



# Brexit: addressing risks in international capital markets

*By Paul Richards*

## Summary

In preparing for Brexit<sup>1</sup>, a great deal of work is already being done by financial institutions on contingency planning.<sup>2</sup> Apart from the preparations needed by financial institutions, there are also risks in international capital markets arising from Brexit that need to be addressed because of their potential impact on capital market integration and on financial stability. The key risks relate to: shortage of time; legal uncertainty;

restricted access to markets and skills; cross-border regulatory divergence; and a “cliff edge” on Brexit. The purpose of this Quarterly Assessment is to examine these risks, and assess what can be done to keep them to the minimum, both from a UK and an EU27 perspective, so as to prevent capital market fragmentation and ensure that financial stability is maintained.<sup>3</sup>

## Introduction

1 After the UK Referendum on 23 June 2016, in which the UK voted by 52% to 48% to leave the EU rather than remain, the Prime Minister set out the British Government’s objectives in a speech at Lancaster House in January 2017 and in a subsequent White Paper.<sup>4</sup> The Government’s objectives involve taking back control of the UK’s borders by limiting EU immigration to the UK, and taking back control of UK laws by bringing an end in the UK to the jurisdiction of the European Court of Justice. As these objectives are not consistent with remaining in the EU Single Market, the British Government proposes to leave the Single Market when it leaves the EU.<sup>5</sup> Instead, the Government wants to negotiate “the greatest possible access” to the EU Single Market through an “ambitious free trade agreement” with the EU as a third country.

2 Following Parliamentary consent, the Prime Minister wrote to the President of the European Council on 29 March in order to invoke Article 50 of the Treaty of European Union and enable the UK and the EU27 to start the process of negotiating UK withdrawal from the EU. Article 50 is due to expire on 29 March 2019. The European Commission’s negotiating guidelines were set by the European Council at a Summit on 29 April.<sup>6</sup>

3 On 18 April, the Prime Minister unexpectedly called a General Election in the UK for 8 June with the objective of achieving for the Conservative Party a larger overall majority in the House of Commons than before. The result of the election on 8 June was that, while the Conservative Party remained the largest party in the House of Commons, it failed to achieve an overall majority. The full implications are not yet clear, but:

1. ie the withdrawal of the UK from the EU.

2. Shortly after Article 50 was invoked, the Prudential Regulation Authority in the UK asked all banks, insurers and designated investment firms undertaking cross-border activities between the UK and the rest of the EU (ie the EU27) to submit their plans by 14 July. The Financial Conduct Authority also wrote to the largest asset managers.

3. The paper does not assess other risks arising from Brexit, such as the risks for the UK and EU27 economies, interest rates and exchange rates. Nor does it consider the impact on the politics of euro-area integration.

4. The Prime Minister: *The Government’s Negotiating Objectives for Exiting the EU*: Lancaster House, 17 January 2017. The British Government White Paper (Cm 9417) was published in February 2017.

5. Within the EU Single Market, the “single passport” allows financial services operators legally established in one EU Member State to establish or provide their services in the other Member States without further authorisation requirements.

6. *European Council (Art. 50) Guidelines Following the UK’s Notification under Article 50 TEU*: 29 April 2017 (“European Council guidelines”).

- it is likely to be more difficult in the new Parliament for the Government to pass the large amount of legislation needed in the UK to enact Brexit in time before Article 50 expires on 29 March 2019, without cross-party support;
- there is expected to be a greater focus in the new Parliament on the potential impact of the Government's approach to Brexit on UK growth and jobs; and
- the risk that the UK and the EU27 will fail to reach agreement before Article 50 expires appears to be at least as great as before.

