Brexit: an opportunity to create a more sustainable financial system and Capital Markets Union?

Background paper

Dr Ian Williams
Commissioned by ShareAction
About ShareAction

ShareAction is a UK registered charity that exists to make investment a force for good. Our vision is of an investment system that truly serves savers and communities, and protects our environment for the long term. We’re working towards a system in which long-term thinking is recognised as the best way to guarantee healthy returns. We believe that anyone can play a part in changing the investment system for good. Fairshare Educational Foundation (ShareAction) is a company limited by guarantee registered in England and Wales (number 05013662 and registered address Ground Floor, 16 Crucifix Lane, London, SE1 3JW) and a registered charity (number 1117244). VAT registration GB 211 1469 53

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Author

Dr Ian Williams
ian.id.williams@talk21.com

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ShareAction exists to make investment a force for good. Our vision is an investment system that truly serves savers, supports communities and protects our environment for the long term.

This vision cannot be achieved without an international outlook, nor without working together with neighbours across Europe.

It was guided by this conviction that we launched ERIN (the European Responsible Investment Network) in mid 2016 in Berlin, a network that now boasts 29 member organisations in civil society from 10 European countries. The striking level of interest in joining ERIN has demonstrated that many in European civil society recognise the growing power of capital markets to shape our world and our future; and they also see the good sense in coming together to co-ordinate, collaborate and support each other as champions of responsible investment.

Like many in business and politics, few actors involved in the field of responsible investment were well prepared for the result of the UK’s June referendum. It was immediately apparent that financial services would be a key battle ground in the Brexit negotiations to come but quite what the referendum result may imply for responsible investment in Europe remains less clear.

In the months preceding the referendum, an astonishing and positive momentum developed: global leaders agreed in Paris in December 2015 to limit global warming to less than 2˚C and, as with the Sustainable Development Goals just a few months earlier, they acknowledged the central role investors would need to play if this challenging ambition was to be achieved. In December 2015 the Financial Stability Board announced the creation of a Task Force on Climate-Related Financial Disclosures and in January 2016 the City of London launched a Green Finance Initiative.

It is crucial this positive momentum is not lost as Brexit negotiations take up huge amounts of time and energy. Too often action on environmental, social and governance issues are seen as something that can be tackled once more pressing issues have been dealt with. But as the United Nations Environment Programme’s latest report[1] shows, we only have 3 years left to cut emissions before the chance to limit global warming to 1.5˚ is lost forever.

Those of us in the movement for responsible investment want to better understand the risks and the opportunities that Brexit presents for our agenda. As a starting point, we have commissioned this paper by Dr Ian Williams, a long-standing supporter and expert adviser to ShareAction. As Ian’s paper points out, financial services groups and their lobbyists have already been making their demands known to the government and asking for their interests to be reflected in any deal. So far, the UK government only seems to have mechanisms in place for interacting with private sector stakeholders. Civil society urgently needs to understand how to make our voices heard and to establish our own ‘red lines’ in this process.

We are incredibly grateful to Ian Williams for producing this insightful and helpful paper, and sharing his expertise from many years working with business, governments and NGOs on trade and regulatory policy affecting financial services. We hope that this paper will enable stronger, more active participation in the Brexit debate by all of us working for a more responsible and sustainable financial system.

Catherine Howarth
Introduction

As the number of media stories and speculations proliferate around the meaning of “Brexit” (hard or soft?), this note will provide a short summary to anchor some of the key facts and the “known unknowns”. While there remains little clarity at the moment on the nature of the UK’s potential market access arrangements, a number of comments can be made with a reasonable degree of certainty.

One of the distinctive elements of the ShareAction agenda is the linking of Brexit to the larger goal of a sustainable financial system - international in scope, and the current CMU flagship programme of the EU. Many of the key regulatory impacts of the UK’s exit from the EU will be played out in the relationship the UK has on CMU.

1.1 Financial services - Importance to the UK

The financial services industry is of central importance to the UK economy (including Edinburgh as a 2nd financial hub). According to a recent HM Treasury Report, the UK financial services sector:

- Contributes slightly more than 7% of UK GDP,
- Exports around 33% of its financial, insurance and pensions services to the EU,
- Employs more than 1 million people, of which two thirds are based outside London, almost 85,000 people in Scotland (which brings into play the Scottish Government’s approach to the Brexit negotiations) and 98,000 people in the North West.

1.2 Single market and financial services

If the UK left the EU, its financial services industry would suffer from reduced access to the Single Market. The aim to establish the Single Market started with the Treaty of Rome. This set targets for creating a customs union and the progressive establishment of the ‘four freedoms’ of movement of goods, services, capital and labour. It was following a step on the road to full economic union. Pressures to accelerate the creation of the single market by 1992 came from big business (the European Round Table of Industrialists) and governments like the UK which supported neo-liberal economic policies in 1980s.

Successive EU initiatives through the 1990s supported the creation of a level playing field for financial services, and in particular the development of ‘passporting rights’. These rights allow firms with operations established in the UK to trade across the entire Single Market with lower costs and complexity.

Financial firms are able to establish a European headquarters in one member state, such as the UK, and then offer services across the whole of the EU without requiring further authorisations. No Free Trade Agreements (FTAs) have equivalent provisions on market access for financial services. As a result, many financial services firms from non-European Economic Area (EEA) countries, notably including the US and Switzerland have established bases in the UK in order to gain full access the Single Market. In September 2016, the UK House of Commons Treasury Committee published a letter from Andrew Bailey, Chief Executive of the UK Financial Conduct Authority (FCA). The Letter contains figures on UK firms currently holding single-market “passports” under certain EU directives to provide services or establish branches elsewhere in the European Union.

The Letter shows that under the Single Market Directives there are:

- 5,476 UK-authorized firms that hold one or more outbound passports to do business in another EU or European Economic Area (EEA) Member State;
• 8,008 firms authorized in other EU or EEA Member States that hold inbound passports to do business in the United Kingdom; and
• 336,421 passports held in total by UK firms for multiple business activities in EU Member States via subsidiaries located in an EU country, and in particular the UK.

Treasury committee chairman, Andrew Tyrie MP, said the figures show that “business put at risk could be significant” if passporting is impacted by Brexit negotiations.

