



The Brexit negotiations and the international capital markets

By Paul Richards

Summary

The UK Government is proposing to invoke Article 50 of the EU Treaty by the end of March 2017. Assuming that the Government goes ahead, this will lead to negotiations between the UK and the remaining 27 EU Member States (EU27) on the terms of the UK's decision to leave the EU (ie Brexit). The purpose of this paper is to set out the main tests by which the Brexit negotiations between the UK and the EU27 are likely to be assessed in the international capital markets:

- **Market access:** The first test is whether the UK and the EU27 negotiate reciprocal access to the EU Single Market on favourable terms as close as possible to the single passport¹ arrangements that exist at present. Both the UK and the EU27 have a mutual interest in maintaining capital market integration across Europe after Brexit. But there are limited ways of achieving this.
- **Skills:** The second test is whether freedom of movement continues for highly skilled people on a reciprocal basis between the UK and the EU27.

- **Continuity:** The third test is whether the UK and the EU27 ensure continuity during the transition from the existing arrangements pre-Brexit to the new arrangements post-Brexit without a gap between the one and the other.
- **Financial stability:** The fourth test is whether financial stability is maintained both during the negotiations between the UK and the EU27 and afterwards.
- **Time to prepare:** The final test is whether the UK and the EU27 clarify as early as possible the changes that will be required in capital markets, and whether they give market firms sufficient time to prepare.

In all five cases, the objective should be to minimise market uncertainty and disruption. This would be of mutual interest to both the UK and the EU27. But the future of the international capital markets forms only part of the negotiations on Brexit between the UK and the EU27. And it is not yet clear what exactly the UK Government will propose, nor how the EU27 will respond.

Background

1 Following the vote in the UK referendum on 23 June 2016 to leave the EU, the UK Government made two announcements about Brexit at the beginning of October:

- First, the UK Government will notify the European Council of the UK's intention to leave the EU by invoking Article 50 of the EU Treaty by the end of March 2017. Once Article 50 has been invoked, the UK Government will have two years to negotiate an agreement with the European Council, acting by a qualified majority after obtaining the consent of the European Parliament. If
- Second, the UK Government will introduce a Great Repeal Bill in the House of Commons in the spring of 2017 to repeal the European Communities Act 1972. The Great Repeal Act will come into effect when the UK leaves the EU, and is intended to "grandfather" EU law at that point into UK law² Until the UK leaves, EU law - including new EU law - will continue to have effect in the UK.³

1. The "single passport" allows financial services operators legally established in one EU Member State to establish or provide their services in the other Member States without further authorisation requirements.

2. The Great Repeal Bill cannot be limited to a "copy and paste" of EU law into UK (ie English and Scottish) law, as some references to organisations and regulations will need to change. But as EU law will apply in the UK until Brexit day, the objective should be to keep legal changes on Brexit day to a minimum, with any substantive changes being introduced subsequently, if Parliament agrees.

3. EU Directives will already have been transposed into UK law. But EU Regulations, which currently apply directly in the UK, will cease to apply when the UK leaves the EU, unless provision is made in the Great Repeal Act to reapply them.

2 In November, following a claim in the High Court against the UK Government, the High Court ruled that the Government cannot invoke Article 50 without the approval of Parliament. The Government appealed against the High Court's verdict. The Supreme Court heard the case from 5-8 December and is due to give its judgment in January.

3 Before the UK leaves the EU, Parliament is expecting to be asked to ratify any agreement that is reached between the UK and the EU27. However, if Parliament is only asked to ratify an agreement shortly before the two-year deadline after Article 50 is invoked, this may be too late to consider alternative options, unless notification under Article 50 can be withdrawn before it expires. The UK Government's position is that, once given, notification under Article 50 will not be withdrawn. But it is not clear whether Article 50 can be revoked or not.⁴ The only definitive way of clarifying this would be through the European Court of Justice.