4 The negotiations between the British Government and the European Commission on behalf of the EU27 began on 19 June. Both sides confirmed that the UK will leave the EU Single Market when it leaves the EU.<sup>7</sup> That is the working assumption in this Quarterly Assessment. An alternative for the UK when it leaves the EU would be to remain in the Single Market by joining the European Economic Area, if necessary temporarily so that Brexit takes place in two stages rather than one.<sup>8</sup>

### The risk of shortage of time

5 The first key risk in international capital markets arising from Brexit is shortage of time to make the necessary preparations, taking account of uncertainty about the outcome of the negotiations between the UK and the EU27, for four main reasons:

- First, it is not expected that Article 50 will be extended when it expires on 29 March 2019, two years after it was invoked, because the EU27 want the UK to leave the EU before the European Parliament elections in 2019, and any extension would require unanimity among the EU27. So far, the British Government has indicated that it does not want to extend Article 50 in any case.
- Second, the timetable for the Article 50 negotiations is in practice shorter than two years. After Article 50 was invoked, the first three months elapsed before negotiations between the UK and the EU27 began on 19 June; and around six months is likely to be needed at the

end of the process to provide time for ratification by the British Parliament, the European Parliament and the EU Member States. That leaves only around 15 months for the negotiations themselves, during which Parliamentary elections are also due to take place in Germany and Italy.

- Third, the Article 50 negotiations are due to cover the withdrawal terms,<sup>9</sup> taking account of the framework for relations between the UK and the EU27 in future. The European Council guidelines set out two phases for the negotiations:<sup>10</sup> the first phase for the withdrawal terms; and the second phase for the framework for the EU's future relations with the UK. "Sufficient progress" needs to be made on withdrawal terms before the framework for a new trade agreement can be negotiated.<sup>11</sup> As the UK and EU27 positions appear to be far apart on the terms of a financial settlement for UK withdrawal, this could reduce the time available to negotiate the framework for a new trade agreement before Article 50 expires.
- Fourth, for the capital markets, the Brexit timetable is complicated by the provision in the European Council guidelines that negotiations under Article 50 will be conducted as a single package, under which "nothing is agreed until everything is agreed".

6 There is also a risk that the negotiations will fail, either because the two sides fail to agree or because they fail to ratify the agreement in time. This may be for reasons unrelated to financial services, which represent only part of the overall negotiation package.

- In the case of the EU27, the withdrawal agreement is concluded by the Council on the basis of a super-qualified majority: 72% of members, comprising at least 65% of the population: ie at least 20 out of the 27 EU Member States (excluding the UK), plus a simple majority in the European Parliament.
- In the case of the UK, Parliament is to be given a vote on the terms negotiated by the British Government before the expiry of Article 50. But if Parliament does not agree with the terms, the UK will leave the EU without an agreement, unless either: (i) the terms can be improved

7. They also confirmed that the UK would leave the Customs Union, though the Chancellor of the Exchequer said that "we will almost certainly need an implementation period, outside the Customs Union itself, but with current customs border arrangements remaining in place, until new long-term arrangements are up and running.": Mansion House speech, 20 June 2017.

8. A more fundamental alternative would be for the UK to stay in the EU but remain outside the euro area under the terms negotiated by the British Government with the EU27 in February 2016. As this approach was rejected in the UK Referendum in June 2016, it could not in practice be reversed without another referendum in the UK. It also assumes that Article 50 could be revoked.

9. The withdrawal negotiations are intended to settle, *inter alia*: UK contributions to the EU budget; acquired rights of UK citizens in the EU27 and EU27 citizens in the UK; and the relocation of EU agencies, including the EBA, from the UK to the EU27.

10. The British Government originally argued that the two phases should be negotiated together at the same time. But it may now take advantage of the first phase to consider its approach to the second phase in more detail.

11. Chancellor Merkel said in the Bundestag on 27 April 2017: "We can only do an agreement on the future relationship with Britain when all questions about its exit have been cleared up satisfactorily."

in the remaining time before Article 50 expires; or (ii) Article 50 is revoked (eg on the grounds that the British Government's intentions have changed). The revocability of Article 50 has not been tested in the Courts.<sup>12</sup> This would be a matter for the European Court of Justice. If Article 50 can be revoked, there is a question whether a change in the British Government's intentions would be sufficient to revoke it, or whether EU27 agreement would also be required, and if so on what basis.<sup>13</sup>

