House of Commons

European Scrutiny Committee

Twenty-second Report of Session 2019–21

Documents considered by the Committee on 24 September 2020, including the following COVID-19 related documents:

Authorisation procedure for the export of Personal Protective Equipment (PPE)
EU Capital Markets Recovery Package

Report, together with formal minutes

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Notes

Numbering of documents

Three separate numbering systems are used in this Report for European Union documents:

Numbers in brackets are the Committee's own reference numbers.

Numbers in the form "5467/05" are Council of Ministers reference numbers. This system is also used by UK Government Departments, by the House of Commons Vote Office and for proceedings in the House.

Numbers preceded by the letters COM or SEC or JOIN are Commission reference numbers.

Where only a Committee number is given, this usually indicates that no official text is available and the Government has submitted an "unnumbered Explanatory Memorandum" discussing what is likely to be included in the document or covering an unofficial text.

Abbreviations used in the headnotes and footnotes

AFSJ	Area of Freedom Security and Justice
CFSP	Common Foreign and Security Policy
CSDP	Common Security and Defence Policy
ECA	European Court of Auditors
ECB	European Central Bank
EEAS	European External Action Service
EM	Explanatory Memorandum (submitted by the Government to the Committee) *
EP	European Parliament
EU	European Union
JHA	Justice and Home Affairs
OJ	Official Journal of the European Communities
QMV	Qualified majority voting
SEM	Supplementary Explanatory Memorandum
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union

Euros

Where figures in euros have been converted to pounds sterling, this is normally at the market rate for the last working day of the previous month.

Further information

Documents recommended by the Committee for debate, together with the times of forthcoming debates (where known), are listed in the European Union Documents list, which is published in the House of Commons Vote Bundle each Monday, and is also available on the parliamentary website. Documents awaiting consideration by the Committee are listed in "Remaining Business": www.parliament.uk/escom. The website also contains the Committee's Reports.

*Explanatory Memoranda (EMs) and letters issued by the Ministers can be downloaded from the Cabinet Office website: http://europeanmemoranda.cabinetoffice.gov.uk/.

Staff

The current staff of the Committee are Ravi Abhayaratne (Committee Operations Assistant), Joanne Dee (Deputy Counsel for European Legislation), Alistair Dillon and Leigh Gibson (Clerk Advisers), Nat Ireton and Apostolos Kostoulas (Committee Operations Officers), Luanne Middleton (Second Clerk), Daniel Moeller (Committee Operations Manager), Jessica Mulley (Clerk), Foeke Noppert (Clerk Adviser), Indira Rao (Counsel for European Legislation), Paula Saunderson (Committee Operations Assistant), Sibel Taner (Second Clerk), Emily Unwin (Deputy Counsel for European Legislation) Dr George Wilson (Clerk Adviser), Beatrice Woods (Committee Operations Officer).

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Contents

1 EU Industrial Strategy[1]

This EU document is politically important because:

- it relates to future EU policy relevant to Northern Ireland under the Protocol on Ireland/Northern Ireland; and
- it concerns policies of interest to the UK more widely, such as trade and climate policies.

Action

- Report to the House.
- Draw to the attention of the Business, Energy and Industrial Strategy Committee, the Environmental Audit Committee and the Committee on the Future Relationship with the European Union.

Overview

1.1 The Commission's industrial strategy set out a range of actions which, while not directed at the UK, will affect the UK either directly due to obligations under the Northern Ireland Protocol or indirectly through trade and strategic interests. We wrote to the Parliamentary Under-Secretary of State (Lord Callanan) seeking his view on the potential relevance to the UK of the following initiatives: re-enforcement of customs controls; a Chemicals Strategy for Sustainability; and an EU Strategy on Offshore Renewable Energy. We also asked whether the UK was engaging with the EU on the further development of UK-relevant policies set out in the document.

1.2 In his response, the Minister does not comment on the EU's reinforcement of its customs controls but draws attention to the UK's own border plans as set out in its "Border Operating Model" on 13 July, including the staged introduction of customs processes on EU-GB trade from 1 January 2021, with full controls for all goods from 1 July 2021.

1.3 Concerning the Chemicals Strategy, the Minister says only that the Government will follow the Strategy's progress as the UK makes its own independent decisions on chemicals policy in the UK, and as the UK develops its own new chemicals strategy.

1.4 Similarly, the UK is following the development of the EU's Offshore Renewable Strategy. The large-scale deployment of offshore wind and other offshore renewable technologies, particularly in the North Sea, is a key area of interest to the Department. The UK's own Offshore Network Transmission Review, announced 15 July 2020, will bring together the key stakeholders involved in the timing, siting, design and delivery of offshore wind to consider all aspects of the existing regime and how this influences the design and delivery of transmission infrastructure. The Review will also consider the role of multi-purpose interconnectors in meeting net zero through combining offshore wind

1 Commission Communication—A New Industrial Strategy for Europe; 6782/20, COM(2020) 102; Legal base:—; Department: Business, Energy and Industrial Strategy; Devolved Administrations: Consulted; ESC number: 41129.

connections with links to neighbouring markets. This is an area where the UK will share knowledge and engage with its neighbours in the North Sea where the EU's Strategy will apply to their jurisdictions.

1.5 Finally, the Minister confirms that, since the UK has left the EU, it is seeking to engage and cooperate with the EU through normal diplomatic channels on the basis of normal diplomatic and international practice, as part of the UK's wider global strategic agenda.

Our assessment

1.6 For the most part, we are content with the response from the Minister. His comments on the Chemicals Strategy, though, are ambiguous. They potentially imply UK-wide autonomy over future chemicals policy. In fact, the UK in respect of Northern Ireland will be obliged to maintain alignment with most EU chemicals legislation. We recognise that the UK is free to have its own chemicals policy post-Brexit, but that policy will need to have some interaction at least with EU chemicals policy. While we are confident that the Government is in fact aware of its obligations under the Northern Ireland Protocol in this instance, our general observation is that it is important that Ministers distinguish between where there will be ongoing policy interaction with the EU and where the UK will be able to pursue its own path.

Action

1.7 We report the Minister's letter to the House for information and draw it to the attention of: the Environmental Audit Committee, the Business, Energy and Industrial Strategy Committee and the Committee on the Future Relationship with the European Union.

2 COVID-19: Authorisation procedure for the export of Personal Protective Equipment (PPE)[2]

These EU documents are politically important because:

- they concern the EU's response to shortages in essential personal protective equipment ("PPE") during the early stages of the COVID-19 pandemic;
- although the measures have now expired, they were applicable in the UK during transition under the provisions of the EU/UK Withdrawal Agreement; and
- any similar EU measures adopted after the post-exit transition period ends on 31 December 2020 will be within the scope of the Protocol on Ireland/ Northern Ireland.

Action

- No further action on these documents required but we expect the Government to continue to update us on UK involvement in any of the EU's COVID-19 related joint procurement schemes.
- Draw to the attention of the Health and Social Care Committee, the International Trade Committee and the Northern Ireland Affairs Committee.

Overview

2.1 These Commission Implementing Regulations form part of the EU's initial response to the COVID-19 public health emergency.[3] The first, in force for six weeks (from 15 March to 25 April 2020), introduced an export authorisation scheme for certain categories of personal protective equipment ("PPE") to prevent critical shortages within the European Union. The second extended the requirement for an export authorisation for a further 30 days (from 26 April to 25 May 2020), while making some modifications in recognition of the need for international solidarity in managing supplies of PPE to counter a global pandemic. Our Seventh and Fourteenth Reports of Session 2019–21 provide a more detailed overview of both Commission Implementing Regulations and the Government's position.[4]

2 Commission Implementing Regulation (EU) 2020/402 of 14 March 2020 making the exportation of certain products subject to the production of an export authorisation; Unnumbered; Legal base—Article 5 of Regulation (EU) 2015/479 on common rules for exports; Department of Health and Social Care; Devolved Administrations informed; ESC number 41141.
Commission Implementing Regulation (EU) 2020/568 making the exportation of certain products subject to the production of an export authorisation.

3 See our Second Report of Session 2019–21, HC 275, *COVID-19 pandemic: the EU's policy response and its implications for the UK,* published on 1 April 2020.

4 Seventh Report HC 229–iv (2019–21), chapter 6 (7 May 2020) and Fourteenth Report HC 229–x (2019–21), chapter 4 (25 June 2020).

2.2 The Commission Implementing Regulations have expired and not been renewed as the EU no longer requires an export authorisation for PPE.[5] We have nonetheless sought further information from the Minister for Prevention, Public Health and Primary Care (Jo Churchill MP) on the wider legal and policy implications of the Regulations for the UK during and after the post-exit transition period established by the EU/UK Withdrawal Agreement.[6]

2.3 In our letter of 25 June 2020, we asked the Minister whether she considered that the UK should have had greater involvement in the process leading to the adoption of the Commission Implementing Regulations, given that the UK was under a legal obligation to implement them during the post-exit transition period provided for in the EU/UK Withdrawal Agreement but, it seemed, had no advance notification or sight of the measures before they were formally adopted by the Commission. We also asked her to explain what mechanisms exist to ensure that the Government has adequate notice of EU laws which will apply to the UK during transition *before* they take effect.

2.4 The Minister responds in her letter of 27 August 2020 that the first Commission Implementing Regulation was adopted (in March 2020) by an urgent procedure, without prior consultation of the UK or EU Member States. The Government was "in discussion with the Commission" before the second Commission Implementing Regulation was published. On the broader point of consultation during transition, the Minister observes:

> While we no longer participate in EU structures, the Government is in contact with the Commission regarding implementation of the Withdrawal Agreement, including the application of EU law during the transition period where relevant.

2.5 We expressed concern at the Minister's view that "it would not be appropriate for the UK Government to comment on the content" of the Commission Implementing Regulations, noting that a willingness to engage with the substance of EU laws that are binding on the UK, even if only for a limited period during transition, was fundamental to the process of scrutiny. In her response, the Minister confirms that "the Government will continue to scrutinise the substance of EU laws which are binding on the UK" and will "continue to scrutinise and facilitate parliamentary scrutiny of documents published by the EU". This falls some way short of the assurance we sought that the Government would not simply "facilitate" scrutiny of EU documents but make a meaningful contribution to the scrutiny process by providing informed analysis of the implications of EU policy and legal proposals for the UK.

2.6 We expressed a particular interest in how any future divergence in EU and UK laws relating to trade in goods might affect Northern Ireland and the rest of the UK under the Protocol on Ireland/Northern Ireland. We noted that the parent Regulation which gave the European Commission the powers to adopt the Commission Implementing Regulations and to introduce an authorisation procedure for the export of PPE outside the EU would continue to apply in Northern Ireland (but not in the rest of the UK) after the end of the post-exit transition period. We asked whether this might mean that an

5 See the Government's guidance on exporting personal protective equipment during coronavirus (COVID-19) which states: "Goods exported from the European Union after midnight on Monday 25 May 2020 will no longer require an export authorisation. The European Union export authorisation requirement for PPE products (Regulation 2020/568) expired on 25 May 2020 and will not be extended."

6 See our letter dated 6 May 2020 from the Chair of the European Scrutiny Committee to the Minister.

export authorisation procedure could apply to the movement of certain goods, such as PPE, from Northern Ireland to Great Britain in the future or whether a specific exemption for Northern Ireland would be needed. The Minister makes clear that this will not be the case:

> Article 6(1) of the NI Protocol states that "Provisions of Union law made applicable by this Protocol which prohibit or restrict the exportation of goods shall only be applied to trade between Northern Ireland and other parts of the United Kingdom to the extent strictly required by any international obligations of the Union." Accordingly, if after the end of the Transition Period, the EU adopts measures that restrict the export of PPE or other essential products from Member States to third countries in order to prevent a critical shortage, those measures will not apply to the movement of those products from Northern Ireland to Great Britain.

2.7 Finally, we asked the Minister to update us on other COVID-related EU initiatives intended to ensure adequate provision of PPE throughout the EU, such as joint procurement schemes and the development of a strategic "rescEU" stockpile of medical equipment under the EU's Civil Protection Mechanism, and to provide details of UK involvement in, or contributions to, these initiatives. She responds:

> Given the long-term nature of rescEU, the UK has not entered into discussions to act as a host country for the rescEU medical stockpile. A participating state can only contribute to the rescEU stockpile if that state opts to become a host country (currently only Germany and Romania have signed such an agreement). Host countries are solely responsible, in collaboration with the Commission, for the acquisition of capacities to the stockpile. The UK has not requested assistance through rescEU for the supply of medical equipment. The UK has worked with industry, the NHS, social care providers and the army, as well as with our international partners, to ensure the supply of PPE over recent weeks and months to ensure the supply of PPE. Whilst the UK is not participating in the first four Joint Procurement schemes launched by the Commission in response to COVID-19, including those on PPE and ventilators, we are in active discussions with the EU on future procurement opportunities and we will decide whether to participate in each on the basis of public health requirements at the time. The UK has formally expressed an interest in participating in two EU procurement schemes in relation to medicines, including the scheme on ICU medicines which was launched by the Commission on 17 June.

Action

2.8 No further action required. We nonetheless expect the Minister to continue to update us on UK involvement in any of the EU's COVID-19 related joint procurement schemes.

3 Northern Ireland Protocol: application of tariff rate quotas and other import quotas[7]

This proposal for a Regulation is legally and politically important because:

- it is intended to prepare for the end of the post-exit transition period and the implementation of the Protocol on Ireland/Northern Ireland;
- it recognises that Northern Ireland will remain part of the UK's customs territory after transition; and
- it makes clear that EU tariff rate quotas (allowing certain goods to be imported at a lower than normal tariff) and other EU import quotas will only apply to goods imported by the EU's 27 Member States, not Northern Ireland, even though EU customs law will continue to apply in Northern Ireland after transition under the Protocol.

Action

- Write to the Parliamentary Under-Secretary of State for Trade (Ranil Jayawardena MP) seeking further information on the Government's position on the EU proposal and its assessment of the implications for Northern Ireland.
- Draw to the attention of the Committee on the Future Relationship with the European Union, the International Trade Committee and the Northern Ireland Affairs Committee.

Overview

3.1 The proposed Regulation is intended to prepare for the end of the post-exit transition period on 31 December 2020 and the implementation of the Protocol on Ireland/Northern Ireland ("the Protocol"—part of the EU/UK Withdrawal Agreement approved by Parliament in January 2020).[8] Its purpose is to clarify how the Protocol will apply (from 1 January 2021) to goods imported on the basis of tariff rate quotas and other import quotas. Under World Trade Organisation (WTO) rules, each WTO member (or, in the case of the 27 EU Member States ("the EU27"), the EU) has its own set of legally binding tariffs and market access commitments which are set out in its Schedule of goods agreed under GATT (the General Agreement on Trade in Goods). The Schedule includes import tariffs as well as import quotas and tariff rate quotas which take the form of "concessions" and allow certain goods below the specified quota to enter the market at a lower than normal tariff.

