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SUBMISSION TO THE DEPARTMENT FOR EXITING THE EUROPEAN UNION BY TRAVERS SMITH LLP

SECOND SUBMISSION: THE UK'S LONG TERM RELATIONSHIP WITH THE EU

Travers Smith LLP is an international law firm with offices in London and Paris. The firm advises a variety of clients from publicly-listed and private companies and financial institutions to central banks, operators of financial market infrastructure and other public bodies, often in relation to complex, multi-jurisdictional legal and regulatory issues[1].

We have provided a separate submission (the "**First Submission**") on transitional arrangements and Principle 12 of the White Paper entitled "The UK's exit from, and new partnership with, the European Union" (the "**White Paper**"). This submission focusses solely on the remaining principles set out in the White Paper but only deals with those which we consider to raise the most pressing and immediate issues that need to be addressed as part of HM Government's negotiating strategy.

We may submit further written evidence to assist HM Government's deliberations on the UK's negotiating objectives for the withdrawal from the EU and/or other related matters.

1. We recognise that Brexit is likely to present many opportunities for the UK (e.g. in terms of possible trade deals with third countries), but it also poses major challenges. We welcome HM Government's decision to publish its negotiating principles, as set out in the Prime Minister's Lancaster House speech and the White Paper and have the following comments and/or recommendations:

PRINCIPLE 1: PROVIDING CERTAINTY AND CLARITY

2. In the White Paper, HM Government states that by preserving rights and obligations that already exist in the UK under EU law, its proposal for a Great Repeal Bill "allows businesses to continue trading in the knowledge that the rules will not change significantly overnight" (paragraph 1.2). We welcome this recognition that simply repealing the European Communities Act 1972 without such preservation measures would leave major "gaps" in the UK's framework of law and regulation, leading to damaging uncertainty.

3. We also welcome the assurance that "the preserved law should continue to be interpreted in the same way as it is at the moment" (grey box headed "Great Repeal Bill" on page 10), together with the commitment in the White Paper entitled "Legislating for the United Kingdom's withdrawal from the European Union" (the "**Second White Paper**") to allow the courts to continue to have regard to EU Treaty provisions and for CJEU rulings up to the date of the UK's exit from the EU to have the same status as decisions of the Supreme Court[2].

1 Whilst we advise many regulated fund managers, corporate finance houses and other financial institutions, we do not focus on global investment banks or insurers, so this evidence does not refer to the issues particularly relevant to them.

2 The Great Repeal Bill will, however, need to allow the courts to have regard to CJEU case law in areas of law beyond those covered by EU legislation. For example, the Competition Act 1998 is modelled on EU competition law but does not implement it in the UK. In our view, it will be extremely difficult for the courts to apply the Competition Act 1998 if they are unable to have regard to CJEU case law up to the date of the UK's exit. Depending on the outcome of the negotiations with the EU, there may be other areas of law which raise similar issues, e.g. where the UK has committed to align itself with the EU legislation in the future and that law will be difficult to apply and interpret without regard to CJEU case law.

Directly applicable EU Regulations

4. As HM Government acknowledges in the Second White Paper, many directly applicable EU Regulations will be technically unworkable if incorporated into UK law without significant modification: see our paper entitled **"Brexit and environmental, product and chemical law: the troublesome one third"**, which uses the EU chemicals regulatory regime (REACH) as a case study. The scale of the task facing civil servants and Parliamentary counsel is considerable: the House of Commons Library estimates that over 5,000 EU Regulations may need to be considered for incorporation into UK law via the Great Repeal Bill[3].

5. **For the purposes of certainty and clarity, it is crucial that the Great Repeal Bill should be on the statute book by the time of Brexit – but this could prove to be a very resource-intensive process, particularly in the light of the other demands on civil service resources as a result of Brexit[4]. We therefore recommend that HM Government should commit to making appropriate additional resources available[5] and/or should explore potential "short cuts" in relation to the problem of directly applicable EU Regulations**. This might include general provisions allowing the courts discretion to interpret the unmodified text of an EU Regulation with appropriate adjustments to take account of changed circumstances due to Brexit. From a legal certainty perspective, such a solution would be far from ideal – but it would be preferable to a situation which left significant "gaps" in regulatory coverage. As regards resources, we have offered to second staff to HM Government to assist with Brexit-related work (as, we believe, have a number of other law firms) but to date have not received a response. The offer remains open should HM Government wish to take it up.

PRINCIPLE 2: TAKING CONTROL OF OUR OWN LAWS

6. There is a significant tension between this objective and Principle 8 (ensuring free trade with European markets). Continued high levels of access to EU markets in many areas are likely to depend on the EU being prepared to recognise UK law as equivalent in all material respects to EU law – and on the UK committing to maintain such alignment in future. The paper which we prepared for our client, Euroclear UK & Ireland Limited (the operator of the UK and Irish CREST securities settlement system), entitled **"Settlement Finality: System Significance – Brexit Implications"** (see Annex 4) provides a detailed, and to-date not widely recognised, example in a financial services context of the crucial importance of mutual recognition in ensuring that the UK remains a leading global financial services centre post-Brexit. It also underscores how, in the specific area of financial stability, there is (or should be) a considerable degree of interest in reaching mutually recognised protections for systems that operate in (and under the laws of) different countries; this is particularly so in view of the material inter-dependencies and cross-participations between international systems and their participants. There are many other areas of law where mutual recognition is likely to prove equally important in terms of maintaining current levels of trade with the EU.

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3 http://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-7863 - see paragraph 2.3.

4 See "Legislating Brexit" (March 2017) and "The civil service after Article 50" (March 2017) by the Institute for Government: https://www.instituteforgovernment.org.uk/sites/default/files/publications/IFGJ5347-Legislating-Brexit-IFG-Analysis-032017-WEB.pdf https://www.instituteforgovernment.org.uk/sites/default/files/publications/IFGJ5327_Report_Brexit_Civil_Service_080317_WEB.pdf

5 The National Audit Office has recently raised concerns over civil service capacity in relation to Brexit, whilst also noting that government has not fully addressed previous NAO criticisms of its workforce planning: https://www.nao.org.uk/wp-content/uploads/2017/03/Capability-in-the-civil-service.pdf

7. If Principle 2 always takes precedence, then the scope for achieving an "ambitious and comprehensive Free Trade Agreement" as envisaged by Principle 8 will in our view be severely curtailed, to the detriment of UK business and the UK economy as a whole. There is also a danger that Principle 2 fails to recognise the utmost importance of upholding international standards of law and regulation to ensure the safe and efficient operation of the UK and other financial markets. The development of UK laws in a silo without reference to their equivalence to global requirements would seriously damage the UK's standing as a financial centre and the appetite for investors (and financial institutions) to participate in our markets or to contract under English law. In our view**, HM Government should adopt a flexible and pragmatic approach towards Principle 2 and should acknowledge that in relation to areas of the economy where market access is particularly important to UK businesses, Principles 8 and 12 (smooth, orderly Brexit) may need to take precedence. We also believe, in any event, that the safe, stable and efficient operation of the UK and EU financial markets after Brexit should be a specific objective of the negotiations. HM Government will not achieve free and secure trade with European markets without such financial stability.**

Dispute resolution mechanisms

8. Principle 2 also encompasses bringing "an end to the jurisdiction in the UK of the Court of Justice of the European Union (CJEU)". However, where the UK wishes to continue to participate in existing EU regulatory frameworks after Brexit, the EU is likely to press for the CJEU to be the forum in which any questions of interpretation of EU law should be resolved – and will argue that this is justified in order to ensure a consistent approach. The EU-Ukraine Association agreement, for example, grants Ukraine significant access to EU markets in return for Ukraine agreeing to align its laws with those of the EU in areas covered by the agreement; disputes relating to the interpretation of relevant EU law are dealt with by the CJEU[6] (even though other disputes arising under the agreement are dealt with by arbitration panels).

