

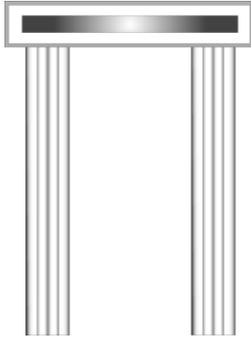


**Barnabas Reynolds**

**Best for the Future, Best for the  
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Barnabas Reynolds

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Reynolds co-edits *Sweet & Maxwell's Journal of International Banking Law and Regulation* and is the co-author of *Shipowners' Limitation of Liability*, Kluwer Law, 2012. He writes regularly on financial services regulatory matters, including recently client money and assets, MiFID II, shadow banking, margin for uncleared swaps, derivatives clearing and senior management liability.

After graduating in law from Downing College, Cambridge, he took an LLM at Queens' College, Cambridge, and now lives in London.

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## Introduction: Financial Services, Sovereignty and Change

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Financial Services Trade will be at the top of the agenda for the new prime minister as he prepares the country for Brexit on 31<sup>st</sup> October 2019.

The first step must be to make a swift offer to the EU for continued trade across as much of the economy as possible, with preparations urgently to be made. The focus must be on future trade rather than the fruitless ‘tidying up’ exit exercise that wasted time and energy and acted as a diversion from a deal for the future. Its legacy was an inexecutable, thrice rejected exit agreement that failed even to pass the first hurdle, in failing to preserve the UK's legal perimeter and losing sight of the Brexit aim to leave the EU and no longer pool sovereignty arrangements. So the now defunct Withdrawal Agreement must be dropped in its entirety – it fell short on the constitutional imperative and on respecting the UK’s national dominion over its affairs.

**Sovereignty** – Sovereignty matters. The draft Withdrawal Agreement failed on grounds of sovereignty in number of ways, two of which will now be highlighted, the others listed at the end of this piece. First, it gave the EU the right to apply its State aid laws in the UK, potentially for ever, in whatever manner the ECJ chose to define these laws over time, far more stringently than under normal WTO arrangements. State aid rules derive from arrangements for the EU’s Customs Union. Already expanded by the ECJ into other sectors, they allow much of legislative, regulatory and tax policy to be controlled by the ECJ and European Commission. Secondly, the Withdrawal Agreement awarded actionable rights (ie directly effective rights which the UK courts would be obliged to recognise and enforce) to anyone seen to benefit from expectations created by the Agreement. So if the UK were to breach the Withdrawal Agreement in future because certain aspects turned out to be damaging to UK interests, that breach would give rise to unquantifiable damages to other parties, to be paid by the UK to those to whom the Agreement had given such rights, with the ECJ being the ultimate judge of the matter.

These and other underlying problems owe much to the assumption that both parties intended to preserve many of the current EU law arrangements and that trade discussions would also build on those premises, if doing so separately. That supposition, enshrined in the Withdrawal Agreement, has rightly been rejected and the new prime minister will start with a clean slate.

What course, therefore, should now be pursued?

## II

# Sovereignty and Services Trade

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While the UK was a member of the EU, it 'pooled' its sovereignty with that of the other EU member states, in exchange for the right to have a say in EU affairs.<sup>1</sup> But under the Withdrawal Agreement it was proposed that such pooling should continue after Brexit during a transitional period of up to 3 years or so, without taking account of the very different arrangements which, after Brexit Day, meant that sovereignty would no longer be co-exercised. Fixing that flaw should be fundamental to any future temporary or transition arrangement, especially given the importance to the UK of exercising its powers alone. This significant and immediate legal shift requires an equally significant change of approach. As David Lloyd George once said, “you can't cross a chasm in two small jumps.”

First, it should be understood that the UK can leave the EU without any withdrawal agreement and that any proposed 'deal' should focus on the future relationship, especially future trade (unlike Theresa May's withdrawal deal). There will be no cliff edge on leaving without an agreement because already key matters have been provided for by both parties' preparatory steps for Brexit, to avoid unnecessary disruption. The European Union Institutions have agreed no less than 17 major measures to safeguard the effects of no deal: on retaining basic connectivity for aviation and on aviation safety, for road haulage trucks, for rail operations and rail safety, fishing, social security, visa waivers and so on.<sup>2</sup>

Moreover, if there is to be an agreement – given that none is in fact necessary to exit - it must improve on that position. This means any future discussions must be rebooted on a basis that recognises UK sovereignty and aims to achieve a mutually beneficial trade arrangement,

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<sup>1</sup> Since Maastricht/Lisbon the qualified majority voting arrangements in the EU Council have in practice resulted in the UK being outvoted more than any other Member State, so the 'pooling' has been unsatisfactory for the UK.