3.2 The UK left the EU on 31 January 2020 but is treated as an EU Member State for the purpose of international agreements concluded by the EU until the end of the post-exit

7 Proposal for a Regulation on the application of Union tariff rate quotas and other import quotas; Council number:—; COM(20) 375; Legal base—Article 207(2) TFEU, ordinary legislative procedure, QMV; Dept—International Trade; Devolved Administrations—consulted; ESC number 41467.

8 Treaty Series No.3 (2020), Command Paper 219.

transition period.[9] The EU's Schedule of Concessions on goods also applies to the UK until the end of 2020.[10] Article 4 of the Protocol recognises that "Northern Ireland is part of the customs territory of the United Kingdom". Therefore, "Nothing in this Protocol shall prevent the United Kingdom from including Northern Ireland in the territorial scope of its Schedules of Concessions annexed to the General Agreement on Tariffs and Trade 1994".

3.3 The Protocol also provides, however, that references in the Protocol to the EU customs territory and the application of EU customs laws (such as the Union Customs Code, the Common Customs Tariff and relevant international agreements) include Northern Ireland after transition.[11] According to the European Commission:

> This means that despite Northern Ireland being formally in the United Kingdom's customs territory, the United Kingdom in respect of Northern Ireland is obliged to apply the Union's customs legislation as if Northern Ireland were still in the Union's customs territory.[12]

3.4 Based on its analysis of the Protocol, the Commission says that EU tariff measures (including tariff rate quotas) would apply to goods brought into Northern Ireland from outside the EU if (based on criteria yet to be established by the EU/UK Withdrawal Agreement Joint Committee) they are considered to be "at risk of subsequently being moved into the Union".[13] As, however, the arrangements set out in the Protocol only apply bilaterally between the EU and the UK, they do not create rights and obligations for other (third) countries. Goods exported from a third (non-EU) country to Northern Ireland would not therefore count against the EU's tariff rate quotas or other import quotas unless the third country agreed that they should. The Commission considers that this could lead to the "possible circumvention of the Union's tariff rate quotas or other quotas", with goods entering the EU through Northern Ireland posing a risk to the proper functioning of the Single Market and to the integrity of the EU's common commercial (trade) policy. Moreover, where an EU trade agreement grants a third country export tariff rate quotas for the EU market, it is conditional on the goods concerned being imported into the EU. A third country might therefore refuse to issue export licences for direct imports into Northern Ireland as it remains part of the UK's customs territory.

3.5 The solution proposed by the Commission is to specify in a Regulation that EU tariff rate quotas and other import quotas should only be available for goods imported from outside the EU and released into free circulation in the territory of the EU which, for these purposes, means the territory of the EU27 and excludes Northern Ireland. The proposed Regulation also provides that it will (if adopted) apply "to and in the United Kingdom in respect of Northern Ireland", citing Articles 5(3) and (4) and 13(3) of the Protocol.[14]

9 This includes agreements concluded by Member States acting on behalf of the EU or jointly with the EU.
10 See the Government's communication to the WTO Secretariat on the UK's Withdrawal from the EU.
11 See Article 13(1) and 5(3) of the Protocol.
12 See p.1 of the Commission's explanatory memorandum accompanying the proposed Regulation.
13 See recital (4) of the proposed Regulation.
14 See recital (10) of the proposed Regulation.

The Government's position

3.6 In his Explanatory Memorandum of 4 September 2020, the Parliamentary Under-Secretary of State for Trade (Ranil Jayawardena MP) says the proposed Regulation makes clear that:

- the bilateral arrangements between the EU and the United Kingdom under the Protocol do not give rise to rights and obligations for third countries;
- the EU's import tariff rate quotas and other import quotas should be available only for goods imported from outside the EU that are released into free circulation in EU's customs territory and not in Northern Ireland; and
- that, by virtue of the Protocol, the proposed Regulation also applies to and in the United Kingdom in respect of Northern Ireland.

3.7 He recognises that the EU's Customs Code "will remain applicable to and in the UK in respect of Northern Ireland in accordance with the Protocol", adding that "the proposed Regulation clarifies the relationship between the EU and third countries in relation to EU tariff rate quotas and other import quotas". The Minister says that the Government's approach to the Northern Ireland Protocol is set out in the Command Paper it published in May 2020 which states that "Northern Ireland businesses will benefit from preferential tariffs just as the rest of the UK will" after transition.[15] He considers that "nothing in the Commission's proposed Regulation changes this approach". He adds, however, that "the full implications" of the proposal for UK trade "will not be known until the wider negotiations on the implementation of the Protocol have concluded". The Government has consulted the Devolved Administrations but sees no need for consultation with other stakeholders. Further guidance for business will be published once the wider negotiations with the EU have concluded.

Our Analysis

3.8 The purpose and effect of the proposed Regulation is clear—to resolve possible ambiguities in the interpretation and application of the Protocol by stating that the EU's tariff rate quotas or other import quotas will only be available for goods imported by the EU27. Similarly, export tariff rate quotas granted by the EU in its trade agreements with third countries will only apply if the goods concerned are for export to an EU27 country, not Northern Ireland.

3.9 As the Minister observes, the proposed Regulation is consistent with the Government's position (and with Article 4 of the Protocol) in recognising that Northern Ireland is part of the UK's customs territory, can be included in the UK's Schedule of Concessions on goods under GATT, and will benefit from any preferential tariffs and quotas negotiated by the UK with third countries. The Minister does not indicate, however, whether the Government welcomes and supports the proposed Regulation, given that it would appear to be consistent with the Government's stated approach to the Protocol. Nor does he provide any detail on the views of the Devolved Administrations, beyond the fact that they have been consulted, examine the practical implications for businesses and consumers in Northern Ireland if there is a change in the flow of imported goods to Northern Ireland, or explain why a

15 Command Paper 226, The UK's Approach to the Northern Ireland Protocol.

wider stakeholder consultation is not justified in this case. The Minister does say that the full implications of the proposed Regulation for UK trade "will not be known until the wider negotiations on the implementation of the Protocol have concluded". It is not clear why this should be the case, though we assume it may be a reference to the role of the EU/UK Withdrawal Agreement Joint Committee in determining which goods brought into Northern Ireland from outside the EU are "at risk of subsequently being moved into the Union" and thus subject to EU customs duties.[16] Depending on the outcome agreed by the Joint Committee, the application of these criteria could create additional administrative burdens for trade in goods between GB and Northern Ireland which have been imported from a third country.

Action

3.10 Write to the Minister seeking further information on the Government's position on the proposed Regulation and its assessment of the implications for Northern Ireland.

Letter to the Parliamentary Under-Secretary of State (Ranil Jayawardena MP), Department for International Trade

The European Scrutiny Committee has considered the proposed Regulation on the application of EU tariff rate quotas and other import quotas under the Withdrawal Agreement Protocol on Ireland/Northern Ireland and your Explanatory Memorandum of 4 September 2020. We understand that the purpose of the proposed Regulation is to resolve possible ambiguities in the interpretation and application of the Protocol arising from the fact that Northern Ireland remains part of the UK's customs territory but, unlike the rest of the UK, is bound to apply EU customs laws as if it were part of the EU's customs territory when the post-exit transition period ends on 31 January 2020.

The proposed Regulation appears to be consistent with the Government's position (set out in its Command Paper on *The UK's Approach to the Northern Ireland Protocol*) that Northern Ireland is an integral part of the UK's customs territory and will benefit from any preferential tariffs and quotas negotiated by the UK with third countries. **Should we infer from this that the Government welcomes the proposal and considers that the clarification it provides is helpful in understanding how the Protocol will apply from 1 January 2021?**

As you state in your Explanatory Memorandum, the proposed Regulation provides that the EU's tariff rate quotas and other import quotas will only be available for goods released into free circulation in the EU customs territory (comprising the 27 EU Member States), not Northern Ireland. You add that "the full implications of this for UK trade will not be known until the wider negotiations on the implementation of the Protocol have concluded". It is not clear why this should be the case. **Would we be right to infer that the wider negotiations you refer to concern the decision yet to be taken by the EU/UK Withdrawal Agreement Joint Committee determining which goods brought into Northern Ireland from outside the EU are "at risk of subsequently being moved into the Union" and thus subject to EU customs duties?**[17] **Do you anticipate that the**

16 See Article 5(2) of the Protocol.
17 See Article 5(2) of the Protocol.

application of these criteria may create additional administrative burdens for trade in goods between GB and Northern Ireland which have been imported from a third country?

We note that you have consulted the Devolved Administrations on the proposed Regulation but provide no indication of their views. **We assume that the Northern Ireland Executive in particular would be interested in any impact that the approach set out in the proposal would have on goods imported by Northern Ireland and on trade in those goods between Northern Ireland and GB and Northern Ireland and the EU, as well as the implications for consumers and businesses in Northern Ireland. We would welcome further information on their position. We would also be interested to hear why you do not intend to carry out a wider stakeholder consultation, especially if there is some doubt as to how the proposed Regulation may affect UK trade.**

Finally, we ask whether you accept that the Regulation (if adopted) will apply "to and in the United Kingdom in respect of Northern Ireland" on the basis set out in recital (10) of the proposal (which refers to Article 5(3) and (4) and Article 13(3) of the Protocol), given that Regulation is neither listed in Annex 2 to the Protocol nor amends or replaces an EU act referred to in the Protocol. What, in your view, would be the correct mechanism for the adopted Regulation to apply to and in Northern Ireland?

We look forward to receiving your response within ten working days.

4 EU supervision of UK Central Counterparties (EMIR 2.2) (update)[18]

These EU documents are legally and politically important because:

- they set stringent new conditions under which UK 'Central Counterparties', entities that play a key role in the orderly functioning of the financial system, could continue providing their services for the EU market in over-the-counter derivatives under 'equivalence' after the UK leaves the Single Market when the post-Brexit transition period ends on 31 December 2020.

Action

- Write to the Economic Secretary to the Treasury (John Glen MP) to request further information on the Government's view of the conditions the EU has attached to equivalence for the UK's Central Counterparties.
- Draw these developments to the attention of the Committee on the Future Relationship with the European Union and the Treasury Committee.

Overview

4.1 Following the 2008 financial crisis, the EU in 2012 introduced stricter oversight of the market for over-the-counter derivatives in a Regulation known as EMIR.[19] In particular, this legislation requires many derivatives transactions entered into by financial market participants based in the EU to be 'cleared'—settled—with a Central Counterparty (CCP) for reasons of market transparency and financial stability. Such CCPs must normally be based within the EU's Single Market,[20] but can also be located outside the EU if their home jurisdiction's regulation of the clearing industry is recognised as 'equivalent' by the European Commission.

4.2 The UK is home to the world's largest clearing industry for many derivatives classes, with its financial services sector therefore performing a key role in maintaining financial stability and market liquidity internationally. After the UK's formal notification of withdrawal from the European Union in March 2017, the EU embarked on substantial tightening of the conditions under which 'third country' CCPs can operate within its

18 (a) REGULATION (EU) 2019/2099 on the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs; (b) COMMISSION DELEGATED REGULATION (EU) …/... supplementing Regulation (EU) No 648/2012 with regard to the criteria that ESMA should take into account to determine whether a central counterparty established in a third-country is systemically important or likely to become systemically important for the financial stability of the Union or of one or more of its Member States; (c) COMMISSION DELEGATED REGULATION (EU) …/... of 14.7.2020 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to the minimum elements to be assessed by ESMA when assessing third-country CCPs' requests for comparable compliance and the modalities and conditions of that assessment; (d) COMMISSION DELEGATED REGULATION (EU) …/... of 14.7.2020 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to fees charged by the European Securities and Markets Authority to central counterparties established in third countries; (a) 10363/17 + ADDs 1–3, COM(17) 331; (b) C(2020)4892; (c) C(2020)4891; (d) C(2020)48925 Legal base: (a) Article 114 TFEU; (b)—(d): Regulation 648/2012; Department: HM Treasury; Devolved Administrations: Not consulted; ESC number: (a) 38840; (b) 41406; (c) 41407; (d) 41408.

19 EMIR stands for European Markets Infrastructure Regulation. It is known formally as Regulation 648/2012.

20 Namely the EU plus the three EFTA-EEA countries Norway, Iceland and Liechtenstein.

Member States under equivalence. The aim was, first, to ensure non-EU firms conform to the requirements of EMIR if they have substantial operations within the European Union and, secondly, gradually increase the EU's own capacity for clearing to become less reliant on companies based outside its regulatory perimeter.

4.3 To achieve this, a new Regulation known as "EMIR 2.2" was adopted in 2019 against the UK's formal opposition while it was still a Member State.[21] This EU legislation essentially makes market access for non-EU CCPs dependent on the domestic regulator for the clearing industry of an 'equivalent' country –the Bank of England in the case of the UK—agreeing to "assure the effective enforcement" of any supervisory decisions vis-à-vis CCPs in its jurisdiction made by the EU's own markets regulator, ESMA.[22] It is unclear what the term "assure" in this context may mean in practice, but the Government has expressed concerns it could lead to an unreasonable expectation on the EU's part that non-EU countries will simply enforce the ESMA's supervisory decisions, and therefore restrict the regulatory autonomy of their domestic authorities (in the UK's instance, of the Bank of England).

4.4 In addition, EMIR 2.2 introduced a new classification system for non-EU CCPs seeking to operate within the Single Market under equivalence. Such firms, where considered "systemically important"[23] for the EU's financial stability, will now face stricter requirements in terms of alignment with the prudential and organisational rules set out in EMIR in order to benefit from equivalence. In the most extreme cases, the EU could—as a last resort—require a CCP to relocate operations to the EU if they want to offer their services there. In July 2020, the EU took further steps towards implementation of the new legal regime for non-EU CCPs when the European Commission published several 'Delegated Acts'—a type of EU Statutory Instrument—to give full effect to this new, stricter equivalence mechanism.[24] These formally took effect in September 2020.

4.5 As our predecessor Committee noted in its Report of 17 July 2019, the revision of EMIR with respect to the activities of non-EU CCPs remains highly relevant for the UK. London is a global hub for the clearing of derivatives, and British CCPs currently have substantial operations for derivatives transactions involving counterparties based in the EU. Their ability to continue performing clearing services for such trades will be fundamentally changed by the UK's recent departure from the EU and, more specifically, by its exit from the Single Market at the end of the post-Brexit transition period on 31 December 2020. From that point, they will be subject to the new "third country" provisions of EMIR 2.2 and therefore face strict conditions under equivalence to continue offering their services within the EU.