4 The main purpose in invoking Article 50 is to deal with the terms of UK withdrawal from the EU: eg settling net budgetary commitments by the UK to the EU; dealing with the acquired rights of EU citizens; dealing with border issues (eg in Ireland and Gibraltar); and relocating EU agencies (eg the EBA). The EU27 negotiators are expected to argue that the negotiations on the terms of the UK withdrawal should take place first. But Article 50 also provides that the negotiations on withdrawal should take account of the framework for UK/EU27 relations in future.⁵

The first test: market access

5 When Article 50 is invoked, the UK Government will need to make proposals to the EU27 on Brexit, and it will then be for the EU27 to respond. The UK Government's proposals are expected to cover not only the terms of UK withdrawal from the EU, but also the terms for UK/EU relations after Brexit in future. There are three potential approaches to the terms for UK/EU relations after Brexit,

with differing implications for market access: the EEA option; a unique bilateral agreement between the UK and the EU27; or trading under WTO rules.⁶

(i) The EEA option

6 Under this option, the UK would seek to join the European Economic Area (EEA) when it leaves the EU. In order to join the EEA, the UK would need to join the European Free Trade Agreement (EFTA). The UK would also need to sign an EEA accession treaty, which would have to be agreed and ratified by all 30 EEA Member States (ie the EU27 as well as the three EFTA members of the EEA.) As a member of the EEA, the UK would remain a member of the EU Single Market, as at present, though without a vote. But the UK is not expected to join the EEA on a permanent basis⁷, because that would not be consistent with controlling immigration to the UK from the EU27; it would also require the primacy of EU law over UK law; and it would be likely to involve continuing budgetary contributions from the UK to the EU27 indefinitely in future.⁸

(ii) A unique bilateral agreement

7 If the EEA option is rejected, the main alternative option is for the UK to seek a unique bilateral (or "association") agreement on free trade with the EU27, under which the UK would no longer be a *member* of the EU Single Market. Instead, the UK would seek to negotiate access to the EU Single Market as a third country on as favourable terms as possible.⁹ One of the key issues in negotiating favourable terms of access would be to establish "equivalence" in capital market regulation between the UK and the EU27. This should technically be possible as the UK has implemented all relevant EU legislation affecting capital markets so far, and will continue to do so until the UK leaves the EU.

8 But there are several problems with negotiating equivalence as a third country which a bilateral agreement between the UK and the EU27 would need to address:

4. For example, Jean-Claude Piris, former Legal Counsel of the European Council and Director General of the EU Council Legal Services from 1988 to 2010, argues: "Even after triggering Article 50 and notifying the EU of its intention to leave, there is no legal obstacle to the UK changing its mind, in accordance with its constitutional requirements.": *The Financial Times*, 1 September 2016.

5. In addition, they should provide for agreement on a transitional period between the point at which the UK leaves the EU and the point at which a permanent agreement between the UK and the EU27 comes into effect. (See below.)

6. The terms "soft Brexit" and "hard Brexit" are confusing because they are used in different ways. In general, "soft Brexit" means that the UK would become a member of the EEA when it leaves the EU and remain a member of the EU Single Market. "Hard Brexit" is sometimes used to mean the negotiation of access to the EU Single Market under a bilateral agreement on favourable terms as a third country. At other times, it is used to mean trading under WTO rules.

7. But if there is a transitional agreement between the UK and the EU27 (see below), the outcome may temporarily be similar.

8. However, on 20 December, the Scottish Government put forward proposals to join the EEA.

9. The EU's free trade agreements with the rest of the world invariably exclude the free movement of people, as do the "association" agreements in 2016 between the EU and the Ukraine, Georgia and Moldova: Michael Emerson: *Which Model for Brexit?* CEPS, 14 October 2016.

