

A New UK/EU Relationship in Financial Services – A Bilateral Regulatory Partnership

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A New UK/EU Relationship in Financial Services – A Bilateral Regulatory Partnership

The proposals in the UK Prime Minister's speech on 17th January and the White Paper on 2nd February will require a new construct for cross-border regulatory coordination between the EU and the UK, which will operate in a complex legal and regulatory environment (outside the EU/EEA single market). CMS and the Legatum Institute Special Trade Commission have produced a joint report which looks at how the new UK/EU partnership might work in the field of financial services. The report aims to move away from binary and simplistic discussion (such as 'passporting' versus 'equivalence') and to contribute to the development of a more informed consensus. The partnership concept that the report envisages is flexible to cater for all political outcomes and is highly negotiable. The report seeks to explain and illustrate the spectrum of possibilities, but it does not attempt to fix on detailed measures or on the priorities for each sub-sector/area of FS. We would like to acknowledge the contribution of various recent reports in this field¹ which have been very helpful in the writing of this report.

The key findings of the report are summarised below. A copy of the full report is being made available on the [RegZone](#).

Key findings

Avoiding confusion

The debate about Brexit and financial services has been confusing for the public and practitioners. Much of the jargon in use means different things to different people. Brexit will require a joint approach combining the practice and terminology of free trade negotiation on one side and the world of European financial services regulation on the other.

We have coined the expressions 'dual regulation coordination' (or 'DRC') and 'dual regulation barriers' (or 'DR barriers') to enable us to address cross-border supply (in the broadest possible sense) and to reference the broad variety of barriers from a host state regulatory regime and the measures used to coordinate dual regulation between home and host state (and thereby eliminate or reduce these barriers). We wanted to include all of these measures and not to use the language of any one example (such as 'passporting', 'substituted compliance', 'home state regulation/supervision', 'deference', 'mutual recognition' and so on). We also wanted to differentiate between the **measures themselves** (which are the objective/benefit to be achieved/agreed); and the **criteria or pre-conditions** for the application of such measures (such as findings of 'equivalence', 'comparable regulation', 'justification by quality of regulatory regimes', 'harmonisation' and so on).

We have referred to a 'DRC agreement' between the UK and EU to address DRC measures. This is intended as a neutral term but it could be described using other terminology such as treaty/accord, MRA or mutual recognition/bilateral/super equivalence.

The status quo – cross-border financial services under the WTO, single market and other regimes (Chapters 2 to 5)

Full host state regulation/dual regulation is a major barrier to cross-border/foreign operation

When FS firms seek to provide financial services from their home state into another country (the host state) or from within the host state, they face substantial barriers from the host state regulatory regime (DR barriers). In some cases these barriers **preclude cross-border modes of supply altogether**. A firm may require host state authorisation which is only possible if it establishes a local branch; a host state may refuse to authorise a branch and may require a local subsidiary to be used. In other cases, regulatory requirements may conflict making cross-border supply or international infrastructure impractical. Additional DR barriers are a mix of

¹ These include [Barnabas Reynolds/Politeia](#); [FSN Forum/Norton Rose Fulbright](#); [IRSG/Hogan Lovells](#).

financial barriers (ineffective use of capital and resources), operational difficulties (maintaining multiple entities, licences and compliance operations) and associated cost.

DRC measures remove or mitigate these DR barriers.

There are three policy parameters at play (forming a triple policy axis)

These are –

- Trade policy (i.e. external commercial policy), including WTO and the broader spectrum of open access versus protectionism
- Regulatory policy in financial services and its prudential objectives in terms of consumer and market protection and financial stability including the risks to the host state by incoming firms under DRC
- Competition aspects – the competitive dynamic of incoming firms and the impact of regulation on competition

These 3 policy perspectives are all at play and feature throughout the report.

Market access (in WTO/FTA terminology) is not the real or immediate priority for financial services – an agreement on DRC is required

Financial services firms, like other service providers, face 'behind the border barriers' to cross-border supply around the world. Outright discrimination against foreign firms (such as quantitative or economic limits) is one example of these barriers. Chapter 2 of the report analyses multilateral WTO/GATS obligations and modern FTA terms as they apply to financial services.

Modern free trade agreements (such as CETA and TPP) provide **market access** rights for financial services firms in many business lines and prohibit discrimination against foreign firms. However, they normally permit the host state to impose its regulation (such as requirements for local authorisation and capital) under WTO terms on 'national treatment' and the 'prudential carve-out'. Extensive mutual recognition has been limited to the goods sectors.

No FTA (with the EU or between other states) has involved significant DRC measures in financial services. Colloquially put, there has never been a real (i.e. substantive) free trade agreement in financial services.

Discussion of 'market access' rights in financial services (as used in WTO/FTA terminology) is to miss the point; after Brexit UK FS firms doing business with EU states and EU firms doing business with the UK will face substantial new DR barriers as dual regulation is re-imposed, unless DRC measures can be agreed. The conclusion of Chapter 2 is that the application of default WTO rules (i.e. the financial services commitments in the EU's WTO schedules) will not assist materially in this regard; nor would an EU/UK agreement based on the most advanced FTAs in the field (such as CETA). An agreement on DRC is required.

There is a broad spectrum of potential DRC arrangements

Chapters 3 to 5 of the Report look at the practicalities of FS cross-border business and the impact of dual regulation and DR barriers. This covers the 3 main modes of supply under the WTO/FTA regime – cross-border supply (mode 1), consumption abroad (mode 2) and commercial presence i.e. via a branch or subsidiary (mode 3). Chapter 4 looks at a range of different DRC arrangements both within the single market and elsewhere. The DRC options are far from binary – there is a broad spectrum of possibilities (in terms of what may be proposed and what may be agreed in a DRC agreement).

EEA states operate extensive single market DRC internally; firms/infrastructure operating across the EEA/UK will face substantial new DR barriers at Brexit

The single market 'passport' is a package of, mainly prudential, DRC to create a 'single licence' for firms from any of the 31 EEA states which is valid for the entire EEA; this now covers most FS infrastructure and sectors/activities. It is based on harmonisation (on a minimum or maximum basis) of applicable rules. The package has many elements, but it is possible to have 'passports' with less DRC (as well as reduced scope). Some passporting was originally introduced with less DRC. The single market also has **important DRC in many areas other than 'passporting'**.

At Brexit the UK will become a 'third country' under the EU regime and UK firms/infrastructure will lose this single market DRC and face new DR barriers in relation to their EEA business; EEA firms would lose the DRC

in relation to their UK business. The loss of single market DRC will also be a new DR barrier to pan-European 'hubbing' (most especially out of the UK).

If one considers the most extreme scenario where EU level DRC was not replicated at all (by any of the states - via agreement or equivalence findings etc.) – then cross border supply (mode 1) which is currently free and frictionless will become completely prohibited in many scenarios, particularly for supply into countries such as France. In these cases, suppliers will have to move-onshore (i.e. switch to mode 3) and use a local subsidiary (or a branch, where permitted) and obtain local authorisation. Those operating via branches under mode 3 may be able to switch to dual authorisation status (which is much less efficient than the single licence) but in some cases will have to establish a free-standing local bank/insurer/subsidiary (which is likely to involve even greater cost). Critical UK based international infrastructure would also be impacted.

EU/EEA groups would face similar barriers but would (on the basis of the current UK treatment of foreign/TC firms) benefit from a more open approach – compared to say France – e.g. for modes 1, 2 and 3 (for branches)). UK/TC groups may switch business from single licence supply from UK entities to an EEA subsidiary and then use its single licence as a hub across EEA states.

Operations would also be impacted by a **loss of DRC in other areas** e.g. where firms would be prohibited from using foreign services (e.g. benchmarks) or would suffer adverse capital treatment increased barriers/costs from a loss of DRC. A number of structures which firms adopt to address DR barriers (such as fronting/bridging, back to back transactions, outsourcing and delegation) may be impacted by a loss of DRC.

TCFs (such as firms from Switzerland) face high DR barriers to EU/EEA business and enjoy very limited DRC (when compared to single market participants)

Without EEA membership, Swiss firms face high DR barriers to EU/EEA business and DRC is limited.

DR barriers and available DRC vary considerably from one EU/EEA country to the next - a complex mix mostly of national rules but also involving international arrangements and EU measures

DRC available to Swiss firms is a complex mix of national member state DRC, a bilateral Swiss/German accord on UCITS, a bilateral 1989 EU/Swiss Treaty on direct non-life insurance branches and EU level harmonisation of external treatment/TCFs (Switzerland follows a large proportion of EU FS legislation and gains available EU equivalence based DRC) some of which reflects international arrangements. Swiss firms therefore take advantage of DRC available to any third country, DRC that is available to third countries that are 'equivalent' (under both EU level and individual member state national DRC arrangements) and some 'Swiss only' DRC under 2 bilateral treaties/accords – one with the EU and the other with one individual member state, Germany.

There are a mix of DRC channels and structures; there are a variety of international arrangements (plurilateral and bilateral) – as well as WTO style market access, there are formal international treaties on DRC (see the 1989 insurance treaty above) and less formal DRC accords, sometimes at a regulator level (see the 2016 accord below). There are EU third country DRC measures (e.g. 'equivalence' based DRC and some other areas of harmonisation which may increase DR barriers) and national level DRC arrangements (see below). The latter often operate at a regulator level and on the basis of regulator to regulator arrangements.

Both the DR barriers (including local 'perimeter rules') and the available DRC vary extensively from one EU/EEA state to the next. Some EEA states are more protectionist, such as France; others are relatively more open, such as Ireland (and indeed the UK). Some have systems for registration/authorisation for cross-border service supply; some have exemptions, whilst others seek to require suppliers to come on-shore to obtain local authorisation.

Mapping by CMS of the DR barriers and available DRC for TCFs across the EU/EEA shows the extensive variances from one EU country to the next and the complexity for TCFs doing business with the EU/EEA. For UK firms trying to assess this matrix and the potential DR barriers that they will face at Brexit, two key ingredients are unknown – the extent of bilateral DRC to be agreed (i) between the UK and EU and (ii) between individual member states and the UK. There is also uncertainty as to how EEA states' domestic level DRC policy will be applied to the UK (and vice versa) and whether EU equivalence based DRC (under current EU legislation) will be available at Brexit. Some of this is 'passport-type' DRC, and some is DRC in other areas. These apply only to a limited FS scope and with limited DRC; the passport DRC elements are limited in scope and depth.

EU legislation gives various powers in relation to bilateral accords – for example the Swiss/EU treaty above and the 2016 European Commission/CFTC accord on central counterparty regulation. The latter arose under the auspices of the G20/FSB and was implemented by equivalence findings by the EU under EMIR and

comparability findings by the US under Dodd-Frank respectively. Existing powers are, however, limited in scope.

An extreme loss of DRC at Brexit should be ‘unthinkable’, but the negotiations will determine the breadth and depth of DRC that survives

Due to the variety of DRC channels, Switzerland/EEA has greater DRC (see below) than in the extreme scenario above for the UK. A comprehensive loss of EU/UK DRC at Brexit in the extreme scenario above would make no sense for the EU or UK. It would represent a total failure of negotiation and a reversal of recent global cooperation on financial stability. We would like to think that this scenario falls into the category of the ‘unthinkable’ and that DRC must continue; the uncertainty is really about how broad and deep that DRC will be.

The UK should not rely upon unilateral EU findings of UK ‘equivalence’ and the DRC under these processes would not be a satisfactory alternative to the broader transposition of DRC

If the UK were to leave the EU without any agreement, UK firms in some lines of business and for certain modes of supply would be assisted by the EU determining (on a unilateral basis) prior to Brexit, that relevant UK regulation was ‘equivalent’ and thereby activating, for the benefit of UK firms, EU external DRC measures. This, however, would not prevent the re-introduction of most of the many substantial DR barriers which have been eliminated between EEA states (because of the limited scope of EU external DRC). The unilateral basis of the DRC measures would mean that they could be withdrawn at a later stage without recourse. The UK should not rely upon unilateral EU findings of UK ‘equivalence’ (see further below re a baseline accord). The DRC under these processes would not be a satisfactory alternative to the broader transposition of DRC (see below re the implementation of DRC by the EU).

There is a danger that the description of the new treaty as an ‘FTA’ could lead to a misunderstanding as to the scope and scale of what is being proposed

There is a danger that the description of the new treaty as an ‘FTA’ could lead to misunderstanding of the scope and scale of what is being proposed. If, for example, the negotiations were to start by taking recent EU FTAs (such as CETA and TTIP) as a start point/precedent, this would miss the point entirely. Whilst these agreements are helpful in certain respects, they lack the substantial DRC which is necessary between the UK and the EU. It is important that the terminology does not confuse this message.

A new UK-EU partnership (Chapter 6)

We recommend a two-pronged approach in financial services – looking at market access and DRC separately

In the field of FS we believe it is best to think of a two-pronged approach – dealing with market access and DRC largely separately (at least initially). This reflects the different approaches and caters for the possibility of interim measures being required. We consider the potential terms of a UK/EU DRC agreement in the report; this is a **bilateral** agreement for **reciprocal** DRC measures.

The DRC agreement cannot follow CETA and simply establish a committee to deal with DRC – detailed DRC measures must be in place for Brexit

Detailed DRC measures should be in operation from Brexit without any gap. If DRC is lost at Brexit, firms will have to react accordingly relying on contingency planning; re-establishing DRC at a later stage may come too late for these businesses.

The UK can and should offer full harmonisation with the entire EU acquis² - but potentially limited to internal rules

The UK is proposing to transpose all EU single market rules (across all sectors and including cross-sectoral (in trade parlance, horizontal) rules such as employment); it can therefore offer complete homogeneity with EU standards, in form and substance, as the start point. It is also committed to implementing all upcoming EU

² Other than the treaties, the customs union/common commercial, agriculture and fisheries policies and foreign policy type parts of the acquis.

legislation in the period up to Brexit (including the period after Article 50 notice has been given). This includes major reforms such as MiFID II, the development of the EU regime via decisions of the CJEU and new binding technical standards and ESA guidelines.

The transposition of FS rules falls into various categories, including:

EU ‘internal’ harmonisation independent of EU/EEA dual regulation coordination can be transposed onto a domestic law basis unilaterally

The UK can proceed on a unilateral basis to “port” all EU derived internal regulatory requirements (whether directive or regulation) onto a domestic law basis; this applies to any EU rules which can stand alone without dual regulation coordination. This requires extensive and painstaking work and raises some policy issues such as the status of post-Brexit judgements of the CJEU, but it can be completed without any agreement with the EU.

EU provisions which establish or reflect dual regulation coordination cannot be transposed unilaterally and must await the negotiations

Some EU provisions, however, concern or are based upon dual regulation coordination between EU/EEA member states. The UK does not know to what extent these will need to be adapted, transposed or replaced (with other cross-border arrangements or domestic only provisions). Preparations under the Great Repeal Bill will need to treat these provisions on a provisional basis (on a worst case scenario of no agreement between the UK and EU) but with a process for implementing the final terms of the DRC Agreement.

EU rules on third country firm treatment

There are some EU harmonised requirements for the treatment of third country firms. Some apply to all third countries and others differentiate on the basis of ‘equivalence’. These include not only the limited passport rights for firms from equivalent third countries but also requirements for branches of insurers from all TCs and recent proposals requiring intermediate EU parent undertakings for large TC bank groups. The UK would need to decide whether to port or mirror these requirements on a domestic basis i.e. to continue treating third country firms within the parameters of EU requirements. Some of these could be ported unilaterally; others involving DRC dependent on European Commission decisions on equivalence are less likely to be ported. The latter would require an agreement effectively to maintain the UK’s external regime as part of the EU/EEA external regime (e.g. making TCF registration with ESMA under MiFIR valid for UK business). The UK may, however, decide that some aspects of the third country requirements would not be ported over or would not be maintained outside the period of interim measures, for example to avoid constraining the UK’s external policy vis a vis non-EU/EEA countries (see Chapter 8 for a new framework under FSMA for external relations DRC).

The roles of the ESAs in direct regulation (for example in regulating specialist firms, such as rating agencies, and ESAs’ emergency powers)

This may involve assigning current EU level roles/powers to the PRA or FCA, but DRC might involve other options, for example, some element of ESAs’ authority might be recognised in the UK.

There is a strong economic case - for both the EU and UK – for transposing full DRC at the outset and certainly for any interim measures

There is a strong economic case – for both the EU and UK - for transposing full DRC (as it currently applies within the single market) at the outset. There is unparalleled regulatory homogeneity between the UK and the 27 EU states.

The UK should make its case for DRC – in trade, regulation and competition policy terms

Pure politics and horse trading across sectors may well feature in the negotiations. In principle however, the case for DRC will rest on the triple axis (see above) of external trade policy, effective cross-border regulation and competition. The UK may seek broader/deeper DRC than certain EU states may be inclined to seek.

The UK can make its case at all three policy levels – its open policy towards foreign firms and the proposed mutual access and treatment for EU firms (in trade policy terms), the lack of risk to EU states from DRC on

account of the UK's effective supervisory and domestic regulatory regime and its close proximity to EU harmonised rules and the UK's approach to fostering competition in the FS sector. On purely regulatory grounds, the UK could argue against full recognition of the EU regime on the basis that other states have not adopted the robust post-crisis measures that apply in the UK banking sector (e.g. ring-fencing and the senior managers regime). The UK can make it clear that, notwithstanding these differences, it is prepared to trust regulation in the 27 EU states by continuing DRC.

Even if the scope of DRC was likely to be limited eventually, there would be a strong case for maximising DRC under any interim measures

If Brexit is implemented in two stages, there would be a strong case for maintaining DRC under the interim measures. This would have 2 objectives – to avoid any DRC being lost for the interim period, if it was possible that it might be agreed under the final deal, and to provide help in the transition (particularly, for example, if there was not to be a sufficient period of adjustment for firms between interim measures being confirmed and their coming into effect).

There may be a logic for a baseline accord approach to entrench key DRC at the outset but with greater DRC to be agreed later

There may be key elements of DRC which can be agreed at the outset as an 'early harvest' in the negotiations (because they are non-controversial/not really in doubt). Both sides may wish to establish an early reciprocal accord as a baseline agreement of DRC that is agreed and guaranteed at the outset (and therefore taken out of the negotiations). These might relate to international commitments on FS infrastructure (for example under the G20/FSB arrangements, the 2016 accord between the European Commission and the CFTC on CCP regulation would need to be extended to include the PRA/UK on a tripartite basis or by bilateral accords) and might cover all DRC currently available to third countries under existing EU FS legislation. Hopefully, these measures would be non-controversial. Broader/deeper DRC could then be negotiated as part of the new partnership/relationship.

The objectives of the DRC agreement should be agreed at the outset

The objectives of the DRC agreement should be agreed at the outset. These should cover regulatory cooperation in the broadest sense with the objective of securing effective regulation and reducing DR barriers –

- facilitating and providing the legal framework for supervisory cooperation (including information exchange and supervisory colleges) between, on one side, the PRA/FCA and, on the other, the ESAs and national regulators
- cooperation on the development of the regulatory regime and regulatory reform including in relation to international standards
- the adoption of specific DRC measures at the outset and the arrangements for DRC in the future (as considered below)

This could acknowledge a joint desire to maintain mutual access and regulatory cooperation between the two sides and to maximise DRC consistent with avoiding host state risks from ineffective home-state regulation or in competition terms.

Financial stability should be a common objective in the negotiations

In recent years, regulatory reform has focused on financial stability and the mitigation of systemic risk. These issues have been addressed at international, EU and national levels. The objectives for the DRC agreement should include financial stability based on a technical and objective basis of what DRC, in the broadest sense, can contribute. For example, it is difficult to see any basis, consistent with G20 financial stability commitments, for the EU withholding DRC for UK central counterparties³. This should be apparent even before one considers broader concerns that fragmentation of the City would have an adverse impact on financial stability and on the financing of the European economy. Any potential plans on the EU side for the clearing/settlement of euro-denominated transactions should not threaten these arrangements.

We have looked at three parameters for the DRC agreement – DRC scope, rules freedom and DRC withdrawal

³ See, for example, FSB's 2010 report [Implementing OTC Market Reforms](#). The report describes CCPs as critical infrastructure and states "the need to ensure non-discriminatory access to CCPs".

Chapter 4 of our report combines a WTO/FTA and a regulatory perspective, looks at the different modes of supply and other areas of DRC, and illustrates DR barriers. It unpicks the different DRC techniques/measures used in each of the modes/areas (under various different international regimes including the single market). This analysis is used in Chapter 6 which looks at the proposed DRC agreement and the potential scope of DRC measures, and at rules freedom (i.e. the extent to which each side can change its rules unilaterally and/or the procedures to be followed – e.g. prior notice) and DRC withdrawal (i.e. the procedure to be followed and the criteria which might determine whether divergence should or could lead to DRC withdrawal). The spectrum of possibilities is illustrated in 3 charts below. We have not attempted to define a landing point for the DRC agreement; indeed it may vary for different areas/sectors/legislation (a ‘mix and match’ approach).

The current UK/EU DRC under the single market is broad in scope with substantial home state reliance; there is a wide spectrum of potential outcomes in terms of the scope and depth of DRC to be agreed for Brexit, possibly with different outcomes in different areas

Current DRC between the UK and the other 30 states of the EEA (under the single market) is broad in scope with substantial reliance by host states (for example) on the home state regulation of incoming firms. As the charts illustrate (and Chapter 4 of the report explains in detail), there is a wide spectrum of potential outcomes in the scope and depth of DRC which may be agreed in any one area. Different DRC may apply area by area and in any one area variances are possible, so for example full single market DRC might be replaced by restricted DRC in one mode of supply but full in another, or there might be no DRC for another mode. Greater DRC may apply to wholesale and less to retail. Mode 3 branches may be permitted but the extent of DRC may be less than under the single market. DRC may apply to prudential regulation but not to conduct of business etc. The possibilities are far from binary and may differ from one area and mode to the next.

Regulatory divergence should be permitted, not prohibited, and must be catered for in the DRC agreement

Neither side will have a veto over the regulatory rules of the other side; the UK, as a third country with a substantial financial services sector, cannot be bound in perpetuity to all EU FS legislation as it emerges. A permanent EEA style model of ‘follow all EU measures’, as accepted by Norway, Iceland and Liechtenstein, would not be practical or desirable for the UK. Divergence is therefore a possibility eventually which must be catered for in the DRC agreement. Unless the agreement prohibits divergence which would threaten DRC (which we also do not think is practical or desirable), the agreement must cater for the possibility of DRC withdrawal (as well as increased/new DRC measures).

Even in areas where the EU harmonisation has been controversial, such as Solvency II (see the [current TSC enquiry](#)), the UK may well decide to maintain the EU derived regime (and not, for example, revert to the previous domestic FSA insurer prudential rules), subject only to some relatively narrow issues where divergence is seen to be desirable (and which may be resolved with the EU). Post-Brexit freedom to move away from EU harmonisation, as ported across for Brexit, may not therefore be exercised to a significant extent in the short to medium term; the question of future rules may be a greater source of divergence, but DRC should not be sacrificed unless and until substantial divergence poses real and unacceptable risk. This should not be based on narrow concepts of matching or equivalent rules but on a substantive assessment of regulatory outcomes and whether the host state would be exposed to unacceptable risk by relying on less effective regulation in the home state. The report refers to these as the principles of sufficiency and proportionality – i.e. that the assessment is relative to the risks involved (as one sees in other DRC arrangements such as the Bank of England’s differentiated policy on third country bank branches).

The UK can consider various and varied options for ‘mirroring’ EU requirements and maintaining close proximity to EU harmonisation

The UK can consider various options where it wishes to maintain close proximity to EU harmonisation. This could be a commitment in the DRC agreement or it could be a unilateral policy decision for the UK. In the former case, it could be binding or an expression of intent and could be limited in time (e.g. for the interim measures period) or to specific pieces of EU legislation. Proximity could be defined in various ways; it might also treat the existing acquis/ported rules at Brexit differently from rules introduced after Brexit.

The UK can offer full EU compliance at Brexit. In principle the UK could offer continued complete conformity (at some level or at least in some areas) and full single market DRC at the outset and for interim measures. Under the final arrangements the UK might be under no legal obligation to maintain EU derived requirements but might choose to do so in practice- thus ensuring related DRC was not at risk.

The spectrum for the DRC withdrawal basis is very broad with many options

There are many different options for the process, procedure and the basis and extent of DRC withdrawal following divergence (or otherwise). There are attractions in seeking objective criteria (as to whether divergence has resulted in an unacceptable increase in risk for one side - as a host state relying on home state regulation of incoming firms) and even of making this subject to independent assessment, such as via dispute resolution/arbitration.

There are potential dangers, however, in that such an approach may be difficult to define and result in the parties being nervous of agreeing extensive DRC. Outside the single market DRC is often agreed (successfully) on a more consensual basis and with arrangements subject to termination on relatively short notice periods.

Implementation of DRC on the EU side will be more complex than in the UK; it must go beyond current EU legislation

The DRC agreement can be implemented in the UK via domestic legislation. This would dovetail with the transposition of the EU acquis in the Great Repeal Bill. DRC in the acquis would have been stripped out and would effectively be replaced by new procedures, processes and transition and the new DRC regime (see Chapter 8 below re a new framework under FSMA for external relations and DRC).

Implementation on the EU side is more complex. The normal basis for the EU (and other countries) entering into DRC accords appears to be essentially consensual. This may enable each side to utilise its domestic procedures to implement the accord (procedures which may be open to other countries and have their own DRC withdrawal criteria/mechanisms) rather than specific powers for the bilateral relationship. One can, however, envisage less consensual approaches (such as reliance on international standards or even objective standards) being used and even a mix of approaches for different DRC. (Although there may be a trade-off between increased legal certainty and limiting the DRC that either side feels comfortable operating on a non-consensual basis?)

The DRC agreement should not be limited to DRC which is already subject to EU level measures. The DRC agreement needs to include DRC that is not currently provided for under EU FS legislation (in terms of equivalence based DRC, or agreements, with TCs) and potentially to put DRC on a different basis to existing TC DRC powers. It would be illogical to regard the present set of EU TC DRC provisions as the limit of DRC measures to be agreed with the UK. EU level harmonisation of TC DRC is patchy and many areas are un-harmonised/differ at member state level. More extensive DRC is logical for both the UK and the EU states. DRC is not a case of 'privileged access' one way or the other if it is supported by the necessary regulatory cooperation.

Implementation will raise technical legal issues on the EU side and might involve further EU harmonisation or member state level arrangements. Depending on the level of DRC agreed with the EU, it may also be necessary/desirable to address DRC barriers at an individual EU state level (for example, in relation to un-harmonised aspects of member state TCF treatment and related DRC). This might be coordinated within the DRC agreement or be covered in separate **national DRC agreements**. There is a precedent for the latter – the Swiss/German agreement on UCITS distribution⁴. The flexibility of international law should be used to address the restraints and difficulties that arise under Article 50 and the rest of the EU treaties.

The EU and UK should promote the development of dual regulation coordination standards

This topic has recently been considered by Andrew Bailey - [Free trade in financial services and global regulatory standards: friends not rivals](#). In the new UK/EU partnership, both sides should commit to work together for the development of international standards (which are currently more developed in banking than, say, in insurance). There should also be a new focus on international prudential standards as a mechanism for dual regulation coordination, to reduce the barriers from dual regulation and stimulate trade and competition. However, the UK should not rely only on the EU, but also its relationship with the US, and other financial services centres such as Switzerland, Hong Kong and Singapore to help develop undistorted standards. Conduct of business, however, is likely to remain the preserve of the host state.

The UK should be taking the lead in promoting this policy; the success of UK/EU partnership could provide further momentum. In future a distinction might be drawn between international standards of broad application

⁴ The [agreement](#) entered into force in 2014 to implement a simplification in the marketing of Swiss securities funds (*Effektenfonds*) in Germany, and German UCITS in Switzerland.

around the world and higher standards where a smaller group of countries use these to agree dual regulation coordination.

A DRC agreement will be required as any broader re-structuring of international and European regulation cannot be guaranteed

There are a variety of longer terms possibilities for re-structuring international and European⁵ regulation/DRC arrangements but the UK cannot be confident that these reforms can be achieved in time for Brexit. A DRC agreement is therefore very likely to be necessary.

The conclusion of a DRC agreement would need to be consistent with WTO requirements

The conclusion of a DRC agreement would be consistent with WTO requirements including MFN, market access and national treatment obligations and there would be **no need** to cast the DRC agreement:

- in terms similar to recent FTAs such as CETA, or
- by reference to WTO market access terminology or with WTO dispute resolution.

There are GATS obligations regarding recognition of prudential measures, licensing, qualifications and similar, under which recognition granted to one country must be made available to other WTO members who meet the same criteria of equivalence, implementation, oversight and procedures for information sharing, so it would in theory be necessary for other states to have the ability to apply for the same DRC. However, if there was reluctance on either side to countenance other countries participating in DRC, there is an exception in the GATS MFN obligations for bi-lateral arrangements that form part of an agreement with “substantial sectoral coverage” that eliminates all discrimination in the areas covered. The DRC agreement is therefore likely to be consistent with the GATS obligations if it operates as part of/under an FTA umbrella. Unlike the GATT in respect of trade in goods, the GATS does not expressly extend this to cover interim measures⁶ pending an FTA but in practice, sectoral and bi-/plurilateral liberalisation is possible under the GATS ‘built-in agenda’ which looks to progressively liberalise services trade through a process of ‘requests and offers’ between WTO members. This could be deployed to mitigate the risk of challenge from other members if DRC were not to be made available to them during any interim period. This is an issue that warrants further consideration, including in the context of the WTO’s ongoing work on services liberalisation. Existing EU DRC legislation is already on the basis of open access to countries who meet the applicable criteria, but GATS obligations would impact how the EU implemented the agreement on other DRC and how the UK implemented DRC in its domestic regime (see above and Chapter 8 below).

WTO is a pre-existing eco-system which could be used for comprehensive DRC between the EU and the UK (outside the single market)

The EU regime (which is plurilateral) is an entire legal order and has the deepest and most comprehensive legal eco-system. It operates both at EU level and by permeating the domestic law/legal system of each EU member state – with its own court, the CJEU, direct application and precedence of EU law in a member state’s domestic regime and national courts, ESAs’ powers under EU treaties/legislation, European Commission powers to enforce DRC against member states via infringement action, fines etc. This provides deep and broad legal protection for both state parties and non-state parties and a very high degree of legal certainty for DRC.

The extension of the EU single market under the EEA agreement affords relatively deep and broad protection for EU players in the 3 EEA/EFTA states and vice versa, but in various respects legal certainty is less than within the EU (for example because EU regulations are not directly applicable in EEA EFTA states and there have been significant delays and difficulties in implementation). The agreement has different institutions on the EEA side – the EFTA Court, EFTA Surveillance Authority etc..

The legal order of EFTA under the EFTA agreement is more restricted and is not directly relevant, given that the EU is not a member (nor currently is the UK).

The WTO provides a legal eco-system for FTAs. This is much shallower than the EU legal order and it does not permeate the domestic law of its members. An FS firm cannot enforce or rely upon the DRC terms in domestic proceedings. It does, however, provide a pre-existing framework and treaty basis with some institutional structure and a dispute resolution mechanism for state parties and some limited scope for non-state party

⁵ There has been some speculation that the new UK/EU agreement might eventually become a new model for the EEA/EFTA states.

⁶ The FMLC has undertaken to address these issues (including the question of WTO and MFN compliance). See FMLC letter on the EU exit and transitional arrangements [here](#).

redress and further potential under the investment court approach (as was agreed in the investor state dispute settlement provisions of CETA) and the broader developments which the EU has proposed. This could enable private sector parties of each side, such as FS firms, who have invested in the other to have rights to challenge host state requirements, at least in relation to their investment in the host state via branches and subsidiaries. The UK and EU would need to consider carefully the application of dispute settlement (including any such private sector rights) to the DRC arrangements.

The third option is an international law treaty, or some lesser accord, outside these structures and any pre-existing mechanism for redress and dispute resolution. The EU has entered into a variety of external agreements under different names – such as partnerships, cooperation agreements – some described as ‘deep’ and others as ‘comprehensive’⁷. The recent Ukraine agreement was an ‘association agreement’ which incorporated an FTA but this does not offer a different legal eco-system or more advanced dispute resolution

The DRC agreement could be incorporated into the FTA umbrella (from the start or after a period of interim measures)

The DRC agreement could operate within the comprehensive EU/UK FTA under the WTO regime, unless or until any new and more appropriate legal eco-system can be established. For financial services, the FTA would have well developed provisions both for market access (see below) and a DRC agreement.

The comprehensive FTA would have separate sector specific schedules, including one for financial services which would include market access commitments. The position of the DRC agreement might be similar to Mutual Recognition Agreements (MRAs) in the goods sector, in that it would be incorporated into the FTA umbrella/WTO regime and would sit alongside the market access commitments. There would be considerable flexibility for DRC to be free-standing or to be subject to dispute resolution and other WTO/FTA mechanisms and approaches.

Institutional approach

The chart above shows a possible high-level structure for the UK/EU partnership, based on recent FTAs such as CETA but covering the key functions for DRC – supervision, regulatory reform and development of the regulatory regime, centralised regulatory roles, authorisation of specialist firms and emergency powers etc., and enforcement and implementation. The process and bodies as deployed in CETA are described further in Annex C.

Market access provisions in the FTA would be ambitious in breadth and magnitude

The market access commitments in the WTO financial services schedules for EU states are limited; they are qualified by a large number of differing reservations by individual member states in the WTO schedule (and in FTAs such as CETA, although the number of reservations in recent FTAs, and the actual regulation in individual member states indicate that the current state of openness is better than the WTO schedule indicates). The UK has relatively few reservations. There has been only limited progress in financial services schedules of recent FTAs. Whilst DRC is the priority, we would also envisage the UK seeking market access commitments in the FTA financial services schedule which were more ambitious in breadth and magnitude than previous FTAs (and the current WTO obligations of EU states).

Market access provisions in the FTA would operate alongside DRC/the DRC agreement

Market access commitments would be negotiated and agreed in the financial services schedule. These would operate alongside DRC. To the extent that in any given business/mode of supply there was no applicable DRC, market access would operate in the usual way, with host state regulation applying. Where a form of business/mode of supply was subject to both market access and DRC, there would be no conflict but the DRC would probably go much further than the market access provision.

Some standard FTA and GATS terms may need to be adapted

The incorporation of the DRC agreement into the FTA umbrella would require careful consideration of the application of FTA/WTO terminology and mechanisms to DRC (such as the standard FTA/GATS terms, for example, on national treatment and the ‘prudential carve out’).

⁷ [EU External Agreements - HoC library](#)

Timeline and legal challenges (Chapter 7)

Early agreement of a legal road map, timeline and key principles for Brexit is important for both private and public sectors in all EU states

There are challenges in the legal construction of Brexit and the timeline. Both sides would benefit from early consensus on a legal road map for Brexit which provides assurance for individuals and firms in the UK and the rest of the EU (and for their government departments and the EU institutions themselves) that change will be managed to ensure they are given sufficient lead times to adapt. Agreeing the structure of the Brexit package and the negotiation process, timeline and dependencies is important to reduce legal and negotiation risk.

Early agreement on sufficient lead times is critical

The FS industry has indicated the need for a 2/3 year period for adjustment to the new regime (once this is finally settled and the implications understood).⁸ Until the position on expiry of Article 50 notice is known, as that date gets closer, uncertainty increases and FS firms/infrastructure providers (both UK and in the rest of the EU/EEA) must move further in implementing their contingency planning. It is therefore critical for all concerned to know how they can plan on the basis of sufficient lead times for any changes. Agreement on this issue needs to emerge at an early stage in the negotiations.

Brexit may take effect in one big bang where current single market DRC is switched off and the new DRC is switched on at the same time or in a two-step process with a period of interim DRC arrangements after single market DRC is switched off and then a later switch to the final DRC regime. In either case, the lead times would need to run from the point when FS firms could understand with sufficient certainty the changes involved at the next/each stage. Currently firms have to plan for a change in DRC at expiry of the Article 50 notice (ie at about 31/3/19).

The roadmap needs to address a variety of negotiation risks including the risks (of delay or failure) in member state ratification. Failure to secure ratification of an FTA normally results in the status quo continuing (or reverting to the prior position before provisional application of the FTA), but the dynamic is different with Brexit because the agreement is to replace current arrangements, such as single market DRC, which will terminate at Brexit.

Various techniques are available to ensure acceptable lead times for FS firms/infrastructure

It may be that there is a 'big bang' moment when withdrawal terms and a comprehensive agreement for the future EU/UK relationship (having been agreed and ratified) all come into effect together on the date when the UK leaves the EU (either in 2019 or at some later date following prolongation).

There are, however, various scenarios where for one reason or another this big bang synchronised moment does not happen and the Brexit process is implemented in two (or more) stages. Planning has to take account of this possibility (however desirable the big bang approach may or may not be).

In order to avoid a change of DRC at the expiry of the Article 50 notice, it would be necessary to maintain single market DRC in operation by one or more of various techniques. These include standstill/stop the clock e.g. via prolongation of full EU membership or of EEA⁹ membership or some other mechanism to maintain single market DRC (sometimes referred to as 'standstill' or 'grandfathering' – see below - of the single market regime). Here the necessary lead time confirmation is early confirmation that there will not be any change to DRC at expiry of the Article 50 notice. There is also the possibility of staged changes to DRC, but here sufficient lead time involves sufficient notice both of the date of the change to DRC and the details of the new DRC arrangements that will apply.

⁸ See the evidence before the Treasury Select Committee [here](#) and the TSC Chair's summary [here](#) (regarding the 'three year standstill' at the end of the Article 50 period).

⁹ EFTA membership would not impact the relationship with the EU and is not services focused.

Transitional arrangements must include DRC but market access could revert to WTO terms/schedules

If Brexit occurs in stages, the market access and national treatment commitments of the EU under its WTO schedules, and the actual state of openness in EU and member state law, could provide a viable default position for market access during any interim or transitional period. This would not, however, assist with DRC. Any transitional arrangements must address DRC and the lead time issues above.

There may be advantages in having a separate DRC/FS agreement at this stage. The recent Advocate General's opinion in the Singapore case, if followed by the court, may offer some assistance in that it finds that financial services is an area where the EU has exclusive competence and measures can be agreed without the need for member state ratification which applies to 'mixed agreements' (which causes delay and implementation risks, as seen recently with CETA).

There are a variety of legal orders for (interim) DRC – from accord type arrangements at a regulator to regulator level to an international treaty. It will be even more difficult to establish a new legal and institutional order in time for interim DRC arrangements. Interim DRC arrangements would be compliant with WTO rules by either being open to other countries to negotiate their accession to them if they also have equivalent regulation, oversight, implementation of regulation and procedures for the sharing of information, or by forming part of an overall arrangement with "substantial sectoral coverage"¹⁰.

During any interim period, it seems sensible for the UK to consider some greater degree of continuation of/participation in the EU FS regime in terms of some or all of –

- Continuation of current EU harmonisation/rules as at Brexit
- Adaption and evolution of these rules in line with post-Brexit development by ESAs, CJEU etc.
- Adoption of new EU FS legislation – within certain parameters. Divergence would therefore only arise in the interim period in respect of new EU legislation and even then only if that legislation strayed beyond these parameters (e.g. discriminatory or not consistent with previous single market principles etc.). Given the lead times for the adoption and implementation on new legislation, the UK will be familiar with the likely pipeline during the interim period
- Continued ESA cooperation if necessary via new legal basis
- Arrangements to maintain/replicate ESAs' central role re specialist firm regulation and emergency powers and CJEU

Further work is being undertaken by the TSC inquiry on transitional arrangements¹¹ and it is hoped that this will evaluate the international law mechanics and institutional arrangements for any interim measures.

'Grandfathering' may assist but is not the same as full DRC

Grandfathering could be applied to FS firms (as it could to residency rights of individuals); i.e. all FS firms currently operating pursuant to passport notifications into/out of the UK would be 'grandfathered' in the host state and would not need to seek local host state authorisation at Brexit (i.e. the single licence which they are currently relying on would not be lost and they would have more time to apply for any host state authorisations they would require under the new regime). Grandfathering in this way would differentiate between firms - only existing firms would be covered and only to the extent that they are currently 'passporting'. This is different from, and more limited than, any interim measures which seek to maintain the single market DRC itself (which would cover new firms/passporting etc.). It seems that most discussion of grandfathering has envisaged the maintenance of the full DRC regime. There may be an additional need for grandfathering of firms in some limited circumstances.

Looking beyond the EU (Chapter 8)

The UK will need to identify all DRC measures which UK infra-structure/firms currently enjoy under the regulatory regimes of all non-EEA countries and take steps to ensure these are maintained at Brexit

¹⁰ As required by Article V GATS

¹¹ See HoC transitional enquiry [here](#) and below re FMLC work on transitionals and WTO/GATS.

The UK will rectify its WTO schedules for Brexit and is considering the EU negotiated FTAs under which the UK currently operates. In the FS sector, however, DRC measures under the regulatory regimes of third countries are a more immediate priority. The UK will need to identify all DRC measures which UK firms currently enjoy under the regulatory regimes of all non-EEA countries. In many cases these arrangements may have been made at an EU level and/or are based on the UK's membership of the EU and may therefore be at risk at Brexit.

These range from critical infra-structure DRC, such as DRC for central counterparties with countries such as Australia, Japan and the US (see above), to less formal arrangements/policies. The full transposition of the EU acquis should assist in gaining any necessary bilateral agreement with the countries concerned.

The UK should explore a DRC agreement with Switzerland which goes beyond maintaining current DRC (and potentially agreements with a broader FS/prosperity zone)

The UK will need to consider its policy on the EU DRC arrangements with third countries and whether to maintain these e.g. via new arrangements – for example the treatment of Swiss insurer branches under the 1989 Swiss/EU agreement and the treatment of US CCPs under the 2016 accord. There is high degree of regulatory homogeneity between the UK and Switzerland. The UK should explore a bilateral DRC agreement with Switzerland that enhances, and not merely maintains current DRC.

The UK can also consider (perhaps as part of its initial scoping of future FTAs) bilateral DRC agreements with the US and other countries with well developed, modern and open regulatory regimes, such as those found in Australia, New Zealand and other countries that may wish to form a 'Prosperity Zone'. Ultimately this might even form a plurilateral FS zone.

We recommend a new framework under FSMA for external relations and DRC

The UK has no single and comprehensive statutory basis for DRC arrangements with countries outside the EEA¹², and some policy aspects fall to PRA and FCA. (For EEA countries, the UK currently deals with the single market DRC under the ECA 1973, various statutory instruments and within the PRA/FCA rulebooks).

We recommend that the UK consider putting DRC and external regulatory policy (which currently hangs off the EU level policy and legal arrangements where these exist) on a more formal/comprehensive statutory basis under the FSMA umbrella. This would be the domestic basis for concluding and implementing DRC agreements. Individual DRC measures would be implemented at the relevant level in the FSMA hierarchy – i.e. statutory instruments and/or at the level of PRA/FCA (via rulebook provisions, policy statements and the day to day operation of the DRC regime). This regime could be used for DRC agreements with the EU and with individual EU/EEA states, as well as with countries outside the EEA.

Once outside the EU/EEA, the UK could establish new criteria and a modern policy for DRC. This would replace the piecemeal policy (part EU and part domestic) that currently applies. DRC would be on a reciprocal basis and could, in principle, be open¹³ to any country which satisfied criteria as to market access (in WTO/FTA terms), competition (and the absence of state aid, market distortions etc.), sufficiency of home state regulation, observance of international standards on tax/money laundering, and the various practical and legal elements for regulatory cooperation. The criteria for 'sufficiency of home state regulation' could reflect the principles described above in Chapter 6. In practice, only those countries with well-developed regulatory regimes would be eligible for extensive DRC and considerable discretion would need to be retained.

Brexit outcomes without the comprehensive partnership (Chapter 9)

Without an agreement, there would be a patchwork of differing national practices and DR barriers

¹² See, for example, FSMA 2000 sections 272-283 re recognised overseas schemes and section 292 re overseas investment exchanges and clearing houses.

¹³ This may assist with GATS compliance.

The extreme scenario is explained above. The DR barriers that firms would face would depend in large part on the differing laws and practices of individual states. EU standardisation in this field is limited in scope. Some DRC elements would depend on unilateral action by both the EU and by national regulators.

The idea of ‘trading on WTO terms’ in FS is a misnomer; the terms have no material impact on dual regulation

The idea of trading on WTO terms in FS is a misnomer; market access obligations for FS are of limited use because they provide no real DRC at all. ‘WTO terms’ would not prevent UK or EU states from re-imposing extensive dual regulation and DR barriers.

CMS Legatum matrix for plotting cross-border requirements, DR barriers and DRC

CMS has undertaken many projects plotting cross-border regulatory requirements for a broad range of FS firms, sectors and countries. These include TC firms doing business in/across the EU/EEA, operations within the single market and supply into countries outside Europe. In preparation for Brexit, we are using these techniques and the analysis from our report to develop a CMS Legatum matrix. This can be used to plot the position under each of the WTO modes of supply 1, 2 and 3 - for UK firms conducting business with any of the 30 EEA states (country by country) and for EEA firms conducting business with the UK. It enables plotting of all requirements (EU derived and domestic) and the DR barriers that result, the current DRC arrangements, and the impact of DRC withdrawal at Brexit and of proposed/agreed DRC measures including WTO/FTA obligations.

Evolution of the UK regulatory regime (Chapter 10)

Brexit should be a spur to ensure UK regulation is pro-competitive

Much of the regulatory regime has escaped effective scrutiny to ensure it meets pro-competitive criteria. The UK has not been able to scrutinise and adapt the EU legislation which is now to be ported onto a domestic law basis; it is not clear that the OFT/CMA review regime¹⁴ has been effective for those rules that are not EU derived. The enhanced competition objectives and powers of the UK regulators cannot currently infringe EU harmonisation.

In the medium term (i.e. after Brexit and probably after any period of interim measures) the UK should consider a one-off comprehensive/holistic review of the entire regime (both legislation and rules) and whether to improve on-going scrutiny of new requirements.

There should be no divergence from detailed EU requirements pre-Brexit; there should be no policy to lower standards after Brexit. Divergence in the longer term will only arise from the UK seeking effective standards balanced with the objectives of pro-competitive regulation and an international focus on maximising DRC

The UK has led in many areas of FS regulation and the EU has followed. The opportunities for the UK, post-Brexit, are not to lower standards (in some form of regulation-driven trade war) – an expectation that is misplaced, runs contrary to the UK’s track record and the realities of consumer politics today. The long term opportunity is to ensure the UK has the correct balance of effective, pro-competitive regulation and an international focus on maximising DRC.