21 The UK voted against the Regulation, while Luxembourg abstained. All other EU countries voted in favour of EMIR 2.2.

22 Under EMIR 2.2, such supervisory decisions which the non-EU regulator of an equivalent country may have to "assure" include for example on-site inspections, the compulsory submission of commercially confidential documentation, or the imposition of fines.

23 Known in the Regulation as "tier 2" non-EU CCPs.

24 These Delegated Acts cover the assessment of whether a non-EU CCP can be considered systemically important, how such CCPs can demonstrate their compliance with EMIR's regulatory requirements, and the fees that will be charged for non-EU CCPs to pay for ESMA's supervision of them.

4.6 On 21 September, the European Commission adopted a formal equivalence decision for the UK under EMIR,[25] which would take effect when the transition period ends and be time-limited, expiring after 18 months.[26] Therefore, by June 2022 at the latest, UK CCPs will be assessed under the new classification system that might see their operations in the EU gradually restricted as the latter seeks to increase its own capacity for clearing services. However, for individual Central Counterparties in the UK to obtain 'recognition'—a licence to operate—from the European Securities & Markets Authority (ESMA) in the short term, namely by the end of the transition period, would still appear to require agreement with the EU on how the Bank of England would "assure" enforcement of ESMA's supervisory decisions. It is unclear what the status of discussions on this matter between the UK and the EU is at present. The equivalence decision of 21 September 2020 does not refer to this requirement explicitly, and it is unclear whether this remains an issue to be resolved if EU-based financial market participants are to retain their access to UK CCPs from 1 January 2021.[27]

4.7 The Economic Secretary to the Treasury (John Glen MP) submitted his latest Explanatory Memorandum on the implications of EMIR 2.2 for the UK on 27 July 2020, based on the recent Delegated Acts produced by the European Commission. However, this made no attempt to clarify how the Government intends to translate the EU's requirement to "assure" ESMA's decisions into a practical arrangement that would allow British CCPs to operate in the EU without impinging on the autonomy of the Bank of England. Nor does it address the wider issue of the EU seeking to impose continued regulatory alignment as a precondition for equivalence, or the impact of the EU's efforts to increase its capacity for derivatives clearing on the London clearing industry or the UK's wider financial 'ecosystem'.

4.8 In light of this, we have described the substance of EMIR 2.2 and its relevance to the UK financial services industry in more detail below. We have also written to the Economic Secretary to request further information, as shown in the Annex.

EU regulation of the over-the-counter derivatives market

4.9 In 2008, the risks to which firms like Lehman Brothers and AIG were exposed because of their participation in derivatives trades—like credit default swaps[28] or interest rate swaps—played a significant part in triggering the financial crash. As part of

25 Although equivalence is available under EU law in around forty different areas of financial services, the decision under EMIR is the only one the Commission has committed to putting in place before the end of the transition period. In July 2020, it announced that it would not even consider equivalence for the UK in a number of areas—including investment services—in the short- or medium-term. See for more information our Reports of 20 May 2020 and 10 September 2020.

26 The ability of individual UK CCPs to obtain permission—"recognition" from the EU to operate under this equivalence decision will be subject to a UK-EU cooperation agreement which settles the "assurance" of ESMA's supervisory decisions. However, whether the classification system for "systemically important" CCPs will apply at that stage depends on whether the European Commission's Delegated Acts are in force by the time ESMA decides on the recognition of British entities. This is discussed further elsewhere in this chapter.

27 The equivalence decision, in recital 15, refers to the fact that the "Bank of England is also to cooperate closely with Union authorities" to ensure that "there are effective cooperation arrangements between ESMA and the responsible United Kingdom authorities regarding the coordination of their supervisory activities, including, in particular, procedures to deal with any emergency situations related to the recognized UK CCPs which have or may have an adverse effect on market liquidity or the stability of the financial system of the Union".

28 A credit default swap (CDS) is an insurance-type derivative contract where one party pays another entity to protect it against the credit risk of an underlying financial instrument, like a mortgage, experiencing a default. The ownership of the underlying instrument is not involved in the swap.

a wider package of financial reform to regulate the market for 'over the counter'(OTC) derivatives[29] more effectively,[30] and in line with an international commitment made at the G20 in Pittsburgh in 2009, the EU in 2012 adopted the European Markets Infrastructure Regulation (EMIR).[31]

4.10 EMIR obliges EU-based financial market participants, like banks and insurers,[32] to "clear"—settle—many types of over-the-counter (OTC) derivative trades through a Central Counterparty (CCP).[33]

4.11 Under this system, the Central Counterparty is, in effect, paid to take on most of the credit risk of both parties to a derivatives contract. As a result, if one of the other parties to a contract defaults on its obligations, the CCP absorbs most of the impact and insulates the remaining counterparty from the resulting losses.[34] This, in theory, prevents a chain reaction of bankruptcies if one financial institution defaults on its obligations linked to derivatives to which it is party and cannot pay others in line with the requirements of its derivatives exposures. Because of this, EMIR also requires the CCP to observe a number of prudential and organisational requirements to ensure it can actually fulfil its function, and absorb the impact of large-scale defaults on trades that it has 'cleared' in times of economic stress. In addition, the Regulation requires the details of derivatives transactions to be reported to a regulated trade repository, used by regulators and policy-makers to assess whether there are potential risks to financial stability.

4.12 Central Counterparties and, to a lesser extent, trade repositories have thus become a key part of the infrastructure that allows the EU's financial markets to function over the past decade. Because of this, the clearing and reporting obligations for financial market participants under EMIR must normally be fulfilled by a CCP or repository based in the EU's Single Market, which—once licensed by their home Member State—then has an automatic 'passport' to operate in any EU country.[35] Alternatively, parties to a derivatives trade to which the Regulation applies can use a non-EU or 'third country' CCP, provided it is located in jurisdiction whose regulatory regime has been approved by the European

29 A derivative is a security which can be sold and which derives its value from an underlying asset, like a currency or bonds, without actually transferring ownership of that asset. It is said to be 'over the counter' if the derivative can be traded without being listed on an exchange.

30 More specifically, the financial crisis in the late 2000s exposed a serious lack of transparency in the trading of OTC derivatives that allowed systemically-important institutions to build up unsustainable levels of exposure to risky securitized assets, including sub-prime mortgages. This eventually resulted in Lehman Brother's collapse, and a $182 billion US Government bail-out for AIG, in September 2008.

31 Regulation 648/2012. The Coalition Government in power in the UK at the time voted in favour of the legislation.

32 Under certain conditions, the clearing obligation also applies to non-financial institutions where their exposure to OTC derivatives exceeds certain thresholds.

33 For derivatives transactions which are not centrally cleared, the Regulation sets other margin and operational risk requirements.

34 To ensure these credit risks are managed sustainably rather than simply transferred to the CCP, the central counterparty is subject to strict prudential and organisational requirements.

35 The same applies to Norway, Iceland and Liechtenstein, because EMIR was incorporated into the EEA Agreement, thereby extending it to these countries, by Decision 206/2016 of the EEA Joint Committee of 30 September 2016. There are currently no CCPs authorised under EMIR based in those three countries but CCPs based in the EU have a right to offer their services there.

Commission as "equivalent" to EMIR, *and* the individual CCP has been granted formal recognition by the central EU regulator for financial markets (the European Securities and Markets Authority or ESMA).[36]

4.13 As noted, the UK is a global hub for the clearing of derivatives trades, including for counterparties based in the EU. For example, in 2017, three British central counterparties were estimated to clear three-quarters of euro-denominated interest rate swaps, which are the largest category of OTC derivatives.[37] The UK of course left the European Union on 31 January 2020. However, for the duration of the post-Brexit transitional period until 31 December, British Central Counterparties are not considered to be 'third country' companies under EMIR and can continue to operate freely throughout the EU. It is only from 1 January 2021 that they will need to meet the relevant equivalence requirements set out in EMIR to continue providing services to counterparties to derivatives transactions based within the EU's internal market. It is in this context that regulatory reforms to the EMIR undertaken by the EU are of particular importance to the British financial services industry.

EMIR 2.2: Reform the supervision of non-EU CCPs operating in the EU

4.14 The act of UK withdrawal itself, given its key role in providing clearing services for derivatives markets throughout Europe, triggered a process of legislative change to EMIR. At the time of the Brexit referendum in 2016, the European Commission had already planned a revision of the rules applicable to specific derivatives trades and to the way in which CCPs operate under EMIR,[38] as well as a new legal framework for the "recovery and resolution" of CCPs at risk of collapse.[39] However, in June 2017—only three months after the Government formally notified the EU of the UK's intention to withdraw—the Commission also proposed amendments to EMIR relating specifically to the way that non-EU CCPs active within the European Union are licensed and supervised.[40]

4.15 Known as EMIR 2.2, the primary purpose of these amendments was, as the Commission stated at the time, to "make the process to recognise and supervise third-country CCPs more rigorous for those which are of key systemic importance for the EU". In other words, it wanted to increase oversight of non-EU Central Counterparties seeking to provide their services within the EU under equivalence. In particular, the Commission's draft legislation foresaw the possibility of refusing permission for a non-EU CCP to operate even where it met all the applicable requirements, because this would not "sufficiently ensure the financial stability of the Union". In those cases, the company

36 Under EU law, regulated financial services providers that trade in derivatives—notably banks and investment firms—face additional prudential requirements if they clear transactions on CCPs that are not authorised or recognised under EMIR.

37 Commission Impact Assessment SWD(2017) 246.

38 This revision, known as EMIR REFIT, was first proposed by the Commission in November 2016 and ultimately adopted in May 2019 as Regulation (EU) 2019/876. See also our predecessors' Report of 2 April 2019.

39 This new Recovery & Resolution Regulation was proposed in November 2016 and expected to be formally adopted by the end of 2020. Its purpose is analogous to a similar approach to failing banks under the Bank Recovery & Resolution Directive. We refer to its potential relevance in the context of the UK seeking market access for its CCPs under the equivalence provisions of EMIR elsewhere in this chapter.

40 The revised Regulation also touches on the way in which EU-based CCPs are supervised, giving ESMA a more prominent advisory role in the supervision of CCPs established in the EU (although decision-making powers, such as whether to grant or withdraw a licence, would remain with individual Member States).

would have to cease offering its services within the EU or relocate the relevant activities to an EU Member State and submit to full application of EMIR, subject to supervision by ESMA and the relevant national EU regulator.

4.16 The European Commission has been explicit from the start that its proposals were linked specifically to the fact that British CCPs would, when the UK left the Single Market, still constitute Europe's largest clearing infrastructure but be outside the EU's regulatory jurisdiction.[41] Concerns about the large-scale clearing of derivatives denominated in euro by financial institutions in London had in fact already been on the political agenda prior to the Brexit referendum, most notably in 2011 when the European Central Bank (ECB) sought to enforce a new "location policy" for CCPs considered to be systemically important to liquidity in the Eurozone. It would have required clearing houses with a large exposure to euro-denominated derivatives, including those based in the UK, to relocate to the Eurozone and thus come under the direct supervision of the ECB. Following a legal challenge by the UK Government,[42] the Court of Justice of the EU annulled the ECB's policy because it did not "have the competence necessary to regulate the activity of securities clearing systems."[43]

4.17 The UK's decision to leave the EU effectively reignited that debate. After the Commission published its proposal to tighten the conditions for the operation of 'third country' CCPs in June 2017, discussions on the final shape of the legislation got underway between the European Parliament and the EU Member States in the Council of Ministers.[44] The Government participated extensively in those negotiations while the UK was a Member State. Following two years of talks, the Parliament and Council reached a provisional agreement on the new legislation in March 2019. Following its formal adoption in October 2019, EMIR 2.2 is now expected to take effect from late 2020.[45] In particular, in July 2020 the European Commission adopted three Delegated Acts—EU Statutory Instruments—to fully give effect to the new arrangements for the supervision of non-EU CCPs under the new legal framework.

41 The Commission's Explanatory Memorandum accompanying the formal proposal for a Regulation states: "A substantial volume of euro-denominated derivatives transactions (and other transactions subject to the EU clearing obligation) is currently cleared in CCPs located in the United Kingdom. When the United Kingdom exits the EU, there will therefore be a distinct shift in the proportion of such transactions being cleared in CCPs outside the EU's jurisdiction, exacerbating the concerns outlined above. This implies significant challenges for safeguarding financial stability in the EU that need to be addressed."

42 Supported by the Government of Sweden.

43 Judgment of the General Court in Case T-496/11 (4 March 2015). The UK had put forward five "pleas in law" in support of its request for annulment. The first of these contended that the ECB lacked the necessary competence to impose the location requirement. The other four pleas related to the substance of the policy, alleging notably that the location requirement infringed both the freedom to provide services and the free flow of capital within the internal market, as guaranteed by the Treaty on the Functioning of the EU. As the CJEU's judges agreed with the UK's first plea, that the Bank did not have the legal competence to pursue the location policy, the Court did not assess the UK's challenges to the substance of the location policy.

44 The EMIR 2.2 proposal was subject to the EU's ordinary legislative procedure and as such needed to be approved jointly by the European Parliament (by simple majority) and the Council of Ministers (by qualified majority).

45 EMIR 2.2 is known more formally as Regulation (EU) 2019/1099.

4.18 The new Regulation and its Delegated Acts are of direct and significant relevance to the British financial services industry because it will govern how UK-based CCPs can provide their clearing services to EU-based customers from 1 January 2021 onwards, when the post-Brexit transition period ends.[46] EMIR 2.2 makes three changes of particular relevance to the UK in this regard, namely:

- First, the new legislation will increase the legal barriers to market entry for all non-EU CCPs wanting to provide clearing services to EU-based counterparties, notably by making it conditional on stringent new cooperation agreements with a CCP's home country regulator. This would be the Bank of England in the case of the UK.[47] It is also unclear how the new EU rules on recovery & resolution of failing CCPs will be factored into general equivalence assessments in the future.

- Secondly, the updated EMIR Regulation will allow ESMA to designate a specific non-EU CCP from "equivalent" countries as being, or likely to become, "systemically important" to the European Union's financial stability. In such cases, additional obligations—including stricter requirements for alignment with EU rules—will apply before such CCPs can obtain recognition from ESMA, which is a precondition for offering services within the EU.[48]

- Thirdly, in the most extreme cases, the Regulation creates a "location policy" allowing the European Commission to refuse a non-EU CCP from offering all or some of its clearing services within the EU, even if meets all the relevant criteria, because the risks to financial stability of having these functions performed from outside the EU's regulatory jurisdiction are considered too great.[49] This "last resort" measure would effectively require the company to relocate the relevant operations to an EU Member State, or cease those activities in the EU.

