sectors, volume of trade affected and modes of supply and should not exclude a priori any mode of supply.

(b). Although the economic integration agreement does not necessarily need to cover all sectors, the number of sectors excluded must be limited (the coverage is defined in the text as "substantial"), as the purpose of Article V is to liberalise trade in an ambitious way at the regional level, "while at the same time guarding against undermining the MFN obligation by engaging in minor preferential arrangements". Article V has been interpreted by a WTO Panel as not having the purpose to extend more favourable treatment "only to a few service suppliers of parties to an economic integration agreement on a selective basis, even in situations where the maintenance of such measures may explicitly be provided for in the agreement itself".

(c). At the same time, a measure is only justified if the second condition of removal of "substantially all" discriminatory measures is also met. This entails the elimination of existing and/or the prohibition of new or more discriminatory measures.

(d). An economic integration agreement must not raise the overall level of barriers to trade in services, in respect of third countries, compared to the level of such barriers before the conclusion of the agreement.

In agreeing the EU/UK Agreement, the parties should take account of the potential impact of existing MFN provisions.

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

The parties should also consider whether the EU/UK Agreement should itself contain an MFN provision – so that any preferential treatment offered by either party under subsequent FTAs they enter into would also have to be offered to the counterparty to the EU/UK Agreement.

A1.2.2 The GATS

(a). Scope

The definition of services trade under the GATS is four-pronged, depending on the territorial presence of the supplier and the consumer at the time of the transaction. Pursuant to Article I:2, the GATS covers services supplied as "modes":

(i). Mode 1 – Cross-border trade: supply from the territory of one WTO member into the territory of any other WTO member.

(ii). Mode 2 – Consumption abroad: supply in the territory of one WTO member to the service consumer of any other WTO member.

(iii). Mode 3 – Commercial presence: supply by a service supplier of one WTO member, through commercial presence in the territory of any other WTO member.

(iv). Mode 4 – Presence of natural persons: supply by a service supplier of one WTO member, through presence of natural persons of a WTO member in the territory of any other WTO member.

A supply of a service can be the production, distribution, marketing, sale and delivery of a service.

Commercial presence means "any type of business or professional establishment". This is very wide and includes (i) the constitution, acquisition or maintenance of a juridical person, or (ii) the creation or maintenance of a branch or a representative office, within the territory of a WTO member for the purpose of supplying a service.

Measures affecting trade in services include (i) the purchase, payment or use of a service; (ii) the access to and use of, in connection with the supply of a service, services which are required by WTO members to be offered to the public generally; (iii) the presence, including commercial presence, of persons of a WTO member for the supply of a service in the territory of another WTO member.

The GATS does not apply to services supplied in the exercise of government authority. For financial services purposes, this means activities conducted by a central bank or monetary authority or by any other public entity in pursuit of monetary or exchange rate policies and specific other activities.

According to Eurostat, Mode 3 trade in services represents the majority of trade flows. By way of example, Mode 3 trade accounted for 69% of EU total services exports in 2013.[16] In particular in the sector of financial services, of the estimated 340 billion EUR in supply of services between the EU and non-EU countries, approximately 265 billion EUR was traded under Mode 3.[17] In the sector of insurance and pensions, which is included in the financial services category, Mode 3 supply concerned approximately 200 billion EUR out of the 230 billion EUR of trade. For financial services, the pattern of UK trade with third countries could differ from that of the EU as a whole.

(b). General obligations v specific commitments

The main body of the GATS is divided into two parts:

(i). General obligations

General obligations apply to any measure covered by the GATS. The principal general obligation is the requirement that each WTO member grants every other WTO member MFN treatment.

(ii). Specific commitments

WTO members agree certain specific commitments to open up their markets in certain areas (that is, commitments on market access), as well as to treat all firms of other WTO members equally to domestic firms in certain areas (that is, commitments on national treatment).

For purposes of structuring their specific commitments, WTO members have generally used a classification system comprised of 12 core service

sectors, e.g. financial services (including insurance and banking). These 12 core service sectors are further subdivided into a total of some 160 sub-sectors. The Financial Services sector is subdivided in two sub-sectors:[18]

- o all insurance and insurance-related services (including life, accident and health insurance, non-life insurance, reinsurance and retrocession services and services auxiliary to insurance, including broking and agency services) and
- o banking and other financial services (excluding insurance).

Under this classification system, any service sector, or segments thereof, may be included in a WTO member's schedule of commitments with specific market access and national treatment obligations. Each Member State has submitted such a schedule as required by the Article XX:1 of the GATS.

The market access provisions of the GATS, laid down in Article XVI, cover six types of restrictions that must not be maintained in the absence of limitations. The restrictions relate to:

(a). the number of service suppliers;

(b). the value of service transactions or assets;

(c). the number of operations or quantity of output;

(d). the number of natural persons supplying a service;

(e). the type of legal entity or joint venture; and

(f). the participation of foreign capital.

WTO members have agreed certain carve-outs to both general obligations and the specific commitment. It is in these carve-outs that the real detail of the GATS negotiations can be found. For general obligations, carve-outs are described as Exemptions, and listed in an Annex on Article II Exemptions to the GATS. For specific commitments, carve-outs are described as Reservations and listed in the Schedules annexed to the GATS.

In addition to the GATS and Annexes, certain additional annexes and protocols in the area of financial services have been agreed. The outcome of these further agreements is consolidated in the Fifth Protocol to the GATS, which came into force on 1 March 1999.

A1.2.3 National treatment

Each WTO member commits to giving the same treatment to services and service suppliers of other WTO members as given to its own like services and service suppliers, subject to any qualifications or conditions set out in its Schedule.

This requirement may be met by granting either formally identical treatment or formally different treatment to that which it grants its own like services and service suppliers.

A1.2.4 GATS Understanding on Commitments in Financial Services

The Understanding is a document setting out a standard set of market access and national treatment commitments, as well as additional obligations which WTO members may undertake, on a voluntary basis, in the financial services sector.

Around 40 WTO members chose to undertake such obligations during and just after the Uruguay Round, including Member States.

Under the Understanding, Members shall list in their financial services schedules existing monopoly rights, with the view to eliminating them or reducing their scope. MFN and national treatment obligations for the resulting specific commitments apply to all modes of supply of financial services. The MFN also applied to the purchase of financial services by public entities of a Member in its territory, while Members must grant to financial service suppliers of any other Member established in their territory access to payment and clearing systems operated by public entities. Members must remove or limit significant adverse effects on financial service suppliers that are caused by discriminatory measures.

The Member States Specific commitments and the Understanding cover (i) insurance and its related services and (ii) banking and other financial services.

The scope of commitments under the GATS is limited, particularly as regards Mode 1 commitments:

(a). Mode 1

The EU commitments for Mode 1 are in the first place limited to certain financial services sub-sectors. Second, they are limited by the market access commitments made by the 28 Member States on foreign providers' market access and national treatment.

For banking and other financial services, for example, Italy excludes from any commitments the role of the financial salesman and Ireland requires authorisation for the provision of investment services or investment advice.

(b). Mode 2

With regard to Mode 2, the scope of application of commitments is also limited to a broad range of financial services including lending of all types, leasing, payment and money transmission services, trading and asset management. The limitations adopted by Member States are similar to the ones for Mode 1. The Member State limitations on banking and other financial services cover, for example, the need to receive payments from Finnish governmental entities through a particular bank, or the need for establishment in order to administer interest and principal payments on securities issued in Greece.

(c). Mode 3

The scope of services covered by the commitments in Mode 3 is less restrictive. Member States admit market access on insurance, banking and other financial services, but sets out some limitations.

With respect to banking and other financial services, the EU schedules provide two limitations applicable to all Member States. First, the establishment of a specialised management company is required to perform the activities of management of unit trusts and investment companies. Second, only firms having

their registered office in the EU can act as depositories of the assets of investment funds.

(d). Mode 4

In what concerns Mode 4, while the EU schedules do not provide any commitments, Article 9 of the Understanding sets out rules for the temporary entry of personnel. Article 9 provides that WTO members shall permit the entrance of senior managers and operations specialists of financial services suppliers that are establishing or have established commercial presence. In addition, specialists in computer services, telecommunication services and accounts of the financial service supplier, actuarial and legal specialists associated with the commercial presence shall also be permitted temporary access subject to the existence of such qualified personnel in its territory.

ANNEX 2

LEGAL BASIS AND CONSTRAINTS IMPOSED UNDER EU LAW ON THE EU ENTERING INTO INTERNATIONAL AGREEMENTS

SECTION SUMMARY

- There are various constraints on the powers of the EU itself to agree free trade agreements. These will affect what the EU can agree to in terms of substance, and may also have structuring and timing implications.
- Exclusive and shared competence:
    - The EU can only enter into international agreements in accordance with the powers conferred on it under the EU Treaties. When entering into such an agreement, the EU must identify – in respect of every commitment that it is seeking to agree – whether it competence to enter into an agreement is:
        - exclusive – meaning that the EU can act alone; or
        - shared – meaning that either the EU or its Member States can act. (In practice, this means that each Member State needs to agree to be bound by the terms of the agreement, otherwise it would be entitled to act of its volition in a way that contravened the agreement.)
    - If an agreement contains provisions relating to matters where competence is shared, it will be a "mixed" agreement and will only be valid if it is concluded jointly by the EU and its Member States in their individual capacities. Any mixed agreement is therefore subject to the Member States' national ratification procedures.
    - The EU's exclusive competence to conclude agreements with third countries in the field of trade is substantial and it includes trade in financial services. However, certain areas that might be considered for inclusion in the EU/UK Agreement – including Investor-State Dispute Settlement mechanisms and non-direct foreign investment – are matters of shared competence.
- Neither the EU nor Member States can enter into an international agreement, even as a mixed agreement, if it purports to amend or alter the scope of the EU Treaties themselves.
- In practice, individual Member States cannot enter into international agreements with third countries in relation to trade matters. This means that:
    - prior to its withdrawal from the EU, the UK cannot conclude international agreements with third countries. The European Parliament has stated that it believes the UK is also prohibited from commencing negotiations in respect of such agreements before withdrawal; and
    - after withdrawal, EU Member States will be prevented from entering into trade-related agreements with the UK individually. They would, however, be entitled to enter into strategic partnerships with the UK (such as that which the UK currently has with China), but such arrangements cannot go so far as to offer binding commitments in respect of trade.
- 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.

A2.1 Background and introduction

In contrast to nation states, international organisations such as the EU have international legal personality and competence to act only to the extent provided for under their constitutional documents. This section concerns the legal basis under which the EU enters into international agreements and the constraints imposed on the contents of such agreements by EU law.