The UK can become an international beacon for pro-competitive regulation in FS

After Brexit, the UK will be able to promote the pro-competitive agenda internationally. A sharper distinction could be drawn between the regulation of international/cross-border firms and those that only operate domestically (as Andrew Bailey proposed). This split approach to regulation could apply to the development of international prudential standards (which would be more clearly applicable to international firms alone) and can also be incorporated into the UK’s domestic regime, so that UK regulation of domestic firms is more tailored to domestic requirements.

¹⁴ See competition scrutiny under FSMA 2000 Chapter 4 sections 140A-H (previously sections 159-164 and 302-310).

1. Introduction

The Prime Minister's speech of 17th January

Theresa May made it clear that the UK is seeking to leave the single market (and would not therefore remain in the EEA). Instead she envisaged a '*new positive and constructive partnership*' between the EU and UK (not based on any existing models) in the form of a '*new, comprehensive, bold and ambitious free-trade agreement. That agreement may take in elements of current single market arrangements in certain areas — on the export of cars and lorries for example, or the freedom to provide **financial services across national borders** — as it makes no sense to start again from scratch when Britain and the remaining member states have adhered to the same rules for so many years.*'

The Prime Minister also said –

*'I want us to have reached an agreement about our future partnership by the time the two-year Article 50 process has concluded. From that point onwards, we believe a **phased process of implementation**, in which both Britain and the EU institutions and member states prepare for the new arrangements that will exist between us will be in our mutual self-interest. This will give businesses enough time to plan and prepare for those new arrangements.*

*This might be about our immigration controls, customs systems or the way in which we co-operate on criminal justice matters. Or it might be **about the future legal and regulatory framework for financial services**. For each issue, the time we need to phase-in the new arrangements may differ. Some might be introduced very quickly, some might take longer. And the interim arrangements we rely upon are likely to be a matter of negotiation.'*

The Prime Minister described what the UK would seek to achieve in the negotiations (as a replacement for EU and EEA/single market membership) only in the broadest possible terms. She hopes for a bold, comprehensive and ambitious new relationship and sees that future as being in the interest of the EU, as well as the UK; but she also recognises the risk that the result may be very different (and outlines potential UK reaction in that event). She maintained the UK view that the new deal can and should be negotiated in parallel with the withdrawal issues/agreement and should be agreed within the 2 year period of Article 50. She then advocates a period of 'phased implementation'.

Clearly the Prime Minister is concerned to maintain the UK's negotiation position and her speech must be read in that light. The government's White Paper¹⁵ did not elaborate on these plans and did not add much, relating to financial services, beyond what the Prime Minister stated. The White Paper states:

"In our new strategic partnership agreement we will be aiming for the freest possible trade in financial services between the UK and EU Member States... there will be a legitimate interest in mutual cooperation arrangements that recognise the interconnectedness of markets, as so clearly demonstrated by the financial crisis... we will seek to establish strong cooperative oversight arrangements with the EU and will continue to support and implement international standards to continue to safely serve the UK, European and global economy."

The UK government argues for 'no change' at Brexit on the basis that the UK will be fully compliant with all EU requirements; the implication is that the any change to reduce cooperation and mutual recognition would only arise as and when UK and EU requirements started to diverge.

Instead of seeking to maintain UK membership of the single market with features such as the single passport, the negotiating strategy is to seek an arrangement which breaks the commitment to EU standards but maintains as much of the benefits as possible, at the outset and for as long as common standards are in practice maintained. In the debate the UK may now avoid the politically charged terminology of passporting (from the single market) but will seek similar mutual recognition on a bilateral/partnership basis.

David Davis' recent speech illustrates this:

"We seek a new strategic partnership. A bold and ambitious free trade and customs agreement that should ensure the most free and frictionless trade in goods and services that is possible.

¹⁵ [The United Kingdom's exit from and new partnership with the European Union' \(February 2017\)](#)

While we cannot sign new trade deals while still members, we can and are preparing the ground for them. This means updating the terms of our membership of the World Trade Organisation, of which the UK was a founding member – which was then constituted as the GATT.

Modern free trade agreements require mechanisms to resolve disputes and to provide certainty for businesses on both sides. So the White Paper examines precedents in this area, and makes clear that we will negotiate an arrangement that respects UK sovereignty.

In terms of clarity and certainty, we recognise the need to provide it wherever we can during a period when some uncertainty is inevitable. That means that the position we start from, a common regulatory framework with the EU Single Market, is unprecedented.

The negotiation will not be about bringing together 2 divergent systems. It is about finding the best way for the benefits of the common systems and frameworks that currently enable the UK and EU businesses to trade with and operate in each other's markets to continue when we leave the EU. And the jurisdiction of the Court of Justice of the European Union in the UK will come to an end.

Delivering a smooth, mutually beneficial exit, avoiding a disruptive cliff-edge, will be the key. A never-ending transitional status is emphatically not what we seek. But a phased process of implementation of new arrangements - whether immigration controls, customs systems, the way we cooperate on criminal and civil justice matters, or future regulatory and legal frameworks for business - will be necessary for both sides. As the White Paper says, the time needed to phase in new arrangements in different areas may vary."

The response from the EU side has been limited by their policy of no negotiation before formal notice is given, but has repeated the no 'cherry-picking' point that the UK should not expect to have the same treatment (or 'privileges') as those within the single market. Assuming the UK seeks greater integration in some sectors only (as the Prime Minister's speech suggested) the UK might argue that it is not seeking full single market benefits without the associated obligations.

FS firms (with EEA membership and a full FS single market ruled out) still face uncertainty over:

- whether a period of less than 2 years is a realistic timetable to conclude a comprehensive and ambitious FTA and whether the EU will concede to parallel negotiation;
- the extent to which the new partnership will maintain 'mutual recognition' in cross-border regulation and what phased implementation means in practice;
- whether and when the 'phased implementation' might be agreed and details relied upon (and how it would be structured under EU and international law).

It is to be hoped that an early outcome of the negotiations will be a commitment to a phased implementation timetable which would enable firms to defer implementation of some parts of their contingency planning. This, however, cannot yet be guaranteed. Firms will need to address these risks, perhaps moving ahead with implementation but with an eye to possible early consensus in the negotiations. Those firms that may need new authorised entities within the continuing EU will now need to progress these plans on a worst case scenario.

Avoiding confusion

Much of the language in the Brexit debate has been misleading and confusing. Terms mean different things to different people. This has been a particular problem in the discussion of the FS sector. Much of the debate has focused on whether the UK should seek 'passporting' or the suggested alternative of 'equivalence'. Recent coverage reported Mark Carney rejecting equivalence on the same day as reports that the City had given up on passporting in favour of equivalence!

In truth the issues and outcomes are much less binary. Passporting, in fact, involves equivalence and the so called EU third country equivalence regime involves passporting. There have also been suggestions of 'topping up or in-filling equivalence' and even of 'filling in' the Swiss cheese! The jargon has started to confuse the message and move away from the practical possibilities.

There is an overlooked distinction between FTA 'market access' and frictionless cross-border dual regulation coordination (of the kind present in the EEA Single Market). The former permits access to the domestic markets so that third country firms can compete on equal terms with local firms. This is generally on condition that domestic regulatory requirements are satisfied and there is compliance with host state regulation (see Chapter 2 below). In contrast, the Single Market provides substantial dual regulation coordination for cross-border supply – including the single passport; this is based on prior harmonisation of rules and requirements (see Chapter 3 below).

We will therefore explain the techniques available for the new FS partnership and how we envisage the new relationship evolving. We also attempt to clarify some of the jargon (see in particular the Glossary and Chapter 7).

We have used the expressions of 'dual regulation coordination' (or 'DRC') and 'dual regulation barriers' (or 'DR barriers') to enable us to address cross-border supply, in the broadest possible sense – as we explain in chapter 6, and to reference the broad variety of:

- barriers from the host state regulatory regime; and
- measures used to coordinate dual regulation between home and host state and thereby (in most cases) eliminating or reducing these barriers.

We wanted to include all of these measures and not to use the language of any one example (such as 'passporting', 'substituted compliance', 'home state regulation/supervision', 'deference', 'mutual recognition' and so on). We also wanted to differentiate between

- the measures themselves (which are the objective/benefit to be achieved/agreed); and
- the criteria or pre-conditions for the application of such measures (such as 'equivalence', 'comparable regulation', 'justification by quality of regulatory regimes', 'harmonisation' and so on).

Avoiding confusion

The debate about Brexit and financial services has been confusing for the public and practitioners. Much of the jargon in use means different things to different people. Brexit will require a joint approach combining the practice and terminology of free trade negotiation on one side and the world of European financial services regulation on the other.

We have coined the expressions 'dual regulation coordination' (or 'DRC') and 'dual regulation barriers' (or 'DR barriers') to enable us to address cross-border supply (in the broadest possible sense) and to reference the broad variety of barriers from a host state regulatory regime and the measures used to coordinate dual regulation between home and host state (and thereby eliminate or reduce these barriers). We wanted to include all of these measures and not to use the language of any one example (such as 'passporting', 'substituted compliance', 'home state regulation/supervision', 'deference', 'mutual recognition' and so on). We also wanted to differentiate between the **measures themselves** (which are the objective/benefit to be achieved/agreed); and the **criteria or pre-conditions** for the application of such measures (such as findings of 'equivalence', 'comparable regulation', 'justification by quality of regulatory regimes', 'harmonisation' and so on).

We have referred to a 'DRC agreement' between the UK and EU to address DRC measures. This is intended as a neutral term but it could be described using other terminology such as treaty/accord, MRA or mutual recognition/bilateral/super equivalence.

Policy perspectives

The issue of cross-border regulation arises in many contexts –

- sometimes the context places greater emphasis on the perspectives and language of free trade and market access – for example in the financial services provisions of a free trade agreement such as CETA;
- sometimes it is more about effective regulation and the practicalities of supervision – for example when a host regulator is addressing the practicalities of branch regulation;
- in the case of the EEA/EU, the language and perspectives reflect the single market concept.

There are often tensions within and between these perspectives; prudential rules and consumer protection may be used as a disguised form of protectionism.

There are three policy parameters at play (forming a triple policy axis)

These are –

- Trade policy (i.e. external commercial policy), including WTO and the broader spectrum of open access versus protectionism;
- Regulatory policy in financial services and its prudential objectives in terms of consumer and market protection and financial stability including the risks to the host state posed by incoming firms under DRC; and
- Competition aspects – the competitive dynamic of incoming firms and the impact of regulation on competition

A new construction

In recent months there have been a number of influential reports from other institutions, groups and law firms¹⁶. These demonstrate that the Prime Minister's vision will not be met by reliance on the UK's third country status under pre-existing EU harmonisation (sometimes referred to as 'equivalence'). Equally, existing WTO commitments and recent Free Trade negotiations in the field of financial services are helpful precedents, but offer insufficient coordination of cross-border regulation and leave the barriers from dual regulation too high. Coordination mechanisms within the single market are currently dependent on the institutions of the EU and the EEA.

Brexit therefore involves issues, perspectives and the specialist language and jargon from various spheres – the world of WTO rules and FTAs, the world of financial services and its regulatory system and the world of the EU and its legal hierarchy and single market. The Prime Minister described the agreement she sought with the EU both as a free trade agreement and a partnership (as in the recent TTIP) but her objectives for FS appeared to go much further – something which maintained regulatory coordination, but operated outside the legal and institutional framework of both the EU and the broader EEA. In short an entirely new construction.

That construction will have to be compliant with WTO rules, evolve from existing FTA frameworks, techniques and negotiation processes, transpose regulatory coordination techniques from the single market context (and potentially elsewhere) into a new construction, and all of this will have to take effect under international law with the withdrawal and implementation (on the EU side) consistent with the EU treaties.

The structure of this report

One of the objectives of this joint report is to bring together the WTO/FTA and trade expertise of Legatum and its Special Trade Commission with the regulatory and EU legal expertise of CMS.

This report starts with analysis of the status quo (Chapters 2 to 5).

In Chapter 2 of this report we explain the current WTO rules for financial services and the financial services provisions that have been agreed in some recent FTAs.

Chapter 3 looks at international and cross-border arrangements for the regulation of financial services.

Chapter 4 then looks in more detail at each of the modes of supply; it looks at the practicalities of cross-border supply, the barriers from dual regulation and provides examples (from within the EEA single market, under WTO and FTA provisions, under EU third country provisions and from the US and elsewhere) of different measures to eliminate or reduce these barriers through dual regulation coordination. These demonstrate the spectrum of possibilities for the new relationship.

¹⁶ *Examining regulatory equivalence* – a FSN Forum and Norton Rose Fulbright paper
<http://www.nortonrosefulbright.com/files/regulatory-equivalence-paper-145872.pdf>; *EU's Third Country Regimes and Alternatives to Passporting* – developed by IRSG, TheCityUK, and Hogan Lovells
<http://www.hoganlovellsbrexit.com/uploads/downloads/TheEUsThirdCountryRegimesandAlternativestoPassporting.pdf>

Chapter 5 looks at the existing approaches around the world where one country evaluates whether it can rely on home state regulation in another country.

Chapters 6 to 9 then look to the future.

Chapter 6 looks at the development of the new EU/UK partnership in financial services.

Chapter 7 (Brexit outcomes without the comprehensive partnership) provides a brief consideration of the position if the UK and EU were to fail to reach agreement on dual regulation coordination.

Chapter 8 looks at how the UK should develop relationships beyond the EU – with countries such as Switzerland.

Finally, Chapter 9 looks at the future for UK domestic policy.

2. Financial services under WTO Rules and FTAs

The treatment of financial services under WTO rules and in FTAs is a somewhat technical area and perhaps not well understood by those who are not directly involved. It is a very important area for the Brexit negotiations because, for example:

- Any new UK/EU arrangements – both the final agreement and any interim measures/phased implementation - must be compliant with WTO and FTA obligations. An understanding of the terminology and framework, as it applies to FS, is therefore important.
- If the negotiations were to fail, WTO terms would apply – but what does this mean in practice?
- A wide range of financial services (though not all) benefit from market access and national treatment commitments with respect to establishing a commercial presence under GATS. EU member states have all accepted commitments in financial services under GATS, although coverage of cross-border supply is more limited. Specific limitations on the commitments given vary between member states and a wide carve out for measures taken for prudential reasons applies.
- While WTO members have committed to transparency and impartial application of regulations, and to ensuring that regulations are not more burdensome than necessary to achieve their objective, there is no compulsion to recognise or harmonise regulations of other countries. There is no obligation to permit a foreign operator to operate a regulated service on the basis of its home state licence, although countries may elect to do so. Some examples of this are described in Chapter 4.
- Recent FTA negotiations (such as CETA, TTIP and TPP) have started to address 'behind the border barriers' in services and have developed an approach for financial services; this may be seen as the natural precedent for a new UK/EU agreement (particularly as the UK has now announced that it will not remain within the single market). Is this a good starting point?

In this chapter we look at services under the WTO agreement, financial services in WTO rules (including General Obligations – MFN and Transparency, Recognition and Domestic Regulation, and Specific Commitments), and advanced treatment of Financial services under modern FTAs (such as CETA, TTP, and TTIP). Some of the examples of market access provisions appear in Chapter 4 when we look at the individual modes of supply.

Services under the WTO Agreement

Services, including financial services, are not subject to tariffs but international trade in services is subject to non-tariff barriers, which can be even more pernicious and distortive than import duties are to trade in goods. Non-tariff barriers in services are generally measures and regulations that either restrict the market generally, for example by imposing an economic needs test for the opening of new branch, or a limit on the number of providers allowed in a sector (market access barriers) or that apply less favourable treatment to overseas suppliers as against domestic suppliers, for example applying a higher premium tax on insurance contracts written with a foreign firm than with a firm established in the territory, or a nationality requirement for service providers¹⁷.

The WTO Agreement comprises a suite of agreements between members. There is a body of cases arising out of dispute settlement and a continuous process of trade policy reviews. The WTO Agreement that was the conclusion of the Uruguay Round in 1994 included the first multilateral agreement aimed at liberalising trade in services. It includes the General Agreement on Tariffs and Trade (“GATT”), the General Agreement on Trade in Services (“GATS”) and the Agreement on Trade related Aspects of Intellectual Property Rights (“TRIPS”). Sector specific agreements and annexes sit under the GATT, and each country has specific “schedules of commitments” under the GATT and the GATS. Under the GATS, countries have general obligations, that apply to all services, and specific obligations that apply only to service sectors identified in that country’s schedule of commitments. The EU has one schedule¹⁸, with limitations and conditions applying either across all member states or country by country where there are differences within the EU.

¹⁷ Residency and nationality requirements are commonly used interchangeably as either market access or national treatment barriers. They have elements of both.

¹⁸ Although the more recent accession states have not yet been consolidated into it.

The UK is a WTO member, and will be bound by its obligations and benefit from its rights under WTO rules, and a process is underway at the WTO to regularise the UK's position independent of the EU¹⁹. In this section we look at the default position that would apply under those rules in the absence of any preferential agreement with the EU and others, and then at the treatment of financial services in two key free trade agreements, one of which (CETA) the EU is party to and the other (TPP) which is the strongest example of what has been achieved in the liberalisation of financial services in an FTA to date.

TISA

in order to try and progress the liberalisation of trade in services, in the absence of a full WTO round to agree a multi-lateral update to GATS, a smaller group of WTO members have been negotiating a plurilateral Trade in Services Agreement (TiSA). While TiSA includes financial services, negotiations are currently stalled and it will not be concluded before the effective date of Brexit. In any event, on the basis of current drafts and offers from the participating parties, it will not move materially further in the direction of dual regulation coordination or recognition of home state authorisation and supervision, although the offer tabled by the EU does give a better view of the openness of the sector in member states than the GATS schedule.

Financial Services in WTO Rules

WTO rules cover financial services in a limited way. WTO members have undertaken some useful commitments in the General Agreement on Trade in Services (GATS), and associated documents, but there are critical gaps and caveats, in particular in respect of recognition of home country regulation and licensing (referred to in this paper as *dual regulation barriers*). There is a broad "prudential carve out"²⁰ that allows countries to derogate from their commitments for prudential reasons, as long as the relevant measures are not used as a means of avoiding commitments and obligations under the GATS.

At the conclusion of the Uruguay Round, it was envisaged that a series of services agreements would follow. Only the Basic Telecommunications Agreement with its Reference Paper on Competition Safeguards was concluded. Steps towards a fully-fledged financial services agreement along similar lines did not move past the WTO Understanding on Commitments in Financial Services (the *Understanding*). It was the EU that was pushing for deeper liberalisation in this area in the mid-1990s, but the US Treasury Department was less supportive of the process. TISA may progress the position on financial services from that under the Understanding, and will at least update and streamline the structure under which commitments are made, but it will still be based around the principles of market access and national treatment, rather than dual regulation coordination.

Some free trade agreements include provisions that build on WTO rules and take steps towards reducing and eliminating dual regulation barriers, as well as agreeing more advanced regulatory cooperation and dispute resolution. Importantly, dispute resolution mechanisms may be opened up to allow affected businesses to enforce state parties' commitments. The operation of the prudential carve out is central to how commitments in financial services work, both in the GATS and in FTAs, where it is commonly repeated in some form. Ultimately the carve out permits states to put non-confirming measures in place (even measures that are outright discriminatory) if they are for prudential reasons. For any arrangement that seeks to agree dual regulation coordination, such that businesses can operate cross-border and set up establishments in reliance on their home state authorisation without a local licence and capital, the prudential carve out will need to be suspended, to the extent that prudential requirements are satisfied by home state authorisation and supervision

General Obligations – MFN and Transparency

Financial services are covered by the general provisions of the GATS so the most favoured nation principle applies²¹. This means that services providers from all WTO members are to be treated no less favourably than providers from any other country, unless more favourable treatment for a country is:

- (a) specifically reserved in a member's annex; or

¹⁹ For a discussion of this process see *The UK's status in the WTO after Brexit* Lorand Bartels (23 September 2016)

²⁰ GATS Annex on Financial Services, paragraph 2

²¹ Article II GATS

- (b) part of an arrangement between adjacent countries to facilitate locally produced and consumed services or an agreement that has “substantial sectoral coverage” and provides for full national treatment of suppliers as between the parties²².

The other general provisions that apply are the transparency obligation²³ to publish and provide information on measures relevant to the agreement, and, with respect to all sectors where a commitment is undertaken, to apply all measures of general application in a reasonable, objective and impartial manner²⁴.

Recognition and Domestic Regulation

The GATS has a framework for the WTO Council for Trade in Services to establish bodies to develop disciplines “with a view to ensuring that measures relating to qualification requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade in services”.²⁵ To date, only disciplines in relation to accountancy have been agreed²⁶. However, pending agreement of further disciplines, members have agreed in respect of sectors where they have undertaken commitments (which includes financial services), not to apply licensing and qualification requirements and technical standards that nullify or impair their commitments in a manner that is:

- (a) not based on objective and transparent criteria, such as competence and ability to supply the service;
- (b) more burdensome than necessary to ensure the quality of the service;
- (c) in the case of licensing procedures, in itself a restriction on the supply of the service;

and could not reasonably have been expected from that member at the time the commitments were made.²⁷

This is a highly qualified control on the application of licensing and qualification requirements for financial services providers. It is also subject to the prudential carve out²⁸. However, it represents a measure of defence against the EU taking protectionist measures against UK operators, and is an area that is commonly expanded and developed in FTAs. It may also form the basis of a nullification and impairment of benefits claim in the WTO (“NVNI Claim”)²⁹ for barriers erected after the GATS was concluded. NVNI Claims are rare in WTO jurisprudence and usually accompany another claim for a violation of other provisions of the GATT or GATS. If the EU were to take such measures against UK operators after the UK leaves the EU, WTO provisions such as these might be relied on, depending on the nature of the EU action (which in any event may be permissible under the prudential carve out).

It is also permitted³⁰ (and specifically envisaged under the Annex on Financial Services) for members to recognise the education, licences and certifications obtained or granted in other countries, through harmonisation or otherwise, by agreement or autonomously. Unless it forms part of a wider agreement with “substantial sectoral coverage” such arrangements should be made available to other WTO members who meet the same requirements. The position of any interim arrangements or financial services before a comprehensive FTA is agreed therefore needs to be considered. In practice, it is unlikely that another country would meet all requirements during an interim period, or that a country that does, (or comes close, like Switzerland,) would challenge such an arrangement in the WTO, as it could prejudice their future relationships with the UK and EU in other areas.

DRC could also be introduced to the GATS “built in agenda”, which works towards progressive liberalisation provided for under Article XIX of the GATS. This could progress recognition among interested WTO members on a plurilateral basis through a process of requests and offers, and would further mitigate the risk of challenge from other WTO members.

Frameworks to achieve harmonisation and mutual recognition are commonly included in FTAs, and feature in all of the FTAs discussed below.

²² This is analogous to Article XXIV of the GATT which permits preferential arrangements as part of an agreement that covers “substantially all trade”.

²³ Article III GATS

²⁴ Article VI(1) GATS

²⁵ Article VI(4) GATS

²⁶ Disciplines on Domestic Regulation in the Accountancy Sector - Adopted by the Council for Trade in Services on 14 December 1998

²⁷ Article VI (5) GATS

²⁸ As confirmed in the recent case between Panama and Argentina before the WTO Appellate Body (WTDS453/R and WTDS453/AB/R), the first to test the application of the prudential carve out.

²⁹ Under Article XXIII GATS

³⁰ Article VII GATS

Specific Commitments – National Treatment

The above provisions apply to all services (or in the case of the obligation of reasonable, objective and impartial application of measures, all services in which a specific commitment is undertaken). Obligations to eliminate market access barriers and afford foreign suppliers treatment no less favourable than that accorded to domestic suppliers (*national treatment*) apply only to sectors specifically identified in a member's schedule of commitments. These obligations are also subject to any conditions and limitations set out against the sector in respect of each mode of supply in the schedule³¹.

If market access commitments are undertaken there are six types of restriction, which members will be deemed to have committed to eliminate unless otherwise specified in their schedule. They are mainly quantitative or economic needs based limits, of a kind that were addressed as between EU (then EEC) member states in early single market legislation such as the first non-life and life establishment directives described in Chapter 4. The six types of restriction are:

- (a) limitations on the number of service suppliers whether in the form of numerical quotas, monopolies, exclusive service suppliers or the requirements of an economic needs test;
- (b) limitations on the total value of service transactions or assets in the form of numerical quotas or the requirement of an economic needs test;
- (c) limitations on the total number of service operations or on the total quantity of service output expressed in terms of designated numerical units in the form of quotas or the requirement of an economic needs test;³²
- (d) limitations on the total number of natural persons that may be employed in a particular service sector or that a service supplier may employ and who are necessary for, and directly related to, the supply of a specific service in the form of numerical quotas or the requirement of an economic needs test;
- (e) measures which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service (but note that the EU has scheduled a general reservation on this for financial services in its schedule of commitments); and
- (f) limitations on the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment.³³

With respect to national treatment, no categories of measures are specified so members must ensure that all of their relevant measures are identified, otherwise unlimited national treatment will be deemed to apply to the listed sector.

This approach to specific commitments where members are not bound in respect of a sector unless it is specifically listed is known as a “positive list” approach. The alternative of a “negative list” (which is deployed in some FTAs, notably NAFTA). The EU favours a hybrid approach, as described further below.

Financial Services

Financial services are covered by the GATS which has an Annex on Financial Services (*the Annex*) and an associated Understanding on Commitments in Financial Services that some WTO members have entered into, including most EU member states³⁴ (*the Understanding*). The Uruguay Round negotiations on financial services were extended into 1997 to complete the Understanding and enable members to schedule commitments accordingly.

The definition of Financial Services in the Annex is wide ranging and covers everything that would be considered to be a mainstream financial service. The definition is set out in Annex C to this report.

³¹ It should also be noted that many WTO members (EU member states included) often have less restrictive measures in place than the legal bindings in the schedule would indicate; the bindings represent a maximum level of restriction.

³² Subparagraph 2(c) does not cover measures of a Member which limit inputs for the supply of services.

³³ Article XVI GATS

³⁴ Australia, Canada, all EU members (except Cyprus, Estonia, Latvia, Lithuania, Malta, Poland and Slovakia), Iceland, Japan, Liechtenstein, New Zealand, Nigeria, Norway, Sri Lanka, Switzerland, Turkey and the USA. Other members have made commitments in their schedules as to financial services, without having subscribed to the Understanding.

The Annex also introduces what is known as the “**prudential carve out**”.³⁵ This provides that no other provision of the GATS will prevent a WTO member from taking measures for prudential reasons, including for the protection of investors, depositors, policyholders or persons to whom fiduciary duties are owed, or for the integrity and stability of the financial system. This is subject to the important qualification that where such measures do not conform with the provisions of the GATS, they are not to be used as a means of avoiding the member’s commitments or obligations.

The carve out is commonly included in some form in FTAs, sometimes more narrowly, and sometimes widening its application, for example by not including the anti-avoidance qualification. CETA includes helpful principles for its application to measures under it, as discussed further below. Given the interconnected nature of the UK and EU financial services’ offerings, we would recommend a negative list approach, in the UK/EU FTA and those that the UK will be looking to strike with other countries.

The Annex also includes provision for members to recognise prudential measures of any other country in determining how measures relating to financial services should be applied³⁶. As with the general GATS provision on recognition, this can be by harmonisation or otherwise, and by agreement or autonomously. A member that is party to such an arrangement must permit other members an opportunity to negotiate accession to the arrangement or negotiate comparable ones under circumstances where there would be equivalent regulation, oversight and implementation, and information sharing procedures if necessary. This may be of assistance to the UK ensuring, as a minimum, recognition under the EU’s existing third country regimes, as it would mean that the EU institutions should not give the UK worse treatment than it would give any other country seeking equivalence recognition under the EU’s frameworks. This is clearly not an obligation that the UK should look to rely on, but at least establishes a baseline. More optimistically, it gives a basis to work from to establish the broad home state recognition envisaged by the Regulatory Partnership model put forward in this paper.

Members who entered into the Understanding have scheduled their commitments on market access and national treatment in financial services in accordance with the approach agreed in the Understanding. The Understanding provides for:

- A **Standstill** - which, in WTO/trade parlance means that conditions, limitations and qualifications to the commitments in the Understanding are limited to existing non-conforming measures. This is clearly different to the use of ‘standstill’ in the Brexit context which has been used to mean a continuation of existing rights and measures as between the UK and the EU;
- B **Market access**
- (i) Monopoly rights – are to be listed in members’ schedules, and members are to endeavour to eliminate or reduce their scope.
 - (ii) Public entities – although under Article XIII government procurement is not covered by the MFN, market access and national treatment provisions of the GATS, the Understanding requires members to ensure that financial services providers established in their territory are accorded MFN and national treatment with respect to the purchase of financial services by public bodies. Financial services are now included in the WTO Government Procurement Agreement in any event.
 - (iii) Cross border trade – members have agreed to permit and accord national treatment conditions for non-resident suppliers to supply:
 - (aa) insurance of risks in shipping, commercial aviation, space launching and freight, goods in international transit, reinsurance and retrocession and auxiliary services such as consultancy, actuarial and claim settlement services;
 - (bb) provision and transfer of financial information and data processing, and the banking auxiliary and advisory services set out in paragraph (b)(xi), except intermediation;

and to permit their residents to purchase the insurance services in paragraph (aa) above and all of the banking and investment and auxiliary/advisory services defined in the Annex above in the territory of any other member. The development of services provided electronically at a distance over the Internet means services can be provided more easily across borders and has confused the boundary between consumption abroad and cross border supply so these modes of service provision can often be fused, and the financial services specific modes of supply we have

³⁵ Para 2 Annex on Financial Services

³⁶ Para 3 Annex on Financial Services

examined in Chapter 4 below reflect this. This is commonly the case in FTAs dealing with services. To recognise this reality, commitments could be made across three modes of supply in the FTA with the EU, unless there are specific differences between modes 1 and 2 coverage in EU member states.

- (i) Commercial presence – members have agreed to give financial services suppliers from any other WTO member the right to establish and expand within their territory. This can be subject to terms, conditions and procedures for authorisation, provided such terms do not violate the other provisions of the GATS, such as the MFN principle, and transparency requirements. This is therefore an example of market access and national treatment commitments that, in the absence of recognition on a bilateral basis, will not remove the relevant dual regulation barriers for service providers wishing to establish in a country.
- (ii) New financial services – members are required to permit financial services suppliers who are established in their territory to provide any new financial service. It should be noted that this will be subject always to the prudential carve out and all other authorisation conditions to which the supplier is subject. It is important to note that the EU in the negotiations for the TiSA has refused to accept coverage of new services which would appear to contravene the Understanding. This refusal has caused the US to question EU commitment to TiSA and therefore represents an opportunity for any US-UK FTA.
- (iii) Transfers and processing of information – members are prohibited from taking measures to prevent transfers of information or the processing of financial information that is necessary for the conduct of the ordinary business of a financial services provider. This is subject to a right for members to protect personal data, privacy and confidentiality, as long as the right is not used to circumvent the provisions of the GATS. This provision may be of use in negotiating the data protection and privacy aspect of an FTA with the EU.
- (iv) Temporary entry of personnel – members are obliged to permit suppliers established in their territory to bring in senior management personnel possessing essential information and specialists in the operation of its financial services and, subject to the availability of qualified personnel already in the country, IT, accounting, legal and actuarial specialists. This is an area that both the EU and the UK will likely wish to liberalise in an FTA.
- (v) Non-discriminatory measures – members are to endeavour to remove or limit the adverse effects of non-discriminatory measures that prevent suppliers from offering permitted financial services in a territory or limit the expansion of activities into the entire territory of a member, and any other measures that are consistent with the provisions of the GATS but adversely affect the ability of financial services suppliers of another member to operate, compete or enter their market.

C. National Treatment

Members are required to ensure financial services suppliers established in their territory have equal access to payment and clearing systems operated by public entities and to official funding and refinancing facilities (though not access to lender of last resort facilities), and membership of or access to any self-regulatory body, exchange, market clearing agency or similar. Accordingly, the EU has scheduled specific commitments in the required sectors in the manner required by the Understanding³⁷. The countries who have not signed the Understanding have their commitments scheduled differently. Some countries have included more conditions and limitations than others and generally there are fewer restrictions on national treatment than on market access. The UK has very few limitations or conditions on its commitments compared to other EU countries, reflecting its generally more open economy (this is the case across all service sectors, under the GATS and in the EU's FTAs). Several countries have legal entity requirements, requirements to have an establishment in their territory and residency/nationality requirements for directors/individual service providers.

It should be noted that the EU's services schedule with the WTO is out of date (although an updated version to reflect accessions was submitted in 2006, it is as yet uncertified and not yet updated for the accessions of Bulgaria and Romania), and does not reflect current regulation. For example there are limitations in respect of Germany and Greece expressed in terms of deutschmarks and drachma, so the usefulness of the schedule in assessing the current restrictions on market access and national treatment in EU member states is limited³⁸. It has also

³⁷ European Communities and their Member States, Schedule of Specific Commitments, Supplement 4, Revision

³⁸ The schedules of CETA and the offer made to the TiSA negotiations are a more realistic view, but TiSA is not agreed.

been noted that in the case of many developed countries, the commitments that were accepted as binding in the GATS are more restrictive than the actual state of openness in financial sectors.³⁹ Since the starting point for the UK will be the EU services schedule, there will potentially be significant difference between the binding that a country has accepted and what is actually applied (in trade negotiator parlance this is known as “water in the schedule”). The goal for the UK, once it is in full control of its WTO services schedule is to eliminate the water from the schedule and bind itself and partners at the liberalised level in FTAs and ultimately in the WTO itself.

Member State Specific Limitations

The EU’s GATS schedule of commitments in financial services includes EU-wide and member-state level reservations on the market access and national treatment commitments accepted under the Understanding or, in case of the non-Understanding countries⁴⁰, the sectors where they accept commitments and the applicable limitations.

There is a general rule that, in a non-discriminatory manner, financial institutions incorporated in an EU member state must adopt a specific legal form. This operates as a reservation to the default GATS market access commitment not to maintain measures which restrict or require specific types of legal entity or joint venture. This kind of requirement is to be expected in the field of financial services and would not generally be regarded as an unduly onerous or unreasonable barrier.

Several member states have limitations on certain mode 1 and mode 2 insurance commitments. For example, Austria, Germany and Denmark provide that compulsory air insurance can only be underwritten by a firm established in the EU (in the case of Germany and Austria, to be a branch established in the country or a subsidiary somewhere in the EU). In France, insurance of risks relating to ground transport may only be carried out by firms established in the EU and Italy requires transport insurance of goods, insurance of vehicles as such and liability insurance of risks located in Italy to be underwritten only by insurance companies established in the EU. Austria and Denmark have residency requirements for staffing of insurance branches. In modes 1 and 2 (where the commitment in the Understanding relates to insurance of risks relating to maritime shipping, commercial aviation, space, goods in international transit reinsurance and retrocession and auxiliary services such as actuarial and risk assessment), Austria prohibits promotional activity and intermediation on behalf of a subsidiary not established in the EU or a branch not established in Austria. Other countries would therefore permit such promotion and intermediation on national treatment terms i.e. local rules on advertising and financial promotions would apply.

In banking and other financial services, there are a number of country specific limitations on commitments in the Understanding. For example, Belgium requires establishment in Belgium for the provision of investment advisory services, and Finland has a residency requirement for establishment. Portugal provides that establishment of non-EU banks is subject to authorisation conditional on the establishment contributing to increasing the national banking efficiency or producing significant effects on the “internationalisation” of the Portuguese economy. Hungary has a general reservation to the effect that the board of a financial institution should include at least two members who are Hungarian citizens and residents, and “have permanent residency in Hungary for at least one year”.

For the non-Understanding countries, the scope of the commitments is less consistent and each has its own limitations.

It should be noted that the limitations in the GATS schedules are reservations of rights, and do not necessarily mean that a country had, much less still has, regulation to that effect in place. The reservations in FTAs like CETA are a better guide to measures actually in place. The right to maintain exceptions and reservations in relation to market access and national treatment is limited to existing non-conforming measures set out in a party’s schedule. The CETA schedule of reservations and the GATS schedule of commitments do not easily read across but a country by country comparison would be possible. For example, the restrictions noted above in relation to Austria are present, but those in relation to Germany and Denmark are not.

³⁹ Working Paper of the International Monetary Fund – *The GATS Agreement on Financial Services – A Modest Start to Multinational Liberalisation* Piritta Sorsa May 1997

⁴⁰ Being Cyprus, Estonia, Latvia, Lithuania, Malta, Poland and Slovenia

In a footnote to the commitments on financial services, the EU schedule clarifies that branches of non-EU financial institutions are not, with limited exceptions, subject to harmonised EU-wide prudential regulation that would enable them to benefit from the facility to set up new establishments and provide cross border services throughout the EU (i.e. these commitments do not constitute passporting-type rights for third country firms). Such branches:

“receive an authorisation to operate in the territory of a [EU] member state under conditions equivalent to those applicable to domestic financial institutions of that member state, and may be required to satisfy a number of prudential requirements such as, in the case of banking, separate capitalisation and solvency requirements... or in the case of insurance, specific guarantee and deposit requirements, a separate capitalisation and localisation in the member state concerned of assets representing the technical reserves and at least one third of the solvency margin⁴¹.”

The note distinguishes the treatment of branches and cross border service provision from the treatment of subsidiaries established in the EU by third country firms, where restrictions may not be applied unless permitted by EU law in relation to the treatment of EU companies and nationals. This again underlines the difference between passporting as a subsidiary established in a member state as opposed to accessing the market as third country firm pursuant to WTO rules, and the importance of addressing dual regulation barriers.

Advanced treatment of financial services – Some FTAs

WTO rules are not just a fall back or default in the absence of a better bi-lateral agreement. They are the foundation for and structure around which all international trade is carried on. Bi-lateral and platform trade deals (such as FTAs and customs unions) build on this structure. WTO rules still apply, both to cover aspects of trade that are not dealt with in the trade deal and to regulate the parties' trade with countries that they do not have a trade deal with.

The financial services chapters or sections in FTAs (including where the EU is a party) commonly adopt the definition of financial services from the Annex and follow the wording of the GATS and the Understanding quite closely, adding and expanding on areas where further liberalisation has been agreed. Obligations from the GATS are restated to bring them within the scope of dispute resolution under the FTA, which is generally more effective and reliable than the equivalent WTO process, and may be open to non-state actors.

They also follow the format of identifying sectors in which commitments are undertaken and exceptions and reservations maintained by the parties in schedules. This can be done either by way of a “negative list” where all sectors will be covered unless otherwise specified, or a positive list, in which only the listed sectors will be covered. The negative lists approach is generally considered to yield greater levels of liberalisation as any measures that are not specified will be a violation, which both incentivises transparency and increases the likelihood that more measures will be subject to commitment as default. The EU generally takes a positive list approach where only sectors specifically identified by it are bound, but a negative list for exceptions and reservations. CETA operates as a further evolution of the hybrid approach with a negative list for market access and national treatment for establishment by financial institutions, a positive list for sectors covered by cross border supply commitments and negative lists with respect to any exceptions and reservations.

A prudential carve out is included with respect to financial services, and its scope and details can vary. The approach under CETA is described below and it both qualifies and clarifies the operation of the carve out. The equivalent provision in the EU Singapore FTA provides that prudential measures “shall not be more burdensome than necessary to achieve their aim” and “shall not constitute a means of arbitrary or unjustifiable discrimination against financial services suppliers of the other party”. When the DRC agreement set out in Chapter 6 is brought within the FTA framework (see final section of Chapter 6), this would need to sit outside the prudential carve out or the carve out would need to have evolved such that it will not apply to prudential measures covering matters where the parties have agreed to recognise home state authorisation and supervision, for so long as the parties agree that their respective measures in the affected field are within the agreed parameters of acceptable prudential regulation.

⁴¹ Solvency II is the up to date regulation on this

CETA

CETA is perhaps the most advanced treatment of financial services in an EU FTA so we have included a detailed examination of the key provisions in its financial services chapter.

CETA makes a distinction between a “financial institution” which is authorised to establish a presence regulated and supervised as a financial institution in their home state, and a “financial service supplier” which is simply a person engaged in the business of supplying a financial service in its home state. Financial institutions are treated differently for the purposes of establishing a commercial presence, the market access commitment that prohibits all of the market access restrictions referenced in the GATS is on a negative list basis⁴². Such establishments are entitled to national treatment on an investment basis⁴³, although it should be noted that this can include authorisation terms, conditions and procedures.⁴⁴

Financial services suppliers are covered by cross border trade commitments to give market access and national treatment in listed sectors, subject always to the prudential carve out and to specified exceptions and reservations set out in the parties’ annexes⁴⁵. The exceptions and reservations are a positive list which includes a standstill obligation so they may not be added to by the parties.

The cross-border supply commitment includes an obligation to permit persons in a party’s territory to purchase a financial service from a cross-border financial service supplier in the territory of the other party (although actually doing business and solicitation in the other party’s territory are specifically not permitted as part of this). This reflects the existing commitment in the Understanding.

In the case of the EU, the services benefiting from market access and national treatment commitments for cross-border supply include:

- (a) (with exceptions for Cyprus, Malta, Poland, Latvia, Lithuania and Estonia) the insurance business covered by the Understanding;
- (b) (with exceptions for the same countries plus Belgium, Slovenia and Romania⁴⁶) financial information and for data processing services, advisory and auxiliary services, other than intermediation; and
- (c) portfolio management services to professional clients, after a transitional period of four years and subject to EU prudential requirements including equivalence assessment.⁴⁷

Regulation – the Domestic Regulation chapter of CETA applies to financial services and in particular the licensing and qualification requirements and procedures provisions apply to the exercise of statutory discretion by financial regulators. This chapter follows the GATS and is helpful in ensuring transparent and objective regulation and impartial application, but does not address dual regulation and does not include the GATS obligation to ensure that licensing and qualification requirements are not more burdensome than necessary (although this will still apply to the sectors where the parties have made commitments under GATS). Each party is obliged, to the extent reasonably possible, to publish in advance any financial services related laws, regulations, procedures and administrative rulings of general application and provide reasonable opportunity for any interested person and the other party to comment⁴⁸.

The possibility of recognising each other’s prudential measures is provided for, but does not go materially further than the GATS and no actual recognition is given in the agreement. A Financial Services Committee is established 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 cooperate in the development of international standards”.

The dialogue is further described as “based on principles and prudential standards agreed at the multinational level [focused] on issues with cross-border impact such as cross-border trade in securities ... the respective frameworks for covered bonds and for collateral requirements in reinsurance, and to discuss issues related to the operation of branches.” The full governance structure under CETA is described in Annex C.

⁴² Article 13.6 CETA

⁴³ Article 13.3 CETA

⁴⁴ Article 13.6(3) CETA

⁴⁵ Article 13.7 CETA

⁴⁶ Who have included more services (except Belgium who included fewer).

⁴⁷ The commitment from Canada with respect to portfolio management is not subject to the four year delay or equivalence recognition but applies to services to collective investment schemes in Canada rather than professional clients.

⁴⁸ Article 13.11 CETA

Prudential carve out and dispute resolution - The prudential carve out under CETA⁴⁹ is both narrower than in the GATS Annex and more precise as to its scope:

“This Agreement does not prevent a Party from adopting or maintaining *reasonable* measures for prudential reasons, including:

- (a) the protection of investors, depositors, policy holders [...]
- (b) the maintenance of the safety, soundness, integrity or financial responsibility of a financial institution, cross-border financial services supplier or financial services supplier; or
- (c) ensuring the integrity and stability of the party’s financial system”.

Prudential measures may include banning a particular service or activity, but the ban is not to cover a whole sub-sector such as “banking”. There is no specific anti-avoidance provision that the prudential measures are not to be used to circumvent other obligations under the agreement, although this is reflected in one of the interpretative principles in the financial services annex.

The financial services annex⁵⁰ sets out principles to guide the parties and tribunals on the application of the prudential carve out. These include:

- (a) parties may maintain higher levels of prudential protection that are established in common international commitments;
- (b) those applying the principles are to defer to the highest possible degree to the regulations and practices in the respective jurisdictions and the decisions and determinations of regulatory authorities;
- (c) a measure will be deemed to be compliant if it:
 - (i) has a prudential objective and is not so severe in light of its purpose that it is manifestly disproportionate to its objective
 - (ii) is in line with international standards that are common to the parties
 - (iii) is for the resolution of a financial institution that is no longer viable, the recovery of an institution under stress or the preservation of financial stability in response to a system wide financial crisis.

Generally, disputes arising under the financial services chapter are subject to the general dispute settlement regime under CETA, with some specific requirements as to the composition and qualifications of the panel of arbitrators who shall be appointed for financial services disputes. If a measure is found to be inconsistent with the terms of the agreement, the complaining party may suspend benefits in the financial services sector that have an equivalent effect to the inconsistent measure.⁵¹

The procedure for the resolution of disputes between investors and states can involve infringements of the financial services commitments in respect of market access, national treatment and the application of MFN to investments in financial services. This can result in the award of monetary compensation or the restitution of property to the investor. The process for investment disputes in financial services includes a specific process for the discontinuance of investment disputes brought by an investor where the prudential carve out is invoked by the state party as a defence and the Financial Services Committee and the CETA Joint Committee together determine that it is a valid defence to the claim.

See further in chapter 6 for a broader explanation of how WTO and FTA dispute settlement works.

TPP

Although the US has pulled out of the TPP thus making it very difficult to realise (since its ratification is conditional on it covering a specific volume of trade which is impossible without the US), TPP was agreed by the parties to it and was widely considered at the time to be the most advanced liberalisation of financial services yet achieved in an FTA (outside of the EEA). At the time of writing, it is still an open question as to

⁴⁹ Article 13.16 of CETA

⁵⁰ Annex 13-B CETA

⁵¹ Article 13.20 CETA

whether the remaining eleven members of the TPP will seek to continue the agreement in more or less its current form.

The principal obligations in respect of market access and national treatment for establishment of financial institutions and cross border supply of financial services respectively are similar to those in CETA. TPP also provides for the possibility of recognition of prudential measures of other parties and a framework chapter on regulatory coherence. The TPP parties were able to go further than CETA in provisions for certain activities and certain specific commitments. For example, there is a provision on “back office functions”⁵² which, although not a binding obligation, recognises “the importance of avoiding the imposition of arbitrary requirements on the performance of those functions”, including by a financial institution itself, an affiliate or an external service provider.