9. It is not clear to us whether Principle 2 rules out any role at all for the CJEU in relation to any future arrangements with the EU, or whether such a role could be contemplated in relation to certain defined areas of law. If the former, then this aspect of Principle 2 could make it much more difficult for HM Government to maintain current levels of access to EU markets, where that can only be achieved by committing to align UK law with that of the EU. In our view, **HM Government should adopt a flexible approach and should not rule out the possibility of a role for the CJEU in relation to certain defined areas of law[7].**

10. That said, we recognise that a major role for the CJEU in relation to future EU-UK arrangements is likely to be politically unacceptable to many in the UK who voted to leave the EU. However, we note that the EFTA Court has been proposed to Switzerland as an option for future dispute resolution in relation to its bilateral arrangements with the EU[8]. In our view, there are sufficient differences between the EFTA Court and the CJEU for it to be worthy of consideration as a potential compromise option, particularly in circumstances where the

6 See Article 322 of Title IV on Trade and Trade –Related Matters: http://ukraine-eu.mfa.gov.ua/en/page/open/id/2900

7 A distinction could be made for these purposes between CJEU decisions having direct effect in UK law as at present and the position under a hypothetical EU-UK Free Trade Agreement (FTA) where the CJEU was simply used as a mechanism to resolve certain disputes. In the case of the latter, decisions by the CJEU would not have direct effect in UK law – they would merely have effect "on the international plane" as between the UK and the EU, in much the same way as a decision by a WTO Panel. Legally, the UK would remain free to act contrary to the ruling, although it would have to be prepared to accept the likelihood of retaliatory measures from the EU under the EU-UK FTA, potentially including loss of access to EU markets.

8 See speech by Judge Baudenbacher, President of the EFTA Court given on 13.10.2016 at page 5: http://1exagu1grkmq3k572418odoooym-wpengine.netdna-ssl.com/wp-content/uploads/2016/11/Baudenbacher-Kings-College-13-10-16.pdf. We accept that use of the EFTA Court would require the agreement of the EEA-EFTA States as well as the EU. However, we consider that, provided the UK was prepared to contribute to the running costs of the court, this would be less problematic to negotiate than, say, full UK membership of EFTA and accession to the EEA Agreement.

"price" demanded by the EU for market access is the acceptance by the UK of an independent dispute resolution mechanism (see Annex 1 for more detail). Accordingly, we consider that **HM Government should not rule out the possibility of seeking to use the EFTA Court as a dispute resolution mechanism**.

Ensuring that the UK legal system remains attractive after Brexit

11. According to a report published by the Law Society in 2016[9], legal services contributed £25.7 billion to the UK economy in 2015[10] and accounted for the employment of 370,000 people. In a 2016 publication by TheCityUK, the UK was estimated to account for approximately 10% of the global legal services market, making the UK the second largest market in the world behind the United States of America and, therefore, the largest market in Europe[11].

12. It is therefore of considerable importance to the economy that the UK's legal system remains attractive both in terms of providing the governing law of international contracts and as being a global centre for dispute resolution. In relation to the latter, the above-mentioned report by TheCityUK cites that, of the 1,100 claims issued in the Commercial Court, more than two thirds of those claims involved at least one party whose address was located outside of England and Wales.

13. Catherine Dixon, the chief executive of the Law Society, said in March 2016, "*[…] like many sectors, legal services operate in a complex and fragile ecosystem. It is important that any changes to the regulatory and legislative environment for the legal services sector are fully considered to avoid any unintended consequences of change, which could put our position as the jurisdiction of choice at risk and so jeopardise future success*"[12].

14. The parts of this "fragile ecosystem" which are particularly vulnerable to the impact of Brexit and which should be carefully considered by HM Government include those EU Regulations that will not be amenable to adoption into domestic UK law under the Great Repeal Bill because they are based on reciprocity and, therefore, do not work as intended if applied unilaterally. Although there a number of instruments which will need to be addressed[13], the two key Regulations are:

    - The Recast Brussels Regulation[14] which governs jurisdiction and the recognition and enforcement of judgments; and

    - The EU Service Regulation[15] which governs the service of proceedings on defendants and their lawyers domiciled in an EEA state.

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9 See: http://www.lawsociety.org.uk/news/documents/legal-sector-economic-value-final-march-2016/

10 As estimated by the Office for National Statistics.

11 See: https://www.thecityuk.com/assets/2016/Reports-PDF/UK-Legal-services-2016.pdf

12 See: http://www.lawsociety.org.uk/news/documents/legal-sector-economic-value-final-march-2016/

13 For example, Regulation (EC) No 1896/2006 of 12 December 2006 creating a European order for payment procedure; Regulation (EC) No 1206/2001 of 28 May 2001 on cooperation between the courts of the Member States in the taking of evidence in civil or commercial matters; Regulation (EC) No 593/2008 on the law applicable to contractual obligations (Rome I); Regulation (EC) No 864/2007 on the law applicable to non-contractual obligations (Rome II).

14 Regulation (EU) No 1215/2012 of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (recast).

15 Council Regulation (EC) 1393/2007 of 13 November 2007 on the service in the member states of judicial and extrajudicial documents in civil or commercial matters.

15. **We recommend that HM Government should seek continued participation in the regimes provided for by these Regulations after Brexit; if this is not possible, HM Government should instead accede to other parallel regimes, such as the Hague Convention on Choice of Court Agreements 2005, or the Lugano Convention 2007.** There is of course the fall-back position of the old common law (i.e. prior to EU/UK statutory intervention), but that will lead to much less certainty for litigants in this jurisdiction. It is therefore vital that these Regulations are considered separately, well in advance of Brexit.

PRINCIPLE 5: CONTROLLING IMMIGRATION

16. As noted at paragraph 7.2 of the White Paper, the UK employment rate is "at a near record high". Many of our clients have expressed concerns that the introduction of controls on migration from the EU may make it difficult to fill vacancies in future[16]. Many have already had to engage in additional recruitment as a result of EU nationals in their workforce deciding to return home, motivated primarily by a feeling that they are no longer welcome in the UK following the Brexit vote.

17. We therefore welcome HM Government's commitment to openness and tolerance in the White Paper and the recognition that new immigration arrangements will raise complex issues. In particular, an appropriate balance will need to be struck between the desire for stronger immigration controls and the importance of ensuring that UK businesses are able to serve their customers and expand – which they will not be able to do if there is a shortage of labour.

18. We believe it is particularly important that **controlling immigration should not always take precedence over other objectives in the White Paper, particularly those concerned with trade**. Free trade, particularly in services, requires movement of people. There are many sectors where the EU has not made any commitments at all under the WTO General Agreement on Trade in Services to "Mode 4" access i.e. the ability for individuals from other WTO member states to travel to the EU on a temporary basis for work purposes (e.g. to visit a client or to perform services on site). If such "fly in fly out" access is not possible (or only possible subject to compliance with onerous bureaucratic requirements), trade between the UK and the EU will be impeded.

19. The EU may be amenable to going beyond its WTO commitments and allowing UK citizens wide-ranging "Mode 4" access after Brexit, but only if the UK offers the same in return for EU citizens. If HM Government's position is that it must have absolute control over immigration at all costs, then agreement with the EU on "Mode 4" access is unlikely and it will not be possible to fulfil Principle 8. In our view, the interests of the UK would be ill-served by such an outcome.

PRINCIPLE 7: PROTECTING WORKERS' RIGHTS

20. **Whilst we welcome HM Government's commitment to protecting workers' rights, it is not clear to us why only "workers" have been singled out as the sole group deserving of protection. HM Government may wish to consider whether its objectives should include broader categories such as "consumers" or even simply "individuals" or "citizens".**

[16] See for example evidence provided by Andrea Wareham, HR Director of Pret A Manger, to the House of Lords Economic Affairs Select Committee on 8 March 2017: http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/economic-affairs-committee/brexit-and-the-labour-market/oral/48754.pdf

21. By way of illustration, as regards consumers, it would be undesirable for cooperation between UK consumer protection authorities and their EU counterparts to cease on Brexit. Scams directed at vulnerable consumers including pensioners (many of whom, having retired, will not be "workers") have often been conducted from outside the UK (sometimes from other EU member states[17]). Effective action against them requires cross-border coordination between regulators. Such scams frequently involve misuse of personal data. It would therefore also be helpful to maintain coordination mechanisms with EU data protection regulators. Indeed, as regards individuals, one example of a right which may merit being added to the White Paper's principles is the protection of privacy.

Privacy and data protection

22. Privacy and data protection also provide a useful illustration of how Principle 7 – if widened to encompass the rights of consumers and/or individuals – could support HM Government's other objectives (particularly Principles 8 and 12) and thus potentially assist in Brexit negotiations with the EU. We welcome HM Government's acknowledgement that "[t]he stability of data transfer is important for many sectors" (paragraph 8.38 of the White Paper). It has also acknowledged that data transfer could be disrupted (with potentially serious adverse effects) if the European Commission does not consider the UK's post-Brexit framework for protection of personal data to be "adequate" (i.e. broadly equivalent to the protection that is available in the EU)[18].