The EU is an international organisation established by two international treaties between signatory states, which together create an autonomous body of constitutional law: the Treaty on the EU ("**TEU**") and the Treaty on the Functioning of the EU (the "**TFEU**") (together, the "**EU Treaties**").

(a). Article 47 TEU confers on the EU international legal personality, so that it can enter into agreements in its own name on the international plane.

(b). The extent of the EU's functions under the EU Treaties is governed by the principle of conferral, as expressed in Article 5(2) TEU:

> *"Under the principles of conferral, the Union shall act only within the limits of the competences conferred upon it by the Member States in the Treaties to attain the objectives set out therein. Competences not conferred upon the Union in the Treaties remain with the Member States."*

This means that the EU can only enter into international agreements in accordance with the powers conferred on it under the EU Treaties, as interpreted by the CJEU. The extent of these powers will determine what is possible in terms of the form and content of any agreement between the EU and the UK regarding the UK's future relationship with the EU, including in relation to financial services, and the process by which they are negotiated and concluded.

This section of the Report outlines the EU's powers under the EU Treaties in respect of entering into international agreements with third countries. The UK is currently a Member State and will not be treated as a third country for the purposes of EU law until it has withdrawn from the EU. Therefore, this section also considers the impact (if any) of the UK's unique circumstances on the EU's competence in relation to entering into an agreement, including: whether there is any legal impediment to the EU and UK beginning the negotiation of the EU-UK future relationship agreement before the UK formally withdraws from the EU; and the possible legal basis for arrangements (sometimes referred to as transitional arrangements, but which we will call "**Interim Arrangements**") to govern any interim period following the UK's ceasing to be a member and the entry into effect of the end-state future relationship (the "**Interim Period**").

A2.2 The EU's ability to enter into international agreements with third countries

The powers granted to the EU under the EU Treaties are expressed in terms of the "competences" conferred on it to legislate and adopt legally binding acts on behalf of Member States. These competences can relate to actions taken within the EU, such as adopting common rules applicable to Member States, (known as the EU's "internal competences") or outside the EU, such as entering into international agreements with third countries, (known as the EU's "external competences").

A further distinction of EU competences is between EU exclusive competence and EU shared competence. The former means that, in the areas where the Member States have conferred such powers to the EU, the EU can act alone. In areas of shared competence, either the EU or the Member States may act, but Member States can only exercise their competence to the extent that the EU has not exercised (or has decided to cease to exercise) its competence. (In practice, this means that each Member State needs to agree to be bound by the terms of the agreement, otherwise it would be entitled to act of its volition in a way that contravened the agreement.) The implications of whether an international agreement covers areas of exclusive or shared EU competence is considered further in paragraph 2.2.

A2.2.1 The EU's general competence to enter into international agreements with third countries

The general competence of the EU to enter into international agreements with third countries is provided by Article 216 TFEU, which states that the EU may conclude an international agreement with a third country in four circumstances:

(a). where the power to do so is provided by the EU Treaties;

(b). where the conclusion of an agreement is necessary in order to achieve, within the framework of the EU's policies, one of the objectives referred to in the EU Treaties;

(c). where the conclusion of an agreement is provided for in a legally binding Union act; or

(d). where the conclusion of an agreement is likely to affect common rules or alter their scope.

The principle of conferral and Article 216 TFEU together mean that, when the EU is seeking to enter into an international agreement with a third country, it must – in respect of each commitment in each provision of the agreement it is seeking to agree – be able to identify, by reference to objective factors, such as the aim and content of the provision in question, the source of its legal power to do so (i.e. the relevant competence conferred under the EU Treaties).

The granularity of the approach to be adopted in identifying the relevant competence is reflected in the CJEU's recent Opinion on the EU-Singapore FTA, where the CJEU analysed each chapter of the proposed agreement in order to identify the nature of the EU's competence to enter into the specific provisions on behalf of Member States.

Therefore, the source of the EU's competence to enter into a particular international agreement will depend on the specific commitments contained in the provisions of the proposed agreement and whether the EU has the competence to agree to such commitments on behalf of its Member States.

If the EU does not have the exclusive competence to agree a particular commitment in a proposed agreement with a third country, the agreement will be a "mixed" agreement, meaning it can only validly be agreed if it is concluded jointly by the EU and Member State in their individual capacities and is thus subject to the Member States' national ratification procedures.

While the EU's exclusive competence to conclude agreements with third countries in the field of trade is substantial and includes trade in financial services, for the reasons outlined below, certain provisions of the EU/UK Agreement, including a number of those recommended in this Report, are likely to fall outside the EU's exclusive competence, thereby rendering the EU/UK Agreement a mixed agreement.

As explained in more detail below, to the extent that any provisions of the agreement are within the exclusive competence of the EU to agree, such provisions may be provisionally applied by a decision of the Council after the EU has concluded the agreement and before the agreement as a whole has been ratified by all the Member States.[19] Whether individual provisions of the agreement are within the exclusive competence of the EU to agree could therefore have implications for the timing of the entering into force of such provisions.

A2.2.2 The extent of the EU's competences in relation to specific areas of policy covered by the EU/UK Agreement

The areas of policy in which the EU Treaties empower the EU to act are wide ranging. The EU's competence to act in a given policy area is either exclusive to the EU or shared between the EU and Member States.

In areas of exclusive EU competence only the EU can legislate or adopt legally binding acts and Member States can only do so only if empowered to do so by the EU or for the implementation of EU acts.

One important policy area in respect of which the EU has exclusive competence by virtue of Article 3(1) TFEU is the EUCCP. Article 207 TFEU defines the EUCCP to include the conclusion of international agreements relating to trade in goods and services, the commercial aspects of intellectual property and foreign direct investment, export policy and trade defence measures. As such, the EU is solely competent to conclude international agreements pertaining to areas falling within the scope of the EUCCP.

The scope of what falls within the EUCCP is set out in the case law of the CJEU. It is settled case law that a provision contained in an international agreement will fall within the scope of the EUCCP if it is intended to promote, facilitate or govern trade and have a direct and immediate effect on trade. In its recent Opinion on the EU-Singapore FTA, the CJEU held that the provisions in that agreement relating to trade in goods, services, including trade in financial services, establishment and e-commerce, government procurement, intellectual property, foreign direct investment, competition, trade and sustainable development fall within EU exclusive competence. By contrast, the commitments relating to portfolio investment and investor-State dispute settlement fall under the shared competence between the EU and its Member States.

The table below summarises the attribution of exclusive and shared competences as determined by the CJEU in its Opinion on the EU-Singapore FTA.

EU *exclusive* competence Art. 3(1) TFEU	**EU *implied* exclusive competence** Art. 3(2) TFEU	**EU *shared* competence** Art. 4 TFEU
Common Commercial Policy Art. 207(1) TFEU The pertinent provisions in the International Agreement *specifically* related to trade: Intended to promote, facilitate or govern trade Immediate and direct effects to trade	The conclusion of an international agreement (a) Is provided for in a legislative act of the EU (b) Is necessary to enable the EU to exercise its internal competence (c) May effect common rules or alter their scope	Art. 216 TFEU Conclusion of international agreements where: (a) The Treaties so provide (b) Such conclusion is necessary in order to achieve, within the framework of the Union's policies, one of the objectives referred to in the Treaties (c) Such conclusion is provided for in a legally binding EU act (d) Such conclusion is likely to affect common rules or alter their scope

Notwithstanding that this ruling is likely to mean that more of the provisions of the EU/UK Agreement will fall within the scope of the EU's exclusive competence than previously thought, it is likely that the EU/UK Agreement will still cover areas of policy that fall outside of the EUCCP and other areas of exclusive EU competence.

As explained above, in certain areas of competence not covered by the EU's exclusive competence, the EU shares its competence to act with Member States. As the diagram above shows, Article 3(2) extends the exclusive competence of the EU to conclude international agreements with third countries to include areas which are not included in the areas provided for in Article 3(1) TFEU, where an international agreement is: (a) provided for in a legislative act of the EU; (b) necessary for the EU to exercise its internal competence; or (c) in so far as the conclusion of the Agreement may affect common rules or alter their scope.

Therefore, the EU will have exclusive external competence to conclude an agreement with the UK in respect of any area of policy that (a) is an area of exclusive competence listed in Article 3(1) TFEU; or (b) is an area of implied exclusive competence to conclude agreements with third countries by virtue of Article 3(2) TFEU.

In other words, if the EU/UK Agreement contains any provisions that relate to an area of policy where the EU either has not been conferred any competence to act under the EU Treaties or the EU has not exercised a shared competence, the EU is not empowered to enter into the agreement without the participation of the Member States.[20] Such provisions can only validly be agreed to jointly by the EU and the Member States, meaning that the agreement must be ratified by each Member State in accordance with its domestic constitutional process.

The two areas of the EU-Singapore FTA the CJEU ruled that the EU does not have competence to agree were "non-direct foreign investment" and ISDS resolution mechanisms. Non-direct foreign investment relates to the free movement of capital and payments between Member States and third States. Examples include financial investments without any intention to influence the management and control of the undertaking ("portfolio" investment) or loans. This rendered the EU-Singapore FTA a mixed agreement, meaning that those provisions falling outside the EU's exclusive competence have to be concluded jointly by the EU and Member States and subject to the Member States' national ratification procedures.

In this Report, we recommend that ISDS be included in respect of the financial services chapter of the EU/UK Agreement. The inclusion of such a mechanism would have to be agreed to by each Member State individually via the conclusion of the EU/UK Agreement as a mixed agreement.

The implications of an agreement between the EU and the UK being a mixed agreement for the process necessary to conclude the agreement is considered further below.

A2.2.3 EU law constraints on the content of the EU/UK Agreement

EU law imposes two types of constraints on the possible contents of the EU/UK Agreement. This will have an impact on what it is possible to agree as part of the future relationship between the EU and the UK.

(a). Relationship with the EU Treaties

The EU cannot enter into an FTA if one of its proposed provisions would have the effect of altering the scope or application of the EU Treaties as regards the EU and its Member States (i.e. the EU27 post-withdrawal).

Article 3(2) TFEU extends the EU's exclusive competence to conclude international agreements with third countries in so far as their conclusion may affect common rules or alter their scope. However, whereas an agreement between the EU and a third country can affect or alter the scope of legally binding acts (such as common rules) adopted by the EU in the exercise of a power granted by the EU Treaties, an agreement between the EU and a third country cannot affect or alter the scope of a provision of the EU Treaties itself. This is because the EU Treaties have primacy over acts adopted in the exercise of a power provided under the EU Treaties, including international agreements concluded by the EU with third countries. International agreements derive their legal validity from, and are therefore subordinate to, the EU Treaties and they cannot impact on the meaning or scope of provisions of the EU Treaties. The EU and the Member States are prohibited from revising the Treaties by any means outside the procedures set out in the Treaties themselves (i.e. in accordance with Article 48 TEU).

