



House of Commons
European Scrutiny Committee

Twenty-ninth Report of Session 2019–21

Documents considered by the Committee on 19 November 2020

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/>.

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1 Energy and Hydrogen Policy¹

These EU documents are politically important because:

- EU policy in this area is of strategic importance to the UK; and
- there are specific policy implications for Northern Ireland due to obligations under the Ireland/Northern Ireland Protocol.

Action

- Report to the House.
- Draw to the attention of the Business, Energy and Industrial Strategy Committee, Environmental Audit Committee and the Northern Ireland Affairs Committee.

Overview

1.1 The European Commission published its policy documents on energy system integration and on hydrogen as part of the EU's Green Deal policy. Despite the UK's withdrawal from the EU, the policies set out have potential implications for the UK given some of the obligations under the Northern Ireland Protocol and the ambition to maintain EU-UK cooperation in the areas of energy and research. In our [letter](#) of 8 October 2020, we pressed the Minister of State for Business, Energy and Clean Growth (Rt Hon. Kwasi Kwarteng MP) for more analysis of the interaction between the policies set out in the Strategies and the UK's ongoing obligations under the NI Protocol. We also requested the Minister's view on the Commission's plans for work on gas quality, mindful of the inherent cross-border difficulties with blending different levels of hydrogen into natural gas.

1.2 In his [response](#), the Minister confirms the Government's understanding that any EU regulatory changes impacting on wholesale electricity markets would have potential implications for Northern Ireland under the terms of the Northern Ireland Protocol, as regards maintaining the functioning of the Irish Single Energy Market. New or revised Regulations will need to be considered, he says, on a case-by-case basis as they are published.

1.3 On state aid, the Minister also acknowledges that, under the terms of the Protocol, EU State aid rules will apply in respect of aid to companies producing goods and also, if related to the production of goods, service sector companies.

1.4 Concerning gas quality, the Department is currently working with regulators and stakeholders on a review of the Gas Safety Management Regulations 1996 (GS(M)R). This includes the introduction of a new industry standard which specifies the quality of gas that is allowed to be injected into the GB gas transmission and distribution network. This

1 (a) Commission Communication—A hydrogen strategy for a climate-neutral Europe, (b) Commission Communication—Powering a climate-neutral economy: An EU Strategy for Energy System Integration; (a) [COM\(20\) 301](#), (b) [COM\(20\) 299](#); Legal base:—; Department: Business, Energy and Industrial Strategy; Devolved Administrations: Consulted; ESC number: (a) 41389, (b) 41390.

standard would replace Schedule 3 of GS(M)R, which sets the current limits. This change should allow more low carbon gases onto the gas grid, help secure safe UK gas supplies from domestic and imported sources, and make it easier in the future to blend hydrogen into the gas network. The Minister agrees that, as the UK and the EU seek to decarbonise gas, it will be important to avoid any potential risks to future cross-border gas flows.

Action

1.5 We require no further information on these files. We are drawing the Minister's response to the attention of the Business, Energy and Industrial Strategy Committee, the Northern Ireland Affairs Committee and the Environmental Audit Committee.

2 Brexit: The future operation of the Channel Tunnel²

These EU documents are legally and politically important because:

- they concern the operation of the Channel Tunnel Fixed Link at the end of the Transition Period on 31 December 2020, in particular, the application and enforcement of the Tunnel’s joint UK/France safety arrangements; and
- they were adopted on 14 October 2020 and stipulate that any agreement France reaches with the UK on the future operation of the Tunnel must:
 - provide for the application of EU law across the entirety of the Fixed Link (including on the UK side);
 - in the event of a dispute concerning safety on the Tunnel being submitted for arbitration, if the dispute raises a question relating to the interpretation of EU law, the arbitral tribunal should not decide on the matter itself but request a ruling from the Court of Justice of the EU (CJEU), with that ruling being binding on the arbitral panel; and
 - in circumstances of emergency or failure of the joint UK/French authority to comply with a decision of the arbitral tribunal, France will retain the right to act unilaterally to regain control of the French section of the Tunnel.

Action

- Write to the Minister, Rachel Maclean MP, requesting that she appear before the Committee within the next four weeks to discuss the Government’s alternative plans for the operation of the Channel Tunnel after the end of the Transition Period and provide an update on the progress of formal negotiations with France in this regard.
- Draw to the attention of the Transport Committee, the International Trade Committee, and the Committee on the Future Relationship with the E U.

2 Document (a) Proposal for a Decision of the European Parliament and of the Council empowering France to negotiate an agreement supplementing its existing bilateral Treaty with the United Kingdom concerning the construction and operation by private concessionaires of a Channel Fixed Link; Council and COM number: 9974/20 and COM(20) 622; Legal base: Article 91 TFEU, QMV; Dept: Transport; Devolved Administrations: consulted; ESC number: 41434. Document (b) Proposal for a Regulation of the European Parliament and of the Council amending Directive (EU) 2016/798, as regards the application of railway safety and interoperability rules within the Channel Fixed Link; Council and COM number: 9976/20 and COM(20) 623; Legal base: Article 91 TFEU, QMV; Dept: Transport; Devolved Administrations: consulted; ESC number: 41435.

Background and current state-of-play

2.1 In our Twenty-third Report of Session 2019–21,³ we considered two EU legislative proposals on the future operation of the Channel Tunnel Fixed Link.⁴ These were: (1) a [proposal for a Decision](#) that would authorise France to negotiate and ratify an agreement with the UK with the aim of ensuring the safe and efficient operation of the Channel Tunnel at the end of the Transition Period;⁵ and (2) a [proposal for a Regulation](#) that would make changes to EU railway rules to ensure compatibility with any agreement reached between France and the UK.

2.2 A full background to the proposals—including an explanation of the role of EU law on the Fixed Link—can be found in our Twenty-first Report of Session 2019–21.⁶

2.3 The proposals were adopted by the Council on 14 October 2020 and published in the Official Journal of the European Union on 22 October.⁷ Their content remains much the same as when originally proposed by the Commission.⁸ The Decision authorises France to negotiate and conclude an agreement with the UK on the Tunnel’s future governance arrangements whilst the Regulation covers issues relating to its unified safety regime and recognition under EU law. The authorisation for France to negotiate and reach an agreement with the UK on the future operation of the Tunnel has been granted by the EU on the condition that:

- i) the authority responsible for safety on the Channel Tunnel—the Channel Tunnel Intergovernmental Commission—applies all relevant EU law on the Fixed Link (including on the UK side);
- ii) in the event of a dispute concerning safety on the Tunnel being submitted for arbitration, if the dispute raises a question relating to the interpretation of EU law, the arbitral tribunal should not decide on the matter itself but request a ruling from the Court of Justice of the EU (CJEU), with that ruling being binding on the arbitral panel; and
- iii) in circumstances of emergency or failure of the joint UK/French authority to comply with a decision of the arbitral tribunal, France will retain the right to act unilaterally to regain control of the French section of the Tunnel.

3 Twenty-third Report (2019–21) HC 229–xix, [Chapter 4](#) (1 October 2020).

4 The term ‘Fixed Linked’ is used to describe the British and French terminals—at Folkestone and Coquelles respectively—and the tunnel itself (comprising two running tunnels and a service tunnel). Throughout this Report chapter the terms ‘Fixed Link’, ‘Channel Tunnel’ and ‘Tunnel’ are used interchangeably.

5 As established by the UK/EU Withdrawal Agreement.

6 Twenty-first Report (2019–21) HC 229–xvii, [Chapter 5](#) (16 September 2020).

7 [Regulation \(EU\) 2020/1530](#) of the European Parliament and of the Council of 21 October 2020 amending Directive (EU) 2016/798, as regards the application of railway safety and interoperability rules within the Channel Fixed Link; and [Decision \(EU\) 2020/1531](#) of the European Parliament and of the Council of 21 October 2020 empowering France to negotiate, sign and conclude an international agreement supplementing the Treaty between France and the United Kingdom of Great Britain and Northern Ireland concerning the Construction and Operation by Private Concessionaires of a Channel Fixed Link.

8 Only minor changes to the text of the proposals were made between publication and adoption. With regard to the Regulation, those parts relating to the participation of third countries in proceedings before the CJEU have been removed and are expected to be included in a future Regulation amending the Statute of the Court of Justice of the European Union. On the Council Decision, the EU laws to be applied across the entirety of the Fixed Link have been clarified as including all relevant CJEU case law.

2.4 During our consideration of the documents, the Government has been steadfast in its instance that an agreement between the UK and France—in line with the terms of the EU Decision—would not be consistent with its ‘red lines’ or reflect the status of the UK as a non-EU Member State. The Government has rejected future dynamic alignment with EU laws on the UK-side of the Fixed Link, oversight of the application and interpretation of EU law in the UK by the CJEU, and any role on UK territory for the European Union Agency for Railways (ERA).

2.5 Ongoing correspondence between the Minister, Rachel Maclean MP, and the Committee has also drawn-out the Government’s position that the effective operation and safety of the Tunnel will not be compromised if, after the end of the Transition Period, an agreement with France—like that envisaged by the EU—is not reached. Although not clearly outlined, the Government’s appears to think the Treaty of Canterbury—the international agreement regulating the operation of the Tunnel—can be relied on after the Transition Period and supplementary arrangements can be reached with France where they are considered necessary.⁹

2.6 With the adoption of the Decision at EU-level, France is now authorised to begin formal negotiations with the UK on the future operation of the Fixed Link. With the end of the Transition Period quickly approaching, it is expected that formal negotiations will have already begun. We are not aware, however, of whether this is the case and therefore do not have any information on the progress of negotiations.

2.7 In our last Report chapter on the proposals,¹⁰ we considered the Government’s alternative plans for the future operation of the Fixed Link and subsequently requested further information on these. The Minister has since responded—dated 15 October 2020—and her correspondence is considered below.¹¹

Government update and implications

2.8 In correspondence dated 1 October 2020, we asked the Government about:

- the safety of the Channel Tunnel should a formal agreement not be reached on its future operation between the UK and France;
- the Government’s alternative proposals—labelled the ‘joint regulation approach’—and whether they are consistent with its own ‘red lines’ on no dynamic alignment with EU law; and
- the implications of a move away from the current safety system—where EU safety laws apply across the entirety of the Fixed Link—to more informal and *ad hoc* arrangements for the concessionary and operators, specifically, for business continuity and liability purposes.

9 Background on the Treaty of Canterbury can be found in our Twenty-first Report of Session 2019–21. In short, the Treaty established the Channel Tunnel ‘Intergovernmental Commission’ (the ‘IGC’) which is formally charged with ensuring the safe operation of the Fixed Link. In practice, the Channel Tunnel Safety Authority (CTSA) is responsible for the day-to-day safe running of the Tunnel. This includes making safety proposals to the IGC, drawing up, monitoring and enforcing safety regulations, and investigating and reporting on any safety incidents.

10 See Twenty-third Report (2019–21).

11 [Letter from Rachel Maclean MP to Sir William Cash MP](#), 15 October 2020.

Safety

2.9 In her response of 15 October 2020, Parliamentary Under Secretary of State for Transport, Rachel Maclean MP, is clear that should a formal agreement between the UK and France not be reached on the future operation of the Fixed Link it will continue to operate safely and effectively. We have previously expressed our scepticism over this, in particular, as it appears difficult to reconcile this position with the fact that the EU has published proposals concerning the future operation of the Fixed Link and the Minister has not outlined the Government’s alternative approach to us.

2.10 In her letter, the Minister states that an agreement with France “... is not essential to ensure the safe and effective operation of the Tunnel from 1 January 2021”. She goes on to outline ‘contingency arrangements’ whereby the French rail safety authority—the *Établissement Public de Sécurité Ferroviaire* (EPSF)—would become the recognised national safety authority (NSA) under EU law for safety in the French half of the Tunnel and the Treaty of Canterbury ‘Intergovernmental Commission’ (IGC) would continue to fulfil its safety function on the UK-side of the Tunnel until arrangements had been made for the UK Office of Rail and Road (ORR) to take over.

2.11 It is important to note that the IGC is comprised of UK and French representatives and this suggestion would, until the ORR took over, appear to give France some say over the governance of the UK-side of the Fixed Link that would not be reciprocated (this is as the Minister explains that the EPSF would have sole responsibility for the French-side of the Tunnel). The Minister’s broader hope is, however, that, in time, a ‘mutually acceptable arrangement’ could be reached allowing the IGC to resume its formal functions as joint safety authority for the entirety of the Fixed Link.

2.12 As we cautioned previously, this would require a change in the EU’s position—substantively different to that set out in the Decision and Regulation under scrutiny—allowing for a French/non-EU Member State (i.e. the UK) NSA that is *not* charged with the oversight and application of EU railway law.

2.13 No mention is made by the Minister of the issue of safety certification and authorisations and whether operators would be required to hold these as issued by both UK and French competent authorities in order to run on the Tunnel. This is not required at present as the IGC is recognised as an NSA for the purposes of EU law.

Rule alignment (binational regulation and joint approach)

2.14 The Minister stresses that the use of ‘binational regulation’ on the Fixed Link—where a common system of regulation establishing rail safety and technical rules is agreed by both UK and French governments—will continue to apply in the event that the EPSF and (eventually) the ORR take responsibility for their respective sides of the Tunnel. The Minister provides a recent example of a binational regulation covering safety certification, safety authorisation and safety management systems, entities in charge of maintenance, specific provisions for the training of train drivers, vehicle authorisations, and accident investigations. The Minister further states that this approach to regulation on the Fixed Link is “tried and test”.

2.15 We would question the long-term viability of binational regulation especially given the Government’s ‘red lines’ surrounding (no) future alignment with EU law. It appears that binational regulation—as it has been agreed and implemented in the past between the UK and France—is premised on substantive rule alignment. After the end of the Transition Period, this would not necessarily be a problem unless, as an example, France wished to give effect to a new EU law rule that the UK did not. Where one side is obliged to comply with a rule (i.e. France by the EU) and the other is not under the same obligation (i.e. the UK after the end of the Transition Period) there is the potential for divergence. This situation has not arisen before on the Fixed Link and therefore its potential implications for the safe and efficient operation of the Tunnel are not known.

2.16 On a linked point, we asked the Minister about the Government’s proposed ‘joint regulation’ approach to the future operation of the Fixed Link. As we explained in our previous Report chapter on the EU’s proposals, central to the Government’s joint regulation approach is the maintenance of similar standards on the UK and French sides of the Fixed Link. For the French side, new standards would be adopted as and when relevant EU law is updated, for example, when new EU technical standards (TSIs) are given effect to by way of EU tertiary legislation. Whereas on the UK-side, updates would be made to the suite of NTSNs—the new UK category of technical standards based on EU TSIs that will come into force at the end of the Transition Period—to ensure consistent technical standards throughout the Fixed Link.¹²

2.17 The link between binational regulation and the Government’s proposed joint regulation approach is unclear. We are unsure of the place of binational regulation within this mode of governance, for example, would a binational regulation be adopted by the IGC and the ‘joint regulatory approach’ result in its implementation by France and the UK in accordance with their own legal and administrative processes? Alternatively, would ‘joint regulation’ be for when a binational regulation cannot be agreed within the auspices of the IGC but action is required (such as when France must give effect to a new EU TSI and the same or similar is required by the UK to ensure that similar standards apply across the entirety of the Fixed Link)?