23. A commitment by HM Government to maintain the substance of existing protections for personal data would therefore be of assistance in persuading the EU and the European Commission that the UK's framework of law is likely to remain "adequate" after Brexit. This in turn would support the objective of ensuring free trade with European markets. **We therefore recommend that protection of individual privacy should form part of HM Government's negotiating objectives and that it should seek an interim agreement from the EU to ensure that data flows will not be disrupted on Brexit, pending a decision from the European Commission on adequacy of the UK's post-Brexit data protection regime.**

PRINCIPLE 8: ENSURING FREE TRADE WITH EUROPEAN MARKETS

24. We welcome HM Government's objective of ensuring "the freest and most frictionless trade possible in goods and services between the UK and the EU." However, that ambition has the potential to conflict with other principles, notably Principle 2 (taking control of own laws): see paragraphs 6-7. **HM Government may wish to consider how it proposes to strike a balance between these principles and whether it has conducted sufficient impact assessments to inform its approach. Critical questions in our view would be:**

- **How much trade with the EU and investment in the UK is HM Government prepared to put at risk in order to achieve Principle 2?** If the aim is also to maintain, so far as possible, current levels of access to EU markets and protections for the safe and efficient operation of our markets, the EU is likely to expect the UK to commit to aligning its laws with those of the EU, both now and, crucially, in the future. Inevitably this will constrain the UK's freedom to make its own laws – because if it diverges in material respects from the EU "norm", it will stand to lose market access and mutual protections for the safe and efficient operation of the UK's financial system, potentially severely harming UK businesses and consumers. It would also clearly make the UK and English law less attractive for global firms

17 See for example: https://www.gov.uk/cma-cases/friedrich-mueller-misleading-prize-draw-mailings

18 See further "Brexit and data protection", House of Commons Library briefing paper 7838, 15 December 2016: http://researchbriefings.files.parliament.uk/documents/CBP-7838/CBP-7838.pdf

wishing to use the UK and its laws as a "platform" to access EU markets and to provide a robust, well-founded and enforceable legal basis for their business activities.

- **To what extent can any loss of trade with the EU be made up for by concluding trade deals with third countries such as the US?** We recognise that Brexit offers a number of opportunities, not least the possibility of concluding a trade deal with major global economies such as the US, China and India. The greater the opportunities provided by such trade deals, the lower the concern about loss of trade with the EU. However, we would caution against over-optimistic projections, as much would depend on the capacity of such trade deals to improve access for the UK's services sector (which in turn is likely to make them more challenging and time-consuming to negotiate)[19]. We would also be concerned if HM Government lost sight of the importance of ensuring that our own markets should remain accessible to financial institutions wherever they may be established – and to ensure that such access does not transmit systemic risk into our markets because of the lack of recognition of UK finality laws under the insolvency laws of EEA and other states. Safe, efficient and open global access to our markets is a key contributor to economic growth, competition and financial stability.

25. There is no guarantee that high quality trade deals with third countries will be achievable after Brexit and, even if they are, it will be some years before the economic benefits will be felt. By contrast, the UK already does a substantial amount of trade with the EU – a significant proportion of which can reasonably be expected to continue if the UK is able to secure preferential access to EU markets and mutual recognition of our respective laws/regulations. In light of these considerations, we consider that, **where significant volumes of UK-EU trade and the stability of the financial system are at stake, HM Government should prioritise Principle 8 over Principle 2[20].**

Too many potentially conflicting objectives?

26. The EU's starting position in negotiations will be that if the UK wants the same level of access as it has at present, it should remain a member of the EU. No existing FTA between the EU and any third country provides the level of preferential access to EU markets which HM Government appears to be seeking or the mutual recognition of finality or other laws to protect the operation of relevant financial markets. Whilst it may be possible to go further than those FTAs in some areas, the EU will be understandably reluctant to grant access or recognition which largely replicates the benefits of membership. It may also feel constrained by "Most Favoured Nation" provisions in existing FTAs, which could require it to extend preferential treatment granted to the UK to other countries as well[21].

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19 See for example this research from the National Institute for Economic and Social Research (NIESR): http://www.niesr.ac.uk/blog/will-new-trade-deals-soften-blow-hard-brexit#.WM_Hr_5F1VL

20 Whilst we recognise that such an approach may raise concerns about constraining the UK's freedom of action under Principle 2, we note that even where no preferential access is available based on equivalence, third countries such as Turkey and Switzerland have chosen to model their own laws on EU regulation in order to minimise the cost and disruption to businesses that are required to comply with 2 formally separate sets of rules (this is the case, for example, in relation to chemicals regulation, where both countries have elected to mirror the EU's REACH regime, even though equivalence is not available under that regime – meaning that whilst businesses may need separate chemical registrations in both jurisdictions, they will be seeking to meet aligned standards in each). Where the UK is likely to follow the EU regulatory approach in any event, the freedom the UK would be giving up by committing to equivalence or by adopting the EU acquis (where these options are available) would in our view be limited – and may be a "price worth paying" in return for a binding, long term commitment from the EU to preferential access for UK businesses.

21 For example, in relation to services, Article 7.8 of the EU-South Korea FTA provides that if one party agrees to grant greater access to another country in a subsequent FTA, the same treatment will be extended to the EU or South Korea, as the case may be. However, the MFN obligation does not apply where the subsequent FTA "stipulates a significantly higher level of obligation" – so a UK-EU FTA which went substantially further than the EU-South Korea FTA could would arguably not trigger this obligation.

27. Nevertheless, the EU may be prepared to concede a higher level of access if the UK were to agree to continued budget contributions (probably at a reduced level compared with current payments), an independent dispute resolution mechanism and some degree of flexibility on immigration. For the reasons explored above, we also consider that the EU should readily acknowledge the mutual benefit of recognising settlement finality and other laws that support the stability of the financial markets. The difficulty for HM Government will be that, as outlined above, such commitments and recognition would potentially conflict with other objectives in the White Paper[22]. For all HM Government's insistence in Parliamentary debate that its hands "must not be tied" in advance of negotiations, its own White Paper risks seriously compromising its ability to adopt a flexible, pragmatic approach, particularly in areas of highly technical regulation which are of little concern to the average voter. **HM Government may therefore wish to consider whether the White Paper sets too many potentially irreconcilable objectives and thus reduces the prospects of an optimal outcome on the central issues of the UK's future trading relationship with the EU and the financial stability of UK and EU financial markets.**

Equivalence/mutual recognition - or continuing to accept aspects of the "acquis"?

28. Assuming that HM Government pursues an FTA with the EU, there are two main ways in which it could seek to preserve as much of the UK's current level of market access as possible, particularly as regards non-tariff barriers.

29. It could seek to continue participating in some aspects of the Single Market by committing to adhere to the relevant part of the "acquis" (much as Ukraine has done in its Association Agreement with the EU). This is likely to involve an obligation to submit disputes to a court, such as the CJEU or potentially (as suggested at paragraph 10), the EFTA Court, so to ensure consistent interpretation of the relevant rules. We recognise that the EU may not be prepared to offer this option at all e.g. because it may be viewed as "cherry picking" (although we note that the EU has in the past entered into agreements to allow third countries to participate in aspects of some EU regulatory frameworks, such as the Single European Sky[23]). Alternatively, HM Government could seek mutual recognition for UK goods and services on the basis that UK law should be regarded as broadly equivalent to the relevant EU regime.

30. Both would involve the UK aligning itself with EU law, although the equivalence route may offer more flexibility (but less certainty and greater cost for the reasons outlined below). As such, it might be thought that equivalence would be preferable (particularly in the light of Principle 2), but the following points should be borne in mind:

    - Flexibility is likely to be limited because any significant divergence from the EU "norm" will have the potential to undermine equivalence (which can be withdrawn).