As a result, the EU/UK Agreement could not contain any provision that sought to alter the scope and application of the EU Treaties or the institutional framework of the EU itself, for example by seeking to create a dispute resolution body under the agreement that contradicted the CJEU's exclusive jurisdiction to give binding interpretations of EU law and determine all disputes between Member States in relation to the application of EU law. The mechanisms of the EU/UK Agreement must therefore be consistent with the constitutional and institutional framework of the EU.

(b). Relationship with the EU's legislative competences

The exercise of the EU's exclusive external competence to conclude international agreement with third countries on behalf of Member States within the field of the EUCCP is subject to a limit imposed by Article 207(6) TFEU. Under Article 207(6), an FTA *"shall not affect the delimitation of competences between EU and Member states, and shall not lead to harmonisation of legislative and regulatory provisions of the Member states insofar as the Treaties exclude such harmonisation"*. In essence, Article 207(6) provides that the EUCCP must not be used to circumvent the limits placed on EU competence elsewhere in the EU Treaties. It has two effects:

(i). The EUCCP cannot be used to extend the EU's internal legislative competences by virtue of its external action. The EUCCP has been extended to fields for which the EU does not have corresponding full internal legislative competence. For example, Article 207(4) envisages the negotiation and conclusion of agreements that cover the area of health services; an area where the EU's internal competence is limited to "*supporting, co-ordinating or supplementing*" actions of the member states. Article 207(6) is therefore intended to prevent external actions taken by the EU under the EUCCP from implying exclusivity in the same field in respect of internal action.

(ii). An international agreement with a third country cannot contain terms that circumvent an express prohibition on harmonisation under EU law. The agreement could not therefore impose obligations on Member States that would de facto result in the harmonisation of their legislative or regulatory frameworks in areas where there is a prohibition on harmonisation under EU law. There are various examples of these fields, including education, culture, and public health. A future EU/UK Agreement could not bypass this prohibition.

This does not mean that international agreements entered into by the EU cannot cover matters with respect to which other provisions of the EU Treaties preclude harmonisation (such as, for example, in matters of social policy, education, public health or culture). Article 207(4) specifically provides for the conclusion of agreements in these areas. Such agreements must simply be concluded jointly by the EU and Member States as joint agreements.

A2.2.4 Process by which the EU concludes international agreements

Article 218 TFEU sets out the internal procedure that the EU must adopt in relation to the negotiation and conclusion of international agreements with third countries. Any international agreement between the UK and the EU must comply with the procedural rules set out in this Article.

Under Article 218 TFEU, to commence the negotiations of an international agreement with a third country the Council must, acting on a proposal from the Commission, make a formal decision to authorise the opening of negotiations, nominate the EU's negotiator and adopt and address to the negotiator Directives that provide the negotiator's mandate for the negotiations. As discussed below, Article 218 has never been exercised to negotiate an agreement with a withdrawing state (such as the UK) so it is unclear whether the Council could as a matter of law adopt a decision commencing the negotiations of a future relationship with the

withdrawing state as a third country while the country is still a Member State prior to withdrawal.

Under Article 218(5) and (6), the Commission is responsible for putting forward a proposal to the Council for the adoption of a decision authorising the signing and conclusion of the agreement on behalf of the EU and, if necessary, its provisional application before entry into force.

Depending on the content of the agreement, either the consent (by simple majority) of the European Parliament will be required to conclude an agreement or it must be consulted. Any international agreement in the field of the EUCCP will require the consent of the European Parliament.

The voting requirement in the Council in respect of concluding the agreement is set out in Article 218(8) TFEU. The general rule of qualified majority voting is displaced, among other situations, "*when the agreement covers a field for which unanimity is required for the adoption of an act of the Union*".

Where the agreement is within the scope of the EUCCP, Article 207(4) provides for departure from the general rule in Article 218(8), in a number of specific circumstances. For example, where the agreement is in the field of trade in services, the commercial aspects of intellectual property or foreign direct investment, the Council must act by unanimity where the agreement includes provisions for which unanimity is required for the adoption of internal rules. Unanimity may also be required in relation to agreements in the field of trade in social, education and health services, where these agreements risk seriously disturbing the national organisation of such services and prejudicing the responsibility of Member States to deliver them.

Finally, Article 218(11) provides for the jurisdiction of the CJEU in respect of agreements, which may be invited by a Member State, the European Parliament, the Council or the Commission to render an opinion on the compatibility of the proposed agreement with EU law. Such an opinion can only be sought before the agreement is concluded. After the conclusion of the agreement, the validity of the agreement is a matter of international law and therefore cannot be challenged directly in the CJEU. Instead, a party wishing to challenge the agreement would need to challenge the validity of the Council decision by which it was concluded, under Article 263 TFEU.

A2.2.5 What happens where the agreement contains provisions that fall outside the exclusive competence of the EU to agree?

As described above, where the EU lacks the exclusive competence to conclude certain provisions of the proposed agreement on behalf of its Member States, such agreements can only validly be concluded if the EU and its Member States jointly enter into the agreement as a "mixed" agreement.

In practice, mixed agreements have often been concluded in situations where the EU arguably had sufficient competence to conclude the agreement alone. It is generally understood that the conclusion of an international agreement as a mixed agreement in such circumstances is voluntary on the part of the EU and the Member States, most commonly as a result of political choice.

A mixed agreement must be concluded both by the EU, in accordance with the process set out in Article 218 (described above), and by all the participating Member States, in accordance with their respective domestic constitutional requirements.

This process can hold up or even stall the conclusion of an agreement, as was the case with the EU-Canada agreement, when the Belgian Walloon Parliament delayed the conclusion of the agreement.

Significantly, even where an agreement is concluded as a mixed agreement, any provisions that fall within the exclusive competence of the EU to agree on behalf of Member States can be provisionally applied by a decision of the Council shortly after approval and before the agreement has completed the ratification process. This was the path proposed by the Commission in relation to the EU-Canada agreement.

As stated above, the EU/UK Agreement is likely to cover matters falling outside the scope of the exclusive competence of the EU and so will be a mixed agreement. Any provisions of the EU/UK Agreement relating to trade in services, including in relation to trade in financial services, will fall within the EUCCP and therefore within the exclusive competence of the EU and can be provisionally applied pending ratification of the agreement by Member States.

A2.3 The impact of the withdrawal negotiations under Article 50

As explained above, the substance of the EU/UK Agreement will need to be concluded between the EU and the UK as a third country. However, at present, the UK remains a member of the EU and subject to the rights and obligations of membership, until the date of withdrawal under Article 50 TEU, other than in respect of the negotiation of the withdrawal agreement under Article 50.

The provisions of the EU Treaties in relation to the EU entering into international agreements with third countries have never been exercised in relation to a withdrawing Member State. This raises a number of questions including, in particular, whether there is a legal impediment to the EU and UK commencing the negotiation of an agreement on their future relationship in accordance with Article 218 TFEU before the UK becomes a third country.

The Guidelines set out the core principles that will apply throughout the negotiations for UK's withdrawal. The Guidelines do not address financial services specifically, aside from the statement that "*any future framework should safeguard financial stability in the Union and respect its regulatory and supervisory regime and standards and their application*".

The Negotiating Directives adopted on 22 May 2017 authorised the Commission to open the negotiations for the UK withdrawal in light of the Guidelines. The Negotiating Directives do not have any further specific provisions related to financial services.[21] The Negotiating Directives are only intended to govern the first phase of the withdrawal negotiations. A new set of directives will be released at a second stage.

The starting position is that negotiations between the EU and a third country cannot commence until the Council adopts a decision under Article 218(3) TFEU formally opening the negotiations.

The Council has indicated that the negotiations on the future EU/UK agreement will not start until it is satisfied that the negotiations on the UK's withdrawal have progressed sufficiently. The press release published alongside the Negotiating Directives also indicates that "*An agreement on a future relationship between the EU and the UK can only be concluded once the UK effectively leaves the EU and becomes a third country.*

However, discussions on an overall understanding of that future relationship could start during a second phase of the negotiations."[28]

An orderly transition between the pre- and post-withdrawal settlement between the EU and the UK will also require the agreement of Interim Arrangements to ensure that there is no gap between the UK's withdrawal and the entry into force of the agreement governing its new relationship with the EU. The Negotiating Directives indicate that the transitional arrangements under the withdrawal agreement – described as including "*bridges towards the foreseeable framework for the future relationship*" – will not be discussed until a later stage in the withdrawal negotiations, once sufficient progress has been made on the matters identified by the Council as being "*necessary to ensure an orderly withdrawal*".

However, if the EU and the UK are unable to commence the negotiations of their future relationship or Interim Arrangements in good time before the UK becomes a third country, this risks no agreement on the future relationship and/or Interim Arrangements being reached before the UK withdraws from the EU. This would create a situation in which the UK's pre- and post- withdrawal relationship with the EU is subject to sudden and disorderly change, giving rise to considerable uncertainty for EU and UK businesses, including in the financial services sector.

Therefore, the questions remain whether, **as a matter of law**:

(a). even if the agreement cannot be *concluded* until the UK is a third country, the EU can *commence* negotiations with the UK before the date of its withdrawal in respect of an agreement pertaining to the future (i.e. post-withdrawal) relationship between the EU and the UK – and, if so, how far can such negotiations progress?

(b). to what extent and under what legal basis is the EU entitled to conclude Interim Arrangements to bridge the gap between the EU-UK relationship pre- and post-withdrawal?

From an EU law perspective, the first stage of giving effect to the UK's withdrawal is provided for under Article 50 TEU, which the UK formally triggered on 29 March 2017, starting the withdrawal process. Article 50 provides that (unless the European Council and the UK unanimously agree otherwise) the UK will cease to be an Member State either upon the entry into force of a withdrawal agreement negotiated in accordance with the process set out in Article 50 or, failing that, two years from the date on which the process began.

Article 50 provides that the EU:

> *"…shall negotiate and conclude an agreement with [the UK], setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union."*

Article 50 therefore provides an express legal basis on which the EU can negotiate a withdrawal agreement with the UK. Article 50 is described by the Negotiating Directives as conferring "*an exceptional horizontal competence to cover in this agreement all matters necessary to arrange the withdrawal" and that "this exceptional competence is of a one-off nature and strictly for the purposes of arranging the withdrawal from the Union*".