Financial services regulation would require particular attention because of the extent to which regulatory competence shifted to the EU level during the period of membership.

1.3 Capital Markets Union (CMU)

The EU’s current major regulatory project for financial services is Capital Markets Union (CMU), which was launched by the Commission in September 2015. CMU is a liberalization project which aims to:

• Reduce the existing barriers to cross-border investment in the EU.
• Increase the funding options available to companies (in part by reducing the existing over-reliance on bank lending), and perhaps most importantly from a policy perspective,
•Reset the post-financial crisis regulatory framework which governs European capital markets.

There is no single measure that will deliver CMU. Instead, there will be a series of steps that, cumulatively, will achieve CMU. Its importance to the UK and ‘the City’, the major capital market centre in the EU, was very high and is likely to have played a key part in its design.

A number of key questions now face the UK as to whether it will be able to make a significant contribution to CMU and what will the likely impact on the liberalisation project when UK is no longer at the table.

This is not just a significant question for financial firms as NGO’s and CSO’s have also actively identified elements of CMU which could further advance the sustainability of the financial system. Accordingly they have made significant contributions through the open consultation process with detailed submissions.

1.4 Timetable for Brexit the UK will leave by March 2019

While the referendum ‘event’ gave the UK its Brexit vote on 23 June 2016, an understanding of the process of leaving only really began to take shape with Theresa May’s PM speeches at the Conservative Party conference on 2-5 October 2016. This provided the broad brush framework for the UK to leave.

1.4.1 Article 50 sets the formal process in motion

One of the new additions to the public lexicon of Brexit are the references to “Article 50”. This is the article in the Treaty of the European Union which sets out the process of withdrawal for a Member State. Theresa May announced that Article 50 will be triggered no later than the end of March 2017.

Two years after it is triggered, Britain will find itself outside the European Union, whether or not negotiations had been concluded, unless there is unanimous agreement among the other member states to extend the time limit, the practical reality is that such an extension is unlikely. This means that the UK will leave the EU by March 2019.

At the time of writing the UK High Court has decided that the Government does not have the power to give notice to the EU under Article 50 to withdraw from the EU without asking Parliament first. While this does not alter the outcome of the referendum and Brexit it does bring into question the timeline that the PM has
Legally, Article 50 does allow for a shadow negotiation on trade matters. But the EU cannot conclude a trade agreement with another country until that country ceases to be a member, and it is highly unlikely that a detailed trade agreement can be achieved within two years. Recent trade agreements negotiated by the EU with highly developed economies have provided some indication of both the political and technical complexity involved including the time and effort involved. For instance the recently agreed EU – Canada free trade agreement (CETA) had taken 7 years to complete. The EU and Singapore reached an agreement in October 2014 on a comprehensive free trade agreement (EUSFTA) following negotiation which were launched in 2009. It was originally expected to come into force by end-2015 but had already been delayed after the European Commission opted to request for a European Court of Justice (ECJ) opinion on its competency to sign and ratify the trade pact. Pending the ECJ’s ruling, the FTA will subsequently need ratification within the European Parliament before eventually coming into force. It is now not expected to enter into force until 2018/19, around 10 years after its inception.

1.4.2 The repeal bill

The PM announced that “A Great Repeal Bill to get rid of the European Communities Act” – will be introduced in the next Parliamentary session.” (Beginning with the Queen’s speech May 2017). This process will be separate from Article 50 negotiations, which will activate the formal mechanism to leave the EU. The legislation will only be prepared by Whitehall and will be debated by MPs and peers.

1.4.3 Transitional arrangement

A major factor in affecting the timeline is the need to organise, in parallel with a separation agreement, a trade deal with the EU. It is vital for the uninterrupted flow of trade that the UK seamlessly moves from trading rights exercisable under the EU Treaties to trading rights exercised under any future UK-EU trade agreement. The time period for doing such a trade deal is likely to take much more than two years.

If no agreement is reached under the Article 50 process the default position for the UK is likely to be the reliance on existing World Trade Organisation (WTO) rules. Although the UK is a member of the WTO, its trade agreements were negotiated by the EU as part of a series of trade schedules and commitments regarding such items as tariff levels on products. On exit from the EU the UK would need to establish separate commitments as it seems unlikely that 161 other WTO members would simply allow the UK to carry over the EU schedules to itself as if nothing had changed. Negotiations would be needed with WTO members to agree what tariffs and market access commitments were appropriate for a UK economy outside the much larger EU trading bloc. It is likely that WTO members would delay detailed negotiations until after the UK leaves the EU and the nature of the economic ties between the EU and an independent UK become clear. WTO decisions are made by consensus and the processes are likely to take a number of years. Even if the UK were able to operate under WTO rules in lieu of negotiating new commitments it would have access to the EU as a non EU or Third country and would be subject to the EU’s external tariffs and market access restrictions as set out in its WTO commitments. The WTO provides little access for services and key UK based industries such as cars would be subject to tariffs and customs/administrative barriers on exporting to the EU.

The FT has reported that Ministers are looking to negotiate a transitional trade deal with the EU – including possibly paying a single market access fee to Brussels, to avoid a “cliff edge” for exporters and the City of London after Brexit. A smooth transition has been a demand of the City.

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i | When Greenland left the then EEC in 1983 it took three years to negotiate and ratify its exit, despite having only a population of 50,000 and only one main product: fish.
On an exit from the EU, the financial services industry will no longer have access to the large single market in financial services on the basis of current arrangements. A number of possible future access arrangements have been proposed, largely based on examples negotiated for some other non-EU countries such as Norway, Switzerland and Lichtenstein. (Ukraine has also been recently added to the list as an example of a “Deep and Comprehensive Free Trade Area” - DCFTA). A bespoke arrangement will be the likely outcome, nevertheless these existing real world arrangements are indicative of the type of reduced access and influence over future regulatory developments, including CMU, which will result from leaving the EU.

2.1 Overview – The main models of market access to the EU

The attached annex provides a simplified overview of the key parameters of the possible arrangements.