4.19 In parallel, the EU has granted new, but limited, powers to the European Central Bank in relation to clearing services performed by non-EU CCPs. For example, it will have a statutory role in any assessment by ESMA of the systemic importance of non-EU CCPs seeking to operate within the Eurozone.[50] This was a substantial reduction in the powers

46 As noted, while UK CCPs retain their ability to "passport" their services to the entire EU market under EMIR for the duration of the post-Brexit transition period until 31 December 2020, they will automatically lose the ability to do so on that date.

47 Article 25(2) and 25(7) of EMIR as amended.

48 Article 25(2b) of EMIR as amended.

49 Article 25(2c) of EMIR as amended.

50 The European Central Bank (ECB) had, in June 2017, asked for an amendment to its Statute that would give it a separate power to also regulate CCPs to "ensure efficient and sound clearing and payment systems, and clearing systems for financial instruments". That would have given the Bank a parallel authority to ESMA and the European Commission to demand a CCP relocate its clearing activities for euro-denominated derivatives to a Eurozone country if they were not based in the single currency area already. The proposed amendment to the ECB Statute was put forward after the Bank's earlier attempt to enforce such a location policy in 2011 was invalidated by the General Court of the European Union (at the UK's request), because the Bank's Statutes did not confer a power to regulate clearing services important to the Eurozone explicitly. See for more information the judgment of the General Court of the European Union in case T-496/11, delivered on 4 March 2015.

the Bank itself had initially sought, which would simply state it could "make regulations, to ensure efficient and sound clearing and payment systems within the Union and with third countries."[51]

4.20 We have considered the implications of the three key elements of EMIR 2.2 on supervision of non-EU CCPs, and their relevance to the UK as it seeks new arrangements for access for its financial institutions to the EU market following the end of the post-Brexit transition period, in the sections below.

Conditions for market access by non-EU CCPs under 'equivalence'

4.21 The fundamental principle under EMIR is that a non-EU CCP can only operate within the EU if it has been formally recognised as an eligible operator for that purpose by the European Securities and Markets Authority (ESMA). Such recognition is dependent on a number of cumulative basic conditions, in particular:

- The European Commission must have approved the domestic legal and supervisory regime of the CCP as being generally "equivalent" to EMIR in terms of regulatory outcomes;
- ESMA must have a cooperation agreement in place with the domestic regulator responsible for CCPs in the "equivalent" jurisdiction, which would be the Bank of England in the case of the UK. Notably, EMIR 2.2 now explicitly requires the non-EU regulator to agree to "procedures […] to assure the effective enforcement of decisions adopted by ESMA" vis-à-vis its non-EU CCPs with operations in the EU; and
- the 'third country' in question cannot be listed by the EU as having "strategic deficiencies" with respect to the risk of money laundering under the Anti-Money Laundering Directive (AMLD).[52]

4.22 We have discussed the first two of these, where the recent changes to the EU's regulation of Central Counterparties are most significant, in more detail below.

Conditions for regulatory equivalence under EMIR

4.23 In financial services, the EU's primary mechanism of facilitating trade with non-EU partners is the use of 'equivalence'. This is a unilateral mechanism, contained for specific areas of the industry in the EU's detailed financial services legislation, which allows the European Commission to formally declare that the regulatory system of a 'third country'

51 Unhappy with the limited powers the European Parliament and the Council were willing to grant it with respect to regulation of clearing services, the ECB withdrew its own proposal on the day the finalised new legal text was announced, preventing it from being formally adopted and taking effect. However, the provisions relating to the ECB as set out in EMIR 2.2 will still take effect. The Bank said it withdrew its proposal because the final outcome of the legislative process, by requiring the Bank to act in alignment with EMIR, "could undermine the ECB's independence," At the meeting of Permanent Representatives of the Member States in Brussels on 2 May 2019, the Council Legal Service raised doubts that the changes made to the Bank's proposal fundamentally deprived it and questioned the validity of the ECB's withdrawal of its own proposal but the matter does not appear to have been pursued further.

52 We considered the potential implications of the EU's anti-money laundering rules for the UK after Brexit in more detail in our Report of 24 June 2020.

delivers the same outcomes as the EU's approach. Such a determination has sector-specific effects, typically lowering the prudential cost for EU-based financial institutions to transact with a counterparty in an 'equivalent' jurisdiction.

4.24 The Government is seeking equivalence determinations from the EU in a range of financial sectors to mitigate, to some extent, the loss of market access for British firms that will occur when the UK leaves the Single Market on 31 December this year. In some limited cases, equivalence grants firms from a non-EU country preferential access to sell their services into the EU market without the need for a legal presence there. EMIR is one of those with respect to clearing services provided by CCPs, and has therefore been identified as a key equivalence determination for the UK by the Government.[53]

4.25 While the equivalence process under EMIR is well established (without prejudice to the recent amendments described in this Report), it is unclear how it will interact with the EU's new statutory framework for the recovery and resolution of CCPs at risk of collapse. As noted above, the purpose of this new Regulation is to address financial stability risks that would arise if a CCP were to fail. The new rules were agreed between the European Parliament and the 27 Member States in June 2020 and are likely to take effect mostly from early 2022. Although the legislation does appear to *require* it to do so, it is not yet clear if the European Commission will in the future take into account the existence of similar rules in a 'third country' when making an assessment of equivalence under EMIR. This would mean that non-EU countries seeking equivalence—like the UK—would need to operate a similar regime for recovery and resolution of CCPs.[54]

Cooperation agreement between ESMA and the 'third country' regulator

4.26 Aside from the uncertainty around the interaction between equivalence under EMIR and the EU's new Recovery and Resolution Regulation, EMIR 2.2 could more generally make it significantly more difficult for non-EU CCPs to provide clearing services within the European Union under EMIR's equivalence regime compared to the previous rules.

4.27 In particular, the new Regulation maintains the existing requirement that CCPs from a country deemed to be equivalent can only provide services within the EU if its domestic regulator also has a cooperation agreement in place with ESMA. Typically, such agreements cover the procedures for exchange of information and coordination of supervisory investigations. EMIR 2.2 modified the necessary substance of such agreements for them to qualify for this purpose under EU law. Importantly, the Regulation now specifies that they must contain "the procedures for third country authorities to *assure* the effective enforcement of decisions adopted by ESMA" in relation to CCPs in the third country's jurisdiction but with operations in the EU under equivalence. The precise implications of the term "assure" in this context are not further defined. As we describe in paragraphs 33 to 41 below, the UK has expressed concerns it could lead to unreasonable restrictions on the regulatory autonomy of 'third countries' seeking market access.

53 In December 2018, the Government said: "We recognise that with the UK exiting the EU there are valid concerns about the future supervision of UK CCPs with EU users. That is why it is important that the actions of UK and EU authorities are well coordinated and built on foundations of deep cooperation."

54 The Commission will in any event not be in a position to factor recovery and resolution issues into its equivalence assessments under EMIR until the new Regulation fully applies in the EU itself, which will not be until 2022. The EU is expected to seek a specific agreement with the UK on cooperation to salvage Central Counterparties at risk of collapse in due course, given its current reliance on the UK industry in this regard.

Requirements for systemically-important non-EU CCPs

4.28 In addition to the new, stricter approach to recognition for non-EU CCPs generally as described above, EMIR 2.2 will apply further restrictions to non-EU Central Counterparties deemed to be (potentially) systemically important to the European Union's financial stability. Under the new Regulation, ESMA can classify these CCPs as Tier 2.[55] One of the Delegated Acts adopted by the European Commission in July 2020 contains the criteria that ESMA will use to determine whether a non-EU CCP is systemically important, including the amount of products cleared in EU currencies and the amount of notional outstanding OTC derivatives in such currencies.[56]

4.29 The new classification system will have practical consequences for individual non-EU CCPs. If ESMA determines a non-EU CCP should be categorised as Tier 2, the company will have to demonstrate granular compliance with a range of substantive regulatory requirements set out in EMIR. In particular, they would need to meet the EU's precise prudential, organisational, conduct and interoperability[57] requirements for Central Counterparties.[58] However, the Regulation allows Tier 2 CCPs seeking recognition to demonstrate they "meet EMIR requirements while following [their] own domestic framework" under a new "comparable compliance" provision. This appears to mean that the regulatory framework in a third country, for example the UK, would need to be closely matched to the relevant provisions of EMIR.

4.30 The level of regulatory alignment expected by the EU under comparable compliance is likely to go above and beyond what was necessary to achieve an initial equivalence decision (which, as noted, is a precondition before any CCP from the non-EU country in question can operate within the EU under EMIR, irrespective of their classification as Tier 2 or not.)[59] ESMA has rejected the notion that the existence of an equivalence decision already demonstrates comparable compliance, since the latter was introduced specifically as a new requirement under EMIR 2.2 and must therefore, by necessity, be different from the existing equivalence assessment process. Instead, ESMA says, assessing comparable compliance will be done at firm-level rather than looking at the CCP's home country's general regulatory framework, involving a "more detailed comparative analysis of the requirements" with which Tier 2 CCPs must comply "on a requirement-by-requirement

55 New Article 25(2b) of Regulation 648/2012. [Where, following that review, ESMA determines that a Tier 1 CCP should be classified as a Tier 2 CCP, ESMA should set an appropriate adaptation period not exceeding 18 months within which the CCP should comply with the requirements applicable to Tier 2 CCPs.]

56 In his Explanatory Memorandum, the Minister notes that "these thresholds are not determinative in themselves, meaning that a CCP could meet a threshold but still be categorised as a Tier 1 CCP. However, ESMA will not be able to classify any CCP as Tier 2 unless they meet at least one of these thresholds [in the Delegated Act.]"

57 Interoperability arrangements are links between two or more CCPs, allowing clearing members (customers) of one CCP to centrally clear trades carried out with members of another CCP, without needing to be a member of the second CCP.

58 Article 25(2b)(a) of EMIR, as amended.

59 ESMA has noted that the EU legislators' decision to introduce a comparable compliance process means it must be separate from the equivalence assessment because there would be no need for it otherwise: "If such assessment was solely to rely on the equivalence decision by the Commission, comparable compliance would be automatically granted to all tier 2 CCPs, as the equivalence of the regulatory regime in the third country is a precondition for their recognition."

basis". In July 2020, the European Commission adopted a detailed Delegated Act with specific issues ESMA will need to take into account when assessing whether to grant comparable compliance.[60]

4.31 If a Tier 2 CCP failed to demonstrate its comparable compliance to ESMA, it would need to demonstrate by other means how it meets the more stringent alignment with the relevant requirements under EMIR. It is not immediately clear from the text of the Regulation how this would take place, although it could mean the CCP would have to make legal commitments to apply the requisite standards under EMIR to operations it wants to perform in the EU, insofar as those are not incompatible with the regulations of its home jurisdiction.[61] Failure to adequately demonstrate compliance with the stricter alignment required of Tier 2 CCPs could result in ESMA refusing recognition, meaning that the company in question could not provide its services in the EU without relocating certain operations into an EU Member State.[62]

Location policy for systemically important non-EU CCPs

4.32 The final set of changes under EMIR 2.2 of direct relevance to the UK financial services industry is the introduction of a "location policy" for the largest non-EU CCPs. The new Regulation will allow ESMA—after a "fully reasoned assessment"—to "conclude that a CCP or some of its clearing services are of such substantial systemic importance [to the EU] that it should not be recognised to provide certain clearing services or activities." This would be the case where even compliance with the more onerous requirements for Tier 2 firms seeking to operate in the EU, as described above, "would not sufficiently address the financial stability risk for the Union or for one or more of its Member States, and in the event that other measures are deemed insufficient to address financial stability risks."[63]

4.33 Based on such a recommendation, the Commission could refuse to allow a non-EU CCP to perform all or some specific services within the EU (even if its domestic regulatory regime otherwise matches EMIR perfectly.)[64] However, such a refusal would have to specify an "adaption period"—in principle lasting no more than two years[65]—during which the non-EU CCP in question could continue to provide its services while alternative infrastructure is established within the EU. This outcome represents a softening of the original Commission proposal of June 2017, where a refusal to grant equivalence would

60 This Delegated Act sets out some minimum elements which a CCP must comply with in order to be granted comparable compliance. These are the elements the European Commission considers "most critical" both in terms of resilience and maintaining a "level playing field" with EU CCPs. They include capital requirements (Article 16 of EMIR), Title IV of EMIR (organisational requirements, conduct of business rules, prudential requirements) and Title V of EMIR (interoperability arrangements).

61 ESMA has referred to the fact that not granting comparable compliance "may result in the impossibility for the Tier 2 CCP to comply with both Union and third-country requirements at the same time."

62 To obtain recognition to provide services in the EU, Tier 2 entities will also face the potential imposition of additional regulatory requirements by any of the EU's Central Banks for whom the CCP's operations are important, primarily the European Central Bank. For example, Central Banks can request the non-EU CCP to provide further information, cooperate in market stress testing, and open a deposit account with the Bank. See Article 25(2b)(b) of Regulation 648/2012 as amended.

63 Recital 38 to Regulation 2019/2099.

64 A Commission Decision to refuse recognition to a particular non-EU CCP would be taken by Implementing Act, meaning it would have to be approved by a Qualified Majority of Member States. The European Parliament cannot block or veto Implementing Acts.

65 Under the new Article 25(2c), this "adaptation period" could be extended once beyond the two-year limit, by no more than six months.

have applied immediately and to all operations performed by a non-EU CCP and not, as in the final Regulation, potentially only to "some of its clearing services" and after an "adaptation period". ESMA's assessments would also need to look at the economic consequences of shutting a particular non-EU CCP out of the EU's market before deciding whether to recommend invocation of the location policy.[66]

The Government's position on EMIR 2.2

4.34 As is clear from our predecessors' correspondence with the Treasury on EMIR 2.2 in recent years, the UK Government has consistently voiced its opposition to the changes made by the Regulation to the supervision of non-EU CCPs operating in the EU. From the Treasury's initial Explanatory Memorandum, dated July 2017,[67] and subsequent engagement with Ministers, it is clear that the UK's concerns centred on two specific elements of EMIR 2.2 which we have already described: the requirement for a non-EU regulator of an "equivalent" country to "assure" ESMA's supervisory decisions; and the location policy, i.e. the ability of the EU to refuse recognition to an individual non-EU CCP even where it met all the conditions under EMIR by reason of its systemic importance to the EU's financial stability.