### **The negotiation of a new trade agreement**

Given the shortage of time, it is not expected to be possible to complete the negotiation of a new trade agreement between the UK and the EU27 before Brexit. For example, the trade agreement between the EU and Canada took seven years. As in the case of the trade agreement between the EU and Canada, if the trade agreement between the UK and the EU27 were to be classed as a "mixed" agreement (ie involving both EU and national competences), this would be likely to require unanimity in the EU27, involving votes in 38 national and regional Parliaments. However, in the case of the trade agreement between the EU and Singapore (completed in September 2014), the European Court of Justice ruled on 16 May 2017 that the EU had exclusive competence – requiring only a qualified majority – in all but two aspects of the agreement,<sup>14</sup> and only these two aspects of the agreement would require unanimity among EU Member States. This suggests that a free trade agreement between the UK and the EU27 would be easier to ratify if it was, at least initially, limited in scope to provisions subject to qualified majority voting.<sup>15</sup>

### **The risk of legal uncertainty**

7 Legal uncertainty is the second key risk in capital markets arising from Brexit. The European Council guidelines recognise that the first phase of negotiations should aim to "provide as much clarity and legal certainty as possible" about the immediate effect of the UK's withdrawal from

the EU, and that the "negotiations should seek to prevent a legal vacuum once the Treaties cease to apply to the UK and to the extent possible reduce uncertainties".

8 The British Government is planning to address legal uncertainty about Brexit in two ways:

- first of all, by accepting that EU law will continue to apply in the UK until the UK leaves the EU, including new EU legislation between now and then (like MiFID II/R, which is due to be implemented on 3 January 2018);
- second, by introducing the Great Repeal Bill, which is intended to take EU law into UK law on the day on which the UK leaves the EU (ie Brexit), with any changes taking place subsequently. A British Government White Paper setting out the aims of the Repeal Bill was published on 30 March. It is already clear that the Repeal Bill cannot just be a "copy and paste" exercise. For example, references to EU institutions need to be replaced by UK institutions. (The EU27 may also need to adjust EU financial legislation to take account of the exclusion of the UK.) The outcome of the General Election in the UK is likely to make the passage of the Repeal Bill – and the other Brexit-related Parliamentary Bills required – more difficult rather than less, without cross-party support.

9 In order to avoid legal uncertainty in the capital markets over Brexit, one of the key issues that needs to be addressed is how to ensure continuity of cross-border financial contracts between market participants in the UK and the EU27 written before Brexit but which mature afterwards.<sup>16</sup> Where these contracts provide for the performance of financial services over a period of time including Brexit, it is important that Brexit does not create any legal uncertainty among market participants about continuing to provide them, even if the regulatory arrangements on which they are based change in the meantime: eg if passporting between the UK and the EU27 is no longer available after Brexit. One possible way of guaranteeing continuity of contracts between UK and EU27 market participants would be to provide for the "grandfathering" of existing contracts outstanding at Brexit in the UK/EU27 withdrawal agreement.<sup>17</sup>

12. The Supreme Court judgment in the Miller case on 24 January 2017 did not directly address whether Article 50 *could* be revoked, as both sides agreed that, once Article 50 was invoked, it *would not* be revoked.

13. The French and German Governments and the European Commission have indicated that the UK might be given the opportunity to remain in the EU, if it wished, possibly until the point at which it leaves.

14. These two areas relate to indirect foreign investment and investor-state dispute settlement mechanisms.

15. See Clifford Chance: *What Does the Singapore FTA Decision Mean for the EU's FTAs and Brexit?* May 2017.

16. There are other issues relating to new contracts: eg uncertainty over the extent to which the authorities in the EU27 will continue to allow English law to be used in new international contracts involving the EU27 in future, or will insist instead on the law of an EU27 Member State.

17. See Freshfields Bruckhaus Deringer: *The Legal Impact of Brexit on the UK-based Financial Services Sector*: May 2017.