    - Equivalence would also involve setting up separate UK regulatory regimes and bodies and (even if the substance of UK and EU regulations were the same) would require business (with UK and EU customers/clients) to comply with two sets of administrative requirements rather than one. As a result, in some sectors, it may be more

22 See "UK-EU Trade Relations Post Brexit: Too Many Red Lines?" by the UK Trade Policy Observatory: http://blogs.sussex.ac.uk/uktpo/files/2017/01/Briefing-paper-5-Final.pdf

23 For example, the following third countries are able to participate in aspects of the EU's Single European Sky regime: Norway, Iceland, Albania, Boznia and Herzegovina, former Yugoslav Republic of Macedonia, Montenegro, Serbia and Kosovo via the European Common Aviation Area Agreement; Georgia and Moldova via the Common Aviation Area Agreements; Morocco, Jordan and Israel via the Euro-Mediterranean Aviation Agreements.

straightforward and cost-effective[24] for the UK to continue to participate in the relevant EU regulatory regime, particularly given the pressure on HM Government resources that Brexit is likely to create.

31. As regards our own sector (legal services), our preference would be for the UK to continue its participation in the existing framework for legal services, which covers the EEA and Switzerland[25]. We consider that this would be more straightforward than an approach based on equivalence and we are not aware of any objections which have been raised to this framework; on the contrary, it is generally considered to have been of significant benefit. Loss of market access would be likely to have a serious adverse economic impact on the sector (see paragraph 11 above).

32. **Whilst HM Government's preference may be for equivalence, we would urge it not to rule out the possibility of committing the UK to continued adherence to parts of the EU acquis, where this represents the best outcome for businesses and the most efficient use of taxpayers' money.**

33. **Where equivalence is the preferred route, HM Government should also seek to ensure that there are appropriate constraints on the EU's ability to withdraw equivalence decisions based on, e.g. political considerations** (as opposed to reasons connected with a substantive lack of equivalence). For further discussion of this point, see Annex 4 at paragraph 17(f).

34. Whilst the UK will no longer have voting rights and will have less influence over EU legislation than it did as an EU Member State, **HM Government should seek a right to participate in the relevant institutional bodies[26]** (mirroring the position of the EEA Member States under Annex II of the EEA Agreement) together with a **right to be involved in discussions on future legislative changes.**

35. The White Paper also refers to international standard setting bodies where the UK is currently represented by the European Commission on behalf of the EU (immediately below paragraph 8.11). These bodies may provide an opportunity to exert influence over the future direction of EU legislation. **HM Government should ensure that adequate expertise and resources will be available for the UK to pursue an active role in international standard setting bodies after Brexit** (particularly those where the UK has only been represented by the European Commission acting on behalf of the EU as a whole).

Tariffs, rules of origin etc.

36. We welcome the aim of securing tariff-free trade in goods, since reverting to WTO tariffs would be damaging for many sectors; moreover, reliance on WTO rules alone would represent a very unsatisfactory basis for the UK's future trade with the EU[27]. However, even with zero or

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24 Whilst the UK would probably have to make budget contributions to pay for Single Market regulatory costs (and would thus still be paying for the relevant regulatory regime), such contributions may represent better value for money than the costs likely to be incurred in setting up new UK regulatory bodies from scratch (which would largely duplicate the functions of existing EU regulators).

25 For more detail, see the Law Society's paper "Brexit and the Law" at pages 13-17: http://www.lawsociety.org.uk/support-services/research-trends/documents/brexit-and-the-law

26 For example, in the context of chemicals and the EU's REACH regime, this would include the European Chemicals Agency, the Member State Committee, the Committee for Risk Assessment, the Committee for Socio-Economic Analysis and the Forum for Exchange on Enforcement.

27 See "The WTO option and its application to Brexit" by Dr. Richard North: http://eureferendum.com/documents/BrexitMonograph002.pdf

relatively low tariffs for most goods, UK businesses are likely to face increased border transaction costs, assuming that, in the longer term, the UK does not remain in a customs union with the EU. This is particularly problematic for businesses, such as those in the automotive sector, with EU-wide supply chains. **Whilst the White Paper states that it seeks an arrangement which will be as "frictionless as possible," it lacks clarity on how this would be achieved. As this is a critical issue for the UK's trading relationship with the EU (see our First Submission at paragraph 2), we recommend that HM Government considers the merits of the options listed at Annex 2.**

37. **For the reasons outlined in our First Submission, we do not consider that either the UK or the EU will be adequately prepared for the introduction of customs controls by 2019. HM Government should therefore seek a transitional arrangement with the EU, ideally allowing the UK to remain in some form of customs union with the EU for an interim period (pending a move to full customs controls once both parties are ready).**

OTHER ISSUES

38. **Annex 3 lists a number of other issues which the HM Government may wish to consider, but which were not addressed in the White Paper. They are all matters that will in our view need to be addressed as part of the UK's negotiations over its exit from and/or its future trading relationship with the EU.**

UK's longer term "vision" for European cooperation

39. The White Paper contains little discussion of the UK's long term vision for the future development of cooperation with other European countries generally (i.e. not just EU Member States but also the EFTA States, Turkey and former Soviet bloc countries such as Ukraine)[28]. The EU's policy towards a number of these states is arguably somewhat problematic; for example, both Turkey and Ukraine have been offered a path towards EU membership but, politically, the prospects of membership look remote. The EU is also known to be unhappy about its arrangements with Switzerland.

40. There may therefore be an opportunity for the UK to play a leadership role in establishing a more coherent framework for countries outside the EU capable of accommodating countries which either do not wish to be part of the EU (e.g. the UK and Switzerland) or which the EU itself is unwilling to accept (e.g. Turkey). Clearly, any such initiative would have to be presented in a sensitive manner as being complementary to the EU, rather than a potential threat to it. However, it would allow the UK to present itself as offering potential solutions to an existing problem rather than (as the EU might see it) merely adding to the challenges facing it at present; as such, it could also help the HM Government to achieve a better outcome in relation to some of its other objectives. **HM Government may therefore wish to consider whether its negotiating objectives should include a more ambitious and positive vision on future cooperation with European countries, both inside and outside the EU.**

Scotland, Northern Ireland and Wales

41. Our clients, partners and staff include Scottish, Northern Irish and Welsh individuals and we relish the diversity that this brings to our firm. Various solutions to the UK's exit from the EU have been suggested which involve further differentiating between the legal systems of parts

[28] Other commentators have also highlighted this issue. For example, the Conservative Group for Europe has criticized the White Paper for adopting a "piecemeal" approach which lacks a coherent vision. See this paper at page 18: http://www.conservativegroupforeurope.org.uk/wordpress/wp-content/uploads/2017/03/Seeking-the-Common-Good-Building-a-New-Constructive-relationship.pdf

of the United Kingdom. We would note such differentiation and the complexity it brings adds cost and friction to trade.

42. **We would urge HM Government to differentiate between parts of the United Kingdom only to maintain the current status quo.**

43. We would note that if Brexit resulted in one part of the UK being within the EU or EEA and others not being, that would exponentially increase the complexity of a withdrawal, as numerous legal and practical anomalies would need to be resolved. The existing examples of Greenland or the Faroe Islands do not provide a useful template due to their geographic distance from Denmark and the economic activities carried on there.

Travers Smith LLP
[ ] May 2017

ANNEX 1

DIFFERENCES BETWEEN CJEU AND EFTA COURT

If the EFTA Court were used solely to resolve disputes between the EU and the UK, the key differences between the CJEU and the EFTA Court would be as follows:

- **Independent and institutionally separate from CJEU - can and does form its own view (subject to CJEU not having already ruled on the same point):**
    - for examples of the EFTA Court adopting a different approach from the CJEU, see Judge Baudenbacher's speech on 13 October 2016 (**"Baudenbacher"**)[29] at pages 12-14.

- **Better suited to pragmatic common law approach:**
    - for examples/discussion, see Baudenbacher at pages 12-14.

- **Greater involvement by UK-nominated judge compared with CJEU:**
    - the CJEU is divided into 10 chambers, with a UK-nominated judge sitting in only two of those chambers – whereas if the UK were to participate in the EFTA Court, a UK-nominated judge would in all probability be able to sit on all cases concerning the UK[30].

If, additionally, national courts in the UK had the ability to make referrals to the EFTA Court under arrangements similar to the EEA Agreement, key differences would also include:

- **EFTA Court rulings on questions referred from national courts are advisory, not binding on EEA-EFTA States**:
    - a point of some constitutional importance to EEA-EFTA States as it arguably shows greater respect for national sovereignty.