4.35 The Treasury has told this Committee of its concerns that the new Regulation would risk "cutting the EU off from the global liquidity pools" provided by UK-based CCPs and "will ultimately raise costs for EU businesses". With respect to the "assurance" requirement in particular, the Treasury warned the remaining 27 Member States as far back as December 2018 that the UK considers this new wording in EMIR 2.2 to be problematic:

> This would mean that ESMA's decisions would be binding on third country supervisors [as a condition of any 'equivalence' decision]. It could require a supervisor to enforce a decision [that] may conflict with its own domestic requirements and could increase financial stability risks in a stress scenario. This proposal is unprecedented in supervisory cooperation and is not a workable solution for cross border supervisory and regulatory cooperation for internationally active CCPs. It could become a barrier to market access in the future as third countries are very unlikely to bind their independent supervisors in this way.
>
> Given the significant supervisory toolkit available to ESMA under EMIR in relation to third country CCPs—including on-site inspections, fines and withdrawal of recognition—it is unnecessary to require a third-country supervisor to agree to enforce decisions that could potentially conflict with their own statutory objectives.[68]

66 While the European Parliament had requested that the "location policy" should be invoked against specific CCPs by means of a Delegated Act—a type of EU Statutory Instrument which the Parliament can block—the final Regulation stipulates such decisions will be taken by means of Implementing Acts (which can be blocked by a Qualified Majority of EU Member States, but not by MEPs).

67 Based on this Explanatory Memorandum, our predecessor Committee first reported the EMIR 2.2 proposal to the House on 22 November 2017. At the time, the then-Economic Secretary (Rt Hon. Stephen Barclay MP) told us that it was "inconsistent [with] a global approach to CCP regulation and supervision", and "would risk fragmenting global derivatives markets", acting as a "drag on growth."

68 The Government also noted that "this proposal is unbalanced in the significant powers it gives ESMA and the ECB over non-EU CCPs when they are not given these same powers over EU CCPs. This means ESMA could potentially have powers to dual supervise all significant CCPs worldwide except those inside the EU."

4.36 During the final stretch of the negotiations on the new Regulation in early 2019, the UK continued to argue—unsuccessfully—for a change to the relevant provisions of the Regulation to read that 'third country' supervisors seeking equivalence (and therefore EU market access for their CCPs) would have to "*appropriately*" assure the effective enforcement of decisions adopted by ESMA, to replace the "unprecedented and unworkable" proposal whereby such decisions would be binding on the third country's domestic regulator irrespective of circumstances, and even if it does not agree with them.[69] The Regulation was eventually adopted with only the UK, then in the final months of its membership of the EU, voting against.[70]

4.37 However, by July 2019 the Treasury told Parliament that the meaning attributed to "assure" in the Government's own statement of December 2018 was only "one possible interpretation of the [legal] text". In particular, by this point the Minister referred to the new provision on "comparable compliance",[71] which would allow individual systemically important CCPs based outside the EU (see paragraphs 26 to 30 above) to seek a declaration that it already meets EMIR's organisational, conduct and prudential requirements by virtue of its domestic regulatory framework.

4.38 As the Committee noted at the time, it is not immediately apparent in what way the comparable compliance mechanism—which relates to the substance of the regulatory framework applicable in a non-EU jurisdiction for Tier 2 CCPs—could neuter the effects of the "assurance" requirement—which relates to the enforcement of the EU's supervisory decisions to firms outside its jurisdiction.[72] Although a broadly similar regulatory approach would reduce the likelihood of ESMA and the Bank of England disagreeing on a course of action, it does not eliminate it all together. Moreover, reliance on "comparable compliance" would also seem to require continued alignment of UK law with EMIR to satisfy the relevant conditions under European rules.

4.39 When the Economic Secretary to the Treasury (John Glen MP) submitted his latest Explanatory Memorandum to Parliament on the detailed Delegated Acts to frame the new rules on market access for non-EU CCPs under EMIR 2.2 in July 2020, he referred only obliquely to this matter and did not refer to the possible interaction between the "assurance" requirement and comparable compliance at all. Instead, he noted that the Government stands "ready to cooperate with EU authorities to manage the impact of the UK clearing market on the EU, as long as the EU's approach remains consistent with international norms on supervisory cooperation and respects the independence of UK authorities." Similarly, the Memorandum did not assess the wider financial or economic implications of EMIR 2.2 as regards its likely use by the EU to gradually seek relocation of clearing activity, in particular for derivatives denominated in euro, away from the UK.

4.40 The UK Government has not been alone in its criticism of the EU's approach: in autumn 2018, the chairman of the US Commodity Futures Trading Commission (CFTC)

69 In particular, the UK had called for ESMA's decisions to be "appropriately" enforced by non-EU countries under equivalence arrangements, rather than setting out in European law a general requirement that that equivalence requires a third country to carry out ESMA's instructions in all circumstances. This change was not accepted by the other Member States or the European Parliament and therefore does not appear in the final Regulation.

70 Luxembourg abstained.

71 New Article 25a of Regulation 648/2012.

72 Our predecessor Committee noted, for example, that the cooperation agreement is a precondition before applications for recognition by individual UK CCPs would be assessed (and therefore must be in place before "comparable compliance", which will be decided on a firm-specific basis, comes into play.)

voiced public concerns about the potential impact of the proposals on American CCPs, saying that "the CFTC has every right to expect that non-U.S. regulators will defer to the [it] on oversight of the U.S. derivatives markets."[73] In March 2019, the European Commission and the US Commodity Futures Trading Commission (CFTC) therefore issued a joint statement saying the Commission would respond to any "legitimate concerns raised by […] major derivatives clearing stakeholders in Third Countries", and that both sides expect to see "more deference between the CFTC and the EU supervisors"—i.e. a more light-touch supervisory approach by the 'host' regulator towards CCPs from the US operating in the EU, and vice versa—than is currently the case.[74] To our knowledge there has been no analogous UK-EU joint statement, and no acknowledgement from the EU side that it intends to exercise more 'deference' towards the Bank of England with respect to British CCPs providing services within the Single Market after the UK's withdrawal.

UK equivalence under EMIR and recognition of British CCPs by ESMA

4.41 Although the EU's new legal framework for non-EU CCPs is now in place, it remains to be seen how it will be applied in practice to countries like the UK.

4.42 As noted, for British CCPs to continue offering their services within the EU after the end of the transitional period on 31 December 2020 will require them to be compliant with the relevant conditions for 'third country' operators set out in EMIR. The Government is actively pursuing an equivalence decision from the EU to facilitate this. It is noteworthy in this respect that the European Commission has already adopted a temporary equivalence decision for the UK pre-emptively in September 2020, ahead of the end of the transition period, having announced its intention to do so in July.[75] This clears a major legal hurdle to British CCPs seeking recognition from ESMA in the coming months, to allow them to continue operating in the EU.[76] The Commission's approach reflects the fact that there is not sufficient capacity within EU-based CCPs to compensate for the loss of access to Britain's markets infrastructure, meaning that there could be "financial stability risks" if equivalence were to be withheld.[77]

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73 Remarks by CFTC Chairman J. Christopher Giancarlo at the ISDA Industry and Regulators Forum, Singapore (12 September 2018).

74 There has been no analogous UK-EU joint statement, and no acknowledgement from the EU side that it intends to be more 'deferential' towards the Bank of England with respect to UK CCPs providing services within the Single Market after the UK's withdrawal on the basis of equivalence.

75 Although equivalence is available under EU law in around forty different areas of financial services, the decision under EMIR is the only one the Commission has committed to putting in place before the end of the transition period. In July 2020, it announced that it would not even consider equivalence for the UK in a number of areas—including investment services—in the short- or medium-term. See for more information our Reports of 20 May 2020 and 10 September 2020.

76 Following the recent political dispute between the Government and the EU over the former's proposals to secure powers under the Internal Market Bill to unilaterally reinterpret several provisions of the Protocol on Ireland/Northern Ireland in the Withdrawal Agreement ratified in January, it was reported the European Commission may be delaying the adoption of the equivalence decision for the UK under EMIR. The Commission denied those reports, saying on 14 September 2020 that it had started the process for adoption of the decision. The absence of equivalence for this sector would, of course, significantly affect EU-based financial market participants that currently rely on services provided by British Central Counterparties when the post-Brexit transition ends on 31 December 2020. It is likely, however, that the row over the Protocol could lead the Commission to delay equivalence for other financial sectors where it has not identified a potential financial stability risk if UK firms do not have preferential access to the EU market after the transitional period.

77 European Commission, "Getting ready for changes: Communication on readiness at the end of the transition period between the European Union and the United Kingdom" (9 July 2020), p. 14. See also our Report of 10 September 2020.

4.43 The Commission adopted similar pre-emptive equivalence decisions under EMIR in 2018 and 2019, when there was a possibility that the UK would leave the EU's Single Market without a Withdrawal Agreement—and therefore a transitional period—being ratified.[78] In February 2019, ESMA and the Bank of England also agreed a Memorandum of Understanding on their cooperation, as required by EMIR before non-EU CCPs can be granted recognition. That arrangement was negotiated before the requirement for the third country regulator to "assure" ESMA's decisions—as described above—took effect under EMIR 2.2, and it is unclear what the current status of the Memorandum is.

4.44 In any event, the EU's latest equivalence decision vis-à-vis the UK under EMIR is time-limited, expiring in June 2022. Moreover, individual British CCPs will still need to obtain recognition—a licence to operate—from ESMA to make use of it.

4.45 Most pressingly, such recognition appears to depend, among other things, on the resolution of the question of how the Bank of England would "assure" ESMA's supervisory decisions vis-a-vis UK Central Counterparties, as now required under the amendments made by EMIR 2.2. It is unclear if the existing Memorandum of Understanding referred to above is considered adequate in that respect for the time being. For that reason, we are seeking clarifications from the Treasury about the status of the previous ESMA-Bank of England cooperation agreement, and in particular whether the EU is seeking changes to its substance in light of EMIR 2.2. The equivalence decision adopted by the Commission in September 2020 does not refer to the "assurance" requirement explicitly, instead noting that the EU expects the Bank of England to "cooperate closely with Union authorities" using "effective cooperation arrangements […] regarding the coordination of their supervisory activities". It is therefore not clear whether this issue remains to be resolved between the Government and the EU before individual UK CCPs could benefit in practice from the equivalence decision.

4.46 The Commission has also been open that its longer-term objective is to replace the need for use of the UK's clearing infrastructure with a 'domestic' EU capacity. The equivalence decision of September 2020 states explicitly that it serves to give "Union clearing members the time to reduce their exposure to United Kingdom market infrastructures and Union CCPs the time to develop further their capacity to clear relevant trades". The additional requirements that EMIR 2.2 creates for "systemically important" Central Counterparties, as the UK's major firms are likely to be classified, should also be seen in this context: they provide a detailed legal mechanism that allows the EU to 'squeeze' individual CCPs to relocate operations from London to an EU Member State gradually over time by withholding, or threatening to withhold, recognition for specific clearing services.

4.47 However, the new requirements under EMIR 2.2 relating to the new "Tier 2" assessment, and the location policy, will not immediately apply to UK CCPs seeking recognition before the end of the transition period. This is because these rules give ESMA 18 months to assess the systemic importance of non-EU CCPs and on "comparable compliance" of those firms.[79] ESMA will therefore be required to assess any British CCPs

78 See Commission Implementing Regulation 2018/2031, which was extended in December 2019 by Commission Implementing Regulation 2019/2211.

79 EMIR 2.2 states: "ESMA shall not exercise its powers pursuant to Article 25(2a), (2b) and (2c) until the date of entry into force of the delegated acts referred to in the second subparagraph of Article 25(2a) and in Article 25a(3) and, in relation to CCPs for which ESMA has not adopted a recognition decision pursuant to Article 25 before 1 January 2020, until the date of entry into force of the relevant implementing act referred to in Article 25(6)". The Delegated Acts were published in the Official Journal on 21 September 2020.

granted recognition for their systemic importance—with the potential consequences described in the previous section—"within 18 months" of the entry into force of the new rules. That means such an assessment of the UK industry's systemic importance for the EU is likely to have concluded by mid-2022 at the latest, at which stage they will likely be made subject to the more onerous alignment provisions introduced by EMIR 2.2 for "tier 2" CCPs. The longer-term implications of this for financial liquidity in the market, and for the UK industry, are not yet clear. However, as noted, the EU is likely to use its new rulebook to seek gradual relocation of clearing activity from London to financial centres like Paris, Frankfurt and Amsterdam.

4.48 With respect to the implications of EMIR 2.2 for domestic UK law, the amendments to the Regulation have taken effect under EU law and, as a consequence, will remain on the Statute Book when the transitional period ends by virtue of section 3 of the European Union (Withdrawal) Act 2018.[80] It is unclear what changes the Government foresees to adapt the Regulation to the UK's post-transition situation when it can regulate the derivatives clearing industry freely without reference to EU law (without prejudice to the implications of regulatory divergence for equivalence, and therefore market access into the EU, under EMIR).[81]

Conclusions and action

4.49 The UK's future flexibility to regulate its financial services industry free from the constraints of EU law has been referred to by the Government as one of the benefits of Brexit. The EU's revision to EMIR nevertheless underlines the potential continued effects that EU law and policy may continue to have for specific sectors in the UK, especially those with significant exports to the Single Market. While the Government consistently opposed the thrust of the reforms contained in EMIR 2.2, it only had limited success in altering the course of the negotiations in advance of the UK's formal withdrawal from the European Union.[82]

4.50 British CCPs, while of course also performing an important function for derivatives denominated in sterling or involving British counterparties, have a global role.[83] EMIR 2.2

80 In 2019, the EMIR 2.2 proposal—then not yet formally adopted as a Regulation—was included in the Financial Services (Implementation of Legislation) Bill. This would have meant that the Government could by means of statutory instrument "make provision corresponding, or similar to" the Regulation once it is adopted by the Council and the European Parliament, "with any adjustments the Treasury consider appropriate" so long as they are not "different in a major way" from the EU legislation.

81 In the Memorandum accompanying the Financial Services (Implementation of Legislation) Bill 2017–19, the Treasury noted that maintaining the changes made by EMIR 2.2 in domestic UK law would "increase [its] ability to manage financial stability risks posed by systemic third country CCPs." The Government subsequently clarified in July 2019 that "no decision has been made" about the potential post-Brexit implementation of the amendments to EMIR. However, in a letter dated 9 July 2019 the Economic Secretary implied that some of the changes to the way in which the EU will supervise foreign Central Counterparties—such as "the ability to tier CCPs according to systemic importance" and the "comparable compliance" provisions—could be helpful tools for the Bank of England to "manage financial stability risks posed by systemic third country CCPs" even once the UK is outside the Single Market and has more control over its regulatory systems.

