

The implications of “full alignment” for Brexit planning by financial institutions

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On December 8, 2017 the negotiators of the European Union (“EU”) and the United Kingdom published a joint report on the progress of phase 1 of the negotiations under article 50 of the Treaty on the European Union (the “**Joint Report**”). The publication of the Joint Report allows the European Commission to recommend that the European Council initiate phase 2 of the negotiations, which will deal with the future trading arrangements between the EU and United Kingdom.

The Joint Report suggests that the United Kingdom will maintain “full alignment” with the rules of the EU internal market and customs union post-Brexit in order to protect cooperation, and to avoid a hard border, between the United Kingdom and Ireland, although it does not address what would amount to “full alignment”. In particular, the Joint Report does not indicate whether alignment would extend to financial services, or what arrangements (if any) could be implemented to govern access for UK financial institutions to EU clients and markets or *vice versa*.

In this short note, we explore potential implications of the Joint Report and its implications for firms’ contingency plans for Brexit.

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1. Introduction

The Joint Report sets out the provisional agreement reached between the UK government and the EU negotiators relating to three elements of the UK's withdrawal from the EU.

Subject to the qualification that “nothing is agreed until everything is agreed”, the report records the “in principle” commitments of each side relating to the rights of UK citizens living in the EU and EU citizens living in the UK respectively, the framework for addressing the relationship between Ireland and Northern Ireland and the financial settlement between the UK and the EU relating to Brexit.

In the context of the future relationship between Northern Ireland and Ireland, paragraph 49 states:

“The United Kingdom remains committed to protecting North-South cooperation and to its guarantee of avoiding a hard border. Any future arrangements must be compatible with these overarching requirements. The United Kingdom's intention is to achieve these objectives through the overall EU-UK relationship. Should this not be possible, the United Kingdom will propose specific solutions to address the unique circumstances of the island of Ireland. In the absence of agreed solutions, the United Kingdom will maintain full alignment with those rules of the Internal Market and the Customs Union which, now or in the future, support North-South cooperation, the all-island economy and the protection of the 1998 [Good Friday] Agreement.”

The paragraph appears to represent a unilateral commitment that, in the absence of any alternative solutions developed prior to Britain leaving the EU, the United Kingdom will maintain “full alignment” with the rules of the internal market and customs union in order to support future co-operation between the United Kingdom and the Republic of Ireland.

2. Would “full alignment” extend to the regulation of the financial services sector?

The paragraph covers those EU rules “*which, now or in the future, support North-South cooperation, the all-island economy and the protection of the 1998 [Good Friday] Agreement*”. On its face, the reference

to rules which support the all-island economy would appear to include those rules supporting the internal market, including in financial services, as they apply between Ireland and the UK. However, the commitment could be interpreted to relate only to those rules which meet all three conditions stated above. As there is little, if any, relationship between financial services regulation and the Good Friday Agreement, there would appear to be plenty of room for the UK government to argue that the commitment does not extend to alignment in financial services regulation.

3. What does “full alignment” mean?

Rather than providing certainty the phrase “full alignment” is ambiguous. It has been widely reported that this was the intention of the drafters of the Joint Report, given the diverging views of a number of the negotiating parties.

We note that the term “full alignment” has been used previously by the European Commission, particularly in the context of accession talks. Acceding countries are often required to achieve “full alignment with the *acquis* [being the body of EU law]” and relevant sectoral rules prior to accession as a member state of the EU.¹ The process of accession is of course distinguishable from the negotiations under article 50 of the Treaty on the European Union. Nevertheless the use of such a term may prove illustrative of how EU negotiators view the sequencing and objectives of the negotiations themselves.

We set out below a number of ways in which the phrase “full alignment” could be interpreted.

The Swiss approach

“Full alignment” may indicate a situation where the UK relies heavily on EU rules in a similar way to the approach currently adopted in Switzerland (the “**Swiss Model**”). The Swiss Model relies on sectoral agreements or treaties between the EU and Switzerland (known informally as “**Bilaterals**”) which govern trading arrangements in a number of specific industries, including aerospace and agricultural products. In addition to the Bilaterals, Switzerland extends EU rules into domestic law by

¹ See e.g. European Commission Staff Working Document SEC 2010/1326 on Croatia and Communication from

the Commission to the Council on Roadmaps for Bulgaria and Romania (COM/2002/0624).

determining whether existing Swiss law is compatible with equivalent EU provisions or, where this is not the case, adapting Swiss law to EU law.

In the event that the *acquis* is incorporated into UK law, the Swiss Model could be relatively easy to adopt for the UK as there would be total alignment on the day of Britain's exit. However there would be significant political pressure on the UK government not to adopt an approach which would inhibit or prevent the UK from adopting a divergent approach to existing and future EU regulatory requirements.

Principles or objectives-based approach

It is more likely that the UK government would seek to pursue "full alignment" by means of a principles-based or objectives-based approach. Under such an approach the future relationship would not be based on prescriptive set of common rules adopted by the UK and deemed to comply with EU law. Rather the UK would regulate with a view to common outcomes or goals which govern their trading relationship.

Such an approach would provide greater flexibility than the Swiss approach of conforming UK law to EU law. It also seems to be closer to the UK government's preferred approach of achieving "the same outcome and high standards, with scope for flexibility in relation to the method for achieving this".² There is, however, no certainty that such an approach would be considered acceptable by the EU authorities, particularly in light of the increasing international pressure on EU authorities not to agree an arrangement with the UK that risks damaging the EU's relationship with other third countries due to perceived special treatment.

4. Would "full alignment" result in access rights for UK financial institutions to EU clients, and vice versa?

The key challenge faced by UK financial institutions in planning for Brexit is ensuring continued access to EU markets following the loss of passporting rights on leaving the EU single market. EU financial institutions face similar challenges in relation to continued access to UK markets.

The commitment does not address these questions. It is unilateral and is not matched by a parallel commitment from the EU to permit access by "fully aligned" UK financial institutions to Irish (or other European) clients or markets. Further, there is no indication that regulatory alignment will be used as a basis to confer rights on European financial institutions to access UK clients. There may be some discussion of how far regulatory alignment should be taken into account in assessing equivalence for purposes of third country access rights under EU law following Brexit (for example under MiFID II), but any commitment to alignment does not of itself guarantee the conferral of such rights.

5. Should the Joint Report affect firms' Brexit planning?

The agreement of "in principle" terms between the EU and UK increases the likelihood of Brexit taking place on agreed terms. This in turn makes transitional relief, during which passporting rights may continue for a period following Brexit, more likely. We consider that in all other respects the commitment in the Joint Report does not provide sufficient clarity as to the framework for future regulatory co-operation between the EU and the United Kingdom to affect firms' base cases for Brexit planning.

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² See HM Government's Position Paper "Northern Ireland and Ireland", p.19.