2.18 The Minister appears to present the joint regulatory approach as a way of managing the regulatory divergence hinted at above. In her letter of 15 October, she suggests that in the future it would be open to the UK to diverge from the content of EU TSIs that France may be required to give effect to on the Fixed Link. The Minister discusses the example of the ‘European Traffic Management System’—an EU system of standards for the management and interoperation of rail signalling—and states that:

France will be bound to apply EU law and the TSIs in the future rather than NTSNs, but we will be able to discuss with them the expected costs or benefits of a revised standard applying to the UK half of the Fixed Link e.g. if the standard for the European Traffic Management System were changed, and the appropriateness of its being reproduced in the relevant NTSN and any implications should it not be.

2.19 Unless provided for in a binational regulation, joint regulation—understood as presented by the Minister—appears less a method of governing together between the

12 NTSN is short for ‘National Technical Specification Notices’.

UK and France and more one of regulating separately. If this is the case, concerns about managing divergence and the extent to which this could affect the application of uniform rules on the Fixed Link—and thus safety—remain unclear.

The concessionary and operators

2.20 In our last chapter we also asked about the potential implications of a move away from the current safety system—where EU safety laws apply across the entirety of the Fixed Link—to more informal and *ad hoc* arrangements for the concessionary and operators, specifically, for business continuity and liability purposes. This was in response to the Government’s acceptance that a formal agreement with France could not be reached on the terms of the EU Decision and that alternative arrangements would have to be sought.

2.21 In this regard, the Minister refers to binational regulation as being well understood and supported by Eurotunnel and key international rail operators and that the Government does not believe that future binational regulation between the UK and France should have any liability implications for the concessionaire and operators.

Action

2.22 As the UK’s only surface transport link to mainland Europe, the safe and efficient operation of the Channel Tunnel at the end of the Transition Period is vitally important.

2.23 The terms on which France has been authorised to negotiate and ratify an agreement with the UK on the future operation of the Tunnel have repeatedly been rejected by the Government and cover the highly politicised areas of future dynamic alignment in the UK with EU laws, and oversight of the application and interpretation of EU law in the UK by the Court of Justice of the European Union.

2.24 At the same time, through our Report chapters and correspondence, we have not been able to discern a clear alternative plan on the part of the Government for how the Channel Tunnel could operate at the end of the Transition Period. The Minister has furnished us with further information in this regard but outstanding questions remain concerning the future governance of the Tunnel, its safety arrangements, and the views and opinions of affected stakeholders.

2.25 In light of the above, we have written to the Minister, Rachel Maclean MP, requesting that she appear before the Committee within the next four weeks to discuss these issues and provide an update on the progress of formal negotiations with France.

2.26 We have drawn this chapter to the attention of the Transport Committee, the International Trade Committee, and the Committee on the Future Relationship with the EU.

Letter from the Chair to the Under-Secretary of State (Rachel Maclean MP), Department for Transport

The Committee have asked me to thank you for your letter of 15 October 2020 on the two above listed documents.

We note that the proposed Decision and Regulation were adopted on 14 October 2020 and that, as such, France is now authorised to begin formal negotiations with the UK on the operation of the Channel Tunnel after the end of the Transition Period.

From our exchanges, we are clear that the terms on which France has been authorised to negotiate and ratify an agreement with the UK on the future operation of the Channel Tunnel are not acceptable to the Government (covering future dynamic alignment in the UK with EU laws, and oversight of the application and interpretation of EU law in the UK by the Court of Justice of the European Union).

This having been said, we remain unclear on the Government's alternative plans for how the Channel Tunnel could operate after the end of the Transition Period. We are concerned, in particular, about the future governance of the Tunnel, its safety arrangements, and the implications of any changes for affected stakeholders.

We therefore request your appearance before the Committee to answer questions on these and other related issues. In light of the start of formal negotiations with France and the end of the Transition Period on 31 December 2020, arrangements should be made for your appearance no later than w/b 14 December. My secretariat will be in contact with your Officials shortly to aid in planning for this.

3 EU/US mini-tariff deal¹³

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

- it concerns an area of trade (the import of lobster products) in which UK tariffs may be higher than the EU's when the post-exit transition period ends on 31 December 2020; and
- it is relevant to the Protocol on Ireland/Northern Ireland.

Action

- No further action. The proposed Regulation raises questions about the interpretation and application of Article 5 of the Protocol on Ireland/Northern Ireland which we are pursuing separately with the Minister for International Trade (Ranil Jayawardena MP).
- Draw to the attention of the International Trade Committee and the Northern Ireland Affairs Committee.

Overview

3.1 On 21 August 2020, the EU and US [announced](#) a mini-tariff deal to boost transatlantic trade and improve bilateral trade relations.¹⁴ The [proposed Regulation](#) would implement the EU's part of the deal, removing tariffs on US exports of four types of lobster products for a five-year period starting on 1 August 2020. For its part, the US has agreed to halve its tariffs on exports to the US of certain prepared meals, crystal glassware, surface preparations, propellant powders, cigarette lighters and lighter parts.¹⁵ Both sets of reductions are to be implemented on a most favoured nation (MFN) basis in compliance with WTO rules. The products covered by the agreement account for around €168 million (\$200 million) in EU and US exports.¹⁶

3.2 The Minister for Trade Policy (Rt Hon. Greg Hands MP) explained that the US and Canada were the main exporters of lobster to the EU.¹⁷ Exports from Canada enter the EU (and the UK until the end of the post-exit transition period) free of customs duties under the EU/Canada Comprehensive Economic and Trade Agreement (CETA). The EU/US mini-tariff deal will have the same (retroactive) effect for US lobster exports from 1 August 2020. The Government is seeking to “roll over” CETA so that duty free access would continue after transition. As there is no equivalent agreement with the US which the UK can also roll over, the [UK's Global Tariff \(“UKGT”\)](#) which sets tariffs of between 6–16% on the lobster products covered by the EU/US deal will apply from 1 January 2021. While the UK's own (higher) tariff rates will therefore apply to US lobster exports from this date, the position will be different in Northern Ireland. This is because EU customs

13 Proposal for a Regulation on the elimination of customs duties on certain products; Council document—; COM(20) 496; Legal base—Article 207(2) TFEU, ordinary legislative procedure, QMV; Department for International Trade; Devolved Administrations—consulted; ESC number 41510.

14 See the Joint Statement of the United States and the European Union on a Tariff Agreement, 21 August 2020.

15 The tariff reductions are set out in the [Annex](#) to the proposed Regulation.

16 €42 million of EU27 imports from the US and €126 million of US imports from the EU (2019 data).

17 See the Minister's [Explanatory Memorandum of 23 September 2020](#).

laws and duties (including the EU’s zero rate tariff under the proposed Regulation) will continue to apply in Northern Ireland under the Protocol on Ireland/Northern Ireland (part of the [EU/UK Withdrawal Agreement](#)) but only, according to the Minister, to lobster products which have entered Northern Ireland from outside the EU and are considered to be “at risk of subsequently being moved” into the EU. Our [Twenty-fourth Report of Session 2019–21](#) provides further details.

3.3 In [our letter of 8 October 2020](#), we asked the Minister to update us on the prospects for reaching a continuity (“roll over”) agreement with Canada by the end of the year and to provide a progress report on the UK/US Free Trade Agreement negotiations. We also asked him to clarify the precise legal base for the continued application of the Regulation (if adopted) in Northern Ireland after transition, in particular, whether it would apply automatically, under Article 5(3) of the Protocol (as a measure implementing or supplementing the Union Customs Code), or would need to be added to one of the Annexes to the Protocol by means of a Joint Committee decision under Article 13(4) of the Protocol.

3.4 The Minister tells us in [his letter of 19 October 2020](#) that “securing a continuity agreement with Canada remains a top priority for the UK” and that constructive discussions with the Canadian Government have been underway since August “with a view to ensuring continuity arrangements are in place for the end of the transition period, to take effect on 1 January 2021”. A fourth round of negotiations for a comprehensive Free Trade Agreement with the US took place in September. The FTA envisaged would provide for the removal of most duties on trade between the UK and the US, going well beyond the mini-tariff deal agreed by the EU and the US. The Minister reminds us that the EU/US deal was agreed on a “Most Favoured Nation” basis, meaning that the tariff reductions will apply to all countries (including the UK after transition) without the need for a similar “mini deal” with either party.

3.5 The Minister clarifies that the Regulation (including any subsequent amendments) will apply in Northern Ireland after transition by virtue of Article 5(3) of the Protocol on Ireland/Northern Ireland in conjunction with Article 13(3). He adds, however, that it will only apply to “specific goods entering Northern Ireland (other than from the Union) that are considered to be ‘at risk’ of subsequently being moved into the EU” and that the decision for determining “at risk” goods (the sub-category of goods entering Northern Ireland which are subject to EU customs duties) has yet to be taken by the EU/UK Withdrawal Agreement Joint Committee.

Action

3.6 The Minister’s response raises questions about the interpretation of Article 5 of the Protocol on Ireland/Northern Ireland and how EU customs laws will apply in Northern Ireland from 1 January 2021 which we have pursued in separate correspondence with the Minister for International Trade (Ranil Jayawardena MP). Our particular concern is to establish whether (and to what extent) the application of EU laws in Northern Ireland under Article 5(3) and (4) of the Protocol (in conjunction with Article 13) is dependent on or subject to Article 5(1) and (2) on “at risk” goods and the extent of any common ground

between the EU and the UK. As we have already written to the Minister for International Trade in relation to other EU customs laws applicable under Article 5(3) or (4) of the Protocol, we are content to let matters rest in this case.

4 EU financial services reform agenda¹⁸

These EU documents are politically important because:

- they set out the European Commission’s agenda for EU financial services reform over the coming years, which could have significant economic and financial stability implications for the UK as a major EU trading partner.

Action

- Draw the European Commission’s reform plans to the attention of the Committee on the Future Relationship with the EU and the Treasury Committee.

Overview

4.1 The EU has significantly expanded and updated its rulebook for financial services in recent years. Its core approach has been to set harmonised rules for all its Member States in relation to specific financial sectors, and in return firms in those sectors based in any EU country can offer their services throughout the entire European Union on the basis of their domestic licence (an arrangement known as “passporting”). The UK will leave this system when it withdraws from the EU’s Single Market at the end of the post-Brexit transition period on 31 December 2020. At that point, it will be able to regulate its financial services sector freely without deference to EU law.¹⁹ Conversely, UK-based financial firms will face a significant reduction in market access into the EU when they lose their ‘passport’.

4.2 The regulatory landscape is not static. We are aware of the Government’s own work on the future of financial services in the UK, as the Chancellor [recently set out to Parliament](#). However, as a Committee, our focus is on developments in EU law and policy and their implications for the UK. The European Commission is currently undertaking a massive work programme in this area, reviewing six major pieces of EU financial services legislation—covering banking, insurance, investment funds and asset management services, payments and money-laundering—concurrently, with a view to tabling draft legislation in the coming months to update the EU’s rules in those areas. In addition, it recently published three policy papers on capital markets, digital finance and retail payments which set out further initiatives for EU financial services reform in more specific areas including securitisation of bank loans, open finance and crypto-assets.

4.3 As we explore further in paragraphs 29 to 40 below, the EU financial services legislation that may flow from these evaluations and policy papers is likely to remain relevant for the UK, in varying degrees, even after it leaves the Single Market.

18 (a) [Communication from the Commission](#): A Capital Markets Union for people and businesses—new action plan; Council and COM number: 11064/20 + ADD 1, COM(20) 590; Legal base: -; Department: HM Treasury; Devolved Administrations: Not consulted; ESC number: 41558.

(b) [Communication from the Commission](#) on a Digital Finance Strategy for the EU; Council and COM number: 11048/20, COM(20) 591; Legal base: -; Department: HM Treasury; Devolved Administrations: Not consulted; ESC number: 41546.

19 Statement by Chancellor Rishi Sunak MP on the [“future of financial services”](#), HC Deb. Vol 683, col. 619 (9 November 2020).

4.4 In particular, the EU is explicitly pursuing a policy of “strategic autonomy”, as part of which it wants to become less reliant on market-critical financial services provided from outside its regulatory jurisdiction (including the UK). Future EU rules could therefore make it more difficult for UK firms to provide services into the Single Market or on behalf of EU counterparties. While this poses no immediate threat to the primacy of the UK as Europe’s foremost financial centre, there may be longer term implications for its competitiveness. Given the economic interdependencies that will continue to exist between the UK and the EU, the way the EU will legislate to address prudential risks in its financial sector could also have financial stability implications for the UK. The EU is also pursuing a ‘green finance’ agenda, which largely correlates with the Government’s own approach, but could lead to divergent and contradictory regulatory outcomes.

4.5 While Ministers have submitted Explanatory Memoranda setting out the Government’s position on the EU’s financial services reform agenda, these are largely summaries and make no attempt to assess the implications of the EU’s approach for the competitiveness or stability of the UK financial sector. In fact, the Economic Secretary to the Treasury (John Glen MP) has [told us](#) that there are only “limited direct policy implications for the UK given [its] status outside of the EU”. We are concerned at that there may be a degree of complacency within Government in this respect. While the EU is unlikely to replace London with global financial hubs of its own, further regulatory tightening may result in the relocation of some financial services activity from the UK to Dublin, Frankfurt or Paris, as required by firms to continue servicing their EU customers when the UK has left the Single Market. Any further reduction in the UK’s market access into the EU could also have a gradual, erosive effect on its competitiveness vis-a-vis other financial centres like New York and Singapore. That dynamic may be reinforced further by the fact that the EU, for political reasons, has not yet granted UK equivalence-based preferential market access in areas where it has done so for other countries (even though the UK has done so for the EU).²⁰

4.6 The Committee therefore intends to continue monitoring changes in EU financial services policy closely, and will engage with the Treasury where necessary to discuss the potential implications of specific European proposals for the UK. In the remainder of this chapter, we have assessed the implications of recent developments in that respect—in particular the substance of the EU’s Capital Markets Union (CMU) Action Plan and the Digital Finance Strategy—in more detail. We have provided an overview of important pending and upcoming EU financial services proposals in the Annex to this Report.

Recent developments in EU financial services reform

4.7 The EU has significantly expanded its rulebook for financial services in recent years, in particular in the aftermath of the 2008 financial and banking crisis. The European Parliament and the EU’s Member States in the Council of Ministers have agreed to progressive harmonisation of the rules governing a variety of financial industries, with recent examples including [crowdfunding platforms](#), new [prudential requirements for investment banks](#) and the [supervision of the market for derivatives trading](#).