82 As our predecessors concluded in July 2019: "The inescapable conclusion is that overall, the Government's efforts to mould EMIR [2.2] in a way beneficial to the UK have largely failed. The cumulative effect of the legal changes to the Regulation is the Treasury and Bank of England will find it more difficult to obtain a long-term existing equivalence decision for the UK clearing industry that is acceptable to both the EU and the UK. […] The longer term implications of the legislation for liquidity in European financial markets are also likely to be negative."

83 Obtaining equivalence and recognition is clearly a major objective for the clearing industry itself, with all major UK CCPs having responded to ESMA's consultation on the implementation of EMIR 2.2.

shows that the EU is willing to explicitly pursue relocation of economic activity from the UK into its Member States, with its professed financial stability concerns about reliance on British companies likely also affected by wider economic considerations.[84] It also demonstrates that, while the Government will be free to diverge from EU law as it sees fit from the end of the post-Brexit transition period, in the case of EMIR the benefits of doing so will need to be weighed against the impact on trade flows and financial liquidity if this resulted in a lack of access into the EU's Single Market for this sector.[85] The EU, equally, needs to be mindful of the potentially significant economic impact of shutting UK Central Counterparties out of its financial services markets. This is reflected in the EU's temporary equivalence decision for the UK to avoid a sudden disruption in its firms' access to London-based clearing services on 1 January 2021.

4.51 The substance of the EMIR 2.2 Regulation and related reforms at EU-level therefore raises a number of specific issues for the UK and its clearing industry which the Minister failed to address in his Explanatory Memorandum of 27 July 2020:[86]

- First, it is unclear how the Government intends to ensure both an operative equivalence mechanism for derivatives clearing giving British CCPs market access into the EU, and reaching a mutually satisfactory arrangement with the EU as regards the latter's new requirement that the Bank of England would have to "assure the effective enforcement" of ESMA's supervisory decisions vis-à-vis those firms.

- Second, the Minister did not offer a view on the EU's new, stricter approach to supervision of Tier 2 systemically important non-EU CCPs. In particular, he made no reference to the likely need for continued close regulatory alignment between the UK and the EU if British CCPs wanted to make use of the "comparable compliance" provisions under EMIR 2.2, or how those firms could meet the necessary requirements if the UK were to diverge from the EU's regulatory approach.

- Last, it is not yet known if the EU's separate new statutory framework for the recovery and resolution of failing CCPs will in the future be taken into account when the Commission assesses the (continued) "equivalence" of third countries with EMIR when deciding whether to grant market access.

4.52 We have therefore written to the Economic Secretary to the Treasury for further clarification of these matters. In the meantime, in anticipation of his reply, we draw these developments to the attention of the Committee on the Future Relationship with the European Union and the Treasury Committee. We will continue to monitor the equivalence process under EMIR closely.

84 The economic repercussions of this are hard to quantify. However, to the extent that the EU is successful forcing relocation of clearing services away from the UK and into its own jurisdiction, this could reduce economic activity in Britain and affect the wider financial 'ecosystem' that makes the UK a global financial services hub.

85 Similar issues are likely to arise in other areas as well, as we recently noted with respect to the European Commission's plans for a new anti-subsidy tool targeting non-EU countries, as well as proposals for a significant overhaul of the EU's anti-money laundering legislation. In addition, ESMA has recently argued in favour of further restrictions on fund management that would affect the extent to which operations for EU-based funds can be delegated back to the UK.

86 In his Explanatory Memorandum, the Minister refers to EMIR 2.2 as "significant" because "UK CCPs will wish to apply for recognition under the EMIR framework."

Letter from the Chair to the Economic Secretary to the Treasury (John Glen MP)

Thank you for your Explanatory Memorandum of 27 July 2020 on the latest developments in the EU's implementation of new, stricter requirements for access by "third country" Central Counterparties (CCPs) into the EU market for derivatives trades under the amended European Markets Infrastructure Regulation (EMIR 2.2). We note that the European Commission has now adopted a temporary equivalence decision for the UK under EMIR ahead of the end of the post-Brexit transition period, the timing of which will defer the full application of the new approach to "systemically important" UK CCPs until no later than mid-2022.

As you will be aware, the Committee has followed the negotiations on the amendments under EMIR 2.2 with respect to the supervision of non-EU CCPs closely for over three years, given the clear implications for the British clearing industry—and therefore Europe's financial markets—when the UK leaves the Single Market at the end of the post-Brexit transition period. We remain concerned about the demands for regulatory alignment that the new Regulation implies in return for market access, as well as the explicit EU objective of increasing its domestic clearing capacity for derivatives at the expense of the UK.

Based on the final text of the EMIR 2.2 Regulation, the Delegated Acts and the equivalence decision published by the European Commission in recent months, as well as the recent agreement of the separate new Regulation on the Recovery & Resolution of failing CCPs, we have some further questions for with respect to the impact of EMIR 2.2.

Supervisory cooperation between the Bank of England and ESMA

First, the Government of course consistently opposed the change to EMIR that now makes market access under equivalence dependent on a supervisory agreement between ESMA and the relevant non-EU regulator—like the Bank of England—which contains a commitment by the latter to "assure the effective enforcement" of supervisory decisions taken by the former.[87]

This, the Government itself has previously said, "could require a supervisor to enforce a decision [that] may conflict with its own domestic requirements and could increase financial stability risks in a stress scenario" and "become a barrier to market access in the future as third countries are very unlikely to bind their independent supervisors in this way". However, there is a lack of clarity as to how the Government intends to address this issue now that it is actively seeking an equivalence decision from the European Commission under EMIR. In particular, it appears that the new requirement on 'assurance' has already taken effect under EU law, and will therefore need to be resolved before UK CCPs can obtain permission from ESMA to operate in the EU under the forthcoming equivalence decision when the transition period ends. The equivalence decision for the UK adopted by the Commission earlier this week mentions the need for "the conclusion of comprehensive and effective cooperation arrangements", but does not explicitly refer to the "assurance" requirement.

We note in this regard that your latest Memorandum also makes no mention of any discussions that have been had with the EU on the precise meaning of "assure" in this

87 New Article 25(7) of Regulation 648/2012.

context, to arrive at a mutually satisfactory solution that preserves the UK's regulatory autonomy in this sector, nor of the status of the ESMA-Bank of England Memorandum on CCPs concluded in early 2019 prior to the recent changes to EU law.

In light of this, it would be helpful if you could confirm whether this new requirement for a "third country" supervisor to "assure" ESMA's decisions still remains to be addressed as part of a supervisory agreement between the UK and the EU before the end of the transition period, if UK CCPs are to be successful in obtaining ESMA recognition ahead of 1 January 2021 under the recent equivalence decision. We would also be grateful if you could clarify, therefore, whether discussions are taking place between the UK and the EU on the practical implementation of this 'assurance' requirement (for example by means of a revision or replacement of the earlier Memorandum of Understanding); outline what the status of any such discussions is at present; and undertake to keep the Committee informed of the outcome of those discussions in due course so that Parliament can scrutinise the implications, if any, for the powers of the Bank of England.

Comparable compliance for "tier 2" non-EU CCPs

Secondly, as you know, a range of stricter conditions will be introduced for systemically important ("tier 2") non-EU CCPs seeking to operate within the Single Market when the Commission's recent Delegated Acts supplementing the EMIR 2.2 Regulation take effect. Notably, they will have to demonstrate more granular compliance with specific provisions of EMIR relating for example to prudential, organisational and conduct requirements in order to obtain recognition from ESMA. One way of doing so is to meet a "comparable compliance" test under which their home jurisdiction's regulatory approach is assessed for its alignment with EMIR, above and beyond what was necessary to achieve equivalence in the first place.

In previous correspondence with the Committee, you referred to the "comparable compliance" provisions as a way of addressing the aforementioned issue relating to "assurance" of ESMA's supervisory decisions by the Bank of England. We take this to mean that, should the UK's regulatory approach continue to match EMIR closely, the EU could be assured that the Bank would take action in any event against "tier 2" CCPs with permission to operate in the EU under equivalence where ESMA would have expected it to do so. However, the UK would in fact need to meet the necessary conditions for ESMA to declare its regulatory framework as comparable to EMIR. That, in turn, implies a high degree of continued regulatory alignment with the relevant provisions of EU law.

In light of this, it would be helpful if you could clarify if the Government—as part of its engagement with the European Commission on equivalence—has made, or intends to make, any commitments with respect to alignment with or divergence from the provisions of EMIR relevant to comparable compliance in the context of the future "tier 2" assessment of UK CCPs, and explain how individual CCPs might demonstrate adherence with those provisions instead if ESMA rejects a request for comparable compliance with respect to the UK (for example due to regulatory divergence).

The EU's Recovery & Resolution Regulation for CCPs

Lastly, your officials have recently informed us of the adoption of a separate new EU Regulation on the recovery & resolution of failing Central Counterparties. While we await

a formal update from you on the substance of those rules, it would be helpful if you could clarify if the substance of that new legislation will be, or is likely to be, taken into account by the European Commission and ESMA when they assess continued equivalence for CCPs based in non-EU jurisdictions under EMIR when this new Regulation has taken effect as a matter of EU law.

We look forward to receiving your response by 16 October.

5 COVID-19: EU Capital Markets Recovery Package[88]

These EU documents are politically important because:

- they contain legislative proposals to amend EU financial services legislation to make it easier for businesses affected by the coronavirus crisis to raise funding on capital markets.

Action

- Draw the proposed changes to the EU's financial services framework to the attention of the Business, Energy and Industrial Strategy Committee, the Committee on the Future Relationship with the European Union and the Treasury Committee.

Overview

5.1 The economic impact of the coronavirus pandemic has triggered numerous public policy interventions in the UK and elsewhere. At EU-level, the European Commission has also presented proposals for various changes to EU legislation and policy in view of the current circumstances. As we have described in our recent Reports, these range from postponement of new EU legislation in areas like vehicle emissions, medical devices and Value Added Tax; a putative €750 billion Coronavirus Recovery Fund for investment in the EU economy; and the introduction of unprecedented flexibility for national governments to provide financial support for companies without falling foul of EU "State aid" rules.

5.2 The UK left the EU on 31 January 2020, but continues to be bound by EU legislation much as if it were still a Member State until a post-Brexit transitional arrangement, established under the Withdrawal Agreement, expires on 31 December this year. During that time, it remains part of the EU's Single Market and Customs Union. As such, short-term measures adopted by the EU in response to the pandemic continue to be of direct relevance for the UK, and—given the volume of trade between the two—its level of success in generating an economic recovery is likely to have a knock-on effect for the UK even after the transition period ends.

5.3 One of the areas where the EU has made legislative changes in response to the current crisis is the financial services sector. In June 2020 the EU agreed an amendment to the

88 (a) Proposal for a REGULATION amending Regulation (EU) 2017/1129 as regards the EU Recovery prospectus and targeted adjustments for financial intermediaries to help the recovery from the COVID-19 pandemic; (b) Proposal for a DIRECTIVE amending Directive 2014/65/EU as regards information requirements, product governance and position limits to help the recovery from the COVID-19 pandemic; (c) Proposal for a REGULATION amending Regulation (EU) 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation to help the recovery from the COVID-19 pandemic; (d) Proposal for a REGULATION amending Regulation (EU) No 575/2013 as regards adjustments to the securitisation framework to support the economic recovery in response to the COVID-19 pandemic; (e) REPORT FROM THE COMMISSION on the creation of a specific framework for simple, transparent and standardised synthetic securitisation, limited to balance-sheet synthetic securitisation; Council and COM number: (a) COM(2020) 281; (b) COM(2020) 280; (c) COM(2020) 282; (d) COM(2020) 283; (e) COM(2020) 284; Legal base: (a), (c) and (d): Article 114 TFEU; ordinary legislative procedure; QMV; (b) Article 53(1) TFEU; ordinary legislative procedure; QMV; (e) -; Department HM Treasury; Devolved Administrations: Not consulted; ESC number: (a) 41430; (b) 41429; (c) 41431; (d) 41432; (e) 41433.

Capital Requirements Regulation to facilitate access to funding for struggling businesses by adjusting and delaying certain prudential requirements for banks, and freeing up additional lending commercial capacity while maintaining the overall stability of the banking sector.[89] However, the European Commission has taken the view that further support is needed to help businesses raise funds from sources other than bank loans to weather the current economic storm. In July 2020, it therefore proposed a "Capital Markets Recovery Package" to change EU policy in three areas: investment prospectuses, investment services and securitisation. More precisely, the Commission's proposals encompass:

- draft legislation to establish an "EU Recovery Prospectus", a short-form prospectus that businesses can issue to sell shares[90] without needing to comply with the usual, more complex requirements for such documents under the EU's existing Prospectus Regulation.[91] The Commission says its proposal would reduce the length of the prospectus significantly, and therefore the cost of producing it.[92] The proposal would also amend the requirements around supplements to prospectuses (which triggers a period where existing investors can withdraw their money),[93] and exempts larger volumes of non-equity securities issued by banks from the requirement to issue a prospectus;[94]

- draft amendments to the EU's Markets in Financial Instruments Directive ("MiFID II") that essentially pre-empts in some ways the outcome of a wider review of that Directive which is due later in 2020. The Commission proposal would remove a number of what it describes as "overly burdensome" regulatory requirements to make it easier and cheaper for investment firms to help businesses tap into capital markets. The proposal would eliminate certain governance,

89 Regulation (EU) 2020/873.

90 The Recovery Prospectus could not be used for more complex types of securities offered for sale.

91 Regulation 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, as amended.

92 According to the European Commission, the Recovery Prospectus would "cut down the length of prospectuses from hundreds of pages to just 30 pages", which it says would save issuers approximately €400,000 in the cost of producing a prospectus. The Recovery Prospectus could only be issued during an 18-month period (with a year-long period where they remain valid after that deadline, if necessary), to reflect its link to the coronavirus crisis, and could only be used by companies which have already issued shares on a regulated market for at least 18 months [before when], and therefore could not be issued for initial public offerings (IPOs). Recovery Prospectus would be fast-tracked for approval by the relevant national regulator within five working days.

93 Under the existing Prospectus Regulation, issuers are required to publish a supplement to the prospectus for every significant new information which may affect an investor's assessment of their offer. Publication of a supplement must be communicated to investors by their financial intermediary on that same day, giving the former the right to withdraw any money already invested within two working days. Under the Commission proposal, intermediaries would have an extra day to draw the supplement to the attention of their clients. It also clarifies that financial intermediaries only have to inform investors of a supplement where the customer purchased securities through them between the time when the original prospectus was approved and the closing of the offer period or the time when trading on a regulated market begins. See Article 1(8) of the amending Regulation.