<sup>2</sup> The EU states that these arrangements are simply to conserve its position and may be temporary. Nevertheless they indicate a sensible wish to minimise damage that would result from no such arrangements at all.

one built on recognising, identifying and eliminating current concerns about sovereignty with the focus on trade. And because trade talks will take time if an agreement is to be reached, a temporary standstill arrangement should and can be agreed to protect both parties' current trade pending a final trade deal. This would prevent unnecessary disruption and, for the EU, preserve its massive trade surplus with the UK which has arisen since the advent of the EU 'single market'. Indeed, the concept of a temporary standstill, even without a temporary trade agreement, was recognised as desirable in analogous circumstances as far back as 1947, by a series of exemptions from GATT recognising that former members of dissolving empires (such as the Ottoman Empire) could maintain their own tariff regimes and disapply most favoured nation principles whilst stabilising their trade relations.

**Re-focus on Services and Navigating Sovereignty in Financial Services** Hitherto, however, there has been an undue concentration on arrangements for goods rather than services, though services trade is central to the UK's economy - representing 80% of its business. Particularly important is the financial services sector, which accounts for much of the cross-border trade into the EU. Theresa May's government was lobbied by the financial industry to agree a transitional (or standstill) arrangement for financial services with the EU to preserve existing access arrangements between the global markets in the UK and the EU27's domestic markets after Brexit while final trading arrangements are negotiated. But her government failed to achieve that result consistent with sovereignty. That was despite the Chancellor, as early as March 2018, having announced that the UK could not be a rule-taker in this important sector.

Under existing so-called 'passporting' arrangements, EU27 customers receive their services directly from London, without the big costs of duplicative regulation and supervision by UK and EU27 regulators. Businesses operate under one set of (EU) rules and one (UK)

supervisor.<sup>3</sup> This mode of delivery is unlike that for rest-of-world customers. They, by contrast, come to the UK's markets in the traditional way, and establish small UK presences from which to receive those services.

These passporting arrangements need re-vamping if they are to work from 31<sup>st</sup> October onwards. However, the Withdrawal Agreement proposed a transitional period under which passporting would continue to apply, unmodified, and the UK would be a rule-taker for up to 3 years or so, subject to all of the EU's financial services laws, interpreted and supervised by the EU – breaching basic and immutable principles of sovereignty.

A transitional period for financial services based on the existing EU law concept of equivalence should therefore have been the aim. That would mean that provided UK and EU financial services laws achieved similar high level outcomes, businesses in the UK could sell to EU27 customers under the UK's equivalent laws, supervised by UK regulators – and *vice versa*. To be deployed correctly, this would require relatively minor adjustments to arrangements already in place between the EU and tens of countries around the world.

**Next Steps** For such an arrangement to be agreed, and if financial services are to be treated as part of a packaged deal, determination and focus are needed. The EU is unlikely to make the negotiation easy. Its behaviour in relation to Switzerland has already shown tendencies to use financial trade as a tool to expand its sphere of control.<sup>4</sup> But the Swiss have shown the way in being resolute and have repatriated Swiss share trading in the face of this EU action, even to the extent of escalating a dispute over equivalence-based access to the EU.

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<sup>3</sup> Different segments of the financial services industry benefit to differing degrees from the passport. It is little used in most of the retail markets, but is widely used (for instance) for many types of investment banking.

<sup>4</sup> In discussions with Switzerland over a new legal relationship, the EU has threatened for EU customers to stop facilitating Swiss stock exchange business unless Switzerland agrees to a type of arrangement the Swiss indicated they do not wish to pursue.

The UK will therefore need to be very focused in indicating what it would like and why this would benefit both parties. An arrangement for Enhanced Equivalence, based on draft Treaty and legislative text, is ready, prepared by me for Politeia<sup>5</sup> and designed to be neutral and fair. It provides the basis for equivalence-based access arrangements in financial services to mutual benefit, and would preserve the existing distribution models for financial services whilst full-blown trade negotiations take place. It would do so without encroaching on either party's sovereignty and could be introduced immediately, so in advance of Brexit Day on 31<sup>st</sup> October. Moreover, with the right negotiating team in place, it should be possible to finalise the text as part of a wider standstill across goods, agriculture and much of services.

Indeed, both parties have in principle agreed they want such an arrangement in the current Political Declaration. The differences between the UK and the EU are after all largely over how to get to the desired end result, not the broad outlines of what that end result should be.

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<sup>5</sup> *A Template for Enhanced Equivalence* (Politeia, July 2017) and *Free Trade in UK-EU Financial Services* (Politeia, October 2018).