- **No obligation on national courts to refer to EFTA Court - likely to mean fewer referrals than under current arrangements**
    - there would be more scope for national courts to take their own view of a matter of EU/EEA law without a referral or to leave it for more senior courts to consider whether a referral was required, should the case be appealed (whereas under current arrangements, the courts are legally obliged to refer to the CJEU unless the point of EU law at issue is clear).
    - as a result, there could well be fewer referrals to the EFTA Court than under the current arrangements with the CJEU; a comparison of Norway with Finland and Sweden suggests that this would be a reasonable expectation[31].

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29 http://1exagu1grkmq3k572418odoooym-wpengine.netdna-ssl.com/wp-content/uploads/2016/11/Baudenbacher-Kings-College-13-10-16.pdf

30 The EU is reported to have offered the Swiss the possibility of "docking" to the EEA/EFTA institutions and in relation to the EFTA Court, the proposal was for Switzerland to nominate a judge who would sit in all cases concerning the sectoral agreements between the EU and Switzerland. See Baudenbacher at page 5.

31 In the 21 years to 2015, courts in Norway made 47 requests to the EFTA Court for an Advisory Opinion (average of 2.2 per year). See: http://www.efta.int/sites/default/files/documents/eea/seminars/eea-a15/2015-09-02-efta-court.pdf at slide 17. Over the same period, courts in Sweden and Finland made, respectively, 121 and 95 requests to the CJEU for a Preliminary Ruling (equivalent to the EFTA Court Advisory Opinion). See http://curia.europa.eu/jcms/jcms/p1_219055/en/ at pages 97-99. This suggests that Norwegian courts make significantly less use of the referral procedure than countries with comparable populations and economies (even allowing for the fact that Sweden and Finland, as EU member states, are subject to more EU legislation than Norway). For comparison, the UK courts make about 14 referrals to the CJEU per year on average.

ANNEX 2

MEASURES WHICH COULD EASE THE POTENTIAL BURDEN ON BUSINESS DUE TO THE RE-INTRODUCTION OF CUSTOMS CONTROLS

NOTE: even if all the following measures are adopted, they are unlikely to result in EU-UK goods trade being as "frictionless" as under the current arrangements with the EU, where customs clearance is not required for trade between EU Member States:

- **Rules of origin – self-certification and cumulation:** in order to benefit from preferential tariffs in any future EU-UK FTA, UK businesses will need to prove that a certain percentage of their goods originated in the UK. No such requirement applies at present on trade with other EU Member States because of the EU Customs Union. The EU-South Korea FTA contains several provisions which may help to reduce the additional burden on businesses of compliance with rules of origin. For example, it allows approved exporters to "self-certify" the origin of their goods by means of an "origin declaration", instead of having to obtain a certificate from customs authorities. It also provides for cumulation of origin; if applied to the UK, this would mean that a car assembled in the UK from parts originating largely from the EU would still be regarded as originating in the UK (and would thus benefit from preferential tariffs if exported to the EU).

- **Committing to match the EU's external tariffs on certain goods:** rules of origin requirements could potentially be waived if the UK agreed to maintain tariffs on imports from non-EU countries which matched the EU's tariffs on such imports into its territory. In that situation, there would be no concern that goods being exported from the UK were unfairly taking advantage of the UK's preferential tariff arrangements with the EU (because, for example, they consisted largely of non-UK components). For example, with a view to easing the position of car manufacturers and others with highly integrated supply chains, the UK could agree to align its tariffs with those of the EU for all products in the automotive sector. Whether this position is sustainable in the long term is open to question, as it would prevent the UK reducing such tariffs when negotiating trade deals with third countries.

- **Authorised Economic Operator ("AEO") system:** essentially, the AEO system allows approved importers and exporters to make use of simplified, fast-track procedures, so that most goods can clear customs with only a documentary check (rather than a full customs inspection, which may involve delays while the container is opened up to verify the contents). The EU has such arrangements in place with the US, Japan and a number of other major economies. The Japanese government[32] has strongly advocated continued participation by the UK in the AEO system post-Brexit.

- **Mutual recognition of conformity testing:** certain products, such as electrical goods, need to be accompanied by proof that they meet relevant standards (without which they will be refused entry). Such proof is normally provided by a testing certificate from an approved laboratory. Mutual recognition involves each country recognising that testing facilities in its jurisdiction can issue valid certificates under the other country's regulatory regime. As a result, rather than the goods having to be held at the port of entry while testing is carried out, the testing can be done in the country of export, with proof of compliance being demonstrated by a certificate to satisfy customs requirements.

- **Investment in technology:** technology such as IT systems to enable advance clearance in combination with automatic number plate recognition (to speed up clearance of HGV traffic) could result in faster and less burdensome customs procedures. However, such systems

[32] http://www.mofa.go.jp/files/000185466.pdf

require time and resources to put in place. For example, the new US customs system, ACE, has suffered repeated delays in implementation, albeit that it is expected to improve the efficiency of customs procedures in the longer term[33].

33 https://www.flexport.com/learn/cbps-automated-commercial-environment-importing/

ANNEX 3

OTHER ISSUES THAT WILL NEED TO BE ADDRESSED IN EXIT/FUTURE TRADE NEGOTIATIONS

Intellectual property (IP)

Other than a cursory reference at paragraph 8.36, the White Paper is silent on how HM Government will approach the difficult issue of EU-wide IP rights, such as the Community Trade Mark ("CTM"). What will happen to these rights on Brexit? Will holders of CTMs, and other EU-wide IP rights simply lose their rights in the UK? Ideally, HM Government should seek agreement from the EU on this issue so that rights holders have clarity and certainty after Brexit. To the extent that holders of EU-wide rights will need to apply for UK national rights in order to maintain protection after Brexit, an early announcement on this matter would be highly desirable (so that UK businesses can take appropriate action to "plug" any gaps left if EU-wide IP rights are no longer applicable in the UK).

Export licensing

Following the UK'S exit from the EU, the transfer of military and dual-use items to and from the UK and the EU will need to be considered. For example, dual-use items may not leave the EU without an individual or general export authorization, but in most cases such items can be transferred between EU nations with limited red tape. Depending on the outcome of Brexit, companies may need licences, prior notifications or registrations in order to continue with such EU-UK trade after Brexit. Such requirements could be potentially burdensome to businesses and give rise to delays whilst the relevant conditions are complied with. Given that both HM Government and businesses may need time to adapt to any new regime, a transitional period under which current arrangements were preserved for a time would be highly desirable.

Sanctions

The House of Commons Foreign Affairs Committee has suggested that HM Government may wish to adopt a "policy mirroring approach" to align itself to EU sanctions (similar to Switzerland and Norway)[34]. However, we would highlight the following issues:

- Certain areas of sanctions legislation will need to be revisited post-Brexit. For example, at present, EU sanctions measures against Russia do not apply to EU-based subsidiaries of Russian blacklisted banks. Will UK businesses which have contracted with such EU subsidiaries be able to continue to do so if the UK is no longer part of the EU customs territory? The frustration of such contracts on grounds of illegality after Brexit could lead to significant exposures for UK businesses, particularly in the financial sector.

- If the UK decides to diverge significantly from the EU approach and/or to grant more authority to enforcement agencies like the Office of Financial Sanctions Implementation, businesses will need to be consulted and given adequate advance warning, as such changes may have a significant impact on existing commercial arrangements which were assumed to be acceptable under the current EU regime[35].

[34] In the short term, this would in our view be the least disruptive option for businesses.

[35] The UK's autonomous measures regarding terrorist asset freezing will continue to apply, as will all restrictions imposed through the UN Security Council. The Joint Comprehensive Plan of Action signed with Iran should also remain unaffected.

ANNEX 4

SETTLEMENT FINALITY: SYSTEMIC SIGNIFICANCE

BREXIT IMPLICATIONS

A. Introduction: some context

1. Euroclear UK & Ireland Limited (***EUI***) is the operator of the CREST system.

2. CREST is the securities settlement system for UK and Irish[36] shares, government securities, money market instruments and other securities. It provides for delivery-versus-payment settlement of transactions in securities against sterling, euros and US dollars[37].

3. In legal terms, EUI operates two *designated systems* under the Settlement Finality Directive[38] (as amended, the ***SFD***). For securities constituted under UK law, the CREST system is designated by the Bank of England under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (as amended, the ***SFRs***); and for securities constituted under Irish law, the CREST system is designated under the Irish European Communities (Settlement Finality) Regulations 2010 (as amended).