There is a specific commitment to permit cross-border supply of investment advice and portfolio management to collective investment schemes, but this remains subject to the right to impose registration or authorisation requirements⁵³. There is also a specific commitment to allow the supply of electronic payment card services for payment card transactions. This may be made subject to registration and authorization, and the conditions suggested for this to be granted are supervisory cooperation with home state supervisor and the right for the regulators of the receiving country to audit and examine the supplier's systems and records.⁵⁴

Similarly to CETA, disputes involving the prudential carve out are to be resolved by the relevant state parties only, and are not subject to investor/state dispute resolution.

TTIP

We have not gone into detail on TTIP as the services chapter at it stood after the latest round of negotiation was not well developed and in particular with respect to financial services there was no consensus between the parties. The priorities of the parties will have shifted significantly with the new administration in the US and the exit of the UK from the EU.

Full host state regulation/dual regulation is a major barrier to cross-border/foreign operation.

When FS firms seek to provide financial services from their home state into another country (the host state) or from within the host state, they face substantial barriers from the host state regulatory regime (DR barriers). In some cases these barriers **preclude cross-border modes of supply altogether**. A firm may require host state authorisation which is only possible if it establishes a local branch; a host state may refuse to authorise a branch and may require a local subsidiary to be used. In other cases, regulatory requirements may conflict making cross-border supply or international infrastructure impractical. Additional DR barriers are a mix of financial barriers (ineffective use of capital and resources), operational difficulties (maintaining multiple entities, licences and compliance operations) and associated cost.

DRC measures remove or mitigate these DR barriers.

Market access (in WTO/FTA terminology) is not the real or immediate priority for financial services - an agreement on DRC is required

Financial services firms, like other service providers, face ‘behind the border barriers’ to cross-border supply around the world. Outright discrimination against foreign firms (such as quantitative or economic limits) is one example of these barriers. Chapter 2 of the Report analyses multilateral WTO/GATS obligations and modern FTA terms as they apply to financial services.

Modern free trade agreements (such as CETA and TPP) provide **market access** rights for financial services firms in many business lines and prohibit discrimination against foreign firms. However, they normally permit the host state to impose its regulation (such as requirements for local authorisation and capital) under WTO terms on ‘national treatment’ and the ‘prudential carve-out’. Extensive mutual recognition has been limited to the goods sectors.

⁵² Article 11.17 TPP

⁵³ Annex 11-B Section A TPP

⁵⁴ Annex 11-B Section D TPP

No FTA (with the EU or between other states) has involved significant DRC measures in financial services. Colloquially put, there has never been a real (i.e. substantive) free trade agreement in financial services.

Discussion of 'market access' rights in financial services (as used in WTO/FTA terminology) is to miss the point; after Brexit UK FS firms doing business with EU states and EU firms doing business with the UK will face substantial new DR barriers as dual regulation is re-imposed, unless DRC measures can be agreed. The conclusion of Chapter 2 is that the application of default WTO rules (i.e. the financial services commitments in the EU's WTO schedules) will not assist materially in this regard; nor would an EU/UK agreement based on the most advanced FTAs in the field (such as CETA). An agreement on DRC is required.

3. Regulating cross-border financial services - general

The previous chapter explained the WTO/FTA regime; this chapter looks at the FS regulatory regime and the differing arrangements between countries and between regulators and supervisors for the regulation of international and cross-border business.

International standards

There are a variety of bodies involved in setting international standards including –

- The Basel Committee on Banking Standards (BCBS), under the auspices of Bank for International Settlements (BIS);
- The Financial Stability Board (FSB) and the G20;
- The International Association of Insurance Supervisors (IAIS);
- The International Organisation for Securities Commissions (IOSCO).

The standards range from principles such as the IAIS Insurance Core Principles for assessing an insurance regulatory regime⁵⁵ to the very detailed and extensive BCBS rules for banks (which are the foundation of bank regulation around the world).

Harmonisation and common standards

There are various mechanisms for harmonising regulatory requirements across national borders. Harmonisation is normally undertaken to establish minimum standards with countries free to have higher requirements. The objective of Basel was to establish **minimum** financial requirements for banks around the world, but with no limitation on countries having higher requirements. This approach which is called '**minimum harmonisation**' was followed by the EU when harmonising FS rules. Member states had to meet the EU requirements but were free to apply higher standards if they wished ('gold plating').

More recently the EU has, in some cases/provisions, legislated on a **maximum harmonisation** basis, or single rule-book approach. Here the intention is that rules in a given field should be identical in all member states.

Harmonisation brings benefits on its own, such as reducing systemic risk; it also facilitates arrangements which assist supervisors to regulate/supervise cross-border activities and which reduce dual regulation barriers for firms.

Institutional arrangements to facilitate cross-border supervision

There are a variety of institutional mechanisms used to assist cross-border supervision – MOUs, confidentiality arrangements, data sharing between supervisors, cooperation between supervisors generally and in relation to the supervision of specific firms/international groups e.g. via colleges of supervisors from 2 or more countries etc. These are common outside the EU/EEA single market; within the EU the arrangements are more developed, particularly with the development of the European Supervisory Authorities and the transfer of responsibility for bank supervision across the Eurozone to the ECB⁵⁶ (see further below and at Annex A).

Cross-border supply and DRC

Firms can face DR barriers in a wide variety of situations, for example:

- a firm in one country doing business with clients/counterparties, or establishing a branch, in another country;
- a group operating subsidiaries in various countries; or

⁵⁵ [IAIS insurance core principles November 2015](#)

⁵⁶ See our reports [here](#) which explain the EU FS institutions and legislative process.

- the treatment of a firm in one country which has exposures to, or intends to use the services of, a firm in another country.

In Chapter 4 we look at each 'mode of supply' in detail and give examples of the different DRC techniques used to cater for the regulation of cross-border activities. DRC come in many forms and with many names and jargon – **mutual recognition, home state supervision, passporting, substituted compliance, country of origin, deference** and so on. These may be designed to assist supervisors and to achieve effective regulation and most are also intended to assist regulated firms/infrastructure by reducing DR barriers.

These arrangements can operate -

- on a unilateral basis (for example PRA's policy on third country bank branches – see Chapter 4 and Annex B for further explanation);
- on a bilateral basis (for example the 1989 EU/Switzerland agreement on non-life insurance and the EU/US arrangements on central clearing – see Chapter 4); or,
- in the EEA single market, on a pluri-lateral basis. The single market in financial services is the only supra-national arrangement of its kind and has achieved a unique level of DRC and DR barrier reduction and supervisory integration for cross-border business.

These arrangements normally dependent on, or only achievable, one state regarding the other as having sufficient or satisfactory regulation and/or supervision and (often) vice versa. In some cases this involves one state in a narrowly focused review of the relevant regulatory requirements of the other state to determine if they are sufficient to permit DRC in that area. This assessment process is sometimes based on a threshold as to whether the other state's requirements are at least 'equivalent' to those of the evaluating state – sometimes referred to as 'equivalence'. Chapter 5 looks at this topic in more detail.

There is a large amount of available literature on many different forms of dual regulation coordination in use around the world and about the related processes and criteria used for evaluating the sufficiency or equivalence of another state's regulation. The examples given in Chapters 4 and 5 are by way of example and are by no means comprehensive. There are, no doubt, many other examples of interest⁵⁷ and this is a topic which could be researched further.

There is increasing drive not only for international standards but also in global level reforms to regulation and in related DRC. Post crisis reform of the OTC derivatives market was led by the FSB (under G20) and the resulting national and supra-national implementation incorporated DRC. As a result UK CCPs have recognition under the implementing legislation of various countries such as Japan, Australia and the US. The US arrangements were concluded by the European Commission and implemented under the EMIR equivalence regime (see further under modes 1 and 2 below in Chapter 4).

DRC within the EU/EEA - why the fuss about the EU 'single passport'?

Annex A to this report contains a brief overview of financial services regulation within the EU single market. It also provides links to a series of RegZone reports which explain the operation of the regime in greater detail.

The single market provides a uniquely integrated model of cross-border regulation with very extensive coordination of dual regulation. These arrangements operate under the umbrella of EU law and the EU level institutions. This regime is extended to the 3 EFTA/EEA states via the EEA treaty. This has its own institutions and processes for adoption of relevant EU legislation (a 'two pillar' structure). The EFTA Surveillance Authority has an enforcement role similar to the European Commission and the EFTA Court has jurisdiction in lieu of the CJEU (and applies EU law on a consistent basis). The role of the new ESAs has proved controversial within the EEA/EFTA states (see this RegZone report⁵⁸ for further details).

⁵⁷ See for example - *Jurisdictions' ability to defer to each other's OTC derivatives market regulatory regimes'* (18 September 2014); *Report of the OTC Derivatives Regulators Group (ODRG) to G20 Leaders on Cross-Border Implementation Issues* (November 2015); *CFTC Comparability Determination for the EU* (March 2016); *The European Commission and the CFTC reach a Common Path Forward on Derivatives* (July 2013); Davis Polk, *Impacts and Implications of the CFTC's Emerging Clearinghouse Exemptive Program* (January 2015).

⁵⁸ http://www.cms-lawnow.com/regzone/articles/2016/jan/recent-problems-eea-agreement?cc_lang=en

Under the EU single passport system, a firm is authorised by the member state where it is incorporated and head-quartered but the licence is effective and valid across all 31 states of the EEA. This entitles the firm to conduct business subject only to a non-discretionary notification process. It covers the main modes of supply (cross-border services and via a local branch) and across all customer types (retail, commercial and wholesale).

The passport is an example of 'mutual recognition' and 'home state compliance' or 'substituted compliance' – prudential regulation follows the licence and is a home state matter (recognised by the other 'host states'), whilst some conduct of business rules are on home state (or country of origin or mutual recognition basis) and others apply on a host state basis. It is called a 'passport' because the licence/authorisation in the home state is valid (to a greater or lesser degree) in the host states i.e. the firm has the same authorised status in the host state as local firms authorised by the local host regulator.

Within the EU/EEA, harmonisation and the related dual regulation coordination (including passporting) has often been achieved in stages. Partial harmonisation (often on a minimum harmonisation basis) underpinned a partial passport providing limited dual regulation coordination. Harmonisation only went so far and so dual regulation coordination/passporting was limited. For example under the insurance directives (life and non-life) dual regulation coordination was introduced in three phases. In the early stages, it did not cover all modes of supply or all types of insureds (services but not branch or commercial but not retail insureds).

The operation of the single passport has enabled groups to de-subsidiarise and use a single legal entity as a hub with a single licence and single prudential regulator to provide services across the entire EEA – operating both across-borders and with local offices/branches in any or all of the 31 countries. Non-EEA groups frequently establish a subsidiary in an EEA state (the hub) which can then use the single passport operate around the EEA; many have chosen the UK for their EEA hub.

A major concern for firms using the passport to hub or trade cross-border from the UK or to trade cross-border from the EEA into the UK is that their current authorisation will cease to cover these activities at Brexit, unless and to the extent alternative arrangements are put in place. They would need to take one or more of the following steps:

- move business operations to existing group entities with the requisite licence in the continuing EEA;
- establish new entities and obtain authorisation in the relevant country,
- obtain local authorisation e.g. for a London branch of an EEA entity whose home state licence would cease to be valid in the UK; or
- cease activities which are no longer covered by the passport.

The arrangements envisaged for the new partnership outlined in this paper would avoid or reduce the need for this reorganisation.

FS regulation in the EU – a mix of EU rules and differing domestic law and practice

It is important to appreciate that the regulatory regimes of any EU state are made up of a patchwork of EU harmonised requirements (some via EU regulations which are directly applicable in the same terms in each state and others implemented in separate domestic legislation⁵⁹ in each country to meet EU directives) and un-harmonised domestic law, regulation and practice. Similarly the institutional structure reflects a complex mix of EU level roles and institutions and domestic roles and national institutions.

So for example, in response to the banking crisis a decade ago, the EU developed CRD IV rules⁶⁰ on a harmonised basis (following Basel international standards). At the same time the UK, for example, introduced two major reforms – the restructuring of major UK banks under ring-fencing rules and a stringent regime to regulate individuals (the 'senior managers' regime). These two important reforms only applied under the UK regime; so there are quite fundamental differences between the UK and other EU countries which have different approaches to the key issue of bank structures⁶¹.

⁵⁹ See Annex K for examples of member states' domestic regimes.

⁶⁰ CRD IV: a credit institution authorised in an EEA member state can carry on banking activities, including deposit-taking, lending and consumer credit, in another EEA Member State on a cross-border basis or through a branch

⁶¹ The proposed [Regulation](#) on structural measures improving the resilience of EU credit institutions is based on the recommendations of the October 2012 [Liikanen Report](#). The Regulation would grant national regulators 'ring-fencing' powers allowing them to force larger banks into separating their deposit-taking from their riskier trading activities. It also includes a proposed ban on proprietary trading. The Regulation would allow member states to adopt different structural reform measures (Member States that are found to have already implemented "super-equivalent" measures may avoid costly alignment of existing, effective provisions with the proposed provisions in the proposed Regulation).

EU harmonisation of the treatment of third country firms

Much of the treatment of firms from third countries (as the UK will be) remains subject to the differing domestic law and practice of each member state. There has **not been any systematic harmonisation of the treatment of third country firms**.

EU FS legislation had traditionally contained reciprocity provisions (to enable the EU to take action against protectionist third countries) and precluded an EU state from giving more favourable treatment to third country firms than their treatment of firms from other EU states. More recently some EU FS legislation has included certain specific provisions dealing with the regulatory treatment of third country firms (i.e. introducing certain harmonised requirements across the EU/EEA). Annex J contains a database of EU FS legislation and identifies each provision relating to third country issues. Many of these relate to the prudential regulation of EU firms/groups with assets/subsidiaries/dealings in third countries, rather than assisting third country firms or groups. Some provisions (such as Article 39 of MiFID II (recast) – see below) may be seen as protectionist measures to prohibit cross-border supply.

These issues were addressed as new legislation arose, rather than by a concerted effort to harmonise the rules for third country firms; harmonisation is therefore limited. A good example is the policy towards EU/EEA branches of third country banks and insurers. Whilst member states have considerable discretion in relation to the authorisation of insurer branches, they must apply the Solvency II requirements and EIOPA guidelines. In the case of bank branches, there are no EU harmonised requirements or rules; it is essentially for member states to develop their own differing policies and requirements. (This is explained in more detail in Chapter 4 and Annex B).

EU derived rules for third country firms that are dependent on 'equivalence' of home state regulation

The EU has increasingly introduced certain harmonisation of third country firm treatment on a basis that differentiates between third countries that meet various tests as to equivalence/comparability/sufficiency in regulatory standards and those that do not (these provisions are perhaps confusingly sometimes referred to as 'equivalence'). This enables the EU to place some element of reliance on the home state regulation in the third country concerned. The process by which the EU reaches its determination is considered in Chapter 5.

Annex J contains a database of EU derived rules relating to third country firms. It identifies in each case

- whether the provision is applicable to all third countries
- whether there is special treatment for firms from third countries declared to be 'equivalent'
- whether it involves passporting rights for such a firm
- which mode of supply it relates to
- a list of the third countries granted equivalence under that provision

The following is a brief overview of the second category (where there is special treatment for firms from third countries declared to be 'equivalent').

Banking

CRD IV/CRR/FICOD – no passporting for TCFs; no equivalence regime for deposit taking/wholesale lending/consumer credit business. Certain categories of banks' exposures to entities located in third countries (including central governments) can be subject to the same risk weights as those that apply to exposures to equivalent entities in the EU. The equivalence regime permits investment firms/credit institutions, where they have a third country parent, to be subject only to third country consolidated supervision (rather than additional EU consolidated supervision).

Securities

SFTR – under Art. 19 the European Commission may adopt implementing acts determining that the legal/regulatory regime of the third country is equivalent. Equivalent third country trade repositories can provide services to counterparties, subject to the SFTR and EMIR reporting obligations. The trade repository must be recognised by ESMA under the SFTR or EMIR. Cooperation arrangements between the third country regulator and ESMA must be in place. Counterparties, so long as one counterparty is established in an equivalent third country, may be deemed to have fulfilled SFTR's requirements if they have complied with the relevant obligations of that third country. Transactions between an EU and third country counterparty may be subject to equivalent rules in the third country (rather than SFTR reporting requirements).

EMIR - the equivalence regime enables a third country trade repository to provide services to counterparties, subject to the SFTR and EMIR reporting obligations. The equivalence regime also permits third country CCPs

to provide services within the EU (without the need to be established in the EEA). In addition, derivatives traded on foreign markets found to be equivalent to EU regulated markets avoid their instruments being designated as 'OTC derivatives'. Where a third country entity is established in an equivalent jurisdiction, an EU or TCF broker can comply with the requirements of the third country regime rather than EMIR requirements.⁶² Where a third country counterparty has equivalent prudential and supervisory requirements, a collecting counterparty may rely on the third country counterparty's jurisdiction's internal ratings rules in order to assess the credit quality of certain capital. Third country CCPs may be recognised as QCCPs under the equivalence regime – under CRR, lower capital requirements are imposed on institutions calculating the risk weight of their exposures for exposures to a QCCP than for exposures to a non-QCCP.

CSDR – equivalence regime allows a third country CSD to provide services, including by establishing a branch, to issuers with securities admitted on regulated markets, MTFs or trading venues in the EU. Co-operation arrangements between the third country regulator and ESMA must be in place.

Short Selling Regulation – equivalence regime allows third country market makers to use the exemption (regarding the restrictions on uncovered short sales in shares and sovereign debt and credit default swap positions and the notification requirements for short sales in shares and sovereign debt) for market making activities envisaged under EU short selling rules.

Market Abuse Regulation – Third-country central banks and other public bodies may be exempt from certain MAR requirements (Art. 6(5)).

Credit Ratings Agencies Regulation - the equivalence regime allows credit ratings issued on non-EU issuers or instruments, and from a CRA established and supervised in a third country, without a presence in the EU, can be used for regulatory purposes in the EU by EU-regulated entities (subject to a number of conditions).

Benchmarks Regulation – the Regulation has three regimes which allow benchmarks produced by a benchmark administrator established in a third country to be used in the EU.

Prospectus Directive - Prospectuses prepared according to rules of an equivalent third country may be used in public offers in the EU (falls short of full equivalence (Art. 20 (1) Prospectus Directive)).

Transparency Directive - Non-EU firms subject to EU rules on transparency may be allowed to fulfil those obligations in accordance with third-country equivalent disclosure standards.

Settlement Finality Directive – no equivalence regime; however, a settlement system that is not located in an EU member state may become a 'designated system' under the Directive provided that the system is governed by the law of an EU member state as chosen by its participants (Art. 2).

MiFID II/MiFIR – equivalence regime for third country firms that wish to conduct professional client and eligible counterparty cross-border business (with or without the establishment of a branch). Under 47(3) MiFIR, EU investment firms may use the exemption regarding providing information related to the appropriateness of a product/service for clients where the service relates to instruments listed on a third country market. Trading obligations under the new regime state that shares/certain classes of derivatives may be traded on equivalent third country trading venues. Third country trading venues may access EU CCPs if the third country jurisdiction is found to be equivalent and other conditions are met (Art. 38 (1) MiFIR).

Investment funds

AIFMD - The passport enabling AIFMs to manage and market funds to professional investors throughout the EU may be extended to funds and managers established in third countries in the future. An access regime rather than equivalence regime is in place currently – this allows non-EU AIFMs authorised in an EU member state to manage/market certain AIFs (see Article 37 AIFMD). Non-EU AIFs may have a depositary established in a third country – this is subject to a number of conditions and requirements, including equivalence of the third country's prudential and supervisory regimes.

Insurance

Solvency II – no passport. Reinsurance contracts concluded with reinsurers from equivalent third countries may be treated in the same manner as contracts concluded with EEA reinsurers (no collateral requirements). If a (re)insurer headquartered within in an equivalent third country has participations or subsidiaries located within

⁶² Note that in certain cases EMIR has extra-territorial effect and EMIR requirements can apply to two non-EU entities.

the EEA, the EEA supervisory authorities will rely on the group supervision exercised by the third country. EEA groups may use the local rules of an equivalent third country relating to capital (own funds) and capital requirements, rather than the Solvency II rules. There is a limited regime under Art. 260 Solvency II for equivalent third country firms to conduct direct insurance business in the EU.

Accounting

International Accountancy Standards Equivalence Mechanism - Non-EU firms subject to EU rules on transparency and prospectuses may be allowed to present their consolidated financial statements in accordance with their own equivalent accounting standards.

Statutory Audit Directive – On the basis of an equivalence decision, the competent authorities of EU Member States may decide to exempt the respective third-country auditors and audit firms partially or entirely from EU rules on registration and oversight if they are subject to an oversight system that operates under similar rules. On the basis of an adequacy decision, EU competent authorities may decide to establish working arrangements with their third-country counterparts to exchange with them audit working papers or other confidential audit related documents (held by the auditors or audit firms that they have approved), as well as inspection or investigation reports relating to the audits in question.

Specific powers in EU legislation for DRC agreements with third countries

Articles 171 (insurers) and 175 (reinsurers) of Solvency II relate to bilateral agreements with TCs. (The 1989 Swiss EU agreement on non-life insurer branches was made under Article 20 of the first non-life directive (now incorporated into Article 171 of Solvency II.)

There is also provision in relation to credit institutions at Recital 23/Article 47 of CRD IV.

Annexes D to J provide a more comprehensive explanation of the main provisions for firms from equivalent countries. These annexes explain the limited extent of passporting rights and the processes followed by the EU to evaluate equivalence. A brief overview is given below -

MiFID

MiFID affords no passporting rights to third country firms. In a high-level overview, the forthcoming MiFID II regime (i.e. MiFID II and MiFIR) will introduce two changes:

- TCFs from those third countries that are judged 'equivalent' can deal with eligible counterparties and certain professional clients in an EU/EEA state on a cross-border basis without local authorisation (i) from the third country⁶³; and/or (ii) from a branch in another EU/EEA state which is authorised under MiFID II⁶⁴.
- There will be a harmonised protectionist regime available (for those EU/EEA states that elect to adopt it) to require a TCF to establish a locally authorised branch in order to conduct business with retail and elective professional clients⁶⁵. This effectively precludes any cross-border services supply from third countries into those states in the retail market.

Banking and CRD IV / CRR

CRD IV/CRR affords no passporting rights to third country credit institutions. There is a limited equivalence regime under CRD IV/CRR. Where the European Commission adopts an Implementing Decision stating that the TCF's regulatory/prudential regime is equivalent, EU banks can apply preferential risk weights to relevant exposures to entities located in those countries⁶⁶. Third countries' supervisory authorities may participate in colleges of supervisors provided that they are subject to equivalent confidentiality requirements being in place.⁶⁷ The EBA has made recommendations regarding amendments to CRD IV concerning equivalence of consolidated supervision regimes applicable in third countries (amendments pending)⁶⁸.

⁶³ An ESMA registration regime applies.

⁶⁴ Branch authorised under Article 39 MiFID II (Articles 46 to 49 MiFIR).

⁶⁵ Article 39 MiFID II. Where EU/EEA states do not opt for the Article 39 MiFID II regime (regarding branches and retail customers) TCFs should note that national legislation applies.

⁶⁶ Article 107 (3) (4) CRR.

⁶⁷ The TC's arrangements must be deemed to be equivalent in the opinion of all competent authorities, to the requirements under Articles 53 and 54 CRD IV. – Article 55 CRD IV.

⁶⁸ EBA maintains that Article 127 CRD IV should be extensively amended ([EBA-Op-2015-19](#)).

AIFMD and UCITS

AIFMD and UCITS afford no passporting rights to TCF funds/managers. Although a marketing passport for third country funds/managers had been proposed⁶⁹ - in relation to AIFMD – there has been little movement on this. Currently, EU/EEA members' differing [national private placement regimes](#) apply⁷⁰.

UCITS funds can only be established in the EU and the ManCo must be in the EU. UCITS V imposes obligations on depositaries when they entrust assets to third parties in third countries.

Insurance and Insurance Intermediaries

Solvency II affords no passport to third country insurers or reinsurers. There are three discrete areas of equivalence assessment under the legislation: reinsurance; solvency calculation; and group supervision. Third countries may be granted three different types of equivalence: full equivalence (for an indefinite period); temporary equivalence; and provisional equivalence. Only Switzerland and Bermuda have so far achieved full equivalence (on an indefinite basis) in all three areas (although the Bermuda decision had certain reservations in relation to captives and special purpose vehicles).

There are no passporting rights granted to third country brokers/intermediaries under IMD. The forthcoming IDD⁷¹ regime (which replaces and recasts IMD) does not introduce any new regime for third country brokers/intermediaries.

The UK should not rely upon unilateral EU findings of UK 'equivalence' and the DRC under these processes would not be a satisfactory alternative to the broader transposition of DRC

If the UK were to leave the EU without any agreement, UK firms in some lines of business and for certain modes of supply would be assisted by the EU determining (on a unilateral basis) prior to Brexit, that relevant UK regulation was 'equivalent' and thereby activating, for the benefit of UK firms, EU external DRC measures. This, however, would not prevent the re-introduction of most of the many substantial DR barriers which have been eliminated between EEA states (because of the limited scope of EU external DRC). The unilateral basis of the DRC measures would mean that they could be withdrawn at a later stage without recourse. The UK should not rely upon unilateral EU findings of UK 'equivalence' (see further below re a baseline accord). The DRC under these processes would not be a satisfactory alternative to the broader transposition of DRC (see below re the implementation of DRC by the EU).

⁶⁹ The marketing passport would be conditional on the third country satisfying a number of criteria – not least an 'equivalence' style assessment conducted by ESMA.

⁷⁰ Please note that Member States have the right to terminate the national private placement regimes and require compliance with AIFMD.

⁷¹ Insurance Distribution Directive ((EU) 2016/97)

4. Regulating the different modes of cross-border supply

In this chapter we combine the workings of the WTO/FTA regime for financial services described in chapter 2 with the regulatory perspective described in chapter 3. We look at the different modes of supply (and related areas) and give illustrations of DR barriers and then unpick the different DRC techniques/measures used in each of the modes/areas (under various different international regimes including the single market). This analysis is then used in Chapter 6 when we look at the proposed DRC agreement and the potential scope of DRC measures.

Modes of supply under the WTO regime

The WTO rules governing trade in services set out in the GATS, and the free trade arena more generally, talk of international trade in services under four 'Modes of Supply'. These are not specific to financial services. WTO describes the modes as follows -

Examples of the four Modes of Supply (from the perspective of an "importing" country – country A)

Mode 1: Cross-border

A user in country A receives services from abroad through its telecommunications or postal infrastructure. Such supplies may include consultancy or market research reports, tele-medical advice, distance training, or architectural drawings.

Mode 2: Consumption abroad

Nationals of A have moved abroad, for example as tourists, students, or patients to consume the respective services.

Mode 3: Commercial presence

The service is provided within A by a locally-established affiliate, subsidiary, or representative office of a foreign-owned and controlled company (bank, hotel group, construction company, etc.).

Mode 4: Movement of natural persons

A foreign national provides a service within A as an independent supplier (e.g., consultant, health worker) or employee of a service supplier (e.g. consultancy firm, hospital, construction company).

These are merely descriptive of the modes of supply and not the barriers which the WTO/FTA regime seeks to mitigate (as discussed in Chapter 2 above). Given the advances in remote means of accessing services through the Internet and other telecommunications, modern FTAs commonly fuse modes 1 and 2 together as simply "cross-border".

Market access and DRC by mode of supply

In this section we look separately at each mode of supply - using the approach of the WTO classification but adapted to the particular practicalities of financial services business. This draws a distinction between services which are supplied under mode 3 above (commercial presence) and those supplied on a cross-border basis.

In regulatory terms the former involves either a branch or a subsidiary.

Cross-border supply or services business may fall outside the host state's regulatory 'perimeter' or it may fall within the scope of host state regulation. This depends on the regulatory approach of the host state concerned (and is not generally harmonised across EU countries). Services may fall outside the perimeter because they are treated as being supplied in the home state (as envisaged by WTO mode of supply 2 above) or because, for example, there are exemptions which take them outside host state regulation.

In each case we give examples of the different ways these types of supply by foreign-based FS providers are treated in different sub-sectors, countries and under different unilateral, bilateral, plurilateral and multilateral arrangements.

These examples demonstrate the breadth and differing nature of:

- the different ways in which behind the border barriers are addressed under the market access mechanics of WTO rules (see Chapter 2 for details of the WTO regime and its institutional/treaty/legal structure);

- the different ways in which barriers are addressed under the market access mechanics of recent FTAs such as CETA (see Chapter 2 for details of the regime for FTAs, such as CETA, and their institutional/treaty/legal structure);
- the different ways in which individual host states may approach DRC on a unilateral or bilateral basis or under international arrangements;
- the different ways in which DRC operates within the EU/EEA single market (see Chapter 3 for details of the single market regime and its institutional/treaty/legal structure);
- the way DRC operates under the 1989 bilateral treaty between Switzerland and the EU for direct non-life insurance;
- DRC between EU states and third countries – under domestic arrangements of EU states and within EU harmonisation (see Chapter 3 for details of the legal structure of EU harmonisation of third country firm rules).

The examples for each mode of supply are listed, very roughly, in order – starting with the most restrictive (i.e. involving the least dual regulation coordination/barrier reduction and the most dual regulation) and then less restrictive forms of cross-border regulation (i.e. with increasing dual regulation barrier reduction/mutual recognition and reducing dual regulation).

As explained above, in relation to FTAs and WTO schedules, states may have ‘water in their schedule’ that is to say they may have reserved the right to operate more protectionist regimes than they in fact apply (sometimes because schedules have not been updated).

Dual regulation coordination can also be beneficial in other situations which do not correspond directly to a particular mode of supply. The section below also includes 15 such areas – many of which are the subject of DRC within the EU/EEA single market. All of these are therefore potential areas for DRC under the new EU/UK partnership (but this is not an exhaustive list).

We have not analysed Mode 4 in detail in this paper. Movement of natural persons across borders to provide services is important to all sectors, and will need to be addressed on a horizontal and sector specific basis as part of the wider debate on immigration policy and movement of workers. Whatever immigration policy the UK adopts for EEA nationals will need to be reflected in the commitments made to the EU on Mode 4 services access, but conversely, the needs of the FS sector should be reflected in that policy so that it delivers the skills and talent that the industry requires.

Cross-border modes 1 and 2 - cross-border services outside/inside host perimeter and consumption abroad

In this mode, the firm operates from outside the host country. As noted above this includes WTO mode 2 where the service is consumed in the home state (consumption abroad) but also includes other situations where the foreign firm is permitted to operate without host state authorisation or registration. This is where its activities fall outside the ‘regulatory perimeter’ of the host state concerned - even though the firm is providing services to clients, or dealing with counterparties, who are located in the host state.

As noted above, WTO modes 1 and 2 are often grouped together simply as ‘cross-border’ or ‘services’ supply. It is often difficult to distinguish between consumption abroad, un-regulated supply into the host state and regulated supply into the host state.

The key point is that under mode 1 and 2, the foreign firm does not come on-shore and it deals with clients/counterparties in the host state from an office overseas. It may send staff to visit clients in the host jurisdiction on a short term/temporary basis. It may also operate on-shore offices such as representative, or marketing offices, not involved in the service supply. (It may also have a local branch or on-shore office but this must not be used in the service supply under the cross-border modes.)

Importantly the definition of the regulatory perimeter itself varies from country to country and also varies as between EU member states. A TCF which wishes to supply services from its home base to clients or counterparties across the EU/EEA must investigate the complex perimeter rules for each activity in each of the 28/31 countries. The rules are often far from clear and present a complex matrix which it is expensive to investigate/comply.

In very broad terms, many/most EU states set a regulatory perimeter which is more protectionist than the UK; the UK permits more TCF activities without local authorisation. For example (unlike the UK) many states will elect to use the Article 39 MiFID II regime to require TCFs to establish a locally authorised branch in order to deal with retail customers. This accords with the limitations in the EU’s GATS schedule of commitments that require establishment for the provisions of many insurance, banking and other financial services, notwithstanding their high level commitments on cross-border supply of services.

The approaches to other aspects of cross-border regulation also vary from state to state. For example the most common approach is to require TCFs which wish to conduct activities that fall within the local regulatory perimeter to establish an on-shore entity and obtain local authorisation (see further below as to whether this entity may be a branch or a separate subsidiary). In many situations countries (including the UK) do not provide local authorisation for cross-border services under mode 1. One factor is the legal and practical difficulties in authorising and regulating (and exercising powers of supervision and enforcement) if the TCF has no operations or management within the jurisdiction. The UK therefore operates a permissive regulatory perimeter but generally requires TCFs to come on-shore and operate under mode 3 in order to conduct any activities within the perimeter.

Various examples are given below of systems which enable foreign firms to obtain a regulatory status under the host regime which permits the firm to conduct cross-border services without coming on-shore and without a local branch or subsidiary.

Cross-border – examples of regulatory approach

1. Restrictions on the buyer of financial services (as distinct from provisions directed at the supplier)

Some countries place restrictions directly on local purchasers of financial services. For example prohibiting them from purchasing from foreign suppliers. These prohibitions have further reach (than the restrictions on incoming suppliers) in that they can bite on business even if it might fall outside their/the host jurisdiction.

Chapter 2 explained that under GATS (and CETA) EU states have accepted market access obligations to permit residents to purchase FS products/services from overseas suppliers under WTO mode 2 'consumption abroad'. This does not however cover suppliers doing, or soliciting, business, in the host state. There are also individual member state reservations which restrict this principle by, for example, requiring that certain classes of compulsory insurance can only be underwritten by EU insurers (see Chapter 2 and below).

2. Regulatory prohibition on foreign suppliers – with possible exception for reverse solicitation (no differentiation based on home state regulation)

Many countries prohibit the supply of certain services, from outside their jurisdiction, by foreign firms without local authorisation. The precise scope of this prohibition depends on the details of the regulatory perimeter of the host state concerned.

Local authorisation may not be available for cross-border supply by foreign firms and they are therefore required to establish an on-shore presence for local authorisation and operate under mode 3. The UK does not offer cross-border authorisation for activities within its regulatory perimeter.

In some cases, there may be an exception for 'reverse solicitation'. This is a narrow concept where the firm does not solicit business in the host state and the client takes the initiative in going abroad or looking abroad to source the service.

In its most extreme form, this may amount to WTO mode 2 i.e. 'consumption abroad' where the consumer travels to, or is in, the home state when they purchase the service.

This approach to TCFs is followed by many EU states in various areas. In some cases it applies to retail business but not to wholesale activities.

MiFID II will give EU states the option to adopt a harmonised requirement for TCFs to use a host state branch, authorised by the host state, in order to supply investment services to retail clients; this is a restrictive provision which prohibits supply under modes 1/2. The only exception is that MiFID II does permit reverse solicitation (further details of the MiFID II TCF rules are explained in Annex E).

3. Prohibited unless the essential place of service performance is outside the host state (no differentiation based on home state regulation)

This is an EU derived principle for determining, in a single market context, whether a firm in one EU state is to be regarded as providing a service in another (host) EU state, thus requiring a notification to activate the single passport. The European Commission⁷² were seeking to establish the principle that cross-border supply does not always involve a supply in the host state for which single passport activation is required. Under this

⁷² [Commission Interpretative Communication: freedom to provide services and the interest of the general good in the Second Banking Directive](#) (1997) and [Commission Interpretative Communication: freedom to provide services and the general good in the insurance sector](#) (2000) (C 43/5); SIB Consultative Paper CP 19 Carrying On Investment Business in the United Kingdom, Draft Guidance Release (March 1989)

approach, one considers the specific features of the service concerned to determine the place of essential supply and whether this is in the home or host state. For deposit taking the place of supply is the home state; for investment advice it is the host state where the client receives the advice. In insurance Solvency II uses 'location of risk rules'⁷³ to determine the state of supply (which, within the single market, determines whether the cross-border passport is triggered).

EU member states have not, however, accepted the above tests as defining the regulatory perimeter for TCFs and there are many cases where the prohibition applies despite the essential place of supply being outside the host state under these tests. Although most EU members have committed to Mode 2/consumption abroad for certain insurance services and most banking and other financial services, the country level limitations in the EU schedule of commitments, summarised in chapter 2 above, demonstrates that some member states have taken different views as to which insurance services may be purchased abroad, and some, such as the Czech Republic, have an outright exclusion on insuring risks in the Czech Republic from outside of the EU.

The UK perimeter rules for TCFs do reflect the essential place of supply in various ways. For example a TCF insurer can conclude inward reinsurance contracts with UK insurers/reinsureds without UK authorisation providing the essential elements of concluding and carrying out the insurance contract take place outside the UK.

4. Prohibited where performance is in the host state - except in limited circumstance (no differentiation based on home state regulation)

The UK perimeter rules include an exemption for various services provided by TCFs to UK clients, even where the essential place of supply is within the UK. The exemption (known as the Overseas Persons Exemption in the Regulated Activities Order⁷⁴) has somewhat complicated conditions and does not cover all services.

It enables TCFs to conduct business without UK authorisation providing the TCF does not use a UK branch/permanent establishment and either deals with or through a UK authorised person or deals with others or gives investment advice without breaching the UK's financial promotion regime (a legitimate approach). For a legitimate approach, the TCF must ensure that any promotions are either approved by a UK authorised firm or that they fall within financial promotion exemptions (such as the exemption for promotions directed at large companies or authorised FS firms).

5. Limited by quantitative or economic limits

Quantitative or economic limits are used by countries to limit market access/participation in their local market. These differ from prohibitions on purchasers and regulatory prohibitions on suppliers in that they limit access in a way which is similar to imposing quotas (depending on local economics).

As explained in Chapter 2, these are GATS obligations to eliminate various forms of quantitative or economic limits (e.g. limiting the number of suppliers in a sector, numerical quotas, limits on output or economic needs tests, sector employment limits, % shareholding limits for foreign ownership or aggregate limits for foreign investment, in sectors where a country accepts a commitment). The abolition of quantitative or economic limits within the single market was addressed in early EU legislation (see for example the first non-life insurance establishment directive and the carry across to the 1989 Swiss/EU agreement below).

6. Authorisation required – dual regulation (home and host)

As noted above, these are challenges in offering local authorisation for cross-border supply into a territory. This is not available for any services in the UK.

Italy – cross-border licence

Italy does have a system for granting a licence to TCFs (banks and investment firms) for cross-border business on a services basis⁷⁵. Firms have not always found this dual authorised status to be easy as there can be conflicts between the requirements of the home state and those under the Italian regime. The regime is likely to change with the implementation of MiFID II.

⁷³ <https://www.lloyds.com/the-market/tools-and-resources/tools-e-services/risk-locator/how-to-establish-the-risk-location>

⁷⁴ [Financial Services and Markets Act 2000 \(Regulated Activities\) Order 2001 \(SI 2001/544\)](#)

⁷⁵ See Annex K for further information on the Italian regime.

There is an interesting example in the AIFMD regime for TCFs. If implemented, this would provide various rights and passports in relation to TCFs and funds. The TC manager passport requires the manager to obtain authorisation. It applies for this in its member 'state of reference'. It does not require the TC manager to establish a branch in the EU – so authorisation is for services supply - but it does require the manager to appoint a legal representative in the jurisdiction of the state of reference to facilitate regulation/supervision. An EU authorised TC manager would then enjoy freedom to provide services across the EU (a form of 'passport').

Historically within the EU, the non-life services/second directive permitted the host state to impose a local (administrative) authorisation requirement for cross-border services supply of 'mass risks' insurance and to impose its own technical reserve requirements for this mass risk authorised business⁷⁶. The life services/second directive (see above) gave similar rights to the host state for life business with the exception of 'own initiative business'.

7. Dual-registered with substituted compliance of certain rules

As noted above, the FSB led a global drive to reform OTC derivatives by the use of central clearing and central counterparties. The FSB's 2010 report⁷⁷ - [Implementing OTC Market Reforms](#) - describes CCPs as critical infrastructure "whose orderly function is vital for financial stability" and states "the need to ensure non-discriminatory access to CCPs". "Authorities should [...] develop frameworks for cooperation and coordination for CCPs with cross-border activity which address regulatory oversight of, and information sharing in relation to such CCPs."

In 2016 the European Commission concluded⁷⁸ an accord with the US CFTC⁷⁹ for a "common approach" to the treatment of CCPs. The accord is a significant bilateral DRC measure, in this case as envisaged under prior international/global level cooperation and with DRC implementation mechanics built into the legislation (i.e., on the EU side, the EMIR DRC provisions for third country CCPs referred to in Chapter 3).

In March 2016, the CFTC [approved a substituted compliance framework](#) for dually-registered central counterparties (CCPs) located in the European Union (EU), together with a [determination of comparability](#) with respect to certain EU rules. This permits EU CCPs to provide services in the US whilst complying primarily with their own local requirements. The CFTC will also streamline the registration process for EU CCPs wishing to register with them.

The European Commission adopted an [equivalence decision](#) with regard to CFTC requirements which allows ESMA to recognise US CCPs⁸⁰. Once recognised, US CCPs may continue to provide services in the EU whilst complying primarily with their own local requirements⁸¹. The [Commission Implementing Decision](#) states that for the purposes of Art. 25 (6) EMIR, the legal and supervisory arrangements for US clearing organisations will be considered equivalent to Title IV EMIR. It applies to systemically important derivatives clearing organisations and opt-in derivatives clearing organisations.⁸²

The press releases which followed the conclusion of the accord suggest further DRC⁸³: *"for the future, we have agreed to continue to work collaboratively and to consider any unforeseen implementation effects that might arise in the application of our respective rules. We will continue discussions with other international partners with a view to establishing a more generalised system that would allow, on the basis of these*

⁷⁶ Matching rules were harmonised under the directive.

⁷⁷ In 2015 the FSB published a [thematic peer review](#) of OTC derivative trade reporting⁷⁷, which identified a number of legal barriers in FSB member jurisdictions. FSB members agreed that, by June 2018, all jurisdictions should remove barriers to full reporting of trade information and have a legal framework in place to permit authorities' access to data in accordance with their mandates. The FSB publishes annual progress reports on OTC market reforms; the next report is expected in July 2017 ahead of the G20 summit.

⁷⁸ See [EU press release](#) for further details on the "common approach".

⁷⁹ The common approach references only the CFTC's requirements for derivatives clearing organisations. It does not reference the United States Securities and Exchange Commission's (SEC) requirements for clearing agencies which is a separate and distinct regime. The European Commission continues to be in constructive and progressive discussions with SEC staff regarding the SEC's requirements, in the context of the European Commission's analysis of equivalence. See this [US press release](#) for further information.

⁸⁰ The MoU concluded between the regulators ESMA and the CFTC is [here](#).

⁸¹ There are a number of new requirements for the US CCPs: shifting to a two-day liquidation period for setting initial margin on clearing member proprietary positions; maintaining "cover-2" default resources; and adjusting initial margin models to mitigate pro-cyclicality.

⁸² Agricultural commodity derivative contracts (that meet certain conditions) are not covered by the EC/CFTC agreement (Art 2 EC implementing decision).

⁸³ It is not clear what steps would be taken by the EC/CFTC regarding the accord should the current US administration's proposals to dismantle the Dodd-Frank Act take effect, but any such reforms may not impact this area.

countries' implementation of the G-20 commitments, an extension of the treatment the EU and the CFTC will grant to each other.”⁸⁴

See also the section ‘International DRC fora and bilateral arrangements’ in Chapter 5.

8. FTA (CETA) – market access for advisory and auxiliary services and portfolio management but with equivalence pre-condition for mode 2 (rather than mode 3) supply.

Under CETA⁸⁵, Canada has committed to permit cross-border supply of:

- (i) advisory and other auxiliary financial services (excluding intermediation) and investment advice;
- (ii) the provision and transfer of financial information and financial data processing; and
- (iii) portfolio management services (excluding custodial, trustee or execution services) from one country to a collective investment scheme located in the other,

in each case on the basis of the market access and national treatment obligations that apply to services generally, which may include local authorisation requirements.

The EU has made similar commitments, though they vary across member states (some have included more services, including, for example lending and securities services). The commitment in respect of portfolio management relates to the service of managing portfolios in accordance with mandates given on a discretionary client by client basis, provided to professional clients located in the EU by financial institutions organised in Canada. It is subject to a four year transitional period and the EU prudential regulatory regime, including equivalence assessment. A footnote clarifies: “this means that once the European Commission has adopted the equivalence decision related to portfolio management and a Canadian financial institution has satisfied other European Union prudential requirements, this financial institution may provide discretionary portfolio management services to a European Union professional client without being established in the European Union”.

Similar commitments on portfolio management were included in TPP.⁸⁶

9. FTA (under TPP) – market access for electronic payment card services.

TPP included a specific commitment by each party to allow the supply of electronic payment service for payment card transactions (which means business to business payment network services, and not the transfer of funds to and from transactors’ accounts) into its territory from the territory of another party by a person of the other party⁸⁷. This may be subject to any or all of the requirements that the supplier register with or be authorised by relevant authorities, that it supplies such services in its home territory, and that it designates an agent office or maintains a representative or sales office in the host territory. While this does include an option to require the supplier to be authorised by relevant authorities, the footnote to this provision states that the registration or authorisation can be conditioned on, for example, supervisory cooperation with the home country supervisor, and the supplier providing host state regulators with the ability to examine its systems and records. As TPP will not now enter into force in its current form with its original parties it cannot be known how this would have been implemented in practice, and whether parties would have permitted supply on a registration only basis.

10. Freedom of services supply under GATS Understanding

GATS freedom of supply modes 1 and 2 – reinsurance and direct insurance of certain commercial risks.

The GATS/Understanding provisions are explained in Chapter 2 above. They provide for market access for cross-border supply under modes 1 and 2 subject to national treatment for insurance covering maritime shipping and commercial aviation and space launching and freight; goods in international transit; and reinsurance and retrocession and the services auxiliary to insurance.

Various EU states have national reservations against these market access obligations under GATS and under the equivalent provisions of CETA. For example, Austria (GATS and CETA) and Germany and Denmark (GATS only) have limitations to enable them to require compulsory air insurance to be underwritten in the EU.

⁸⁴ See CFTC [press release](#) under the heading ‘Future collaborative efforts’

⁸⁵ CETA Annex 13A

⁸⁶ TPP Annex 11-B section A

⁸⁷ TPP Annex 11-b section D

France (GATS) has similar limitations in relation to ground transport insurance and Italy (GATS) in relation to goods transport, vehicle and Italian located risks insurance. Cyprus, Malta, Poland, Latvia, Lithuania and Estonia also have limitations under the CETA obligations.

Belgium registration system

Belgium has not reserved any limitations in relation to the above market access and national treatment.