20 By contrast, the UK [granted equivalence](#) to financial services providers from the EU in a wide range of sectors in November 2020. The economic context is different of course: 20% of the UK’s services exports to the EU in 2019 [were financial services](#), whereas only 5% of the EU’s services exports to the UK that year were financial services.

4.8 The EU’s legislation in this field is not static: driven by both European and international developments, not least the UK’s withdrawal from the EU and its implications for the EU’s capacity and infrastructure to provide economically-important financial services, the European Commission is currently preparing proposals for significant amendments to at least six major pieces of EU financial legislation, with detailed proposals due to follow either later this year or in 2021:

- The [Capital Requirements Regulation](#), which governs the prudential soundness of the EU banking industry. A key issue here is how the EU will decide its rules should reflect the latest international standards agreed by the Basel Committee on Banking Supervision;
- The [Solvency II Directive](#), which sets prudential and organisational requirements for the insurance and re-insurance industries but which has been criticised by some in those sectors for its costs to firms and the impact on their ability to invest their assets;
- The [Markets in Financial Instruments Directive](#) (MiFID II),²¹ the EU legislation that sets out the rules applicable to the financial markets and investor protection, including access of shares to regulated markets and the provision of investment advice;
- The [Alternative Investment Fund Managers Directive](#) (AIFMD), a post-crisis piece of EU legislation which introduced rules for the activities of private equity and hedge funds that primarily invest on behalf of institutional investors or high-net worth individuals;
- The [Payment Services Directive](#), which contains the EU’s rules for electronic payments in terms of security, data protection, transparency of fees and preventing fraud; and
- The [Anti-Money Laundering Directive](#) (AMLD), used to impose obligations on a range of entities in both financial and non-financial sectors. We published a [report in June 2020](#) on the Commission’s high-level proposals on how this legislation could be reformed.

4.9 The EU is also implementing its first “Green Finance” package, which recently saw the adoption of an innovative [“Sustainable Investment Taxonomy”](#) to grade the environmental impact of economic activities, with a proposal for a European “Green Bond” to follow in 2021. Moreover, because of the extraordinary economic impact of the coronavirus (COVID-19) pandemic, the Commission has already brought forward certain proposed reforms of the EU’s financial services rulebook. A set of draft European legislation published in July, which we discussed [in our Report of 24 September 2020](#), aims to make it easier for distressed businesses to raise funding on the capital markets to weather the economic storm, and presages some of the wider reforms the Commission intends to pursue in its comprehensive reviews of the above pieces of EU legislation.

4.10 However, the EU’s political agenda for financial services reform goes further: in addition to the above, the European Commission published three policy papers in autumn 2020 setting out its specific plans for EU regulatory reform in two specific parts

21 The review also includes the linked Markets in Financial Instruments Regulation (MiFIR).

of the financial services industry of importance to the UK:²² the capital markets, where businesses can access finance to fund investment and growth, and the digital finance “fintech” sector, including the retail payments industry. These documents contain a range of policy proposals, many of which would involve changes to EU legislation. Many of the initiatives set out in these papers are, in effect, specific issues the Commission will seek to address as part of the upcoming major revisions listed above.

4.11 As we explore in more detail in paragraphs 29 to 40 below, changes to EU financial legislation are likely to remain relevant for the UK and its economy despite our withdrawal from the European Union on 31 January 2020. We have therefore considered the Commission’s policy papers on capital markets, digital finance and retail payments in more detail below. For ease of reference, an overview of pending and upcoming EU financial services proposals is provided in the Annex to this chapter.

The EU Capital Markets Union

4.12 In addition to the above ‘flagship’ EU policies undergoing review, one of the European Commission key focal areas is the gradual construction of a “Capital Markets Union” (CMU) within the EU’s Single Market.

4.13 The CMU has been long-standing economic priority for the EU, originally [launched in 2015](#). Its purpose is to make EU-based businesses less reliant on bank lending and increase their ability to tap into funding opportunities offered by capital markets within the EU itself, rather than relying on capital pools in New York, Asia and—since Brexit—London. This reflects a growing political focus within the EU on its Member States’ collective “strategic autonomy”, which in the financial services sphere relates largely to the EU’s desire to enforce its own regulatory standards for flows of capital and—by increasing its ‘domestic’ capacity to provide the services and infrastructure necessary for deep capital markets—be in a position to deny market access to non-EU companies in those sectors which do not observe them. To help achieve this, the CMU aims to dismantle regulatory barriers between businesses and investors based in different EU countries, to create more cross-border investment opportunities—and therefore increase EU businesses’ access to equity—without jeopardising financial stability or investor protection. At the same time, the CMU also foresees increased harmonisation of the supervision of relevant financial services activities, including by non-EU firms.

4.14 In pursuit of this, the EU Member States and the European Parliament have adopted a range of new EU legislation affecting capital markets in recent years, including [new prudential rules for investment banks](#) and [tightened supervision of the derivatives markets](#).¹⁰ However, the practical impact of the EU’s efforts in this area, in terms of unlocking easier access for businesses to capital, has not been conclusively established, with the European Commission [having noted recently](#) that the impact of the first wave of EU CMU legislation agreed since 2015 “is *expected* to show up in data”. It therefore intends to publish regular assessments “of how EU capital markets are evolving”, based on a set of “targeted”—but as yet unspecified—“indicators” going forward. The European Court of Auditors also recently [warned](#) that “although some progress had been made, [...] the [CMU] measures to diversify financing sources for businesses were too weak to stimulate

22 A third Commission policy paper focused on the [future of EU policy for retail payments](#).

and catalyse a structural shift towards more market funding in the EU”. This is, in part, because some of the barriers to deeper capital markets must be resolved by Member States at the national level, and cannot be addressed centrally by the EU.²³

4.15 On 24 September 2020, the European Commission published its latest “[Action Plan](#)” on a “Capital Markets Union for people and businesses”.²⁴ This document reiterates the original objectives of the initiative to “move steadily in all areas where barriers to the free movement of capital still exist” between EU countries, and underlines the importance of deeper EU capital markets to help businesses stay solvent in the longer term following the economic impact of the COVID-19 crisis and associated lockdowns.²⁵ The Commission also places the CMU in the context of the need for businesses to fund energy efficiency measures under the “European Green Deal”,²⁶ and the need for private equity to provide the necessary financing for digital start-ups.²⁷ The Commission also emphasises the benefits it sees flowing from deeper capital markets in making EU businesses more competitive and attract foreign investors, as well supporting “a stronger international role of the euro and Europe’s open strategic autonomy” by building “critical market infrastructure and services” within the EU itself while “stay[ing] open to global financial markets”.

4.16 In pursuit of these objectives, the latest CMU Action Plan sets out [16 initiatives](#). Many of these, to varying extents, seek to further harmonise the regulation and supervision of capital markets at EU-level so that “businesses, including small- and medium-sized ones, should be able to access funding and investors should be able to invest in projects across the EU”. They also overlap with the major financial services reforms currently under preparation, for example in relation to potential regulatory change that could incentivise banks and insurers to take equity stakes in (small) businesses under the Capital Requirements Regulation and the Solvency Directive respectively.²⁸

23 The Court of Auditors has [noted](#), for example, barriers to cross-border investment within the EU arising from national law and practice relating to “insolvency law and withholding tax or [...] financial education”.

24 In October 2019 the Commission had established a “[High Level Forum](#)” (HLF) of some 30 experts to “prepare targeted recommendations for policies to strengthen and to speed up the works towards the CMU”. The HLF published its final report in June 2020, making [17 recommendations](#) for changes to EU law in areas including investor disclosures, shareholders’ rights, asset securitisation and insolvency law. The report also refers to the need for the EU to “scale up” its financial services sector so that it can “compete globally on an equal footing” with other capital pools, including the UK following its withdrawal from the EU, noting: “Brexit threatens to move some of the key market infrastructures outside the EU, increasing the risk of dependence of the EU’s economy on non-EU capital markets. It will lead to greater fragmentation in the EU, loss of liquidity and increase in costs for end-users. It is also making the EU financial system increasingly polycentric, making it all the more important to increase regulatory and supervisory convergence, foster independence and sovereignty and ensure robust and effective consumer protection across the EU”.

25 The Action Plan notes that while the “public support and bank loans” which have so far helped European businesses “stay afloat by addressing the short-term liquidity squeeze caused by lock-downs”, a more stable funding structure” in the form of equity will be needed to help them “stay solvent in the medium- and longer-term”.

26 The Commission states that the Green Deal will require “an efficient single market for capital [...] to mobilise the necessary funds”—estimated at €350 billion annually—to make the EU’s economy more energy-efficient.

27 The Commission notes in this regard that its recent Digital Finance Strategy sets out initiatives to boost “technological advancement” in the EU’s financial sector to make it more efficient and competitive, while a forthcoming EU [Sustainable Finance Strategy](#) to integrate “climate and environmental risks [...] into the EU’s financial system”. We will consider these policy papers separately in due course.

28 Similarly, the CMU Action Plan sets certain objectives for the revision of the Markets in Financial Instruments Directive: the Commission will aim to amend that legislation to reduce the amounts of information that need to be provided to certain retail investors, and to introduce a “consolidated tape” improving transparency of prices and volumes of securities traded in the EU.

4.17 Also of particular note is the Commission’s continued focus on harmonised supervision for capital markets. Although its [previous attempt](#) in 2017 to make the European Securities & Markets Authority (ESMA) more assertive and expand its supervisory responsibility at the expense of the EU’s national regulators was unsuccessful,²⁹ the Commission in its latest Action Plan says it will consider ways to make “gradual progress towards more integrated capital markets supervision”. It calls this “indispensable”, because “the impact of a national supervisory failure extends far beyond the borders of a single Member State”.³⁰ By the end of 2021, the Commission is therefore expected to make new proposals for “further harmonisation of EU rules” governing capital markets, as well as “measures for stronger supervisory coordination or direct supervision” of financial services at the European level.

4.18 Other policy initiatives set out in the CMU Action Plan include, notably, a new legal framework with substantive rules for investor protection on cross-border investments between EU Member States, to shield investors against government interventions that discriminate between domestic and foreign investments (in effect, an EU equivalent of investor-state protection mechanisms commonly found in international trade agreements).³¹ The document also foresees proposals for new EU legislation on withholding tax relief at source,³² insolvency proceedings,³³ loan securitisation,³⁴ financial advice and inducements in the distribution chain for retail investment products,³⁵ and shareholder rights.³⁶ In

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- 29 At present, ESMA has some direct regulatory responsibility on the EU’s capital markets in relation to credit rating agencies, trade repositories for derivatives trades and securitisation repositories. However, the bulk of supervisory work remains the competence of national regulators. In 2017, the European Commission unsuccessfully proposed to transfer more powers from the national regulators to ESMA. It also wanted to make the latter more assertive, by reducing the need for approval for ESMA’s policy decisions by domestic supervisory bodies on Authority’s Board of Supervisors, which undermines the independence of ESMA’s oversight role.
- 30 The Action Plan refers, in particular, to the recent collapse of German payments company Wirecard following numerous mistakes by its regulators.
- 31 This initiative could also include “improved dispute resolution mechanisms at national and EU level and other measures such as [provision of] information on investors’ legal rights”.
- 32 As already announced in the Commission’s separate [Taxation Action Plan](#). This has been under consideration for some time, with the Commission having commissioned a study into such harmonization of withholding tax relief on cross-border investments within the EU in 2011. The Commission says this would “lower tax-related costs for cross-border investors and prevent tax fraud”.
- 33 It is unclear how this would interact with the EU’s [existing rules on insolvencies](#).
- 34 Securitisation is the practice whereby lenders repackage outstanding loans into securities that are then sold to investors. These financial instruments played a major role in the 2008 financial crisis, and are now subject to specific rules under the EU’s Securitisation Regulation. The Commission wants to explore how securitisation can be ‘scaled up’ safely to give banks additional capacity to lend to businesses.
- 35 The Commission will carry out an assessment of the EU’s existing rules in the area of inducements (such as commission for advisors and product intermediaries) for different kinds of financial products, and the information provided to retail investors. Based on this, it may “propose to amend the existing legal framework in order to ensure that retail investors receive fair and adequate advice as well as clear and comparable product information”. It is also considering an EU-wide legal requirement for financial advisors to “obtain a certificate that proves that their level of knowledge and qualifications”, including the “feasibility of setting up a pan-EU [quality] label for financial advisors”.
- 36 In particular, a review of the Shareholder Rights Directive (Directive (EU) 2017/828). The review will consider, in particular to facilitate investor engagement in the companies in which they hold a stake, which may include an EU-wide legal definition of “shareholder” and the feasibility of harmonising the rules governing the “interaction between investors, intermediaries and issuers as regards the exercise of voting rights and corporate action processing”.

addition, it commits the Commission to the establishment of a European single access point (ESAP) where investors would have “EU-wide access to all relevant information [...] disclosed to the public by companies”, including financial and sustainability data.³⁷

4.19 A fuller overview of the policy initiatives, including those under the CMU Action Plan is set out in the Annex to this chapter.

The EU Digital Finance and Retail Payments Strategy

4.20 The second European Commission policy paper on EU financial services reform we wish to draw to the attention of the House focuses specifically on the digital finance (“fintech”) industry, accompanied by a separate [strategy on retail payments](#) with which it partially overlaps.

4.21 These documents are part of the EU’s [wider digital agenda](#), which aims to support the “digital transformation” of the European economy. The Commission emphasises that the digital financial services can “bring significant benefits to both consumers and businesses”, such as product innovation, improved access to financial services—for businesses and individuals—and spill-over economic effects. However, this document also echoes the CMU Action Plan focus on “strategic autonomy”, arguing that these opportunities should be built around “strong European players”—in other words, not reliant on non-EU financial firms—and subject to a “sound regulation of risks”.

4.22 With this combination of objectives in mind, the Commission’s Digital Finance Strategy sets out “actions [it] intend[s] to take to enable consumers and businesses to enjoy the benefits of digital finance while also mitigating risks”. These are built around a number of priority areas:

- removing market access barriers between EU countries to the digital delivery of financial services, to allow EU companies in this space to scale up;
- tailoring the EU’s regulatory approach so that it facilitates fintech innovation but also addresses risks to financial stability and consumer protection; and
- the creation of a “European financial data space” where data on and held by financial firms can be shared more freely within the EU.

4.23 Among the key initiatives set out in the Strategy to support, and regulate, the fintech sector are a future legislative proposal for an EU “Open Finance” framework. This will build on the existing possibility under the PSD for consumers to share their transaction data, held by their bank, with third party providers to see all the contents of their different bank accounts in a single place.³⁸ The Commission wants to expand on this by allowing

37 Other measures announced in the Action Plan relate to listing rules for small businesses on regulated markets; an evaluation of the [Central Securities Depositories Regulation](#), which governs the post-trade settlement of securities transactions; a review of a specific type of EU-regulated investment vehicle known as the “European Long-term Investment Fund” (ELTIF); initiatives to promote financial literacy; and supporting individual EU countries in developing “pension dashboards” where individuals can access information about their retirement entitlements digitally.