2.1.1 EEA - European Economic Area (Norway, Iceland, Liechtenstein)

The EEA goes beyond traditional FTAs by extending the full rights and obligations of the EU’s internal single market to the European Free Trade Area (EFTA) countries (with the exception of Switzerland). If the UK joins the European Economic Area (“EEA”) – the Norwegian model is “soft Brexit” writ large and is the closest arrangement to continuing membership of the EU. The UK would retain access to the single market, but would continue to be subject to EU law in the areas covered by the EEA Agreement including financial services, company law, consumer protection and environment. However, it would lose all formal rights and ability to influence the production of EU legislation. The HM Treasury analysis spelt this out before the referendum:

“The UK would have little or no say over future rules governing the EU Single Market. Over time, this would have a cumulatively damaging impact on the UK economy, as the UK Government would have little influence on new rules that might be potentially damaging to UK companies. The European Commission is due to propose new legislation covering areas such as legal, business and financial services, which are crucial areas for UK exports. Inside the EU we have a major voice on this legislation, including for instance the Capital Markets Union, which will improve the flow of investment into businesses across Europe. At present, the UK Commissioner holds the portfolio for financial services, and is leading on this particular area of legislation. Outside, we would have little influence and no ability to try to block measures that would put our companies at a disadvantage.”

The UK Commissioner, Lord Hill resigned following the referendum, 25.6.16 and the portfolio has now been allocated to the Latvian Commissioner Valdis Dombrovsksis.

The EEA has recently signed an agreement with the EU by which they also become observers in the European Supervisory Authorities (ESAs) and implement secondary legislation.

The UK would have to make budget contributions and be open to freedom of movement of people.

This rather unattractive combination seems to be specific to Norway. Other former EEA members Finland, Sweden and Austria used the EEA as a preparatory stage to full EU membership. Norway lost a referendum on full membership and got ‘stuck’ for domestic political reasons.
2.1.2 EFTA - European Free Trade Association (the Swiss model)

If UK joins the European Free Trade Association ("EFTA") – the Swiss model, the UK would retain limited access to the single market (and be subject to single market rules) in those areas in which it is able to negotiate bilateral agreements with the EU.

As an EFTA member Switzerland took part in the negotiations to join the EEA but failed to join due to a national referendum which voted against it. Subsequently the EU and Switzerland have signed over 120 bilateral agreements, including a FTA in 1972 and 2 major series of sectoral agreements which aligned a large portion of Swiss law with that of EU law at the time of signing.

While the selectivity and flexibility of the Swiss model might appeal to the UK, the EU is unlikely to allow a repetition of this process which they see as allowing a degree of “cherry picking”. Switzerland has not managed to negotiate a bilateral deal on financial services and it has also had to accept the principle of free movement of people. It also has to make a contribution to the EU budget.

2.1.3 Customs Union (the Turkish model)

If the UK remains in the EU customs union the UK would retain access to the single market for goods but not have access to the single market for services. Under this model the UK would have no vote or formal influence on the EU’s external trade deals or how the single market rules are developed.

Membership of a customs union would curtail the UK’s ability to pursue its own trade deals outside the EU. In common with the EEA and EFTA models, a customs union would rather defeat the purpose of the newly established Department for International Trade with its remit of developing and negotiating free trade agreements and market access deals with non-EU countries.

The UK would make no financial contribution to the EU and would not have to accept free movement of people.

A positive political benefit for the UK would be the avoidance of the need to renew the customs controls at the Northern Ireland/Ireland border.

2.1.4 UK negotiates a comprehensive trade agreement with the EU – the Canadian model

Similar to the Swiss model, the scope of the UK’s access to the single market and the degree to which the UK would need to agree to be subject to EU rules as a condition of such access (including, for example, free movement of people) would be a function of the agreement reached between the UK and the EU. This type of agreement has, historically, taken a long time to negotiate (7 years for CETA). The Canadian agreement is regarded as a ‘deep trade agreement’ in its coverage but it is actually very limited in the services sector.

In theory, the UK would make no financial contribution to the EU. However, as it would be a negotiation and the EU could well ask for budget contributions, free movement of people and other EU rules (environmental, social and health?) in return for increased access for services.

Under this FTA the UK financial services are unlikely to maintain their passporting status and would have to seek access as a ‘Third country’ provider under equivalence agreements.

The question of non-EU or third country access to the EU’s market has been a subject of political controversy throughout the evolution of the EU single market. There were concerns expressed by the EU’s major trading partners, notably the US, that the single market risks becoming a ‘fortress Europe’ unless there were measures to ensure that non-EU countries and their companies could gain access.

ii | The CETA agreement also serves to show the difficulties the UK may encounter when it faces the fact that any new UK – EU agreement will need the agreement of all other 27 Member States - together with their own domestic constitutional arrangements. Despite reaching a final deal there was a last minute hiatus because while Belgium’s federal government supported the trade deal, opposition from the Socialist-led Walloon parliament, which has argued that the CETA gives too much power to multinationals, held it up to gain more concessions.
The negotiations over this access became part of a major debate on including ‘reciprocity’ provisions in key EU directives, for instance US banks were prominent lobbyists over the third country provisions in the key single market banking and investment securities directives. As a result the EU has built up a body of provisions in key financial services directive which do allow restricted access to foreign firms based upon the reciprocity of access to the EU and non EU market based upon the level of ‘equivalence’ between the regulation and supervision in each country. The treatment of third countries in EU financial regulation and the national supervisory authorities has not been standardised and there are not equivalence solutions available for all financial services directives.

Without a positive equivalence assessment a firm established in the UK may be authorised by an individual EU member state to operate a bank branch or investment firm to provide services but only within their own territory. To access the EU single market an equivalence assessment of the third country’s regulatory regime would need to take place where these provisions exist in EU law.

This lack of standardised system for dealing with third countries adds further uncertainty to UK based firms and may limit the options for services available. It will mean that the future access to the EU’s single market will be very limited when compared to access achieved as a full member of the EU.

2.1.5 WTO – World Trade Organisation

UK trades with EU under WTO rules. The UK would lose access to the single market and UK trade with the EU would be subject to the same framework as other non-EU WTO members without a free trade agreement. It would therefore lose the level of market access that membership of the EU has provided as it has evolved. This is especially significant for financial services. It will not be possible to replicate that level of access through WTO rules which have been notoriously unproductive on the multilateral liberalisation of the services markets.