94 The Prospectus Regulation exempts credit institutions (banks) in certain circumstances from having to publish a prospectus where they issue non-equity securities, like bonds, where the total consideration is €75 million or less over a twelve-month period. The Commission proposal would temporarily increase this threshold to €150 million. The objective is to make it easier for banks to access financing, and therefore be able to lend more to businesses affected by the coronavirus pandemic.

disclosure and reporting obligations for financial market participants,[95] in particular where they provide investment services to experienced customers (professional investors and "eligible counterparties").[96] The proposal would also amend rules relating to the energy derivatives markets,[97] and the Commission is consulting separately on changes to increase the representation of small businesses in investment research produced for prospective investors;[98] and

- a proposal to amend the EU's regulatory framework for securitisation.[99] Securitisation of existing loans is seen as an important way for banks to free up capital, allowing them to increase new lending to the real economy by selling the credit risk for their existing loans to other financial market participants. The draft legislation presented by the Commission would amend the EU's 2017 Securitisation Regulation and the Capital Requirements Regulation to create a specific regulatory regime for securitisation of "non-performing loans" which are unlikely to be repaid in full,[100] and for "synthetic" securitisation (where the original lender retains the loan underlying the security on its balance sheet but the credit risk is transferred to investors by means of a guarantee or derivatives contract).[101] Like the proposal to amend MiFID, this element of the package foreshadows a formal, comprehensive review of the EU Securitisation Regulation which is due in 2022.

95 The regulatory requirements targeted by the Commission proposal concern costs and charges disclosures for services other than investment advice and portfolio management; ex-post, ex-ante and "best execution" reporting requirements, for example relating to investment services provided and their costs; and the lifting of MiFID product governance requirements for "vanilla" corporate bonds with a "make-whole" (early repayment) provision.

96 "Eligible counterparties" are the most sophisticated type of market participant under MiFID, including most types of regulated financial institution such as banks, insurance companies and investment firms.

97 MiFID imposes limits on the maximum size of positions that an entity can hold in any commodity derivative contract on an EU trading venue, to protect underlying commodity markets from financial speculation. The current limits are considered to be too restrictive, and the proposal would therefore narrow the scope of the position limits regime to certain significant or critical commodity derivatives contracts and agricultural commodity derivatives contracts. The draft legislation would also amend the "ancillary activities test", which determines whether a non-financial company has to seek authorisation from its financial regulator to trade in commodity derivatives based on whether the trading activity is ancillary to their main economic activity.

98 One of MiFID II's core features was to mandate the unbundling of the costs of investment research from general transaction fees paid by fund investors, to increase the transparency of what investors were paying for. However, it has been suggested this has made investment research a less attractive activity because fewer investors are willing to pay for it separately. This, in turn, has led to a decrease in the coverage of small companies in particular in research made available to prospective investors, making it more difficult for such companies to reach the widest possible investor base. The Commission has published a draft Delegated Regulation which would exempt research from the unbundling rules where it pertains exclusively to shares in companies with a cumulative market capitalisation of less than €1 billion.

99 Banks and other loan providers can repackage their stock of outstanding loans into securities and sell these to investors (typically institutional investors such as pension funds). In this way, securitisation transfer some of the risks associated with the loans not being repaid to the investors, who benefit from the cash flow generated by repayments from the loan-holders. It also frees up some of the capital set aside by the originating bank to cover those risks, giving it the ability to create new loans.

100 The Commission bases its proposal on a report by the European Banking Authority (EBA) that found that EU law as it stands prevents effective securitisation of banks' non-performing exposures because it sets capital requirements which are too high. The EU is pursuing a broader policy agenda related to non-performing loans which aims to reduce stocks of such loans in the banking sector of various EU Member States, as it is considered a financial stability risk. Securitisation, by transferring the credit risk out of the banking sector, is seen as one of the ways of achieving this.

101 The European Commission published a report on synthetic securitisation alongside its legislative proposal, as required by Article 45(2) of the Securitisation Regulation.

5.4 All of the Commission proposals in the Capital Markets Recovery Package must be agreed jointly by the European Parliament and by a qualified majority of the EU's Member States in the Council of Ministers, with amendments if necessary, before they can become law. While discussions have begun in both institutions to establish their respective positions on the proposals ahead of legislative negotiations, it is not clear when they expect to reach agreement. EU Finance Ministers are expected to discuss the package when they meet in Luxembourg in October 2020. The Commission has suggested that the new rules should take effect within weeks of being formally approved, with the exception of the changes to the Markets in Financial Instruments Directive. These would have to be 'transposed' into EU countries' domestic legal system in late 2021.

Implications for the UK and the Government's position

5.5 The potential direct implications for the UK of the EU's Capital Markets Recovery Package are twofold: they may have to be applied under domestic law if they take effect during the post-Brexit transition period when the UK must still apply EU law, and they may have broader ramifications for the UK as a "third country" when it leaves the Single Market at the end of the transition, when the UK will need new arrangements for EU market access for its financial services sector.

5.6 However, it does not appear that the draft legislation as described above will have direct policy implications for the UK under either scenario.

5.7 First, as noted, it is not yet clear when the proposed changes to EU financial services legislation may take effect, as they are still awaiting formal approval by the European Parliament and Council. The changes to MiFID II would not take effect until 2021 in any event. Moreover, given there are only three months left until the end of the transition period, the impact of the changes *if* the UK had to apply the new rules relating to prospectuses and securitisation as a matter of EU law under the Withdrawal Agreement are likely to be minimal.

5.8 Second, the Commission's proposals do not directly refer to the conditions for market access into the EU by non-EU financial services providers. In particular, they do not seek to amend the existing criteria under current EU law for granting non-EU countries "equivalence", which—as we described in our Reports of 26 March and 14 May 2020—can make it easier for companies from "third countries" to sell financial services into the EU. This is the arrangement the Government is pursuing in the talks on a new economic relationship with the EU, for example in an attempt to secure market access for the UK's investment services and asset management industries under the Markets in Financial Instruments Directive. While not directly relevant to the Capital Markets Recovery Package, we note that the European Commission in July effectively ruled out granting the UK equivalence for that sector in any event for the foreseeable future, ostensibly because "the EU legal framework is not yet fully in place" pending the aforementioned full review of MiFID II.[102]

102 European Commission, "Getting ready for changes Communication on readiness at the end of the transition period between the European Union and the United Kingdom", page 13 and footnote 21. Equivalence assessments have also not been initiated for the same reason under the Statutory Audit Directive, the Market Abuse Regulation, the Short Selling Regulation and the Prospectus Regulation.

5.9 More broadly speaking, the UK does have an interest in whether the proposals will make an appreciable impact on the EU's economic recovery without creating new financial stability risks, especially through widespread securitisation of loans which are unlikely to be repaid in full. This sentiment is echoed by the Economic Secretary to the Treasury (John Glen MP) in his Explanatory Memorandum on the EU's Capital Markets Recovery Package, which he submitted to Parliament on 26 August 2020. In this document, the Minister states the Government's view that the Commission's proposals relating to prospectuses and investment services "will not unduly harm investor protection standards", but with respect to the changes to the EU's securitisation regulatory regime he warns that that "any changes […] must be completed in the context of ensuring prudential standards are not reduced and financial stability is upheld".

Action

5.10 The Committee has taken note of the European Commission's Capital Markets Recovery Package and the Government's position thereon. It considers that the proposals have no immediate policy impact for the UK, given the time that will be needed for the legislation to be finalised means the new rules are unlikely to apply directly in and to the UK during the post-Brexit transition period for any appreciable amount of time (if, indeed, at all).

5.11 However, the Committee notes that the proposed amendments to the EU's regulatory framework for securitisation raise potential financial stability concerns. As securitisation played a key part in the financial crisis a decade ago, in particular arising from the extensive use of collateralised non-performing loans such as "sub-prime" mortgages, any changes to the legal framework in this area should be considered carefully in light of any stability risks they may entail. There is a risk that the pressures of the coronavirus crisis, and the desire for speedy regulatory change to facilitate securitisation as a means of freeing up lending capacity in the European banking sector, could increase financial stability risks further down the line. This is an issue we are sure the Government and Bank of England will give due consideration.

5.12 We draw the EU's Capital Markets Recovery Package to the attention of the Business, Energy and Industrial Strategy Committee, the Committee on the Future Relationship with the European Union and the Treasury Committee.

6 Northern Ireland Protocol: continued application of EU firearms laws[103]

This EU document is politically important because:

- it concerns an EU law—the Firearms Directive—which will continue to apply in Northern Ireland under the Protocol on Ireland/Northern Ireland when the post-exit transition period ends on 31 December 2020; and
- it gives rise to questions about the Government's policy on regulatory alignment or divergence in the laws applicable in different legal jurisdictions in the UK after transition.

Action

- Write to the Minister for Security (Rt Hon. James Brokenshire MP) seeking further information on how the Firearms Directive will apply in Northern Ireland after transition, what steps the Government may wish to take to avoid unnecessary friction or divergence in the laws applicable in different parts of the UK, and what assessment the Government has made of any possible impact on the operational effectiveness of cross-border law enforcement on the island of Ireland.
- Draw to the attention of the Northern Ireland Affairs Committee, the Home Affairs Committee, and the Committee on the Future Relationship with the European Union.

Overview

6.1 This Commission Communication sets out the main elements of the EU Action Plan on Firearms Trafficking for the period 2020–25. The illicit trafficking, distribution and use of firearms increases the threat posed by organised crime and terrorism. The purpose of the Action Plan—which is not legally binding—is to establish a framework for cooperation between the EU and the main source countries for illicit weapons in the EU's neighbourhood (the Western Balkans, Moldova and Ukraine) focussing on four priority areas:

- Safeguarding the market for legally owned firearms by ensuring that Member States properly implement and effectively enforce the EU Firearms Directive and encouraging neighbouring countries to apply similar controls.[104]
- Improving mechanisms for exchanging information on lost and stolen firearms (including systematic use of the Schengen Information System to record losses and thefts), seizures of firearms, firearms-related incidents and use of the "dark net" for trafficking in firearms.

103 Commission Communication: 2020–2025 EU action plan on firearms trafficking; Council number 10035/20 + ADD 1, COM(20) 608; Legal base:—; Devolved Administrations consulted; ESC number 41428.

104 Directive (EU) 2017/853 amending Council Directive 91/447/EEC on control of the acquisition and possession of weapons.

- Increasing pressure on criminal markets by encouraging national ratification of the UN Firearms Protocol, stronger cooperation between law enforcement, forensic and prosecution authorities, and launching a Commission-led consultation on the need for common criminal law standards on trafficking in firearms.

- Stepping up international cooperation, particularly with countries in North Africa and the Middle East.

6.2 The Action Plan is of interest as it highlights the implementation of the EU Firearms Directive (and delegated and implementing acts made under it) as a key priority for the EU. The Firearms Directive forms part of the retained EU law which will continue to apply in the UK under the European Union (Withdrawal) Act 2018, but without any obligation to keep in step with changes to the Directive itself or to implement measures made under it after the post-exit transition period ends on 31 December 2020.[105] By contrast, Northern Ireland will be required to implement the Directive, as well as any changes made to it or measures adopted under it *after* transition, because it is one of the EU laws listed in Annex 2 of the Protocol on Ireland/Northern Ireland ('the Northern Ireland Protocol'). These laws, or subsequent EU laws amending or replacing them, will continue to apply in Northern Ireland after 31 December 2020. The Directive is included in the Northern Ireland Protocol because it is an (EU) internal market measure intended to regulate the movement of goods—in this case lawfully-owned firearms—within the EU while ensuring that adequate safeguards are in place across the EU.

6.3 In its introductory comments to the Communication, the Commission observes that "Member States are notably still far from having fully transposed and implemented the Firearms Directive".[106] The UK is not one of the 17 Member States listed in the Communication as having notified full transposition of the Directive in national law. The Commission says it will "step up its commitment to ensure that the Firearms Directive and its corresponding delegated and implementing acts are correctly transposed and effectively enforced by all Member States" and that it will "keep on using all the powers given by the Treaty to that effect".[107] The Commission also says it will carry out an impact assessment on another EU law applicable in Northern Ireland under the Northern Ireland Protocol—a 2012 Regulation establishing controls on the import and export of civilian firearms—with a view to improving the traceability of firearms and the security of import and export control procedures.[108]

6.4 Most of the remaining elements of the Action Plan, such as more systematic use of the Schengen Information System to log information on lost and stolen firearms, improved cooperation among national law enforcement authorities and prosecutors, and greater involvement of EU agencies such as Europol and Eurojust, are not within the scope of

105 Two sets of changes have been made to the Directive since its adoption in 1991—see Directive 2008/51/EC and Directive 2017/853/EC. Changes resulting from the UK's exit from the EU have been made by the Law Enforcement and Security (Amendment) (EU Exit) Regulations 2019 and will take effect at the end of transition.

106 See p.4 of the Communication.

107 See p.8 of the Communication.

108 See Regulation (EU) No 258/2012 implementing Article 10 of the United Nations' Protocol against the illicit manufacturing of and trafficking in firearms, their parts and components and ammunition, supplementing the United Nations Convention against Transnational Organised Crime (UN Firearms Protocol), and establishing export authorisation, and import and transit measures for firearms, their parts and components and ammunition.

the Northern Ireland Protocol. Their policy implications for the UK will depend on the outcome of negotiations on the future relationship between the EU and the UK and any arrangements that are agreed on security cooperation after transition.

The Government's position

6.5 In his Explanatory Memorandum of 28 August 2020, the Minister for Security (Rt Hon. James Brokenshire MP) confirms that the Firearms Directive is one of the measures that will continue to apply in Northern Ireland after transition under the Northern Ireland Protocol, adding:

> This means that any future EU legislative changes applied to Northern Ireland through the Protocol (including adding the Action Plan to the Directive) could affect how firearms are controlled in Northern Ireland.

6.6 The Minister notes that the Action Plan "broadly aligns with the UK's priorities and does not present any significant concerns". As it will not apply to the UK, the Government does not expect it to have any direct policy implications.

Our analysis

6.7 The EU Firearms Directive establishes a set of common minimum rules on the acquisition of firearms and their movement within the EU. Member States are free to exceed the rules by including more stringent provisions in their national laws. There is, as a result, no full harmonisation of national laws across the EU. Changes agreed in 2017 sought to strengthen the Directive's safeguards by improving the tracking of legally held firearms (to reduce the risk that they are "diverted" into illegal markets), making it harder legally to acquire certain high capacity weapons, and improving the traceability of firearms as well as the systems for exchanging information between EU countries.