38 This “common financial data space” will also include the aforementioned “Single Access Point” to be established as part of the Capital Markets Union, where statutory disclosures made by companies throughout the EU could be accessed by interested parties, as well as a new strategy on the submission of supervisory data by the financial sector (which will focus on automated reporting in formats that can be easily machine-read, thereby facilitating analysis).

consumer to share their financial data in relation to a wider range of services.³⁹ As a first step, the Commission wants to introduce amendments to the Anti-Money Laundering Directive⁴⁰ (see above) and the e-IDAS Regulation⁴¹ to make it easier for EU financial services providers to “on board” new customers from other EU countries, by facilitating cross-border verification of customer identities. It is also supporting work by the European Central Bank to develop a digital currency as an alternative to cash.

4.24 The Commission is also reviewing the need for further EU legislation specifically to make it easier for fintech firms to provide services from one EU country into another. Building on the recent agreement to create a [European regulatory framework for crowdfunding platforms](#), it has already tabled a [legislative proposal](#) for a common rulebook and “passport” for crypto-assets and distributed ledger technology (which we intend to consider separately in the near future), and it is also considering further EU legislation to regulate the cross-border provision of loans by non-bank entities. Separately, the Commission is exploring certification and cross-border interoperability of “RegTech” (technical solutions that aim to make it easier for fintech firms to demonstrate their compliance with country-specific rules).

4.25 The Commission also repeatedly refers to the potential regulatory risks—in particular consumer protection, fair competition and financial stability—of the digitalisation of financial services, including payment systems.⁴² To mitigate these, it has—for example—already tabled [draft rules](#) on operational resilience for the financial sector’s digital infrastructure, including in particular requirements around the use of cloud computing systems. The bigger risk it identifies relates to the “large technology companies” now providing financial services where this was not traditionally part of their offering. These firms make the sector “more complex” and therefore more difficult to supervise. The Commission considers these entrants create certain risks in terms of both competition, consumer protection and financial stability, which is likely to increase further as digital finance develops in new areas like “loans, insurance and asset management” (having initially been mostly concentrated in payment services).⁴³

4.26 The Commission’s overarching approach here is that the principle of “same activity, same risk, same rules” should apply: in other words, technology companies entering the market for financial services should be subject to the same prudential and conduct standards as their counterparts in the ‘traditional’ financial sector. As a first step, as noted,

39 The UK Financial Conduct Authority has identified, for example, how open finance could be used for automated switching or renewals of financial services, more accurate creditworthiness assessments, and new financial advice services.

40 In the UK, an example of this is the GOV.UK Verify system, used for example by HM Revenue & Customs.

41 Regulation (EU) No 910/2014 on electronic identification and trust services for electronic transactions in the internal market, which is currently being reviewed by the European Commission (the e-IDAS Regulation). At present it focuses on allowing people and businesses to their own national electronic identification schemes (eIDs) to access public services available online in other EU countries.

42 For example, as part of the revision of the Capital Requirements Regulation, the Commission will consider updating the EU’s prudential rules applicable to banks’ holdings of crypto-assets in light of the specific risks to financial stability they pose. Similarly, in recognition of the “significant investments in software” that the financial industry is making to digitalise its operations, the Commission is reviewing EU rules on the prudential treatment of such investments, which it says are “more stringent” than in other jurisdictions.

43 The Commission notes, for example, that well-established technology companies can quickly become larger market players by utilising their existing user base and also often provide infrastructure—like cloud computing infrastructure—for other financial firms, making them an “integral part of the financial ecosystem”. In addition, technology is allowing “previously integrated value chains for a particular financial service to be broken up into separate pieces”, making supervision more complex.

the Commission will review whether the Payment Services Directive provides sufficient oversight of technical services providers in the payments industry. This will be followed in 2022 by draft legislation to adapt the EU’s existing financial services regulatory framework more generally, where necessary to ensure activities by technology firms are adequately captured.⁴⁴ It is also considering the need for specific EU legislation to introduce prudential legislation for “large-scale lending operations by firms outside the banking perimeter”.⁴⁵

4.27 As regards potential competitive issues presented by the entry of technology giants into the market financial services, the Commission “is already reviewing its competition policy to ensure that it is fit for the digital age”, in particular by exploring the need for a “[New Competition Tool](#)” to “address structural competition problems that current competition rules cannot tackle in the most efficient manner”.⁴⁶ In a similar vein, the Commission is working on specific guidance for the use of artificial intelligence (AI) when determining whether to offer specific financial services to individuals, based on an automated assessment of their circumstances. The Commission is separately working on a [more general EU regulatory framework](#) to govern the use of AI across the economy, as set out in its [White Paper of February 2020](#). As a potential new international standard for products and services that incorporate or rely on artificial intelligence, that proposal will undoubtedly be of wider relevance for the UK.

4.28 The Retail Payments Strategy accompanying the Digital Finance Strategy is focussed primarily, although not exclusively, on the evaluation of the 2015 [Payment Services Directive](#) (PSD),⁴⁷ in particular with respect to “open finance” (see below), anti-fraud measures, and the regulation of technical service providers.⁴⁸ It also floats the possibility of EU measures to “enhance the effectiveness of the crisis management of payment systems”.

Implications of EU financial services reform for the UK

4.29 The timetable for the initiatives set out by the European Commission as described above varies on a case-by-case basis, with the Commission expected to make several policy announcements throughout 2021 and 2022 as it finalises its preparations for specific policy measures and draft legislation. The European Parliament and the Member States in the EU’s Council of Ministers must first agree on any legislative proposals before they become European law. As such, any significant reforms will take time and it is unlikely that all of the initiatives announced by the Commission will survive the political process.

44 In particular, the Digital Finance Strategy indicates that the Commission will “review whether provisions on group supervision in EU financial services legislation, such as the Financial Conglomerates Directive (FICOD), have a sufficiently broad and flexible institutional scope to adapt to a constantly changing financial market structure regardless of the corporate structure and the group’s main activities”.

45 The Commission will examine whether it is appropriate to propose legislation aimed at securing a right of access under fair, reasonable and non-discriminatory conditions, to technical infrastructures considered necessary to support the provision of payment services

46 The Commission is currently reviewing the rules applicable to horizontal and vertical (potentially anti-competitive) agreements between companies, as well as the Market Definition Notice.

47 [Directive 2015/2366/EU](#).

48 These are companies that “support the provision of payment services without entering into possession of funds at any time”.

4.30 The UK of course left the European Union on 31 January 2020 and EU legislation on financial services will cease to apply here at the end of the post-Brexit transition period on 31 December 2020.⁴⁹ From that point, the UK will no longer be bound by EU law, and the Government, with Parliament’s agreement, will be able to regulate the sector as it sees fit.

4.31 However, that regulatory flexibility comes at a cost. UK-EU trade in financial services will be based on World Trade Organization (WTO) rules, which offer little by way of market access. In particular, UK providers will from 1 January 2021 lose their legal right—the so-called “passport”—to operate throughout the EU on the basis of their British licence, significantly reducing their export opportunities. By extension, UK providers will also not benefit from new passporting arrangement introduced for additional financial sectors, unless they establish subsidiaries—fully compliant with applicable EU and domestic law—in one of the remaining 27 Member States. To mitigate against this reduction in market access and export opportunities, the UK financial services industry have made significant preparations to be able to continue servicing their EU customer base after the transition period by the transfer of some of their staff and assets from the UK to the EU.⁵⁰

4.32 However, beside initial adjustment to the new legal reality at the end of the transition period, the financial services initiatives currently being worked on by the European Commission will still be of political and economic relevance for the UK even as a non-Member State in the future.

4.33 First, the EU is explicitly pursuing policies to reduce its reliance on UK financial services providers. That may have ramifications for the level of economic activity in the UK, as well as affecting the international competitiveness of its financial sector. The Commission policy papers described in this Report refer directly to the EU’s wider pursuit of “[strategic autonomy](#)” in its external partnerships, especially in its economic relations where the EU has substantial market and regulatory heft.⁵¹

4.34 With respect to financial services, this is leading to efforts to introduce EU legislation in emerging areas like crypto-assets in a bid to maintain the EU’s competitiveness and innovative capacity, a desire to supervise—and sometimes limit—market access for financial services providers more strictly, and a focus on increasing the EU’s own ‘domestic’ capacity to provide key financial services activities and infrastructure.⁵² The UK is in the EU’s cross hairs in particular in this respect because of the size of its financial industry and the large volumes of such services and market infrastructure it currently provides into and for the EU. Ahead of the UK’s exit from the EU’s regulatory jurisdiction on 1 January 2021, many on the EU side have voiced concerns in recent years about continued reliance on London for such essential functions.

49 In particular, British firms will until the end of the transition period benefit from the Single Market “passport”, allowing them to provide financial services throughout the European Economic Area on the basis of their domestic licence.

50 See for example the EU “[Financial Services Brexit Tracker](#)”, which reports that 7,500 financial services jobs were moved from the UK to the EU between June 2016 and October 2020. Over that same period, it estimates that £1.2 trillion in assets have been moved from the UK to the EU ahead of the former’s exit from the Single Market.

51 The CMU Action Plan refers to this as “strategically-open autonomy”, where EU capital markets are in principle open to providers—in this case, of capital and associated financial services—from outside the EU, except where for strategic reasons a more ‘closed’ approach is preferred.

52 Strategic open autonomy is one of the key planks of the current European Commission’s political agenda. For example, in June 2020 the Commission consulted on a “renewed trade policy for a stronger Europe”, which articulates the desire to “strike the right balance between a Europe that is ‘open for business’ and a Europe that protects its people, companies and standards”, by accessing “foreign markets through trade and investment” but “understanding [the EU’s] dependencies and reducing vulnerabilities”.

4.35 The EU’s determination to reduce that dependency is already evident: the EU has passed [specific legislation](#) as part of the Capital Markets Union to supervise the activities of the UK’s “Central Counterparties” for the derivatives market more closely.⁵³ More recently, the European Commission ruled out “equivalence” for the UK in the short- and medium-term in many of the most important financial sectors (a mechanism that would give UK firms preferential access into the EU market for specific financial services above and beyond the baseline provided by World Trade Organization rules that will otherwise apply from 1 January 2021).⁵⁴ This is despite the fact that the UK has granted EU firms equivalence in a wide range of areas.⁵⁵ As part of its CMU Action Plan,⁵⁶ the Commission is also looking at limiting the existing mechanisms by which EU-based companies can effectively delegate or outsource financial services operations to third parties in non-EU countries, including the UK, in particular for lucrative [investment management activities](#).⁵⁷

4.36 Future legislative efforts that flow from that policy paper or the Digital Finance Strategy may lead to a further reduction in UK-EU trade flows in financial services, by affecting on what basis the EU may grant equivalence-based market access, by limiting cross-border access, or by incentivising the development of markets and infrastructures within the EU itself.⁵⁸ In the fintech and green finance sectors in particular, the EU may seek to use its economic heft to try and mould international standards for technologies and products like crypto-assets, artificial intelligence and green bonds on its own legislation.⁵⁹ As the UK is currently considering its own options with respect to regulation of those sectors, it should be mindful of developments in Brussels, especially if the UK and EU opt for divergent regulatory routes that would make it costly for firms and start-ups to operate in both jurisdictions simultaneously.

4.37 The cumulative effect of the EU’s efforts may lead, in due course, of further relocation of operations from the UK to the EU to the extent necessary for firms to continue servicing their European customers. However, the EU cannot by means of regulation replace the UK’s unparalleled financial services ecosystem, and there is no immediate risk of a large-scale relocation of financial services—including those for the benefit of EU companies—away

53 Regulation (EU) 2019/2099 on the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs (also known as “EMIR 2.2”).

54 European Commission document [COM\(2020\) 324](#), “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), footnote 21.

55 The UK Government granted equivalence to financial services providers from the EU in a wide range of sectors by means of regulations in November 2020. The economic context is different of course: 20% of the UK’s services exports to the EU in 2019 were financial services, whereas only 5% of the EU’s services exports to the UK that year were financial services.

56 The Action Plan stresses the need “to prevent regulatory arbitrage, forum shopping, and a race to the supervisory bottom”, a thinly-veiled reference to oft-repeated concerns on the EU side that the UK financial services industry will seek to exploit perceived loopholes in the EU’s regulatory approach to preserve to the extent possible its market share in financial services into the EU via letterbox entities, where the actual services are effectively provided from the UK into the EU.

57 Letter by the European Securities & Markets Authority to the European Commission of 8 August 2020.

58 New EU rules could, for example, amend the requirements for the aforementioned “equivalence” determinations in specific pieces of EU financial services legislation to require stricter adherence to EU standards before a non-EU country like the UK could benefit from any preferential market access arrangements they provide.

59 For example, the European Commission recently proposed draft EU legislation to [regulate crypto-assets](#) like bitcoin at the European level and introduce a [pilot scheme](#) for trading of such assets on regulated EU markets. We intend to consider the implications of those proposals separately in due course.

from the UK to Dublin, Paris or Frankfurt.⁶⁰ The Committee on the Future Relationship with the EU [was recently told](#) that despite the EU's efforts to “diminish London's role”, the UK's position as a global financial centre “at the moment is very strong” and it would take “many years” for any “significant shift” of activity to the EU to occur.⁶¹ This is also underlined by the EU's inability to date “to catalyse substantial progress in achieving the [Capital Markets Union]”, as set out in a [recent European Court of Auditors report](#). However, the EU's desire to limit its openness to the services sector of the UK once it is outside of the Single Market could have a knock-on effect on London's competitiveness vis-à-vis other global financial centres like New York and Singapore, because its unique position as an entry point into the EU's Single Market will disappear.⁶²

4.38 Finally, we wish to emphasise that the implications of EU financial services reform for the UK are not confined to issues of competitiveness and regulatory flexibility. There are also potential ramifications from the EU's actions for financial stability.

4.39 While the Financial Policy Committee of the Bank of England has [provided assurances](#) that the immediate stability risks arising from the UK's exit from the EU's Single Market on 31 December “have been mitigated” thanks to “extensive preparations made by authorities and the private sector”,⁶³ the UK will remain exposed to spill-over effects from financial instability within the EU beyond then. This is of course an especially pertinent concern for the banking sector, where the potential international spill-over effects of a crisis were on display all too clearly in 2008. While the UK outside of the Single Market will be able to address prudential risks in its domestic financial services sectors more flexibly, it has also ceded its role in the drafting of legislation setting such standards for the EU as a whole.⁶⁴

4.40 We note in this respect that the EU is still [struggling to reduce](#) the large volume of “non-performing loans” held by banks in several EU countries, a financial stability risk that is being exacerbated by the COVID crisis. The EU is also preparing a more general revision of its prudential regulation for banks, including its Bank Recovery & Resolution Directive, and the Commission wants to [incentivise securitisation](#) of bank loans—one of the drivers of the previous financial crisis—as a means of expanding banks' lending capacity to help more businesses access the capital they need. Insofar as EU reforms have an impact on the stability of its own financial system, this will also be relevant for the UK given the interdependencies that will continue to exist between the British and the EU economies.