## The risk of restricted access to markets and skills

10 The third risk is that access to markets and skills is restricted as a result of Brexit. This risk arises because the British Government has stated that the UK will leave the EU Single Market when it leaves the EU and proposes instead to negotiate a new free trade agreement with the EU27.<sup>18</sup> The Government accepts that, after Brexit, the UK will trade with the EU27 on rules set by the EU27 without any direct UK involvement in future (as in the case of other markets around the world).<sup>19</sup>

### (i) Regulatory equivalence between the UK and the EU27

11 Under a free trade agreement between the UK and the EU27, it needs to be clear to what extent capital market firms will be able to rely on mutual recognition of regulatory equivalence between the UK and the EU27 after Brexit to obtain market access, both from the UK to the EU27 and vice versa. The current arrangements for regulatory equivalence represent a patchwork of equivalence, endorsement, recognition and third country passporting.<sup>20</sup> There are provisions for determining equivalence in some EU regulations but not others and, where equivalence does apply, it is not always complete; determining equivalence involves a judgment by the European Commission as well as a technical assessment, and takes time; and the determination of equivalence can be withdrawn at short notice, though this has not happened to date.<sup>21</sup>

12 The current patchwork of regulatory equivalence has clearly not so far evolved with Brexit in mind. But on Brexit, capital market regulations in the UK and the EU27 will be the same. Consequently, the negotiation of a free trade agreement between the UK and the EU27 would provide the opportunity to establish mutual recognition of each other's regulatory regime. However, this would also mean

that UK and EU27 regulations would need to continue to be consistent in future after Brexit; and the free trade agreement would also depend on setting up appropriate mechanisms for enforcing the agreement and settling any disputes.<sup>22</sup>

### (ii) Authorisation in both the UK and the EU27

13 Capital market firms will need to ensure that they can continue to provide services to their clients after Brexit without interruption, especially if the UK leaves the EU Single Market. If they cannot rely on regulatory equivalence alone as the basis for providing services between the UK and the EU27, the main alternative is to be authorised (or licensed), capitalised (eg by establishing a subsidiary) and staffed in both the UK and the EU27, where they are not so authorised already.<sup>23</sup> The key question is what the minimum requirements in the UK and the EU27 will be, and whether they will be the same in different national jurisdictions throughout the EU27:

- Banks in the UK need to decide how to maintain access to the EU Single Market, if the UK leaves the Single Market on Brexit. The main option considered by the ECB is for banks "to set up a subsidiary in an EU country. This requires a banking licence. In the euro area, it is the ECB that grants these licences. And rest assured that we will stick to our high standards."<sup>24</sup>
- In the case of the securities markets, ESMA has set out general principles "to ensure a consistent supervisory approach to safeguard investor protection, the orderly functioning of financial markets and financial stability". In particular, ESMA states: "National competent authorities should reject any relocation request creating letter-box entities where, for instance, extensive use of outsourcing and delegation is foreseen with the intention of benefitting from an EU passport, while essentially performing all substantial activities or functions outside the EU27."<sup>25</sup>

18. The European Council guidelines state that "a non-member of the Union that does not live up to the same obligations as a member cannot have the same rights and enjoy the same benefits as a member."

19. The Prime Minister's letter to President Tusk invoking Article 50: 29 March 2017.

20. Steven Maijor, Chair of ESMA: *Review of the European Supervisory Authorities: Opportunities to Ensure a Safe and Sound Financial System*: European Parliament, Brussels, 8 February 2017.

21. European Commission Staff Working Document: *EU Equivalence Decisions in Financial Services Policy: an Assessment*, 27 February 2017.

22. See also Andrew Bailey, Chief Executive of the UK FCA: "We need to preserve close regulatory and supervisory links with the EU. Looking ahead, strong coordination is a sensible approach to take in order to demonstrate the strength of the system: ... comparability of rules, but not exact mirroring; supervisory coordination; exchange of information; and a mechanism to deal with differences. I would add to this importance of transitional arrangements being put in place which allow for a smooth path to the new post-Brexit world." *Why Free Trade and Open Markets in Financial Services Matter*: Reuters Newsmaker, 6 July 2017.

23. An EU branch of a non-EU bank can only be used to provide services to clients in the relevant Member State.

24. Danièle Nouy, Chair of the Supervisory Board of the ECB: *Regulation and Supervision in Europe - Can Many Cooks Make a Good Broth?* 15 May 2017.