As a general rule, third country insurers may not carry on activities in Belgium on a freedom of services basis: they must establish a branch and the branch must comply with most of the local regulatory rules under supervision of Belgian regulators.⁸⁸

Belgian law provides, however, that for the above risks a TC re/insurer can provide these types of insurance to Belgium insureds/re-insureds on a freedom of services basis without obtaining Belgium authorisation or establishing a Belgian branch. There is an administrative process whereby they notify the National Bank of Belgium before commencing these activities/underwriting these risks. Part of the information to be provided to the National Bank of Belgium is confirmation that the TCF is licenced in its home state to conduct the relevant activities.

This Belgium policy appears to be quite an open interpretation/application of the GATS provisions; some EU/EEA states may have more restrictive provisions e.g. prohibiting the use of a local intermediary/broker or only accepting reverse solicitation⁸⁹. As already seen in Chapter 2, many EU countries have national exemptions/reservations from commitments under the GATS; these include limitations which prevent the use of local intermediaries or active solicitation.

In the UK, third country insurers and reinsurers must avoid conducting any class of insurance business in the UK – i.e. effecting or carrying out insurance contracts in the UK. This means that the potential involvement of a UK broker is restricted in various ways and that the core functions of both underwriting and paying claims must take place in the home country and not in the UK. It is assumed that the UK regards this regime (applicable to all kinds of insurance) as resulting in its compliance with the Uruguay round obligations (which only cover reinsurance and the specific classes of commercial direct insurance mentioned above).

GATS freedom of supply modes 1 and 2 – certain banking and advisory services (excluding intermediation)

Cross border supply subject to national treatment applies to various banking and advisory services (excluding intermediation) – such as banking and investment advice (see Chapter 2). Belgium, however, has limitations (under GATS) to allow for certain investment advisory activities to be subject to an establishment requirement.

11. Examples of freedom of services supply – with home state prudential regulation/mutual recognition (differentiation based on home state regulation)

MiFID II - third country firm cross-border passport.

Under MiFIR, TCFs from equivalent jurisdictions (as explained in detail in Annex E) will register with ESMA and can then provide cross-border services and deal with counterparties in any EU country. This only covers cross-border supply in investment services/activities and is limited to professional clients and eligible counterparties.

This registration system for cross-border services will be a new approach for the UK. MiFIR takes effect in 2018. At Brexit the regime would cease to apply as the UK will itself become a third country, but the UK could decide to operate a mirror system or, in theory, the UK and EU could agree that the UK would recognise ESMA registration.

EU single passport for EEA firms – example of cross-border supply permitted under mutual recognition of their home state authorisation, regulation and supervision

This is the basis of the EEA single passport. A firm authorised in its home state can provide cross-border services into another EEA state without host state authorisation and only has to give an administrative notification (to its home state regulator) prior to its first supply into that state. The single passport covers cross-border supply under modes 1 and 2 and mode 1; so, in principle, the firm does not have to be concerned

⁸⁸ Belgium implemented Solvency II through the Law of March 13, 2016 “relating to the status and supervision of insurance and reinsurance undertakings”. Belgium’s implementing legislation covers the treatment of third country re/insurers.

⁸⁹ TheCityUK and Hogan Lovells [The EU's Third Country Regimes and Alternatives to Passporting](#) (February 2017)

about the distinction between mode 1 (consumption abroad/outside the host perimeter) and mode 2 (within the perimeter).

The single passport applies to supply from the firm’s home state and also to supply from any branches of the firm in another state into a third host EEA state.

As explained in Chapter 3, under the single passport EEA firms have authorised status (based on home state prudential regulation) across all other EEA states including freedom to supply services. (The single passport covers a broad range of financial services.) This covers temporary visits by firm representatives into the host country (e.g. to meet clients and give advice). It covers cross-border business (including the provision of services in the host state i.e. where the essential place of supply is in the host state), so firms are less concerned as to whether their activities fall outside or inside the host state perimeter. The foreign firm is able to conduct activities without local authorisation in the host state and without a local branch. It can also provide cross-border services even where it has a local branch for other business streams. The firm will normally be subject to various non-prudential **host state requirements such as conduct of business rules**.

As noted above, the single passport for insurers was developed in stages (under separate legislation for the non-life and life sectors). The non-life services directive (or second non-life directive 88/357/EEC) had given non-life insurers the right (for the first time) to provide cross-border services in ‘large risks’ without host state authorisation and without host state financial regulation – and with technical reserves being exclusively under home state control. The life services directive (or second life directive 90/619/EEC) gave life insurers the equivalent rights in relation to ‘own initiative’ business (a concept very broadly similar to ‘reverse solicitation’ but with its own particular definition). DRC was subsequently increased with the full passport under the third insurance directives (now under Solvency II). DRC can therefore be applied in many different ways and on a broad or narrow basis.

U.S. Part 30 regime

[CFTC Regulation 30.4](#): any domestic or foreign person engaged in activities like those of a futures commission merchant (FCM), introducing broker (IB), commodity pool operator (CPO), or commodity trading advisor (CTA) must register in the appropriate capacity or seek an exemption from registration under [CFTC Regulation 30.5](#) or [CFTC Regulation 30.10](#).

Pursuant to [CFTC Regulation 30.10](#), persons located outside the U.S., who are subject to a **comparable regulatory framework** in the country in which they are located, may seek an exemption from the application of certain Commission regulations, including those with respect to registration. The UK was granted extended relief under 30.10:

Financial Services Authority	United Kingdom	Amended request for Extended relief. This order consolidated and updated the relief set forth in prior orders issued to the AFB, IMRO, SFA, SIB and TSA. 68 Fed. Reg. 58583 (October 10, 2003)	Order Issued Granting	09/30/2003
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Individual exemption

In Germany, TCFs can apply to BaFin for an exemption to enable them to undertake cross-border supply of certain activities without German authorisation⁹⁰. Requirements include effective home state supervision of the relevant services and cooperation of home state supervisor with BaFin. Quite a few Swiss firms operate under this exemption.

A recent CityUK/Hogan Lovells report⁹¹ identified two further examples of exemption procedure for cross-border services business.

⁹⁰ See Annex K for further information on the German regime.
⁹¹ TheCityUK and Hogan Lovells *The EU’s Third Country Regimes and Alternatives to Passporting* (February 2017) - “In **The Netherlands**, a third country firm can avoid the need for a licence if it is established in a jurisdiction which the Netherlands considers to have a regulatory framework of at least equal standing.... **Hungary** has an exemption under which a financial institution which has its registered seat in an OECD Member State can apply to provide certain financial services in Hungary without having a licence. In practice, however, this exemption appears to be used only rarely.” The Dutch authorities consider the USA, Switzerland and Australia to be equivalent in relation to licences for investment firms, and the USA, Guernsey and Jersey to be equivalent in relation to investment management.

12. Examples of freedom of services supply – with home state conduct of business rules/mutual recognition as well as home state prudential regulation (differentiation based on home state regulation)

EU single passport

EU legislation such as the Investment Services Directive introduced a single passport on the basis of home state regulation of prudential regulation, but host state regulation of conduct of business.

MiFID extended the home state regulation/country of origin principle for cross-border services provision to conduct of business (COB) rules. This additional element of DRC is not to be found in some other EEA passports under mode 1/2 cross-border supply.

Cross-border supply from a foreign branch outside the home state into a third state

Cross-border services may involve a supply from the home country of the firm. The position may be similar where the supply is from a branch in one country (not the home state of the firm) into another country, but this can give rise to different arrangements -

1. Cross-border services passport within single EEA passport

The single passport of an EEA firm covers the provision of cross-border services from any branch in an EU/EEA state to any client/counterparty in any other EU/EEA state.

2. Specific cross-border services passport for a branch

Under the MiFID II regime, a TCF from an equivalent third country which has established a branch under Article 39 MiFID (recast) (see above) will be given cross-border services rights in relation to professional clients and eligible counterparties in all other EU/EEA states.

Summary

As the above demonstrates, there are a wide variety of approaches to cross-border supply. A key issue is the definition of the regulatory perimeter i.e. the national rules (and exemptions) which determine when a service provided by a foreign firm falls within local regulation/authorisation. (In extreme cases the host state may also prohibit the purchase of services from abroad.) The local perimeter rules are therefore very important in determining the approach to cross-border supply.

If a form of supply falls within the local perimeter, then there are a wide variety of different treatments - from

- prohibition (normally meaning a requirement to trade from an office in the host state and with host state authorisation under mode 3 below); to
- dual authorisation – home and host – without requiring a local branch; to
- administrative registration requirements where the host state relies heavily on home state prudential regulation with no host state vetting/discretion; and even
- extending to home state regulation of other areas such as conduct of business.

WTO mode 3 - establishment (1) – branch

Branch business is defined as services supplied, or activities conducted, from a permanent establishment of the foreign firm in the host jurisdiction. It is normally quite clear when a branch is being used. The concept of permanent establishment frequently arises under tax law and is often looked at in a similar manner in cross-border regulation.

In modern FTAs this mode would also be protected as investment.

A foreign firm may well prefer to establish a local branch rather than a locally incorporated and capitalised subsidiary. A subsidiary brings additional obligations and will require its own regulatory capital, which may be less efficient. The difficulty with a branch (from the regulator's perspective) is that it is not a separate legal entity but is just one part of the foreign company. It does not, therefore, have its own assets and in the event of insolvency will be wound up under the home county regime. The host state authorisation is not therefore limited to the branch but technically is a second authorisation of the company. Various techniques are used in the host state regulation to rely upon the home state regulator and/or to apply financial regulation at a branch level (see for example the PRA's approach to third country bank branches and to third country insurers below).

A host regulator may well prefer to regulate a subsidiary (and to refuse to authorise a branch) because a subsidiary will be fully regulated by the host regulator (like a domestically owned firm), will have its own dedicated capital and financial resources and will be subject to the host state laws including the host state insolvency regime. Where the host state requires a subsidiary (rather than a branch), it is refusing any element of mutual recognition – it is requiring full host state regulation and there is no DR barrier reduction.

Establishment 1 – examples of regulatory approach

1. Prohibited

Some states will refuse to authorise foreign branches for some or all activities (irrespective of the home state concerned). They therefore require foreign firms to establish a local subsidiary (see below) which must apply for local authorisation as a separate legal entity.

This is a common approach around the world. For example even within the EU, various CEE countries always require third country banks to operate via a subsidiary and have not granted authorisation to any third country banks to operate a local branch.

PRA policy on bank branches.

The UK is one of the most open jurisdictions and has authorised a large number of third country banks to operate UK branches (often in the City of London). PRA will, however, require a subsidiary to be used in certain circumstances (see below).

EU requirements and PRA policy on insurer branches.

Where EU requirements for branches of TCF insurers cannot be met in relation to a UK branch, the PRA must refuse authorisation and require a local subsidiary to be used.

2. Permitted but with host state authorisation (dual authorisation) and host state prudential requirements

EU requirements and PRA policy on insurer branches.

The EU has harmonised requirements for the authorisation of EU branches of third country insurers conducting direct business (under Article 162 of Solvency II and the related EIOPA Guidelines - see Annex B for further details). This accords with the summary of branch authorisation requirements found in the footnote to the financial services section of the EU's GATS schedule of commitments. Solvency II outlines the minimum standards that must apply where the host state regulator grants authorisation⁹². The PRA assesses the entire insurance undertaking against the Threshold Conditions in FSMA 2000⁹³. For authorised branches of non-EEA insurers, the PRA expects:

- TCF branch undertaking to comply with EIOPA Branch Guidelines; and
- TCF branch undertaking to comply with relevant rules in the PRA Rulebook.

For authorised branches of non-EEA pure reinsurers, the PRA expects:

- TCF branch to comply with the EIOPA Branch Guidelines that are relevant to them
- TCF branch to comply with the rules in the PRA Rulebook that apply to them in light of the EIOPA Branch Guidelines as if the scope extended to them⁹⁴.

Where the PRA is satisfied that the home regulatory regime applied to the insurer as a whole is equivalent⁹⁵ and where the PRA has assured itself over the home regulator's supervisory approach, the PRA relies where possible on the home regulator's prudential supervision as regards the whole insurer.

⁹² See article 18 Solvency II (conditions for authorisation) and article 25 Solvency II (refusal of authorisation). EIOPA also published [Guidelines](#) for third country branches of insurance undertakings.

Article 162 Solvency II states that any third country insurer wishing to access insurance business in the EU/EEA must be authorised in a member state and must establish a branch in the member state (where authorisation is sought). This article does not apply to pure reinsurers: member states apply their own regimes to the authorisation of third country pure reinsurers (article 174 Solvency II states that member states cannot treat them more favourably than EEA firms).

⁹³ See PRA SS44/15 which replaces SS10/15. See also UK Financial Services and Markets (The Solvency II Regulations 2015) statutory instrument.

⁹⁴ PRA SS44/15

PRA policy on bank branches (no EU requirements)

There are no EU harmonised requirements in relation to TC bank branches (although member states cannot afford third country banks more favourable treatment than banks from other EU states and see further re CRD IV below). The PRA policy is explained in detail in Annex B (and see Chapter 5 below). The whole firm⁹⁶ is required to meet the Threshold Conditions in FSMA 2000 (minimum condition for authorisation). The concerns relate to home state financial regulation and the position of UK depositors in the event of resolution/winding up. A system of national depositor preference which favours home state depositors over UK depositors will be problematic and likely to lead to branch authorisation being refused in favour of a UK subsidiary. There is a two-tier or differentiated threshold which differs⁹⁷ based on the risks posed to the financial system. If the TCF wishes to conduct CEF business (such as significant retail deposit taking) the threshold for branch operation is higher (a high level of assurance over resolution and an agreed split of supervisory responsibilities is required) and the PRA is more likely therefore to require the TCF to operate via a UK subsidiary. With a subsidiary the full UK regime (regulation, supervision and resolution) apply in full. In contrast, where the branch will not be involved in CEF business⁹⁸ the PRA will be more ready to permit branch operation and to rely on the home state supervisor/regime.

Bank branches – EU/third country agreements for harmonised treatment

Article 47 CRD IV is a facilitative provision in that it provides for EU/third country agreement on harmonised treatment for branches of banks from that third country to be accorded the same treatment by all member states.⁹⁹ As far as we are aware, there are no current agreements concluded under this Article. (See Annex I for further information on CRR/CRD IV).

GATS

Austria (under CETA and GATS) and Denmark (under GATS) have limitations which permit residency requirements for the staffing of insurance branches

3. As in 2 but with more extensive mutual recognition of home prudential/financial regulation and reliance by host state supervisor on home state supervision/prudential requirements

The 1989 agreement between the EU and Switzerland

This is an international treaty with treaty style mechanisms. It introduced harmonised solvency requirements and a regime for reciprocal treatment of branches of non-life insurers (direct business). This was introduced under Article 29 of the first non-life directive. (These types of arrangements between EU and a TC are now provided for under Articles 171 and 175 of Solvency II.)

The arrangements above were based on the first non-life directive (or non-life establishment directive – 73/239/EEC), effectively extending these to include Switzerland. The directive had given EEC non-life insurers (in the mid-1970s) the right to establish a branch in another EEC state; in particular this meant an EEC state could not require the insurer to establish a local subsidiary nor could it refuse branch authorisation on economic grounds (i.e. on ‘**quantitative or economic limits**’ grounds such as the market being already well serviced or over-supplied). Swiss insurers were given the right to establish a branch in an EU state and vice versa. The insurer had to obtain authorisation from the host state but this was based on the home state’s regulation of the solvency (i.e. the balance sheet capital adequacy) of the entire business of the insurer. The host state was left to regulate the technical reserves (i.e. the reserves/assets held against claims to be paid) of the branch under its rules.

The agreement is essentially consensual (although for some aspects there is an arbitration process for the settlement of disputes). Under provisions on the ‘evolution of the domestic legislation’, however, one side

⁹⁵ Where the TCF home state supervisory regime is not found to be ‘broadly equivalent’ authorisation will be refused. The PRA may consider authorising a stand-alone subsidiary. Please see Annex B for further details.

⁹⁶ Not only the branch.

⁹⁷ For non-EEA banks, PRA will refuse authorisation unless –

The Home State Supervisor (HSS) is judged to be equivalent AND

The HSS will accept responsibility for the branch AND

Either

The branch does not/will not conduct CEFs AND there is an appropriate level of assurance over resolution

OR

(where CEFs are involved) there is a high level of assurance over resolution AND an agreed split of supervisory responsibilities and focus on UK financial stability, such that the risk to UK financial stability is within PRA’s risk appetite.

⁹⁸ I.e. focus on wholesale and not go above ‘de minimis’ level for retail services.

⁹⁹ It does not appear to require a Member State to accept a particular third country branch, which would remain at the discretion of the Member State.

must give a year's **prior notice of proposed changes to their domestic law** which would **diverge** from the agreement. If the other side believes the changes undermine the agreement, the matter is referred to a joint committee. This is a '**blocked committee**' and if it reaches no decision, the adoption of the proposed new law by the notifying state will **trigger termination of the entire agreement** (as if the treaty had been denounced). In addition either side has the right to **denounce the treaty on 12 months' notice**.

4. Registration or similar admin procedure (no host state authorisation) with no host state vetting/discretion and with home state responsibility for prudential/financial regulation

EEA single passport

The single passport incorporates a right to establish a host state branch without host state authorisation or host state prudential control. This is subject only to home state approval/control and prudential supervision with only limited host state prudential powers (e.g. for banks in relation to branch liquidity policy, but not capital adequacy). Host state COB will apply.

WTO mode 3 - Establishment (2) – subsidiary

In this mode the foreign firm establishes a local subsidiary in the host country and obtains host state authorisation. This may be the preferred structure for the group concerned or because authorisation of a branch is not available (or, indeed, because authorisation is not available for cross-border services supply or a branch – so any service within the local perimeter can only be supplied via a subsidiary).

In modern FTAs this mode would also be protected as investment.

GATS and applicable FTAs

Firms undertaking this route will generally benefit from market access and national treatment and investment protection commitments in the GATS and applicable FTAs, if the services they wish to provide are covered (subject always to the prudential carve out).

National treatment

A local subsidiary is incorporated and authorised in the host state. It will therefore have to meet all the host state requirements that apply to local firms and authorisation is normally on stand-alone basis, but cannot be discriminated against versus local operators.

Requirements for board and/or management positions to be held by local nationals (nationality requirements)

CETA prohibits nationality requirements on management and board positions. Under WTO rules, nationality requirements for service providers are classed as a market access limitation on the number of service providers equivalent to a zero quota. Discriminatory approval and qualification requirements, which would include nationality qualifications for agents, managers and directors, are classified as national treatment limitations. Some countries maintain limitations under WTO schedules and/or specific FTAs to permit them to operate nationality requirements.

For example, the EU GATS schedule includes limitations allowing a Greek limitation that "a majority of the members of the board of directors of a company established in Greece shall be nationals of one of the Member States of the Community".

Requirements for board and/or management positions to be held by local residents (residency requirements)

Residency requirements are prohibited under GATS and FTAs where a commitment has been given in respect of a service. This is classed as a national treatment restriction. Some countries maintain limitations under WTO schedules and/or specific FTAs to permit them to operate residency requirements.

For example, Finland (under GATS) has residency requirements for at least half of the founders, board members, supervisory board and the managing director of establishments in its territory for banking and other financial services and Slovakia requires that the majority of the management board of an insurance company with an establishment in Slovakia be domiciled there. Sweden (under GATS) has a limitation for the establishment of a commercial presence to the effect that "a founder of a banking company shall be a resident

in the European Community or a foreign bank. A founder of a savings bank shall be a natural person resident in the European Community". The savings bank reservation is also included as a reservation in CETA.

A requirement for the presence of senior management and other functions, if not accompanied by a residency requirement would not seem to contravene national treatment, although if a foreign resident was carrying out such a role that would comprise mode 4 supply, so the horizontal and specific limitations on mode 4 would need to be checked.

Single market regime

There is no substantive waiver (under the EU/EEA single market regime) of solo requirements, even for a subsidiary owned by a parent from another EU/EEA state. In terms of solo supervision, the subsidiary will have to be fully capitalised to meet the financial requirements of the state of incorporation. That state is the home state of the subsidiary. Whilst solo supervision of the local subsidiary will operate under the host state regime, the group will also be potentially concerned about consolidated supervision, group level financial requirements/accounting and holding company requirements (see Other area 3 below).

Other area 1 – recognition of foreign regulated firm/infrastructure/products

Regulation of financial institutions may restrict the parties from whom the firm can obtain certain important services. These requirements become complicated when the service is being obtained from a supplier abroad where the host state legal and regulatory regime is different.

Benchmarks

Within the EU benchmarks are regulated and financial institutions must use regulated benchmarks. There is mutual recognition of benchmark regulation within the EEA/EU Single Market but beyond this the cross-border use of third country benchmarks is dependent on equivalence. The majority of the Benchmark Regulation¹⁰⁰ provisions will apply as of 2018: it introduces three regimes¹⁰¹ regarding the use of benchmarks provided by an administrator located in a third country.

The Regulation **offers interim measures** to mitigate/avoid the risks to the market of ceasing to use a third country benchmark while the formal equivalence assessment¹⁰² is pending. A Member State's competent authority can grant 'recognition' at the national level¹⁰³. Other firms and EU benchmark administrators can also 'endorse'¹⁰⁴ benchmarks provided by a third country.

The basis of the interim regimes is **compliance with the international IOSCO principles**.

This is an example of a flexible approach to dual regulation coordination. Two interesting features are

- the ability of member states, and even firms, to evaluate the foreign benchmarks (before any equivalence finding by the European Commission); and
- the reliance on compliance with international standards.

See also 'Other area 10' below.

Other area 2 – exposure of firm to foreign firm

Financial regulation of a firm often provides differing treatment for the firm's exposure to third parties, reflecting the perceived strength of counterparties. In the case of foreign counterparties, this treatment may depend on some form of differentiation or assessment of the regulatory regime applicable to the foreign counterparty – a form of dual regulation coordination.

Treatment of EU reinsured with third country reinsurer

¹⁰⁰ Regulation (EU) 2016/1011

¹⁰¹ Equivalence, recognition, and endorsement.

¹⁰² The third country benchmark administrator must be registered under the Regulation following an equivalence assessment before it can be used in the EU. Article 30 outlines the rules on equivalence.

¹⁰³ This is conditional – including compliance with some of the Benchmark Regulation requirements. Article 32 outlines the recognition regime.

¹⁰⁴ Article 33 outlines the endorsement regime.

There are no EU harmonised requirements for pure reinsurers from third countries. However, where an EU/EEA reinsured has reinsured with a third country reinsurer, the treatment of that reinsurance asset in the books of the reinsured will depend on the position of the relevant third country. If this has been found to be equivalent under Article 172 Solvency II, the reinsurance asset will receive the same treatment as a reinsurance with an EEA/EU reinsurer.

See Annexes G and I for further details. Annex J provides details of the third countries for which equivalence findings have been made. See also the EU-US agreement on insurance and reinsurance in the section 'International DRC fora and bilateral arrangements' in Chapter 5.

CRD IV – exposures

A similar issue arises under CRD IV in relation to an EU/EEA banks exposures to bank counterparties in third countries. Where the third country concerned has found to be 'equivalent', EU/EEA banks can apply preferential risk weights to relevant exposures¹⁰⁵. The Commission publishes Commission Implementing Decisions (and Acts) that list the third countries and territories whose supervisory and regulatory requirements are considered equivalent under the regime (See Annex J for the three types of equivalence under CRD IV).

Other area 3 – groups - cross-border consolidated supervision and intermediate holding companies

Consolidated supervision (and related issues concerning the treatment of holding companies and group structure) becomes complicated when a group has subsidiaries/holding companies in different jurisdictions, particularly where they are authorised and subject to solo supervision under different national systems.

One question is where there is a requirement for consolidated financial supervision, can the group rely on accounts and financial treatment under foreign/host solo supervision or must it re-calculate under the home state rules?

Intermediate holding companies

The European Commission published legislative proposals to amend the framework for prudential regulation of banks/investment firms¹⁰⁶. A new requirement is introduced in CRD IV for *“establishing an intermediate EU parent undertaking where two or more institutions established in the EU have the same ultimate parent undertaking in a third country. The intermediate EU parent undertaking can be either a holding company subject to the requirements of CRR and CRD, or an institution authorised in the EU. The requirement will apply only to third-country groups that are identified as non-EU G-SIIs or that have entities on the EU territory with total assets of at least EUR 30 billion (the assets of both subsidiaries and branches of those third-country groups will be taken into account in the calculation)”*¹⁰⁷. The Bank of England recently addressed its plans for holding-company based resolution¹⁰⁸ as part of its broader work on MREL as required by the BRRD. The UK's domestic ring-fencing regime for banks may be at odds with the EU's new proposals. Under the UK regime, a ring-fenced body is prohibited from certain conduct such as having non-EEA branches and subsidiaries carrying on regulated activities¹⁰⁹.

See also 'WTO mode 3 – Establishment (2) Subsidiary' above, and 'International DRC fora and bilateral arrangements' in Chapter 5.

Insurance – cross-border consolidated supervision.

Currently, the harmonised EU regime means that solo reporting is compatible for EU groups with subsidiaries in other Member States. The EU has a regime for equivalent third country firms: the solvency calculation under Article 227 Solvency II. A positive equivalence finding by the Commission permits EEA internationally active

¹⁰⁵ Article 17 (3) (4) CRR.

¹⁰⁶ The proposals cover amendments to [CRD IV](#), [CRR](#), BRRD [first](#) and [second](#) proposal, and the [SRMR](#). An explanatory memorandum covering all of the proposals is available [here](#).

¹⁰⁷ http://europa.eu/rapid/press-release_MEMO-16-3840_en.htm

¹⁰⁸ <http://www.bankofengland.co.uk/publications/Pages/news/2016/082.aspx>

¹⁰⁹ Groups may be required to split their retail/investment banking operations into separate groups if the PRA deems the ring-fence to be ineffective.

insurance groups to use local rules relating to capital (own funds) and capital requirements as opposed to Solvency II rules. (See Annex G for further detail).

Without these dual regulation coordination measures, there would be a need to recalculate firms' financial position under the rules of the parent company's jurisdiction.

Other area 4 – cross-border insurance portfolio transfers

Court or regulator approved schemes for the transfer of contracts, such as insurance policies and bank accounts, remove the need for each transfer to be agreed by the account/policy holder. Problems arise, however, where the holder is outside the jurisdiction, particularly where the contract is under local law.

Insurance – cross-border portfolio transfers within the EU

Within the Single Market rules on portfolio transfers were introduced in stages – gradually increasing the level of DRG/mutual recognition. This led to the current position under Article 39¹¹⁰ Solvency II where the transfers are now dealt with exclusively by the home state authorities and the scheme is automatically binding on policyholders in all EU states. Authorisation will be granted by the home state authorities if two conditions are met: (i) the competent authority of the home member state of the accepting undertaking certifies that this undertaking possesses the necessary eligible own funds to cover the solvency capital requirement after taking the transfer into account, and (ii) the competent authorities of the member states where the contracts were concluded have consented, or did not react within a period of three months after receiving a request for consultation.

Insurance – cross-border portfolio transfers: Switzerland and the EU

Dual regulation coordination for insurance portfolio transfers was also introduced¹¹¹ in the Swiss-EU 1989 agreement. Article 24 permits insurance undertakings to transfer all/part of their portfolio of contracts to an accepting office established in the same territory as the transferring undertaking, if the supervisory authority of the contracting party in whose territory the head office of the accepting office is situated certifies that the latter possesses the necessary margin of solvency after taking the transfer into account.

Dual regulation coordination developed in the EU in stages. The Swiss-EU agreement reflects the level of dual regulation coordination at that time. We can see from the current regime (Solvency II) that the level of dual regulation coordination has increased.

Other area 5 – cross-border resolution, compensation schemes and winding up

Dual regulation coordination is also important in the context of resolution schemes, winding up and compensation schemes.

Winding up of EU credit institutions and insurers

The EU has harmonised regimes for the winding up of EEA/EU credit institutions and insurance undertakings.¹¹² These provide for a single state (the home member state) to have jurisdiction in the reorganisation/winding up and the arrangements are binding throughout the EU. The possibility of separate/conflicting proceedings in, for example, another member state where the bank/insurer has a branch is precluded. The legislation also addresses credit institutions/insurance undertakings with head offices not located in the EEA/EU¹¹³.

¹¹⁰ Article 39 Solvency II provides that an insurance undertaking is allowed to transfer a portfolio of contracts to an insurance undertaking established in a Member State after it has received the authorisation of the supervisory authority of its home Member State

¹¹¹ Insurance transfers covering EU countries and Switzerland under 1989 agreement: the basis of the 1989 agreement is reciprocity/non-discrimination. Article 24 (1) concerns portfolio transfers – it permits insurance undertakings to transfer all/part of their portfolio of contracts to an accepting office established in the same territory as the transferring undertaking, if the supervisory authority of the contracting party in whose territory the head office of the accepting office is situated certifies that the latter possesses the necessary margin of solvency after taking the transfer into account

¹¹² Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions, and Solvency II respectively.

¹¹³ See Articles 1(2), 8, and 19 Directive 2001/24/EC and Articles 267 (b), 268 (2), 274, 296 Solvency II.

Resolution of EU banks

BRRD¹¹⁴ established a recovery and resolution framework for EU credit institutions and investment firms. It contains mechanisms for co-operation between resolution authorities in applying resolution tools and powers to financial groups operating on a cross-border (within the EU) basis. It contains a number of provisions regarding third country branches/parent institutions¹¹⁵. Directive 2001/24/EC (Winding Up Directive) provides for a single state (the home state) to have jurisdiction in the winding up of credit institutions and the arrangements are binding throughout the EU. BRRD amended the Winding Up Directive to apply the same principle to special resolution actions (such as transfers of assets and liabilities) taken by home member states under their national bank resolution laws¹¹⁶.

EU compensation schemes – depositor protection and investment services

The Deposit Guarantee Schemes Directive¹¹⁷ (DGSD) requires that each member state has at least one deposit guarantee scheme (DGS) in their jurisdiction¹¹⁸ with the aim of providing protection to depositors. The Directive has dual regulation coordination elements: credit institutions¹¹⁹ must participate in their home state DGS¹²⁰ and their branches in other member states are covered by this home state DGS¹²¹ (mutual recognition of national DGS). DGSD requires that member states assess, in respect of branches of non-EU credit institutions established in their jurisdiction, whether home state deposit protection schemes provide an equivalent level of cover to depositors. Under Article 15(1), if the coverage is not equivalent member states must require these branches to join a DGS in their jurisdiction.

The Investor Compensation Schemes Directive¹²² (ICSD) introduced the requirement that each member state have at least one investor compensation scheme with the aim of providing harmonised minimum levels of protection for investors across the EU. In terms of dual regulation coordination introduced: firms conducting business via a branch in another member state are covered by the home state scheme¹²³. However, where the host state has more generous scheme(s), the branch is allowed to participate in the host state scheme.

Other area 6 – cross-border supply contracts – choice of law, jurisdiction and enforcement

DRC is also important in the context of ‘choice of law’ and ‘jurisdiction’ in contracts between a regulated firm in one state and a client in another country and in relation to ‘enforcement’ of related judgements. In some respects the coordination measures are legal rather than regulatory but EU FS legislation does regulate cross-border choice of law in certain areas.

EU wide rules and EU participation in international conventions

The EU has non-sectoral (or horizontal) legislation covering choice of law, jurisdiction and enforcement¹²⁴. These provide dual regulation coordination in that they prevent conflict under the laws/regulation of the home and host state.

These issues are also addressed by international conventions¹²⁵ that the EU subscribes to which cover non-EU countries.

¹¹⁴ [Bank Recovery and Resolution Directive \(2014/59/EU\)](#)

¹¹⁵ Articles 94(4)(a) (i) and (ii) BRRD request that Member States equip their authorities with powers to enforce third country resolution proceedings by being able to exercise resolution tools over, respectively, "assets of third country institution or parent undertaking that are located in their Member State or governed by the law of their Member State" and "rights or liabilities of a third-country institution that are booked by the Union branch in their Member State or governed by the law of their Member State, or where claims in relation to such rights and liabilities are enforceable in their Member State". Article 96 BRRD applies to Union branches that are not subject to third-country resolution proceedings or where the third-country resolution proceeding cannot be recognised.

¹¹⁶ See for example, [Goldman Sachs International v Novo Banco SA \[2015\] EWHC 2371](#) (Comm) which examined the BRRD with regard to the divide of responsibility (and degree of mutual recognition) between home and host jurisdictions in the resolution of a European bank.

¹¹⁷ [\(2014/49/EU\)](#)

¹¹⁸ Article 4(1) DGSD

¹¹⁹ Authorised in the EU under CRD IV (2013/36/EU)

¹²⁰ Article 4(3) DGSD

¹²¹ Article 14(1) DGSD

¹²² [\(97/9/EC\)](#)

¹²³ Article 7(1) ICSD

¹²⁴ See for example, [Brussels I](#) and [Brussels \(recast\)](#), and [Rome I](#).

¹²⁵ Such as Lugano [1988](#), [2007](#), etc.

Solvency II harmonisation of choice of law rules in insurance

There are sector-specific rules on choice of law in the Single Market. Under Solvency II there are areas where member states must provide freedom of choice¹²⁶ (large risks) and others where member states have the freedom to impose requirements to use host state law (mass risks).

Other area 7 – free movement of capital

EU rules on free movement of capital – internal and external transfers

Free movement of capital¹²⁷ is one of the Single Market's four freedoms. The freedom is a fully-implemented core principle of the Single Market. The unusual feature of this freedom is that it not only applies between Member States but also between Member States and third countries. The interpretation of this Treaty freedom falls to the Court of Justice of the European Union (CJEU) – there is case law determining to what extent Member States can restrict capital moving directly to a third country¹²⁸. The European Commission collated [key CJEU cases](#) that indicate how the court has interpreted the free capital principle (and exceptions to the principle). Justified restrictions on capital movements in general, including movements between member states, which member states may decide to apply, are set out in Article 65 TFEU: (i) measures to prevent infringements of national law (namely in view of taxation and prudential supervision of financial services); (ii) procedures for the declaration of capital movements for administrative or statistical purposes; and (iii) measures justified on the grounds of public policy or public security¹²⁹.

Other area 8 – Distribution of products and prospectus and private placement regimes and listing requirements

One example of harmonisation measures regarding distribution of products within the Single Market is UCITS. The UCITS Directive prescribes common standards for funds intended to be sold to retail clients; with a passport these funds can be sold to investors in any Member State. There are no third country provisions in the UCITS Directive (see Annex F for further details).

There is precedent for a (limited) bilateral agreement between an EU Member State (Germany) and an EFTA state (Switzerland which is neither an EU nor EEA Member State). The agreement entered into force in 2014 to implement a simplification in the marketing of Swiss securities funds (*Effektenfonds*) in Germany, and German UCITS in Switzerland. This protocol followed an earlier cooperation agreement regarding the area of taxation and financial markets in 2011. The agreement states that German UCITS and Swiss securities funds are considered as equivalent – this allows for a simpler, faster notification process based on the UCITS Directive. See also the Australian-Hong Kong MoU on collective investment funds in the section 'International fora and bilateral arrangements'.

Another example of EU rules harmonising the treatment of marketing of funds¹³⁰ is AIFMD. AIFMD has limited third country provisions (third country passporting provisions not yet in force) – see Annex D for further information. The alternative to the third country passport is reliance on Member State national private placement regimes.

Within the EEA there are harmonised transparency¹³¹ and listing requirements (Prospectus Directive¹³² and Prospectus Regulation¹³³). The EEA listing requirements apply to EEA regulated markets. In terms of dual regulation coordination, issuers can passport prospectuses that have been approved by the competent

¹²⁶ Non-life insurance contracts (Articles 183 & 184).

¹²⁷ Article 63 TFEU provides that "all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited." This treaty freedom was introduced via the entry into force of the Maastricht Treaty. The freedom is balanced with the need to ensure Member States are not exposed to national/public security threats.

¹²⁸ With regard to capital movements between member states and third countries, member states have: (1) the option of safeguard measures in exceptional circumstances; (2) the possibility to apply restrictions that existed before a certain date to third countries and certain categories of capital movements; and (3) a basis for the introduction of such restrictions — but only in very specific circumstances. See http://www.europarl.europa.eu/atyourservice/en/displayFtu.html?ftuld=FTU_3.1.6.html

¹²⁹ This is supplemented by Article 75 TFEU providing for the possibility of financial sanctions against individuals, groups or non-state entities to prevent and combat terrorism.

¹³⁰ Marketing of EU funds by an EU AIFM.

¹³¹ Transparency Directive (Directive 2004/109/EC) and Market Abuse Regulation (Regulation (EU) No 596/2014).

¹³² Directive 2003/71/EC

¹³³ Regulation 809/2004 (there is a [recast prospectus regime](#) due to enter into force in the EEA).

authority (in their home state) into other member states. Dual/multiple listings on regulated markets involving the UK post Brexit will be met with dual regulation barriers: the current regime gives member states, competent authorities the ability to approve prospectuses from issuers incorporated in third countries provided that (i) they have been drawn up in accordance with international standards and (ii) the information requirements are equivalent to those under the EEA prospectus legislation¹³⁴.

Other area 9 – Settlement finality and collateral

The EU has harmonised rules aimed at mitigating the risk of insolvency of participants in payments and securities settlement systems: the Settlement Finality Directive¹³⁵, the Central Securities Depositories Regulation¹³⁶ and the Financial Collateral Arrangements Directive¹³⁷. The EU updated the rules on settlement finality and financial collateral in 2009¹³⁸. The settlement finality rules also cover third country participants in these systems¹³⁹. There is no third country ‘equivalence’ regime under the Settlement Finality Directive¹⁴⁰. Similarly, the financial collateral rules also include third country participants¹⁴¹ but do not provide for a third country ‘equivalence’ regime. There is, however, mutual recognition of competent authorities and CSDs under the CSDR¹⁴² – the Regulation¹⁴³ aims to harmonise certain aspects of the settlement cycle and settlement discipline and to provide a set of common requirements for CSDs operating securities settlement systems¹⁴⁴ across the EU. A third country CSD may provide services in the EU, including through the establishment of branches¹⁴⁵.

Supply chain structuring to address dual regulation barriers

Supply chains in financial services are sometimes quite complex involving multiple entities. There are a variety of arrangements which are used for a variety of purposes such as business efficiency and specialisation. Within groups these arrangements may be used for tax efficiency or to consolidate support functions.

Sometimes these arrangements are used in a cross-border context and this includes arrangements to deal with, or operate in the context of, dual regulation barriers to cross-border supply. Typically the arrangements

¹³⁴ In the case of an offer to the public or admission to trading on a regulated market of securities, issued by an issuer incorporated in a third country, in a Member State other than the home Member State, the requirements set out in Articles 17, 18 and 19 shall apply (Art. 20 (2) Prospectus Directive).

¹³⁵ Directive (98/26/EC). Under this Directive, member states must ensure that their insolvency laws do not prejudice the finality of settlement or the enforcement of collateral by settlement systems designated by them or other member states.

¹³⁶ Regulation on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC (Settlement Finality Directive (SFD)) and 2014/65/EU (MiFID II) and Regulation (EU) No 236/2012 (Short Selling Regulation) (known as CSDR) (Regulation 909/2014).

¹³⁷ Directive (2002/47/EC)

¹³⁸ http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/misc/107390.pdf and the Settlement Finality Directive was subsequently amended by the CSDR (Regulation on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC (Settlement Finality Directive (SFD)) and 2014/65/EU (MiFID II) and Regulation (EU) No 236/2012 (Short Selling Regulation)) (Regulation 909/2014).

¹³⁹ The Settlement Finality Directive provides that “Member States may apply the provisions of this Directive to their domestic institutions which participate directly in third country systems and to collateral security provided in connection with participation in such systems”.

¹⁴⁰ [EU paper on UK withdrawal from the EU and single market access](#)

However, a settlement system that is not located in an EU member state may become a designated system under the SFD provided that the system is governed by the law of an EU member state as chosen by its participants (Art. 2).

¹⁴¹ [Explanatory memorandum](#) regarding the Directive: “*The possibilities for Community counterparties to conclude collateral arrangements with counterparties from third countries should also be enhanced[...]*” and “*The lex rei sitae rule, according to which the applicable law for determining whether a collateral arrangement is properly perfected and therefore good against third parties is the law of the country where the collateral is located, including where the location is in a third country, is currently recognised by all Member States.*”

¹⁴² See, for example, Article 8 CSDR regarding enforcement: *The competent authority of the CSD that operates the securities settlement system, the relevant authority responsible for the oversight of the securities settlement system concerned as well as the competent authorities for the supervision of trading venues, investment firms and CCPs shall be competent for ensuring that Articles 6 and 7 are applied by the institutions subject to their supervision and for monitoring the penalties imposed. Where necessary, the respective competent authorities shall cooperate closely. Member States shall inform ESMA about the designated competent authorities that are part of the supervision structure at the national level.*

¹⁴³ The Regulation introduces for the first time at European level, a common authorisation, supervision and regulatory framework for CSDs. It is interdependent on certain aspects of [TARGET2](#) the pan-European platform for securities settlement in central bank money, which harmonises operational aspects of securities settlement.

¹⁴⁴ The requirements under Article 3(2) CSDR applies to all transferable securities, including those issued by the issuers established in third countries, to the extent that the settlement of the transactions in such securities takes place in a securities settlement system governed by the law of a Member State.

¹⁴⁵ Article 25 (1) CSDR. During any transitional period (Article 69(3) CSDR) third country CSDs providing CSD services that require recognition under CSDR remain subject to existing national regimes until they have been recognised under CSDR.

seek to avoid the effects of dual regulation by using multiple entities (holding any necessary authorisation in their home state) to perform different roles in different jurisdictions, rather than one entity having to be authorised and regulated in 2 or more jurisdictions.

Arrangements of this kind include

- insurance fronting/bridging (see other area 10 below);
- back to back trading/deal booking intra group entity (see other area 10 below);
- outsourcing (see other area 10 below);
- delegation (see other area 10 below);
- the broader use of intermediaries and agency principles (see other area 10 below); and
- conduit arrangements (see other area 10 below).

There have always been regulatory tensions and differing national approaches and policy as to what was lawful/permissible. These issues, which may arise for each entity in the chain, may relate to questions of authorisation (when is an entity to be regarded as carrying on a regulated activity or when is that activity regarded as being carried on in a particular country) or whether a regulated entity is permitted to operate via relationships of this sort.

There is particular interest in arrangements of this sort as a way to deal with new dual regulation barriers arising at Brexit between the UK and other EU/EEA states. There is considerable interest in the current approach of UK/EU regulators to these arrangements and speculation as to how these policies might change if Brexit occurs without a substantive agreement on dual regulation coordination. Could a UK insurer (without a licence in other EU states) operate a fronting/bridging structure across the EU under PRA rules and under the perimeter rules of each EU jurisdiction? EU states might take a more aggressive stance post-Brexit than they have to date, because of increased risk with the UK outside the single market or for more protectionist motives.

Other area 10 – agents, outsourcing and delegation

Outsourcing and delegation and agents/agency are common in financial services and often have a role in 'chains' of supply. Outsourcing is a common feature of intra-group arrangements.

These are frequently used in cross-border arrangements and may be important to avoid DR barriers. For example an insurer in country A may wish to underwrite a risk in country B, but may be admitted or authorised only in country A. A local agent in Country B (authorised as an intermediary in country B but not country A) may therefore be involved in the chain. Whether or not this is permitted will depend on the regulatory perimeters in both countries. If state B were the UK, for example, the agent would need to ensure it did not act as principal (i.e. act as an insurer reinsured by the country A insurer) and that its involvement on the claims side and in the conclusion of the insurance contract did not cause the insurer to be conducting insurance business in the UK.

The position under GATS market access provisions.

Depending on the composition of the service to be provided, elements of it, in particular, support and administration activities may be outsourced or delegated. The Understanding includes the provision cross-border provision of financial information and data processing services, and advisory and other auxiliary services relating to banking and other financial services (excluding intermediation). This is also committed to in CETA by all parties (except Belgium, which committed only to the information and data processing element), and in TPP. TPP goes further and expressly recognises the importance of outsourcing of back office functions and the importance of avoiding the imposition of arbitrary requirements on the performance of those functions. This too is qualified, however, as the provision states that nothing prevents a country from requiring a financial institution in its territory to retain certain functions.^[1]

Outsourcing by authorised EU firms to third country entities under EU and national rules.

The extent to which and the circumstances in which regulated entities are permitted to outsource and delegate functions has been an important issue for many years. There are some EU harmonised rules in this area but there is much divergence between sectors and regulators.

There has been keen interest in this topic in the context of UK groups contingency planning for Brexit – looking to use EEA based authorised entities to front client services across the EEA and then outsource internal functions back to the existing UK staff/divisions/entities. Similarly fund groups have looked at using EEA fund managers to operate funds with the EEA passport and then delegate investment management back to the UK.

^[1] Article 11.17 TPP

An example - Delegation under UCITS – including third country provisions.

Delegation of functions in connection with regulated services is specifically provided for in some EU legislation. For example under the UCITS directive, member states may permit UCITS management companies to delegate performance of their functions (including portfolio management) to third parties, and some permit such delegation to firms established in third countries, subject to certain conditions and a general requirement that the management company should not be relegated to being a “letterbox entity”^[2]. Investment management may only be delegated to an undertaking in a third country where co-operation between competent authorities is ensured and the delegate is authorised and supervised in its home state for the purposes of asset management. The management company needs only to retain responsibility for monitoring and ensuring performance of functions and this can be done by a designated person responsible for that function in the territory. Ireland permits delegation to any of 15 countries (including the USA, Australia, Japan and Hong Kong) where it has Memoranda of Understanding in place with regulators, subject to satisfaction of certain conditions for the appointment of the delegate^[3].

Depositaries may also delegate the performance of certain functions to third parties, who may be established in third countries, provided that the delegation is done for objective reasons and not in order to avoid the requirements of the directive, and subject to exceptions that require ultimate responsibility for ensuring compliance rests with the depositary^[4].

Other area 11 - insurance fronting

In insurance the activity of ‘fronting’ is well known and widely used, particularly in an international or cross-border context. An insurer in the home state may arrange for a local insurer in the host state to issue policies to local insureds; the risk is transferred back to the home state insurer via a contract of reinsurance (which might transfer 100% or a slightly lesser percentage of the risk). In this way the home state insurer avoids the need for host state authorisation, because the direct policy is issued by the host state authorised fronting insurer. This mechanism is already in use and may be used as a more developed structure – a ‘bridge’ or ‘bridging structure’ – for UK insurers to undertake EU risks post-Brexit via group, captive or independent EU insurers. Regulators have in the past queried artificial insurance structures such as financial insurance and 100% fronting. So this may become an area of focus – like outsourcing and delegation.