Article 50 has not previously been exercised and so its operation and scope is unclear. The scope of the withdrawal negotiations, and the extent to which they can include

and/or be conducted in parallel with the negotiations on the UK's future relationship with the EU, is not one on which the UK Government and the EU appear to be aligned. The meaning of "*arrangements for… withdrawal" and "taking account of the framework for its future relationship*" in Article 50(2) is not expressly set out in Article 50 itself; the EU Institutions and the UK Government have so far each asserted their own interpretation of what these phrases mean.

The following points are relevant for the purposes of this Report in terms of the process of the negotiations under Article 50.

(a). Following the notification of the withdrawing state's intention to withdraw from the EU, the European Council must adopt guidelines setting the mandate for the negotiations of a withdrawal agreement with the withdrawing state. The European Council adopted the Guidelines on 29 April 2017.

(b). In light of the Guidelines, the Council must:

- o adopt a decision, on the basis of a proposal from the Commission, formally opening the negotiations and nominating the Commission as the EU negotiator; and
- o produce the "Negotiating Directives" to the Commission on basis of the Guidelines.

The Council adopted the Decision opening the negotiations and the Negotiating Directives on 22 May 2017.

(c). Upon the entering into force of the withdrawal agreement, which must take place before 30 March 2019, the EU Treaties will cease to apply to the UK, unless the Council and the EU unanimously agree a later date.[22] When the Treaties cease to apply, the UK will become a third country for the purposes of EU law.

The Guidelines and Negotiating Directives define the negotiating mandate granted by the Council to the Commission (the sole negotiator on the EU's behalf). As such, the Commission is bound by Article 50 to conduct the negotiations in accordance with the Guidelines. An important element is that the Directives may be amended or supplemented as necessary during the negotiations, in order to reflect the European Council's guidelines as they evolve. However, although the view of the European Council and the Commission as expressed in the Guidelines and Negotiating Directives will be central to the likely conduct and scope of the negotiations under Article 50, as explained below, neither the Guidelines nor the Negotiating Directives can be said to represent the definitive legal interpretation of Article 50, which is a matter of EU law that can only conclusively be determined by the CJEU; nor are they fixed, as it is open to the Council to revise them if its interpretation or political position evolves.

The Guidelines set out the core principles the EU will pursue throughout the withdrawal negotiations and the process by which the EU expects the negotiation of the withdrawal agreement to be conducted, including the extent to which the EU will be prepared to discuss the framework for the EU-UK future relationship and/or transitional arrangements.

In respect of the core principles, the Guidelines state:

(a). any agreement with the UK will have to be based on a balance of rights and obligations, and ensure a level playing field;

(b). preserving the integrity of the Single Market "*excludes participation based on a sector-by-sector approach*";

(c). a non-member of the EU, which does not have the same obligations as a member, cannot have the same rights and enjoy the same benefits as a member;

(d). the four freedoms of the Single Market are indivisible and that there can be no "cherry picking";

(e). negotiations with the UK will be conducted "*as a single package*" and in accordance with the principle that "*nothing is agreed until everything is agreed*", such that individual items cannot be settled separately; and

(f). the above principles "*apply equally to the negotiation on an orderly withdrawal, to any preliminary and preparatory discussions on the framework for a future EU-UK relationship and any form of transitional arrangements*".

In terms of process for the negotiations, the Guidelines provide for a phased approach, whereby:

(a). *"the first phase of negotiations will aim to provide as much clarity and legal certainty as possible on the immediate effects of the UK's withdrawal; and settle the disentanglement of the UK from the EU and from all the rights and obligations the UK derives from commitments taken as a Member State"*; and

(b). *"the European Council will monitor progress closely and determine when sufficient progress has been achieved to allow negotiations to proceed to the next phase".*

In respect of the extent to which the EU is prepared to discuss the future relationship between the EU and the UK as part of the Article 50 negotiations, the Guidelines state:

> *"While an agreement on a future relationship between the Union and the United Kingdom as such can only be finalised and concluded once the United Kingdom has become a third country, Article 50 TEU requires [the withdrawal agreement] to take account of the framework for its future relationship with the Union in the arrangements for withdrawal. To this end, an overall understanding on the framework for the future relationship should be identified during a second phase of the negotiations under Article 50 TEU. We stand ready to engage in preliminary and preparatory discussion to this end in the context of negotiations under Article 50 TEU, as soon as the European Council decides that sufficient progress has been made in the first phase towards reaching a satisfactory agreement on the arrangements for an orderly withdrawal".*

With regards to transitional arrangements, the Council Guidelines state:

> *"To the extent necessary and legally possible, the negotiations may also seek to determine transitional arrangements which are in the interest of the Union and, as appropriate, to provide for bridges towards a foreseeable framework for the future relationship in the light of the progress made. Any such transitional arrangements must be clearly defined, limited in time, and subject to effective enforcement mechanisms. Should a time-limited prolongation of Union acquis be considered, this would require existing Union regulatory, budgetary, supervisory, judiciary and enforcement instruments and structures to apply."*

The Guidelines have been supplemented by the Negotiating Directives, adopted by the Council on 22 May 2017. The Negotiating Directives confirm the EU's intention to conduct a phased approach to the negotiations and states that the Negotiating Directives cover the first phase of the negotiations, which "*prioritise some matters which, at this stage, have been identified as necessary to ensure an orderly withdrawal*".

The Negotiating Directives confirm that *"[o]ther matters, such as services, where there may be a need to reduce uncertainty or avoid a legal vacuum, will be covered by subsequent sets of negotiating directives"*.

The Negotiating Directives confirm that transitional arrangements "*(i.e. bridges towards the foreseeable framework for the future relationship)*" are not covered by the Negotiating Directives and will be included in future sets of negotiating directives in light of the progress made in phase one of the negotiations. The Negotiating Directives state that this approach "*will allow an efficient allocation of the limited time that Article 50 [TEU] imposes for the conclusion of the Agreement by avoiding the need to address the same matter several times at different phases of the negotiations*".

The Negotiating Directives do not consider the extent to which the EU will consider the framework of the future relationship between the EU and the UK. The press release that accompanied the Negotiating Directives explains this omission:

> *An agreement on a future relationship between the EU and the UK can only be concluded once the UK effectively leaves the EU and becomes a third country. However, discussions on an overall understanding of that future relationship could start during a second phase of the negotiations.*

In summary, the EU's position appears to be that:

(a). an agreement on the future relationship between the EU and UK can only be finalised and concluded once the UK is a third country, in other words after the EU Treaties have ceased to apply to the UK in accordance with Article 50;

(b). the withdrawal negotiations should take place in phases, the EU will determine when sufficient progress has been made so that the negotiations can progress to the next phase and the EU is not prepared to discuss the framework of the future relationship between the UK and the EU or transitional arrangements until the second phase;

(c). before the UK's withdrawal takes effect, only a "*preliminary and preparatory discussion*" that identifies the "*overall understanding on the framework for the future relationship*" can take place about the UK's future relationship with the EU as part of the withdrawal negotiations; and

(d). the EU "*may*" seek to determine transitional arrangements "*to the extent necessary and legally possible… to provide for bridges towards a foreseeable framework for the future relationship in the light of the progress made*" in the withdrawal negotiations. Any such transitional arrangements must be clearly defined, limited in time, and subject to effective enforcement mechanisms and any time-limited prolongation of EU law must apply existing Union regulatory, budgetary, supervisory, judiciary and enforcement instruments and structures.

It is significant that:

(a). the Guidelines and the Negotiating Directives do **not** state that the negotiations of the EU/UK Agreement relating to the future relationship **cannot** commence while the UK remains a Member State nor that such negotiations **cannot** be conducted in parallel with the negotiation of the withdrawal agreement. Indeed, the press release accompanying the Negotiating Directives state that "*discussions on an overall understanding of that future relationship could start during a second phase of the negotiations*"; and

(b). the Guidelines and the Negotiating Directives appear to acknowledge that transitional arrangements, including bridges towards the foreseeable framework for the future relationship, can be adopted under the withdrawal agreement, albeit "*to the extent necessary and legally possible*".

The UK Government's position, as set out in its White Paper published in February 2017, is that it intends to seek to negotiate the UK's future relationship alongside the terms of its withdrawal from the EU. The White Paper states that the UK Government wants:

(a). "*to avoid a disruptive cliff-edge" and "consider the need for phasing in any new arrangements we require as the UK and the EU move towards a new partnership*";

(b). "*to have reached an agreement about our future partnership by the time the two year Article 50 process has concluded*"; and

(c). to agree a "*phased process of implementation*" after withdrawal in which "*the UK, the EU institutions and Member States prepare for the new arrangements that will exist between us*".

The EU and the UK Government therefore are not presently aligned in relation to the extent to which they wish to negotiate the UK's future relationship with the EU and any transitional arrangements during the withdrawal negotiations, although mutual agreement on the process of the negotiations appears possible. The respective sides will need to come to a mutual agreement on the contents of the withdrawal agreement and the point at which they can commence the negotiation of an agreement regarding the future relationship as soon as possible; failure to do so would inevitably result in a disruptive "cliff-edge".

Both sides acknowledge the importance of avoiding undue regulatory and legal disruption during the period of the UK's withdrawal from the EU. The Guidelines explicitly recognise the possible impact of the outcome of the negotiations (or lack thereof) on EU businesses trading with and operating in the UK and UK businesses trading with and operating in the EU, stating that:

> *Negotiations should seek to prevent a legal vacuum once the Treaties cease to apply to the United Kingdom and, to the extent possible, address uncertainties.*

However, given the legal effect of the Guidelines under Article 50 is to provide the mandate under which the Commission must conduct the negotiations, it is not legally possible at present for the EU to seek to negotiate other than in accordance with the Guidelines. This means that, in order for the EU to change its position in relation to the extent to which it is prepared to commence negotiations (and the timing of such negotiations) in respect of the future relationship and/or transitional arrangements, the Council would need to adopt amended Guidelines.

This is recognised by the Guidelines themselves, which state "the European Council will remain permanently seized of the matter, and will update these guidelines in the course of the *negotiations as necessary*". The Negotiating Directives confirm this, stating:

> *"The negotiating directive may be amended and supplemented as necessary throughout the negotiations, in particular to reflect the European Council guidelines as they evolve."*

As explained above, as a matter of EU law, although the EU's positions adopted in the Guidelines and the Negotiating Directives represent the mandate for the EU negotiators, thereby restricting the matters that the negotiator is legally entitled to agree as part of the negotiations, they do not represent the extent of what is legally possible to agree under Article 50. What is legally possible is a question that can only conclusively be determined by the CJEU.