60 The European Commission itself also acknowledges this, saying in its CMU Action Plan that “building the [Capital Markets Union] takes time” and noting that “there are still significant barriers to a well-functioning CMU [...] driven by history, customs and culture. They are deep-rooted, and will take time to tackle”.

61 The witnesses did note, however, that the EU's efforts “in a couple of cases” could serve to undermine the “profitability and long-term sustainability” of certain sectors. See: Committee on the Future Relationship with the EU, Oral evidence taken on 21 October 2020 on [“Progress of the negotiations on the UK's Future Relationship with the EU”](#) (HC 203), Q887 and Q914.

62 Indeed, from 1 January 2021, other “third countries” look set to have [more preferential access](#) into the EU under equivalence than the UK if the Commission does not grant the UK such access.

63 Financial Policy Committee, [“Financial Stability Report”](#) (August 2020).

64 Even though the UK will continue to contribute to international standards, the EU has previously already demonstrated its willingness to diverge from those standards, for example with respect to [prudential rules for banks](#).

The Government's position

4.41 The Economic Secretary to the Treasury (John Glen MP) submitted an Explanatory Memoranda on the Commission's [CMU Action Plan](#) on 21 October 2020 and on the [Digital Finance Strategy](#) on 28 October.

4.42 The Minister states the policy initiatives to complete the EU's Capital Markets Union have "limited direct policy implications for the UK given the UK's status outside of the EU", because after 31 December 2020 "the UK Government will have responsibility for previously EU-set capital markets legislation applying in the UK". While acknowledging that the UK's withdrawal from the EU is cited as one of the driving forces behind the CMU initiative—implicitly, therefore, recognising the potential competitive and strategic implications for Britain's financial services industry—the Minister states only that "the proposals put forward in the Action Plan focus entirely on intra-EU capital flows and do not refer directly to impacts on "third country" capital markets". As such, the Minister concludes, "the Government has not sought to engage formally with the Commission on its proposals".

4.43 Similarly, with respect to the Digital Finance Strategy, the Minister told us that it "has no direct legal or policy implications for the UK" because any new EU legislation that may ultimately flow from it "as will not be in effect prior to the end of the transition period" and "the document does not refer to the UK's future relationship with the EU". He also refers to various UK Government initiatives in this area, including the "Payments Landscape Review" and Ron Kalifa's Independent Review of the UK Fintech sector. The Financial Conduct Authority is also undertaking work similar to the European Commission as regards "open finance", and the Government intends to consult "later in 2020" on the UK's broader regulatory approach to crypto-assets.

Conclusions and action

4.44 The EU's legislative efforts to revise its financial services rulebook could still have regulatory, economic and fiscal implications for the UK. They may impact on the UK financial sector's competitiveness, require relocation of activities into the EU for regulatory purposes, and have wider financial stability consequences from which the UK, as a major economic partner of the EU, cannot easily shield itself unilaterally.

4.45 The fact that the European Commission's policy papers do not, in the Minister's words, "refer directly to impacts" on non-EU countries markets is of course no reason to presume that no such impacts will occur, especially in light of the fact that the Commission has been explicit that its efforts to deepen its own capital markets is driven in part by the UK's exit from the EU, and a desire to lessen the dependency of the European economy on services and market infrastructure provided from London. While there will be clearly be no "big bang" of relocation of UK financial services activity to the EU, such transfers have taken place gradually. The Government cannot afford to be complacent about the strength of this industry domestically when a major trading partner is explicitly pursuing a policy designed to reduce imports of our financial services. We also question the wisdom of not engaging with the European Commission on the proposals it intends to put forward given the UK has a clear interest in how the EU chooses to regulate its financial services industry.

4.46 Given the scope of the EU’s work programme for financial services and the uncertainties around how they might affect the UK, Parliament will inevitably need to be selective in prioritising which of the upcoming EU proposals to focus on. Scrutiny efforts should be targeted at those EU proposals with the greatest continued relevance to the UK, in particular where they engage its strategic or competitive interests; affect the baseline for UK equivalence with EU rules or otherwise impact on its market access; or entail potential financial stability concerns, for example if the EU seeks to diverge from internationally-agreed prudential standards for banks. With respect to the specific proposals announced in the CMU Action Plan and the Digital Finance Strategy, the precise implications for the UK are difficult to discern at this point in time, given the initiatives outlined are still being developed. Of especial interest to us at this stage are the draft EU Regulation on crypto-assets, as well as the future “Open Finance” legislative framework.

4.47 The Committee will continue to monitor legislative developments at EU-level and continue to report them to the House where sufficiently significant. In particular, the European Commission is also due to publish a policy paper on the EU’s “financial sovereignty” in December 2020, which may flesh out further how it intends to reduce the EU’s reliance on overseas financial services providers. Similarly, it is preparing a new Sustainable Finance Strategy which is likely to overlap with the Government’s ‘green finance’ agenda. We will further consider the implications of those papers in due course, in the context of the UK Government’s own review of how it regulates the UK financial services industry to guarantee the “future success of the UK financial sector”.⁶⁵

4.48 In the meantime, we draw the CMU Action Plan and Digital Finance Strategy to the attention of the Committee on the Future Relationship with the EU and the Treasury Committee.

Annex: List of pending and upcoming EU financial services initiatives

The table below shows key pending and upcoming European Commission proposals to reform EU financial services legislation. This list is not meant to be comprehensive, but to capture the EU policy initiatives in this area likely to be of the greatest interest, or relevance, to the UK in a post-Brexit context.

In most cases, any legislative initiatives will require an initial proposal by the European Commission and the joint approval of the European Parliament and the EU Member States in the Council of Ministers. Where such approval is forthcoming, there will be a further implementation or transposition period. As such, the practical effects of the initiatives listed will in most cases take many years.

Sector	Policy initiative	Timetable
Pending EU financial services proposals		
Banking	European Deposit Insurance Scheme (EDIS)	Proposal tabled in 2015, negotiations on-going
	Non-performing loans: debt management and collateral enforcement	Proposal tabled in March 2018, negotiations on-going

65 Written Ministerial Statement HCWS309, “Financial Services update” (23 June 2020).

Sector	Policy initiative	Timetable
Fintech	Digital operational resilience of financial services providers	Proposal tabled in September 2020, negotiations on-going
	Pilot regime for market infrastructures based on distributed ledger technology	Proposal tabled in September 2020, negotiations on-going
	Regulation of crypto-assets and distributed ledger technology	Proposal tabled in September 2020, negotiations on-going
Securities & markets	Amendment to the Benchmark Regulation in relation to the cessation of LIBOR	Proposal tabled in July 2020, negotiations on-going
	COVID-19: Capital Markets Recovery Package	Proposals tabled in July 2020, negotiations on-going
	Recovery and resolution for central counterparties	Proposal tabled in 2016. Agreement reached , awaiting formal adoption
Upcoming EU financial services proposals		
Cross-cutting	Review and possible harmonisation of national insolvency regimes in the EU	Proposal expected in Q2 2022
	Review of the European System of Financial Supervision and the powers of the EU financial regulators	Policy announcement expected in Q4 2021
Anti-money laundering	Review of the Anti-Money Laundering Directive	Proposal expected in Q1 2021
Banking	Implementation of the Basel III prudential standards for banks under the Capital Requirements Regulation	Proposal expected in Q4 2020
	Potential EU regulation of non-bank lending	Timetable unclear
	Review of the Bank Recovery & Resolution Directive (BRRD)	Proposal expected in
Fintech	Development of a Central Bank Digital Currency by the European Central Bank	Timetable unclear
	EU Open Finance legal framework	Proposal expected by mid-2022
	EU regulatory framework for Artificial Intelligence (AI)	Proposal expected in 2021
	EU Strategy on financial supervisory data	Expected in 2021
	Extension of the EU regulatory framework to financial services offered by tech companies	Proposal expected by mid-2022
	Review of passporting and “RegTech” opportunities for fintech firms	Timetable unclear
	Review of the e-IDAS Regulation on digital identities and customer verification	Proposal expected in Q4 2020
Insurance	Review of the Solvency II Directive	Proposal expected in Q3 2021

Sector	Policy initiative	Timetable
Investment	EU-wide professional qualification requirements for financial advisors	Policy announcement expected in Q4 2021 ⁶⁶
	European Green Bond standard	Proposal expected in Q2 2021
	European Single Access Point for company disclosures	Proposal expected in Q3 2021
	Intra-EU investor protection framework	Proposal expected in Q2 2021
	Review of EU rules on inducements and advice in the distribution of financial products	Policy announcement expected in Q1 2022
	Review of the Alternative Investment Fund Managers Directive	Proposal expected in Q3 2021
	Review of the legal framework for European Long-Term Investment Funds	Proposal expected in Q3 2021
	Review of the Shareholder Rights Directive	First report expected in Q4 2021, followed by a proposal in Q3 2023 ⁶⁷
	Withholding tax relief at source for cross-border investments	Proposal expected in Q4 2022
Payments	Potential recovery and resolution mechanism for payment services providers	Timetable unclear
	Review of the Payment Services Directive and E-Money Directive	A policy announcement is expected in 2021
	Review of the Settlement Finality Directive	Timetable unclear
Securities & markets	Review of the Central Securities Depositories Regulation	First report expected in Q4 2020, followed by a proposal in Q4 2021
	Review of the Markets in Financial Instruments Directive	Proposal expected in Q4 2021
	Review of the Securitisation Regulation	The outcome of the review is expected in Q4 2021

66 This relates to financial advice given in relation to services regulated by the Markets in Financial Instruments Directive, in the context of the review of that legislation. The Commission intends to report on the feasibility of an EU quality label for financial advisors by Q1 2022, and on advice for insurance products as part of the review of the Insurance Distribution Directive in Q1 2023.

67 The report in Q4 2021 is expected to relate to whether “there are national regulatory barriers to the use of new digital technologies that could make communication between issuers and shareholders more efficient and facilitate the identification of shareholders by the issuers or the participation and voting by shareholders in general meetings”.

5 Northern Ireland Protocol: reduction of EU VAT rates on COVID-related medical goods⁶⁸

This EU document is legally and politically important because:

- it amends EU law to allow for lower rates of VAT on COVID-related goods such as testing kits and vaccines. However, there is still significant uncertainty as to how these EU VAT rules on goods could affect Northern Ireland beyond the end of the post-Brexit transition period under the Northern Ireland Protocol.

Action

- Write to the Financial Secretary to the Treasury requesting further information on the implications of the Government’s position for VAT on PPE and medical equipment in Northern Ireland.
- Draw the European Commission’s proposals to the attention of the Northern Ireland Affairs Committee.

Overview

5.1 Value Added Tax (VAT) is extensively regulated at the European level. In particular, the [2006 VAT Directive](#)⁶⁹ sets the minimum rate of VAT individual EU countries have to apply to the sale of specific types of goods and services, within certain bands. The coronavirus pandemic has highlighted the fact that the Directive often requires the standard rate of VAT—which is at least 15%—for many of the goods used to prevent or treat the disease, such as personal protective equipment and medical devices.⁷⁰

5.2 In light of the coronavirus pandemic, the European Commission has made efforts to find ways to allow individual EU countries to reduce or waive VAT on goods relevant to the public health response. This, it argues, would “make it easier financially” for hospitals to acquire the equipment they need in fighting the pandemic.⁷¹ In pursuit of this, the Commission has taken the following steps:

68 [Proposal for a COUNCIL DIRECTIVE amending Council Directive 2006/112/EC as regards temporary measures in relation to value added tax for COVID-19 vaccines and in vitro diagnostic medical devices in response to the COVID-19 pandemic](#); COM number: COM(2020) 688; Legal base: Article 113 TFEU; special legislative procedure; unanimity; Department: HM Treasury; Devolved Administrations; ESC number: 41617.

69 [Directive 2006/112/EC](#), as amended.

70 The VAT Directive sets a standard VAT rate of at least 15% for most purchases, and restricts in which cases Member States can apply a zero-rate of VAT or a reduced rate (between 5% and 15%) to supplies of particular goods and services. Individual EU countries also benefit from certain specific exemptions from these rules, such as the UK’s zero-rate on most types of food.

71 European Commission, [“COVID-19: Waiving VAT and customs duties on vital medical equipment”](#) (accessed 11 November 2020).

- first, in April 2020 it used emergency provisions under EU law, intended for disaster relief, to [waive VAT \(and customs duties\) for imports of PPE and medical equipment](#) into the EU from non-EU countries under certain conditions until 30 April 2021;⁷²
- this VAT waiver, for legal reasons, applied only to imports of relevant goods from outside the EU.⁷³ As a second step, the Commission therefore [issued guidance](#) that it would not take legal action against EU countries which also chose to apply a reduced or zero-rate of VAT to COVID-relevant goods where these are purchased domestically or from another EU Member State, even though this is not technically permitted under the VAT Directive;⁷⁴ and
- thirdly, in October 2020 it tabled a [formal proposal](#) to amend the VAT Directive to provide all EU countries with a formal legal basis to apply a zero-rate of VAT to COVID testing kits and vaccines, irrespective of whether such goods are imported, bought domestically or bought from another EU country, until 31 December 2022.⁷⁵ This proposal is yet to be approved by the EU’s Council of Ministers, where each of the remaining 27 Member States has a veto.⁷⁶

5.3 We have considered the implications of these initiatives for the UK in more detail below.

Implications for the UK

5.4 The UK of course left the European Union on 31 January 2020. Under the terms of the Withdrawal Agreement ratified by the Government and the EU, the UK remains bound by EU VAT rules only for the duration of a post-Brexit transition period, which ends on 31 December 2020. However, the Agreement also contains a specific Protocol on Ireland/Northern Ireland, which requires the UK to continue applying EU VAT law “concerning goods” and customs formalities under the EU’s Customs Code in and to Northern Ireland until at least the end of 2026 as part of a wider arrangement to avoid a “hard border” on the

72 [Commission Decision \(EU\) 2020/491](#), as amended by [Commission Decision \(EU\) 2020/1101](#) and [Commission Decision \(EU\) 2020/1573](#). These legal acts lifted both customs duties and import VAT on imports from non-EU countries of “[goods needed](#)” to combat the effects of the COVID-19 outbreak”, such as respirators, face masks and other medical equipment, provided they are being made available free of charge for practical use in “approved organisations” such as hospitals. This course of action was relatively easy, legally speaking, because EU VAT law already authorised the Commission to exempt imports from VAT where intended “for the benefit of disaster victims”.