Other area 12 - back-to-back trading

In the banking, securities and derivatives sector it is common for transactions to be ‘booked’ to a particular group entity/branch or establishment and then for the exposure to be transferred to another group establishment by a back-to-back trade. (This is therefore similar to fronting arrangements in the insurance sector.) A variety of factors may drive and/or limit the use of this practice – tax, regulation and the issue of local authorisation. This is another technique which might be used by UK firms post Brexit, using an EEA authorised entity to enter into transactions with the client and then doing a back-to-back trade to transfer the exposure to the UK group entity.

Other area 13 – conduit arrangements

A structure which reverses the back-to-back trade has also been considered in the context of Brexit. Here it is the client or counterparty which sets up the structure by establishing a UK conduit vehicle to enter into transactions with the UK bank or broker dealer.

Other area 14 – Rules with extra territorial effect or impact

Some elements of EU FS legislation have extra-territorial effect and UK firms should establish what obligations are imposed notwithstanding the UK’s status as a third country – examples include EMIR¹⁴⁶ and MAD II¹⁴⁷.

Regulatory rules sometimes have extra-territorial effect even where there is no substantive cross-border supply into the state concerned. EMIR and Dodd-Frank, for example, contain obligations on foreign parties entering into certain OTC swap/derivative transactions.

^[2] Recital 16 and Article 13 UCITS V

^[3] <https://www.centralbank.ie/regulation/industry-sectors/funds/ucits/Pages/UCITSandAIFThirdPartyapprovalandfundauthorisationprocesses.aspx>

^[4] Article 22A UCITS V

¹⁴⁶ Extra-territorial clearing and risk mitigation requirements apply to third country firms.

¹⁴⁷ To learn more about MAD II, [click here](#) to access our MAD II topic page.

U.S. swaps – The general rule is that any non-security-based swap entered into with a US person, as defined in the CFTC's July 13 2013 [final cross-border guidance](#), is subject to all applicable Dodd-Frank Title VII swaps rules. However, a **substituted compliance determination** permits the non-US counterparty to the swap to comply with their local equivalent regime/rules.

The CFTC has approved a series of broad **comparability determinations** that would permit substituted compliance with non-U.S. regulatory regimes as compared to certain swaps provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Commission's regulations. The decisions are [here](#) (EU, Japan, Hong Kong, Canada, Australia, Switzerland).

Other area 15 – Horizontal/non-sectoral barriers/dual regulation

FS firms also operate under EU harmonised rules/regimes under horizontal or non-sectoral legislation. This extends to competition and state aid regimes and applicable single market legislation such as Distance Marketing, E-commerce and Consumer Rights.

Under [the General Data Protection Regulation](#) (“**GDPR**”) the European Commission may, with effect for the whole Union, decide whether a third country/territory/specified sector(s) of a third country offers adequate levels of data protection¹⁴⁸. Transfers of information outside of the EU have to be made in full compliance with the GDPR¹⁴⁹. As transfer of data is central to all financial institutions business, the EU will need to recognise the UK for this purpose and the UK reciprocate under its iteration of the GDPR that will be transposed into UK law as at Brexit.

EEA states operate extensive single market DRC internally; firms/infrastructure operating across the EEA/UK will face substantial new DR barriers at Brexit

The single market ‘passport’ is a package of, mainly prudential, DRC to create a ‘single licence’ for firms from any of the 31 EEA states which is valid for the entire EEA; this now covers most FS infrastructure and sectors/activities. It is based on harmonisation (on a minimum or maximum basis) of applicable rules. The package has many elements, but it is possible to have ‘passports’ with less DRC (as well as reduced scope). Some passporting was originally introduced with less DRC. The single market also has **important DRC in many areas other than ‘passporting’**.

At Brexit the UK will become a ‘third country’ under the EU regime and UK firms/infra-structure will lose this single market DRC and face new DR barriers in relation to their EEA business; EEA firms would lose the DRC in relation to their UK business. The loss of single market DRC will also be a new DR barrier to pan-European ‘hubbing’ (most especially out of the UK).

If one considers the most extreme scenario where EU level DRC was not replicated at all (by any of the states - via agreement or equivalence findings etc.) – then cross border supply (mode 1) which is currently free and frictionless will become completely prohibited in many scenarios, particularly for supply into countries such as France. In these cases, suppliers will have to move-onshore (i.e. switch to mode 3) and use a local subsidiary (or a branch, where permitted) and obtain local authorisation. Those operating via branches under mode 3 may be able to switch to dual authorisation status (which is much less efficient than the single licence) but in some cases will have to establish a free-standing local bank/insurer/subsidiary (which is likely to involve even greater cost). Critical UK based international infrastructure would also be impacted.

EU/EEA groups would face similar barriers but would (on the basis of the current UK treatment of foreign/TC firms) benefit from a more open approach – compared to say France – e.g. for modes 1, 2 and 3 (for branches)). UK/TC groups may switch business from single licence supply from UK entities to an EEA subsidiary and then use its single licence as a hub across EEA states.

Operations would also be impacted by a **loss of DRC in other areas** e.g. where firms would be prohibited from using foreign services (e.g. benchmarks) or would suffer adverse capital treatment or increased barriers/costs from a loss of DRC. A number of structures which firms adopt to address DR barriers (such as fronting/bridging, back to back transactions, outsourcing and delegation) may be impacted by a loss of DRC.

TCFs (such as firms from Switzerland) face high DR barriers to EU/EEA business and enjoy very limited DRC (when compared to single market participants)

Without EEA membership, Swiss firms face high DR barriers to EU/EEA business and DRC is limited.

¹⁴⁸ The assessment will take into account how the third country respects human rights norms, the rule of law, and other criteria.

¹⁴⁹ To read more about the GDPR [click here](#) to read our December 2015 article.

DR barriers and available DRC vary considerably from one EU/EEA country to the next - a complex mix mostly of national rules but also involving international arrangements and EU measures

DRC available to Swiss firms is a complex mix of national member state DRC, a bilateral Swiss/German accord on UCITS, a bilateral 1989 EU/Swiss Treaty on direct non-life insurance branches and EU level harmonisation of external treatment/TCFs (Switzerland follows a large proportion of EU FS legislation and gains available EU equivalence based DRC) some of which reflects international arrangements. Swiss firms therefore take advantage of DRC available to any third country, DRC that is available to third countries that are 'equivalent' (under both EU level and individual member state national DRC arrangements) and some 'Swiss only' DRC under 2 bilateral treaties/accords – one with the EU and the other with one individual member state, Germany.

There are a mix of DRC channels and structures; there are a variety of international arrangements (plurilateral and bilateral) – as well as WTO style market access, there are formal international treaties on DRC (see the 1989 insurance treaty above) and less formal DRC accords, sometimes at a regulator level (see the 2016 accord below). There are EU third country DRC measures (e.g. 'equivalence' based DRC and some other areas of harmonisation which may increase DR barriers) and national level DRC arrangements (see below). The latter often operate at a regulator level and on the basis of regulator to regulator arrangements.

Both the DR barriers (including local 'perimeter rules') and the available DRC vary extensively from one EU/EEA state to the next. Some EEA states are more protectionist, such as France; others are relatively more open, such as Ireland (and indeed the UK). Some have systems for registration/authorisation for cross-border service supply; some have exemptions, whilst others seek to require suppliers to come on-shore to obtain local authorisation.

Mapping by CMS of the DR barriers and available DRC for TCFs across the EU/EEA shows the extensive variances from one EU country to the next and the complexity for TCFs doing business with the EU/EEA. For UK firms trying to assess this matrix and the potential DR barriers that they will face at Brexit, two key ingredients are unknown – the extent of bilateral DRC to be agreed (i) between the UK and EU and (ii) between individual member states and the UK. There is also uncertainty as to how EEA states' domestic level DRC policy will be applied to the UK (and vice versa) and whether EU equivalence based DRC (under current EU legislation) will be available at Brexit. Some of this is 'passport-type' DRC, and some is DRC in other areas. These apply only to a limited FS scope and with limited DRC; the passport DRC elements are limited in scope and depth.

EU legislation gives various powers in relation to bilateral accords – for example the Swiss/EU treaty above and the 2016 European Commission/CFTC accord on central counterparty regulation. The latter arose under the auspices of the G20/FSB and was implemented by equivalence findings by the EU under EMIR and comparability findings by the US under Dodd-Frank respectively. Existing powers are, however, limited in scope.

An extreme loss of DRC at Brexit should be 'unthinkable', but the negotiations will determine the breadth and depth of DRC that survives

Due to the variety of DRC channels, Switzerland/EEA has greater DRC (see below) than in the extreme scenario above for the UK. A comprehensive loss of EU/UK DRC at Brexit in the extreme scenario above would make no sense for the EU or UK. It would represent a total failure of negotiation and a reversal of recent global cooperation on financial stability. We would like to think that this scenario falls into the category of the 'unthinkable' and that DRC must continue; the uncertainty is really about how broad and deep that DRC will be.

DRC is very flexible technique with many varied applications

In conclusion, there are many different types of dual regulation coordination which may be used in the new UK/EU FS partnership. Techniques such as mutual recognition (including passporting) are not binary – mutual recognition might be limited or extensive in terms of scope, sector, customer type, modes of supply and so on. Different techniques may therefore be used – to a greater or lesser extent - in different sub-sectors where market dynamics, or the risk to host state markets, differ or depending on the level of divergence in the respective regulatory regimes.

5. Assessing the sufficiency of regulation in another country for dual regulation coordination

Home state sufficiency

As can be seen from Chapter 4, there are many cases where DRC is dependent on the home state having sufficient standards in regulation and supervision. In the case of mode 3 branch business it is almost inevitable that the host state supervisor will need to rely to some degree on home state regulation and supervision (HSS).

In many cases this will involve the putative host state or its supervisors in an assessment of the home state regime. In this chapter we look at examples of how this works in practice and at the different processes involved.

Approaches around the world

There are many examples of a country (or supra-national body) evaluating the regulatory regime of another (with a view to some element of dual regulation coordination/mutual recognition). The language/terminology and the process/level of scrutiny vary. There is extensive information¹⁵⁰ available about the process, the policy options, the standards, the scope of the review etc. We have not attempted a comprehensive review, but have focused on examples which are of interest when we turn to consider the terms of the new UK/EU relationship in the next chapter.

Different jurisdictions use different terms for what we call 'home state sufficiency' – such as comparability, quality justification and equivalence. As noted above, these issues can arise in the context of unilateral, bilateral or multi-lateral arrangements. In most cases the assessment of home state sufficiency is determined by the host state authorities under their own domestic processes. This may take place on a unilateral basis or as part of bi-lateral arrangement. There are often 3 required elements:

- Cooperation arrangements at a supervisory level – confidentiality, information gateways/exchange and cross-reporting etc.;
- Reciprocity of treatment and access;
- Evaluation of HSS.

Sometimes these arrangements are fostered at an international level. For example, the question of home state sufficiency arose at a supra-national level regarding derivatives/central clearing. The FSB published a report¹⁵¹ which reiterated the G20 leaders' desire that, "*jurisdictions and regulators should be able to defer to each other when it is **justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes***". In the case of derivatives/central clearing the US defers to the EU's EMIR regime and the EU defers to the US regime.

In many cases these issues are dealt with domestically. For example, in the U.S., the Commodities and Futures Trading Commission (CFTC) assesses home state jurisdictions to determine if they have a '**comparable regulatory scheme**'¹⁵². The features of a comparable regulatory scheme include¹⁵³ - registration, authorisation or other forms of licensing, fitness review or qualification of persons soliciting and accepting customer orders.

In Singapore, the Monetary Authority of Singapore (MAS) will recognise the 'adequacy' of a third country firm where arrangements exist for cooperation between MAS and the primary financial services regulatory authority responsible for the supervision of that firm and the firm is, in its home country, subject to requirements and supervision **comparable**, to an appropriate degree to achieve the MAS' objectives, to the requirements and supervision to which firms are subject under the Securities and Futures Act.

In Australia, the Australian Securities and Investment Commission (ASIC) take a similar approach to that of the EU compared with that of the US. Underpinning the Australian equivalence process are **international standards** used as benchmarks. In determining whether a third country jurisdiction is equivalent, ASIC will consider whether the home state regime is clear, transparent and certain; **consistent with IOSCO rules**; adequately enforced; and achieves regulatory outcomes equivalent to that of the Australian regime.

¹⁵⁰ See, for example, FSN Forum & Norton Rose Fulbright '*Examining Regulatory Equivalence*' (12 January 2017)

¹⁵¹ '*Jurisdictions' ability to defer to each other's OTC derivatives market regulatory regimes*' (18 September 2014)

¹⁵² For exemption under Part 30 CFTC regulations.

¹⁵³ Together with an information sharing agreement between the US and the home state regulators/supervisors.

The ASIC is interesting in that it specifically provides for international standards to be used as a benchmark.

The approach of countries in the EU/EEA

Domestic policy and process

In most areas the EU leaves individual states to develop their own policy and processes vis a vis DRC with third countries and the associated assessment of home state sufficiency (although a state cannot prefer third country firms over firms from other EEA countries).

For example as explained in Chapter 4 above and Annex B¹⁵⁴, the PRA has a free hand¹⁵⁵ (in that there are no EU requirements to follow) when it comes to setting the threshold and evaluation process for the authorisation¹⁵⁶ of third country banks seeking to set up a UK branch. The PRA will take account of supervisory work undertaken by the home state supervisor and of any opinion of the home state supervisor about the firm's compliance with the UK's Threshold Conditions.¹⁵⁷

The PRA's equivalence assessment will focus on:

- "HSS's rules, powers, consolidated supervision, information sharing, confidentiality, and the **competence and independence of supervision**";
- Capital, liquidity, and resolution regimes to determine if these are consistent with **international standards**;
- The nature of the firm's activities in the UK – whether this amounts to Critical Economic Functions (CEFs)¹⁵⁸.

Domestic determination within EU rules

For dual regulation coordination of branches of third country insurers the EU has established harmonised requirements¹⁵⁹, but leaves the assessment¹⁶⁰/authorisation of third country firms to individual member states' regulators. Solvency II outlines the minimum standards that must apply where the host state regulator grants authorisation¹⁶¹. The PRA assesses the entire insurance undertaking against the Threshold Conditions in FSMA 2000¹⁶². The PRA also considers (at the point the branch seeks authorisation and on an ongoing basis) the 'adequacy' of the home state supervisor. The PRA's assessment will focus on (not an exhaustive list): "HSS's rules, powers, consolidated supervision, information sharing, confidentiality, and the competence and independence of supervision" and "capital, liquidity, and resolution regimes to determine if these are consistent with international standards".

For authorised branches of non-EEA insurers, the PRA expects:

¹⁵⁴ See Annex B for detailed information on the PRA authorisation process for TCF branches of credit institutions/insurance undertakings

¹⁵⁵ See [CRD IV](#) Article 47

¹⁵⁶ The PRA's approach can be found in a Policy Statement (PS8/14) available [here](#) and a Supervisory Statement (SS10/14) available [here](#).

¹⁵⁷ [PRA SS10/14](#)

¹⁵⁸ 'A function whose disruption or withdrawal could have an adverse material impact on financial stability in the UK'. PRA says that it expects new non-EEA bank branches to focus on wholesale activities and at a level that is not critical to the UK economy. PRA has particular concerns over retail banking and about non-EEA bank branches undertaking this activity other than on a *de minimis* basis. Eligible (mostly retail) deposits of an EEA branch, if any, will be covered by the home rather than

host country deposit guarantee scheme. However, eligible deposits placed in non- EEA branches are can be covered by the UK deposit guarantee scheme.

¹⁵⁹ Different rules apply to reinsurers under Solvency II.

¹⁶⁰ The European Commission makes the equivalence determinations regarding third countries.

¹⁶¹ See article 18 Solvency II (conditions for authorisation) and article 25 Solvency II (refusal of authorisation). EIOPA also published [Guidelines](#) for third country branches of insurance undertakings.

Article 162 Solvency II states that any third country insurer wishing to access insurance business in the EU/EEA must be authorised in a member state and must establish a branch in the member state (where authorisation is sought). This article does not apply to pure reinsurers: member states apply their own regimes to the authorisation of third country pure reinsurers (article 174 Solvency II states that member states cannot treat them more favourably than EEA firms).

¹⁶² See PRA SS44/15 which replaces SS10/15. See also UK Financial Services and Markets (The Solvency II Regulations 2015) statutory instrument.

- TCF branch undertaking to comply with EIOPA Branch Guidelines; and
- TCF branch undertaking to comply with relevant rules in the PRA Rulebook.

For authorised branches of non-EEA pure reinsurers, the PRA expects:

- TCF branch to comply with the EIOPA Branch Guidelines that are relevant to them; and
- TCF branch to comply with the rules in the PRA Rulebook that apply to them in light of the EIOPA Branch Guidelines as if the scope extended to them.¹⁶³

EU evaluation of third country regimes for EU level treatment

As EU equivalence assessments are structured as a unilateral process. The EU grants (and withdraws) equivalence status under an internal process set out in EU legislation. As explained in chapter 4, the EU has introduced certain harmonisation of the treatment of firms from TCs that meet various tests as to equivalence. This enables the EU to place some element of reliance on the HSS. This approach is often dependent on a lengthy EU evaluation (by the European Commission with the advice of EBA, ESMA or EIOPA) of whether third country regulation is equivalent to EU regulation in each area. The assessment process can take as much as 4 years to complete. This process is unilateral rather than mutual/bi-lateral (although it can be used by the European Commission in a bilateral context – see for example the 2016 Accord with the CFTC and see CETA which envisaged mutual recognition between the EU and Canada which might have been implemented by the EU through equivalence findings.)

One example of the EU process is briefly summarised below but more detailed information about all the EU processes can be found in Annexes D – I.

*MiFID II/MiFIR regime*¹⁶⁴ - TCF passport for cross-border services for professional clients and eligible counterparties.¹⁶⁵ –

For a third country regime to be determined as being equivalent a number of conditions must be satisfied (Article 47(1) (a) to (e) MiFIR); they are broadly summarised in two limbs:

- firms authorised under the regime must be subject to **adequate and appropriate** prudential and business conduct requirements compared to those contained under MiFID II; and
- the third country must have an **effective equivalent system for recognising EU/EEA investment firms** so as to enable them to conduct activities within the third country.

So here, there are two assessments. First the assessment of HSS and second the market access position.

It should be noted that the EU processes regarding assessment of sufficiency of third country regimes vary (between sectors/different pieces of legislation). The processes often vary in terms of formality and prescription. The test/threshold can differ – for example, some tests assess ‘equivalence’ of third country regimes while others offer a more lenient¹⁶⁶ (albeit temporary) test e.g. under Benchmarks Regulation.

It is within the EU’s discretion as to how far it might withdraw these third country assessment provisions in the future or simply fail to conclude equivalence assessments for a particular country¹⁶⁷.

There are nearly 40 areas where EU legislation provides for DRC based on equivalence. The European Commission has issued one or more equivalence decisions for 21 of these. Some of the remainder are not yet in force. The importance or value of individual equivalence provisions varies enormously and depends on the extent of DRC. Under Solvency II, only two countries (Switzerland and Bermuda) have full equivalence status.

¹⁶³ PRA SS44/15

¹⁶⁴ Not yet in effect.

¹⁶⁵ Article 4(1)(11) MiFID II defines professional client as ‘per se professional client or an elective professional client’. Article 4(1)(12) MiFID II defines retail client as a client who is not a professional client or an eligible counterparty.

¹⁶⁶ With regard to the tests under the Benchmarks Regulation, the temporary findings are underpinned by adherence to internationally recognised standards by the third country.

¹⁶⁷ The Financial Times reported on the 6th November, citing senior officials as a reference that equivalence was “not automatic and not a right”, further stating that it was under review and that its original purpose did not anticipate the City of London taking advantage¹⁶⁷. Another report suggests that senior officers are reviewing equivalence to strengthen the approval course so that it is extra rigorous for systemically similar jurisdictions¹⁶⁷. The Financial Times reported; “A senior French official who has discussed the issues with the commission said: “They are already reviewing all of this. The equivalence rules were never envisioned for the City.” One negotiator in Brexit talks joked that overhauling equivalence would be like moving the legal goalposts “to another pitch”. British ministers have admitted that the uncertainty around equivalence — and the fact that rights can be abruptly withdrawn — means it “wouldn’t necessarily work” for international banks in London.”¹⁶⁷

For some measures, however, equivalence has been granted to many countries including minor financial services states, such as Mauritius and Taiwan. It is therefore apparent that the level or threshold of 'equivalence' or 'sufficiency' test varies very considerably depending on the DRC involved and the risk to the EU as host state. (Full details of the EU's equivalence decisions are set out in Annex J.)

International DRC fora and bilateral arrangements

Sometimes DRC is introduced at the same time as, or in the context of, harmonisation or the development of common rules. Within the single market, dual regulation coordination is agreed hand in hand with at least the minimum required harmonisation. So there is no equivalence assessment. States cannot go back on the harmonisation and DRC is therefore introduced on a permanent basis. There is therefore no need to provide for 'divergence'.

The 1989 non-life insurance agreement between the EU and Switzerland involved harmonisation. DRC was not, however, permanent and the treaty catered for potential divergence. It provided therefore for divergence to trigger the withdrawal of DRC (see chapter 4 for details of the DRC involved and the divergence/DRC withdrawal provisions).

In the case of the 2016 EU/CFTC accord, the regulatory reform of OTC derivatives had been agreed at an international level by the FSB/G20 and these plans had emphasised the importance of cohesion via DRC measures between national implementation. The European Commission adopted a [Commission Implementing Decision](#) stating that for the purposes of Art. 25 (6) EMIR, the legal and supervisory arrangements for US clearing organisations will be considered equivalent to Title IV EMIR. The European Commission reviewed the Commodity Exchange Act, as amended by Titles VII and VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and the CFTC's regulations when determining equivalence. The accord applies to systemically important derivatives clearing organisations and opt-in derivatives clearing organisations.¹⁶⁸

Both the US and EU legislation therefore contained the necessary mechanisms to implement DRC and this was achieved under the 2016 accord. This does not appear to have the formality of the 1989 Swiss/EU treaty (in terms of DRC withdrawal mechanisms). Both, however, appear to be fundamentally consensual. We have found **no examples** of a home state sufficiency or DRC withdrawal being determined or triggered on the basis of an **objective threshold** by or with a **right of appeal or challenge to an independent body**.

In April 2017 the European Commission adopted [proposals](#) on the conclusion and signing of the EU-US [bilateral agreement](#) on insurance and reinsurance. The proposed agreement would cover three areas: group supervision, reinsurance and exchange of information between supervisors. Articles 3 and 4 concern reinsurance and group supervision. When the agreement enters into effect reinsurers of the home country will not be subject to the requirements to post collateral/ establish a branch or subsidiary in the host country so long as the home country adheres to the prudential requirements¹⁶⁹ outlined in the agreement. Any insurance groups that meet the requirements will not be required to carry out a group solvency calculation for their worldwide operations. The relevant host state supervisor(s) can exercise group supervision on groups established within the host state jurisdiction, and can require information to be provided about worldwide activities which risk seriously harming policyholders in their jurisdiction or threatening financial stability, or seriously harm the capacity to pay claims. Article 5, 6, and the [Annex](#) deal with exchange of information between regulators.

The EU gave ESMA a mandate in 2012 to provide technical advice on equivalence regarding other third-country regulatory regimes and certain aspects of EMIR¹⁷⁰. Annex J outlines the third countries that received an equivalence determination formally recognised by European Commission Implementing Act¹⁷¹. ESMA also concluded MoUs with a number of third country regulators in relation to EMIR: [Australia](#), [Brazil](#), Canada ([Quebec](#), [Ontario](#), [Manitoba](#)) ([Alberta](#)), [Dubai](#), [Hong Kong](#), [India](#), [Japan](#) (MAFF/METI), [Mexico](#), [Republic of Korea](#), [Singapore](#), [South Africa](#), [Switzerland](#), [United Arab Emirates](#), [United State of America](#). These MoUs largely concern cooperation and information exchange mechanisms between the regulators – the pre-conditions for DRC (rather than the DRC measures themselves).

The US and Japan had a (now defunct) 'Framework for a New Economic Partnership' (1997-2001)¹⁷². A number of measures¹⁷³ were agreed in order to facilitate market access, such as "liberalisation of cross-border

¹⁶⁸ Agricultural commodity derivative contracts (that meet certain conditions) are not covered by the EC/CFTC agreement (Art 2 EC implementing decision).

¹⁶⁹ This includes, for example, own funds/capital requirements for the head offices in US/EU. See Articles 3 and 4 for the full list of prudential requirements.

¹⁷⁰ In particular, (i) the recognition of third country (non-EU) CCPs; and/or (ii) the recognition of third country (non-EU) TRs; and/or (iii) the identification of potentially duplicative or conflicting requirements regarding the clearing obligation, reporting obligation, non-financial counterparties and risk-mitigation techniques for OTC derivative contracts not cleared by a CCP. <https://www.esma.europa.eu/regulation/post-trading/central-counterparties-ccps>

¹⁷¹ ESMA also lists these countries [here](#)

¹⁷² <http://www.mofa.go.jp/region/n-america/us/economy/framework-2.html> This covered financial services and other sectors.

capital transactions” and “mutual entry between the insurance business and other financial business areas”. Subsequent [reports](#) noted further progress towards DRC e.g.

- “Introduction by SEC of an abbreviated examination system for licensing of Japanese and other foreign securities representatives”
- “Supervision of foreign bank branches should be conducted solely by the authorities of the state where the principal branch of the foreign bank is located”
- “The Government of Japan requests the citizenship requirements for board members of financial institutions be abolished; there is no such requirement in Japan”

The Australian Securities and Investment Commission (ASIC) and the Hong Kong Securities and Futures Commission (SFC) signed an [MoU](#) in 2008 declaring mutual recognition of cross-border offering of collective investment schemes (CIS). Under this framework the SFC recognises for the purpose of authorisation Australian management investment schemes that are registered with ASIC, and ASIC recognises all Hong Kong CIS for the purpose of exemption from registration as an Australian management investment schemes. In terms of mitigating the risk to the host state, an offer of a dual scheme in the jurisdiction of the host authority must comply with all host state laws and other requirements that are applicable. The MoU outlines the instances where the host state has unfettered powers and discretion e.g. regulating the marketing and dealing in dual schemes within the host state, to obtain information/documentation from the manager of the dual scheme for the purpose of ensuring compliance with the mutual recognition framework, etc.

The EU is engaged in dialogue with Japan about introducing DRC measures, and is a participant in a number of FS fora discussing cross-border regulatory issues. A number of high-level talks were held with Japan. During the latest dialogue ([January 2016](#)) both parties:

“ welcomed significant progress in enhancing their regulatory cooperation framework... They also discussed the joint work on developing an advanced regulatory co-operation framework involving the possibilities to rely on each other’s rules and supervision: substantial progress at technical level was achieved over the last year [2015] and both parties look forward to concluding the discussions and reaffirming their commitments in the currently negotiated EU-Japan Free Trade Agreement / Economic Partnership Agreement.”

The EU participated in the EU-Asia-Pacific Forum on Financial Regulation: the [joint statement](#) noted that the October 2016 forum discussed “*the cross-border implications of financial services regulatory frameworks; asset management and funds passporting; and opportunities in fintech*”. The EU also participates in the [Joint EU-US Financial Regulatory Forum](#). The latest forum (July 2016) discussed banking, bank resolution, CCP resolution, OTC derivatives, fund issues, insurance, audit, data protection and G-20 regulatory reforms.

Postscript: Switzerland provides a lesson for the UK. It has been far ahead of the EU in some areas of regulation and a model that the EU has followed. It follows/implements a large proportion of EU FS legislation (see our RZ report [here](#)) and the EU has given Switzerland higher/more ‘equivalence’ findings than any other third country. The two Swiss/EU bilateral packages did not cover FS, so despite a very high degree of ‘equivalence’, Switzerland has limited DRC with the EU/EEA (as noted above.)

¹⁷³ The list of measures outlined in the first joint status is available [here](#).

Criteria for DRC measures

What DRC measures are available, and what these measures imply, varies across sectors. At a high level, however, we can identify a common set of recurring elements/criteria where DRC measures are granted:

- Compliance with international standards¹⁷⁴
- Reciprocity i.e. market access in the third country for EU/EEA firms
- Inter-regulator mechanisms such as cooperation agreements, confidentiality, information exchange, etc.
- Compliance with anti-money laundering/terrorist financing policies as set out by FATF
- Nature of the home state's supervision¹⁷⁵
- Assessment of the relevant rules and regulations in the third country jurisdiction – often prudential but sometimes extending to relevant business conduct rules¹⁷⁶

Not all of these elements are required in order for DRC measures to be granted. A pattern emerges in that the **criteria applied differs given the DRC concerned and the level of risk the DRC measures could pose to the host state through reliance on the home state**. For example, as discussed above, where a third country bank branch proposes to undertake CEF business in the UK, the evaluation process of the home state regime will be more stringent.

¹⁷⁴ For example, the interim regimes under the Benchmarks Regulation are underpinned by adherence to IOSCO principles.

¹⁷⁵ The PRA uses the language of “the competence and independence of supervision” in reference to the supervision of bank/ insurance branches of third country firms.

¹⁷⁶ For example, under MiFIR (Article 47(1) (a) to (e)) firms authorised under the regime must be subject to adequate and appropriate prudential and business conduct requirements compared to those contained under MiFID II.

6. A new UK-EU partnership

Overview

The UK Prime Minister has rejected membership of the single market (whether via EFTA and EEA membership or on some other bilateral basis).

There is a danger that the suggestion that UK membership of the EU and the single market should be replaced by **an FTA** leads to confusion (within the UK or on the EU side) about what is really being proposed, particularly in the field of financial services. The scope and scale of the proposal, however, goes far beyond any financial services provisions of any FTA to date. Even the most ambitious FTAs have barely achieved any FS DRC.

The UK should make it clear that it is proposing that the new relationship goes much further than any previous FTA. The use of the FTA tag should not be seen as limiting the scale and scope of what is being proposed; this is not merely a slightly more ambitious version of another EU FTA such as CETA or TTIP. The start point is the unique homogeneity of UK and EU regulation and the agreement should reflect that start point with substantive and substantial transposition of DRC in FS.

There is a danger that the description of the new treaty as an 'FTA' could lead to a misunderstanding as to the scope and scale of what is being proposed

There is a danger that the description of the new treaty as an 'FTA' could lead to misunderstanding of the scope and scale of what is being proposed. If, for example, the negotiations were to start by taking recent EU FTAs (such as CETA and TTIP) as a start point/precedent, this would miss the point entirely. Whilst these agreements are helpful in certain respects, they lack the substantial DRC which is necessary between the UK and the EU. It is important that the terminology does not confuse this message.

The two-pronged approach – potentially in two stages

As explained in Chapter 7, Brexit and the new relationship involve a complex legal and political mix and it is too early to be certain about the structure and timeline for Brexit, the negotiations, outcomes, the agreements and their implementation. It is not possible to say exactly how financial services and DRC will fit into the bigger picture and the broader arrangements.

We recommend a two-pronged approach in financial services – looking at market access and DRC separately

In the field of FS we believe it is best to think of a two-pronged approach – dealing with market access and DRC largely separately (at least initially). This reflects the different approaches and caters for the possibility of interim measures being required. We consider the potential terms of a UK/EU DRC agreement in the report; this is a **bilateral** agreement for **reciprocal** DRC measures.

Contingency planning should cover the possibility of interim measures in case the Brexit 'big bang' cannot be achieved

It may be that there is a 'big bang' moment when withdrawal terms and a comprehensive agreement for the future EU/UK relationship (having been agreed and ratified) all come into effect together on the date when the UK leaves the EU (either in 2019 or at some later date following prolongation).

There are, however, many scenarios where for one or reason or another (or a combination) this big bang synchronised moment does not happen and the Brexit process is implemented in two (or more) stages. Planning has to take account of this possibility (however desirable the big bang approach may or may not be). We have assumed that the UK government has ruled out interim membership of the EEA¹⁷⁷ (which would maintain full single market DRC) as an alternative to interim measures.

¹⁷⁷ EFTA membership would not impact the relationship with the EU and is not services focused.

The DRC agreement could be incorporated into the FTA umbrella (from the start or after a period of interim measures)

The DRC agreement could operate within the comprehensive EU/UK FTA under the WTO regime, unless or until any new and more appropriate legal eco-system can be established. For financial services, the FTA would have well developed provisions both for market access (see below) and a DRC agreement.

The comprehensive FTA would have separate sector specific schedules, including one for financial services which would include market access commitments. The position of the DRC agreement might be similar to Mutual Recognition Agreements (MRAs) in the goods sector, in that it would be incorporated into the FTA umbrella/WTO regime and would sit alongside the market access commitments. There would be considerable flexibility for DRC to be free-standing or to be subject to dispute resolution and other WTO/FTA mechanisms and approaches.

In the event of a staged implementation, we envisage that -

Market access in FS

- Immediately following Brexit, market access (as between EU states on one side and the UK on the other) would be dealt with under the multilateral WTO structure according to their respective plurilateral obligations under their respective WTO schedules (including individual EU state reservations in the EU schedule). No negotiation between the EU and UK is required to achieve this. It will arise automatically at Brexit.
- At a later stage, improved bilateral (negotiated) market access terms would come into effect under the financial services schedule of a comprehensive UK/EU FTA

DRC in FS

- A negotiated bilateral DRC agreement would be in effect for Brexit. There may be more scope for avoiding the risks and delays of member state ratification for a DRC agreement in FS alone, as compared with other sectors (see the blue shaded box 'Ratifying the deal...' in Chapter 7). Assuming no FTA is in place at Brexit, the agreement needs to avoid breaching WTO obligations but would not be made as/under an FTA/WTO structure. Although the agreement will only relate to FS (which is too narrow for bilateral trade agreements under WTO), the provisions allowing for bi-lateral recognition of prudential measures and licensing, and the opportunity to include it in the "built-in agenda" under the GATS should ensure that it will not be challenged in the WTO. The negotiated DRC measures would operate alongside the plurilateral market access obligations in the first bullet above. So for each mode of supply, the current market access provisions would apply and would operate alongside the DRC measures. Within the scope of DRC measures, the market access obligations in the WTO schedules might add relatively little in practice, but would have some practical application.
- At the later stage, the DRC agreement could then be incorporated into the full FTA framework and the financial services schedule. This would enable cross-linkage with the broader FTA provisions (both within FS and in other areas) and, if desirable, WTO/FTA features such as dispute settlement (but the DRC arrangements could also be quite separate – similar to the approach taken with MRAs in the goods sector). There are examples (outside FS) of agreements of this kind being incorporated in FTAs and sitting alongside basic market access provisions in the relevant sector specific schedule.

The DRC agreement cannot follow CETA and simply establish a committee to deal with DRC – detailed DRC measures must be in place for Brexit

Detailed DRC measures should be in operation from Brexit without any gap. If DRC is lost at Brexit, firms will have to react accordingly relying on contingency planning; re-establishing DRC at a later stage may come too late for these businesses.

The current EU acquis - scope, scale and transposition

Financial services legislation has various objectives and benefits. The focus has evolved from protection of individual consumers to the integrity of markets and associated risks; since the financial crisis there has been a greater explicit focus on measures to promote 'financial stability'. This is directed at promoting the stability, strength and robustness of the financial system as a whole and in reducing 'systemic' – or system wide - risk.

EU FS legislation is directed at all of these benefits and objectives with the additional single market objectives and techniques of harmonisation and dual regulation coordination. EU FS legislation is a vast, complex and diverse body of law, regulation and cross-border arrangements. Some of the principal EU financial services legislation is listed in Annex J (but this only includes the level 1 legislation and does not include the more detailed level 2 regulations and directives, the binding technical standards at level 2.5 or the level 3 ESAs guidelines.) Solvency II runs to over 300 pages. The material is constantly changing and evolving with new material being published by the ESAs all the time. The legislation is highly technical and with many different objectives and benefits¹⁷⁸.

When considering potential transposition (to the new UK/EU relationship and to UK domestic law (as considered in the next paragraph)) some EU derived measures, and the benefits they deliver, can be maintained by replication or transposition to a purely domestic UK context on a unilateral basis. Clearly this is not possible for dual regulation coordination as we explain in the next paragraph.

The transposition of the 'EU acquis' onto a domestic law basis will therefore be a large undertaking. Line by line analysis is required for the Brexit project.

- EU law derived provisions which simply impose requirements (for example, for conflicts of interest to be managed or certain capital to be maintained) will simply be adopted by the UK as domestic requirements. This will be achieved by removing the EU basis for UK requirements made in fulfilment of UK obligations under EU directives and replicating requirements in directly applicable EU regulations in domestic law;
- There are many provisions, however, which cannot be transposed unilaterally because they are dependent, one way or another, on the cross-border regime. This applies to provisions on passporting, rules on cross-border application and the many provisions which are conceived within the single market structure and cannot therefore be simply transposed into a domestic context without cross-border arrangements to support them¹⁷⁹. These must be deleted, replaced or adapted to reflect whatever cross-border arrangements (or lack of such arrangements) will be in operation between the UK and the EU at Brexit. EU derived provisions which confer powers and functions on EU level institutions (such as the direct powers of intervention of the ESAs) are a form of DRC; here if no DRC is to be carried forward, the powers would need to be assigned under domestic law to UK institutions (mostly to PRA and FCA).

The first bullet will involve a painstaking process raising some technical issues (for example, as to CJEU interpretation etc.), but ultimately this can be delivered without any difficulty by the UK acting alone.

This transposition is important not only as the basis for the UK's negotiations with the EU and the DRC agreement, but also, potentially, in the context of maintaining arrangements with third countries which currently benefit UK firms (see Chapter 8) and might also be relevant in relation to the UK/EU relationship if the negotiations for DRC/FTA were not successful (see Chapter 9).

In principle, the second element of the transposition will have to await the outcome of the negotiations, because these provisions will make no sense without equivalent implementation in the EU states. It would probably be sensible to prepare a fail-safe/base-line transposition of these provisions on the basis that no agreement were to be in place at Brexit, but this will need to be re-worked once agreement with the EU is reached.

The UK can and should offer full harmonisation with the entire EU acquis¹⁸⁰ - but potentially limited to internal rules

The UK is proposing to transpose all EU single market rules (across all sectors and including cross-sectoral (in trade parlance, horizontal) rules such as employment); it can therefore offer complete homogeneity with EU standards, in form and substance, as the start point. It is also committed to implementing all upcoming EU

¹⁷⁸ The objectives and benefits of the legislation include (in very broad terms) – Consumer (retail) protection, protection of non-retail clients, policyholders and wholesale counterparties, protection of investors, protection of the financial system as a whole and the promotion of financial stability, protection of markets, exchanges and trading platforms and direct/end users, promotion of legal certainty, single market objectives – the reduction of non-tariff/behind the border barriers – principally dual regulation barriers - via harmonisation and mutual recognition (including the single licence or passport), effective and efficient supervision of cross border operations/groups – including supervisory colleges/cooperation, Eurozone objectives – such as the SSM and enhancing market access for EU firms and establishing mutual recognition via equivalence.

¹⁷⁹ In some (probably limited cases) mutual recognition might be achieved by reference or resort to international/global standards or conventions – for example by the UK joining the Lugano Convention to which the EU is party.

¹⁸⁰ Other than the treaties, the customs union/common commercial, agricultural and fisheries, policies and foreign policy type parts of the acquis.

legislation in the period up to Brexit (including the period after Article 50 notice has been given). This includes major reforms such as MiFID II, the development of the EU regime via decisions of the CJEU and new binding technical standards and ESA guidelines.

The transposition of FS rules falls into various categories, including:

EU ‘internal’ harmonisation independent of EU/EEA dual regulation coordination can be transposed onto a domestic law basis unilaterally

The UK can proceed on a unilateral basis to “port” all EU derived internal regulatory requirements (whether directive or regulation) onto a domestic law basis; this applies to any EU rules which can stand alone without dual regulation coordination. This requires extensive and painstaking work and raises some policy issues such as the status of post-Brexit judgements of the CJEU, but it can be completed without any agreement with the EU.

EU provisions which establish or reflect dual regulation coordination cannot be transposed unilaterally and must await the negotiations

Some EU provisions, however, concern or are based upon dual regulation coordination between EU/EEA member states. The UK does not know to what extent these will need to be adapted, transposed or replaced (with other cross-border arrangements or domestic only provisions). Preparations under the Great Repeal Bill will need to treat these provisions on a provisional basis (on a worst case scenario of no agreement between the UK and EU) but with a process for implementing the final terms of the DRC Agreement.

EU rules on third country firm treatment

There are some EU harmonised requirements for the treatment of third country firms. Some apply to all third countries and others differentiate on the basis of ‘equivalence’. These include not only the limited passport rights for firms from equivalent third countries but also requirements for branches of insurers from all TCs and recent proposals requiring intermediate EU parent undertakings for large TC bank groups. The UK would need to decide whether to port or mirror these requirements on a domestic basis i.e. to continue treating third country firms within the parameters of EU requirements. Some of these could be ported unilaterally; others involving DRC dependent on European Commission decisions on equivalence are less likely to be ported. The latter would require an agreement effectively to maintain the UK’s external regime as part of the EU/EEA external regime (e.g. making TCF registration with ESMA under MiFIR valid for UK business). The UK may, however, decide that some aspects of the third country requirements would not be ported over or would not be maintained outside the period of interim measures, for example to avoid constraining the UK’s external policy vis a vis non-EU/EEA countries (see Chapter 8 below re a new framework under FSMA for external relations DRC).

The roles of the ESAs in direct regulation (for example in regulating specialist firms, such as rating agencies, and ESAs’ emergency powers)

This may involve assigning current EU level roles/powers to the PRA or FCA, but DRC might involve other options, for example, some element of ESAs’ authority might be recognised in the UK.

Transposing dual regulation coordination to the new DRC agreement

There is a strong economic case, for both the EU and UK, for transposing current FS single market ‘dual regulation coordination’. Some FTAs set up fora to discuss regulatory convergence, in the hope of gradually achieving DRC measures over the years. This approach would be wholly inadequate in this case; there is unparalleled regulatory homogeneity between the UK and the 27 EU states and detailed dual regulation coordination must apply from the outset.

On purely prudential grounds, the UK could argue against full recognition on the basis that other states have not adopted the robust post-crisis measures that apply in the UK banking sector. This would be illogical, however, as the UK currently operates dual regulation coordination notwithstanding these differences.

There is strong economic case - for both the EU and UK – for transposing full DRC at the outset and certainly for any interim measures

There is a strong economic case – for both the EU and UK - for transposing full DRC (as it currently applies within the single market) at the outset. There is unparalleled regulatory homogeneity between the UK and the 27 EU states.

The UK should make its case for DRC – in trade, regulation and competition policy terms

Pure politics and horse trading across sectors may well feature in the negotiations. In principle however, the case for DRC will rest on the triple axis (see above) of external trade policy, effective cross-border regulation and competition. The UK may seek broader/deeper DRC than certain EU states may be inclined to seek.

The UK can make its case at all three policy levels – its open policy towards foreign firms and the proposed mutual access and treatment for EU firms (in trade policy terms), the lack of risk to EU states from DRC on account of the UK's effective supervisory and domestic regulatory regime and its close proximity to EU harmonised rules and the UK's approach to fostering competition in the FS sector. On purely regulatory grounds, the UK could argue against full recognition of the EU regime on the basis that other states have not adopted the robust post-crisis measures that apply in the UK banking sector (e.g. ring-fencing and the senior managers regime). The UK can make it clear that, notwithstanding these differences, it is prepared to trust regulation in the 27 EU states by continuing DRC.

Even if the scope of DRC was likely to be limited eventually, there would be a strong case for maximising DRC under any interim measures

If Brexit is implemented in two stages, there would be a strong case for maintaining DRC under the interim measures. This would have 2 objectives – to avoid any DRC being lost for the interim period, if it was possible that it might be agreed under the final deal, and to provide help in the transition (particularly, for example, if there was not to be a sufficient period of adjustment for firms between interim measures being confirmed and their coming into effect

Might an early baseline accord be desirable?

There may be key elements of DRC which can be agreed at the outset as an 'early harvest' in the negotiations (because they are non-controversial/not really in doubt). Both sides may wish to establish an early reciprocal accord as a baseline agreement of DRC that is agreed and guaranteed at the outset (and therefore taken out of the negotiations).

These might relate to international commitments on FS infrastructure (for example under the G20/FSB arrangements, the 2016 accord between the European Commission and the CFTC on CCP regulation would need to be extended to include the PRA/UK on a tripartite basis or by bilateral accords).

Logically it might cover all DRC currently available to third countries under existing EU FS legislation. Hopefully, these measures would be non-controversial because there would no issue (on the EU side) about equivalence or about implementation mechanics (see further below) and because such measures could not be seen as privileged access to EU markets.

Broader/deeper DRC could then be negotiated as part of the new partnership/relationship.

There may be a logic for a baseline accord approach to entrench key DRC at the outset but with greater DRC to be agreed later

There may be key elements of DRC which can be agreed at the outset as an 'early harvest' in the negotiations (because they are non-controversial/not really in doubt). Both sides may wish to establish an early reciprocal accord as a baseline agreement of DRC that is agreed and guaranteed at the outset (and therefore taken out of the negotiations). These might relate to international commitments on FS infrastructure (for example under the G20/FSB arrangements, the 2016 accord between the European Commission and the CFTC on CCP regulation would need to be extended to include the PRA/UK on a tripartite basis or by bilateral accords) and might cover all DRC currently available to third countries under existing EU FS legislation. Hopefully, these

measures would be non-controversial. Broader/deeper DRC could then be negotiated as part of the new partnership/relationship.

THE DRC AGREEMENT

The objectives of the DRC agreement should be agreed at the outset

The objectives of the DRC agreement should be agreed at the outset. These should cover regulatory cooperation in the broadest sense with the objective of securing effective regulation and reducing DR barriers –

- facilitating and providing the legal framework for supervisory cooperation (including information exchange and supervisory colleges) between, on one side, the PRA/FCA and, on the other, the ESAs and national regulators
- cooperation on the development of the regulatory regime and regulatory reform including in relation to international standards
- the adoption of specific DRC measures at the outset and the arrangements for DRC in the future (as considered below)

This could acknowledge a joint desire to maintain mutual access and regulatory cooperation between the two sides and to maximise DRC consistent with avoiding host state risks from ineffective home-state regulation or in competition terms.

Financial stability

If there were not to be full transposition under a new UK/EU partnership, what would be the impact in financial stability terms? This is an important issue for both the EU and the UK. The public debate of this topic to date seems to have consisted in each side arguing the other has more to lose. There should, however, be more objective and technical analysis of the extent to which the financial stability objective needs the agreement of measures between the UK and the EU. Financial stability should be a stated objective of the UK and of the EU in the negotiations.