### III

## Negotiating Free Trade – Ensuring continuity for the interim

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How does this fit into the process for negotiating a full-blown FTA? Negotiating an FTA, particularly for goods and agri-products, will take time, given the trade options and the complexities prompted by EU claims about the Irish border. And the EU is likely to wish to agree arrangements for all of its trade – for goods, agri-products, services (including financial services) and other matters - at one time. Professor David Collins has set out an outline final form FTA framework in *The EU, the UK and Global Trade – A New Roadmap*.<sup>6</sup> So how best can trade relations be preserved meanwhile?

As indicated, one immediate problem to resolve will be the position of financial services under the new rules constantly being made by the EU with the interpretations handed down. An arrangement such as that in the Withdrawal Agreement must not and need not be ratified, particularly as the UK will leave the EU with identical laws on Day 1. The Chancellor rightly announced in March 2018 in his speech at HSBC that the UK could not become a rule-taker in this important sector. It is particularly important therefore not to slip into nodding through the EU proposal for UK ‘dynamic alignment’ with EU measures not yet on the books, or to EU interpretation or oversight. Indeed the lesson from the 2007-8 financial crisis should be taken: it is essential for the UK to have freedom to change its rules or reinterpret them swiftly to meet the challenges of an evolving, and potentially damaging economic, financial or monetary crisis. Besides, the EU’s desired rule-making for its domestic EU27 markets and the eurozone does not necessarily reflect the interests of the UK’s global markets, and the UK will after Brexit no longer have a role or voice in shaping such rulemaking to take account of UK interests, or indeed judicial representation. For such reasons the transitional arrangements must reflect the differences between and long term aims for goods and services. It is necessary to consider the desired arrangements for both, side-by-side.

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<sup>6</sup> 2nd edition, June 2019, Politeia with New Direction.

**Standstill for Goods Trade** For goods, agri-products, and related matters for which time will be needed to finalise the text for future agreements, the UK should propose a temporary or transitional Trade Agreement and a standstill period of 2 years in order for the EU and UK to negotiate a full-blown Free Trade Agreement covering these. The terms of that temporary Trade Agreement would be on a sovereign-to-sovereign basis in the manner of FTAs the world over. Given that rules in this area rarely change, a standstill arrangement involving mutual recognition of each other's existing, identical standards would be relatively straightforward for a 2-year period – and there is no need for any 'dynamic alignment' as proposed by the EU.

**Financial Services – Interim Enhanced Equivalence agreement** On financial services, there must be an immediate Enhanced Equivalence arrangement allowing for mutual access by way of mutual recognition of regulatory and supervisory standards. Although it requires new measures to be put quickly into place, it is nevertheless a viable, swift and executable way to avoid rule-taking for the transitional period. The arrangement could lapse after the 2-year standstill, permitting a final, negotiated FTA to be implemented at that point, covering goods, agri-products, services, financial services and all other matters.

The UK's long term aim is to trade with the EU on the basis of Enhanced Equivalence. That basis has been tentatively agreed by the EU in the draft Political Declaration. Enhanced Equivalence would avoid the problems of dynamic alignment with EU rules. It would also avoid the problem of how and by whom the rules are interpreted. In particular, such an agreement would provide for:

- a. broad equivalence-based access by the EU to the UK and *vice versa*, with the same scope as the current passporting arrangements, where each party's financial businesses obtain access to the other's markets subject to their financial rules achieving similar high level outcomes;
- b. the automatic inclusion of new equivalence provisions for any future topics where the EU introduces a further passport, for instance in the

forthcoming Capital Markets Union. The UK would obtain the option to acquire equivalence-based access on that topic if it wished to do so at the time. The UK would commit to offer the same to the EU. That way both parties can genuinely collaborate on future market improvements knowing they are working towards a mutual end;

- c. clear definition of the types of outcomes acceptable when applying the equivalence concept – to be specified at a high level, based on international standards where possible, and only legitimately referable to a party’s own systemic risk, in the case of the wholesale markets, and consumer protection, in the case of the retail markets (consistent with how equivalence already operates); and
- d. an independent tribunal, with an ability to call on expert evidence, which should oversee the application of the outcomes-based equivalence definition by both parties, such that in the normal manner of FTA trading arrangements, each party commits to abide by their word.

## IV

### Enhanced Equivalence Advantages and implications

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**No transition, no fragmentation** Such a financial services agreement would bring many advantages.

- The legal framework being already prepared, it could be agreed rapidly with the EU, ready for operation after withdrawal from the EU on 31<sup>st</sup> October.
- It avoids any time during which the UK would be obliged to subjugate its sovereignty and become a rule-taker, a course inconsistent with Brexit and also inconsistent with remaining within the EU's pooled sovereignty arrangements.
- It avoids allowing individual EU member states to try to pick off bits of the industry by playing up the chances of a 'no deal' outcome. The UK has thus far been unable to protect itself from such interested parties, for example by removing regulatory red tape or negotiating FTAs with third countries, because that could be treated as contrary to EU law. A proper deal would ensure the UK is free to ensure fair play.