73 There is no analogous legal mechanism in the VAT Directive that allows the Commission to unilaterally vary the applicable rates of VAT for domestic or intra-EU acquisitions of PPE and medical equipment, unlike for imports. Instead, this would require a formal amendment to the VAT Directive, which requires unanimity in the Council where the Member States’ national governments are represented and is therefore less straightforward to achieve.

74 The Commission’s justification for allowing such apparent breaches of the VAT Directive is that it tabled in 2018 a proposal for reform of the EU’s rules on VAT rates, still being discussed in Brussels, which “if adopted [...] would allow all Member States to apply a reduced or even zero rate to the supply of such goods”. The Commission’s general approach, as set out in a [2016 paper on enforcement of EU law](#), is that “it will not normally launch infringement procedures when a legislative proposal which would make the conduct in question lawful is pending”.

75 The proposal states: “Pursuant to Article 94(2) of the VAT Directive, the potential reduced rate and the VAT exemption in the form of zero rate applied to the above supplies within the territory of a Member State will also be applicable to the intra-Community supply to or importation into that Member State of COVID19 vaccines and in vitro diagnostic medical devices.”

76 It is unclear why the Commission proposal does not also introduce a general derogation from the EU’s standard VAT rate for other COVID-relevant goods, such as Personal Protective Equipment.

island of Ireland.⁷⁷ EU measures to change its VAT rules, including in the context of the coronavirus pandemic, could therefore still have an impact on Northern Irish businesses, hospitals and consumers.

5.5 The implications of the Commission’s efforts to introduce flexibilities with respect to VAT on COVID-relevant goods for the UK to date can be summarised as follows:

- First, the UK Government availed itself of the legal cover offered by the European Commission’s to introduce the [Value Added Tax \(Zero Rate for Personal Protective Equipment\) \(Coronavirus\) Order 2020](#). This reduced the applicable rate for purchases of such equipment from 20% to zero [between 1 May and 31 October 2020](#), even though this is not technically allowed under the VAT Directive. On 1 November, the Government allowed the [zero-rate order to expire](#) and the standard UK rate of 20% has again applied to purchases made in the UK of PPE from that date, whether from within the UK or from the EU.
- The EU-wide waiver of VAT and customs duties for imports of PPE and medical equipment from outside the EU [will continue to apply to the UK](#) until the end of the transition period on 31 December 2020. However, it is unclear what effects this waiver has had on the cost of procuring coronavirus equipment for UK hospitals.
- The formal amendment to the VAT Directive proposed in October 2020, to create a statutory basis for the optional zero-rating of coronavirus vaccines and testing kits by EU Member States, is not likely to take until near the end of the transition period on 31 December 2020 (if not after it), and therefore will not have any practical application to the UK as a whole.

5.6 However, as noted, EU VAT law “concerning goods” will remain applicable in Northern Ireland beyond the end of the transition period under the Northern Ireland Protocol. We discuss the implications of the Protocol in the specific context of EU rules on VAT for COVID-related goods further below.

Implications for Northern Ireland and the Government’s position

5.7 From 1 January 2021, VAT law as it applies in Great Britain can be set by the UK Government without being restricted by EU VAT law on issues such as minimum rates. However, the situation for Northern Ireland is different.

5.8 In particular, Article 8 of the Protocol on Ireland/Northern Ireland in the Withdrawal Agreement requires the UK to continue applying EU VAT law ‘concerning goods’ to and in Northern Ireland even beyond the end of the post-Brexit transition period. Similarly, Article 5 stipulates that the EU’s “Customs Code”, including its external tariff, will apply to goods entering from Northern Ireland. However, here it provides the option for the UK and EU jointly agreeing when goods shipped into Northern Ireland from Great Britain or the rest of the world are not “at risk” of ending up in the EU, in which case no import duty

77 The regulatory alignment provisions of the Protocol can become inoperative by vote of the members of the Northern Ireland Assembly, which will hold a vote on this matter for the first time by December 2024. If they vote against continued alignment with the EU, the relevant provisions of the Protocol will cease to apply at the end of 2026.

would be applicable where the goods enter Northern Ireland from the rest of the UK.⁷⁸ Nevertheless, even in those cases, the Protocol appears to require customs formalities such as entry summary declarations on trade between Great Britain and Northern Ireland, as well as the collection of import VAT.

5.9 As of November 2020, less than two months before the Protocol takes effect, discussions are on-going in the UK-EU Joint Committee established by the Withdrawal Agreement on the practical implementation of the Protocol, not least in relation to the practical implementation of the new VAT system and determining when goods entering Northern Ireland from Great Britain are considered “at risk” of being diverted into the EU and therefore subject to the EU’s external tariff.

5.10 Against this legal background, the European Commission’s waiver of import VAT and its proposal for an optional zero-rate on domestic and intra-EU supplies of COVID-relevant goods remain of potential relevance to Northern Ireland. The Financial Secretary to the Treasury (Rt Hon. Jesse Norman MP) submitted an [Explanatory Memorandum](#) on the Commission’s initiatives on 10 November 2020.

Waiver of customs duties and import VAT

5.11 First, with respect to the European Commission’s decision to lift import VAT and import duty on COVID-related supplies of PPE and medical equipment until 30 April 2021, the implications for Northern Ireland are unclear.

5.12 The [legal act](#) prolonging this EU-wide waiver into 2021 states that the UK Government supported such an extension “until the end of the transition period” (i.e. 31 December 2020) so that it could be applied UK-wide until then. However, it “did not request for relief from import duties and exemption from VAT on imported goods to Northern Ireland” beyond that date. Although it remains unclear to what extent the Government believes EU rules on import VAT and customs duties will apply to Northern Ireland under the Protocol, this appears to mean that from 1 January 2021, it will be a legal requirement for the UK to collect applicable EU import taxes⁷⁹ on PPE and medical equipment brought into Northern Ireland from Great Britain, and from other non-EU countries. The European Commission has explicitly stated that “the provisions of [EU] legislation regarding relief from import duties and exemption of VAT on importation of goods, in accordance with Article 5(3) and (4) and Article 8 of the Protocol [...] are to apply to and in [...] Northern Ireland from the end of transition period”.⁸⁰

5.13 It is not clear why Government did not request the import VAT and customs duty waiver be extended with respect to Northern Ireland under the Protocol. The Memorandum submitted by the Minister did not clarify the reason for this decision, but when pressed the Treasury has said offered the, rather cryptic, reason that “as Northern Ireland is a part of the UK’s customs territory, it is subject to UK trade policy”. This assertion hints

78 For goods imported into Northern Ireland from the rest of the world (i.e. non-EU countries other than the UK), where they are not deemed “at risk” of ending up in the EU, the UK’s new independent external tariff would apply.

79 As noted, no EU import duty would be due under the Protocol on goods entering Northern Ireland from Great Britain if the goods in question are considered to be not “at risk” of ending up in the EU, as defined by the UK-EU Joint Committee established under the Withdrawal Agreement. The Government is apparently considering seeking powers under domestic law to be able to define “at risk” goods unilaterally if it cannot come to an agreement with the EU in the Joint Committee.

80 [Commission Decision 2020/1573](#) of 28 October 2020.

at the fact that the Government does *not* accept the Commission’s assertion that “the provisions of Union legislation regarding relief from import duties and exemption of VAT on importation of goods [...] are to apply to and in [...] Northern Ireland from the end of transition period”, although Ministers have not stated so explicitly. If our interpretation of the Government’s position is correct, the logic seems to be that the UK did not need to request a further waiver specifically for Northern Ireland under the Protocol, because the Government will be free to waive customs duties and import VAT on the COVID-related goods coming into Northern Ireland by means of domestic legislation. It would be part of the wider, fractious discussion between the Government and the EU about the extent to which the Protocol actually requires alignment of Northern Ireland with EU rules, especially where this would create barriers to trade between Northern Ireland and the rest of the UK.

5.14 Of further potential relevance is the fact that the forthcoming Finance Bill will reportedly contain clauses allowing Ministers to unilaterally dis-apply the provisions of the Protocol that may require the collection of import VAT and customs duty on goods shipped from Great Britain to Northern Ireland.⁸¹ That would cut across EU law on VAT and customs as it might otherwise apply under the Protocol. As such, it is not clear what arrangements for import VAT and customs duties will apply to goods entering Northern Ireland from Great Britain or other non-EU countries from 1 January.

Option to zero-rate testing kits and vaccines

5.15 With respect to the recent Commission proposal to create a temporary statutory basis for zero-rates for domestic and intra-EU supplies of COVID testing kits and vaccines, the Minister has [told us](#) that “this EU measure would be available in Northern Ireland after the transition period” as and when the Directive is approved by the remaining Member States and takes effect.

5.16 However, it would be a matter for the UK Government to decide whether to make use of this option in respect of Northern Ireland. The Minister notes in his Explanatory Memorandum that “there are currently no plans to do so”, which is in line with the Government’s decision not to extend the zero-rate of VAT for purchases of personal protective equipment beyond October 2020.

5.17 The Financial Secretary’s Memorandum also states that despite the continued relevance for Northern Ireland, the Government “has not engaged with the EU on this proposal”. While acknowledging that “Northern Ireland will be bound by EU VAT law in relation to goods” under the Protocol, he adds that “VAT is a UK-wide tax” and does not refer to any consultation or engagement with the devolved authorities in Belfast on the European Commission’s initiatives.

81 In a [policy paper](#) published on 17 September 2020, the Government said that it could be a “material breach of the [EU’s] duties of good faith” if it interpreted the Northern Ireland Protocol as requiring “GB-NI tariffs and related provision such as import VAT [to] be charged in ways that are not related to the real risk of goods entering the EU single market”. On 11 November 2020, the Financial Times [reported](#) the Government wanted to include clauses in the forthcoming Finance Bill that “would give ministers control over a post-Brexit tariff regime for goods passing from the mainland UK to NI”.

Conclusions and action

5.18 Since 2019, this Committee has repeatedly pressed the Government for information of how Article 8 of the Northern Ireland Protocol will operate in practice, and in particular for it to set out which elements of EU VAT law are considered to ‘concern goods’ and therefore remain applicable in Northern Ireland beyond the end of the post-Brexit transition period. We have previously asked the Treasury to clarify, for example, whether Northern Ireland will continue to benefit from the UK’s country-specific exemptions allowing it to zero-rate certain supplies by derogation from the VAT Directive, and whether the EU’s VAT threshold for small businesses will continue to apply there for companies involved in the trade in goods.

5.19 To date, confirmation of even these basic implications has not been forthcoming, even though the Protocol is due to take effect on 1 January 2021. At the root of this appears to be a significant divergence in the legal interpretation of the Protocol between the Government and the EU, especially with respect to the extent of which it requires Northern Ireland to remain aligned with EU rules in ways that would cause barriers to its trade with the rest of the UK (such as, for example, the need for formalities related to import VAT and customs duties on goods moved from Great Britain to Northern Ireland).

5.20 In particular, as we noted above, it also remains unclear to what extent the Government believes EU rules on import VAT and customs duties will apply to Northern Ireland under the Protocol.

5.21 The relevant provisions of the Protocol would suggest that, from 1 January 2021, the Government could have an obligation under international law to collect EU import taxes on PPE and medical equipment brought into Northern Ireland from Great Britain, and from other non-EU countries, as a result of its own decision not to ask for an extension of the relevant waiver under EU law for Northern Ireland. However, the Government has now told us that it did not seek a prolongation of the waiver for Northern Ireland because, “as [...] a part of the UK’s customs territory it is subject to UK trade policy”. This suggests that, in the Government’s view, it will be for the UK to determine unilaterally what import VAT and customs duties will apply to COVID-related goods covered by the Commission’s waiver entering Northern Ireland from Great Britain (or other non-EU countries). If our interpretation is correct, it is difficult to reconcile it with the provisions of the Protocol which state that the EU Customs Code and its VAT law ‘concerning goods’ will apply “to and in” Northern Ireland. We note that the forthcoming Finance Bill will reportedly contain clauses to give Ministers to override the provisions of the Protocol unilaterally under UK domestic law.⁸²

5.22 As regards the proposed possibility for EU countries (and the UK in respect of Northern Ireland) to apply a zero-rate of VAT to domestic and intra-EU supplies of coronavirus vaccines and testing kits, the Minister notes that the Government is not intending to make use of this option. That is a policy choice that is not for us to assess.

5.23 However, the key issue is that, even though the Government may not have plans to reduce VAT on vaccines and testing kits at present, it may well want to do so in the future. As such, within the confines of the Protocol, it is imperative that the UK has maximum

82 In the same vein as its clauses in the Internal Market Bill seek to do in relation to export declarations on trade from Northern Ireland and Great Britain and the “State aid” provisions of the Protocol.

flexibility to vary VAT rules in Northern Ireland to match its freedom to vary them in the rest of the country. A European Commission proposal to give EU countries—and the UK in respect of Northern Ireland—much more wide-ranging autonomy to vary VAT rates has been under discussion since 2018. Until it is adopted, we would expect the Government to support any interim proposals—such as the one described in this Report—that provide additional flexibility to vary VAT rates for specific types of goods or services. It is of course a complicating factor that the Government has not been able to date to confirm specifically how EU rules on minimum VAT rates will apply in Northern Ireland under the Protocol.

5.24 Even so, the UK undoubtedly retains a direct interest in the European Commission’s approach to reform of the EU’s VAT rules, especially those initiatives aimed specifically to support the public health response against the coronavirus. It is worrying therefore that the Government by its own admission has not engaged with the Commission on its latest proposals, and—from the information provided to us—appears not to have liaised in any meaningful way with the Northern Ireland Executive. We recorded a similar concern recently in relation to the Commission’s planned reforms of the EU Customs Union, which similarly engage the UK’s interests under the Protocol.

5.25 More generally, while changes to EU VAT law will soon only directly affect Northern Ireland, the resulting divergence resulting from the emergence of two distinct VAT systems in the UK—one in Northern Ireland and one in Great Britain—could also have economic and political implications, for example by increasing barriers to intra-UK trade. VAT is not a devolved competence, meaning that any future legislation to align Northern Ireland with changes in EU rules under the Protocol will be the responsibility of the UK Government, subject to the applicable procedures for parliamentary approval. The Government should therefore engage actively with the Commission to provide input into the EU VAT policy reform where appropriate, and Parliament needs the opportunity to scrutinise those reforms and the Government’s actions.

5.26 In light of the above, the Committee has written to the Financial Secretary to the Treasury to seek further clarification of the Government’s interpretation of the effects of the lapse of the waiver of import VAT and customs duty on imports of PPE and medical equipment into Northern Ireland on 1 January 2021, and in particular whether that would—under the Protocol—require the collection of any applicable import VAT and customs duties on such goods shipped from Great Britain to Northern Ireland. A copy of that letter is included below.

5.27 In anticipation of the Minister’s reply, we have drawn these developments to the attention of the Northern Ireland Affairs Committee and the Treasury Committee.