Under the WTO, the UK’s trade with the EU and other WTO members would be subject to standard tariffs of the importing countries as set down in their WTO commitments. This would raise the cost of exporting to the EU for UK companies. The UK’s services trade would also be subject to WTO rules on services which are far less liberal than in the EU. Therefore UK access to EU services markets would be reduced under this scenario. It is uncertainty around what level of access will be permitted that could encourage UK based firms to establish bases in the EU to ensure a continuation of their passporting rights across the EU/EEA.

Politically a WTO fall-back position would bring its own complications, it will be recalled that the WTO has been the target of active “anti-globalisation” movements in the past. If UK politicians see Brexit as an expression by voters who felt “left behind” by the harsher and more competitive world brought on by globalisation then a dependence on WTO and its globalisation agenda is hardly an appropriate frame of reference. Those “left behind” risk being hurt further.
3.1 HMG “No running commentary” position

The “No running commentary” refrain is largely a political act to manage expectations and to protect HMG from criticism regarding the eventual outcome of Article 50 exit negotiations. (The former PM’s treatment of his “renegotiation” will be fresh in the collective memory).

Most expert observers believe that any deal in terms of market access will be less than that currently experienced as a member of the EU (and therefore single internal market).

While not spelling it out explicitly, the Prime Minister has made it clear that her conditions regarding control over free movement of labour effectively rules out access to the single market even through EEA/EFTA configurations. “But let’s state one thing loud and clear: we are not leaving the European Union only to give up control of immigration all over again. And we are not leaving only to return to the jurisdiction of the European Court of Justice. That’s not going to happen.”

Against this background of possible access models various business groups and lobbyists have started to put pressure on the UK government to reflect their interests in any negotiated agreement. They will be aware that despite the ‘free trade’ rhetoric trade policy involves trade-offs. In bilateral multi-sector agreements it is possible to trade concessions in one service sector against concessions in another sector. Therefore it is far from certain that all important UK sectors will benefit in tough trade negotiations.

Greg Clark, the business secretary, has shed a little more light on what has been offered to Nissan. In an unpublished letter to Nissan, the government made an explicit trade policy commitments in addition to flanking measures to support training and skills and to boost UK research: It promised to seek tariff free access to the EU for the car sector (not just Nissan). This would strongly suggest the UK government wishes to maintain membership of the customs union. It has been speculated that if this were not negotiated the UK government would compensate the car manufacturers for the 10% tariffs the EU imposes on cars from non EU members. However, it is thought that such a subsidy would be incompatible with WTO rules. Such an agreement has spurred on moves by other sectoral groups such as financial services, pharmaceuticals and aerospace to get similar specific assurances.

A past feature of trade negotiations is that the special interests which besiege trade ministries rarely represent consumer interests. This has largely been ascribed to lack of organisation but the Government is not giving any indication that it is open to consultation other than to key industry groups through what
appear to be informal routes. It is also unclear just how involved MPs will be, this is important if wider stakeholders are to use the parliamentary representatives in the Brexit negotiations.

At present the main announcements are being made by business groups (especially financial services and motor vehicles) with the Government appearing to only have mechanisms for dealing with business stakeholders.

3.2 Financial services lobbying

The financial services sector has a well-established network for lobbying through both sectoral trade associations (banking, Investment, Insurance), broader coalitions and prominent individuals. In addition to the individual trade associations a number of groups have begun to take up the Brexit case.

3.2.1 The CityUK

This is the main established group lobbying for the City. It includes all of the major financial services figures on its advisory board including Prudential chairman Paul Manduca, HSBC’s group chairman Douglas Flint, Goldman Sachs International’s co-chief executive Richard Gnodde and Standard Life chairman Sir Gerry Grimstone.

City UK is expected to be the main focal point for the City in Brexit talks and has issued a number of important reports setting out the wishes of the City services community from any negotiations.13

3.2.2 The Financial Services EU Task Force

The brainchild of former government minister and Santander UK chair Shriti Vadera, this Task Force represents the interests of 12 influential City executives including HSBC chairman Douglas Flint, Allianz Global Investors’ vice-chair Elizabeth Corley, Morgan Stanley International’s chief executive Rob Rooney, and Barclays chairman John McFarlane. As of early August 2016, the group now operates as a sub-group of TheCityUK. It was integrated as an attempt to provide a more unified front for City interests.

3.2.3 The Financial Services Negotiating Forum

This new body was officially launch in October 2016. Daniel Hodson, a former chief executive of the derivatives exchange Liffe and deputy chief executive at Nationwide who sat on the board of the Vote Leave campaign, will chair the executive committee. Anthony Belchambers, founder of the FIA Europe, formerly known as the Futures and Options Association, is acting chairman of the group’s advisory board. It aims to bring together those from both sides of the referendum debate and to have one shared objective: the best negotiated EU-UK deal achievable, one that is pro-business and pro-growth for all stakeholders. It notes that much of what has been written in the press to date reflects the views of the bigger market players on these Brexit issues and there is a need for the other industry practitioners to have a stronger voice.

It has announced its research focus as concentrating on the following areas of Clearing, Equivalence and Liquidity.

3.2.4 First among equals?

Even amongst these ‘privileged’ groups there appears to be discontent regarding access to the Government. There was reported frustration that PM Theresa May held a meeting with the heads of US banks in New York but had found no time to collectively meet with British banks. There will no doubt be increasing pressure between sectors as details emerge of particular interest group agreement such as the recent disclosures over a Nissan ‘deal’.

It interesting to note that press reports have indicated some scepticism amongst senior politicians regarding the complaints, especially by banks, because of previous published statements saying they would leave the UK if something they disliked occurred.
3.3 Transparency - Finding out what is going on?

Despite the Government’s statement that there will be no running commentary on the negotiations it is clear from press reports that some business interests are clearly involved in detailed requests and offer talks. The problem for wider stakeholder community and NGOs will be to get greater access. Parliamentary representatives are an obvious first point of call but it is unclear how much access our elected representative will actually get.

The fact that all other 27 Member States are involved in the negotiations leads to the possibility of a lot of potential ‘leakage’ of information from the trade negotiations. In addition, MEPs also have more rights to information in parts of EU trade talks. It seems that unless something changes, MEPs are more likely to be better informed that MPs in the UK who have far less scrutiny powers. This area is being looked at in the UK to see how it might be resolved.