4. In designating a system in the EEA, the relevant designating authority is required to have regard to systemic risks[39]. The systems designated by the Bank of England under the SFRs comprise the CREST securities settlement system, payment systems and systems operated by central counterparties (***CCPs***). All of these systems are financial market infrastructures (***FMIs***) that are required to operate with regard to the Principles for financial market infrastructures[40] (the ***PFMIs***).

5. In recognition of the critical role that FMIs play in the financial system and broader economy, the PFMIs apply international standards to enhance safety and efficiency in their operation so as, more broadly, to limit systemic risk and foster transparency and financial stability[41]. The PFMIs reflect the fact that safe and efficient FMIs *"contribute to maintaining and promoting financial stability and economic growth"*, but if FMIs are not properly protected they *"can be sources of financial shocks … or a major channel through which these shocks are transmitted across domestic and international financial markets"*[42].

6. The CPMI-IOSCO Report recognises the fundamental importance of a well-founded, clear and enforceable legal basis for settlement finality in achieving the aims of the PFMIs: see paragraph 3.1.6 of the CPMI-IOSCO Report and PFMI 8 (*Settlement finality)*. Specifically, the CPMI and IOSCO express the view that:

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[36] CREST also settles securities constituted under the laws of Guernsey, the Isle of Man and Jersey.

[37] The daily average value of securities held in the CREST system in December 2016 was in the order of £4.9 trillion. Daily average securities movements were £915 billion; and daily average cash movements were £610 billion.

[38] Directive of the European Parliament and of the Council (98/26/EC) of 19 May 1998 on settlement finality in payment and securities settlement systems.

[39] See, for example, regulation 4(2) of the SFRs. In the UK, the Bank of England has designated (in addition to the CREST system): Bacs (operated by Bacs Payment Schemes Limited); CHAPS (operated by CHAPS Clearing Company); Cheque Clearing System and Credit Clearing System (operated by the Cheque and Credit Clearing Company); CME Clearing Europe system; CLS (operated by CLS Bank International); Faster Payments Service (operated by the Faster Payments Scheme Limited); ICE Clear Europe; LCH.Clearnet Limited; LME Clear Limited; and SIX x-clear.

[40] The PFMIs were promulgated in a report published in April 2012 by the Committee on Payment and Settlement Systems (now the Committee on Payments and Market Infrastructures) and the Technical Committee of the International Organization of Securities Commissions (the ***CPMI-IOSCO Report***).

[41] See paragraph 1.15 of the CPMI-IOSCO Report. The aims of the SFD are expressed in similar terms: see Recitals (1), (2), (3) (4), (9) and (10).

[42] See paragraph 1.3 of the CPMI-IOSCO Report.

"The laws of the relevant jurisdictions should support the provisions of the FMI's legal agreements with its participants and settlement banks relating to finality."

7. In the EEA context, the finality laws that the CPMI-IOSCO Report contemplates are those contained in the SFD and the SFRs. A failure, therefore, by HM Government to ensure that post-Brexit UK designated systems continue to benefit from equivalent statutory protections to those currently provided by the SFD/SFRs would potentially:

   (1) cause the UK's legislative framework for FMIs to fall below international best standards for systemically-important systems;

   (2) adversely affect the ability of the UK's designated systems to contribute to the UK's financial stability and economic growth; and

   (3) result in the designated systems being a source of financial shocks for the UK and international financial markets, as well as the broader financial system.

B. Settlement finality: specific protections

No reversal or unwinding of transactions

8. The stability and efficiency of financial markets relies on confidence in the finality of transfers of value. If an investor has paid for and received a security, it must have a high-level of certainty that there is minimal risk that it will be compelled to return the security; and if an investor has delivered a security in return for payment, it requires the same level of certainty that it will not be compelled to repay the cash received. Any reversal or unwinding of a transaction that the parties considered complete creates risk for investors - including credit[43], liquidity[44], market[45] and, ultimately, systemic risk[46]. Further, it undermines market confidence that the asset or cash received may be freely onward transferred or used so as to confer good title on the recipient. This endangers the efficient and safe operation of the financial system itself.

9. The principal source for the potential unwinding or reversal of market transactions is applicable insolvency law. If a participant in a system enters insolvency proceedings, preference, transaction at an undervalue, zero-hour, anti-deprivation or other rules applying in those proceedings may have the effect of reversing a delivery or payment that has settled through the system.

10. This risk is removed under the SFRs/SFD where the relevant insolvency proceeding, to which the participant is subject, is governed by the law of an EEA state.

    (1) Under Article 8 of the SFD[47], any EEA court exercising insolvency jurisdiction over a participant in a designated system is required to apply the (insolvency) rules of the law that governs the designated system to determine the participant's rights and

[43] Credit risk arises because the investor's counterparty (whether through insolvency or otherwise) may be unable to re-deliver the relevant asset or repay as part of the required reversal process.
[44] Liquidity risk arises because the investor's counterparty may have insufficient assets or cash to meet its obligation to re-deliver or repay when required to do so, although it may do so in the future.
[45] Market risk arises because the investor may suffer adverse fluctuations in the value of the asset delivered or received in the period before the asset is re-delivered or repayment made.
[46] Systemic risk may arise because of the adverse impact upon market confidence in the systems operated by the UK's FMIs if there is (or there is perceived to be) a lack of robust protection under UK law against the unwinding or reversal of payments or deliveries considered final in the system (see paragraph 2.2 of the CPMI-IOSCO Report).
[47] Article 8 is implemented in the UK through regulations 24 to 26 of the SFRs.

obligations arising from or in connection with its participation. This is the case even if the law that governs the designated system is different from the law of the relevant EEA court. Such rights and obligations include those arising in relation to any settlement instructions (***transfer orders***) given by or on behalf of the insolvent participant that have entered the designated system[48] and any transfer or payment effected in performance of the transfer order after it has become irrevocable[49].

(2) A system designated under the SFD must be governed by the laws of an EEA state. Each EEA state will have implemented the SFD to form part of that state's insolvency law[50]. In implementing the SFD, the EEA state will have disapplied those rules of its own insolvency law that would otherwise (a) revoke or terminate the authority/mandate to settle contained in a relevant transfer order[51], (b) empower an insolvency office-holder or court to prevent or interfere with the settlement of a relevant transfer order and (c) result in the unwinding or reversal of any settlement effected in performance of a relevant transfer order.

(3) One important result of (1) and (2) is that a system designated in the UK[52] (and the participants of such a system) enjoy a high degree of legal certainty that if a participant enters insolvency proceedings governed by the law of another EEA state, the courts of that EEA state:

(a) will apply UK (insolvency) law (as the law governing the designated system) to determine the rights and obligations of the insolvent participant in relation to relevant transfer orders and their settlement through the system; and

(b) under UK (insolvency) law, the effect of the SFRs is that (i) any relevant transfer order by the insolvent participant cannot be revoked by the insolvency office-holder or any other party, (ii) the settlement of any such relevant transfer order cannot be prevented or interfered with by the insolvency office-holder or a court and (iii) the settlement of any such relevant transfer order cannot be unwound or reversed[53].

Protection of netting and other default arrangements

11. Netting[54] was recognised in the *Report of the Committee on Interbank Payment Schemes of the Central Bank of the Group of Ten countries (November 1990)* (the ***Lamfalussy Report***) as

[48] The time at which a transfer order is to be treated as having entered a designated system is determined by reference to the rules of the system (see Article 3(3) of the SFD and paragraph 5(1)(a) of the Schedule to the SFRs).

[49] The time at which a transfer order may not be revoked is determined by reference to the rules of the system (Article 5 of the SFD and paragraphs 5(1)(b) and (c) of the Schedule to the SFRs).

[50] See, for example, regulation 25(1) of the SFRs.

[51] A ***relevant transfer order*** for the purposes of this paper is a transfer order given by or on behalf of an insolvent participant that (a) has entered the designated system before the opening of the insolvency proceedings in respect of the participant, and (b) has become irrevocable. In certain circumstances, a transfer order may be a relevant transfer order if it has entered the system after the opening of insolvency proceedings, but this will only be the case if the transfer order is settled on the same business day (i.e. during the same business cycle of the system) as the day on which the proceedings were opened and if the transfer order had become irrevocable before the operator had actual or constructive notice of the insolvency proceedings: see Article 3(1) of the SFD and regulation 20 of the SFRs.