Financial stability should be a common objective in the negotiations

In recent years, regulatory reform has focused on financial stability and the mitigation of systemic risk. These issues have been addressed at international, EU and national levels. The objectives for the DRC agreement should include financial stability based on a technical and objective basis of what DRC, in the broadest sense, can contribute. For example, it is difficult to see any basis, consistent with G20 financial stability commitments, for the EU withholding DRC for UK central counterparties¹⁸¹. This should be apparent even before one considers broader concerns that fragmentation of the City would have an adverse impact on financial stability and on the financing of the European economy. Any potential plans on the EU side for the clearing/settlement of euro-denominated transactions should not threaten these arrangements.

Three key elements of the DRC agreement – DRC, rules freedom and DRC withdrawal

We have looked at three parameters for the DRC agreement – DRC scope, rules freedom and DRC withdrawal

Chapter 4 of our report combines a WTO/FTA and a regulatory perspective and looks at the different modes of supply and other areas of DRC and illustrates DR barriers. It unpicks the different DRC techniques/measures used in each of the modes/areas (under various different international regimes including the single market). This analysis is used in Chapter 6 which looks at the proposed DRC agreement and the potential scope of DRC measures, and at rules freedom (i.e. the extent to which each side can change its rules unilaterally and/or the procedures to be followed – e.g. prior notice) and DRC withdrawal (i.e. the procedure to be followed and the criteria which might determine whether divergence should or could lead to DRC withdrawal). The spectrum of possibilities is illustrated in 3 charts below. We have not attempted to define a landing point for the DRC agreement; indeed it may vary for different areas/sectors/legislation (a 'mix and match' approach).

¹⁸¹ See, for example, FSB's 2010 report [Implementing OTC Market Reforms](#). The report describes CCPs as critical infrastructure and states "the need to ensure non-discriminatory access to CCPs".

DRC under the DRC Agreement

The normal approach to financial services in FTAs is that the FTA itself only contains very limited (if any) specific dual regulation coordination measures. A process is established (for example with a joint committee) to discuss regulatory coordination and cooperation with a view to agreement being reached gradually over the years. The negotiation of the FTA does not provide agreement on, or the introduction, of significant dual regulation coordination measures.

At Brexit, the default position (without a new agreement) is that all UK/EEA dual regulation coordination under the single market umbrella will fall away. So detailed dual regulation coordination measures must be negotiated and agreed in the DRC Agreement and must take effect at the outset (and not at some later stage).

The UK will need to propose, and the parties agree (hopefully in the initial stage), the approach to the negotiations. In some areas, this might well be based around the current EU single market legislation, or blocks of legislation, and negotiating to what extent current cross-border arrangements (such as dual regulation coordination and mutual recognition) are to be replicated in the bilateral context and to what extent such arrangements are to be limited, modified, replaced or not carried over. This approach might work well in FS. The alternative would be a clean sheet approach to design new arrangements without reference to EU legislation.

The Prime Minister's speech seemed to envisage that full transposition of current cross-border arrangements, at least within the FS sector, would be logical and would be supported by the UK. To this end, the UK will ensure that it is fully EU harmonised at Brexit (see above).

It is a matter of speculation, however, as to how far the EU may agree a full transposition of DRC into the DRC Agreement without UK membership of the single market and its full free movement principles. It seems unlikely that there will be full transposition across the entire single market but there might, in theory, be full transposition across individual pieces of EU legislation or across blocks of legislation or across all the FS sectoral legislation. It may be, however, that, even within the FS field, agreement is more limited.

As noted above, three policy areas will be at play here:

- External trade policy;
- The competitive dynamic of incoming firms;
- Pure regulation i.e. the regulatory risks of DRC for a host state.

There will also broader trade-offs in the negotiation and clearly the outcome may be impacted by political pressures at various levels.

As can be seen from Chapter 4, dual regulation coordination is not binary. There is a wide range of issues and potential outcomes/cross-border arrangements which might be agreed. There is the possibility of negotiating different arrangements by sector, business activity, type of firm, customer type, area of regulation and mode of supply/area (as can be seen from the examples above).

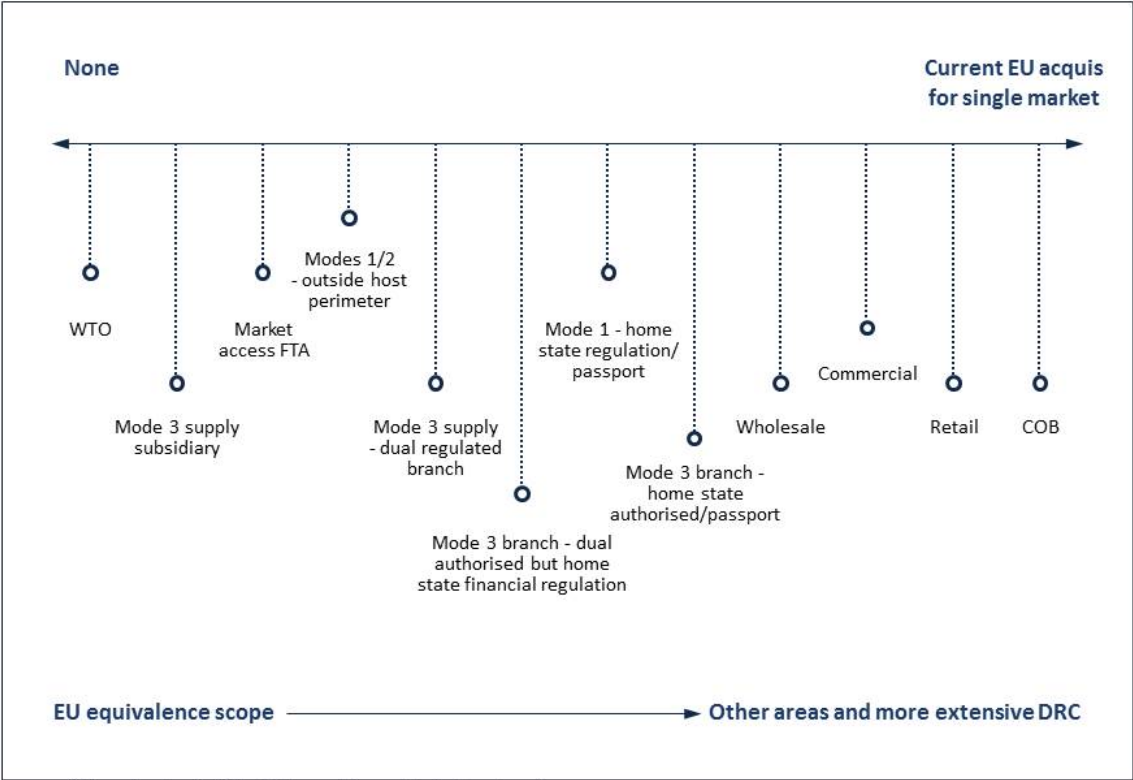
It will be easier, for example, to agree DRC arrangements:

- for wholesale counterparties than for retail business;
- for prudential regulation than for conduct of business;
- for the use of a subsidiary than for a branch (under mode 3).

It is envisaged that the DRC arrangements will be bilateral and mutual – so EU firms will benefit in exactly the same way as UK firms and the basis for DRC rights would be reciprocal (but see below re implementation

issues for the EU and for both sides under WTO).

DRC scope and depth illustrations*



* See chapter 6 of the full report for a detailed explanation.

The current UK/EU DRC under the single market is broad in scope with substantial home state reliance; there is a wide spectrum of potential outcomes in terms of the scope and depth of DRC to be agreed for Brexit, possibly with different outcomes in different areas

Current DRC between the UK and the other 30 states of the EEA (under the single market) is broad in scope with substantial reliance by host states (for example) on the home state regulation of incoming firms. As the chart illustrates (and Chapter 4 of the report explains in detail), there is a wide spectrum of potential outcomes in the scope and depth of DRC which may be agreed in any one area. Different DRC may apply area by area and in any one area variances are possible, so for example full single market DRC might be replaced by restricted DRC in one mode of supply but full in another, or there might be no DRC for another mode. Greater DRC may apply to wholesale and less to retail. Mode 3 branches may be permitted but the extent of DRC may be less than under the single market. DRC may apply to prudential regulation but not to conduct of business etc. The possibilities are far from binary and may differ from one area and mode to the next.

The CMS Legatum matrix

In Chapter 9 we explain the CMS Legatum matrix which is based on the analysis in this report and the many assignments undertaken by CMS to map regulation for cross-border supply. This matrix can be used in various ways.

Mapping – the matrix can be used to plot the extent and detail of current dual regulation coordination across the border between the UK and each of the 27/30 EU/EEA states¹⁸². It is a relatively simple task to map EU rules for coordination within the single market and EU level third country rules. Adding country by country data is much more of an exercise, particularly when mapping the differing treatment of non-EEA/third country firms under national regimes. CMS has handled many projects of this kind.

¹⁸² See Annex K for examples of member states’ domestic regimes.

Negotiating – the matrix could also be used to negotiate dual regulation coordination, showing the possibilities, proposals and agreement of measures sector by sector, mode of supply by mode of supply etc. It can also be used to track the position at an individual member state level – both their current third country firm treatment and the impact of agreed or proposed dual regulation coordination measures.

Plotting linkage – the matrix can also assist when addressing the possibility of future divergence (see below) by plotting the linkage between dual regulation coordination measures and the specific underlying rules on whose homogeneity the measure is based.

Rules freedom – convergence and divergence?

Background

A modern regulatory rulebook is not static, it must evolve and change all the time both in the detail and with more substantive changes to address new risks and market developments.

EU harmonisation is agreed via the legislative process. In FS this normally involves QMV – so no single state has an individual veto. The EU construct is also a one way process of **convergence** via harmonisation and increasing DRC. The possibility of **divergence** and unwinding harmonisation/DRC is not catered for (except in theory on an EU wide basis)!

Essentially as EU legislation is adopted, harmonisation and DRC are agreed in parallel. Member states can develop their own regulation in areas that are not harmonised and can add/gold plate if harmonisation is on a 'minimum' basis (see Chapter 3 above). They cannot change regulation in areas where maximum harmonisation has been agreed and cannot withdraw – or diverge from - any harmonisation (maximum or minimum). Member states' rules can only diverge within these parameters and there is no situation which would entitle any state to withdraw DRC.

The position is the same for EEA EFTA states, except that the 'follow EU' approach means that they were not party to the original negotiation and agreement of the legislation.

Some FTAs provide a process for future '**convergence**' and possible mutual recognition but none of these have a legal mechanism to put any resulting DRC on a formal legal basis within the WTO/FTA structure i.e. it seems, broadly speaking, to be adopted on an 'accord' approach.

Very unusually, the UK and EU regulatory regimes will start with a very high degree of convergence/harmonisation – within the EU context sufficient to underpin very broad and extensive DRC, but what would be the arrangement for the future and the adoption of new rules and changes to the rulebook that will be in place at Brexit?

The adoption of new rules and changes to the Brexit rulebook

The parties might agree various different restrictions on their freedom to adopt new rules and change their rulebooks in the future. Logically this would only apply to rules which were the basis of DRC measures. This might only apply to harmonised areas unless DRC was extended to include areas that are not subject to EU harmonisation.

The possible models/variants are illustrated in the chart below:

- a mutual veto model ie no relevant rulebook changes (by EU or UK) without agreement of the other (similar to the internal position of EU member states but with an absolute veto, rather than QMV);

- one side (say the UK) must follow changes made by the other (the EU) and must continue to meet all harmonisation (ie the 'follow EU' model that applies to the 3 EEA/EFTA states);

- both sides commit to follow/meet third party standards i.e. continuing mutual implementation of developing international standards;

- a consultation and conciliation procedure to avoid changes that would threaten DRC (eg CETA style committees to encourage close cooperation on the development of regulatory policy). This may well foster continued joint cooperation in international fora and on international standards. There is no reason why there

might not be further convergence or aligned approaches to new risks and technologies on an ad hoc consensual or accord basis;

- each side is ultimately free to change its rulebook as it sees fit but prior notice must be given and may risk DRC withdrawal (see below) - the 1989 Swiss/EU model.

The mutual veto model is very unlikely to be viable (except conceivably – but even this is difficult to imagine - in some core/narrow areas).

Model 2 - a permanent EEA style model of 'follow all EU FS measures' (past and future) as accepted by Norway, Iceland and Liechtenstein, would not seem to be practical or desirable for the UK (given the size and importance of its financial services sector) in the longer term. Could the UK be bound in perpetuity to follow the micro-detail of all EU FS legislation as it emerges over the years?¹⁸³ There might, however, be some elements of follow-me that might be acceptable – such as during a limited period (such as interim measures) or a commitment to particular/existing legislation. The UK could at least consider the possibility of defining a basis for it maintaining the relevant EU harmonisation to support DRC for this initial period. There may be differences from one area to another. Variations might emerge by sub-sector/area/legislation, for example, because some EU legislation is closely based on G20 initiatives or international standards.

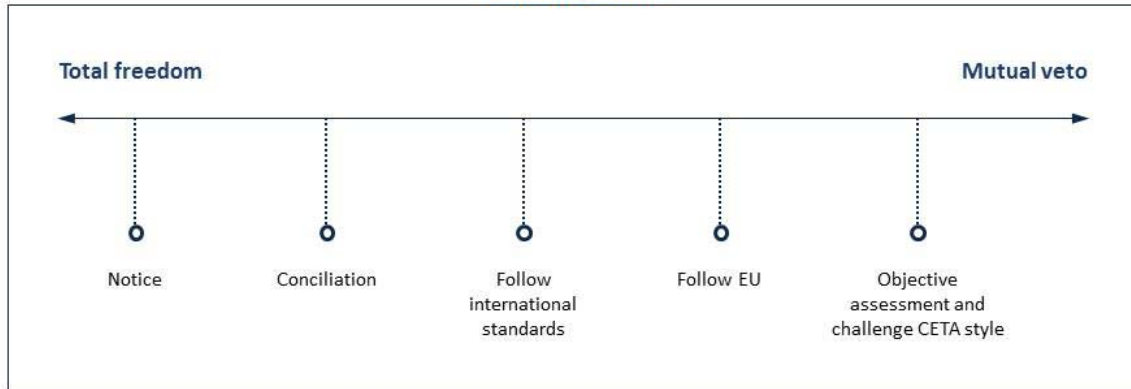
We consider the question of international standards below. It should be possible to agree some DRC on this basis and so this model may feature in the DRC agreement but it appears that in the short to medium term it would be unlikely, on its own, to justify the extensive DRC envisaged for the UK/EU partnership. Cooperation on regulatory reform is desirable, but ultimately this could not amount to a mutual veto, so each side would be free to implement changes, or not to match reforms that the other was making, and risk divergence triggering DRC withdrawal.

It does appear therefore that divergence, to some degree, must be a legal possibility and must be catered for in the DRC agreement. What would happen in terms of DRC withdrawal as and when there was divergence between the 'EU' and UK rulebooks? Each side would be able to avoid divergence for so long as that was desirable and to balance any potential divergence against potential loss of DRC.

The implications for the remedies available under a DRC agreement will be relevant. Generally under FTAs, the chapters concerning regulatory coherence and efforts to coordinate or harmonise regulation are non-binding and therefore no remedies as between state or investor parties will accrue for their breach. This is for obvious and valid reasons, including the constitutional imperatives of the EU in preserving the legal autonomy of its institutions. Accordingly, the level of freedom is likely to rest closer to the 'total freedom' end of the below spectrum than to the 'mutual veto' end.

¹⁸³ Harmonisation to standards that have anti-competitive effects and go beyond what is necessary to satisfy prudential goals has a negative impact on consumer welfare and reduces the supply of services/increases their cost. It is sometimes assumed that harmonisation by itself is a goal. In fact the goal should be a minimum of divergence, consistent with an overall direction of travel towards pro-competitive standards. However, if one party insists on anti-competitive standards, divergence becomes necessary. Further, if the UK is to negotiate FTAs with other countries, which will include significant services provisions, it must be able to negotiate on domestic regulatory matters (as regulatory co-operation and market access affect all service sectors, not just financial services), which is not possible as a single market member where implementation of EU single market rules is mandatory. This kind of liberalisation in the domestic regulatory aspects of services trade was a goal of the WTO's uncompleted Doha Round, and hopes have been raised in the WTO that the UK's future independent trade policy will revitalise that agenda in the multilateral context.

Rules freedom



Regulatory divergence should be permitted, not prohibited, and must be catered for in the DRC agreement

Neither side will have a veto over the regulatory rules of the other side; the UK, as a third country with a substantial financial services sector, cannot be bound in perpetuity to all EU FS legislation as it emerges. A permanent EEA style model of 'follow all EU measures', as accepted by Norway, Iceland and Liechtenstein, would not be practical or desirable for the UK. Divergence is therefore a possibility eventually which must be catered for in the DRC agreement. Unless the agreement prohibits divergence which would threaten DRC (which we do not think is practical or desirable), the agreement must cater for the possibility of DRC withdrawal (as well as increased/new DRC measures).

Even in areas where the EU harmonisation has been controversial, such as Solvency II (see the [current TSC enquiry](#)), the UK may well decide to maintain the EU derived regime (and not, for example, reverting to the previous domestic FSA insurer prudential rules), subject only to some relatively narrow issues where divergence is seen to be desirable (and which may be resolved with the EU). Post-Brexit freedom to move away from EU harmonisation, as ported across for Brexit, may not therefore be exercised to a significant extent in the short to medium term; the question of future rules may be a greater source of divergence, but DRC should not be sacrificed unless and until substantial divergence poses real and unacceptable risk. This should not be based on narrow concepts of matching or equivalent rules but on a substantive assessment of regulatory outcomes and whether the host state would be exposed to unacceptable risk by relying on less effective regulation in the home state. The report refers to these as the principles of sufficiency and proportionality – i.e. that the assessment is relative to the risks involved (as one sees in other DRC arrangements such as the Bank of England's differentiated policy on third country bank branches).

The UK can consider various and varied options for 'mirroring' EU requirements and maintaining close proximity to EU harmonisation

The UK can consider various options where it wishes to maintain close proximity to EU harmonisation. This could be a commitment in the DRC agreement or it could be a unilateral policy decision for the UK. In the former case, it could be binding or an expression of intent and could be limited in time (e.g. for the interim measures period) or to specific pieces of EU legislation. Proximity could be defined in various ways; it might also treat the existing acquis/ported rules at Brexit differently from rules introduced after Brexit.

The UK can offer full EU compliance at Brexit. In principle the UK could offer continued complete conformity (at some level or at least in some areas) and full single market DRC at the outset and for interim measures. Under the final arrangements the UK might be under no legal obligation to maintain EU derived requirements but might choose to do so in practice- thus ensuring related DRC was not at risk.

Managing ‘divergence’ instead of ‘convergence’

The next question is what effect rulebook divergence would have on previously agreed DRC (which may have been based on the proximity of the respective rulebooks). Presumably at some point divergence would have to trigger DRC withdrawal but when would that point be reached?

The impact of any divergence on agreed DRC.

The partnership could be based on a purely consensual/accord approach whereby DRC measures can be withdrawn by either side – perhaps on notice – i.e. something along the lines of the 1989 Swiss EU model above.¹⁸⁴ In that case each side must pre-notify the other of intended changes to their rulebook. There is no right of veto but if the other side does not approve, then implementation of the proposed changes by the notifying party triggers a unilateral right of withdrawal for the other. In that case the entire treaty is treated as if it has been denounced, so all DRC is terminated.

This can be refined in various ways - (i) the trigger might only apply to relevant DRC measures impacted by the divergence, (ii) the trigger might be based on an objective assessment of the impact of divergence and/or (iii) the divergence might work in either direction i.e. a party adding new rules (to improve regulation or address new risks) might be able to challenge DRC measures if the other side does not adopt sufficient rules to address those risks. Under these approaches, DRC measures would be linked to specific rules. The principle would be the opposite to the Swiss/EU model in that divergence would not be presumed to undermine DRC measures; so although the EU harmonised rules and UK domestic rules had diverged, previously agreed DRC would continue. If, however, divergence in the rules in one area occurred to such an extent that one side might be prejudiced by continuance of the DRC measure related to those rules, that DRC measure might be withdrawn. Divergence in one area of the rulebook would **only threaten directly related DRC measures** and only where this exposes one side to **unacceptable increased risk as a host state relying on the home state supervision**.

Benchmarking host state risk to determine when divergence triggers DRC withdrawal – bilateral accords implemented via unilateral local processes

There are many examples of different approaches to the assessment of home state supervision and the criteria used to determine whether to rely upon home state supervision via DRC measures. Some of the examples are considered in Chapter 5 and summarised in the table at the end of that chapter. In many cases, a state has legislation or procedures in place to provide for DRC on a given basis, sometimes with specific criteria which have to be met. These often envisage that these **unilateral powers** will be used on a **reciprocal basis** by agreeing **mutual DRC arrangements** that are then **implemented under the local procedure**. In some cases these reciprocal arrangements were envisaged in the original design of international level reform and the resulting local legislation (as in the case of FSB plans for OTC derivative reform and the resulting EMIR and Dodd-Frank provisions and the 2016 accord).

None of the examples in chapter 5, however, relate to an accord or agreement of a broad spectrum of DRC; most seem to leave each side to deal with continuing DRC under its domestic procedure and criteria (which will often have **continuing criteria** and a procedure for **unilateral DRC withdrawal** when, for example, **divergence** means that home state regulation is no longer adequate); there may be no (further) bilateral basis as to when one side might be entitled to trigger DRC withdrawal.

In the case of the EU/UK arrangement (given the scope of DRC envisaged), it may be appropriate, however, to consider some broadly based principles which might underpin the agreement, and the maintenance, of DRC measures and the grounds for DRC withdrawal. We suggest these should be based on the principles of ‘sufficiency’ and ‘proportionality’. If the relevant rules diverge, the related DRC would continue unless and until the rules on one side (side A) ceased to be ‘sufficient’ to maintain effective regulation of state A firms under the state B host state regime. At that point the DRC measure would be withdrawn or adapted accordingly.

The test of sufficiency should be one of substance, not form, (as others have already suggested) and be outcome based, as the FSB has suggested (in relation to DRC relating to OTC derivative reforms). It should be applied on a proportional basis taking account of the DRC measure in question and, bearing in mind the extent of host state regulation thereby waived, the risks posed for the host state, and the specific dangers or

¹⁸⁴ The 1989 Swiss agreement reflects this approach (although there are committees for arbitration but these are ‘blocked 50:50 and the entire agreement may be denounced on 12 months’ notice) that changes to regulation on one side would trigger must be agreed by the other with either side free to withdraw at will or as a result of changes to the other system. See Chapter 4, ‘Establishment 1 – branch (WTO mode 3)’ example 3 for further details on the 1989 agreement.

increased risks from the divergence in regulatory standards/rules. The proportionality principle might mean that measures would be adapted to the minimum extent necessary, so the scope of the measure might be restricted rather than lost completely. The proportionality principle reflects the general approach seen in Chapter 5 that the assessment criteria are applied to a higher threshold when the risks are greater (as best illustrated by the PRA's differentiated policy on third country bank branches).

Could there be objective benchmarks of host state risk criteria and arbitration?

One could imagine, in theory, a system whereby DRC measures were determined solely according to objective criteria – both their introduction and their withdrawal – but this seems impractical, certainly in the short term. DRC measures would therefore have to be adopted by agreement.

There seems more possibility that objective standards of sufficiency and proportionality could be applied in the context of divergence and the withdrawal of DRC in such a way that they could be applied by an independent body, for example in arbitration. This would provide greater legal certainty and avoid the risk that one side could use the inevitable need for rulebook changes to trigger DRC withdrawal where it was not really justified. The downside may be that without a unilateral right of withdrawal under a more consensual approach, less DRC might be agreed in the first place. Indeed, might a purely 'objective and arbitrated system' of this kind prove too difficult and complex to negotiate, agree and operate in the context of Brexit?

If such an approach was to be considered, it would be helpful to look at modern FTAs and their dispute resolution system (see further below under the heading – 'Dispute resolution – state level and private sector rights?'). These procedures have jurisdiction for state party disputes and narrower jurisdiction for non-state party claims against a state party. It seems that alleged breaches of agreed DRC measures might be subject to both state and private party claims, but any question of divergence and DRC withdrawal would be restricted to state party challenges.

As noted above, there are three policy dimensions to DRC – prudential protection, free trade/protectionism and finally competition. These may all play their part when agreeing DRC measures. Market access will be an on-going pre-condition. Should any objective standards of sufficiency and proportionality in the context of DRC withdrawal be based entirely on prudential considerations or should they also take account of the competitive dimension? If the divergent side could establish that its regime achieved sufficient regulatory protection by more pro-competitive means, then its rules would remain 'sufficient' despite divergence and DRC measures would not be withdrawn.

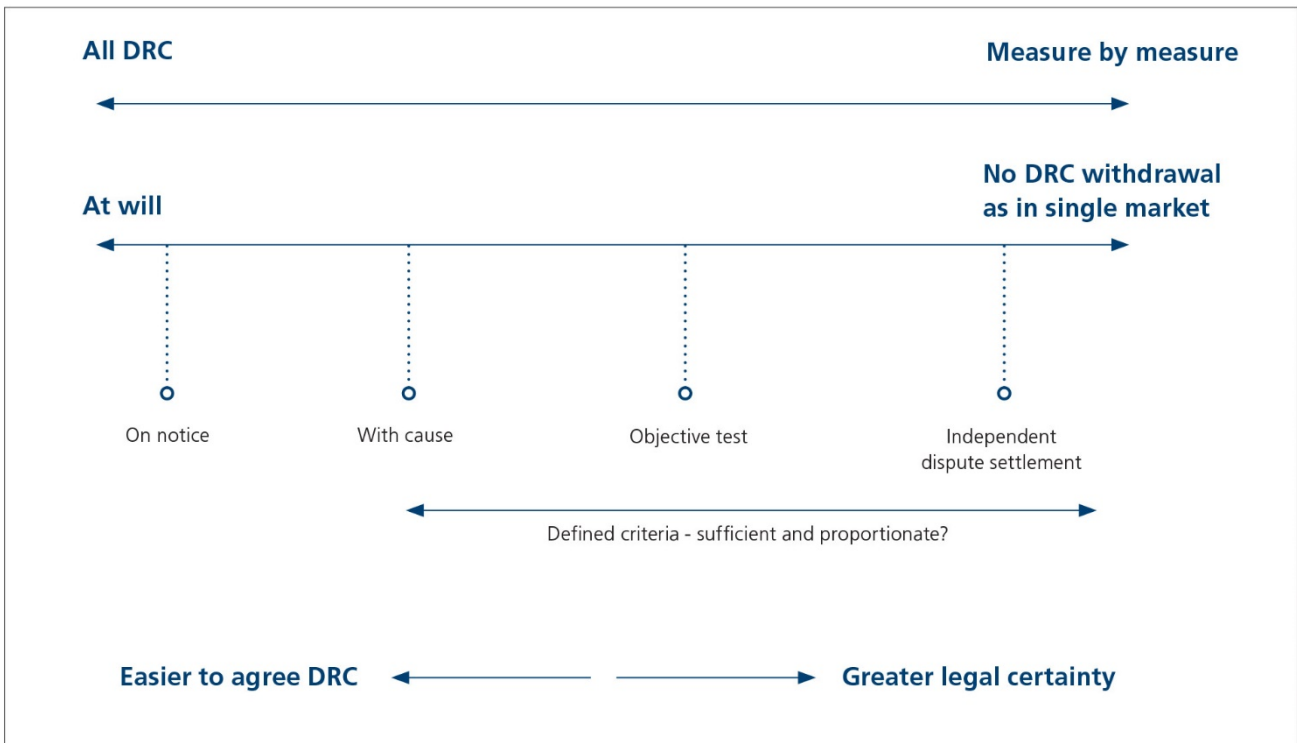
Principles such as these, and for the other criteria identified at the end of Chapter 5 – maintenance of international standards etc, might be deployed in various ways. They might be used in a system of objective based criteria and arbitration or they might have some lesser legal status reflecting broad principles that the parties would use under a more consensual construction. As noted above, there may well be a trade-off with greater legal certainty via objective assessment resulting in reduced agreement of DRC at the outset.

The spectrum for the DRC withdrawal basis is very broad with many options

There are many different options for the process and procedure and the basis and extent of DRC withdrawal following divergence (or otherwise). There are attractions in seeking objective criteria (as to whether divergence has resulted in an unacceptable increase in risk for one side – as a host state relying on home state regulation of incoming firms) and even making this subject to independent assessment, such as via dispute resolution/arbitration.

There are potential dangers, however, in that such an approach may be difficult to define and result in the parties being nervous of agreeing extensive DRC. Outside the single market DRC is often agreed (successfully) on a more consensual basis and with arrangements subject to termination on relatively short notice periods.

DRC withdrawal



Regulatory divergence should only be assessed on substantive grounds according to principles of sufficiency and proportionality

The UK/EU FTA will be highly unusual. FTAs (and other arrangements such as the EEA single market) normally cater for a process of convergence; the UK/EU treaty will be starting from a position of unparalleled homogeneity and must inevitably cater for the possibility of divergence. In the longer term divergence may be limited by common development of international standards, but current standards are insufficient to justify comprehensive dual regulation coordination.

Divergence should be assessed on a substantive basis under principles of sufficiency and proportionality. Ideally these would be applied on an objective basis and with independent determination under FTA dispute resolution. It is difficult at this point to judge the trade-off; rights of challenge to an independent body would provide greater legal certainty but might deter agreement of more extensive dual regulation coordination in the first place?

Implementation of the DRC agreement.

DRC measures could be expressly linked to the relevant rules (and pre-existing divergence would therefore be mapped). On the EU side these 'rules' might be EU rules (i.e. minimum EU requirements or maximum harmonised rules – see chapter 3 for further information on these terms) or possibly un-harmonised areas (e.g. commercial lending). There may or may not be pre-existing legislation for 'equivalence' assessments or for third country agreements, but there would also be DRC which would fall outside these existing EU TC legislative provisions; the DRC envisaged would be broader (i.e. in sectors where there no existing EU harmonised TC DRC measures) and deeper (i.e. going further than the EU's current TC DRC) and may involve areas which are regarded as domestic member state policy such as perimeter rules.

Implementation might involve further EU harmonisation or member state level arrangements. It would be illogical to regard the present set of EU TC DRC provisions as the limit of DRC measures to be agreed with the UK. EU level harmonisation of TC DRC is patchy and many areas are un-harmonised/differ at member state level. More extensive DRC is logical for both the UK and the EU states. DRC is not a case of 'privileged access' one way or the other if it is supported by the necessary regulatory cooperation.

Implementation of DRC on the EU side will be more complex than in the UK; it must go beyond current EU legislation

The DRC agreement can be implemented in the UK via domestic legislation. This would dovetail with the transposition of the EU acquis in the Great Repeal Bill. DRC in the acquis would have been stripped out and would effectively be replaced by new procedures, processes and transition and the new DRC regime (see Chapter 8 below re a new framework under FSMA for external relations and DRC).

Implementation on the EU side is more complex. The normal basis for the EU (and other countries) entering into DRC accords appears to be essentially consensual. This may enable each side to utilise its domestic procedures to implement the accord (procedures which may be open to other countries and have their own DRC withdrawal criteria/mechanisms) rather than specific powers for the bilateral relationship. One can, however, envisage less consensual approaches (such as reliance on international standards or even objective standards) being used and even a mix of approaches for different DRC. (Although there may be a trade-off between increased legal certainty and limiting the DRC that either side feels comfortable operating on a non-consensual basis.)

The DRC agreement should not be limited to DRC which is already subject to EU level measures. The DRC agreement needs to include DRC that is not currently provided for under EU FS legislation (in terms of equivalence based DRC, or agreements, with TCs) and potentially to put DRC on a different basis to existing TC DRC powers. It would be illogical to regard the present set of EU TC DRC provisions as the limit of DRC measures to be agreed with the UK. EU level harmonisation of TC DRC is patchy and many areas are un-harmonised/differ at member state level. More extensive DRC is logical for both the UK and the EU states. DRC is not a case of 'privileged access' one way or the other if it is supported by the necessary regulatory cooperation.

Implementation will raise technical legal issues on the EU side and might involve further EU harmonisation or member state level arrangements. Depending on the level of DRC agreed with the EU, it may also be necessary/desirable to address DRC barriers at an individual EU state level (for example, in relation to un-harmonised aspects of member state TCF treatment and related DRC). This might be coordinated within the DRC agreement or be covered in separate **national DRC agreements**. There is a precedent for the latter – the Swiss/German agreement on UCITS distribution¹⁸⁵. The flexibility of international law should be used to address the restraints and difficulties that arise under Article 50 and the rest of the EU treaties.

Compliance with global standards as the basis for DRC measures

IOSCO's 2015 report¹⁸⁶ stated that a variety of tools could be used in cross-border regulation. IOSCO recognised the need for international standards of 'recognition' or equivalence: this would be on a unilateral or mutual basis. IOSCO's report highlighted four steps that could underpin the development of this type of system of international recognition:

- Identifying regulatory outcomes
- Selecting regulatory outcome measures
- Gathering materials for evaluation
- Evaluation and use of benchmarks

ESMA responded¹⁸⁷ to the earlier IOSCO consultative report and drew attention to key challenges from their perspective. ESMA noted that developing the tools outlined by IOSCO would require time and analysis. ESMA believes "*IOSCO should play a central role as regards the promotion of these tools, the development of standard methodologies, in developing internationally recognized and consistent standards of regulation, oversight and enforcement and in facilitating dialogue and mutual trust between competent authorities.*"

More recently, Andrew Bailey (Chief Executive of the UK's FCA) reiterated the need for global standards as the basis for market access in his address¹⁸⁸ to the Economic Council Financial Markets Policy Conference in Berlin in January 2017¹⁸⁹. Bailey's central question¹⁹⁰ is whether we can base market access on common

¹⁸⁵ The [agreement](#) entered into force in 2014 to implement a simplification in the marketing of Swiss securities funds (*Effektenfonds*) in Germany, and German UCITS in Switzerland.

¹⁸⁶ [IOSCO Task Force on Cross-Border Regulation: Final Report, FR23/2015, September 2015](#)

¹⁸⁷ <https://www.iosco.org/library/cross-border-taskforce/pdf/ESMA%20Submission.pdf>

¹⁸⁸ [Free trade in financial services and global regulatory standards: friends not rivals](#)

¹⁸⁹ [Free trade in financial services and global regulatory standards: friends not rivals](#)

¹⁹⁰ Bailey would require:

recognition of global standards that are transparent and subject to regular review¹⁹¹. Current global standards were not put in place to facilitate market access but, arguably, capture the essence of broad equivalence on which market access could depend.

“If the body of global standards were to be judged sufficient, it could provide a broader basis on which market access decisions could be made. This would of course need to be supported by consideration of how such standards would be created, implemented and then overseen. Market access on this basis would help to reduce barriers to entry and promote more competitive markets. A system of mutual recognition could thereby be established.”

As these standards continue to be developed, it is critical that competition agencies such as CMA, DG Competition and the Federal Trade Commission in the US are fully engaged in their competition advocacy mandate to promote standards that are in fact consumer welfare enhancing.

There is therefore scope for linkage to international standards; in the longer term it would be desirable to develop international standards in all sectors of FS and to introduce ‘DRC standards’ which would underpin DRC internationally. The UK/EU partnership might act as a model for this approach. Indeed the partnership should include a forum for the joint coordination of policy work and regulatory reform which could include the development of international/global standards, possibly assisting with the development of global DRC standards.

International standards have a place in this construction, but it must be recognised that there are limitations in the short term as noted above and because global standards in some areas (such as insurance under the IAIS) are limited/high level. In short it seems unlikely that regulators would be prepared to envisage **full DRC** solely on the basis of current international standards. Nonetheless, international standards will have an important and growing role in DRC and in the UK/EU arrangement.

The EU and UK should promote the development of dual regulation coordination standards

This topic has recently been considered by Andrew Bailey - [Free trade in financial services and global regulatory standards: friends not rivals](#). In the new UK/EU partnership, both sides should commit to work together for the development of international standards (which are currently more developed in banking than, say, in insurance). There should also be a new focus on international prudential standards as a mechanism for dual regulation coordination, to reduce the barriers from dual regulation and stimulate trade and competition. However, the UK should not rely only on the EU, but also its relationship with the US, and other financial services centres such as Switzerland, Hong Kong and Singapore to help develop undistorted standards. Conduct of business, however, is likely to remain the preserve of the host state.

The UK should be taking the lead in promoting this policy; the success of UK/EU partnership could provide further momentum. In future a distinction might be drawn between international standards of broad application around the world and higher standards where a smaller group of countries use these to agree dual regulation coordination.

However....

A DRC agreement will be required as any broader re-structuring of international and European regulation cannot be guaranteed

Global standards for core prudential requirements, resolution of failed firms where they need special regime beyond standard insolvency law, & market practices where those present sufficient threat to financial stability. These would be broad global standards of equivalence;

Home authorities of the country in which the firm is based to be transparent about the standards they set for governance, remuneration and other areas that affect critical incentives & thus culture within firms. These should be subject to peer review as that are now by the IMF;

Would leave much of the regulation of financial conduct to be done at national/regional level in the countries in which firms operate;

All firms operating in a country would be subject to the conduct rules of their ‘host’ & this should apply whether they have a presence in the host country or sell services across borders;

Smaller firms that chose not to trade across borders would not be subject to global standards. Smaller firms would be subject to national standards.

¹⁹¹ Bailey acknowledges that currently the approach to market access is national/regional.

There are a variety of longer terms possibilities for re-structuring international and European¹⁹² regulation/DRC arrangements but the UK cannot be confident that these reforms can be achieved in time for Brexit. A DRC agreement is therefore very likely to be necessary.

A mix and match approach?

In conclusion, there are a variety of possible approaches and the best approach may involve different elements and with a different approach for any interim measures. The construction might involve elements of the following (in order of increasing legal certainty):

- Purely consensual DRC which can be withdrawn on notice (the accord approach);
- DRC which can be withdrawn on divergence (subjective test and no independent appeal);
- International standard based DRC;
- DRC which can only be withdrawn on basis of objective assessment of risk to host state and with independent appeal/dispute resolution.

The normal basis for the EU (and other countries) entering into DRC accords appears to be the first and, perhaps, the second of the above (i.e. essentially a consensual basis). This may enable each side to utilise its domestic procedures to implement the accord (procedures which may be open to other countries rather than specific powers for the bilateral relationship). One can, however, envisage the less consensual approaches being used and even a mix of approaches for different DRC. (Although there may be a trade-off between increased legal certainty and limiting the DRC that either side feels comfortable operating on a non-consensual basis.)

Extending DRC – the EEA states?

What will happen to cross-border business between the UK and the 3 EFTA states in the EEA? The new relationship will be negotiated and agreed between the EU and the UK. The EEA are bound to equivalence recognition decisions of the EU, and would, as a matter of course, have to implement whatever the EU implements in the course of commitments it makes in FTAs that go to single market regulation¹⁹³. One way or another it therefore seems likely that the arrangements will be extended to include the EEA.

Extending DRC - bilateral relationships with member states?

The UK will need to consider what it can achieve by way of bilateral relationships with other EU/EEA Member States following the conclusion of an EU-UK agreement.

There is an interesting precedent for a bilateral agreement between an individual EU Member State (Germany) and a third country (Switzerland). The agreement came into force in 2014 to implement a simplification in the marketing of Swiss securities funds (*Effektenfonds*) in Germany, and German UCITS in Switzerland. This protocol followed an earlier cooperation agreement relating to taxation and financial markets in 2011. The agreement states that German UCITS and Swiss securities funds are considered as equivalent – this allows for a simpler, faster notification based process as exists within the EU/EEA under the UCITS Directive.

The possibility of the UK entering into bilateral arrangements with individual member states (in addition to, or as part of, the its partnership with the EU) is interesting because it might assist the UK's negotiating position if proposals are supported by some EU states but not by all or by a 'qualified majority' and because it may assist in dealing with arrangements which cover un-harmonised areas (such as national perimeter rules).

Further analysis is required to clarify the scope for bilateral agreements of this kind. It seems that they are possible where the EU has not harmonised third country treatment but are not possible where it has (e.g. MiFIR harmonisation for third country cross-border supply)?

¹⁹² There has been some speculation that the new UK/EU agreement might eventually become a new model for the EEA/EFTA states.

¹⁹³ This was causing the EFTA countries some concern while TTIP was on the table, as they would have been bound in to anything agreed on regulation harmonisation/recognition with the US.

Under the default scenario, absent any agreement, of the UK as a third country, member states would have to determine how to apply their domestic regime to the UK (and vice versa). Each member state would have to decide, for example, whether they regard UK regulation as sufficient to permit UK banks to trade via a local branch and whether and to what extent they can rely upon home state (i.e. UK) financial supervision. Similarly the UK will have to make the same assessment for each EU/EEA country. There are strong arguments for both sides to coordinate treatment in both directions.

This extent of national practice is also important for the scope of DRC in the UK/EU agreement.

MARKET ACCESS TERMS AND THE COMPREHENSIVE FTA

Market access provisions in the FTA would be ambitious in breadth and magnitude

The market access commitments in the WTO financial services schedules for EU states are limited; they are qualified by a large number of differing reservations by individual member states in the WTO schedule (and in FTAs such as CETA, although the number of reservations in recent FTAs, and the actual regulation in individual member states indicate that the current state of openness is better than the WTO schedule indicates); the UK has relatively few reservations. There has been only limited progress in financial services schedules of recent FTAs. Whilst DRC is the priority, we would also envisage the UK seeking market access commitments in the FTA financial services schedule which were more ambitious in breadth and magnitude than previous FTAs (and the current WTO obligations of EU states).

Market access provisions in the FTA would operate alongside DRC/the DRC agreement

Market access commitments would be negotiated and agreed in the financial services schedule. These would operate alongside DRC. To the extent that in any given business/mode of supply there was no applicable DRC, market access would operate in the usual way, with host state regulation applying. Where a form of business/mode of supply was subject to both market access and DRC, there would be no conflict but the DRC would probably go much further than the market access provision.

Some standard FTA and GATS terms may need to be adapted

The incorporation of the DRC agreement into the FTA umbrella would require careful consideration of the application of FTA/WTO terminology and mechanisms to DRC (such as the standard FTA/GATS terms, for example, on national treatment and the 'prudential carve out').

The question of emergency action in a banking crisis/major bank failure or other acute threats to financial stability will need to be considered in this context.

Bringing the DRC agreement into the comprehensive FTA umbrella

Institutions

Cross-border regulatory coordination and mutual recognition between the UK and the 27 other EU states currently operates under the umbrella of the EU treaties, EU law and the EU institutions (in particular the European Commission, the European Supervisory Authorities (ESMA, EIOPA, EBA) the CJEU). At Brexit the relationship will fall outside this umbrella and a new structure will be needed.

The EEA-EFTA framework operates under the EEA treaty with the functions of the EU institutions undertaken by different EEA institutions (the EFTA court and the EFTA Surveillance Authority) but with close integration of EU law and between the EU and the EEA-EFTA institutional frameworks, including joint committees. This model is not relevant to an EU/UK relationship after the UK has left both the EU and the single market. The Swiss/EU bilaterals have a more arms-length structure but this has proved problematic.

The partnership should have a well-developed structure (most likely formed as joint committees), evolved from current arrangements within the ESAs, to deal with different aspects of regulatory and supervisory cooperation covering:

- Day to day supervisory cooperation for cross-border firms and groups including supervisory colleges;
- Supervisory cooperation for recovery, resolution, emergencies and crisis measures and winding up;
- Policy development, regulatory reform and coordination on the development of international standards;
- Assessment of proposed rulebook developments involving divergence and related issues of 'sufficiency'.

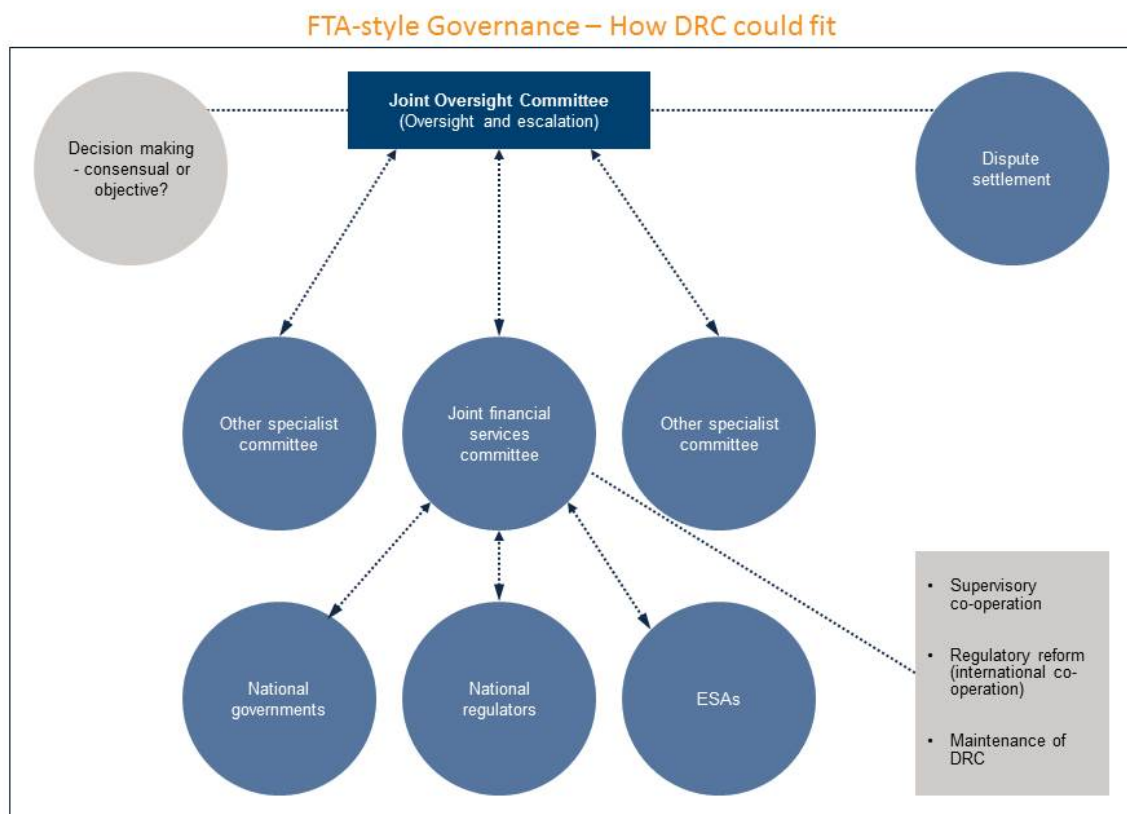
The normal arrangements (via treaty provisions, MoUs or other means) will need to be in place to enable cooperation to take place – for example, covering the exchange of information and data sharing, confidentiality etc. as between UK bodies (FCA, PRA, HMT etc.) and the national and EU bodies involved (national regulators and supervisors, the ESAs etc.).