Letter from the Chair to the Financial Secretary to the Treasury (Rt Hon. Jesse Norman MP)

Thank you for your Explanatory Memorandum of 10 November on the recent efforts by the European Commission to allow EU countries to reduce or zero-rate VAT for certain

goods needed to address the coronavirus pandemic.⁸³ The UK will of course generally cease to be bound by EU VAT law at issue at the end of the post-Brexit transitional period on 31 December 2020. However, as you are aware, EU rules in that field will retain particular relevance for Northern Ireland, because the Protocol on Ireland/Northern Ireland foresees that EU VAT law “concerning goods” will continue to apply there until at least 2026.

In this context, we appreciate your confirmation that the recent Commission proposal for an amendment to the VAT Directive, allowing for an optional zero-rating for COVID testing kits and vaccines, would “be available” to the UK in respect of Northern Ireland but that such a reduction is not currently Government policy.

Given that VAT rules for goods in Northern Ireland will be restricted by EU law from 1 January 2021 under the Protocol while those for Great Britain will not, it is in the UK’s interest that EU legislation on VAT rates as they apply in Northern Ireland are as flexible as possible, to allow the Government to keep rates aligned across the UK to the maximum extent. With this in mind, we would have considered it in the UK’s interest for the Commission proposal for an optional zero-rate to cover a wider range of goods than just testing kits and vaccines, such as personal protective equipment and other medical goods, which *are* exempt from import VAT and customs duties across the EU and the UK under an emergency legal act adopted by the Commission in April this year.

With respect to this latter measure, there is further uncertainty about its implications for Northern Ireland under the Protocol. The Commission has stated that the “provisions of [EU] legislation regarding relief from import duties and exemption of VAT on importation of goods [...] are to apply to and in [...] Northern Ireland from the end of transition period”. It is unclear to what extent the Government agrees with that interpretation. When the import tax waiver was extended into April 2021, the Commission also noted that the Government “did not request for relief from import duties and exemption from VAT on imported goods to Northern Ireland” beyond 31 December.

Your Department has offered the cryptic explanation for this decision that “as Northern Ireland is a part of the UK’s customs territory, it is subject to UK trade policy”. This suggests that, in the Government’s view, it will be for the UK to determine unilaterally what import VAT and customs duties will apply to COVID-related goods covered by the Commission’s waiver entering Northern Ireland from Great Britain (or other non-EU countries). If our interpretation is correct, it is difficult to reconcile it with the provisions of the Protocol which state that the EU Customs Code and its VAT law ‘concerning goods’ will apply “to and in” Northern Ireland, with the application of the EU external tariff only to those goods which the UK-EU Joint Committee has decided to be “at risk” of ending up in the EU’s Customs Union. As you know, no such Decision has yet been agreed.

As such, the implications of the Government’s choice not to seek an extension of the import tax waiver for Northern Ireland from the European Commission are unclear. From the

83 European Commission document COM(2020) 688, “Proposal for a COUNCIL DIRECTIVE amending Council Directive 2006/112/EC as regards temporary measures in relation to value added tax for COVID-19 vaccines and in vitro diagnostic medical devices in response to the COVID-19 pandemic” and Commission Decision (EU) 2020/1573 of 28 October 2020 amending Decision (EU) 2020/491 on relief from import duties and VAT exemption on importation granted for goods needed to combat the effects of the COVID-19 outbreak during 2020.

information available to us, it appears that, from 1 January 2021, the Government could be legally obliged under the Protocol to collect import taxes, i.e. import VAT and EU customs duties, on PPE and medical equipment brought into Northern Ireland from Great Britain, and from other non-EU countries. We are aware of course of the on-going discussions in the UK-EU Joint Committee on the collection of such taxes on intra-UK trade under the Protocol, and that the forthcoming Finance Bill may contain clauses to give Ministers to override the provisions of the Protocol unilaterally under UK domestic law.

We are also concerned at your apparent lack of consultation with the Northern Ireland Executive on these Commission initiatives, and decision not to engage with the European Commission on them. While there may not currently be any plans to reduce the VAT rates on coronavirus vaccines or testing kits, the Government’s ability to introduce such reductions on a UK-wide basis will depend on the available legal options under EU VAT law as it will continue to apply in Northern Ireland under the Protocol. More generally, we would expect the Government, as the Contracting Party to the Withdrawal Agreement, to engage with the Commission proactively whenever draft EU legislation is put forward which would or could apply in Northern Ireland under the Protocol.

In light of the above, we ask you to write to us to clarify:

- If the Government agrees with the European Commission’s assertion that “the provisions of [EU] legislation regarding relief from import duties and exemption of VAT on importation of goods, in accordance with Article 5(3) and (4) and Article 8 of the Protocol on Ireland/Northern Ireland [...] are to apply to and in the United Kingdom in respect of Northern Ireland from the end of transition period”; and
- By extension, to state explicitly whether—in the absence of an extended Commission waiver for such import taxes covering Northern Ireland beyond 31 December—COVID-related goods at present covered by such a waiver would as a matter of international law under the Protocol attract the applicable EU customs duty and import VAT as required by EU law (and in the absence of any UK-EU Joint Committee Decision to the contrary), including where such goods are moved to Northern Ireland from the rest of the UK.

We look forward to receiving your reply before the end of November.

6 Review of EU rules on the use of Passenger Name Record (PNR) data⁸⁴

These EU documents are politically important because:

- they illustrate differences in the European Commission’s approach to internal PNR policy, governed by the EU’s PNR Directive (which applies in the UK until the post-exit transition period ends on 31 December 2020), and its external PNR policy, governed by a series of agreements with third countries; and
- they are relevant to the future relationship negotiations between the EU and the UK which include arrangements for the continued transfer and processing of PNR data for law enforcement purposes.

Action

- No further questions on these documents but write to the Security Minister (Rt Hon. James Brokenshire MP) welcoming his offer to report back to us on the outcome of negotiations with the EU and requesting updates on any negotiations underway or planned for bilateral PNR agreements with other (non-EU) third countries, including “rollover” or continuity agreements with Australia and the United States of America.
- Draw to the attention of the Committee on the Future Relationship with the EU, the Home Affairs Committee and the Justice Committee.

Overview

6.1 This [European Commission report](#) sets out the findings of a review of the [EU Passenger Name Record \(PNR\) Directive](#) which Member States were required to implement in their national laws by 25 May 2018.⁸⁵ The Directive, adopted in 2016, establishes common rules on the collection, processing and retention of PNR data so that they can be used by law enforcement authorities to combat serious crime and terrorism while also ensuring that there are robust safeguards to protect personal data and the right to privacy. The UK chose to participate in the PNR Directive and will remain bound by its provisions until the post-exit transition period ends on 31 December 2020.

6.2 The EU and the UK are keen to establish reciprocal arrangements for exchanging PNR data after transition,⁸⁶ when the Directive will cease to apply to the UK, and both

84 (a) European Commission report on the review of Directive (EU) 2016/681 on the use of PNR data for the prevention, detection, investigation and prosecution of terrorist offences and serious crime; Council number 9954/20 + ADD 1; COM(20) 305; Legal base—; Dept: Home Office; Devolved Administrations: Consulted; ESC number 41425.

(b) Recommendation for a Council Decision authorising the opening of negotiations on an Agreement between the EU and Canada for the transfer of Passenger Name Record (PNR) data to prevent and combat terrorism and other serious transnational crime; Council number 13490/17 + ADD 1; COM(17) 605; Legal base: Articles 16(2), 87(2)(a) and 218(3) and (4) TFEU, QMV; Dept: Home Office; Devolved Administrations: Consulted; ESC number 39151.

85 Directive (EU) 2016/681 on the use of passenger name record (PNR) data for the prevention, detection, investigation and prosecution of terrorist offences and serious crime.

86 See paragraph 84 of the [Political Declaration setting out the framework for the future relationship between the European Union and the United Kingdom](#) agreed in October 2019.

have included provisions on PNR in their draft legal texts on future law enforcement cooperation.⁸⁷ There are, however, material differences in the EU and UK positions. The EU’s draft legal text:

- makes the transfer of PNR data conditional on the UK securing two “data adequacy decisions” (one under the [EU’s General Data Protection Regulation](#) and one under the [EU’s Law Enforcement Data Protection Directive](#)) certifying that its level of personal data protection is essentially equivalent to that required in the EU and also requires the UK to agree to remain bound by (and give effect in domestic law to) the European Convention on Human Rights (ECHR);
- imposes strict conditions on the retention of passengers’ PNR data once they have left the UK and on the onward transfer of PNR data to third countries; and
- is based on existing EU precedents for the sharing of data with third countries while the UK text seeks to go further by including the PNR data of passengers travelling by train and ship as well as by air.

6.3 The Commission report considers whether the scope of the EU PNR Directive (currently limited to passenger data collected by air carriers) should be extended to other forms of international transport (maritime, road and rail) or to non-carrier economic operators (such as travel agencies and tour operators) and whether, in light of the COVID-19 pandemic, the purposes for which PNR data may be used should be expanded to assist in tackling the spread of infectious diseases and to protect public health. It concludes that changes of this scale would require a thorough assessment of their legal, financial and technical impact and their implications for fundamental rights and would be premature, given the need for Member States to focus on the full and effective application of the Directive.

6.4 As we noted in our [Twentieth Report of Session 2019–21](#), any future changes will also need to take account of the outcome of recent references to the EU Court of Justice (CJEU) for preliminary rulings relating to the PNR Directive, as well as a [CJEU Opinion issued in July 2017](#) (‘the 2017 Opinion’) which led to the renegotiation of the draft EU/Canada PNR Agreement because the Court ruled that some of its provisions were incompatible with the EU Charter of Fundamental Rights.⁸⁸ The time limits governing the retention of PNR data were one of the areas of concern highlighted by the Court. It determined that the systematic retention of the PNR data of *all* air passengers for up to five years, as envisaged in the draft Agreement, was not strictly necessary to protect public security.

6.5 This aspect of the Court’s ruling could be relevant to the PNR Directive which also authorises the retention of the PNR data of air passengers for up to five years. The Commission, however, is keen to underline that “the factual and legal circumstances of the PNR Directive are different”, stating that:

[...] the PNR Directive clearly seeks the objective of ensuring security in the Union and its area without internal borders, where the Member States share responsibility for public security. In addition, unlike the draft agreement with Canada, the Directive does not concern data transfers

87 See chapter three of the [amended draft text](#) presented by the Commission on 14 August 2020 and part three of the [UK’s draft agreement on law enforcement and judicial cooperation in criminal matters](#).

88 See Opinion 1/15 of the CJEU issued on 26 July 2017.

to a third country, but the collection of passenger data on flights to and from the EU by the Member States. In this respect, the nature of the PNR Directive as secondary law means that it is applied under the control of the national courts of the Member States and, in the final instance, of the Court of Justice. Furthermore, national laws implementing the [EU Data Protection] Law Enforcement Directive also apply to the processing of data provided for in the PNR Directive, including any subsequent processing by competent authorities.

6.6 As the Commission report concerns an EU Directive which will cease to apply to the UK at the end of 2020, the Government told us that it had no legal, policy or financial implications for the UK.⁸⁹ On a related matter—[a proposed Council Decision](#) (adopted in December 2017) authorising the Commission to renegotiate the draft EU PNR Agreement with Canada in light of the CJEU’s 2017 Opinion—the Government noted that the revised Agreement was unlikely to be finalised and take effect before the end of the post-exit transition period, would therefore not apply to the UK, and so asked us to clear it from scrutiny.

6.7 In [our letter of 10 September 2020](#), we reminded the Minister for Security (Rt Hon. James Brokenshire MP) that the Government had not provided any progress reports on negotiations on the revised EU/Canada PNR Agreement despite our predecessor Committee having requested them in December 2017 because of the possible implications for a future EU/UK PNR Agreement. We asked:

- whether the Government shared the Commission’s view that the factual and legal circumstances of the PNR Directive were different from those considered by the Court in its 2017 Opinion and that (implicitly) a longer data retention period would be permissible for the sharing of PNR data amongst EU Member States than with non-EU third countries;
- how the distinction made by the Commission between the EU’s internal PNR policy, governed by the Directive, and its external PNR policy, governed by a series of agreements with third countries,⁹⁰ had affected the changes made to the revised EU PNR Agreement with Canada, and what this might mean for the sharing of PNR data between the EU and the UK after transition;
- whether the Commission’s decision to focus on the effective implementation and application of the EU PNR Directive rather than push for further changes to its scope made it less likely that the EU would agree to the transfer and processing of PNR data collected by rail and sea transport operators, as envisaged in [Part Three of the UK’s draft agreement on law enforcement and judicial cooperation in criminal matters](#); and
- whether meeting the conditions set out in the [EU’s amended draft text on law enforcement and judicial cooperation in criminal matters](#) on data adequacy and human rights protection would make it easier for the UK to secure a

89 See the [Explanatory Memorandum of 21 August 2020](#) submitted by the Minister for Security (Rt Hon. James Brokenshire MP).

90 The EU has concluded PNR Agreements with Australia and the United States—both may require further review and evaluation in light of the CJEU’s Opinion on the proposed EU PNR Agreement with Canada. The Council has authorised the Commission to open negotiations with Japan. Negotiations with Mexico are “at a standstill”.

more ambitious PNR agreement with the EU, on terms similar to the EU PNR Directive, than had been the case for other third countries, such as Australia, Canada or the US.

6.8 In his [response dated 16 October 2020](#), the Minister tells us that Member States were not involved in negotiations on the revised EU/Canada PNR Agreement and were not given substantive updates by the Commission. The [Joint Declaration](#) issued at the EU/Canada Summit in July 2019 noted that the negotiations had concluded and that the revised Agreement was awaiting legal review and political endorsement by the Canadian authorities. The Minister confirms that the review has not yet concluded. He indicates that the changes in the revised Agreement are in line with the CJEU’s 2017 Opinion and reflected in the draft legal text proposed by the EU in its [Agreement on the New Partnership with the UK](#) in March 2020.⁹¹

6.9 The Minister is unwilling to comment on the scope of any post-transition EU/UK PNR agreement or on the conditionality included in the EU’s proposed text while future relationship negotiations are ongoing. He makes clear, however, that the Government “does not see data adequacy as a pre-requisite to our future law enforcement arrangements with the EU”, adding that “there is no precedent in existing EU-third country arrangements that requires data adequacy to be a pre-requisite”.

6.10 Noting that in previous correspondence we had requested updates on the progress of negotiations with the EU on PNR data sharing arrangements and on PNR negotiations between the UK and other third countries,⁹² the Minister tells us that it would be “inappropriate to comment in detail” on ongoing negotiations with the EU but adds:

The safety and security of our citizens is the Government’s top priority which is why we have said the agreement with the EU on PNR should be based on, and in some respects go beyond, precedents for PNR agreements between the EU and third countries.

6.11 PNR agreements with other third countries are “still at the stage of informal exchanges”. New International Civil Aviation Organisation Standards and Recommended Practices on the processing and protection of PNR data will become applicable from 28 February 2021. These Standards will provide a foundation for bilateral agreements with countries that seek to place requirements on UK airlines to transfer PNR data. The Government expects to begin “formal engagement” with these countries “in early 2021”.