3.3.1 Parliamentary scrutiny of the formal negotiations

A recent report by the Parliament European Union Committee ‘Brexit: parliamentary scrutiny’ highlighted the key issues.\(^\text{14}\)

The EU committee determine that the Ministerial commitment to “accountability after the event” was not sufficient. They want Parliament to play a vital role in offering constructive and timely comment on both the process and the substance of the negotiations.

“For parliamentary scrutiny to be effective, the Government will need to provide a regular flow of information to designated committees. We therefore welcome the Secretary of State’s (Rt Hon David Davis MP) undertaking to this Committee… that the Westminster Parliament will receive at least the same level of information during the negotiations as the EP. The evidence we have received on the way the European Parliament scrutinises negotiations on international agreements suggests that, if Westminster is to enjoy parity with the EP:

- Relevant committees should have access, if necessary in confidence, to a wide range of relevant documents;
- Documents should be supplied in sufficient time for committees to be able to express their views, and for the Government to be able to take these views into account;
- In particular, the Government should respond to any formal recommendations made by committees, and, if recommendations are rejected, explain why;
- Both the Government and Parliament should adopt procedures to safeguard confidential information.

We therefore invite the Government to confirm that these principles should underpin parliamentary scrutiny of the forthcoming negotiations.”

3.3.2 UK MEPs

Another clear channel to gaining an insight into the negotiations is through direct contact with UK MEPs. Until the UK formally leaves the EU, possibly in 2019 (when next EP election take place), its MEPs remain full members of the Parliament. So there’s nothing preventing them from trying to impact EU legislation. This would be important for instance if they were informed that the type of deal the UK wanted was to in effect have equivalent legislation to the EU to facilitate access to the single market once it has left the EU. It is conceivable that Conservative MEPs would be instructed as to what legislation in the pipeline should be addressed in order to ensure a soft landing for when the UK leaves.

Despite the formal position of UK MEPs, in practice it is expected that they would lose most of their political weight and would be urged to step down from posts chairing committees and as rapporteurs in charge of new policy discussions. An early indication of this process could come as soon as January 2017 the halfway point of the current EP, when important jobs can change hands. This is an area which should be closely watched.\(^\text{viii}\)
4.1 Accelerating CMU – the sustainability components

Because of the important role the UK was playing in the development of the CMU programme, there were concerns as to whether the programme would move forward following the Brexit vote and the rapid resignation of Lord Hill. Early suggestions of its probable demise or dilution were put aside when on the occasion of President Juncker’s 2016 State of the Union address (14 September 2016), the European Commission set out the next steps to accelerate the completion of the Capital Markets Union (CMU), as a flagship project of the Juncker Commission to boost jobs and growth in Europe.15

The Communication appears to indicate a desire by the Commission to speed up the process of CMU and to extend its remit. The CMU proposal still puts forward measures of keen interest to the UK including:

- Urgent progress regarding the development of the Simple, Transparent and Standardised securitisation regime.
- Modernisation of the Prospectus Directive regime before the end of 2016, and
- Finalise the proposal to strengthen venture capital markets and social investments by the end of 2016.

These measures are likely to be completed before the UK leaves in 2019, therefore it is credible for the UK to maintain its influence over the legislative process and to attend the relevant meetings. The position would be that the UK may have to apply these measures in a future relationship with the EU.

The problems will lie with those measures that are unlikely to see the light of day before Brexit. Of special interest to the responsible investment community is the development of new CMU priorities. The Commission will:

- Support green bond standards. (As this has been left largely to the private sector, the UK should be able to influence it through market participation and also through international public policy such as G20. This would have been facilitated if Mark Carney had agreed to stays on as Governor of the Bank of England until 2021 but he has announced he will now leave in 2018.) There are indications that Commissioner Dombrovskis may intensify EU policymakers involvement in developing mandatory standards and verification processes. This is something that the UK would have played an important role in given its expertise.
- Establish an expert group to develop a comprehensive European strategy on green finance. By decision of 28 October 2016, the Commission has set up a high-level group of experts on sustainable finance (“the group”). The group’s tasks shall be to help develop an overarching and comprehensive EU strategy on sustainable finance to integrate sustainability in EU financial policy.16
- More broadly, in respect of environmental, social and governance (ESG) issues, the EU has adopted mandatory disclosure requirements for certain large companies and will also adopt non-binding guidelines on the methodology for reporting such information to investors and consumers. (The Non-Financial Reporting Directive which enters into force in 2017). This will apply in the UK unless it is unpicked at some later stage following the Repeal Act (see below).

ii | Normally committee chairs stay in place for a full 5 year term but the influence of Brexit could change this. A particular indicator is thought to be the case of Vicky Ford, conservative East of England MEP who currently chairs the Single Market Committee.
• It is also assessing the follow-up to the recent consultation on long-term and sustainable investment which emphasised the importance of ESG issues for the longer-term performance of companies and investors. UK involvement in any EU follow up would be determined by the timetable. It is unlikely any legislative proposals would be brought forward in a sufficient state of development to legitimise a detailed UK input when it is about to exit. There is a feeling among senior UK officials that they will be “listened to” but not acted upon. This will be an important matter for the UK community seeking to promote responsible investment internationally.

4.2 Non CMU legislation

In addition to the CMU programme there are additional dossiers of interest to the sustainable finance community which need to shepherded through while the UK retains influence. These include consolidating ESG provisions in:

• The Shareholder Rights Directive proposal, which it is hoped will be back on track 2017.

• The IORP II Directive; In March 2014, a proposal for a Directive on the activities and supervision of institutions for occupational retirement provision (IORP II), in which the Commission proposed to amend the IORP I directive to include the provision that covering investment information on how environmental, climate, social and corporate governance issues are considered in the investment approach. The timetable of this proposal means that the UK should stay involved as this will impact the UK on leaving if it seeks to maintain equivalence with key financial sector legislation.

• Packaged Retail and Insurance-based Investment Products (PRIIPS) via European Supervisory Agencies. The details on how ESG information will be made to retail consumers requirements will be developed by the European Supervisory Authorities. The UK will remain a member until it exits the EU.

• Cross border marketing of funds consultation by the European Commission. An indication that barriers still exist even within the single market is demonstrated by the further move to develop the retail fund market. An important constituent from a sustainability point of view would be to embed ESG criteria in any proposed new legislative measures. The window of opportunity for the UK is likely to close as the point of Brexit approaches. 