The more challenging institutional issues are how to deal with:

- Disputes between the parties (i.e. UK/EU/EU member states); and
- The rights of private sector companies, firms and natural persons.

It appears that the UK government will propose the dispute settlement mechanism found in modern style FTAs such as CETA. As explained above, these provide for disputes between the parties to be adjudicated without reference to the CJEU. There are also certain rights for firms to bring actions. These are not equivalent to the access to redress enjoyed by EU firms and nationals under EU law, but have nonetheless proved controversial (e.g. in the case of CETA).

Information about the committee structure under CETA is given in Annex C. An illustration of how such a structure might work under the EU/UK arrangements is given below -



Institutional approach

The chart above shows a possible structure for the UK/EU partnership based on recent FTAs such as CETA but covering the key functions – supervision, regulatory reform and development of the regulatory regime, centralised regulatory roles – authorisation of specialist firms and emergency powers etc., and enforcement and implementation of DRC.

Dispute resolution – state level and private sector rights?

The UK Government's Brexit White Paper acknowledged the need for satisfactory dispute resolution mechanisms (a common feature of FTAs, including where the EU is a party):

“the UK will seek to agree a new approach to interpretation and dispute resolution with the EU. This is essential to reassure businesses and individuals that the terms of any agreement can be relied upon, that both parties will have a common understanding of what the agreement means and that disputes can be resolved fairly and efficiently. The actual form of dispute resolution in a future relationship with the EU will be a matter for negotiations between the UK and the EU, and we should not be constrained by precedent. Different dispute resolution mechanisms could apply to different agreements, depending on how the new relationship with the EU is structured. Any arrangements must be ones that respect UK sovereignty, protect the role of our courts and maximise legal certainty, including for businesses, consumers, workers and other citizens.”¹⁹⁴

How are WTO and FTA disputes managed?

How are WTO and FTA disputes managed? In the WTO, dispute settlement (which operates between state parties only) is governed by the Dispute Settlement Understanding (“DSU”), which was agreed at the Uruguay Round. The DSU is a much more legally binding mechanism than the previous GATT panel system which allowed the defendant country to essentially veto any decisions that went against it. The DSU system by contrast consists of a consultation mechanism which if unsuccessful leads to binding dispute settlement by a WTO panel. The panel will adjudicate on the question of whether the measure in dispute is a violation of the relevant WTO agreement or not. The panel merely finds on the issue of whether there is a present violation and if there is, recommends that the measure be made to conform and how. It cannot at this stage provide for remedies. Parties have a certain period of time to implement panel decisions. If they do not, trade sanctions are available to the harmed party. Both parties can appeal to the WTO Appellate body which will also only rule on whether the measure in question is a violation of WTO rules or not. The Appellate Body is a permanent body of seven members, three of whom sit on each appeal. They are individuals with recognised standing in law and international trade and must not be affiliated to any government.

If after appellate review, or if there is no appeal, the measure in question is still found to be in violation, the losing country must follow promptly the recommendations of the panel or the Appellate Body (as applicable). If it does not do so it is required to negotiate with the complaining country or countries to determine mutually acceptable compensation for the offending measure. If compensation is not agreed within 20 days, the complaining country may request permission to take retaliatory action, such as suspension of concessions or other obligations with respect to the offending country (where practicable in the same sector as the dispute). These trade sanctions usually take the form of a withdrawal of tariff concessions, but in some recent cases, other benefits of WTO agreements can be suspended (for example intellectual property protections afforded under the TRIPs agreement).

Dispute settlement in FTAs (including those to which the EU is a party) is modelled on the WTO process, with dispute settlement mechanisms involving arbitrators from jurisdictions which are not parties to the agreement. Modern FTAs often include investment protection provisions, backed by investor/state dispute settlement (ISDS) where non-state actors can bring action against state parties, including to claim compensation for losses from measures taken by the state. Tribunals in this context usually operate under the rules of the World Bank's International Centre for Settlement of Investment Disputes (ICSID), which have been in place for decades to deal with disputes under bi-lateral investment treaties. Since foreign direct investment became part of the common commercial policy following the Lisbon Treaty, it is therefore within the competence of the EU for the purposes of international agreements. Investment, and investor state dispute settlement has been included in the EU's FTAs with Singapore and Canada (see below for how this has been treated in a case currently at the CJEU on exclusive competence in respect of the Singapore agreement, and in particular the distinction made between FDI and portfolio investment).

In CETA and the EU-Singapore agreement all of the investment protection provisions are expressly incorporated in the financial services chapter and therefore subject to ISDS¹⁹⁵. The process for ISDS is also analogous to the WTO model, with reference to a tribunal under ICSID or UNCITRAL rules. The process in CETA includes some subtle but important distinctions from ISDS in other FTAs. Christened the Investment Court System or “ICS”, rather than ad hoc arbitrators being appointed by the parties, the tribunal dealing with investor/state disputes will be drawn from a standing panel of 15 members appointed jointly by the CETA joint Committee and comprising 5 nationals from each side and five from third countries¹⁹⁶. There will be an appellate tribunal, the composition of which is to be established by the CETA Joint Committee. This was also the EU's proposed approach for TTIP. The EU and Canada have agreed in CETA to “pursue with other trading partners the establishment of a multilateral investment tribunal and appellate mechanism for the resolution of

¹⁹⁴ ‘*The United Kingdom's exit from and new partnership with the European Union*’ p. 14 (February 2017)

¹⁹⁵ There has been a proposal for a multilateral investment court (see EU press release [here](#)).

¹⁹⁶ Article 8.27 CETA

investment disputes". Once established, the multilateral tribunal will take over the settlement of dispute from the CETA tribunal. The international, multilateral tribunal has been a policy goal of the EU since 2015¹⁹⁷ as it seeks to make ISDS more palatable to concerned citizens, as the presence of ISDS almost derailed CETA and was, and remains, a highly controversial aspect of TTIP.

As described in chapter 2 above, CETA includes a filter mechanism whereby the state parties can agree that the disputed measure falls within the prudential carve out for financial services obligations, and the claim will be discontinued. ISDS and intra-state dispute settlement is usually irrelevant for regulatory convergence/cooperation provisions, at least in part because they are usually non-binding so not capable of being arbitrated or having remedies attached to them. The Joint Interpretative instrument on CETA issued by the parties makes clear their intention to preserve their respective abilities to make their own laws and regulations. It also seeks to clarify that "governments may change their laws regardless of whether this may negatively affect an investment or an investor's expectation of profits", while conceding that compensation for resulting losses may still be due but "will not be greater than the loss suffered by the investor".

As well as the competence issues outlined above, the other constraint in EU treaty-making that affects dispute settlement in particular is that the terms of an international agreement must have no "adverse effect on the autonomy of the EU legal order". It cannot "alter the essential character of the powers conferred" on EU institutions by the Treaties and "must not have the effect of binding the EU and its institutions to a particular interpretation of the rules of EU law".¹⁹⁸ Legal advice to the European Parliament on CETA concluded that "the inclusion in an international agreement concluded by the EU, of investment dispute settlement provision envisaging the creation of a tribunal responsible for their interpretation does not appear to be incompatible with the Treaties", provided such provisions "have no adverse effect on the autonomy of the legal order of the EU... ensure the respect of principles regarding the delineation of competences and respect the constitutional principles of the EU, notably the principles of non-discrimination and protection of fundamental rights".¹⁹⁹ The advice considered that the CETA investor/state dispute settlement provisions are compatible with the Treaties.

Regulatory co-operation/coherence chapters are usually excluded from dispute settlement (both between the state parties and investor/state) but in this case, as the dual regulation coordination element has live effects on the provision of services, rather than being a hortatory mechanism, it would be essential to have either a process of escalation and decision making in disputed scenarios (although we would not envisage this applying to investment claims and, as described above, the only remedy could be the withdrawal of reciprocal recognition). This may be politically untenable from either or both of the UK and EU, and would risk being considered to have an adverse effect on the autonomy of the EU legal order, so an alternative would be to provide that if either party considered the regime of the other to be too divergent, it could withdraw recognition unilaterally.

In either case, the withdrawal mechanism would need to be formulated to apply to the affected sector and mode of supply only and not the whole dual regulation coordination system. The unilateral, consensual approach may appear to introduce uncertainty as recognition of home state regulation would be susceptible to being withdrawn, but as long as the process was transparent and a transition period for affected operators would apply the uncertainty need not be greater than that under which FS operators work as the rule book develops through EU and member state regulation in the normal course²⁰⁰. FTAs, or in case of a plurilateral or platform agreement, the participation of a party, are generally terminable on six months notice and huge amounts of trade and investment is carried on under those terms.

Models for UK/EU agreement

In Chapter 4 we looked at particular examples of DRC (and market access) measures. As the UK refines its proposals, it will need to refine and agree the structure and legal form of the new arrangements to be negotiated. There are many descriptions being used - 'partnership' (a name which has become popular for recent FTAs), regulatory cooperation agreement, an equivalence treaty and so on.

The 'handle' is one thing but it is clear that there is no pre-existing precedent which matches the Prime Minister's proposal. The EU and UK cannot simply take out a copy of some previous international agreement and start amending it up to fit their requirements. Each precedent may have something to offer but none is the complete answer.

¹⁹⁷ See for example Commission Concept Paper of 5 May 2015 "Investment in TTIP – the Path Beyond"

¹⁹⁸ Opinion 1/92 ("creation of the European Economic Area after renegotiation"); Opinion 1/100 ("establishment of a European Common Aviation Area") and opinion 2/13 ("accession of the EU to the European Convention on Human Rights"), as summarised in European Parliament Legal Service Legal Opinion on compatibility with the Treaties of investment dispute settlement provisions in EU trade agreements (June 2016)

¹⁹⁹ European Parliament Legal Service Legal Opinion on compatibility with the Treaties of investment dispute settlement provisions in EU trade agreements, (June 2016)

²⁰⁰ For example the UK's introduction of ring fencing and the still looming threat of euro clearing localisation.

It is also important to bear in mind that these 'precedents' might also become relevant in contexts other than the full 'end state' partnership or final FTA. Planning needs to take account of these of the risks in the process for negotiating and bringing the new arrangements into effect (see further in Chapter 7). This includes, for example, the risk of an interregnum, of ratification failure or other delays to the end state partnership being in effect on a permanent (rather than provisional basis).

Contingency planning for these scenarios, might, for example, involve looking at measures which might be invoked to cover an interregnum (as an alternative to full scale prolongation) or as a failsafe or fall-back to cover the risk of ratification failure. Different limitations, legal requirements, priorities and objectives might apply. Clearly there are many political considerations. The point is simply that some broad based thinking on the legal measures and mechanisms available is clearly desirable.

The structuring of all the new EU/UK relationships across diverse areas will be a complex issue. Will it be on the basis of 'nothing is agreed until everything is agreed' or will some areas be de-linked into separate negotiations? How will the agreements themselves be structured – a single treaty or series. Will termination/denunciation/breach in one area trigger termination in other areas and so on. There are some precedents here in terms of the negotiation and terms of the Swiss EU bilateral packages 1 and 2.

It is quite possible that there may be umbrella agreements/treaties with separate/detailed accords or schedules in different areas. Some of these might be free standing. It is clearly not possible to foresee the entire package that will emerge, how this will be structured in legal terms or even the legal 'eco-system' which the new arrangement will operate under or how FS can or will feature within this.

Examples of international arrangements and eco-systems identified earlier in this report above include -

- Comprehensive FTAs under the WTO framework for FTAs – such as CETA and TPP/TIPP;
- TiSA (see Chapter 2);
- Mutual recognition agreements of the kind commonly agreed for conformity assessment of goods;
- The 1989 Swiss/EU agreement for non-life insurance;
- The 2016 accord between the European Commission and the CFTC in the US for mutual recognition of CCP under Dodd Frank and EMIR (see Chapter 3 above);
- The EU legal eco-system and the extended EEA legal eco-system with their single market DRC mechanisms;
- The EU has international treaties with many third countries with various different styles such as free trade, partnership, cooperation, development and 'association' agreements, and the Swiss/EU 'bilateral packages' 1 and 2 mentioned above. There are signs that the EU may thinking of the new UK/EU relationship would be established through an Association agreement between the EU, the EU member states and the UK; an association can act as an umbrella treaty and accommodate chapters on a broad range of areas including both non-trade topics, such as security cooperation, and trade (including both conventional FTA terms and DRC). In that case, the dispute resolution mechanisms referenced above would only apply within the trade area. Disputes under non-trade co-operation aspects of association agreements or under the Swiss bilateral package are not subject to CJEU jurisdiction or other independent dispute settlement mechanism.

Some of the relevant features of these eco-system and arrangements are

- The legal order(s) or eco-system(s) under which the agreements operate
- Institutional arrangements – the institutions and their roles and powers
- Rights in respect of breach
- Enforcement rights/mechanisms and dispute settlement/resolution and the Court of jurisdiction
- Rights of redress for state parties
- Right of redress for the private sector
- Term and termination/denunciation rights
- Inter-linkage/de-linkage of obligations and agreements/treaties in different areas

It seems both likely and desirable that the full/end state partnership (in the broad areas of trade) should operate as a comprehensive free trade agreement. There is an established legal order/eco-system for such an arrangement which provides both a vocabulary to express obligations and a dispute settlement/remedy framework.

Further work is required to establish how the FS sector arrangements should best fit within the overall construction. There is no FTA precedent for the scope and scale of DRC in FS and analysis is required to see how the FTA/WTO blueprint, mechanics and terminology would operate with the comprehensive DRC measures envisaged, rather than the previous market access type provisions. However, the GATS specifically provides for WTO members being able to enter into arrangements for the recognition of prudential measures for other countries²⁰¹. The question is not completely binary; any agreements in this field will need to be consistent with the WTO obligations of each of the 28 countries involved but can fit into that architecture either by forming part of a wider agreement or by conforming to the requirements in respect of recognition under the GATS.

WTO is a pre-existing eco-system which could be used for comprehensive DRC between the EU and the UK (outside the single market)

The EU regime (which is plurilateral) is an entire legal order and has the deepest and most comprehensive legal eco-system. It operates both at EU level and by permeating the domestic law/legal system of each EU member state – with its own court, the CJEU, direct application and precedence of EU law in a member state's domestic regime and national courts, ESAs' powers under EU treaties/legislation, European Commission powers to enforce DRC against member states via infringement action, fines etc. This provides deep and broad legal protection for both state parties and non-state parties and a very high degree of legal certainty for DRC.

The extension of the EU single market under the EEA agreement affords relatively deep and broad protection for EU players in the 3 EEA/EFTA states and vice versa, but in various respects legal certainty is less than within the EU (for example because EU regulations are not directly applicable in EEA EFTA states and there have been significant delays and difficulties in implementation). The agreement has different institutions on the EEA side – the EFTA Court, EFTA Surveillance Authority etc..

The legal order of EFTA under the EFTA agreement is more restricted and is not directly relevant, given that the EU is not a member (nor currently is the UK).

The WTO provides a legal eco-system for FTAs. This is much shallower than the EU legal order and it does not permeate the domestic law of its members. An FS firm cannot enforce or rely upon the DRC terms in domestic proceedings. It does, however, provide a pre-existing framework and treaty basis with some institutional structure and a dispute resolution mechanism for state parties and some limited scope for non-state party redress and further potential under the investment court approach (as was agreed in the investor state dispute settlement provisions of CETA and the EU Singapore FTA) and the broader developments which the EU has proposed. This could enable private sector parties of each side, such as FS firms, who have invested in the other to have rights to challenge host state requirements, at least in relation to their investment in the host state via branches and subsidiaries. The UK and EU would need to consider carefully the application of dispute settlement (including any such private sector rights) to the DRC arrangements.

The third option is an international law treaty, or some lesser accord, outside these structures and any pre-existing mechanism for redress and dispute resolution. The EU has entered into a variety of external agreements under different names – such as partnerships, cooperation agreements – some described as 'deep' and others as 'comprehensive'²⁰². The recent Ukraine agreement was an 'association agreement' which incorporated an FTA but this does not offer a different legal eco-system or more advanced dispute resolution

The conclusion of a DRC agreement would need to be consistent with WTO requirements

The conclusion of a DRC agreement would be consistent with WTO requirements including MFN, market access and national treatment obligations and there would be **no need** to cast the DRC agreement:

- in terms similar to recent FTAs such as CETA, or
- by reference to WTO market access terminology or with WTO dispute resolution.

²⁰¹201 GATS Annex on Financial Services paragraph 3 (Recognition)

²⁰²202 [EU External Agreements - HoC library](#)

There are GATS obligations regarding recognition of prudential measures, licensing, qualifications and similar, under which recognition granted to one country must be made available to other WTO members who meet the same criteria of equivalence, implementation, oversight and procedures for information sharing, so it would in theory be necessary for other states to have the ability to apply for the same DRC. However, if there was reluctance on either side to countenance other countries participating in DRC, there is an exception in the GATS MFN obligations for bi-lateral arrangements that form part of an agreement with “substantial sectoral coverage” that eliminates all discrimination in the areas covered. The DRC agreement is therefore likely to be consistent with the GATS obligations if it operates as part of/under an FTA umbrella. Unlike the GATT in respect of trade in goods, the GATS does not expressly extend this to cover interim measures²⁰³ pending an FTA but in practice, sectoral and bi-/plurilateral liberalisation is possible under the GATS ‘built-in agenda’ which looks to progressively liberalise services trade through a process of ‘requests and offers’ between WTO members. This could be deployed to mitigate the risk of challenge from other members if DRC were not to be made available to them during any interim period. This is an issue that warrants further consideration, including in the context of the WTO’s ongoing work on services liberalisation. Existing EU DRC legislation is already on the basis of open access to countries who meet the applicable criteria, but GATS obligations would impact how the EU implemented the agreement on other DRC and how the UK implemented DRC in its domestic regime (see above and Chapter 8 below).

²⁰³ The FMLC has undertaken to address these issues (including the question of WTO and MFN compliance). See FMLC letter on the EU exit and transitional arrangements [here](#).

7. The timeline and legal challenges

There has been much discussion of the challenges to the Brexit process in terms of:

- the timeline for the negotiations and the implementation of Brexit and the new arrangements; and
- the legal constraints under the EU treaties, which apply to the withdrawal agreement generally and more broadly to the EU side in relation its new arrangements with the UK.

The Brexit process is complex and without precedent. These issues are beyond the scope of this report but in essence the challenges are these -

Sufficient lead time²⁰⁴. How to provide sufficient lead time for both the public sector and the private sector to adjust - from the moment when there is clarity as to the legal and regulatory changes involved (and the steps which must be taken, for example, to introduce new computer systems for customs or establish new EU subsidiaries and obtain regulatory authorisation) and the time when these changes take effect. Firms²⁰⁵ are normally given at least 2 years notice of major regulatory change²⁰⁶, but this does not fit with the Brexit date in Article 50 two years after notice is given. Clarity for business would be unlikely to emerge before the latter stages of the negotiations ie towards the end of this period. A further challenge is that whilst the possibility remains that Brexit will occur in 2019, business has to roll out their contingency plans (based on worst case modelling); only early confirmation that the EU and UK have agreed a satisfactory solution will enable business to delay restructuring (which may prove to have been unnecessary). It is hoped that this can be an 'early harvest' measure when the negotiations commence in the spring.

Political pressures to get on with the process (and deliver Brexit as soon as possible) and the challenge of Article 50 - in that any delay to the Brexit date (probably) requires unanimity amongst all 28 states.

The uncertainty over the legal construction of the Brexit process and the timeline. In particular, to what extent can the simplified process for an Article 50 withdrawal agreement (with 'qualified majority voting' and no member state ratification procedures envisaged) regulate the post-Brexit relationship. It seems likely (and is the position of the UK Government set out in the letter giving notice under Article 50 on 29 March 2017) that there will be at least some parallel negotiation of the post-Brexit relationship at the same time as the negotiation of the 'pure' Brexit/divorce issues such as financial liabilities and assets. Although in his speech on 22 March, Barnier stressed the need to progress negotiations in the right order and envisaged that "settling the accounts" and agreeing the situation of citizens in each others' territories would be the first priorities, he did not rule out negotiating the future partnership during the two year period under Article 50.

National ratification requirements may impact the ultimate FTA. Ratification risk is two-fold – the potential delay in timing and the risk that an agreement which has been approved by the EU, UK and European Parliament fails to secure national ratification. The AG opinion in the Singapore case discussed below indicates that most areas relevant to service provision and investment are within the EU's exclusive competence. The Commission considers that it will be a mixed agreement but where there are items falling outside exclusive competence, provisional application may assist.

²⁰⁴ There have also been references to a 'Cliff edge' – a term coined by Andrew Tyrie last year to refer to the risk of a dramatic break in regulatory continuity which is an extreme outcome and even more dramatic than the lead time problem. Here the negotiations not only fail to achieve any lead time but Brexit occurs without any transitional or new arrangements in place. This would pose very acute difficulty for both the public and private sector in both the UK and the EU. There does not now appear to be consensus on the EU side and the UK side that a dramatic break of this kind is to be avoided.

²⁰⁵ The scale of change and the practicalities will vary from sector to sector and from business to business. Clearly there will potentially be some very major changes in regulation and the legal environment impacting many players in the financial services sector – firms, investors, markets, exchanges, platforms and systems, regulators and supervisors and suppliers.

²⁰⁶ Recent evidence from HSBC, LSE, and Allianz Global Investors before the UK Treasury Select Committee has pointed to the need for five years in total for the Brexit process (starting from the date notice is given to the EU). Two years would be needed for the negotiations with a further three years after this for adaptation. See <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/the-uks-future-economic-relationship-with-the-european-union/oral/45035.pdf>

EU and international law basis

There is a distinction between the withdrawal agreement and the agreement on the future EU-UK relationship (FTA). The Treaty base for the withdrawal agreement is Article 50 TEU and concerns the EU and the UK: "*unlike accession treaties, the withdrawal agreement is not primary EU law, since it is concluded between the EU and the withdrawing state and not between the latter and the rest of the Member States.*"²⁰⁷ Given its legal status as an **international agreement**, it may be subject to legal challenge before the Court of Justice of the European Union under Article 263 TFEU, as could the ultimate FTA/association agreement.²⁰⁸

The EU has exclusive competence for the conclusion of international agreements in the circumstances set out in Article 3(2) TFEU, being "*when its conclusion is provided for in a legislative act of the Union or is necessary to enable the Union to exercise its internal competence, or in so far as its conclusion may affect common rules or alter their scope*". In the context of trade agreements, what is covered by these areas is explored most recently in the Singapore case summarised in this Chapter. For the EU to enter into an international agreement (including the withdrawal agreement, except to the extent varied by Article 50) the process set out in article 218 TFEU applies. Generally the Council acts by qualified majority in the process, but unanimity is required for association agreements, which establish "an association involving reciprocal rights and obligations, common action and special procedure"²⁰⁹. They focus on broader matters of co-operation in addition to trade and often, though not always, these are a pre-cursor to accession. The consent of the European Parliament is required where an agreement covered certain matters, which are all things that a comprehensive FTA would include. Consent was required for the conclusion of CETA, for example.

If parts of an agreement fall outside of the exclusive competence of the EU, making it a 'mixed agreement', each member state will need to agree it under their own constitutional requirements.

In his speech to the European Committee of the regions on 22 March 2017, Michel Barnier, Chief Negotiator for the Preparation and Conduct of Negotiations with the United Kingdom, stated that the "bold and ambitious Free Trade Agreement" that he and Theresa May agree to be necessary will "undoubtedly be a mixed agreement". He also outlined a number of non-trade aspects that he expects will be included, such as research and innovation, climate change, security and possibly defence co-operation, which suggests that the ultimate goal will be an association agreement. This is underlined by the focus on security matters in the Article 50 letter.

Even if, as seems likely, member state ratification is required, those elements of the FTA that are within the exclusive competence of the EU can come into effect on a provisional basis, pending completion of member state formalities, so interim arrangements need not be delayed by national parliamentary approvals.

It may be possible to structure an agreement on financial services which does not require member state ratification, whereas ratification may be required in other areas. In order to meet the GATS article V requirement for "substantial sectoral coverage"²¹⁰; it would be necessary to cover services trade more widely, but acknowledge that it will apply provisionally only (as was the case with CETA) until the chapters that fall outside of exclusive competence have been fully ratified. This is consistent with Article V GATS which permits provisions under an FTA to be brought in under a reasonable timetable after the agreement comes into effect. Notably, this provision (unlike the equivalent for trade in goods under Article XXIV GATT) does not permit measures in anticipation of a full agreement – the agreement must be in place, but the preferential measures can be implemented in phases. This will need to be reflected in the drafting of any provisional /interim measures in the Withdrawal Agreement and the FTA, for example by agreeing in principle at the outset that discriminatory measures between UK and EU service providers will continue to be prohibited, while modalities to implement this permanently in law are being negotiated. This may require de facto continuation of relevant EU law and jurisdiction of the CJEU during such period, which would reflect Barnier's statement that "a certain number of transitional arrangements may be necessary... these possible arrangements must be supervised by European (sic) law and its associated legal system. Their duration will be strictly limited".

²⁰⁷ European Parliament Research Paper, 'Article 50 TEU: withdrawal of a Member State from the EU', (February 2016), p.5

²⁰⁸ European Parliament Research Paper, 'Article 50 TEU: withdrawal of a Member State from the EU', (February 2016), p.5

²⁰⁹ Article 217 TFEU

²¹⁰ This is clarified to refer to coverage in terms of number of sectors, volume of trade affected and modes of supply. Agreements should not exclude any mode of supply.

Ratifying the deal - International agreements under EU law – EU exclusive competence, mixed agreements and individual Member State agreements

Article 50 provides specific formalities for concluding the agreement on the terms of a member state's exit, such agreement to take account of the framework for the future relationship between the EU and the exiting state. It remains to be seen how much of the longer term arrangements will be agreed as part of that package, or whether substantive future arrangements will need to be agreed entirely separately, either concurrently with or after the Article 50 exit agreement.

If the agreement includes measures that are outside of the EU's exclusive competence, ratification by each member state will be required, the process that caused delays and last minute renegotiations of CETA. A timely case has been heard in the CJEU that will establish the scope of the exclusive competence in respect of the EU's FTA with Singapore.

The EU has exclusive competence to enter into international agreements in certain matters. Exclusive competence means that it can do so acting through the institutions of the EU, without requiring the involvement of Member States (other than acting through their representation in the Council). In many cases, these agreements can be entered into pursuant to a decision by a qualified majority in the Council, and with either the approval of or in consultation with parliament, depending on the subject matter/content of the agreement.

On 21 December 2016, Advocate General Sharpston (AG) published an opinion pursuant to a reference by the Commission that opined on which of the provisions of the Free Trade Agreement envisaged between the European Union and the Republic of Singapore (the EUSFTA) fell within the European Union's exclusive competence, the European Union's shared competence and the Member States' exclusive competence respectively (the Opinion). It is important to note that such opinions are not binding on courts, however they can be persuasive and are often followed. The judgment in this case is expected in May 2017. The principle consideration was whether the provisions fell within the common commercial policy under Article 207 TFEU, and if so, whether they could be exclusively dealt with by the EU.

Chapter 8 ('*Services, Establishment and Electronic Commerce*') of the EUSFTA lays down the necessary arrangements for the cross-border supply of services, to include cross-border trade of financial services. Chapter 9 ('*Investments*') addresses the treatment of investments, split into two parts. The AG considers whether each of these falls within the EU's common commercial policy and as such is subject to exclusive competence by the EU.

With regard to financial services, the AG considered arguments from Member States that cross-border trade in financial services does not fall within the EU's common commercial policy on the basis that MiFID II harmonises only certain aspects of the supply of financial and investment services by third country nationals. This argument is rejected by the AG on the basis that the TFEU does not make the EU's competence dependent on any prior adoption of harmonised rules or other rules governing the commercial relations between the EU and third countries. The AG concludes that the financial services sub-section of Chapter 8 applies to all four modes of supply under GATS, which in principle falls within the scope of Article 207(1) TFEU. Accordingly, the sub-section falls within the EU's common commercial policy as it has a direct and immediate effect on trade which is an area of exclusive competence.

Chapter 9 of the EUSFTA deals with investments in two parts. Section A deals with international investments (not intra-EU investment) and Section B provides for an 'Investor-State Dispute Settlement' mechanism. The mechanism, which may involve arbitration, applies to disputes relating to breach of the provisions of Section A and causing loss or damage to the claimant or its locally established company.

It was opined that an agreement falls within the scope of Article 207(1) TFEU if it relates specifically to international investment, in that it is essentially intended to promote, facilitate or govern international investments and has a direct and immediate effect on those investments. On this basis, the AG found that foreign direct investment was a matter of exclusive competence. "Foreign direct investment" was defined by the AG as:

"investments made by natural or legal persons of a third state in the EU and investments made by EU natural or legal persons in a third state which serve to establish or maintain lasting and direct links, in the form of effective participation in the company's management and control, between the person providing the investment and the company to which that investment is made available."

The AG then concluded that Section A of Chapter 9, in so far as it applies to types of investment other than foreign direct investment (referred to in the case as “portfolio investment”) was not an area of exclusive competence either as part of the common commercial policy or because it affects common EU rules.

Section B of Chapter 9 was considered alongside a number of other provisions of the EUSFTA also concerning dispute resolution and mediation. The AG concluded that the competence of the EU in relation to these provisions was dependant on whether the EU enjoys exclusive external competence or shared competence in relation to the associated provisions under which the dispute arises. In so far as the dispute arises from a part of the EUSFTA for which the European Union enjoys exclusive external competence, the EU shall enjoy exclusive competence over the ancillary dispute mechanism, and vice versa. In this instance therefore, the EU would enjoy exclusive competence for any dispute arising in relation to foreign direct investment. It would have shared competence for a dispute arising in respect of any other investment.

It is also worth noting that the AG considered whether the EU could succeed to an international agreement concluded between a Member State and a third country, and terminate such agreement. The EUSFTA purported to terminate a number of bilateral investment agreements concluded between EU Member States and Singapore on its entry into force. This was rejected on the basis that such a rule would be an exception to the fundamental rule of consent in international law-making. The Opinion makes clear that the right to terminate bilateral investment agreement concluded between Member States and third countries is a matter exclusively reserved for the Member States.

Although the Opinion is not binding, it is a persuasive reference that indicates that the EU will be able to negotiate the provisions of the FTA relating to cross-border trade in financial services, foreign direct investment and any ancillary disputes on an exclusive basis, without the need to obtain the approval of each of the member states (and their regional parliaments, as applicable), which would significantly delay negotiation and finalisation of the FTA.

In contrast, other “portfolio” investments and related dispute mechanisms are likely to fall within the shared competencies of the EU and Member States and must therefore be agreed to by the individual Member States in accordance with their domestic requirements, which include reference to national parliaments. The UK government may need to balance the interest in having portfolio investment included in an FTA with the EU against the interest in a quicker and more straightforward process to conclude it under EU exclusive competence.

Interim measures

Ideally the new partnership would be negotiated, agreed and brought into effect in time for the expiry of the notice given by the UK under Article 50. There has been discussion of ways to maintain continuity and avoid lead time risk via ‘prolongation’, ‘standstill’, ‘grandfathering’, ‘transitional arrangements’, ‘interim measures’ and ‘phased implementation’.

These terms are sometimes used inter-changeably but it is not clear exactly what each is understood to mean. **‘Prolongation’** refers to the possibility of delaying the Brexit implementation date beyond the 2 year notice period under Article 50. **‘Standstill’** is a technical term used in finance and under WTO rules but neither of those uses is relevant here. It seems to suggest a form of prolongation.

‘Grandfathering’ – might be understood to be the same as standstill but normally it has a more precise meaning. Grandfathering is term familiar to regulatory lawyers; it refers to provisions which ‘grandfather’ existing firms or individuals into a new regulatory system. An existing firm may be excused applying for a new form of authorisation or may be given additional time to do so via provisional authorisation. New requirements for individuals to pass examinations may involve ‘grandfathering’ individuals who have been in those roles for some years and are exempted from the new requirements (permanently or for a transitional period). In the context of Brexit, this technique could be applied, for example, to existing FS firms with single market licences. They could be ‘grandfathered’ at Brexit. For example German banks with a London branch could be automatically granted provisional authorisation under the UK domestic regime (without having to complete the normal application processes) and vice versa in relation to UK firms with branches in the EU. Currently it would be impossible for these banks to obtain a local licence in advance of Brexit (as this would conflict with the single market legislation). This technique would assist the position of existing firms but would not maintain the full EU regime post Brexit. It is also possible that grandfathering could be applied in the context of UK nationals living in other EU countries and vice versa i.e. they might be given grandfathered rights to remain without having to apply for a visa.

‘Transitional arrangements’ is another term used to describe a solution to the lead time/cliff edge problem, most recently by Michel Barnier. This is a term which is normally used to describe legal measures to facilitate the introduction of new laws – such as grandfathering or phased implementation. “Transitional” could be

thought to suggest arrangements that could be in place for a significant duration, which could deter third country trading partners from pursuing FTAs (though Barnier indicated their duration would be “strictly limited”). The government seems to prefer the term ‘interim measures’ and has referred to an implementation phase. ‘Interim measures’ is WTO terminology for measures that precede an FTA.

It has also been suggested that given the complexity of negotiating the new arrangement, it might be advisable for the UK to remain in the single market at Brexit (as an EEA member) as a transitional stage or stepping stone. In principle, a more attractive alternative would be to agree, at an early stage, a standstill whereby following Brexit the full single market regime, or at least the full FS sectoral package, remain in place for a period to allow time for the completion of the detailed negotiation of the new partnership and the completion of the legal processes (such as member state ratification if required) to bring this into effect on a permanent and secure basis. For this period the UK might not only maintain the existing EU acquis but might also commit to adopt new EU requirements and respect the guidelines of the ESAs (but perhaps not the direct exercise of the ESA’s emergency powers) and the interpretative rulings of the CJEU (although perhaps not the direct jurisdiction of the court).

It is important that early harvest measures can be agreed in advance of a comprehensive FTA with the kinds of provisions discussed in this paper. Such an early harvest would give comfort to financial institutions who are currently in the early stages of contingency planning.

Early agreement of a legal road map, timeline and key principles for Brexit is important for both private and public sectors in all EU states

There are challenges in the legal construction of Brexit and the timeline. Both sides would benefit from early consensus on a legal road map for Brexit which provides assurance for individuals and firms in the UK and the rest of the EU (and for their government departments and the EU institutions themselves) that change will be managed to ensure they are given sufficient lead times to adapt. Agreeing the structure of the Brexit package and the negotiation process, timeline and dependencies is important to reduce legal and negotiation risk.

Early agreement on sufficient lead times is critical

The FS industry has indicated the need for a 2/3 year period for adjustment to the new regime (once this is finally settled and the implications understood).²¹¹ Until the position on expiry of Article 50 notice is known, as that date gets closer, uncertainty increases and FS firms/infrastructure providers (both UK and in the rest of the EU/EEA) must move further in implementing their contingency planning. It is therefore critical for all concerned to know how that they can plan on the basis of sufficient lead times for any changes. Agreement on this issue needs to emerge at an early stage in the negotiations.

Brexit may take effect in one big bang where current single market DRC is switched off and the new DRC is switched on at the same time or in a two-step process with a period of interim DRC arrangements after single market DRC is switched off and then a later switch to the final DRC regime. In either case, the lead times would need to run from the point when FS firms could understand with sufficient certainty the changes involved at the next/each stage. Currently firms have to plan for a change in DRC at expiry of the Article 50 notice (i.e. at about 31/3/19).

The roadmap needs to address a variety of negotiation risks including the risks (of delay or failure) in member state ratification. Failure to secure ratification of an FTA normally results in the status quo continuing (or reverting to the prior position before provisional application of the FTA), but the dynamic is different with Brexit because the agreement is to replace current arrangements, such as single market DRC, which will terminate at Brexit.

Various techniques are available to ensure acceptable lead times for FS firms/infrastructure

It may be that there is a ‘big bang’ moment when withdrawal terms and a comprehensive agreement for the future EU/UK relationship (having been agreed and ratified) all come into effect together on the date when the

²¹¹ See the evidence before the Treasury Select Committee [here](#) and the TSC Chair’s summary [here](#) (regarding the ‘three year standstill’ at the end of the Article 50 period).

UK leaves the EU (either in 2019 or at some later date following prolongation).

There are, however, various scenarios where for one reason or another this big bang synchronised moment does not happen and the Brexit process is implemented in two (or more) stages. Planning has to take account of this possibility (however desirable the big bang approach may or may not be).

In order to avoid a change of DRC at the expiry of the Article 50 notice, it would be necessary to maintain single market DRC in operation by one or more of various techniques. These include standstill/stop the clock e.g. via prolongation of full EU membership or of EEA²¹² membership or some other mechanism to maintain single market DRC (sometimes referred to as 'standstill' or 'grandfathering' – see below - of the single market regime). Here the necessary lead time confirmation is early confirmation that there will not be any change to DRC at expiry of the Article 50 notice. There is also the possibility of staged changes to DRC, but here sufficient lead time involves sufficient notice both of the date of the change to DRC and the details of the new DRC arrangements that will apply.

Transitional arrangements must include DRC but market access could revert to WTO terms/schedules

If Brexit occurs in stages, the market access and national treatment commitments of the EU under its WTO schedules, and the actual state of openness in EU and member state law, could provide a viable default position for market access during any interim or transitional period. This would not, however, assist with DRC. Any transitional arrangements must address DRC and the lead time issues above.

There may be advantages in having a separate DRC/FS agreement at this stage. The recent Advocate General's opinion in the Singapore case, if followed by the court, may offer some assistance in that it finds that financial services is an area where the EU has exclusive competence and measures can be agreed without the need for member state ratification which applies to 'mixed agreements' (which causes delay and implementation risks as seen recently with CETA).

There are a variety of legal orders for (interim) DRC – from accord type arrangements at a regulator to regulator level to an international treaty. It will be even more difficult to establish a new legal and institutional order in time for interim DRC arrangements. Interim DRC arrangements would be compliant with WTO rules by either being open to other countries to negotiate their accession to them if they also have equivalent regulation, oversight, implementation of regulation and procedures for the sharing of information, or by forming part of an overall arrangement with "substantial sectoral coverage"²¹³.

During any interim period, it seems sensible for the UK to consider some greater degree of continuation of/participation in the EU FS regime in terms of some or all of –

- Continuation of current EU harmonisation/rules as at Brexit
- Adaption and evolution of these rules in line with post-Brexit development by ESAs, CJEU etc.
- Adoption of new EU FS legislation – within certain parameters. Divergence would therefore only arise in the interim period in respect of new EU legislation and even then only if that legislation strayed beyond these parameters (e.g. discriminatory or not consistent with previous single market principles etc.). Given the lead times for the adoption and implementation on new legislation, the UK will be familiar with the likely pipeline during the interim period
- Continued ESA cooperation if necessary via new legal basis
- Arrangements to maintain/replicate ESAs' central role re specialist firm regulation and emergency powers and CJEU

Further work is being undertaken by the TSC inquiry on transitional arrangements²¹⁴ and it is hoped that this will evaluate the international law mechanics and institutional arrangements for any interim measures.

'Grandfathering' may assist but is not the same as full DRC

Grandfathering could be applied to FS firms (as it could to residency rights of individuals); i.e. all FS firms currently operating pursuant to passport notifications into/out of the UK would be 'grandfathered' in the host state and would not need to seek local host state authorisation at Brexit (i.e. the single licence which they are currently relying on would not be lost and they would have more time to apply for any host state authorisations

²¹² EFTA membership would not impact the relationship with the EU and is not services focused.

²¹³ As required by Article V GATS

²¹⁴ See HoC transitional inquiry [here](#) and below re FMLC work on transitionals and WTO/GATS.

they would require under the new regime). Grandfathering in this way would differentiate between firms - only existing firms would be covered and only to the extent that they are currently 'passporting'. This is different from, and more limited than, any interim measures which seek to maintain the single market DRC itself (which would cover new firms/passporting etc.). It seems that most discussion of grandfathering has envisaged the maintenance of the full DRC regime. There may be an additional need for grandfathering of firms in some limited circumstances.

8. Looking beyond the EU

There are a large number, and a wide variety, of (unilateral, bilateral, plurilateral and multi-lateral) cross-border arrangements involving countries around the world which currently assist UK FS firms in relation to those foreign jurisdictions and which regulate the UK treatment of firms from those countries. At Brexit the UK will leave the EU and the single market. At that point, the change in the UK's status may undermine many of these arrangements. These are, we assume, undergoing review by the relevant UK government departments and regulators, to see if they are at risk and whether it is necessary or appropriate to seek to maintain, grandfather or replace these arrangements. The loss of such arrangements might prejudice UK firms under foreign regulatory regimes and visa versa.

There are a range of arrangements which stand to be lost/cease to apply in relation to the UK at Brexit:

Issues for UK/EU – at EU level - The loss of internal EU/EEA DRC within the single market has already been considered in Chapters 3 and 6. The UK's position under the EU's third country treatment and under WTO schedules is considered in Chapter 9.

Issues for UK/member states of EU at national level - This aspect is considered in Chapters 6 and 9.

Issues for UK/non-EEA countries

To complete the list, one must also consider the position in relation cross-border activity between the UK and non-EU/EEA countries (see examples in Chapters 2, 3, 5 and 6 above).

WTO schedules. There has been much discussion about the need for the UK to rectify its WTO schedules. In the FS field WTO rectification is a reasonably straight forward process (see Chapter 2 above). In FS, however, the issue may be less important because market access obligations are limited (and provide no real DRC).

EU negotiated FTAs. In theory, the position under each of these FTAs would need to be analysed agreement by agreement to determine whether the FS related market access provisions provide any material benefits for UK firms over WTO schedules, with a view to trying to get these grandfathered across in time for Brexit. In practice, however, these are almost certainly limited to market access provisions which add little to WTO schedules in FS and in any event their loss would be unlikely to trigger new DR barriers.

More importantly, UK firms may benefit from DRC measures under the domestic regulatory regime of many third countries around the world (as third countries may benefit from UK DRC measures). When the UK ceases to be an EU member at Brexit, this may prejudice the ability of UK firms to take advantage of DRC if it is based on EU membership/applicable to EU states.

The UK and Switzerland currently operates reciprocal dual regulation coordination for non-life insurer branches under the 1989 EU/Switzerland treaty. This will cease to apply at Brexit unless the Swiss and UK agree a separate arrangement or a tripartite agreement is reached between the EU, Switzerland and the UK.

Some third countries have arrangements with the EU outside fully blown treaties/FTAs whereby EU equivalence treatment and associated DRC have been granted on a reciprocal basis. For example the 2016 accord between the European Commission and the CFTC in the USA (see the sub-section above on 'dual-registered with substituted compliance of certain rules'). The UK will need to obtain US comparability to enable UK CCPs to register, or maintain their registration, in the US on the current basis (in addition to the issue of the status of UK CCPs under EMIR in the EU (see Chapter 9)).

The UK will need to identify all the DRC arrangements involving non-EEA countries that UK firms and infrastructure currently benefit from and determine whether these are available as a result of /depend upon the UK's membership of the EU or might otherwise be at risk at Brexit. These DRC measures may take many different forms from treaties and accords to more informal regulator to regulator arrangements or even unilateral determinations. Where necessary new arrangements will need to be put in place on a bilateral basis before Brexit.

Where there are mutual EU/third country arrangements, the UK may well need to replicate/guarantee the DRC/access provided by the EU (if the UK decides not to port across the EU's external third country treatment regime - see Chapter 6 above). There are about 118 formal EU decisions relating to third country measures (see annex J).

The UK will need to identify all DRC measures which UK infra-structure/firms currently

enjoy under the regulatory regimes of all non-EEA countries and take steps to ensure these are maintained at Brexit

The UK will rectify its WTO schedules for Brexit and is considering the EU negotiated FTAs under which the UK currently operates. In the FS sector, however, DRC measures under the regulatory regimes of third countries are a more immediate priority. The UK will need to identify all DRC measures which UK firms currently enjoy under the regulatory regimes of all non-EEA countries. In many cases these arrangements may have been made at an EU level and/or are based on the UK's membership of the EU and may therefore be at risk at Brexit.

These range from critical infra-structure DRC, such as DRC for central counterparties with countries such as Australia, Japan and the US (see above), to less formal arrangements/policies. The full transposition of the EU acquis should assist in gaining any necessary bilateral agreement with the countries concerned.

A DRC agreement between Switzerland and the UK?

At Brexit, there will be a high degree of regulatory homogeneity between the UK and Switzerland (due to Switzerland having extensively followed EU FS legislation). Various DRC arrangements that currently operate between the 2 countries will need to be reorganised for Brexit (see above).

There is therefore scope for the UK and Switzerland reviewing current DRC arrangements and considering a bilateral DRC agreement which might enhance and not merely maintain current DRC.

Further bilateral agreements?

The UK is scoping potential trade agreements with a number of countries around the world. For the purposes of FS, the key early negotiations will be with the US and Singapore (as well as Switzerland). The UK may wish to consider the possibility of further bilateral DRC agreements as part of these FTAs and with other well developed, modern and open regulatory regimes, such as those found in Australia, New Zealand and other countries.

A plurilateral arrangement for dual regulation coordination across a new 'FS zone'?

Eventually it is conceivable that this might evolve as a plurilateral arrangement, for example, amongst countries that may wish to form a Prosperity Zone of like-minded countries focussed on core principles such as protection of property rights and competition on the merits as an organising economic principle²¹⁵.

The UK should explore a DRC agreement with Switzerland which goes beyond maintaining current DRC (and potentially agreements with a broader FS/prosperity zone)

The UK will need to consider its policy on the EU DRC arrangements with third countries and whether to maintain these e.g. via new arrangements – for example the treatment of Swiss insurer branches under the 1989 Swiss/EU agreement and the treatment of US CCPs under the 2016 accord. There is high degree of regulatory homogeneity between the UK and Switzerland. The UK should explore a bilateral DRC agreement with Switzerland that enhances, and not merely maintains current DRC.

The UK can also consider (perhaps as part of its initial scoping of future FTAs) bilateral DRC agreements with the US and other countries with well developed, modern and open regulatory regimes, such as those found in Australia, New Zealand and other countries that may wish to form a 'Prosperity Zone'. Ultimately this might even form a plurilateral FS zone.