6.8 The Directive allows individuals lawfully in possession of a firearm to obtain a European Firearms Pass to travel (with their firearm) to another EU country. Guidance issued by the Home Office on 30 October 2019 makes clear that the European Firearms Pass ("EFP") will not be available when EU law ceases to apply to the UK at the end of the transition period, stating:

> UK residents who want to travel to the EU with their firearms or shotguns will no longer be able to apply for a European Firearms Pass (EFP) from 1 January 2021.
>
> Instead, you should check the firearms licensing requirements of the EU country you're travelling to, ahead of travelling. These requirements will also apply if you will be in an EU country with your firearm, covered by a EFP, when we leave the EU.[109]

6.9 There is no separate Guidance for Northern Ireland, even though the Firearms Directive will continue to apply after 21 January 2021. In his Explanatory Memorandum on the Communication, the Minister notes that firearms, "subject to some exceptions", are a devolved matter in Northern Ireland. The relevant legislation implementing the Directive

109 The UK left the EU on 31 January 2020, but EU law continues to apply under the EU/UK Withdrawal Agreement during a post-exit transition period which will end on 31 December 2020.

in Northern Ireland is The Firearms (Northern Ireland) Order 2004. Amendments made to the Firearms (Northern Ireland) Order 2004 by the Law Enforcement and Security (Amendment) (EU Exit) Regulations 2019 remove those parts of the Order which concern the European Firearms Pass. It seems, therefore, that new export control and licensing arrangements will apply when taking personal firearms from any part of the UK to an EU country, including from Northern Ireland to the Republic of Ireland, from 1 January 2021.

Action

6.10 Noting the importance placed on the correct transposition and effective enforcement of the EU Firearms Directive in the EU Action Plan on Firearms Trafficking for 2020–25, we seek further information from the Minister on the following matters:

- Whether he is satisfied that UK domestic law complies fully with the Directive.
- Whether he expects domestic firearms laws in the UK to remain in lockstep with the Directive (and changes made to it or rules adopted under it) after transition to avoid any unnecessary friction or divergence in the laws applicable in different parts of the UK.
- Whether Northern Ireland residents will still be able to request a European Firearms Pass after transition and, if not, what procedures will apply if they intend to take a lawfully owned firearm to an EU country, including the Republic of Ireland.
- Whether Northern Ireland will continue to participate in the information exchange mechanisms provided for in the Directive and, if not, what assessment the Government has made of the possible impact on the operational effectiveness of cross-border law enforcement on the island of Ireland.

Letter to the Minister for Security (Rt Hon. James Brokenshire MP), Home Office

We have considered the Commission Communication establishing an EU Action Plan on Firearms Trafficking for the period 2020–25 and your accompanying Explanatory Memorandum of 28 August 2020.

Noting the priority attached to the correct transposition and effective enforcement of the EU Firearms Directive in the EU Action Plan, the possibility of enforcement action by the European Commission to address any shortcomings, and the fact that the Directive will continue to apply in Northern Ireland after the transition period ends on 31 January 2020, we would welcome further information on the following matters.

UK implementation of the EU Firearms Directive

The Commission observes that "Member States are notably still far from having fully transposed and implemented the Firearms Directive" and says it will "step up its commitment to ensure that the Firearms Directive and its corresponding delegated and

implementing acts are correctly transposed and effectively enforced by all Member States […] using all the powers given by the Treaty to that effect".[110] **Are you satisfied that UK domestic law complies fully with the Directive?**

Alignment of law across the UK

The Firearms Directive forms part of the retained EU law which will continue to apply in the UK under the European Union (Withdrawal) Act 2018, but without any obligation to keep in step with changes to the Directive itself or to give effect to measures made under it after the post-exit transition period ends on 31 December 2020. By contrast, Northern Ireland will be required to implement the Directive, as well as any changes made to it or measures adopted under it *after* transition, because it is one of the EU laws listed in Annex 2 of the Protocol on Ireland/Northern Ireland ("the Northern Ireland Protocol"). These laws, or subsequent EU laws amending or replacing them, will continue to apply in Northern Ireland after 31 December 2020.

We recognise that there is no full regulatory alignment within the EU as the Directive establishes a set of common minimum rules, leaving Member States free to exceed them by including more stringent provisions in their national laws should they choose to do so. **Would we be right to assume that the Government will nonetheless wish to maintain close alignment of laws on legally owned firearms within the UK? Does this mean that domestic firearms laws in the UK will remain in lockstep with the Directive (and changes made to it) after transition to avoid any unnecessary friction or divergence in the laws applicable in different parts of the UK?**

Availability of the European Firearms Pass

The Directive allows individuals lawfully in possession of a firearm to obtain a European Firearms Pass to travel (with their firearm) to another EU country. Guidance issued by the Home Office on 30 October 2019 makes clear that the European Firearms Pass will not be available when EU law ceases to apply to the UK at the end of the transition period. The Law Enforcement and Security (Amendment) (EU Exit) Regulations 2019 remove those parts of the law in Northern Ireland (The Firearms (Northern Ireland) Order 2004) which refer to the European Firearms Pass. **Can you confirm that Northern Ireland residents will not be able to request a European Firearms Pass after transition and that new export control and licensing arrangements will apply when taking a lawfully owned firearm to an EU country, including the Republic of Ireland, from 1 January 2021? Will the arrangements in Northern Ireland be the same as in the rest of the UK?**

Information sharing

Recent changes to the EU Firearms Directive have sought to improve systems for exchanging information between EU countries. **Will Northern Ireland continue to participate in these information exchange systems after transition and, if not, what assessment has the Government made of the possible impact on the operational effectiveness of cross-border law enforcement on the island of Ireland?**

I look forward to receiving your response within ten working days.

110 See p.4 of the Communication.

7 Documents not considered to be legally and/or politically important

Department for Business, Energy and Industrial Strategy

(41130) 6778/20 COM(20) 94	Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions Long term action plan for better implementation and enforcement of single market rules.
(41131) 6779/20 + ADD1 COM(20) 93	Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions Identifying and addressing barriers to the Single Market.

Department for Transport

(41143) 6909/20 COM(20) 115	Communication from the Commission COVID-19: Temporary Restriction on Non-Essential Travel to the EU.
(41195) 7286/20 COM(20) 148	Communication from the Commission to the European Parliament, the European Council and the Council on the assessment of the application of the temporary restriction on non-essential travel to the EU.
(41238) 7971/20 COM(20) 222	Communication from the Commission to the European Parliament, the European Council and the Council on the second assessment of the application of the temporary restriction on non-essential travel to the EU.
(41367) 8786/20 + ADD 1 COM(20) 399	Communication from the Commission to the European Parliament, the European Council and the Council on the third assessment of the application of the temporary restriction on non-essential travel to the EU.
(41405) 9208/20 —	Council Recommendation on the temporary restriction on non-essential travel into the EU and the possible lifting of such restriction.
(41462) 9047/20 COM(20) 287	Proposal for a Council Recommendation on the temporary restriction on non-essential travel into the EU.

(41463) — —	Council Recommendation (EU) 2020/1052 of 16 July 2020 amending Council Recommendation (EU) 2020/912 on the temporary restriction on non-essential travel into the EU and the possible lifting of such restriction.
(41464) — —	Council Recommendation (EU) 2020/1144 of 30 July 2020 amending Recommendation (EU) 2020/912 on the temporary restriction on non-essential travel into the EU and the possible lifting of such restriction.
(41465) — —	Council Recommendation (EU) 2020/1186 of 7 August 2020 amending Council Recommendation (EU) 2020/912 on the temporary restriction on non-essential travel into the EU and the possible lifting of such restriction.
(41474) 10314/20 + ADDs 1–4 COM(20) 433	Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Progress report on the implementation of the TEN-T Network in 2016–2017.
(41476) 10565/20 + ADD 1 COM(20) 472	Proposal for a Council Decision on the position to be taken on behalf of the European Union as regards the amendments to the Annexes of the European Agreement concerning the International Carriage of Dangerous Goods by Road (ADR) and to the Annexed Regulations to the European Agreement concerning the International Carriage of Dangerous Goods by Inland Waterways (ADN).
(41479) 10352/20 + ADDs 1–2 COM(20) 434	Proposal for a Council Decision approving amendments to the Agreement for co-operation in dealing with pollution of the North Sea by oil and other harmful substances (Bonn Agreement) with regard to the extension of its material and geographical scope of application.

Foreign and Commonwealth Office

(41353) 8962/20 + ADD1 COM(20) 239	Report from the Commission to the Council Sixteenth report on the implementation of Council Regulation (EC) No 866/2004 of 29 April 2004 and the situation resulting from its application covering the period 1 January until 31 December 2019.

HM Revenue and Customs

(41352) 8960/20 COM(20) 238	Report from the Commission to the European Parliament and the Council Fourteenth Annual Report 2019 on the implementation of Community assistance under Council Regulation (EC) No 389/2006 of 27 February 2006 establishing an instrument of financial support for encouraging the economic development of the Turkish Cypriot community.

(41470) — COM(20) 427	Proposal for a Council Decision on the position to be taken on behalf of the European Union in the 66th session of the Harmonized System Committee of the World Customs Organization in relation to the envisaged adoption of Classification Opinions, classification decisions, amendments to the Harmonized System Explanatory Notes or other advice on the interpretation of the Harmonized System and recommendations to secure uniformity in the interpretation of the Harmonized System under the Harmonized System Convention.

HM Treasury

(41466) — COM(20) 383	Report from the Commission to the European Parliament and the Council on the implementation of Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market as amended by Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries.

Home Office

(41425) — COM(20) 607	Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions EU strategy for a more effective fight against child sexual abuse.
(41426) — COM(20) 606	Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions on the EU Security Union Strategy.
(41427) — COM(20) 606	Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions EU Agenda and Action Plan on Drugs 2021–2025.

Annex

Documents drawn to the attention of select committees:

('SNC' indicates that scrutiny (of the document) is not completed'; 'SC' indicates that scrutiny of the document is completed)

Business, Energy and Industrial Strategy Committee: COVID-19: EU Capital Markets Recovery Package [Proposed (a)(c)(d) Regulations, (b) Directive, (e) Commission Report (SC)]; EU Industrial Strategy [Commission Communication (SC)]

Environmental Audit Committee: EU Industrial Strategy [Commission Communication (SC)]

Committee on the Future of the European Union: EU supervision of UK Central Counterparties (EMIR 2.2) (update) [Proposed Regulations (SNC)]; Northern Ireland Protocol: application of tariff rate quotas and other import quotas [Proposed Regulation (SNC)]; COVID-19: EU Capital Markets Recovery Package [Proposed (a)(c)(d) Regulations, (b) Directive, (e) Commission Report (SC)]; Northern Ireland Protocol: continued application of EU firearms laws [Commission Communication (SNC)]; EU Industrial Strategy [Commission Communication (SC)]

Health and Social Care Committee: COVID-19: Authorisation procedure for the export of Personal Protective Equipment (PPE)[Commission Implementing Regulation (SC)]

Home Affairs Committee: Northern Ireland Protocol: continued application of EU firearms laws [Commission Communication (SNC)]

International Trade Committee: Northern Ireland Protocol: application of tariff rate quotas and other import quotas [Proposed Regulation (SNC)]; COVID-19: Authorisation procedure for the export of Personal Protective Equipment (PPE)[Commission Implementing Regulation (SC)]

Northern Ireland Affairs Committee: Northern Ireland Protocol: application of tariff rate quotas and other import quotas [Proposed Regulation (SNC)]; COVID-19: Authorisation procedure for the export of Personal Protective Equipment (PPE)[Commission Implementing Regulation (SC)]; Northern Ireland Protocol: continued application of EU firearms laws [Commission Communication (SNC)]

Treasury Committee: EU supervision of UK Central Counterparties (EMIR 2.2) (update) [Proposed Regulations (SNC)]; COVID-19: EU Capital Markets Recovery Package [Proposed (a)(c)(d) Regulations, (b) Directive, (e) Commission Report (SC)]

Formal Minutes

Thursday 24 September 2020

After consulting all Members of the Committee, the Chair was satisfied that the Report represented a decision of the majority of the Committee and reported it to the House.

(Order of the House of 24 March 2020).

Standing Order and membership

The European Scrutiny Committee is appointed under Standing Order No.143 to examine European Union documents and—

a) to report its opinion on the legal and political importance of each such document and, where it considers appropriate, to report also on the reasons for its opinion and on any matters of principle, policy or law which may be affected;

b) to make recommendations for the further consideration of any such document pursuant to Standing Order No. 119 (European Committees); and

c) to consider any issue arising upon any such document or group of documents, or related matters.

The expression "European Union document" covers—

i) any proposal under the Community Treaties for legislation by the Council or the Council acting jointly with the European Parliament;

ii) any document which is published for submission to the European Council, the Council or the European Central Bank;

iii) any proposal for a common strategy, a joint action or a common position under Title V of the Treaty on European Union which is prepared for submission to the Council or to the European Council;

iv) any proposal for a common position, framework decision, decision or a convention under Title VI of the Treaty on European Union which is prepared for submission to the Council;

v) any document (not falling within (ii), (iii) or (iv) above) which is published by one Union institution for or with a view to submission to another Union institution and which does not relate exclusively to consideration of any proposal for legislation;

vi) any other document relating to European Union matters deposited in the House by a Minister of the Crown.

The Committee's powers are set out in Standing Order No. 143.

The scrutiny reserve resolution, passed by the House, provides that Ministers should not give agreement to EU proposals which have not been cleared by the European Scrutiny Committee, or on which, when they have been recommended by the Committee for debate, the House has not yet agreed a resolution. The scrutiny reserve resolution is printed with the House's Standing Orders, which are available at www.parliament.uk.

Current membership

Sir William Cash MP (*Conservative, Stone*) (Chair)

Tahir Ali MP (*Labour, Birmingham, Hall Green*)

Jon Cruddas MP (*Labour, Dagenham and Rainham*)

Allan Dorans MP (*Scottish National Party, Ayr Carrick and Cumnock*)

Richard Drax MP (*Conservative, South Dorset*)

Margaret Ferrier MP (*Scottish National Party, Rutherglen and Hamilton West*)

Mr Marcus Fysh MP (*Conservative, Yeovil*)

Mrs Andrea Jenkyns MP (*Conservative, Morley and Outwood*)

Mr David Jones MP (*Conservative, Clwyd West*)

Stephen Kinnock MP (*Labour, Aberavon*)

Mr David Lammy MP (*Labour, Tottenham*)

Marco Longhi MP (*Conservative, Dudley North*)

Craig Mackinley MP (*Conservative, South Thanet*)

Ann Marie Morris MP (*Conservative, Newton Abbot*)

Charlotte Nichols MP (*Labour, Warrington North*)

Greg Smith MP (*Conservative, Buckingham*)