• The Alternative Investment Fund Managers Directive (AIFMD). The review of AIFMD in 2017 will be a major test case for the new balance of power in EU policy making. Prior to the crisis, the regulation of AIFMs had been a long-standing goal of the market-shaping coalition, first and foremost France, Germany and Italy, as the activities of these financial institutions were seen as clashing with national varieties of capitalism on the Continent. By contrast, the UK and the US had opposed any regulation of credit rating agencies (CRAs), hedge funds and derivatives markets prior to the crisis.

4.3 Expert group – an early indicator?

An interesting early test of whether there is any ‘chilling effect’ towards UK participation in future EU policy making activities will be the treatment of UK representation in the proposed expert group.

The UK has acknowledged expertise both commercially and in NGOs in the area of sustainable finance and could normally be expected to be represented amongst the 20 members of the Group. The Group will run for 12 months through 2017 so the UK will still be a full member of the EU and there is therefore no reason for UK members to be omitted.

4.4 Importance of international representation and lobbying likely to grow?

Because of the global nature of financial services many of the key drivers of regulation and standards are international bodies to which the UK will have direct involvement. One policy question is whether the UK will be able to rely more on influencing international standards bodies to help shape legislation.
For example, key bodies include the Financial Stability Board (FSB), the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IASB). Political direction tends to come from the G20. It should be recalled that in the face of the financial crisis, the EU found it was able to act rapidly to assimilate into action key decisions made at G20 level concerning, for example, credit rating agencies, hedge funds (AIFMD), short selling and remuneration.

The EU Expert Group on Sustainable Finance, referred to above, illustrates how important international norms will be to sustainable finance policy making:

“The group when elaborating its contribution to the EU’s strategy on sustainable finance will take into account ongoing international work streams on sustainable, green and climate related finance, such as the G20 Green Finance Study Group and the Financial Stability Board’s industry-led Task Force on Climate-Related Disclosures, as well as emerging initiatives in Member States or at EU level. This work represents an important starting-point for framing sustainable, green finance issues and challenges.”

It remains to be seen whether on exit from the EU, the UK’s ability to influence and impose its preferences on these international standards will be severely diminished.”

ix A positive sign has been the key role the Bank of England is playing in G20 green finance talks – see Resolving the climate paradox - Mark Carney 22 September 2016. http://www.bankofengland.co.uk/publications/Pages/speeches/2016/923.aspx
5.1 Risk of deregulation

The ‘Repeal Act’ frames the previous EU laws as potential deregulatory targets. As noted above legislation such as the Non-Financial Reporting directive could be ‘fixed’ in the UK at a later date should business think it too onerous (note it has already been diluted due to lobbying at the EU level).

The arguments posed in favour of a ‘Leave’ vote often referenced the possibility of lower levels of financial regulation i.e a deregulatory agenda which suggests that measures put in place during the financial crisis were hasty and no longer needed. This is before they start unpicking the established corpus of legislation covering issues such as working rights, consumer protection and the environment.

There will be a need by CSOs, consumer groups and others, for vigilance in the UK legislature to ensure that wide scale deregulatory agenda is not undertaken under the guise of a supposed mandate given by the Brexit referendum. Action will also be needed to retain what is best from the EU acquis the UK has helped create over the past 40 years.

The exact nature of the remaining (EU sourced) UK legislation will largely depend on the type of Brexit arrangement which is finally accomplished.

Some arrangement may serve to put a brake on the ability of the UK to completely overturn EU sponsored legislation.

5.2 Lobbying with an eye on equivalence

What goes on in the EU will remain relevant as the City and any UK government will seek to protect the huge earnings generated for the UK by the financial services trade with the EU. This will increase in importance as other economic downsides appear to other parts of the economy in the wake of Brexit. The “passport” provisions which the UK has as a member of the EU have been developed over decades and would be almost impossible to replicate inside a trade deal. This will encourage the UK to try and maintain access to the single market as much as possible which would then provide leverage to the UK when negotiating the terms of equivalence. If the UK can show that it has fully implemented EU legislation and in some cases may even have gone further that the EU required (super equivalent or gold-plated) then it would be easier for the UK to argue, when it has left the EU, that its supervision and regulatory framework is at least as equivalent as the EU’s. This will be assisted if the UK does not take a static approach but continues to upgrade its regulations in parallel with EU regulatory developments.

There are signs that not all financial services participants share the same point of view on the importance of maintaining access to the single market. There has been much resistance to EU efforts to control remuneration in Banks and this may well cause difficulty in the UK aligning its domestic regulation as equivalent to the EU if UK bank lobbyists win out.

Once the UK leaves the EU (or EEA) it will be a “third country” as far as EU laws are concerned. Its access to EU markets will be determined by “equivalence” measures. In certain cases the EU may recognise that a foreign legal, regulatory and/or supervisory regime is equivalent to the corresponding EU framework. That recognition, in turn, makes it possible for authorities in the EU to rely on supervised entities’ compliance with the equivalent foreign framework. The benefits of equivalence are that it:
• reduces or even eliminates overlaps in compliance for the EU and/or third-country entities concerned,
• it leads to considering certain services of third countries’ firms as acceptable for the various regulatory purposes in the EU,
• allows to apply a less burdensome prudential regime in relation to EU financial institutions’ exposures to an equivalent third country
• It provides better market access than under WTO rules but less than the ‘passporting’ system associated with full membership of the EU

Negotiations surrounding the assessment of equivalence are notoriously political and time consuming. They are usually led by the Commission with significant Council engagement and EP oversight with technical input from the European Supervisory Authorities (which highlights the need to keep across all of these bodies).

These negotiations have been shown to be extremely detailed. In the case of AIFMD, third party equivalence agreements have been very difficult to achieve and this includes the US. If the UK has to negotiate access as non-EU member (‘Third Country’) it would join the queue with Japan, Cayman Islands, Bermuda and others.

This highlights the fact that despite years of convergent and adoption of EU legislation the subject of de facto equivalence should not be taken for granted if the UK leaves not just the EU but an EEA type arrangement. Equivalence negotiations would be intensely political. In addition, not all key pieces of legislation have third country or equivalence provisions, making the negotiations for the UK even more difficult on leaving the EU/EEA.