²¹⁵As proposed in *Trade Tools for the 21st Century*, Shanker A Singham and A Molly Kiniry, 2016

We recommend a new framework under FSMA for external relations and DRC

The UK has no single and comprehensive statutory basis for DRC arrangements with countries outside the EEA²¹⁶, and some policy aspects fall to PRA and FCA. (For EEA countries, the UK currently deals with the single market DRC under the ECA 1973, various statutory instruments and within the PRA/FCA rulebooks).

We recommend that the UK consider putting DRC and external regulatory policy (which currently hangs off the EU level policy and legal arrangements where these exist) on a more formal/comprehensive statutory basis under the FSMA umbrella. This would be the domestic basis for concluding and implementing DRC agreements. Individual DRC measures would be implemented at the relevant level in the FSMA hierarchy – i.e. statutory instruments and/or at the level of PRA/FCA (via rulebook provisions, policy statements and the day to day operation of the DRC regime). This regime could be used for DRC agreements with the EU and with individual EU/EEA states, as well as with countries outside the EEA.

Once outside the EU/EEA, the UK could establish new criteria and a modern policy for DRC. This would replace the piecemeal policy (part EU and part domestic) that currently applies. DRC would be on a reciprocal basis and could, in principle, be open²¹⁷ to any country which satisfied criteria as to market access (in WTO/FTA terms), competition (and the absence of state aid, market distortions etc.), sufficiency of home state regulation, observance of international standards on tax/money laundering, and the various practical and legal elements for regulatory cooperation. The criteria for 'sufficiency of home state regulation' could reflect the principles described above in Chapter 6. In practice, only those countries with well-developed regulatory regimes would be eligible for extensive DRC and considerable discretion would need to be retained.

²¹⁶ See, for example, FSMA 2000 sections 272-283 re recognised overseas schemes and section 292 re overseas investment exchanges and clearing houses.

²¹⁷ This may assist with GATS compliance.

9. Brexit outcomes without the comprehensive partnership

The possibility of failure. The Prime Minister recognised the possibility that the negotiations with the EU might fail to deliver the partnership she envisages. Indeed it is possible, at least in theory, that the EU/UK negotiations fail completely and no agreement is in effect at Brexit - for the FS sector, this would mean no agreement on substantive DRC and no phased implementation of a new regime. This is the worst-case scenario that EU/EEA and UK financial institutions are currently using for their contingency planning.

In that event, all 28 states would need to ensure they observed the market access obligations (in terms of UK access to EU states and EU access to the UK) of their respective WTO schedules (see Chapter which explains the limited impact these have on DRC). It is wrongly assumed that because the EU negotiates for member states, member states have the same obligations under WTO schedules and under FTAs negotiated by the EU (such as CETA). In fact there are numerous individual reservations and exceptions for each country in relation to financial services commitments. Although the UK has few national exceptions, most member states have many differing national reservations. Some of these provide for measures which are surprisingly protectionist for a European country - such as nationality requirements for a local branch/establishment and quantitative or economic limits in the banking sector.

Subject to these limited provisions, each side would, in theory, address DRC on a unilateral basis under its own procedures and according to its own timetable. On the EU side, this would be a mix of EU level and national member state level procedures. UK firms would need to obtain beneficial TCF treatment available under EU provisions and under national procedures. The EU would be able to conduct equivalence reviews for areas of harmonised treatment of TCFs which depend on equivalence (see Chapter 3 “EU derived rules for third country firms that are dependent on equivalence of home state regulation”) and member states would follow their own processes for domestic assessment in un-harmonised areas (see some examples in Chapter 4). Currently the UK will have no status as these provisions do not apply to an EU/EEA state.

Similarly the UK would need to review its current foreign/third country DRC policy in relation to its new relationship with EU/EEA states. For example, PRA will need to decide whether it can rely upon home state supervision and other criteria under its policy on authorisation of UK branches of foreign banks and insurers (and in the latter case it may not have ported across the EU requirements it currently follows in relation to TCFs (see Chapter 4 and Annex B for details).

In practice, however, PRA, FCA, the EU ESAs, ECB and national regulators/supervisors in each EU state would still need to find ways to cooperate over the regulation and the supervision of cross-border supply.

Without an agreement, there would be a patchwork of differing national practices and DR barriers

The extreme scenario is explained above. The DR barriers that firms would face would depend in large part on the differing laws and practices of individual states. EU standardisation in this field is limited in scope. Some DRC elements would depend on unilateral action by both the EU and by national regulators.

‘Trading on WTO terms’

There has been much debate about the possibility of the EU and UK ‘trading on WTO terms’ if no agreement is in effect at Brexit. In financial services this is misleading as existing WTO/GATS terms for financial services are very limited (see Chapter 2 above). The market access obligations agreed in the Uruguay round for FS are limited and provide no real DRC at all. In this scenario, ‘WTO terms’ would not prevent the EU states from re-imposing extensive DR and DR barriers for UK firms (and vice versa).

More substantive (albeit limited) relief from DR barriers would potentially be available via local member state DRC under domestic regulatory regimes for third country firms and under the EU harmonised regimes.

The idea of ‘trading on WTO terms’ in FS is a misnomer; the terms have no material impact on dual regulation

The idea of trading on WTO terms in FS is a misnomer; market access obligations for FS are of limited use because they provide no real DRC at all. 'WTO terms' would not prevent UK or EU states from re-imposing extensive dual regulation and DR barriers.

What would this mean at Brexit?

Even in this scenario, there would be many variables, so one cannot be certain how it would play out. In very high-level terms, some of the key points for existing firms by each mode of supply are –

Cross-border services and consumption abroad (modes 1 and 2)

UK firms will be able to continue to deal with clients/counterparties in an EEA state to the extent this falls outside the local regulatory perimeter rules (which vary from country to country but may include, for example, reverse solicitation). Otherwise cross-border supply will in many scenarios be prohibited because authorisation is required but not available without coming 'on-shore' under mode 3 (some domestic DRC arrangements, such as systems for registration for services business, are designed to mitigate this impact and may be available).

In theory UK credit institutions and investment firms might be able to take advantage of the third country cross border services passport for professional clients and eligible counterparties investment business under MiFIR, but this would depend on an early finding of UK equivalence by the European Commission and special arrangements for early registration of UK firms. There are other equivalence based provisions (see the list in Chapter 3 under 'EU derived rules for third country firms that are dependent on 'equivalence' of home state regulation'). However, some of these are not yet operative and in order for UK firms to exercise the rights under these provisions there would need to be a unilateral equivalence finding or transitional arrangement. Moreover, there is no provision in EU FS legislation that affords a passport for banks, insurers, insurance intermediaries/brokers, or investment firms (other than as above).

Some services will be able to rely on specific commitments under the GATS, for example some states, such as Belgium, would permit provision of reinsurance and the relevant classes of commercial insurance.

Establishment – branch (mode 3)

UK firms would lose their single licence at Brexit and would become 'unauthorised' entities in the local jurisdiction at Brexit. Local authorisation of the branch would depend on local assessment of UK home state regulation/supervision and the necessary arrangements with UK regulators etc. for information exchange etc. This might not be in place in time for Brexit unless special arrangements were made – current EU single market law prevents host state authorisation and UK firms could not therefore apply for that status until after they had ceased to be EU firms. EEA states might introduce some system to allow firms to migrate to local authorisation (e.g. some form of grandfathering and/or special rules to allow a UK firm to apply pre-Brexit). If such arrangements were made UK firms might be able to get branches authorised pre-Brexit in EU states which adopt the article Art 39 MiFID II regime (to prohibit mode 1 supply to retail clients) and thereby enjoy the cross border services passport for professional clients and eligible counterparties business.

See also the (defunct) US-Japan agreement in Chapter 5 'International DRC fora and bilateral arrangements'.

Establishment – local subsidiary (mode 3)

These would remain authorised as EU/EEA firms with a single licence. The impacts would relate to issues such as consolidated supervision.

DRC in other areas

New DR barriers would also arise as a result of the loss of DRC in the other areas considered in chapter 4).

The position of EU/EEA firms in relation to the UK would be broadly similar. If unchanged, they could take advantage of the UK's overseas persons exemption. This probably already provides similar scope to the MiFIR passport above (but extends beyond investment business to include, for example, insurance mediation). If the EU had taken steps to make the MiFIR passport available, it would be on terms that the UK offered a similar facility.

The UK has traditionally been relatively open to cross-border business by TCFs under all modes of supply, with relatively low behind the border barriers – both market access and DR barriers. This is consistent with the City of London’s position as an international financial centre. Even if the EU/UK negotiations were to fail to achieve extensive DRC, the UK should seek to maintain its open policy and pursue DRC and related international standards with other states (as explained in Chapter 8).

EEA states operate extensive single market DRC internally; firms/infrastructure operating across the EEA/UK will face substantial new DR barriers at Brexit

The single market ‘passport’ is a package of, mainly prudential, DRC to create a ‘single licence’ for firms from any of the 31 EEA states which is valid for the entire EEA; this now covers most FS infrastructure and sectors/activities. It is based on harmonisation (on a minimum or maximum basis) of applicable rules. The package has many elements, but it is possible to have ‘passports’ with less DRC (as well as reduced scope). Some passporting was originally introduced with less DRC. The single market also has **important DRC in many areas other than ‘passporting’**.

At Brexit the UK will become a ‘third country’ under the EU regime and UK firms/infra-structure will lose this single market DRC and face new DR barriers in relation to their EEA business; EEA firms would lose the DRC in relation to their UK business. The loss of single market DRC will also be a new DR barrier to pan-European ‘hubbing’ (most especially out of the UK).

If one considers the most extreme scenario where EU level DRC was not replicated at all (by any of the states - via agreement or equivalence findings etc.) – then cross border supply (mode 1) which is currently free and frictionless will become completely prohibited in many scenarios, particularly for supply into countries such as France. In these cases, suppliers will have to move-onshore (i.e. switch to mode 3) and use a local subsidiary (or a branch, where permitted) and obtain local authorisation. Those operating via branches under mode 3 may be able to switch to dual authorisation status (which is much less efficient than the single licence) but in some cases will have to establish a free-standing local bank/insurer/subsidiary (which is likely to involve even greater cost). Critical UK based international infrastructure would also be impacted.

EU/EEA groups would face similar barriers but would (on the basis of the current UK treatment of foreign/TC firms) benefit from a more open approach – compared to say France – e.g. for modes 1, 2 and 3 (for branches)). UK/TC groups may switch business from single licence supply from UK entities to an EEA subsidiary and then use its single licence as a hub across EEA states.

Operations would also be impacted by **a loss of DRC in other areas** e.g. where firms would be prohibited from using foreign services (e.g. benchmarks) or would suffer adverse capital treatment and other areas where operations would face increased barriers/costs from a loss of DRC. A number of structures which firms adopt to address DR barriers (such as fronting/bridging, back to back transactions, outsourcing and delegation) may be impacted by a loss of DRC.

TCFs (such as firms from Switzerland) face high DR barriers to EU/EEA business and enjoy very limited DRC (when compared to single market participants)

Without EEA membership, Swiss firms face high DR barriers to EU/EEA business and DRC is limited.

DR barriers and available DRC vary considerably from one EU/EEA country to the next - a complex mix mostly of national rules but also involving international arrangements and EU measures

DRC available to Swiss firms is a complex mix of national member state DRC, a bilateral Swiss/German accord on UCITS, a bilateral 1989 EU/Swiss Treaty on direct non-life insurance branches and EU level harmonisation of external treatment/TCFs (Switzerland follows a large proportion of EU FS legislation and gains available EU equivalence based DRC) some of which reflects international arrangements. Swiss firms therefore take advantage of DRC available to any third country, DRC that is available to third countries that are ‘equivalent’ (under both EU level and individual member state national DRC arrangements) and some ‘Swiss only’ DRC under 2 bilateral treaties/accords – one with the EU and the other with one individual member state, Germany.

There are a mix of DRC channels and structures; there are a variety of international arrangements (plurilateral and bilateral) – as well as WTO style market access, there are formal international treaties on DRC (see the 1989 insurance treaty above) and less formal DRC accords, sometimes at a regulator level (see the 2016 accord below). There are EU TC DRC measures (e.g. ‘equivalence’ based DRC and some other areas of

harmonisation which may increase DR barriers) and national level DRC arrangements (see below). The latter often operate at a regulator level and on the basis of regulator to regulator arrangements.

Both the DR barriers (including local 'perimeter rules') and the available DRC vary extensively from one EU/EEA state to the next. Some EEA states are more protectionist, such as France; others are relatively more open, such as Ireland (and indeed the UK). Some have systems for registration/authorisation for cross-border service supply; some have exemptions, whilst others seek to require suppliers to come on-shore to obtain local authorisation.

Mapping by CMS of the DR barriers and available DRC for TCFs across the EU/EEA shows the extensive variances from one EU country to the next and the complexity for TCFs doing business with the EU/EEA. For UK firms trying to assess this matrix and the potential DR barriers that they will face at Brexit, two key ingredients are unknown – the extent of bilateral DRC to be agreed (i) between the UK and EU and (ii) between individual member states and the UK. There is also uncertainty as to how EEA states' domestic level DRC policy will be applied to the UK (and vice versa) and whether EU equivalence based DRC (under current EU legislation) will be available at Brexit. Some of this is 'passport-type' DRC, and some is DRC in other areas. These apply only to a limited FS scope and with limited DRC; the passport DRC elements are limited in scope and depth.

EU legislation gives various powers in relation to bilateral accords – for example the Swiss/EU treaty above and the 2016 European Commission/CFTC accord on central counterparty regulation. The latter arose under the auspices of the G20/FSB and was implemented by equivalence findings by the EU under EMIR and comparability findings by the US under Dodd-Frank respectively. Existing powers are, however, limited in scope.

CMS Legatum matrix for plotting cross-border requirements, DR barriers and DRC

CMS has undertaken many projects plotting cross-border regulatory requirements for a broad range of FS firms, sectors and countries. These include TC firms doing business in/across the EU/EEA, operations within the single market and supply into countries outside Europe. In preparation for Brexit, we are using these techniques and the analysis from our report to develop a CMS Legatum matrix. This can be used to plot the position under each of the WTO modes of supply 1, 2 and 3 - for UK firms conducting business with any of the 30 EEA states (country by country) and for EEA firms conducting business with the UK. It enables plotting of all requirements (EU derived and domestic) and the DR barriers that result, the current DRC arrangements, and the impact of DRC withdrawal at Brexit and of proposed/agreed DRC measures including WTO/FTA obligations.

10. Evolution of the UK regulatory regime

Medium term objectives

We suggest the objectives for the UK in terms of the policy perspectives identified at the end of Chapter 1 should be:

- Effective domestic regulation – in terms of market/consumer protection and financial stability;
- Pro-competitive regulation;
- Maintaining an open approach to foreign participation via market access and mutual DRC - with the EU (See Chapter 6 and 7) and with other well regulated economies (see Chapter 8) - and by the development of international DRC standards (see Chapter 8).

Competition and FS

Background

In the post-war period in the UK, financial services, like banking and insurance, were seen as being at the junction of the public and private sectors. They operated in close cooperation with government and state institutions and were not subject to normal UK competition rules. Gradually these exemptions were withdrawn and FS regulatory requirements were subject to review by the competition authorities to ensure they were not more restrictive than was necessary.

FSMA 2000 gave the newly formed FSA statutory objectives, and then secondary factors to consider including the need to avoid or mitigate adverse effects on competition (as well as promoting UK competitiveness and ensuring the burden of regulation was proportionate to the benefits).

When regulation was re-organised after the financial crisis, the role of competition had advanced further and was much debated. FCA was given extensive new competition powers and objectives, reflecting the close connection between regulation and competition and the desire for a pro-competitive FS regulator and rulebook. The competition objective was also extended (in a different form) to the PRA.

Considerable resource has been committed to these new competition roles and objectives²¹⁸, particularly at FCA²¹⁹. One of the FCA's operational objectives is to promote effective competition²²⁰ in the interests of consumers and it has concurrent powers with the Competition and Markets Authority (CMA)²²¹. The FCA is required to publish estimates of both costs and benefits when consulting on proposed interventions (where possible and reasonably practicable) as is the PRA²²². The FSA, FCA's predecessor, did not have this competition objective.

In practice, the UK approach to competition assessment is a hybrid system (with multiple regulators involved²²³). For example, the UK's retail banking market and matters such as ring-fencing highlighted the issues of boundaries for UK regulators - the CMA and PRA were both considering the impacts of action in this area on competition (see CMA final report on retail banking market above and PRA [evaluation report](#)²²⁴). The

²¹⁸ The FCA approaches considerations of competition analysis through the lens of consumer detriment and impact on market outcomes/participants. [FCA Occasional Paper 13](#) (March 2016) *Economics for effective regulation (EFER)* explains the new approach "to economic analysis of financial services, which has been developed to support the FCA's efforts in ensuring that financial services markets work well for consumers." EFER has been designed "to support market-based regulatory analysis for competition and strategy, as well as **complex instances of rule making**".

²¹⁹ See for example, our seminar slides on the FCA [here](#) and the FCA competition law page [here](#).

²²⁰ See [FCA Objectives Guidance](#) and [FCA competition powers page](#)

²²¹ Since 1 April 2015, legal basis of the competition powers is Competition Act 1998 and Enterprise Act 2002. See also FCA FG15/8 [The FCA's concurrent competition enforcement powers for the provision of financial services: a guide to the FCA's powers and procedures under the Competition Act 1998](#) and FG15/9 [Market studies and market investigation references: a guide to the FCA's powers and procedures](#)

²²² Articles 138I-J FSMA 2000.

²²³ The Payment Systems Regulator also holds [concurrent competition powers](#) with the CMA. The PSR's roles, responsibilities and powers were established by the Financial Services (Banking Reform) Act 2013.

²²⁴ Pages 53ff in the PRA report.

CMA made 'strong observations about prudential regulation but didn't go further'²²⁵. The PRA has a secondary responsibility to consider the effects on competition of its regulatory practice, but its primary responsibility is to ensure the stability of the UK financial system. The ring-fencing reform highlighted the tensions between the PRA's objectives and the CMA.

Scrutiny of regulatory requirements

This FSMA framework is interconnected with the Enterprise Act 2002. Under section 7 of the Enterprise Act 2002 the CMA's function²²⁶ is to make proposals, or give other information or advice, regarding the potential effect of a proposal for Westminster legislation on competition within any market or markets in the United Kingdom for goods or services.

FSMA sections 140A-H and 141A provides the framework for competition scrutiny and powers to make consequential amendments. The CMA²²⁷²²⁸ can give 's.140B advice' to the FS regulators in accordance with s. 7 or s.136 Enterprise Act 2002. This advice would be based on CMA's opinion that e.g. the regulating practice of one/more regulators²²⁹ may cause, or contribute to, the effect mentioned e.g. prevention, restriction or distortion of competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom. When giving this advice to a regulator, the CMA must publish the advice in such a manner as it thinks fit.²³⁰ Before giving s.140B advice, the CMA must consult with the regulator to which the advice is to be given.²³¹

A few years after it came into effect, the OFT examined the effects of FSMA 2000 on competition in financial markets²³² (see [OFT report \(2004\)](#)). While the report concluded that there were no areas where FSMA had a negative impact on competition, it acknowledged that the behaviour of firms is largely influenced by FSA rules. The scope of the OFT report did not extend to indirect influence via FSA rules or impact of FSMA rules on international competitiveness²³³. See sections 6.10 – 6.17 of the OFT report for further details.

The opportunity for competition based review and pro-competitive regulation

At Brexit, the UK regulatory regime will comprise (i) extensive EU derived rules – including all the rules by which virtually all international standards will be implemented in the UK. This will all have been 'ported' onto a domestic law basis without change; (ii) the pre-existing FSMA umbrella regime; and (iii) various PRA and FCA rules of domestic origin. This corpus of regulation will not have been subject to any previous broad based/comprehensive review against effective UK based criteria for effective pro-competitive regulation.

²²⁵ <https://www.gov.uk/government/speeches/aldasair-smith-on-the-expected-impact-of-the-cmas-banking-investigation>

²²⁶ See s. 7 Enterprise Act 2002

²²⁷ The CMA may also make reference for a market investigation to determine whether any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom²²⁷.

²²⁸ One example of the CMA exercising its powers under the competition scrutiny legislative framework was the [market study investigation](#) in the retail banking market. The statutory basis for the investigation was sections 131 and 133 Enterprise Act 2002. The investigation concerned the supply of retail banking services to personal current account customers and to small and medium-sized enterprises in the UK. The report contained recommendations for a number of bodies, including the FCA.²²⁸ The FCA [published a response](#)²²⁸ to the CMA report in November 2016, which outlined the FCA's next steps.

²²⁹ See s.140B (4) and (5) FSMA 2000

²³⁰ s.140E FSMA 2000.

²³¹ s. 140C FSMA 2000

²³² In 2003 HM Treasury announced a two-year review of FSMA 2000 – this led, among others things, to the OFT review and report. (OFT (2003), 'OFT Role in Review of FSMA', PN 142/03, November 4th.)

²³³ OFT report (2004) on the effects of FSMA on competition:

The service markets covered by FSMA were divided into 4 categories

- A: competition and market failure indicators are above a critical threshold (the markets are highly concentrated, there are significant barriers to entry and there is evidence of market failure).
- B: markets are unconcentrated with low barriers to entry, but where there are significant market failures.
- C: markets are concentrated and characterised by entry barriers but market failures are relatively limited.
- D: market is unconcentrated and there are no market failures.

With regard to A-C, these questions were considered:

- Whether FSMA unduly distorts the competitive structure
- Whether FSMA unduly reduces the dimensions of competition
- Whether FSMA facilitates market functioning

The report concluded that there are no areas where FSMA itself might have, or have had, a significant adverse impact on competition. Regarding whether FSMA has affected the dimensions of competition, "FSMA sets out only a general regulatory framework for financial services. This means that the behaviour of firms is largely influenced by specific FSA rules rather than by the FSMA itself." Indirect influence via the affect of FSA rules was outwith the scope of this report. The report also did not consider the impact of FSMA rules on international competitiveness by imposing UK-specific rules. In 2005 the OFT said that there would be no further investigation into these markets.

The EU derived rules have been outside the scope of any UK based review and, in any event, the UK had no ability to change these rules. The 2004 review was limited in scope to UK regulation and then only considered the statutory framework and not the FSA rulebook. The review of residual UK domestic derived rules has been piecemeal and understandably (given the mass of EU legislation which was out of reach) lacking in clear policy

We recommend a more holistic review of the entire regulatory regime in the medium term to determine the correct balance of effective and pro-competitive regulation.

Brexit should be a spur to ensure UK regulation is pro-competitive

Much of the regulatory regime has escaped effective scrutiny to ensure it meets pro-competitive criteria. The UK has not been able to scrutinise and adapt the EU legislation which is now to be ported onto a domestic law basis; it is not clear that the OFT/CMA review regime²³⁴ has been effective for those rules that are not EU derived. The enhanced competition objectives and powers of the UK regulators cannot currently infringe EU harmonisation.

In the medium term (i.e. after Brexit and probably after any period of interim measures) the UK should consider a one-off comprehensive/holistic review of the entire regime (both legislation and rules) and whether to improve on-going scrutiny of new requirements.

The longer term potential for divergence from the detail of current and future EU harmonisation

The Prime Minister has indicated that the UK will port over the entire corpus of EU rules per se, and any potential changes will not be made before Brexit (see Chapter 6). The Government intends that the *acquis* will be recognised at the time of Brexit – so that the UK will be 100% compliant in all areas. This should and will include all developments of the EU regime which come into effect prior to Brexit – such as detailed development at ESA level and substantive legislation such as MiFID II.

This is an important principle not only for the UK/EU negotiations, but also because at Brexit the UK will need to maintain its position under DRC arrangements with third countries which currently operate on the basis of the UK's membership of the EU (see Chapter 8).

In the longer-term when the terms of the new UK/EU relationship will be known the UK should review its regulatory regime - both EU ported and domestic derived – against the three objectives above. At that stage the UK will be able to balance all three objectives in one review and know whether and to what extent changes to the UK regime might prejudice DRC measures with the EU and other countries.

The debate in the UK has already started to examine areas where the UK may wish to move away from the detail of EU requirements but suggestions of a wholesale move away from the current EU derived rulebook seem unlikely to materialise.

Setting out a roadmap which shows that the UK may diverge from EU regulation with a mechanism to manage that divergence will also give an incentive for financial services firms to want to increase their UK and rest-of-world operations out of London, and not move to New York or elsewhere, or, for so long as DRC remains in place in relevant sectors, to move their EEA operations to the continent.

²³⁴ See competition scrutiny under FSMA 2000 Chapter 4 sections 140A-H (previously sections 159-164 and 302-310).

An example - what future for the Solvency II regime?

A number of areas have been the focus of attention over the years. In 2016, the Bank of England [published its response](#) to the European Commission's Call for Evidence on the EU regulatory framework for Financial Services²³⁵. Currently, there is a [Treasury Committee inquiry](#) regarding Solvency II.

EU prudential rules for insurers had long been viewed as inadequate and outdated and, driven in part by the financial difficulties experienced by Equitable Life, risk-based prudential regulation of UK insurers (in the form of individual capital assessment and guidance) was introduced by the FSA well before Solvency II was under development (or perhaps even in contemplation). Nevertheless, although the Solvency II regime was, in key respects, substantially based on the existing UK framework, its long-delayed implementation in January 2016 has given rise to substantially increased capital requirements (and, hence, capital costs) for many insurers with the impact being felt particularly acutely by many long-term insurers – in particular those with significant annuity portfolios.

With that context in mind, and following the Brexit vote in June 2016, the Treasury Select Committee announced an investigation into Solvency II^{236,237} with its objectives, outlined in the [Terms of Reference](#), including (amongst other things) to consider the options for the UK insurance industry created by the decision to leave the EU, to assess any impact of Solvency II on the competitiveness of the UK insurance industry and to examine the impact of Solvency II on the role of insurance in meeting the needs of UK customers and the wider UK business economy. Expressed in more overt terms, the question for evaluation was whether “*Brexit provides an opportunity for the UK to assume greater control of insurance regulation.*”

Based on the oral evidence presented before the Committee, there is clearly (and perhaps unsurprisingly) appetite for elements of the Solvency II regime to be altered to some degree although, notwithstanding views expressed by (for example) Lord Turnbull (“*it will actually help insurance companies if we can leave the [Solvency II] arrangement*”²³⁸), the balance of opinion has appeared to be in favour of retaining much, if not all, of the features and detailed provisions of Solvency II, not least with a view to ensuring that the UK regime remains (at least) “equivalent” following the UK's departure from the EU.

In this context, two specific features of the Solvency II regime, which have material implications for UK insurers with significant annuity books, have been the focus of particular discussion: being the Matching Adjustment and the design of the risk margin.

The Solvency II rules, as currently drafted, include very specific and, ostensibly inflexible, criteria which must be met by assets in order to be eligible for inclusion in an insurer's Matching Adjustment portfolio²³⁹. Although the PRA has “*sought to interpret them [the Solvency II requirements] in a purposive and proportionate way so that firms can back annuities with a wide range of assets, including illiquid assets, and still benefit from the Matching Adjustment*”²⁴⁰ the current rules are viewed as complex and too restrictive by many. David Belsham, External Member of the Prudential Regulation Authority Board, in giving evidence before the Treasury Select Committee commented, “*I would prefer principles-based regulation in this sort of area, and that was the approach under the ICAS regime...there is a cost and operational disadvantage for firms.*”²⁴¹

The current approach to the calculation of the risk margin under Solvency II has been the subject of similarly critical comment. The European Commission has indicated that it will assess the risk margin (which is “*calculated by multiplying a fixed cost of capital (6%) by the net present value of future capital requirements [and] is intended to provide the financial resources necessary to cover the return on the capital a hypothetical acquirer would need to run off the insurance liabilities*”²⁴²) in the context of its general post-implementation

²³⁵ This set out the rules affecting the ability of the economy to finance itself and grow; unnecessary regulatory burdens; interactions of individual rules, inconsistencies and gaps; rules giving rise to possible other unintended consequences. The BoE report covered a number of pieces of EU legislation, including CRD IV, MiFID, BRRD, Solvency II, and DGSD.

²³⁶ Led by Andrew Tyrie, MP. <https://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news-parliament-2015/eu-insurance-regulation-inquiry-16-17/>

²³⁷ <https://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news-parliament-2015/eu-insurance-regulation-inquiry-16-17/>

²³⁸ See [Terms of Reference](#) p. 2

²³⁹ See article 77b Solvency II

²⁴⁰ [Speech](#) delivered by David Rule, Director of Insurance Supervision, Bank of England (February 2017).

²⁴¹ Treasury Committee, [Oral Evidence - EU Insurance Regulation](#), 22 February 2017.

²⁴² Speech by David Rule, op. cit.

review of the Solvency II regime. Equally, the PRA (whilst viewing itself as bound by the current EU rules in this regard), believes that the risk margin (which primarily affects firms in the UK with long-dated annuity liabilities) is too high, not least given currently low levels of interest rates²⁴³ and, in the circumstances, this is an area of the Solvency II regime which appears subject to adjustment in due course.

UK regulators, however, have made it clear that they are not planning any move away from the Solvency II regime in the short term²⁴⁴; any pre-Brexit divergence would prejudice the policy of the UK being able to 'port' the entire EU FS corpus.

In the Brexit debate, the discussion has sometimes focused on a debate about high or low regulatory standards, as if the options for bank regulation were high or low bank capital requirements. This discussion often assumes that the EU is the leader in setting regulatory standards and the question is whether post-Brexit the UK will decide to opt for low regulatory standards. This misses the point that the UK has led in almost all areas of FS regulation and the EU has followed. Its harmonisation program has often been years, and sometimes even a decade or more, behind the UK.

The opportunities for the UK, post-Brexit, are not to lower standards (in some form of regulation-driven trade war) – an expectation that is misplaced, runs contrary to the UK's track record and the realities of consumer politics today. The long term opportunity is to ensure the UK has the correct balance of effective, pro-competitive regulation and international DRC.

There should be no divergence from detailed EU requirements pre-Brexit; there should be no policy to lower standards after Brexit. Divergence in the longer term will only arise from the UK seeking effective standards balanced with the objectives of pro-competitive regulation and an international focus on maximising DRC

The UK has led in many areas of FS regulation and the EU has followed. The opportunities for the UK, post-Brexit, are not to lower standards (in some form of regulation-driven trade war) – an expectation that is misplaced, runs contrary to the UK's track record and the realities of consumer politics today. The long term opportunity is to ensure the UK has the correct balance of effective, pro-competitive regulation and an international focus on maximising DRC.

A more differentiated approach to UK regulation – international, EU and domestic?

There are various examples of differentiation in regulation between international and domestic firms. For example, under the Investment Services Directive the EU gave certain smaller/limited scope firms the option either to elect to trade without meeting certain EU standards and without a passport for cross-border business, or to opt into EU standards with the benefit of a passport.

There have been suggestions that the UK develop a 2 or 3 tier structure to differentiate between UK firms involved in domestic business only (a domestic regime) and those trading cross-border with the EU (an EU based regime), and possibly a third category of firms trading internationally but not with the EU (an international regime). One idea is that the UK might base the domestic regime on domestic factors without having to be concerned with EU standards, whilst maintaining a regime more closely aligned with the EU for UK firms operating across Europe. The third regime would be for UK firms seeking to develop international business outside the EU. This might be based on international regulatory standards.

It is too early to say whether, and how, these ideas might be pursued. This is an issue which should be left until after Brexit.

In principle, the idea of international standards for international firms and national standards specifically designed for firms operating only domestically is attractive (see Chapter 6 and discussion in Andrew Bailey's recent speech²⁴⁵). The UK can and should be promoting the idea of international standards for DRC and

²⁴³ Speech by David Rule, *ibid*.

²⁴⁴ See the oral evidence before the Treasury Committee - [Oral Evidence - EU Insurance Regulation](#), 22 February 2017.

²⁴⁵ [Free trade in financial services and global regulatory standards: friends not rivals](#)

getting some international consensus and support for the domestic/international split in regulation. The idea of the UK securing broader, or multiple, DRC agreements with non-EU states was considered in chapter 8. Success in this arena would go hand in hand with this approach.

There are, however, some difficulties. It seems unlikely that the EU would agree to the domestic/EU split if there is to be a high degree of dual regulation coordination between the UK and the EU in financial services. EU states do not currently have the ability to exempt domestic only firms from EU standards on a broad basis. In addition EU firms doing business with the UK would face competition from UK firms operating under the domestic regime. The suggestion of the UK establishing an international zone for non-EU international firms if conceived as a system for light touch regulation with lower standards would probably be unattractive to the UK given concerns about 'last resort' liability.

Benefits of pro-competitive regulation

The Legatum Institute Special Trade Commission has proposed a 4 pillar approach to the UK's post-Brexit trade policy²⁴⁶. The first pillar involves a review of domestic policy, and recommends an enhanced emphasis on the competition dynamic (the remaining pillars involve bi-lateral, plurilateral and multilateral work with trade partners).

It is important to distinguish between the economic goal of consumer welfare, which is the benefit that individuals derive from the consumption of goods and services, and is dependent on competitive markets to deliver price and availability benefits, and the more familiar goal, in FS regulation terms, of consumer protection, aimed at countering asymmetry of information between consumers and providers of services, and ensuring the solvency and security of institutions holding deposits/underwriting insurance policies.

The two goals are not mutually exclusive and are in fact symbiotic. As the OECD's Competition Committee found in its review of Competition and Financial Markets post financial crisis²⁴⁷ "*competition and stability can co-exist in the financial sector. In fact, more competitive market structures can promote stability by reducing the number of banks that are 'too big to fail'.*" One of its recommendations for governments as they exit from post-crisis interventions was to "*review financial market regulations and regulatory structures for unintended or unnecessary restrictions on competition*".

In current EU prudential regulation there are a number of examples of measures that could be considered to be disproportionate or unnecessary in their approach to the protective goal, such that competitive markets are damaged. In its submission in response to the European Commission's '*Call for Evidence on EU Regulatory Framework for Financial Services*'²⁴⁸, HM Treasury catalogued regulations across the financial sectors where unnecessary, disproportionate and out of date regulations are "creating a barrier to the effective implementation of the financial stability regime and to the delivery of jobs and growth". The submission²⁴⁹ includes:

- feedback on the implementation of Solvency II, which according to the Treasury has "issues around the impact of the framework on long-term investment and competitiveness of the European insurance industry";
- a call for a "more proportionate and fit-for-purpose prudential framework for smaller/less complex banks and credit institutions";
- a recommendation for a review of EMIR and future work on capital requirements to "assess whether the overall economic incentives in place through EU legislation to encourage a move away from bi-lateral OTC derivatives trading and towards clearing are proportionate", given that "a significantly higher cost of entering into bi-lateral OTC derivatives may deter market participants from entering into economically useful trades"; and

²⁴⁶ As outlined by Shanker Singham in a speech to Commonwealth trade ministers on 13 March 2017 <http://www.li.com/media/commentary/shanker-singham-delivers-speech-to-commonwealth-trade-ministers>

²⁴⁷ OECD Competition and Financial Markets – Key Findings 2009

²⁴⁸ HM Treasury Response to the EU Commission: Call for evidence on EU regulatory framework for financial services (February 2016)

²⁴⁹ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/496887/PU1903_HMT_response_to_EU_consultation.pdf

- examples of directives and regulations whose rules have given rise to barriers to entry, including the Multilateral Interchange Fee Regulation, AIFMD and the Short Selling Regulation.

See also the Bank of England paper in response to the same consultation.²⁵⁰

While HMT also acknowledges the value of co-ordinated action across the EU, if such action is not forthcoming, or would take years to achieve, the gains from being able to unilaterally implement the recommendations in the submission could be huge. Under the regulatory partnership model the question would arise as to whether any of these reforms would be viewed as taking the UK's regime outside of the necessary and proportionate parameters to qualify for home state recognition, and if not, whether the efficiency and competitiveness gains from implementing them would outweigh the benefits of DRC with the EU.

The long term pro-competitive goal

The longer term ambition from a trade perspective would be to agree a mechanism substantively to address behind the border barriers and market distortions that stifle competition and innovation. This would require, as the OECD suggests, that competition authorities engage in dialogue with regulators who are involved in expanding the scope of regulation *"in order to help frame it and ensure that it is consistent with the aims of robust competition policy"*²⁵¹.

The DRC model outlined in this paper would address, as between the UK and the EU, the single most problematic barrier of authorisation and supervision requirements by introducing home state recognition and a forum for monitoring and progressing regulatory reform on a bi-lateral basis. This model does not envisage, at the outset, that conduct regulation would be a home state matter. Instead it would continue to be governed by the host state, subject to commitments on MFN, market access and national treatment, whereby as long as a measure is not restrictive on market access and is applied equally to local and foreign operators, it is beyond challenge by the other party. Ultimately, in order to maximise the benefits of competitive financial services markets and grow the market in a welfare enhancing way, the UK and EU could agree not to operate measures that would have an adverse effect on consumer welfare unless justified by the regulatory or prudential objective. Such a mechanism was agreed in the WTO for the telecommunications sector, where members committed to maintain competitive safeguards, and to implement certain pro-competitive measures such as ensuring interconnection and requiring that universal service obligations are non-discriminatory, competitively neutral and not more burdensome than necessary to achieve the universal service objective.

The UK can become an international beacon for pro-competitive regulation in FS

After Brexit, the UK will be able to promote the pro-competitive agenda internationally. A sharper distinction could be drawn between the regulation of international/cross-border firms and those that only operate domestically (as Andrew Bailey proposed). This split approach to regulation could apply to the development of international prudential standards (which would be more clearly applicable to international firms alone) and can also be incorporated into the UK's domestic regime, so that UK regulation of domestic firms is more tailored to domestic requirements.

²⁵⁰ <http://www.bankofengland.co.uk/financialstability/Pages/regframework/response.aspx>

²⁵¹ OECD Competition and Financial Markets – Key Findings 2009

Glossary

A

AG	Advocate General
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Manager Directive (2011/61/EU)
AML	Anti-Money Laundering
Article 50	Article 50 of the Treaty of the European Union (sets out the process by which a Member State may withdraw from the EU)
ASIC	Australian Securities and Investment Commission

B

BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlement
Brexit	The UK's prospective withdrawal from the EU
BRRD	Bank Recovery and Resolution Directive (2014/59/EU)

C

CCPs	Central Counterparties
CEE	Central and Eastern Europe
CEFs	Critical Economic Functions i.e. a function whose disruption or withdrawal could have an adverse material impact on financial stability in the UK' (as defined by the PRA – see further information here)
CETA	EU-Canada Comprehensive Economic and Trade Agreement
CFTC	Commodities and Futures Trading Commission
CJEU	Court of Justice of the European Union
CMA	Competition and Markets Authority
CMS	CMS Cameron McKenna
COB	Conduct of Business
CPO	Commodity Pool Operator
CRA	Credit Ratings Agencies
CRD IV	Capital Requirements Directive IV (2013/36/EU)
CRR	Capital Requirements Regulation (Regulation 575/2013)
CSD	Central Securities Depository
CSDR	Central Securities Depositories Regulation (Regulation 909/2014)
CTA	Commodity Trading Advisor
CTF	Counter Terrorism Financing

D

DGS	Deposit Guarantee Scheme
DGSD	Deposit Guarantee Schemes Directive (2014/49/EU)
Dodd-Frank	The Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111–203, H.R. 4173,) is a piece of US legislation passed in response to the 2008 financial crisis
DRC agreement	Proposed agreement between the UK and EU to address DRC measures
DSU	Dispute Settlement Understanding
Dual regulation barriers or DR Barriers	Variety of barriers from a host state regulatory regime which affect cross-border activity/supply in any modes. Examples include full host state regulation - most often the barriers are a mix of financial barriers (ineffective use of capital and

resources), operational difficulties (maintaining multiple entities, licences and compliance operations) and associated cost

Dual regulation coordination or DRC

Measures used to coordinate dual regulation between home and host state to ensure effective and efficient cross-border activity/supply in any of the WTO modes. Such measures contribute to the mitigation/elimination of dual regulation barriers. Examples include EU-wide harmonisation in certain areas, and techniques such as mutual recognition and home state supervision

E

EBA	European Banking Authority
ECA 1973	European Communities Act 1972
ECB	European Central Bank
EEA	European Economic Area
EFER	Economics for effective regulation as set out in FCA Occasional Paper 13 (March 2016)
EFTA	European Free Trade Association
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	European Market Infrastructure Regulation (648/2012)
Equivalence	Test used (though not in an identical fashion) by the EU to evaluate third country jurisdictions' regulatory/supervisory regimes in a given area to determine if sufficiently equivalent to EU regulation in order for DRC measures to apply
ESAs	European Supervisory Authorities, i.e. EBA, EIOPA, and ESMA
ESMA	European Securities and Markets Authority
EU	European Union
EUSFTA	European Union and the Republic of Singapore Free Trade Agreement

F

FATF	Financial Action Task Force
FCA	Financial Conduct Authority
FCM	Futures Commission Merchant
FDI	Foreign Direct Investment
FICOD	Financial Conglomerates Directive (2002/87/EC)
FS	Financial Services
FSA	Financial Services Authority
FSB	Financial Stability Board
FSMA	Financial Services and Markets Act 2000
FTA	Free Trade Agreement

G

GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDPR	General Data Protection Regulation (Regulation (EU) 2016/679 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC)
Great Repeal Bill	Bill designed to repeal the European Communities Act 1972 and transpose EU law into domestic law
G-SII	Global Systemically Important Insurers

H

HMG	Her Majesty's Government
HMT	Her Majesty's Treasury

HSS	Home State Supervisor
Hubbing	Using a single legal entity and/or location to provide financial services across a number of different jurisdictions – a process which is much assisted for EEA jurisdictions by Single Market DRC and in particular the Single Market passport
I	
IAIS	International Association of Insurance Supervisors
IB	Introducing Broker
ICAS	Individual Capital Adequacy Standards regime that existed in the UK pre-Solvency II
ICS	Investment Court System
ICSD	Investor Compensation Schemes Directive (97/9/EC)
ICSID	International Centre for Settlement of Investment Disputes
IDD	Insurance Distribution Directive ((EU) 2016/97)
IMD	Insurance Mediation Directive (2002/92/EC)
IOSCO	International Organisation of Securities Commissions
ISDS	Investor/State Dispute Settlement
M	
MAD II	MAD II legislative package - comprises the Market Abuse Regulation (Regulation 596/2014) and the Directive on Criminal Sanctions for Market Abuse (2014/57/EU)
MAR	Market Abuse Regulation (Regulation 596/2014)
MAS	Monetary Authority of Singapore
MFN	Most Favoured Nation principle under the rules of the WTO
MiFID II	Markets in Financial Instruments Directive recast (2014/65/EU) and MiFIR due to enter into effect in 2018
MiFIR	Markets in Financial Instruments Regulation ((EU) No 600/2014)
Mixed agreements	An agreement, in the context of Article 50, in which Member State and EU competencies are engaged. In most cases, ratification of the agreement must be completed by Member States before the Council of the EU will conclude the agreement
Modes of Supply	Classification used under WTO rules for different types of supply – cross-border, consumption abroad, commercial presence (branch or subsidiary), and movement of natural persons
MOU	Memorandum of Understanding
MRA	Mutual Recognition Agreement
MREL	Minimum requirement for own funds and eligible liabilities (a requirement under the Bank Recovery and Resolution Directive (2014/59/EU) (BRRD))
MTF	Multilateral Trading Facility
N	
NAFTA	North American Free Trade Agreement (a three-country accord negotiated by the governments of Canada, Mexico, and the United States that entered into force in January 1994)
NPPR	National Private Placement Regime
NVNI	Non violation nullification and impairment claim in the WTO under Article XXIII GATS
O	
OECD	Organisation for Economic Cooperation and Development
OFT	Office of Fair Trading
OTC	Over the counter (regarding securities trading)
P	

Passporting The right to conduct financial services business in an EEA/EU Member State on a services basis or through a branch. The pre-conditions for passporting vary under various pieces of EU FS sectoral legislation (in some instances there is no right to passport)

PRA Prudential Regulatory Authority

Prosperity Zone A high standards, plurilateral agreement among countries that are disposed to accept the foundational pillars of a liberal, open economy—property rights protection, open trade at the border, and competition on the merits inside the border. These countries could agree among themselves a set of rules that optimised their respective environments and broke down barriers to trade. For more information on the prosperity zone, see the Legatum Institute report [here](#).

Q

QCCP Qualifying Central Counterparties

QMV Qualified majority voting (as used by EU institutions)

Quantitative or economic limits There are 6 types:

(i) limitations on the number of service suppliers whether in the form of numerical quotas, monopolies, exclusive service suppliers or the requirements of an economic needs test;

(ii) limitations on the total value of service transactions or assets in the form of numerical quotas or the requirement of an economic needs test;

(iii) limitations on the total number of service operations or on the total quantity of service output expressed in terms of designated numerical units in the form of quotas or the requirement of an economic needs test;

(iv) limitations on the total number of natural persons that may be employed in a particular service sector or that a service supplier may employ and who are necessary for, and directly related to, the supply of a specific service in the form of numerical quotas or the requirement of an economic needs test;

(v) measures which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service (but note that the EU has scheduled a general reservation on this for financial services in its schedule of commitments); and

(vi) limitations on the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment]

S

SFTR Securities Financing Transactions Regulation ((EU) 2015/2365)

Solvency II Recast Directive on the taking-up and pursuit of the business of Insurance and Reinsurance (2009/138/EC) (Solvency II)

SSM Single Supervisory Mechanism

T

TCF Third Country Firm

TEU Treaty on European Union

TFEU Treaty on the Functioning of the European Union

Third Countries (TC) A term used by the EU to denote a country that is not a member of the Union/EEA

TISA Trade in Services Agreement

TPP Trans-Pacific Partnership. Proposed FTA widely considered at the time to be the most advanced liberalisation of financial services yet achieved in an FTA (outside of the EEA). The parties are Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States (until January 23, 2017) and Vietnam

TRIPS Agreement on Trade related Aspects of Intellectual Property Rights

TSC UK's Treasury Select Committee

TTIP Transatlantic Trade and Investment Partnership Proposed FTA between the EU and US

U

UCITS

Undertakings for Collective Investment in Transferable Securities

UCITS IV

Undertakings for Collective Investment in Transferable Securities Directive IV (UCITS IV) (2009/65/EC)

UNCITRAL

The United Nations Commission on International Trade Law

Uruguay Round

The Uruguay Round was the 8th round of multilateral trade negotiations conducted within the framework of GATT

W

WTO

World Trade Organisation

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