Given the current positions of the EU and UK Government, there appears to be a material probability that the UK could withdraw from the EU without having already determined an agreement providing for its post-withdrawal relationship with the EU. In the event that an agreement regarding the UK's future relationship is not agreed to enter into force at the same time/immediately after the UK's withdrawal from the EU, this will give rise to an Interim Period in which the UK is neither a Member State nor subject to a new agreement that provides the basis for its new relationship with the EU. In these circumstances, there are three possible scenarios for what will happen during the Interim Period:

(a). the default position: the EU Treaties will cease to apply and the UK must begin to trade with the EU in accordance with WTO rules (see Annex 1) (the "**cliff edge scenario**");

(b). the EU and the UK agree an Interim Arrangement (under the withdrawal agreement, a separate agreement or some other legal instrument) whereby the full application of the EU Treaties is extended, including in respect of passporting rights for financial services, such that the UK's withdrawal from the EU is effectively deferred until a later date (the "**delayed withdrawal scenario**"). It may be possible for some limited accommodations to be made for the unique situation within the context of the continued application of the Treaties. In the case of an extension of the Union acquis for the UK, the Guidelines and the Negotiating Directives state that the existing EU regulatory, budgetary, supervisory, judiciary and enforcement instruments will continue to apply; or

(c). the EU and the UK agree a bespoke Interim Arrangement (under the withdrawal agreement, a separate agreement or some other legal instrument) whereby the EU Treaties cease to apply directly but are replaced by an institutional framework provided under the terms of the Interim Arrangement such that the institutional relationship between the UK and the EU continues in on similar terms, albeit on an alternative, prescribed basis (the "**bespoke scenario**").

It is outside the remit of this Report to consider the possible scope and content of the bespoke scenario described above. This would be subject to negotiation and depend on the willingness of the parties to negotiate an arrangement that has not previously existed, whereby the EU treats the UK as a quasi-Member State, whose rights and obligations under the EU Treaties are prescribed by the terms of an agreement sitting outside the scope of EU law.

A2.4 To what extent can individual Member States conclude or negotiate their own agreements with third countries?

Under the EUCCP, only the EU can adopt international agreements with third countries in the area of external trade. This is to ensure that the integrity of the Customs Union is not undermined by inconsistent agreements reached by the individual Member States. This has two important consequences for the UK both before and after its withdrawal.

Prior to the UK's withdrawal, the EU's exclusive competence over the EUCCP prevents the UK from entering into trade agreements with non-EU countries while it remains a Member State. The European Parliament has taken the view that, while it is a Member State, the UK is also unable to "*begin negotiations on possible trade agreements with third countries*".[23]

However, the EU Treaties do not prohibit the UK from engaging in discussions with non-EU countries prior to withdrawal. This would suggest that the UK is entitled to have exploratory talks on the terms of a possible trade agreement with other non-EU countries.

Post-withdrawal, the EUCCP will continue to prohibit the remaining Member States from seeking to enter into agreements on trade related issues with a post-withdrawal UK on an individual basis.

However, the UK will be able to engage in high-level strategic dialogue or partnerships with individual Member States as it is currently able to do with non-EU countries. The UK, as a Member State, has lawfully engaged in this type of dialogue with third countries such as China. A strategic partnership of this nature would, for example, allow the UK to agree to mutual commitments to participate in international financial regulatory fora at the G20 level or to provide for information sharing between the countries' financial regulatory authorities. Such arrangements could not go as far as offering binding commitments in respect of trade, such as the removal of the need for each party's firms to obtain regulatory authorisation to access the other party's markets.

A2.5 Different categories of international agreements concluded by the EU

There are various different categories or models of agreement that the EU concludes with third countries and international organisations, depending on the nature of the third country party and the objectives of the agreement:

A2.5.1 FTAs

The legal basis for FTAs is Article 207 TFEU and these agreements deal solely with trade relations – for example, the agreements concluded with South Korea or Canada.

A2.5.2 Partnership and Co-operation Agreement ("PCAs")

The legal basis of these agreements is Articles 207, 209 and 212 TFEU. PCAs have been reached with Russia and countries of Eastern Europe, the Southern Caucasus and Central Asia. The EU states that the aim of PCAs is to strengthen "*democracies and develop their economies through co-operation in a wide range of areas and through political dialogue*." PCAs provide for both economic co-operation and political dialogue but tend to be aspirational in nature, covering commitments to the rule of law and human rights, and do not generally provide for a high degree of economic integration.

A2.5.3 Associations Agreements ("AAs") and Deep and Comprehensive Free Trade Agreements ("DCFTAs")

The legal basis for these agreements is Article 217 TFEU. AAs provide for both political and economic integration and have been used as a precursor to accession for EU membership for the third country, with the agreement providing for the implementation of the various accession criteria. In particular, the EU has adopted this approach towards the Eastern European states of Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine as part of its Eastern Partnership initiative. The EEA Agreement concluded with Iceland, Liechtenstein and Norway is also an AA.

There is no difference in the legal process for the negotiation and conclusion of the different categories of agreement other than AAs always requiring unanimous approval by the Council. The types of agreement can instead be distinguished on the basis of their content and on the nature of the third country partner.

AAs have been mooted as a potential option for the future EU/UK relationship. On 5 April 2017, the European Parliament voted to adopt a resolution on negotiations with the UK that suggested that an AA under Article 217 TFEU could "*provide an appropriate framework for such a future relationship*".

AAs provide for closer political and economic co-operation of a nature which falls outside EU exclusive competence, and therefore requires unanimous agreement by the Member States. The CJEU has described AAs as agreements "*creating special, privileged links with a non-member country which must, at least to a certain extent, take part in the Community system*". It identified the special nature of AAs as being agreements that relate to areas in respect of which the Treaties provide a legal basis for internal action, e.g. freedom of movement.

AAs reached by the EU with its "close neighbours", Ukraine, Georgia and Moldova, which entered into force in 2016, contain so-called DCFTAs which establish free trade areas and an agreement with the UK could provide for a similar arrangement.

DCFTAs aim to facilitate more extensive economic integration. For example, the Commission states that, "*unlike classical FTAs", the EU-Ukraine DCFTA provides for "both the freedom of establishment in services and non-services sectors, subject to limited reservations, and the expansion of the internal market for a set of key services sectors once Ukraine effectively implements the EU-acquis*."

These 2016 AAs provide for the third country partner's inclusion in the single market in respect of three of the four fundamental freedoms (free movement of goods, service and capital, but not people). With regard to the mobility of people, the Ukraine agreement, for example, has an eventual objective of a visa-free travel regime but this is subject to Ukraine's implement of a "Visa Liberalisation Action Plan" which requires the satisfaction of various conditions such as the introduction of laws to prohibit discrimination on the basis of sexual orientation.

The EU-Ukraine DCFTA, which forms part of the broader AA, is also accompanied by a process of legislative approximation in financial services and other service sectors. In respect of financial services, the AA provides for reciprocal "internal market treatment" to be granted once EU has determined, after a monitoring procedure, that the Ukraine has successfully implemented EU financial regulation.

This internal market treatment would allow for freedom of establishment and freedom to provide services in the other party's territory and put in place non-discrimination

obligations. However, during the period of Ukraine's implementation of EU rules, both the EU and Ukraine have tabled significant reservations in a range several service sectors, including financial services, which provide exceptions to the equal treatment requirements.

The approach adopted in the Ukraine agreement suggests that equivalent regulatory standards, as the EU and UK will have post-Brexit, should allow for deeper economic integration. There are, however, differences between the position of the UK and that of Ukraine.

ANNEX 3

COMMONLY USED CONCEPTS IN FTAS AND EXAMPLES FROM EXISTING AGREEMENTS

A3.1 EU trade agreements: the EU-Canada CETA and the EU-US TTIP negotiations

This section focuses on the CETA, which is both the EU's most recent major trade agreement and its most wide-ranging FTA with an OECD partner. It also considers the content of the TTIP negotiating texts exchanged between the EU and the US, and in particular the EU proposal as last published by the Commission in July 2015.

After more than five years of negotiations, the EU and Canada signed the CETA on 30 October 2016. The European Parliament approved the CETA on 15 February 2017. The EU has decided that the provisional application of the CETA will not include certain provisions relating to investment, certain provisions of the Financial Services chapter to the extent that they concern portfolio investment or the resolution of investment disputes, as well as the chapters pertaining to trade and sustainable development, labour and environment and certain provisions on administrative matters. The provisional application of the CETA is expected later this year and on the first day of the month following the date of notification of both parties on the completion of their respective procedures for provisional application. The CETA will enter into full force once it has been approved by the EU and its Member States in accordance to their constitutional requirements, as it constitutes a "mixed" agreement.

References to the CETA in this Report are to the signed text.

After 4 years and the conclusion of 15 rounds of negotiations, the TTIP negotiations were suspended on 20 January 2017. References to TTIP in this Report are to the last official text proposal on services (including financial services) published by the EU in July 2015,[24] as well as to the EU latest financial services offer published in July 2016.[25]

The CETA presents a good reference as the most recent example of an EU trade agreement with a developed country. TTIP is instructive to review because of the similarity between the US and UK financial services markets. Both the US and UK have strong financial services seeking the widest possible access to the EU market. Canada's financial services sector is less prominent and therefore ranked lower in the CETA negotiations.[26]

A3.2 Trade in Services Agreement ("TiSA")

A recent pluri-lateral initiative to further liberalise trade in services is the TiSA. The agreement involves the EU and its Member States and Australia, Canada, Chile, Chinese Taipei, Colombia, Costa Rica, Hong Kong China, Iceland, Israel, Japan, Korea, Liechtenstein, Mauritius, Mexico, New Zealand, Norway, Pakistan, Panama, Peru, Switzerland, Turkey and the United States, representing approximately 70% of the world services exports. Negotiations started in 2013 and 21 negotiating rounds have taken place. No formal deadline for the conclusion of the negotiations has been set.

TiSA aims at facilitating trade in services by tackling existing barriers, including discriminatory rules. The agreement is based on the GATS. It will include a core text, Schedules of Commitments of the Parties and a series of Annexes containing additional sector-specific rules. TiSA will include both general and specific obligations for its Members, namely MFN, market access and national treatment obligations.

TiSA will cover areas such as transparency, domestic regulation, e-commerce, localisation requirements (mostly relevant for Mode 3), temporary entry and stay of high-skilled

professionals (Mode 4), with chapters on services including air, maritime and road transport services, delivery services, financial services, and telecommunications.