25. ESMA: *Principles to Support Supervisory Convergence in the Context of the UK Withdrawing from the EU*, 31 May 2017.

### (iii) Access to market infrastructure

14 It is also important to avoid the risk of market disruption to the euro market infrastructure as a result of Brexit. Central counterparties (CCPs) play a critically important role in providing the market infrastructure for managing risk. Market firms are required to clear certain derivatives trades through CCPs authorised for the activity concerned, and CCPs are also used to clear other products (eg repo), where use of CCPs is discretionary rather than mandatory. Most central euro-denominated clearing currently takes place in London as an international financial centre.<sup>26</sup>

15 The European Commission has argued<sup>27</sup> that, as a result of Brexit, the framework for the recognition of third country (ie non-EU) CCPs and their supervision needs to be enhanced, because of the “potential risks to the EU’s financial stability”.<sup>28</sup> Under the Commission’s proposal, ESMA, in agreement with the relevant central banks, will recommend to the Commission whether or not a non-EU CCP is of “substantial systemic importance”. If so, the Commission will then have the power to decide whether or not the CCP should be required to relocate activities within the EU27 as a condition for obtaining the regulatory approvals needed to operate in the EU Single Market. The implications for capital markets relate both to location and supervision:

- *Location:* Mandatory relocation would involve costs and risks for users of capital markets. For example, if CCPs with significant euro-denominated derivatives business are required to be located in the EU27, this is likely to increase costs for end-users of the derivatives market, given current economies of scale in London from pooling liquidity in several currencies, which allow multilateral netting of transactions and a reduction in the collateral needed.<sup>29</sup> There is also a risk that mandatory

relocation will cause market disruption, particularly if relocation is not properly organised over a sufficient period of time; and that it will lead to further capital market fragmentation,<sup>30</sup> if there is a response by third countries.<sup>31</sup>

- *Supervision:* Mandatory relocation should not be needed if there is sufficiently effective cooperation between the supervisory authorities involved. The Governor of the Bank of England has noted that the Commission’s proposals “include potential provisions for deference to the rules to which a CCP is subject in its home jurisdiction in line with the intent of the G20.” Cross-border arrangements for the supervision of CCPs “should be based on deep cooperation between jurisdictions and authorities who defer to each other’s regimes where they meet international standards and deliver similar outcomes.”<sup>32</sup> The question is whether sufficiently robust arrangements can be established between the UK and the EU27 or not.

### (iv) Access to skills

16 Besides ensuring continued access to markets, a related issue for market firms is ensuring continued access to skills, both as regards: (i) the preservation of the rights of EU27 and UK citizens living in each other’s territory before Brexit; and (ii) free movement between the UK and the EU27 after Brexit. The British Government’s policy of controlling EU immigration to the UK may make free movement of highly skilled people more difficult to achieve in future than at present. It remains to be seen whether free movement of highly skilled people can be accommodated within the overall framework of UK controls over EU immigration, though the British Chancellor of the Exchequer has indicated that it may.<sup>33</sup>

26. Mark Carney, Governor of the Bank of England: “The UK houses some of the world’s largest CCPs. For example, LCH in London clears swaps in 18 currencies in 55 jurisdictions, handling over 90% of cleared interest rate swaps globally and 98% of all cleared swaps in euros. All currencies, products and counterparties benefits from the resulting economies of scale and scope.”: *A Fine Balance*: Mansion House speech, 20 June 2017.

27. European Commission proposal to amend EMIR, 13 June 2017. In addition, the ECB is seeking to amend its Statute so that it has clear legal competence in the area of central clearing. See also Francois Villeroy de Galhau, Governor of the Banque de France: “Do not let sources of systemic risks for the EU grow outside the EU.”: FESE Convention, 22 June 2017.

28. The alternative view is that clearing does not need to take place in the jurisdiction in which a financial asset is denominated, as central bank swap agreements can counter any systemic risks.

29. ISDA has estimated that “a requirement that euro-denominated interest rate derivatives be cleared post-Brexit in an EU-based CCP would result in an overall initial margin increase in the range of 15 to 20%.”: Letter to Commissioner Dombrovskis, 8 June 2017.