- One is that there is full provision for equivalence in some EU capital market regulations but not in others:¹⁰ The arrangements for equivalence are largely untested, and it would be difficult for market firms to know how far they could rely on them.
- Another is that the assessment of equivalence is subject to a political judgment in the EU, so may be delayed or caught up in the political negotiations between the UK and the EU27.
- A third is that an equivalence assessment, once granted, can be withdrawn by the EU at short notice if UK law does not keep up-to-date with new EU law in future. Although this has not happened in any other case so far, it may be difficult politically for the UK Government to agree to keep UK law up-to-date with EU law, because this would involve giving priority to EU law over UK law after Brexit.
- Fourth, new EU regulatory requirements affecting equivalence are likely to be introduced in the period ahead: for example, MiFID II is due to be implemented on 3 January 2018; and the European Commission is proposing that non-EU banks should set up intermediate holding companies in the EU with sufficient capital and liquidity to minimise the risk of failure.
- Finally, an independent process for resolving disputes may also be needed to make equivalence work fairly in practice. This process should be easier to manage if close cooperation between the FCA and ESMA can continue after Brexit, though the FCA will no longer be a member of ESMA.

9 The European Commission is expected to review the current arrangements for third country equivalence on the basis that they were not designed with the UK's withdrawal from the EU in mind. It is not yet clear how long such a review will take, nor what the outcome will be, though the bilateral negotiations in prospect between the UK and the EU27 might provide an opportunity for such a review. The outcome could well affect - and be affected by - EU equivalence with other third countries (like the US) as well as the UK. Indeed, there may be a case for establishing equivalence at global level through the G20.

10 If market firms cannot rely on EU equivalence, they are likely to seek the authorisations they need to operate

after Brexit within the EU27 (and vice versa in the UK), in those cases in which they do not have authorisation already. Authorisation may take time to obtain, particularly if a significant number of market firms apply to the same financial centre at once. Given the lead-times involved, there is a risk that market firms will need to take decisions before they know the outcome of the negotiations between the UK and the EU27. As a condition for obtaining the authorisations they require, market firms may need to transfer resources (eg from the UK to the EU27) to meet the requirements of supervisors, which may vary from one financial centre to another. They will also ultimately need to decide what configuration post-Brexit will be best for their capital markets business, taking account of its potential viability if based in two different European financial centres: ie in the UK and in the EU27.

(iii) Trading under WTO rules

11 The other alternative for trade in services would be for the UK to trade with the EU27 under World Trade Organisation (WTO) rules, when the UK leaves the EU.¹¹ This is not expected to be the UK Government's preferred option, but the UK Government will need a contingency plan in case it happens anyway. That would be the case if a bilateral agreement between the UK and the EU27 - or a transitional agreement pending the conclusion of a bilateral agreement - cannot be put in place in time for the UK's exit from the EU when Article 50 expires.

12 Under WTO rules, there is only an overarching framework for trade in services within the General Agreement on Trade in Services (GATS). The WTO has provisions attempting to limit the non-tariff barriers a member can impose on other members. But GATS rules provide a "prudential carve-out", under which the parties are generally permitted to retain restrictions on their financial markets for prudential reasons.

13 In terms of capital market regulation, the UK Government would have freedom to introduce different capital market regulation in the UK from the EU27 once the UK leaves the EU. As a result, the UK Government would become a "rule maker" rather than a "rule taker", and could set rules - and provide incentives (eg lower rates of tax) - designed to make the City of London a more attractive international financial centre. But if the UK Government did so, there would be an increased risk

10. Examples of EU legislation, showing whether there are provisions for third country equivalence or not: CRD IV: None. Solvency II: For reinsurance but not for direct insurance. MiFIR: Will allow firms from third countries to offer certain securities services cross-border to wholesale customers and counterparties. UCITS: None, though there could be scope for a redomiciled management company to delegate day-to-day fund management back to the UK; and funds could be marketed from the UK as alternative investment funds (AIFs). AIFMD: Yes. Source: House of Lords EU Committee: *Brexit: Financial Services* (December 2016).