In July 2014, the EU proposed a draft text for the TiSA,[27] as well as a draft Annex on Financial Services.[28] The EU's proposed specific commitments on financial services are listed in the EU draft Schedules. The EU proposal in Article 7 of its draft Annex on Financial Services also includes limited commitments on market access for modes 1 and 2 services (cross-border trade) that would permit non-resident suppliers to supply a narrow range of financial services, including (a) insurance of risks relating to maritime shipping and commercial aviation, (b) reinsurance and retrocession, (c) auxiliary services, (d) provision and transfer of financial information and data processing and (e) advisory and other auxiliary services. Article 8 of the EU's draft Annex on Financial Services provides for market access in mode 3 supply of financial services, that is, allowing foreign financial suppliers the right to establish and expand their commercial presence within its territory, though the host State maintains the right to impose an authorisation requirement. The EU's proposed horizontal commitments and Article 9 of the EU's draft Annex on Financial Services address conditions relevant to mode 4 supply (entry of personnel).

A3.3 Key financial services definitions used by the EU in FTA negotiations

Definitions are crucial in delineating the coverage of an FTA and can often be a matter of prolonged discussions during negotiations. It follows that the specific definitions used in a prior EU FTA are a product of negotiations between the parties and so offer only indicative guidance as to the definitions that might be used in the EU/UK Agreement.

This section analyses the financial services definitions used in the CETA and in the TTIP negotiations respectively. The basis of reference will be the EU proposal on TTIP, with comparisons with the CETA where appropriate. References to TTIP are made on the basis of EU latest public proposal and as a product under negotiation.[29]

A3.3.1 Financial services

"Financial services" is defined in EU FTAs as "a service of a financial nature" that is provided by a financial services supplier, namely a natural or juridical person that seeks to provide such services (the EU prefers not to use the term "financial institution", which is both more limited and used with specific connotations in the domestic law of trade partners). Based on the definition in Article 5 of the GATS Annex on Financial Services, the main sub-sectors of financial services are insurance and related services and banking and other financial services, which includes capital market instruments and services.

(a). Insurance

In the insurance sector both the CETA and EU's proposal for TTIP include:

(iii). direct insurance, including co-insurance for life and non-life;

(iv). reinsurance and retrocession;

(v). insurance intermediation, such as brokerage and agency; and

(vi). services auxiliary to insurance – such as consultancy, actuarial, risk assessment and claim settlement services.

(b). Banking and other financial services

This sub-sector includes both banking and capital market services. Services of this category covered in EU's trade agreements include:

(i). the acceptance of deposits and other repayable funds from the public

(ii). lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transactions;

(iii). financial leasing

(iv). all payment and money transmission services, including credit, charge and debit cards, traveller's cheques and banker's drafts;

(v). guarantees and commitments

(vi). trading of certain financial instruments, done for own account or for customers' account, whether on an exchange, in an over-the-counter market or otherwise. Such trading includes the following instruments: (A) money market instruments, including cheques, bills or certificates of deposits, (B) foreign exchange, (C) derivative products, including futures and options, (D) exchange rate and interest rate instruments, including products like swaps and forward rate agreements, (E) transferable securities and (F) other negotiable instruments and financial assets, including bullion;

(vii). the participation in issues of all kinds of securities, which also covers underwriting and placement as agent, publicly or privately, and supply of related services;

(viii). money broking;

(ix). asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial, depository and trust services;

(x). the settlement and clearing services for financial assets, including securities, derivative products and other negotiable instruments,

(xi). the provision and transfer of financial information and financial data processing and related software; and

(xii). advisory, intermediation and other auxiliary financial services on all the above categories, including credit reference and analysis, investment and portfolio research and advice and advice on acquisitions and on corporate restructuring and strategy.

A3.3.2 Cross-border supply of financial services

Under EU's FTAs, the supply of financial services may be done either from the territory of a Party into the territory of the other Party or in the territory of a Party to the service consumer or a person of the other Party. In the CETA, it is further clarified that the second mode of supply of financial services does not include the supply of a service in the territory of a Party by an investment in that territory.

A3.3.3 Financial service supplier

A financial service supplier is a person, either natural or juridical, that is engaged in the business of supplying or seeks to supply a financial service within the territory of the

other Party. A supplier of financial services cannot be a public entity.[30]

Relevant to the issue of suppliers and investment in the form of loans and debt instruments, as will be explained below, is the definition of 'financial institution', which appears in the CETA. A financial institution is a supplier of financial services as defined in the agreement, if it is "*regulated or supervised in respect of the supply of those services as a financial institution under the law of the Party in whose territory it is located, including a branch in the territory of the Party of that financial service supplier whose head offices are located in the territory of the other Party*".

A financial institution of the other Party means a financial institution, including a branch that is located in the territory of a Party and is controlled by a person of the other Party.

A3.3.4 Investment and investor

The establishment and operation of investments in the territory of the other Party is closely connected with the cross-border supply of financial services.

In general, investment is a term defined in a very broad way, so as to encompass "every kind of asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment, which includes a certain duration and other characteristics such as the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk."

Investments may take several forms, and include forms like an enterprise, shares, stocks and other forms of equity participation in an enterprise, bonds, debentures and other debt instruments of an enterprise, loans, interests arising from concessions, turnkey, construction, production or revenue-sharing and similar contracts, intellectual property rights, moveable or immovable property and claims to money or to performance under a contract.

For the purposes of the financial services chapter, the CETA makes further clarifications with regard to loans and debt instruments as forms of investment. In particular, it is stated that "a loan to or debt instrument issued by a financial institution is an investment in that financial institution only if it is treated as regulatory capital by the Party in whose territory the financial institution is located." On the other hand, "a loan granted by or debt instrument owned by a financial institution, other than a loan to or debt instrument of a financial institution referred to in subparagraph (a), is not an investment".

In relation to loans and debt instruments, the position under the CETA is as follows: the Investment Chapter applies to a loan or debt instrument as long as it is not covered in the Financial Services Chapter. Moreover, "a loan granted by or a debt instrument owned by a cross-border financial service supplier, other than a loan to or debt instrument issued by a financial institution, is an investment for the purposes of the Investment Chapter if that loan or debt instrument meets the criteria for investments set out in Article 8.1".

An investor is a person, natural or juridical, who seeks to make, is making or has made an investment in the territory of the other Party.

A3.4 PCO

FTAs commonly contain a PCO, i.e. the ability for a Party – where justified by prudential reasons – to introduce measures which would otherwise have put the party in breach of the FTA

The list of "prudential reasons" is usually stated to be non-exhaustive, but among the examples given in existing FTAs are measures taken:

(a). for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier;

(b). to ensure the integrity and stability of the financial system; and

(c). for the maintenance of the safety, soundness, integrity, or financial responsibility of a financial institution, cross-border financial service supplier, or financial service supplier.

A3.5 Investor-state dispute settlement

FTAs with an investment chapter and bilateral and multi-lateral investment treaties typically contain an ISDS mechanism. An ISDS mechanism allows investors from one contracting state to bring claims against the national governments of other contracting states[31] for alleged breaches of substantive obligations assumed by contracting states under a treaty with respect to investments of foreign investors.

Typically, an ISDS mechanism requires that an investor notifies the host government of the existence of a dispute and invites the government to resolve the dispute amicably. If the dispute is not resolved amicably in a prescribed period of time (typically three to twelve months), the investor may request that the dispute is resolved by a body specified in the treaty, usually by an arbitral tribunal. Typically, an arbitral tribunal is composed of three arbitrators: one appointed by an investor, one by the contracting state, and one by the co-arbitrators, or, if the co-arbitrators cannot come to an agreement, by an appointing authority. The remedy for breach of an investment protection guarantee under an investment treaty will typically consist of monetary compensation. An award issued by an arbitral tribunal is final and binding on the parties to the dispute.

Almost all of the approximately one hundred bilateral investment treaties concluded by the UK contain some form of ISDS mechanism. ISDS mechanisms have also been included in FTAs negotiated by the EU. For example, Section B of Chapter Nine (Investment) of the EU-Singapore FTA provides for an ISDS mechanism, whereby a dispute, if not resolved amicably through negotiations, and not settled within three months of the submission of the request for consultations, may be submitted to arbitration under the auspices of the International Centre for Settlement of Investment Disputes, an arbitral tribunal established in accordance with the arbitration rules of the United Nations Commission on International Trade Law, or any other arbitral institution or under any other arbitration rules if the disputing parties so agree.

In the White Paper, the UK underscores the importance of establishing dispute resolution mechanism ensuring a single understanding, both in terms of interpretation and application of the EU/UK Agreement.[32] Such a mechanism should also be available for investor-state disputes.

A3.5.1 Current landscape regarding ISDS

The starting point for an analysis of ISDS provisions which may act as a constraint or assist with a future EU/UK Agreement are bilateral investment treaties ("**BITs**") concluded by the UK with other Member States.

There are twelve BITs in force between the UK and another Member State, that is: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland,

Romania, Slovakia, and Slovenia.[33] All of these intra-EU BITs were concluded with Member States that joined the EU in 2004 or thereafter. Conversely, there are no BITs between the UK and the other fifteen Member States.

A3.5.2 ISDS provisions in existing UK investment treaties which act as a constraint upon a future agreement

Given that there are BITs in force between the UK with some, but not all, Member States, the question is what would be the impact of the EU/UK Agreement including an ISDS mechanism:

(a). Where there is a BIT between the UK and a Member State

In cases where there is a BIT between the UK and a Member State, the question is whether these BITs will remain in force once the EU/UK Agreement is concluded or whether they will be terminated. The issue of treaty termination is governed by BITs themselves and the VCLT. One question would be whether the UK and the Member States with whom the UK concluded the BITs would be interested in terminating the existing BITs. From a UK perspective, this does not seem to be very likely because the UK is more likely to have an interest in having these BITs with Member States in place. From the perspective of the Member States that have a BIT in force with the UK, this seems more likely as they are more likely to face claims by UK investors than vice versa. Another question is whether and what impact such a termination would have on "sunset clauses" contained in most BITs, which stipulate that a treaty will continue to be effective for a further period from the date of the termination in respect of investments made before that date.