This overriding requirement to maintain passporting or at least equivalence status, could serve to stop the UK pursuing its own (or US style) deregulation and continues to make EU lobbying highly relevant to developments in the UK.

An interesting initiative worth considering through a Brexit lens is the recent United Nations Environment programme (UNEP) publication “The UK: global hub, local dynamics - mapping the transition to a sustainable financial system.”

The report was released at a major event co-hosted by UNEP and the City of London Corporation, where a new Green Finance Initiative was launched by the City with the aim of making London the world leader in green finance. Consciously or not the report makes no recognition to Brussels as the source code for key legislation. It focusses on UK initiatives and its international connections, notably G20, as a way forward. It seems to suggest that building on the existing base of legislation (whether or not it originated in Brussels) there is a sufficient foundation for the UK – at least in the area of sustainable finance – to be globally successful post Brexit.

5.3 NGOs and sustainable finance

NGOs and civil society organisations have made significant contributions to the deliberations taking place at EU level on creating a more financially sustainable business and investment environment. Some of the these benefits have already become embedded in EU law or are in the process of being translated into legislative possibilities through initiatives like CMU and other EU measures aimed at improving corporate governance and investor stewardship.

With Brexit there is the real possibility of UK influence being diminished. In order to push back from this there is a need for NGOs to continue to push for influence in the EU while the UK remains a full member through active engagement in Brussels through officials and MEPs.

It will also be imperative to ensure that a full role is played in the Brexit negotiations primarily through having full access to information provided by political representatives. In the section on parliamentary scrutiny (3.3.1) it is highlighted why it will be important for NGOs to get the Government to support strong
disclosure principles for sharing information for effective parliamentary scrutiny. If this happens NGOs will be able to provide a useful input through representation to the various Parliamentary Committee members and ensure that the sustainable finance agenda gains made at the EU level are retained and built upon domestically.
If in the event of a hard Brexit, a substantive deregulatory programme was followed in the UK it would not be restricted to financial services; other parts of the ESG agenda could be impacted. Much of the UK Brexit political support has been to promote a more deregulated state with an emphasis on “getting rid of red tape”, with the EU seen as a major purveyor of anti-business legislation.

It will have been noted by many NGO and civil society more generally, that the EU has acted in ways that have prevented certain domestic UK initiatives which would negatively impact for instance, human rights, working rights, consumer rights, the environment and animal welfare. The EU has served to safeguards rights and standards in these areas.

It will remain vital for the wider stakeholder community to scrutinise the process of repealing EU laws in great detail so that gains made over the years of UK membership of the EU are not lost. On the other side of the coin and subsequent to Brexit, important issues that were previously blocked by the UK will be back on the table at EU level. This may have already started as some EU finance ministers agreed on October 10 2016 to get the European Commission to draft an EU directive authorising an EU financial transaction tax (FTT), which would apply to ten of the EU’s 28 member states.\textsuperscript{a} This follows debates since 2011, when the idea was first proposed by the European Commission, but blocked by the UK.

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\textsuperscript{a} The FTT is a tax, proposed by the European Commission, to be applied to transactions in “financial instruments” (e.g. bonds, derivatives, shares, securities and units trusts) involving “financial institutions” where at least one party to the transaction is established in a participating member state (the FTT Zone) or where the transaction involves financial instruments issued in the FTT Zone.
Further reading


- CityUK (August 2016), UK financial and related professional services: meeting the challenges and delivering opportunities, available at https://www.thecityuk.com/research/uk-frps-challenges-and-opportunities


## Annex: Possible post Brexit arrangements

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<thead>
<tr>
<th></th>
<th>Soft exit</th>
<th>Hard exit</th>
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<tbody>
<tr>
<td></td>
<td>1. EEA (Norway)</td>
<td>2. EFTA (Switzerland)</td>
</tr>
<tr>
<td><strong>Access to single market?</strong></td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Duty free trade of goods?</strong></td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Market access for financial services?</strong></td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td><strong>EU Rule making</strong></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Free to negotiate bilateral deals with non-EU partners?</strong></td>
<td>No</td>
<td>Yes</td>
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<tr>
<td><strong>Must adhere to EU social and employment rules?</strong></td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Makes EU budget contributions</strong></td>
<td>Yes</td>
<td>Yes but reduced</td>
</tr>
<tr>
<td><strong>Part of Common Agricultural Policy</strong></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Ability to restrict inward EU migration</strong></td>
<td>No</td>
<td>No</td>
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Article 50

Article 50 of the Treaty on European Union allows a member state to notify the EU of its withdrawal and obliges the EU to try to negotiate a ‘withdrawal agreement’ with that state. Article 50 does not set down any substantive conditions for a Member State to be able to exercise its right to withdraw, rather it includes only procedural requirements. It provides for the negotiation of a withdrawal agreement between the EU and the withdrawing state, defining in particular the latter’s future relationship with the Union. If no agreement is concluded within two years, that state’s membership ends automatically, unless the European Council and the Member State concerned decide jointly to extend this period.

Brexit

A term for the potential departure of the United Kingdom from the European Union.

There are a myriad of possible post-EU arrangements being discussed and, although there are no definitive definitions, they can be loosely categorised as “hard” or “soft” Brexit options.

A hard Brexit arrangement would likely see the UK give up full access to the single market and full access of the customs union along with the EU. The arrangement would prioritise giving Britain full control over its borders, making new trade deals and applying laws within its own territory.

Initially, this would mean the UK would likely fall back on World Trade Organisation (WTO) rules for trade with its former EU partners.

A soft Brexit would leave the UK’s relationship with the EU as close as possible to the existing arrangements. The UK would no longer be a member of the EU and would not have a seat on the European Council. It would lose its MEPs and its European Commissioner. But, it would keep unfettered access to the European single market.

Goods and services would be traded with the remaining EU states on a tariff-free basis and financial firms would keep their “passporting” rights to sell services and operate branches in the EU. Britain would remain within the EU’s customs union, meaning that exports would not be subject to border checks.

Capital Markets Union (CMU)

The Capital Markets Union (CMU) is a plan of the European Commission to create a true single market for capital in Europe. It will channel increased capital to all companies, including Small and Medium Enterprises (SMEs), and to infrastructure projects.