30. Mark Carney, Governor of the Bank of England: “Any development which prevented EU27 firms from continuing to clear trades in the UK would split liquidity between a less liquid onshore market for EU firms and a more liquid offshore market for everyone else.”: Mansion House speech, 20 June 2017.

31. Christopher Giancarlo, Acting Head of the US Commodity Futures Trading Commission, said that an EU move to tighten control over the clearing of derivatives trades “will undoubtedly inform the evolution of US regulatory policy”: 10 May 2017.

32. Mansion House speech, 20 June 2017.

33. Chancellor of the Exchequer: “While we seek to manage migration, we do not seek to shut it down.”: Mansion House speech, 20 June 2017.

## The risk of cross-border regulatory divergence

17 The fourth market risk is that there will be growing cross-border regulatory and supervisory divergence between the UK and the EU27 after Brexit. This is not just a question whether market access between the UK and the EU27 will be restricted if and when the UK becomes a third country on Brexit, but whether regulatory paths in the UK and the EU27 will subsequently diverge. Restriction of market access will increase the costs of compliance for market firms as they will need to operate in two separate jurisdictions - ie the EU27 and the UK - rather than one.<sup>34</sup> But regulatory and supervisory divergence would also create the risk of regulatory arbitrage between the UK and the EU27. If regulators and supervisors were to compete through a "regulatory race to the bottom", under-regulated activities could put at risk the stability of the international financial system as a whole. In an attempt to prevent this, the European Council guidelines state that "any future framework should safeguard financial stability in the Union and respect its regulatory and supervisory regime and standards and their application." Consequently, "any free trade agreement must ensure a level playing field, not only in terms of competition and state aid, and in this regard encompass safeguards against unfair competitive advantages through, *inter alia*, tax, social, environmental and regulatory measures and practices."

18 There is an opportunity for the UK and the EU27 to avoid regulatory divergence, as they are both represented at global level in the G20. The Financial Stability Board (FSB), which implements G20 policy, "is not a treaty-based organisation, so its standards do not have direct force in any member jurisdiction. Decisions are ultimately matters for national authorities."<sup>35</sup> But "equivalence regimes are easier to establish when they are based on international standards. For example, while the EU and US treat prudential capital for banking differently, both regimes are equivalent, as they are implementing a Basel international standard."<sup>36</sup> The Chair of the FSB has confirmed: "We now have agreed common standards that are being consistently and transparently implemented. The playing field for cross-border activities is being levelled. Opportunities for regulatory arbitrage are being reduced. In short, a platform

is being created for deference to each other's approaches when they achieve similar outcomes."<sup>37</sup>

19 The best way of avoiding cross-border regulatory divergence is through cooperation between regulators (eg by means of mutual recognition of regulatory equivalence) and supervisors (eg by means of supervisory colleges). Where regulatory divergence *does* occur, cooperation between supervisors is even more important. Brexit needs to allow for continued and effective working relationships between the UK authorities and EU bodies, with a clear understanding of the potential risks likely to arise post-Brexit. The Chair of the FSB has stated that authorities need to "share relevant information and work together to manage cross-border challenges to financial stability. The FSB and Basel Committee have developed a number of information sharing guidelines to help foster trust and cooperation between international regulators. These include supervisory colleges and crisis management groups."

20 The consequence is that "Brexit will be a litmus test of the future of international cooperation. The UK and the rest of the EU have exactly the same rules and the most highly developed frameworks of supervisory cooperation. Their capital and banking markets are already highly integrated. They have the potential to create the template for trade in financial services."<sup>38</sup>

## The risk of a "cliff edge" on Brexit

21 Finally, it will be important to ensure a smooth changeover in the regulatory arrangements between the UK and the EU27 when Brexit takes place, so as to avoid the risk of a "cliff edge". There will be a "cliff edge" if no agreement is reached between the UK and the EU27 before Brexit, leaving the UK to trade with the EU27 after Brexit under WTO and GATS rules.<sup>39</sup> Alternatively, even if there is an agreement before Brexit, there will still be a "cliff edge" if the agreement involves a significant change in the regulatory regime when Brexit takes place, particularly if there has been insufficient time to prepare for the change.