A similar agreement could also be made covering other services. Professional qualifications could be subject to mutual recognition. Ancillary benefits can also be recognised, for instance privilege protection for lawyers, rights of audience and so on.

By contrast, were the UK were to continue even for the interim under the existing passporting arrangements for financial services, as proposed in Mrs May's draft Withdrawal Agreement, not only would the EU require that its new rules be applied within the UK. But it would control how the rules are interpreted and police the UK's compliance. The reason for rule-taking being unacceptable is not purely a matter of maintaining sovereignty. It would expose UK taxpayers to the systemic risk arising from an external, foreign regulatory system, increasingly unsuited to the UK's diverse and multi-faceted sector, over which its own legislators

and regulators could exercise no control. Such a scenario could not and should not be accepted by the UK.

**Other Caveats** The EU has always contended that the UK has to make a payment on exit. There is no legal obligation to make such a payment, something made quite clear by the House of Lords EU financial affairs sub-committee and other distinguished legal opinion. If this matter is disputed by the EU, the UK could agree to arbitrate the point before an independent tribunal.

These arrangements would mean that on 31st October, the UK would leave the EU with a fully binding (but temporary) trade deal on services including financial services, and a temporary agreement on goods, agri-products and security, in both cases for 2 years pending negotiation of an FTA on these. There would therefore be a different basis for transitioning to the fully fledged free trade deal with the EU and other countries, as intended. The UK would once again be an independent trading nation under UK law, without subjugation to the EU or its law.

# Appendix I

## The Withdrawal Agreement – Why it must go

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It has been suggested by some adherents of Theresa May's Withdrawal Agreement that (i) the EU will not accept any alternatives, although perhaps minor modifications may be made or (ii) parts of the WA can be salvaged. Yet not only has no formal alternative proposal so far been made by the UK to the EU, but the magnitude of the task needed to convert the Withdrawal Agreement into an acceptable and executable deal needs to be recognised. So numerous are the problems and difficulties it prompts, that only a cursory list can be given here of the matters that could not be accepted even if parts of the Withdrawal Agreement could be contemplated.

1. Remove the Northern Ireland Protocol and propose in its place arrangements for an invisible border between Northern and Southern Ireland, failing which the UK should rely (as it is entitled to do) on the security-based exemption from the WTO rules to avoid putting in place a hard border, leaving the EU to decide what to do on the Irish side of the border, perhaps imposing checks at the Irish ports facing the EU26, thereby pulling Ireland out of the 'single market'.

2. Remove all reference to EU law, since no normal Treaty arrangements subject one party to the laws of the other.

3. Remove the point that all EU terms are to be given EU meanings.

4. Remove all reference to ECJ jurisdiction, direct or indirect.

5. Remove the Article 4 'direct effect' provision, which purports to give direct entitlements and causes of action to anyone seen to benefit from the provisions of the Withdrawal Agreement.

6. Put a short time limit on EU citizens' rights or make mutual unilateral non-binding declarations not to discriminate between citizens on the basis of their antecedents. The UK should not agree to create a second, permanent category of UK citizen whose rights are determined in part by the ECJ.

7. Crystallise payment with a cap to avoid uncertainty, and only allow for the payment after delivery by the EU of an acceptable final form FTA across all

sectors of the economy, plus a satisfactory collaboration arrangement on security and other matters.

8. Insert language to force a trade deal, building from an up to 2 year binding temporary arrangement that freeze-frames the status quo without any transitional period that would otherwise render the UK a rule-taker. The trade deal would have to contain a 2 year exit provision where it ends up not working for either party.

9. Provide for mutual recognition of standards across all topics, clearly and carefully defined so both parties agree to achieving internationally defined outcomes.

10. Re-write the Political Declaration to reflect a full free trade deal across goods and services as the outcome which both parties seek to negotiate.

11. Any security-based and other cooperation arrangements to be as equals on an entirely voluntary, not pre-committed basis.

12. Tighten drafting of the text throughout so it is clear what is being agreed and the parties are comfortable with the arrangements in all circumstances.

Such changes would lead to an entirely new document, one which would not be the Withdrawal Agreement. Far better for both parties to focus on their aims, and far better to reach them through arrangements along these lines – based on equality, sovereignty and fairness. It is time to make the proposition to the EU to enable the parties quickly to determine one of two prospects: whether the intentions for a free trade arrangement in the Political Declaration truly reflect the EU's ambitions and indicate that any differences between the UK and EU are no more than procedural, or whether the Withdrawal Agreement was a more cynical mechanism for ensnaring UK sovereignty, as some believe it to have been.

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