CETA - EU-Canada Free Trade Agreement

The Comprehensive Economic and Trade Agreement (CETA) is a trade agreement negotiated between the EU and Canada. Once implemented, it will remove customs duties, end limitations in access to public contracts, open up services markets (limited), and help prevent illegal copying of EU innovations and traditional products. It has taken 7 years to agree.
Customs union

The EU customs union means that goods are not subject to tariffs when they cross borders between Member States within the EU. All Member States including the UK must apply the EU common rate of customs tariffs to all goods entering them from outside the EU. Member States are not allowed to vary from these rates in either the higher or lower direction, since this would lead to goods entering the EU through the ports of the country with the lowest tariffs and then being re-exported to other Member States tariff-free inside the customs union. It also means that Member States are not allowed to conclude trade agreements with non-Member countries.

EEA (European Economic Area)

The EEA is an internal market providing for the free movement of persons, goods, services and capital. It is made up of 31 countries: the EU’s 28 Member States plus Norway, Iceland and Liechtenstein. It is governed by a common set of rules. Members are subject to the benefits and burdens of the financial services single market directives and regulations, including passporting rights.

European Economic Community (EEC) and European Community (EC)

The European Economic Community (EEC) was a regional cooperation organisation and precursor to the EU, as one of the European Communities. It was founded in 1957 to promote economic integration between its member states. When the Maastricht Treaty created the European Union (EU) in 1993, the EEC was incorporated and renamed the European Community (EC). In 2009 the Lisbon Treaty provided for the EC to be fully incorporated into the European Union.

EFTA (European Free Trade Association)

The European Free Trade Association (EFTA) was created to allow European countries to partake in a free trade area with less integration as within the European Communities (later European Union). Most of the countries initially in EFTA have since joined the EU itself, so only four remain outside, Norway, Iceland, Liechtenstein and Switzerland.

Equivalence

In certain cases the EU may recognise that a non EU (“Third Country”) legal, regulatory and/or supervisory regime is equivalent to the corresponding EU framework. That recognition, in turn, makes it possible for authorities in the EU to rely on supervised entities’ compliance with the equivalent foreign framework. That approach brings benefits to both the EU and third-country markets by reducing or even eliminating overlaps in compliance for the EU and/or third-country entities concerned and it leads to considering certain services / products / activities of third countries’ firms as acceptable for the various regulatory purposes in the EU.

EUSFTA (EU-Singapore Free Trade Agreement)

Negotiations for the EUSFTA were launched between Singapore and the EU in 2009. It is a highly ambitious and comprehensive agreement covering all trade, services and investment issues, as well as other modern trade and investment topics. It is not expected to enter into force until 2018/2019 subject to the domestic administrative procedure on both sides.

European Union (EU)

The EU is a group of 28 countries that operates as a cohesive economic and political block. Nineteen of the countries use the euro as their official currency.
Free Trade Area (FTA)

An FTA does not require its members to adopt uniform external tariffs in trade with third countries nor to give up their independent ability to do trade deals with them. This is because an FTA only applies to goods which originate within the members of the FTA, so the problem of third country exporters avoiding higher tariffs by routing imported goods through one member of the FTA with lower external tariffs does not apply. On the other hand, it is necessary for customs authorities between the FTA members to check that goods do originate within the other FTA member (according to “rules of origin”) in order to be entitled to tariff-free access.

WTO rules allow its member states to sign FTAs granting each other preferential market access, subject to certain conditions. FTAs usually cover agreements to reduce tariffs and other restrictions to trade on goods and, to a lesser extent, services.

G20

The Group of Twenty (G20) is a forum for international economic cooperation and decision-making. It comprises 19 of the world’s leading economies, including the UK, plus the European Union.

Passporting

A central plank of the European Union’s vision for a single market in financial services is that financial services firms authorised by their local member state regulators may carry on business in any other member state by establishing a local branch or by providing services on a cross-border basis without the need for separate authorisation in every host state.

Subject to its fulfilment of conditions under the relevant single market directive, a firm authorised in a European Economic Area (EEA) state is entitled to carry on permitted activities in any other EEA state by either exercising the right of establishment (of a branch and/or agents) or providing cross-border services. This right is known as ‘passporting’

Single Market

A single market (in fact called the “internal market” in the EU Treaties) is a common trade area that extends beyond the deepest and most comprehensive Free Trade Agreements. It works to remove all regulatory obstacles to the free movement of capital, people, goods and services. It stimulates competition and trade, improves economic efficiency and helps to lower prices. The EU’s Single Market is the largest in the world.

Third Country

A non-EU or EEA country.

UNEP (United Nations Environment Programme)

The United Nations Environment Programme (UNEP) is the leading global environmental authority that sets the global environmental agenda, promotes the coherent implementation of the environmental dimension of sustainable development within the United Nations system and serves as an authoritative advocate for the global environment. [http://www.unep.org/about/](http://www.unep.org/about/)

WTO

The WTO is the international organisation that regulates global trade between nations. It was established in 1995 as the successor to the General Agreement on Tariffs and Trade (GATT). The WTO enables participating member states to agree trade rules, negotiate trade agreements, and resolve disputes. A total of 162 countries are members, including the UK.
2. Members of the European Economic Area (which comprises the 28 EU member states and Norway, Liechtenstein, and Iceland) are subject to the benefits and burdens of the financial services single market directives and regulations, including passporting rights. Non EEA members are usually referred to as “Third Countries.”
3. Letter is available here: http://www.parliament.uk/documents/commons-committees/treasury/Correspondence/AJB-to-Andrew-Tyrie-Passporting.PDF
5. These consultation responses can be viewed on the Commission website at http://ec.europa.eu/finance/consultations/2015/capital-markets-union/index_en.htm
7. FT UK Looks for transitional trade deal after Brexit. https://www.ft.com/content/cc84f9ee-8a53-11e6-8cb7-e7ada1d123b1
8. “A clear agreement will be needed on a transition period between the UK’s formal exit from the EU and the implementation of the new rules.” https://www.thecityuk.com/news/the-impact-of-the-uk-s-exit-from-the-eu-on-the-uk-based-financial-services-sector/
10. 4 March 2016 Cabinet Office Policy paper. Alternatives to membership: possible models for the United Kingdom outside the European Union
11. As 7.