22 Although the withdrawal agreement under Article 50 needs to take account of the framework for future relations between the UK and the EU27, it is very unlikely

34. See the ECB: "Moving from a centralised wholesale banking market based in London towards a potentially more fragmented landscape, and thereby forgoing synergies reaped from the economies of scale and scope of the City of London, could increase the cost of capital for households and non-financial corporations." The Financial Stability Review, May 2017.

35. Mark Carney, Chair of the FSB and Governor of the Bank of England: *What a Difference a Decade Makes*: IIF, Washington, 20 April 2017.

36. Sir Jon Cunliffe: Evidence to the House of Lords European Committee: *Brexit: Financial Services*, 15 December 2016.

37. Mark Carney: *What a Difference a Decade Makes*: IIF, Washington, 20 April 2017.

38. Mark Carney: *What a Difference a Decade Makes*: IIF, Washington, 20 April 2017.

39. The GATS Annex on Financial Services contains a "carve-out clause" for "measures for prudential reasons".

to be possible to negotiate and implement a detailed new trade agreement before Article 50 expires. (A new trade agreement between the UK and the EU27 is likely to be much more complex than the agreement between the EU and Canada, which took seven years and does not fully cover financial services.) The European Council guidelines state that it “stands ready to initiate work towards an agreement on trade, to be finalised and concluded once the UK is no longer a Member State.”

23 So agreement will need to be reached during the negotiations *before* Brexit on a transitional period – which is referred to by the British Government as an “implementation phase” – *after* Brexit to provide a degree of regulatory continuity and certainty until a new free trade agreement between the UK and the EU27 can be reached. If agreed early during the Article 50 negotiations, a sufficiently long transitional period should help reduce execution and operational risks for market firms involved in the capital markets and help ensure a smooth transition on Brexit.<sup>40</sup> The British Government recognises the importance of “negotiating mutually beneficial transitional arrangements to avoid unnecessary disruption and dangerous cliff edges” and is confident of “early agreement” on this.<sup>41</sup> And the European Council guidelines specifically provide for a transitional period: “To the extent necessary and legally possible, the negotiations may also seek to determine transitional arrangements which are in the interest of the EU and, as appropriate, to provide for bridges towards the foreseeable framework for the future relationship in the light of the progress made. Any such transitional arrangements must be clearly defined, limited in time, and subject to effective enforcement mechanisms.”

## Conclusion

24 It is important to address these five risks in international capital markets during the Brexit negotiations in order to prevent capital market fragmentation and to ensure that financial stability is maintained. Addressing these risks will also help capital market firms to prepare, once the terms of a future trade agreement between the UK and the EU27 are known.<sup>42</sup> In some cases, market firms will need long lead-times, particularly where they need to be authorised to operate in the EU27 or in the UK, if they are not so authorised already.<sup>43</sup> Even if they are already authorised, operating from two centres in Europe rather than one is likely to increase capital and running costs, as well as the costs of moving staff, and may affect the competitiveness of their business. In both cases, they may need to take decisions – at least for the period immediately after Brexit – before the outcome of the negotiations between the UK and the EU27 is known.

### ICMA's role

ICMA's role on Brexit is to encourage efficient and integrated capital markets, which are necessary to support economic growth. We are not lobbying for any particular financial centre. We are discussing capital market preparations for Brexit with members through our Market Practice and Regulatory Policy Committees and reporting to our Board. We are keeping in contact with the authorities in the UK, the EU27 and the euro area. We are also keeping our Brexit webpage up-to-date, not just with our own work, but also with links to work by law firms and others, so as to provide information for members.

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40. However, this may only put off market disruption until a later date if market firms are not properly prepared for a free trade agreement, when it comes into force.

41. Chancellor of the Exchequer: Mansion House speech: 20 June 2017.

42. See, for example, the ECB: “It is important that banks engage in proper and timely planning to reduce the risks of a cliff-edge effect, especially if no transitional agreement is reached. Generally, risks appear to be contained, provided that affected entities adequately plan for a “worst case” scenario.”: Financial Stability Review, May 2017.

43. In the third quarter of 2016, new wholesale authorisations in the UK took 21 weeks on average.