Given the potentially overlapping scope of the BITs and the chapter on investment to be included in the EU/UK Agreement, under Article 59 of the VCLT BITs between the UK and Member States could be considered as terminated due to a conclusion of a "later treaty relating to the same subject-matter" if it appears from the EU/UK Agreement or is otherwise established that the UK and the Member States intended that the matter should be governed by that treaty. One question would be whether and to what extent the BITs and the EU/UK Agreement will relate to the same subject matter. Another question would be whether the parties would stipulate that the EU/UK Agreement should "replace" the BITs between the UK and Member States. In principle, the advantage of having the UK's existing BITs with Member States replaced by virtue of the EU/UK Agreement is that that will be a level playing field such that there would be investment protection for UK investors in all Member States and for all Member States investors in the UK.

(b). Where there is no BIT between the UK and a Member State

Where there is no BIT between the UK and a Member State, the EU/UK Agreement would establish investment protection and allow UK investors to bring claims against the EU and all Member States, as appropriate, which is currently not available. Conversely, it would also expose the UK to similar claims brought by nationals of all Member States.

The issue of BITs between the UK and Member States should be carefully considered in the light of a potential inclusion of an investment chapter to the EU/UK Agreement. The EU may be interested in levelling the playing field by having the same investment protections and ISDS mechanism available to nationals of all Member States with respect to investing in the UK. An example of a solution of this issue is included in the CETA (please see below).

Depending on the provisions negotiated in the EU/UK Agreement, the UK may consider whether it would be beneficial for its nationals investing in Member States with whom the UK concluded BITs to still be able to rely on these BITs.

A3.5.3 ISDS provisions in existing UK investment treaties which might assist with a future agreement

It is difficult to identify provisions in existing UK investment treaties which might assist with a future agreement.

It is worth noting that Article 30.8 of Chapter Thirty (Final Provisions) of the CETA on termination, suspension or incorporation of other existing agreements stipulates that BITs between Canada and Member States listed in Annex 30-A[34] shall cease to have effect, and shall be replaced and superseded by the CETA with termination taking effect from the date of entry into force of the CETA. It further provides that a claim may be submitted under a BIT listed in Annex 30-A in accordance with the rules and procedures established in the BIT if: (a) the treatment that is object of the claim was accorded when the BIT was not suspended or terminated; and (b) no more than three years have elapsed since the date of suspension or termination of the BIT.

Similar provisions are included in the EU-Vietnam FTA (Article 20 of Section 2 of Chapter II of Chapter Eight) and the EU-Singapore FTA (Article 9.10 of Section A of Chapter Nine).

These provisions may be indicative of the EU's preference to level the playing field between its counterpart (such as Canada or – in future – the UK) and Member States with respect to protection of investment and ISDS mechanisms.

A3.5.4 Investor-state dispute resolution under the EU/UK Agreement

In the context of citizen's rights, the EU has said that it wants to ensure that such rights are "directly enforceable" – which tends to suggest that this aspect of the withdrawal agreement may be enforceable in the EU/UK domestic courts. Could something similar be agreed in the context of financial services?

(a). Investment Court System ("ICS")

In recent years, partly as a result of criticism of various aspects of ISDS, certain changes have been proposed. In particular, the EU suggested establishing an ICS. Unlike ISDS, the ICS is conceived as an institutionalised investment dispute resolution system with permanent tribunals (a first instance body and an appellate body), both comprised of permanent adjudicators (rather than arbitrators appointed for a particular case). The ICS was included in the CETA and the EU-Vietnam FTA, and was proposed by the EU to the US in the course of the TTIP negotiations.

Section F of Chapter 8 of the CETA establishes the Tribunal and the Appellate Tribunal, both comprised of permanent Members appointed by the CETA Joint Committee. There shall be fifteen Members of the Tribunal, five of whom shall be nationals of a Member State, five shall be nationals of Canada, and five shall be nationals of third countries. An investor-state dispute shall be resolved by a division of the Tribunal appointed on a rotation basis by the President of the Tribunal from the Members. An award issued by a division of the Tribunal shall be binding unless successfully appealed to the Appellate Tribunal.

Similar provisions are contained in Section 3 of Chapter 8 of the EU-Vietnam

FTA. In addition, Article 15 provides for an option to negotiate a multi-lateral investment tribunal. This indicates the interest of the EU in setting up a single multi-lateral investment tribunal, which would hear disputes under various agreements concluded by the EU.

Although the ICS is a recent concept, the EU seems to favour it as its preferred system for investor-state dispute resolution, potentially subsequently multi-lateralised to encompass more than individual FTAs. It may be the EU's preference in its negotiations with the UK. It remains to be seen what the UK's view on this proposal would be though it is possible at least that the UK may favour the traditional ISDS mechanism. One risk is that the ICS has not yet been implemented and relied on, so there is uncertainty as to its functioning. On the other hand, the fact that the ICS is a novel idea may leave room for further improvements that could be accommodated in the EU/UK Agreement. In any case, the inclusion of the ICS by the EU in its recently negotiated FTAs indicates the willingness of the EU to agree to be bound by third party determination.

(b). Interpretative bodies

One of the criticisms of ISDS is that international arbitral practice is not consistent in interpreting identical or similar standards of protection contained in investment treaties.

A solution may be for the EU/UK Agreement to establish an independent body responsible for issuing interpretations of the terms of the agreement that are binding on the ISDS tribunal provided for under the agreement's Investment Chapter. The ISDS tribunal would then have to decide individual cases on the basis of these interpretations.

One example of such a body is the FTC. It was established by Article 2001 of NAFTA and it is composed of cabinet level representatives of the NAFTA parties or their designees. The FTC has the power to supervise implementation of NAFTA, oversee its further elaboration, and resolve disputes that may arise regarding its interpretation or application. Pursuant to Article 1131(2) of NAFTA, interpretations issued by the FTC shall be binding upon arbitral tribunals resolving investor-state disputes under the NAFTA. To date, the FTC has issued Notes of Interpretation with respect to Access to Documents and Minimum Standard of Treatment in Accordance with International Law (31 July 2001).[35]

The CETA establishes the CETA Joint Committee comprising representatives of the EU and Canada. Pursuant to Article 26.1(5)(e) of the CETA, the CETA Joint Committee may adopt interpretations of the provisions of the CETA, which shall be binding on tribunals established under Section F of Chapter Eight (Resolution of investment disputes between investors and states) and Chapter Twenty-Nine (Dispute Settlement) of the CETA. Article 8.31(3) stipulates that such interpretations may be adopted where serious concerns arise as regards matters of interpretation which may affect investment.

Importantly from the perspective of financial services, the Committee on Services and Investment acting under the auspices of the CETA Joint Committee may, at the request of a party, or upon a reference from the relevant specialised committee, or when preparing a discussion in the CETA Joint Committee, also address matters arising in the area of financial services if this facilitates the resolution of a matter that cannot otherwise be resolved by the relevant

specialised committee (Article 26.2(1)(b) of the CETA). Prior to signing the CETA, the Council of the EU issued a Joint Interpretative Instrument for endorsement by the Permanent Representatives' Committee to be made at the moment of signature, which also addressed certain issues pertaining to investment protection. [36]

Similar provisions are contained in Chapter 17 of the EU-Vietnam FTA (establishing the Trade Committee comprising representatives of the EU and Vietnam) and in Article 17.4(d) of the EU-Singapore FTA.

It may be in the interest of the UK to agree to the establishment of such a body (likely comprising representatives of EU and UK), which would be empowered to make binding interpretations regarding the EU/UK Agreement.

The nature of any ISDS arrangement may also depend on whether retail clients will be able to have recourse to it. If they do, the ISDS provisions may need to be more rigorous and more carefully defined.

A3.6 Positive and negative lists

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

A3.6.1 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.

A3.6.2 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.

A3.6.3 The position under existing FTAs

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 operates on the basis of a negative list – albeit that CETA does not itself offer substantial commitments in relation to financial services.

A3.7. EU financial services commitments under the CETA

The CETA commitments on financial services do not follow the GATS model. There is no single schedule of commitments setting out the four modes. Rather, Chapter 13 of the CETA sets out the rules governing financial services as a whole. In addition, the scope of application of Mode 1 is further defined by Annex 13-A: Cross-Border Trade in Financial Services. Annexes I and II set out the EU reservations on services, including financial services.

(a). Mode 1

The main restriction when operating under Mode 1 is that the scope of application of commitments is limited greatly by Annex 13-A, which sets out the type of services to which the commitments are applicable. These are credit reference and analysis, investment and portfolio research and advice, and advice on acquisitions and on corporate restructuring and strategy.

The sectors to which the commitments are applicable, as defined in Annex 13-A, generally enjoy wide commitments on National Treatment, Formal Requirements and Market Access under Article 13.7. However, the Member States' reservations, as listed in Annexes I and II, limit Market Access or National Treatment.

(b). Mode 2

Article 13.7.6, provides that residents and nationals of the EU are permitted to purchase financial services from financial services suppliers in Canada. However, this does not entitle suppliers to do business or solicit in the territory of the other party.

As opposed to the GATS commitments under Mode 2, the list of services that can be purchased by EU persons in Canada is not limited.

The commitments granted by Article 13.7.6 might be limited in certain situations by the Member States' reservations listed in Annexes I and II.

(c). Mode 3

Article 13.6 establishes wide rights with respect to market access through establishment. It prevents the EU from imposing limitations on the number of Canadian financial providers (even in the form of monopolies or economic needs tests); the total value of financial service transactions or assets; limits to the maximum foreign capital participation or persons employed; or the requirement of specific types of legal entity or joint venture through which a financial service supplier may perform an economic activity. However, same as for Module 2, these wide rights are subject to the limitations established by Member States' commitments in Annexes I and II.

(d). Mode 4

Chapter 10 sets out the rules for the entry and stay of natural persons for business purposes. In broad terms, the temporary entry for business purposes of natural persons is permitted if they comply with the EU immigration measures applicable to temporary entry. In addition, Chapter 10 allows the temporary entry and stay of key personnel, contractual services suppliers, independent professionals, and short-term business visitors subject to some limitations in Annexes 10-B and 10-E.

A3.8 EU financial services offer in TTIP

The EU offer on financial services reviewed for the purpose of this analysis is set out in two documents: (i) the EU proposal for services, investment and e-commerce text ("**Proposal**"), which was tabled for discussion with the US in the negotiating round of 12 -17 July 2015; and (ii) the EU Offer, which was tabled for discussion with the US in the negotiating round of 11-15 July 2016 (the "**Offer**").

(a). Mode 1 and 2

Chapter 3 of the Proposal sets out broad Market Access, National Treatment and Most-Favoured Nation clauses for the cross-border supply of services between the EU and the US, including financial services. These broad provisions are however limited by the reservations formulated in the Offer. For example, commitments relating to banking and other financial services market access are also limited except for provision of financial information and financial data processing and for advisory and other auxiliary services excluding intermediation.