11. A bilateral free trade agreement between the UK and the EU27 would allow them both to trade with each other on terms more favourable than those under WTO rules. Unless the UK reaches a bilateral free trade agreement with the EU27, or remains in the European Customs Union (which relates to trade in goods), the EU27 cannot offer the UK more favourable treatment than it does under the WTO, without also offering the same treatment to every other country. See Clifford Chance: *The UK's Future Trade Relationships* (October 2016).

that UK regulation would be judged not to be equivalent to EU27 regulation, as UK and EU27 regulation would no longer be the same.¹²

14 It is important to note that the City of London would not necessarily be subject to less capital market regulation under UK law than it would be otherwise under EU law, as: (i) the overall regulatory framework is determined at G20 level rather than solely at EU level, and the UK will remain a member of the G20 when it leaves the EU; and (ii) the national regulators in the UK (ie the FCA and PRA) are proponents of strict regulation. There is even an argument that the UK authorities may on occasion need to go beyond the regulatory requirements in other countries, because of the size of the UK financial services sector.

The second test: access to skills

15 The second market test for the negotiations between the UK and the EU27 is whether they preserve freedom of movement for skilled people in both directions between the UK and the EU27. This test is critically important in the international capital markets, where firms rely on unrestricted access to an international pool of talent, both in relation to their *existing* workforce in the UK and the EU27, and in relation to *new* entrants in future. The Chancellor of the Exchequer has indicated that the UK Government's overall policy of controlling EU immigration would not prevent companies from bringing highly skilled working people into the UK.¹³

16 Given that the City of London is in many ways a European financial asset, there is a question whether it would be possible for the UK and the EU27 to negotiate a sectoral agreement covering wholesale financial markets and involving free movement of skilled people and unrestricted free access to the EU Single Market in both directions.¹⁴ This would enable the City of London in practice to stay "in" while the UK as a whole would come "out" of the EU. The City would not be defined by its physical location but by the EU capital market regulation to which it would continue to be subject after Brexit under UK law. But a UK approach of this kind may be resisted by the EU27: for example, on the grounds that sectoral agreements would amount to "cherry picking", or that the EU27 would not want the City to become the "offshore financial centre of the EU" when the UK leaves.

The third test: continuity

17 Once Article 50 has been invoked (ie by the end of March 2017), the UK will leave the EU two years later,

unless there is unanimity among the EU27 on extending the period beyond two years. It would be very difficult to secure unanimity in the EU27 on an extension, and the UK Government is in any case planning to leave the EU before the next General Election (scheduled for 2020). But it also looks unlikely that a bilateral agreement between the UK and the EU27 could be negotiated and ratified in two years, particularly if it has to be ratified in all 38 national and regional parliaments in the EU first. (For example, the Canadian bilateral agreement with the EU took seven years before it was signed at the end of October 2016, and was held up at the last minute by opposition in the Wallonian Parliament in Belgium). The Chief Negotiator for the European Commission has pointed out that the negotiating period under Article 50 will in practice be less than two years. When Article 50 is invoked by the end of March 2017, the EU27 will take time to respond; and the negotiations will need to be concluded by October 2018, so that there is sufficient time for ratification in Member States, the European Parliament and the UK before Article 50 expires.

18 If a bilateral agreement between the UK and the EU27 cannot be negotiated and ratified in two years (or less), the third test for the negotiations is whether the gap will be bridged by a transitional agreement covering the period between the point at which the UK leaves the EU and the point at which the bilateral trade agreement takes effect. Should that not be possible, the UK would have to fall back on trading with the EU27 under WTO rules when it leaves the EU. Agreement on a transitional period would need to be reached as soon after Article 50 is invoked as possible; and give sufficient time for market firms to prepare for implementing whatever outcome the UK and the EU27 agree. If there is a "presumption of equivalence" between the UK and the EU27, that should give market firms in the UK and the EU27 a "third party passport" during the transitional period. A transitional agreement of this kind would avoid the risk of a "cliff edge": in other words, a sudden change in the regulatory regime when the UK withdraws from the EU as well as another sudden change when the bilateral agreement between the UK and the EU27 takes effect later.

19 It is not clear whether the UK Government would need to make continuing budgetary payments to the EU27 in exchange for continuing access to the EU Single Market after the UK leaves the EU. This is a separate issue from settling the terms for UK withdrawal from its existing budgetary commitments to the EU, but the two issues may in practice become related during the negotiations between the UK and the EU27.

12. However, the UK authorities might argue that, where UK regulation differed from EU27 regulation, it would still be consistent with G20 requirements at global level, and the regulatory result would therefore be equivalent.