[52] In order to be designated in the UK, the governing law of the system must be English law, Scottish law or Northern Irish law: see paragraph 1(1) of the Schedule to the SFRs.

[53] Further, the UK courts are prohibited from recognising or giving effect to (a) any order of another EEA or third country court, or (b) any act of any insolvency office-holder appointed in another country in so far as the making of the order or the doing of the act would be prohibited in the case of a UK court or insolvency office-holder under the SFRs: see regulation 25 of the SFRs. Under regulation 26 of the SFRs, a UK court is required to apply the protections afforded by the SFRs to any transfer order ("equivalent" to a relevant transfer order) that has entered a system designated in another EEA state. Regulation 26 also applies to protect *"equivalent overseas security"*.

[54] ***Netting*** for the purposes of the Lamfalussy Report is a wide concept. It covers both bilateral and multilateral netting. It includes ***payment netting*** and ***novation netting*** (which are netting processes that operate *prior* to a default of a netting party); and ***close-out***

an important measure to reduce legal, credit, settlement and other risks associated with participation in payment systems. Netting is potentially vulnerable to challenge under applicable insolvency law because it may contravene rules as to *pari passu* distribution or anti-deprivation in the event insolvency proceedings are opened against a netting party.

12. In order to protect the risk mitigation benefits provided by netting and other measures that form part of a designated system's default arrangements, the SFD/SFRs (1) prohibit a court or insolvency office-holder from taking any action that may prevent or interfere with any action taken under a designated system's netting or other default arrangements[55], and (2) recognise and uphold the results of any settlement or other action taken in accordance with those arrangements[56].

13. An insolvent participant's rights and obligations under a designated system's netting or other default arrangements will form part of the *"rights and obligations arising from, or in connection with, the participation of that participant"* which (in accordance with Article 8 of the SFD[57]) must be determined by the governing law of the system. This means that any EEA court outside the UK which has insolvency jurisdiction over a participant in a UK designated system will be required to recognise and uphold the protections afforded to the system's netting or other default arrangements (as impacting upon that insolvent participant) under the SFRs.

Protection of collateral security

14. Applicable insolvency law may adversely affect the (proprietary) rights that a collateral-taker has been granted over the assets of a collateral-giver[58]. Under the SFD/SFRs there are two specific types of ***collateral security*** that benefit from a number of protections from applicable insolvency law:

    (1) collateral security that is provided to secure rights and obligations potentially arising in connection with a participant's participation in a designated system[59] (***collateral security in connection with participation***); and

    (2) collateral security provided to a central bank of an EEA state (or the ECB) for the purpose of securing rights and obligations in connection with the operations in

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netting (which is a netting process that operates upon or after a default of a netting party). In light of the fact that Recital (1) of the SFD makes express reference to the Lamfalussy Report, it was reasonable for HM Government to conclude that in implementing the SFD it should ensure that the protections of the SFRs extend to all types of netting and other arrangements put in place by a designated system to limit systemic and other types of risk which arise in the event of a participant appearing to be unable, or likely to become unable, to meet its obligations in respect of a transfer order. This was achieved through incorporating the concept of ***default arrangements*** in the SFRs. This concept is broader than the corresponding concept of "default *rules*" contained in Part VII of the Companies Act 1989 for two reasons: first, it extends to all designated systems (i.e. not just CCPs required to have default rules within the meaning of Part VII); and, second, default arrangements can operate prior to, on or after the occurrence of a participant default (whereas default rules under Part VII only operate on or after default by a netting party).

[55] See Article 3 of the SFD and regulations 14(1)(b) and 14(2)(b) of the SFRs

[56] See regulation 15 of the SFRs.

[57] See footnote 12.

[58] For example, the ability of the collateral-taker to enforce its rights under the collateral arrangement may be suspended during any relevant moratorium that applies as an incident of the relevant insolvency proceedings or the appointment of the insolvency office-holder. There is some legal uncertainty under the SFD, and the SFRs, as to whether third party security (given by a *non*-participant) to secure the rights and obligations of a participant would qualify for protection as collateral security in connection with participation. This uncertainty stems from Recital (9) of the SFD and regulation 13(2) of the SFRs. As part of any legislative changes to UK law that may be required to ensure that finality and related protections continue to apply for the benefit of UK designated systems and their participants post-Brexit, EUI would support amendments to the existing legislative scheme to resolve this and a number of other uncertainties/anomalies that we (and other designated systems) have identified with the current operation of the SFRs.

[59] An example of such collateral security is the system-charge given by CREST members to CREST settlement banks to secure the reimbursement obligation of the CREST member in relation to credit advanced by its settlement bank to enable the member to make payments through the CREST system.

carrying out its functions as a central bank[60] (***collateral security in connection with the functions of a central bank***).

15. Under the SFD[61] and the SFRs[62], insolvency proceedings in respect of the collateral-giver/participant cannot affect the rights of the collateral-taker in respect of the collateral security (including its enforcement rights)[63]. In accordance with Article 9(2) of the SFD[64], where collateral security is legally recorded in a register, account or centralised deposit system located in an EEA state, the rights of the collateral-taker in relation to the collateral security are governed by the law of the EEA state (or the part of the EEA state) where the relevant register, account or centralised deposit system is located[65].

16. In the CREST context, where a CREST settlement bank takes collateral security over a member's UK CREST securities, the SFD/SFRs will require an EEA court to apply the relevant law of the part of the UK (i.e. English, Scots or Northern Irish law) under whose law the relevant securities are constituted to determine the CREST settlement bank's (proprietary) rights in respect of the collateral security (including its rights of enforcement). In this way, a court of another EEA state is required to recognise and uphold the protections under the SFRs afforded to collateral security arrangements taken over CREST (or other) securities constituted under UK law.

C. Brexit impact

17. In the Brexit context, the key points to draw from our analysis set out in Sections A and B above are as follows.

    (1) It will be essential *as a minimum* to preserve the current protections afforded by the SFRs to UK designated systems (and their participants) for (a) relevant transfer orders and their settlement, (b) netting and other default arrangements put in place by the system and (c) collateral security arrangements[66]. The SFRs themselves were made under section 2(2) of the European Communities Act 1972 and, therefore, in principle would be revoked upon the abrogation of the 1972 Act as part of any Brexit process in the absence of positive steps to affirm the SFRs (with any necessary modifications) as part of continuing UK law.

    (2) However, it is apparent from our analysis above that in order to maintain the *international* standing of (and market confidence in) the UK's financial system, it will also be necessary (e.g. as part of the negotiation of the Withdrawal Treaty once the Article 50, TFEU process is initiated) to ensure the *mutual recognition* by the

[60] It should be emphasised that it is *not* a condition to receive protections under the SFD/SFRs that collateral security in connection with the functions of a central bank secure rights and obligations arising in connection with a designated system.

[61] See Article 9(1) of the SFD.

[62] See regulations 14(1)(d) and (e), 14(2)(c) and (d), 16(1) and (3), 17(1) and (3) and 19.

[63] The practical benefit of the protections afforded to collateral security in the CREST context was evident in the administration of Lehman Brothers International (Europe) (***LBIE***). LBIE was a participant in the CREST system and used [***Information withheld***] as its CREST settlement bank. The protections afforded to [***Information withheld***] system-charge over LBIE's CREST accounts, as result of the qualification of that charge as a collateral security charge under the SFRs, was a key component in the efficient and rapid enforcement of the collateral security. This was an important process in managing any potential contagion risk to other parts of the UK (and international) financial system that would otherwise have arisen had there been any material delay or impediment in [***Information withheld***] management of its exposure to LBIE through the swift realisation of its CREST collateral security charge and the return of excess collateral to the LBIE administrators (for the benefit of the general body of LBIE's creditors).

[64] Article 9(2) of the SFD is implemented in the UK through regulation 23 of the SFRs.

[65] These provisions are interpreted as applying to the *proprietary* rights of the collateral-taker. These rights cover (a) the requirements for perfection so as to make the collateral security effective against third parties, and (b) the steps required to realise the collateral security following a default. The contractual terms of the collateral security instrument will continue to govern the *personal* rights and obligations of the parties to the instrument (under the law expressed to govern the instrument).