National treatment is limited to the provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services; and advisory and other auxiliary financial services including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy, but excluding intermediation.

(b). Mode 3

Chapter II (Section 1) of the Proposal provides rights on Market Access, National Treatment and Most-Favoured Nation on investment, which set out the rules for the provision of services under Mode 3. These rights are also limited by the reservations in the Offer.

First, the Offer provides that non-discriminatory requirements of form of juridical person may apply. In the field of banking and other financial services, only firms having their registered office in the EU can act as depositories of the assets of investment funds. The establishment of a specialised management company, having its head office and registered office in the same Member State of the EU, is required to perform the activities of management of unit trusts and investment companies. Additional limitations are set out by Member States – for example, the management of pension funds in Portugal.

(c). Mode 4

Chapter IV of the Proposal set out the rules for the entry and temporary stay in their territories of categories of natural persons for business purposes. These rules allow for the granting of access to several types of professionals, including Intra-corporate Transferees, Business Visitors; Service sellers and Services Salespersons; and Contractual Service Suppliers, Fashion Models and Speciality Occupations.

These commitments are, however, limited by the derogations in the Offer.
As an example, residency is required for financial salesmen in Italy and Poland reserves its right to establish nationality requirements for at least one of the bank executives.

ANNEX 4 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

ENDNOTES

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).

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

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

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

5 MiFIR formally incorporates an outcomes based approach, stating that any assessment "should assess to what extent the respective third country regulatory and supervisory framework achieves similar and adequate regulatory effects and to what extent it meets the same objectives as Union law."

6 See http://www.efta.int/eea/eea-agreement/eea-basic-features#15. The Joint Committee operates by consensus to exchange views and agree on incorporating EU laws with EEA relevance into the EEA Agreement. It typically meets six to eight times a year. The EEA Joint Committee comprises the ambassadors of the EEA EFTA States and representatives from the European External Action Service. Whenever an EEA-relevant legal act is amended or a new one adopted by the EU, a corresponding amendment needs to be made to the relevant Annex of the EEA Agreement to maintain the principle of homogeneity of the EEA. The amendment to the EEA Agreement should be taken as closely as possible to the adopted legislation on the EU side, with a view to permitting simultaneous application in the Community and in the EEA EFTA States. The preparatory work for EEA Joint Decisions is the responsibility of the EFTA subcommittees and working groups in which representatives of the EEA EFTA States are present. The EEA Joint Committee makes the decision to incorporate Joint Decisions into the EEA Agreement. The EEA Joint Committee therefore plays a key role in the EEA decision-making procedure. Recent decisions can be found here The EEA Joint Committee therefore plays a key role in the EEA decision-making procedure.

7 Under the SSM Regulation and the SSM Framework Regulation, a bank is considered "significant" by reference to a number of criteria, namely:

- size: the total value of its assets exceeds €30 billion;
- economic importance: for the specific country or the EU economy as a whole;
- cross-border activities: the total value of its assets exceeds €5 billion and the ratio of its cross-border assets/liabilities in more than one other participating Member State to its total assets/liabilities is above 20%; and
- direct public financial assistance: it has requested or received funding from the European Stability Mechanism or the European Financial Stability Facility.
  A supervised bank can also be considered significant if it is one of the three most significant banks established in a particular country.

8 https://www.esma.europa.eu/press-news/esma-news/steven-maijoors-address-alde-seminar-review-european-supervisory-authorities

9 EBA Report on the functioning of supervisory colleges in 2016: see Report.

10 A notable exception to this general principle is the provision under MiFID II which provides a framework for the authorisation of branches of third country firms. Even in this situation, however, the question of whether to allow authorisation remains at the discretion of Member States.

11 https://www.esma.europa.eu/file/22278/download?token=Itu5XwcE

12 https://www.eba.europa.eu/documents/10180/746034/EBA-CP-2014-12+%28CP+on+draft+RTS+and+ITS+on+Colleges+of+Supervisors%29.pdf

13 http://www.iosco.org/library/pubdocs/pdf/IOSCOPD322.pdf

14 See article: "A Roadmap to a Deep and Special Partnership" by Michael-James Clifton. See also https://www.instituteforgovernment.org.uk/sites/default/files/publications/IfG_Brexit_Euro_Court_Justice_WEB.pdf and Baudenbacher, C., 'After Brexit: Is the EEA an option for the United Kingdom?', 42nd Annual Lecture of the Centre for European Law, King's College London, 13 October 2016, transcript retrieved 15 June 2017, www.kcl.ac.uk/law/tli/about/Baudenbacher-Kings-College-13-10-16.pdf.

15 Investments are generally defined very broadly in FTAs and investment treaties. For example, Article 8.1 of the CETA defines an investment an "every kind of asset" under direct or indirect control of an investor and sets out a non-exhaustive list of investments including shares, stocks and other forms of equity participation in an enterprise, bonds, debentures and other debt instruments of an enterprise and loans to an enterprise.

16 European Commission, Trade In Services By Gats Modes Of Supply: Statistical Concepts And First EU Estimates, Chief Economist Note, Issue 3, November 2016, p.16: http://trade.ec.europa.eu/doclib/docs/2016/december/tradoc_155119.pdf.

17 Eurostat data for 2013, available at http://ec.europa.eu/eurostat/statistics-explained/index.php/Services_trade_statistics_by_modes_of_supply

18 This sub-sector covers acceptance of deposits and other repayable funds from the public; lending of all types, including among others consumer credit, mortgage credit, factoring and financing of commercial transaction; financial leasing; all payment and money transmission services; guarantees and commitments; trading for own account or for account of customers on an exchange, in an over-the-counter market or otherwise money market instruments (cheques, bills, certificate of deposits etc), foreign exchange, derivative products including futures and options, exchange rate and interest rate instruments including products such as swaps, forward rate agreements etc, transferable securities or other negotiable instruments and financial assets including bullion; participation in issues of all kinds of securities, including under-writing and placement as agent (whether publicly or privately) and provision of related services; money broking; asset management, such as portfolio management, all forms of collective investment management, pension fund management, custodial depository and trust services; settlement and clearing for financial assets, including securities, derivative products and other negotiable instruments; advisory and other auxiliary financial services in all the activities listed in Article 1B of MTN.TNC/W/50, incl. credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy; provision and transfer of financial information, and financial data processing and related software by providers of other financial services.

19 We note that the EU institutions seeking provisionally to apply provisions of mixed agreements pending ratification has been criticised by Member States. In particular, the Commission's proposal for the provision of certain provisions of the CETA was highly controversial. It cannot be ruled out that the provisional application of the EU's exclusive competence of the EU/UK Agreement could be subject to considerable political debate among the Member States.

20 It remains a point of debate between the Council and the Commission as to whether the EU's competence to enter into international agreements is limited to the extent to which the EU has exercised its shared competence by adopting common rules in a particular policy area: in other words, whether the EU can only act externally in areas of shared competence where it has already adopted common internal rules. See, in particular, a recent Advisory Opinion on this issue by Advocate General Szpunar in Case C-600/14 Germany v Council ECLI:EU:C:2017:296, par. 122-134.

21 The present set of Negotiating Directives is intended for the first phase of the negotiations. In line with the aim established for the first phase of the negotiations by the European Council, these Negotiating Directives prioritise some matters which, at this stage, have been identified as necessary to ensure an orderly withdrawal of the UK from the EU. The Negotiating Directives state (at paragraph 31) that other matters, such as services, where there may be a need to reduce uncertainty or avoid a legal vacuum, will be covered by subsequent sets of negotiating directives.

22 Although the withdrawal of the UK from the EU is not dependent on the successful conclusion of a withdrawal agreement, this Report does not consider the legal position in circumstances where the UK ceases to be a Member State without having entered into a withdrawal agreement under Article 50.

23 http://www.europarl.europa.eu/news/en/news-room/20170329IPR69014/brexit-meps-set-out-conditions-for-approving-uk-withdrawal-agreement

24 The last official version is available at http://trade.ec.europa.eu/doclib/docs/2015/july/tradoc_153669.pdf

25 The last public official offer on financial services is available at http://trade.ec.europa.eu/doclib/docs/2016/july/tradoc_154794.pdf

26 See World Economic Forum, The Global Competitiveness Report 2016-2017, 28 September 2016, available here: https://www.weforum.org/reports/the-global-competitiveness-report-2016-2017-1 (accessed on 11/05/2017).

27 The July 2014 draft text is at http://trade.ec.europa.eu/doclib/docs/2014/july/tradoc_152687.pdf (accessed 11 May 2017).

28 The July 2014 draft Annex is at http://trade.ec.europa.eu/doclib/docs/2014/july/tradoc_152688.pdf (accessed 11 May 2017).

29 EU's proposals on text and offers can be found here: http://trade.ec.europa.eu/doclib/press/index.cfm?id=1230 (access on 10/05/2017).

30 Public entities are defined, in EU's trade agreements, as encompassing two main categories of entities: (i) governments, central banks or the monetary authorities of a Party or any entity owned or controlled by a Party that is principally engaged in carrying out governmental functions or activities for governmental purposes (but not including an entity principally engaged in supplying financial services on commercial terms) and (ii) private entities that perform functions normally performed by a central bank or monetary authority when exercising those functions.

31 Regulation (EU) No 912/2014 of the European Parliament and of the Council of 23 July 2014 establishing a framework for managing financial responsibility linked to investor-to-state dispute settlement tribunals established by international agreements to which the European Union is party regulates the questions of whether the EU or a Member State should act as respondent and who should bear the financial responsibility.

32 See the White Paper at paragraph 2.5.

33 Some of these Member States (Denmark, Poland, and Romania) have recently been reported to consider proceeding with termination of their intra-EU BITs.

34 Croatia, Czech Republic, Hungary, Latvia, Malta, Poland, Romania, and Slovak Republic.

35 Notes of Interpretation of Certain Chapter 11 Provisions (NAFTA Free Trade Commission, July 31, 2001), http://www.international.gc.ca/trade-agreements-accords-commerciaux/topics-domaines/disp-diff/NAFTA-Interpr.aspx?lang=eng

36 Joint Interpretative Instrument on the CETA between Canada and the European Union and its Member States, 27 October 2016, http://data.consilium.europa.eu/doc/document/ST-13541-2016-INIT/en/pdf

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:

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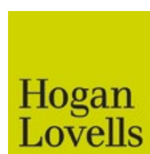
The IRSG would particularly like to thank Rachel Kent, Dominic Hill and the team at Hogan Lovells for their extensive work on this Report



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