13. House of Commons, 25 October 2016.

14. Free trade agreements generally deal with trade in goods and services separately.

The fourth test: financial stability

20 The fourth test is whether it will be possible to maintain financial stability both during the negotiations between the UK and the EU27 and afterwards. A smooth transition – from the existing arrangements pre-Brexit to the new arrangements post-Brexit without a cliff edge – would help to achieve this. Financial stability could be put at risk if there is market uncertainty not only about the ultimate outcome of the negotiations, but also if the market perceives a risk of sudden regulatory change in the meantime. This could be the case if there are no new – or transitional – arrangements in place, when the UK leaves the EU, to ensure continuity with the arrangements that exist at present.

21 The best way of securing financial stability is to ensure that market integration between the UK and the EU27 continues. By contrast, if the market fragments between London as Europe's largest international financial centre and the financial centres in the EU27, so that there are different regulatory regimes in the UK and the EU27, this could be to the disadvantage of them both, because of the extra costs and risks involved. These risks would be greatest if the UK trades with the EU27 under the rules of the WTO and GATS (in the case of trade in services). If so, financial centres in Europe may become less competitive as centres for capital markets business, and the principal beneficiary may be New York.

22 There may also be potential implications for financial stability if the arrangements for euro clearing change once the UK leaves the EU. The European Court of Justice decided in 2015 that euro clearing can continue in London. But the position may change when the UK leaves the EU, if EU legislation is introduced to make euro clearing in the EU27 mandatory.¹⁵

- On one side, the argument is that euro clearing in the EU27 (or specifically in the euro area) should become mandatory, because a clearing house needs to be located in the same currency area as the central bank providing liquidity support and a “back stop”, if the clearing house is “too big to fail”.
- On the other side, the argument is that clearing does not need to take place in the jurisdiction in which a financial asset is denominated, as central bank swap agreements can counter any systemic risks, and it is more efficient to clear on an international basis, regardless of currency, because this allows firms to net their risk in different currencies.

The fifth test: time to prepare

23 The fifth and final test is whether sufficient time is given to capital market firms to prepare for any changes required

when the UK leaves the EU. This is partly a question of how substantial the changes would be; and partly a question of how long market firms would have to prepare for them. For example, if a transitional agreement can be agreed early in the process which sets out the general direction of future relations between the UK and the EU27, and gives market firms a sufficient time to prepare for implementing them, that should help reduce market uncertainty and market disruption. Such an outcome would be less likely, if a transitional agreement is only reached later during the UK/EU27 negotiations, once the terms for UK withdrawal have been settled.

24 If capital market firms in the UK are not clear sufficiently early in the process, or not given sufficient time to prepare, they may well conclude that they need to be authorised to provide all relevant capital market products from the EU27, as a contingency, in cases in which they are not authorised already. The length of time needed to obtain these authorisations could well become a constraint, particularly if a significant number of financial institutions all apply to the same authorities in the EU27 at the same time. There is also a risk that capital market firms will need to make decisions before they know the outcome of the Brexit negotiations, particularly if they are responding to competitive pressure from their clients. Similar considerations are also likely to apply – in the other direction – to firms based in the EU27 needing authorisation to operate in the UK. Finally, the preparations for Brexit in the UK are complicated further by the requirement for large UK banks to separate their wholesale from retail activities at the same time.

Conclusion

25 Against this background, our understanding is that many ICMA member firms are still waiting to see what the UK proposes and how the EU27 respond, but that they are also undertaking contingency planning. They cannot wait for long, if they do not yet have the authorisations they would need to operate after Brexit, and they may have to take decisions before they know the outcome of the negotiations between the UK and the EU27, given the lead-times involved.

26 At ICMA, we are keeping the practical implications of Brexit on the agenda of our Market Practice and Regulatory Policy Committees to see how we can best help members both in the UK and the EU27 to prepare; we are in touch with the UK, the euro area and the EU authorities; and we are cooperating with other trade associations by sharing information where we can.

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15. This could affect euro clearing in New York as well as London.