[66] EUI would also welcome the opportunity to discuss with HM Treasury where the existing SFRs create issues of legal uncertainty or other anomalies for designated systems and how those issues might be resolved in the interests of the wider financial system.

remaining EEA states of the protections afforded to the UK's designated systems under the SFRs. The relevant issues here are as follows.

(a) The maintenance of the UK's financial markets as premier (or, at least, leading) global financial services centres post-Brexit will be dependent upon the continuing access of non-UK financial institutions to those markets. It will be an integral part of that access that these non-UK financial institutions be (or continue to be) participants in one or more of the UK's designated systems. As a general principle, if such a non-UK financial institution were to become insolvent, it would be subject to principal insolvency proceedings in (and governed by the laws of) its centre of main interests (i.e. usually the place of its incorporation and where it has its head office).

(b) In relation to an EEA (non-UK) financial institution that participates in a UK designated system, this means that we would expect the insolvency law of that other EEA state to govern the institution's insolvency proceedings.

(c) Under the *existing* SFD/SFRs regime, the fact that another EEA law may govern insolvency proceedings in respect of a participant in a UK designated system will not adversely affect the protections afforded to the system (and its other solvent participants) from the prejudicial effects of that other EEA state's insolvency laws on (i) relevant transfer orders given by the insolvent participant, (ii) action taken under netting or other default arrangements in relation to the insolvent participant or (iii) collateral security provided by the insolvent participant. This is because the courts of that other EEA state (and any insolvency office-holder appointed under the relevant insolvency proceedings) are required to uphold and maintain the protections afforded to the system under the SFRs. UK law will govern the system. As such, the rights and obligations of the insolvent participant in connection with its participation will (in accordance with Article 8) be governed by UK law (including the protections afforded to the system and the participants under the SFRs). As far as collateral security provided by the insolvent participant is concerned, if taken over securities constituted under UK law, Article 9(2) will require the proprietary aspects (including realisation) to be governed by UK law (including the protections afforded to collateral security arrangements under the SFRs).

(d) However, once the UK secedes from the European Union, the insolvency courts of the remaining EU/EEA states will no longer be obliged to recognise and uphold the protections afforded under the SFRs (as a part of UK insolvency law) in the face of insolvency proceedings opened before them against a participant in the UK designated system. This means that any rule of that EEA insolvency law (as applied by the insolvency court) that:

(i) revokes any relevant transfer order given by the insolvent participant;

(ii) prevents or interferes with the completion of settlement of any relevant transfer order by the insolvent participant, or any step taken by the system under its netting or other default arrangements;

(iii) requires the reversal or unwinding of any settlement completed through the system in response to a relevant transfer order given by the insolvent participant; or

(iv) interferes with the proprietary (including enforcement) rights of a collateral-taker in respect of collateral security provided by the insolvent participant,

will in each case apply so as potentially to undermine the integrity, stability and efficiency of the UK designated system.

(e) Recital (7) of the SFD contemplates that EEA states ***may*** apply the provisions of the SFD to their domestic institutions which participate directly in *third country systems*[67] and to collateral security provided in connection with participation in such systems. However, we strongly believe that HM Government should ***not*** seek to rely on the mechanism contemplated by Recital (7) to seek to meet the concerns identified in this paper for the following reasons:

(i) the mechanism only applies in respect of an EEA state that itself and individually determines to apply the provisions of the SFD to its domestic institutions participating in UK designated systems (i.e. it is not a collective procedure capable of binding all EEA states through one legislative instrument) - and presumably it would be equally open to that EEA state unilaterally to withdraw its determination without further reference to the UK or affected UK designated systems;

(ii) although the wording is ambiguous, it appears to be a piece-meal mechanism in which each adhering EEA state would apply its own insolvency rules (as implementing the SFD in that state) to extend relevant protections to a UK designated system and its other participants in response to the insolvency proceedings (in respect of the insolvent participant) governed by that EEA state's insolvency law[68];

(iii) it would not protect collateral security taken in connection with participation in the UK designated system over securities constituted under UK law because the relevant register, account or centralised deposit system on which such securities are legally recorded would not be located in an EEA state (as required under Article 9(2) of the SFD); and

(iv) the mechanism does not extend to protect collateral security provided to the Bank of England (as the Bank would no longer be a

[67] After Brexit, UK designated systems would be *"third country systems"* for this purpose.

[68] This would create potential legal uncertainty and risk for each relevant UK designated system (and its remaining participants) because of the variations between the substantive insolvency laws across the EEA states and their respective implementations of the SFD into their local law. At the very least this might impact upon the efficiency and effectiveness of the UK designated system's response to the insolvency of a (non-UK) EEA participant, but it might also raise material concerns for the ability of the system to comply with PFMI 1 (*Legal basis*) or its ability to do so without incurring material costs in obtaining (and regularly updating) legal opinions as to the substance and effect of each relevant EEA state's implementation of the SFD (see paragraph 3.1.3 of the CPMI-IOSCO Report), and the impact upon the system in the event that a participant in the system enters insolvency proceedings governed by the insolvency laws of that EEA state.

central bank of an EEA state[69], and its collateral security is not or may not be taken *"in connection with participation"* in the UK designated system as required by Recital (7) itself).

(f) In consequence, EUI's preferred option to ensure the continuing recognition of settlement finality and related protections for UK designated systems by other EEA states would be to incorporate a mechanism in the Withdrawal Treaty (or equivalent) under which (inter alia):

(i) the legal, supervisory and enforcement arrangements of the SFRs are irrevocably[70] declared to be equivalent to those laid down in the SFD, and that the SFRs provide equal recognition of the finality laws of each EEA state (as implementing the SFD) in relation to designated systems governed by the law of that EEA state[71];

(ii) a system designated under the SFRs shall, therefore, be treated as a system designated under the SFD for the purposes of Article 8 of the SFD (i.e. the EEA courts would be required, in the event of insolvency proceedings being opened under EEA law against a participant in a UK designated system, to recognise and uphold the law governing that UK designated system as determinative of the rights and obligations arising from, or in connection with, the participation of the insolvent participant);

(iii) the provisions of Article 9(2) of the SFD are extended to any register, account or centralised deposit system located in the UK;

(iv) collateral security provided to a participant in a UK designated system is included within the scope of collateral security in connection with participation in a system for the purposes of Articles 2(m), 9(1) and 9(2) of the SFD; and

(v) collateral security provided to the Bank of England is included within scope of collateral security in connection with the functions of a central bank for the purposes of Articles 2(m), 9(1) and 9(2) of the SFD[72].

The EEA legal instrument used to effect these changes into EEA law should itself be one that has direct effect throughout the EEA (i.e. not a directive which would be subject to potential delays and inconsistent implementation across the EEA).

[69] This is a requirement for collateral security to qualify under the SFD as collateral security in connection with the functions of a central bank.

[70] We recognise that there is likely to be a need to include an appropriate procedure to allow the recognition arrangements to evolve as the respective finality laws of the UK and the EEA states develop over time. However, it would be important to ensure that sufficient legally-binding protection is afforded to the UK (and the UK designated systems) to prevent the risk of the unilateral withdrawal of recognition for political or other reasons that are not associated with an equivalence assessment of the finality laws adopted by the UK and the EEA states respectively.

[71] It should be noted that there is no formal mechanism (or requirement) as such for mutual recognition (on the basis of equivalence) of third country systems under the provisions of the SFD. However, we envisage that at the policy level and as a means of providing an objective basis to ensure continuity of protection, the relevant EEA instrument would need to provide some form of legislative basis for its initial and continuing recognition of UK finality laws.

[72] Other consequential matters that are likely to require inclusion in the finality-related provisions of the Withdrawal Treaty or other relevant instrument include protections and provisions relating to *"system operators"*, *"interoperable systems"* and to the *"participants"* of a system. These terms, as used in the SFD, are limited to operators of systems designated under the SFD, interoperable arrangements between such systems and the participants of such systems. It would be necessary to ensure that any relevant provisions of the SFD which HM Government would wish EEA states to extend to UK designated systems are not (inadvertently) disapplied because of the status of UK designated systems, post-Brexit, as systems which will not be designated as such under the SFD.

The intention and effect should be that any changes we have described above to any Article of the SFD would immediately and automatically apply to the implementing provisions of that Article under the local law of each EEA state; and without the requirement of any further amending act by each EEA state.

Euroclear UK & Ireland Limited
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