Action

6.12 We have no further questions on these documents but are writing to the Security Minister (Rt Hon. James Brokenshire MP) to welcome his offer to report back to us on the outcome of negotiations with the EU and to request updates on any negotiations underway or planned for bilateral PNR agreements with other (non-EU) third countries, including “rollover” or continuity agreements with Australia and the United States of America.

91 See Part Three, Chapter Three on the transfer and processing of passenger name record data.

92 See [our letter of 16 July 2020](#) to the Minister for Security (Rt Hon. James Brokenshire MP).

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

Thank you for your [letter of 16 October 2020](#) responding to questions raised in our [Twentieth Report of Session 2019–21](#) and our [letter of 10 September 2020](#) concerning arrangements for sharing Passenger Name Record (PNR data) with EU and other international partners for law enforcement purposes.

We are surprised to hear that there was no Member State involvement in negotiations on the revised EU/Canada PNR Agreement and no substantive updates provided by the Commission. The reason given by the Government for opting into the proposed Council Decision authorising the EU to re-open negotiations was to influence the Council’s position and role in the negotiations, given that the outcome could potentially set a precedent for a future PNR agreement between the EU and the UK.⁹³ The then Immigration Minister (Rt Hon. Brandon Lewis MP) told our predecessors in November 2017 that the UK (and some other Member States) had insisted on the inclusion of wording requiring the Commission to conduct the negotiations with Canada “in consultation with the relevant Council Working Party” (on which Member States are represented) and in line with any subsequent directions given by the Council. If, in practice, there was no Member State involvement in the negotiations (which took place in 2018 and 2019, while the UK was still a member of the EU) or substantive Commission updates, we assume it is because the Council Working Party did not request any.

We note that you “do not see data adequacy as a pre-requisite to our future law enforcement arrangements with the EU” given that “there is no precedent in existing EU third country arrangements that requires data adequacy to be a prerequisite”. As you make clear later in your letter, however, the agreement the UK is seeking with the EU on PNR data transfers would be based on, “and in some respects go beyond, precedents for PNR agreements between the EU and third countries”. The point of our questions, therefore, was to understand whether the conditionality required by the EU is justified by the scope and scale of the third country arrangements requested by the UK which are, indeed, without precedent.

We have no further questions to raise but welcome your offer to report back to us on the outcome of negotiations with the EU. We would also welcome updates on any negotiations underway or planned for bilateral PNR agreements with other (non-EU) third countries, including “rollover” or continuity agreements with Australia and the United States of America.

93 See our Thirteenth Report HC 301–xiii (2017–19), [chapter 2](#), 7 February 2018.

7 Standardising data protection rules in EU law enforcement instruments⁹⁴

This EU document is politically important because:

- it sets out a timetable for amending a number of EU law enforcement measures so that they are fully aligned with the EU Law Enforcement Data Protection Directive, reinforcing the importance of the Directive in establishing a baseline for future data sharing arrangements between the EU and the UK in the law enforcement field after the end of the post-exit transition period.

Action

- No further action required.
- Draw to the attention of the Committee on the Future Relationship with the EU, the Home Affairs Committee and the Justice Committee.

Overview

7.1 The [Data Protection Law Enforcement Directive](#) (“the Law Enforcement Directive”) establishes a set of common rules applicable to law enforcement authorities when they are processing personal data in connection with the investigation and prosecution of criminal offences or threats to public security.⁹⁵ These rules apply to all EU Member States (including the UK until the end of the transition period on 31 December 2020) and to the four non-EU countries participating in the Schengen free movement area (Iceland, Norway, Switzerland and Liechtenstein). They are given effect in UK law by the [Data Protection Act 2018 \(Part Three\)](#).

7.2 The Law Enforcement Directive does not affect the data protection provisions contained in various EU police and criminal justice measures which were in force before 6 May 2016 (the date on which the Directive entered into force). Under Article 60 of the Directive, these “grandfathered” provisions continue to apply, pending a Commission review to determine whether they should be aligned with the data protection rules set out in the Directive. This [Commission Communication](#), published in June 2020, sets out the results of the Commission review. Of the [26 legal acts](#) covered by the review, the Commission identifies 10 which it says should be amended so they are aligned with the Directive.⁹⁶ These ten legal acts, and the timetable for amending them, are described in our [Nineteenth Report of Session 2019–21](#).

7.3 The Commission also indicates in its Communication that wider changes are afoot, with feasibility studies already underway to inform “the possible future codification of EU

94 Commission Communication: Way forward on aligning the former third pillar acquis with data protection rules; Council number—; COM(20) 262; Legal base—; Dept—Home Office; Devolved Administrations—consulted; ESC number 41364.

95 Directive (EU) 2016/680 of 27 April 2016 on the protection of natural persons with regard to the processing of personal data by competent authorities for the purposes of the prevention, investigation, detection or prosecution of criminal offences or the execution of criminal penalties, and on the free movement of such data, and repealing Council Framework Decision 2008/977/JHA.

96 The 26 legal acts are listed in the [Annexes](#) to the Communication.

law enforcement cooperation” and to examine changes to the Prüm framework on cross-border data sharing, for example by including new categories of data and linking Prüm to other EU central databases.

7.4 In her [Explanatory Memorandum of 18 August 2020](#), Baroness Williams (Lords Minister at the Home Office) told us that the changes envisaged in the Commission Communication would not take effect before the end of the post-exit transition period and so were “not of direct relevance to the UK”. While the UK would no longer be bound by the Law Enforcement Directive or the [EU General Data Protection Regulation](#)⁹⁷ (“the GDPR” which applies to the processing of personal data for commercial purposes) after transition, the Minister confirmed that the Government was seeking “positive adequacy decisions from the EU” under both instruments before the end of 2020, as foreseen in the [Political Declaration](#) agreed by the EU and the UK in October 2019. The purpose of these adequacy decisions is to allow the continued free flow of personal data between the EU and the UK based on standards of protection and oversight which are robust and “essentially equivalent” to those applicable in the EU. The Government has submitted extensive explanatory material on the UK’s domestic data protection framework to inform the adequacy assessment being carried out by the Commission.⁹⁸

7.5 While recognising that the nature of any changes that might flow from the Commission Communication and their implications for the UK is uncertain, we suggested that they could nonetheless be significant if they were to raise the bar for cooperation with third countries. We noted that the [draft text published by the EU in March 2020 for an Agreement on the New Partnership with the United Kingdom](#) would make future (post-transition) cooperation with the UK on law enforcement and criminal law matters conditional on the UK being awarded an adequacy decision under the Law Enforcement Directive and continuing to ensure standards of data protection essentially equivalent to those required by EU law.⁹⁹ We asked the Minister for:

- her assessment of the progress being made to secure the necessary adequacy decisions by the end of 2020;
- her insight into feasibility studies being carried out by the Commission on the codification of EU law enforcement cooperation and possible changes to the Prüm framework (in the expectation that there must have been some discussion of both studies before the UK left the EU on 31 January 2020) and her views on whether or how they might affect future EU/UK cooperation in this field; and
- an update on progress being made in negotiations with the EU on future arrangements for criminal justice and law enforcement cooperation after transition.

7.6 In her [response of 26 October 2020](#), the Minister says that formal adequacy discussions began in March 2020 and are ongoing, with the UK providing the Commission with “extensive material on the high data protection standards applicable in the UK”. While

97 Regulation (EU) 2016/679 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation).

98 See <https://www.gov.uk/government/publications/explanatory-framework-for-adequacy-discussions>.

99 See Part Three, Title One, chapter 11, Article LAW.OTHER.44 of the Agreement on suspension and disapplication. An adequacy decision under the GDPR is also necessary for sharing passenger name record (PNR) data and exchanging personal data for the purpose of combating money laundering and terrorism financing.

the timelines for reaching an agreement are “challenging”, she expects to have adequacy decisions by the end of the year “in line with the commitments provided in the Political Declaration”, adding that “no other third country’s standards have ever been closer to the EU’s”.

7.7 The Minister notes that the UK “is no longer a party to internal EU discussions” and has no information on the Commission’s feasibility studies on codification of EU law enforcement cooperation or on possible changes to the Prüm framework, but adds that “the UK and the EU are working towards a stand-alone Law Enforcement Treaty” which would govern future EU/UK cooperation in law enforcement and criminal justice matters. Negotiations with the EU are “entering the final phase”. The Minister continues:

There is a good degree of convergence in what the UK and EU are seeking to negotiate in terms of operational capabilities, and we will keep working to bridge the gaps where differences remain. There is still a mutually beneficial agreement to be had, and we will continue to work hard to achieve it.

Action

7.8 No further action on the Commission Communication. We note, however, that the EU and UK starting points for continued cooperation on law enforcement after transition are different. The Government is seeking a “stand-alone” agreement whereas the EU continues to support a single overarching framework agreement covering trade, economic and security cooperation.

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

Department for Business, Energy and Industrial Strategy

(41086) Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee: Report on the safety and liability implications of Artificial Intelligence, the Internet of Things and robotics.
6263/20
COM(20) 64

(41585) Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Energy prices and costs in Europe.
11965/20

+ ADDs 1–6

COM(20) 951

Department for Environment, Food and Rural Affairs

(41517) Commission Delegated Regulation (EU) .../... of 28.8.2020 amending Delegated Regulation (EU) 2019/2238 as regards high survivability and de-minimis exemptions applicable to certain demersal fisheries in the North Sea.
10373/20
C(20) 5823

(41596) Proposal for a Council Decision on the position to be taken on behalf of the European Union in the fortieth meeting of the Standing Committee of the Convention on the Conservation of European Wildlife and Nature Habitats (Bern Convention).
12020/20
COM(20) 654

(41599) Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee: The state of nature in the European Union Report on the status and trends in 2013—2018 of species and habitat types protected by the Birds and Habitats Directives.
11973/20
COM(20) 635

(41605) Proposal for a Council Regulation fixing for 2021 and 2022 the fishing opportunities for Union fishing vessels for certain deep-sea fish stocks.
12126/20

+ADD 1

COM(20) 666

(41606) Report from the Commission to the European Parliament and the Council: Report on the implementation and functioning of Regulation (EU) 2017/1004 of the European Parliament and of the Council of 17 May 2017 on the establishment of a Union framework for the collection, management and use of data in the fisheries sector and support for scientific advice regarding the common fisheries policy and repealing Council Regulation (EC) No 199/2008 (recast).
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COM(20) 664

(41614) Proposal for a Regulation of the European Parliament and of the Council establishing a catch documentation programme for bluefin tuna (Thunnus thynnus) and repealing Regulation (EU) No 640/2010.

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COM(20) 670

Foreign, Commonwealth and Development Office

(41444) Report from the Commission to the European Parliament, the Council and the Court of Auditors on the management of the Guarantee Fund of the European Fund for Sustainable Development.

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COM(20) 346

(41587) Regulations Council Implementing Regulation (EU) 2020/1463 of 12 October 2020 implementing Regulation (EU) 2018/1542 concerning restrictive measures against the proliferation and use of chemical weapons.

(41588) Council Decision (CFSP) 2020/1466 of 12 October 2020 amending Decision (CFSP) 2018/1544 concerning restrictive measures against the proliferation and use of chemical weapons.

(41600) Council Implementing Regulation (EU) 2020/1505 of 16 October 2020 implementing Regulation (EU) No 36/2012 concerning restrictive measures in view of the situation in Syria.

(41601) Council Implementing Decision (CFSP) 2020/1506 of 16 October 2020 implementing Decision 2013/255/CFSP concerning restrictive measures against Syria.

HM Revenue and Customs

(40930) Recommendation for a Council Decision to authorise the European Commission to open negotiations for a Customs Cooperation and Mutual Administrative Assistance Agreement (CCMAA) with the Republic of Belarus.

13708/19
+ ADD 1

COM(19) 576

HM Treasury

(41331) Communication from the Commission Enhanced Surveillance update—Greece, May 2020.

8508/20

+ ADD 1

COM(20) 529

Home Office

- (40949) Court of Auditors Special Report No. 2019/20: EU information systems supporting border control—a strong tool, but more focus needed on timely and complete data.
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- (41064) Report from the Commission to the European Parliament and the Council on the implementation of Directive 2010/63/EU on the protection of animals used for scientific purposes in the Member States of the European Union.
5858/20
COM(20) 15
- (41165) COVID-19 Guidelines for border management measures to protect health and ensure the availability of goods and essential services.
6842/20
C(20) 1753
- (41551) Report from the Commission to the European Parliament and the Council based on Article 29(1) of Directive (EU) 2017/541 of the European Parliament and of the Council of 15 March 2017 on combating terrorism and replacing Council Framework Decision 2002/475/JHA and amending Council Decision 2005/671/JHA.
11424/20
COM(20) 619
- (41561) Commission Recommendation of 23.9.2020 on an EU mechanism for Preparedness and Management of Crises related to Migration (Migration Preparedness and Crisis Blueprint).
11700/20
C(20) 6469
- (41564) Communication from the Commission: Commission Guidance on the implementation of EU rules on definition and prevention of the facilitation of unauthorised entry, transit and residence.
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C(20) 6470

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: Energy and Hydrogen Policy [Commission Communications (SC)]

Environmental Audit Committee: Energy and Hydrogen Policy [Commission Communications (SC)]

Committee on the Future of the European Union: EU financial services reform agenda [Commission Communications (SC)]; Review of EU rules on the use of Passenger Name Record (PNR) data [(a) Commission Report, (b) Recommended Council Decision (SNC)]; Standardising data protection rules in EU law enforcement instruments [Commission Communication (SC)]

Home Affairs Committee: Review of EU rules on the use of Passenger Name Record (PNR) data [(a) Commission Report, (b) Recommended Council Decision (SNC)]; Standardising data protection rules in EU law enforcement instruments [Commission Communication (SC)]

International Trade Committee: EU/US mini-tariff deal [Proposed Regulation (SC)]; Brexit: The future operation of the Channel Tunnel [Proposed (a) Decision, (b) Regulation (SNC)]

Justice Committee: Review of EU rules on the use of Passenger Name Record (PNR) data [(a) Commission Report, (b) Recommended Council Decision (SNC)]; Standardising data protection rules in EU law enforcement instruments [Commission Communication (SC)]

Northern Ireland Affairs Committee: Energy and Hydrogen Policy [Commission Communications (SC)]; EU/US mini-tariff deal [Proposed Regulation (SC)]; Northern Ireland Protocol: reduction of EU VAT rates on COVID-related medical goods [Proposed Council Directive (SNC)]

Transport Committee: Brexit: The future operation of the Channel Tunnel [Proposed (a) Decision, (b) Regulation (SNC)]

Treasury Committee: EU financial services reform agenda [Commission Communications (SC)]

Formal Minutes

Thursday 19 November 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*)